Inflation Report

April – June 2001

BANCO DE MEXICO

JULY, 2001

THE BOARD OF GOVERNORS

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FOREWARNING

Unless otherwise stated, this document has been prepared using data available as of July 23rd, 2001. The figures are preliminary and subject to change.

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TABLE OF CONTENTS

I. Introduction

The world economy is experiencing a slowdown mainly due to a more pronounced than expected slowdown of the United States' economy.

In the first semester of 2001, Mexico confronted three external shocks: the swift transmission of the weakening of its main trading partner's economy; falling oil prices; and the repercussions of events in Argentina.

Although the adjustment of the Mexican economy to this unfavorable external environment has had negative effects —as shown by slower growth of exports, the contraction of industrial output and the loss of jobs— it has nevertheless been an orderly process. Mexico's entrance into the trough of the economic cycle has not been accompanied by unsustainable imbalances in the external accounts, nor by rising inflation or extreme volatility in domestic financial markets.

It is likely that economic expansion of both the Mexican and the United States' economies in the second semester will be lower than had been originally expected. Consequently, the Mexican economy will continue to register growth rates below those of its potential GDP. This suggests that inflationary pressures will tend to tone down over the remainder of the year. There are, however, two factors that could hinder the favorable performance that has been achieved so far in this area. Firstly, the downward rigidity of nominal wage increases in the context of declining productivity and inflation. Secondly, expectations are still above the inflation targets for 2002 and 2003.

The main uncertainty factors faced by the Mexican economy are related to the strength and speed of the economic recovery in the United States and to the approval of a fiscal reform that would confirm the favorable expectations that markets have regarding an increase in tax revenues.

II. Recent Developments in Inflation

Price developments during the second quarter of the current year were compatible with the objective of attaining an annual inflation rate below 6.5 percent in December 2001. Regarding the behavior of the main price indices, the following is worth mentioning:

(a) The annual inflation of the National Consumer Price Index (*Indice Nacional de Precios al Consumidor*, INPC) and of the core price index continued to decline;

(b) Annual core inflation of both goods and services fell;

(c) The gap between overall inflation and the annual growth rate of the prices of goods and services provided or regulated by the public sector narrowed; and

(d) The annual inflation of the National Producer Price Index (*Indice Nacional de Precios Productor*, INPP) excluding oil and services dropped significantly.

Notwithstanding, the decline of overall inflation was curbed by the modest reduction registered by core inflation.

II.1. Inflation Indicators

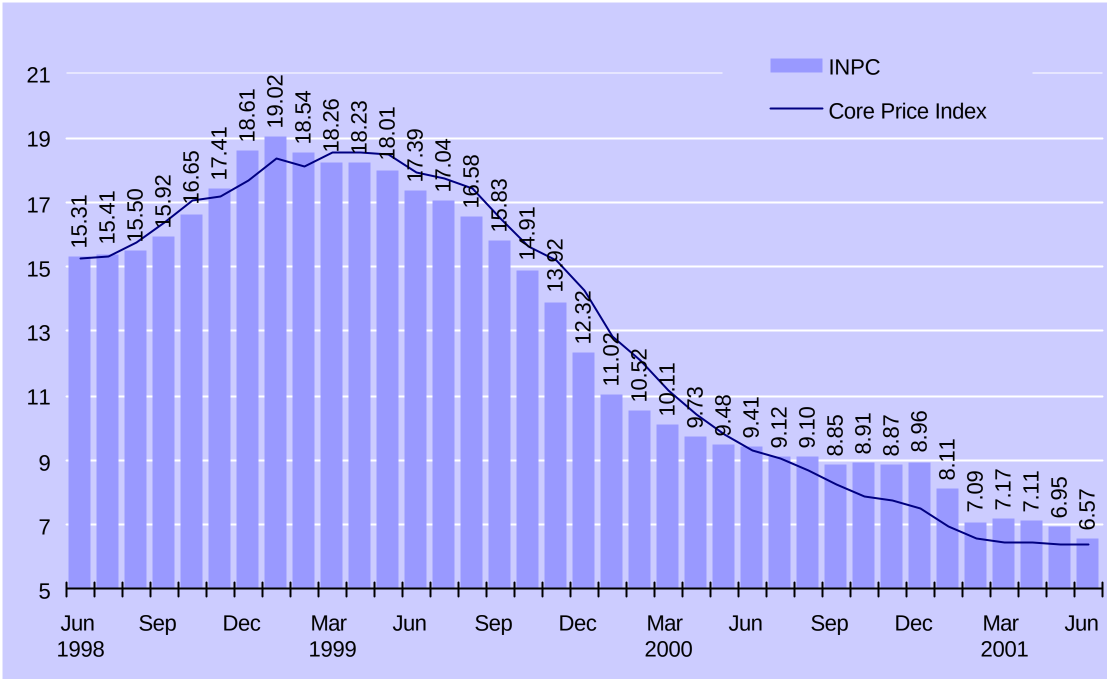
The evolution of the main price indices during April-June 2001 is analyzed in the following section.

II.1.1. Annual Inflation of the National Consumer Price Index and Core Price Index

In June 2001, annual INPC inflation was 6.57 percent, while it had been 7.17 percent in March (Chart 1).

Chart 1 **National Consumer Price Index and Core Price Index**

Annual percentage change



In turn, the annual growth rate of the core price index was 6.36 percent in June 2001, slightly lower than that observed in March. Thus, April–June was the fourth consecutive quarter in which annual core inflation was below overall inflation (Chart 1). Nevertheless, this period was also the second quarter running where the differential between the INPC annual inflation rate and that of core inflation narrowed (Table 1).

Table 1 **Price Indices: INPC, Core Prices, Agricultural and Livestock Products, Education, and Goods and Services Provided or Regulated by the Public Sector**

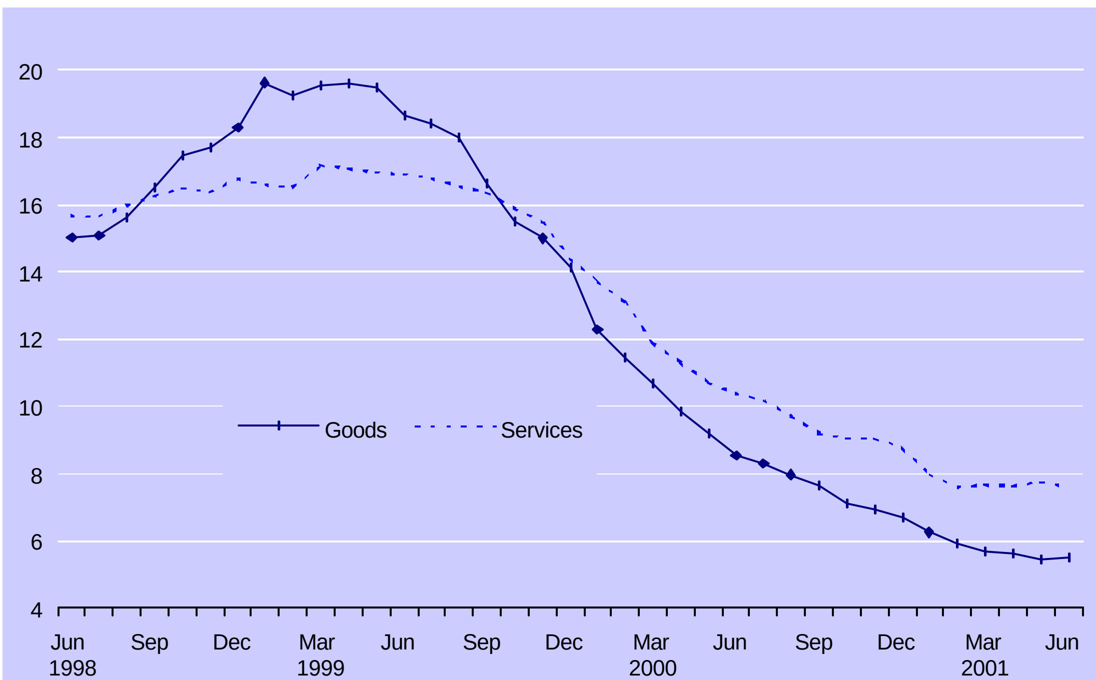
Percent

	Annual Changes			Quarterly Changes		
	Jun 2001/ Jun 2000	Mar 2001/ Mar 2000	Jun 2000/ Jun 1999	Jun 2001/ Mar 2001	Mar 2001/ Dec 2000	Jun 2000/ Mar 2000
INPC	6.57	7.17	9.41	0.97	1.12	1.54
Core Inflation	6.36	6.46	9.29	1.28	2.20	1.38
Goods	5.52	5.66	8.55	1.03	2.01	1.16
Services	7.58	7.66	10.39	1.63	2.46	1.70
Agricultural and Livestock Products	2.35	3.98	3.91	2.96	-6.33	4.60
Education	14.49	14.63	17.66	0.59	1.35	0.71
Goods and Services Provided or Regulated by the Public Sector	8.87	10.62	12.54	-1.27	2.15	0.32

During the quarter, the annual core inflation of goods declined slightly more than that of services (Chart 2). This can be partly explained by the appreciation of the exchange rate, which helped to curb increases in the prices of goods. The slower decline of core inflation for services was fundamentally due to the fact that real wages rose more than productivity. The latter led to a rise in unit labor costs, which in turn had an upward effect on the prices of services due to the fact that they are more sensitive than the prices of goods to this type of costs. As a result, while the annual growth rate of core prices for goods moved from 5.66 percent in March 2001 to 5.52 percent in June, the annual inflation of core prices for services declined from 7.66 to 7.58 percent.

Chart 2 **Core Price Indices: Goods and Services**

Annual percentage change



II.1.2. Monthly Inflation of the National Consumer Price Index and Core Price Index

The monthly growth rates of the INPC during April-June were lower than had been forecasted by private sector analysts at the end of the previous quarter (Table 2). It is worth mentioning that in May and June observed inflation was nearly one third of what had been expected by analysts.

Table 2 **Observed and Expected Inflation**

Percent

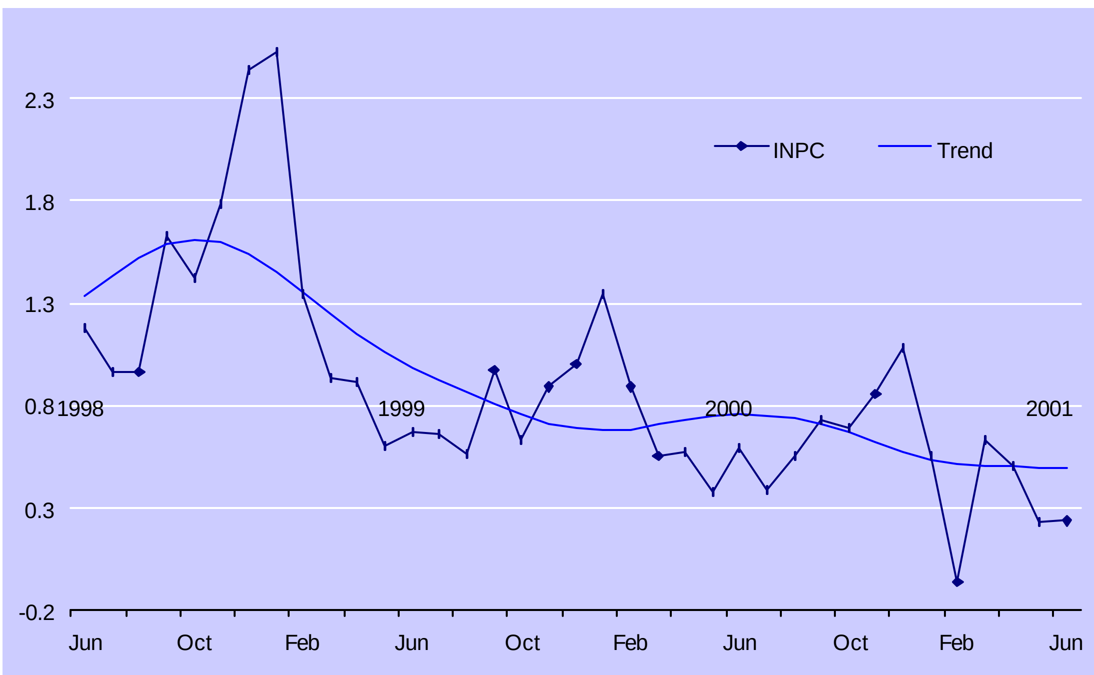
	2001		2000	
	Observed	Expected 1/	Observed	Expected 1/
April	0.50	0.51	0.57	0.66
May	0.23	0.69	0.37	0.57
June	0.24	0.63	0.59	0.56

1/ Inflation expected in March, according to the Survey of the Expectations of Private Sector Economic Specialists carried out by Banco de México.

Although in April, May and June of the current year monthly inflation was below that registered over the same period of 2000, the trend series[1] for monthly inflation remained practically constant (Chart 3).

Chart 3 **National Consumer Price Index**

Monthly percentage change

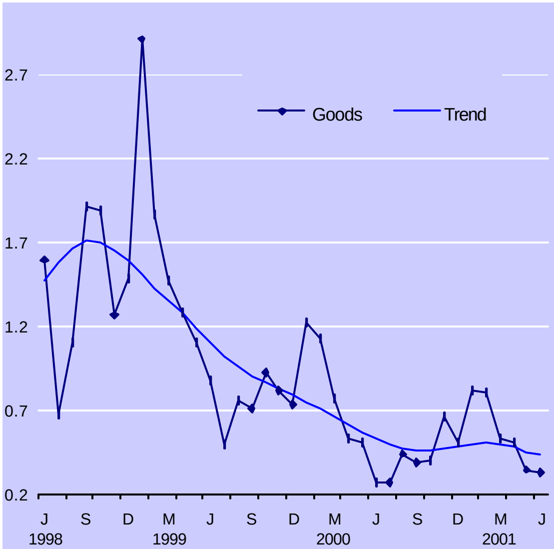


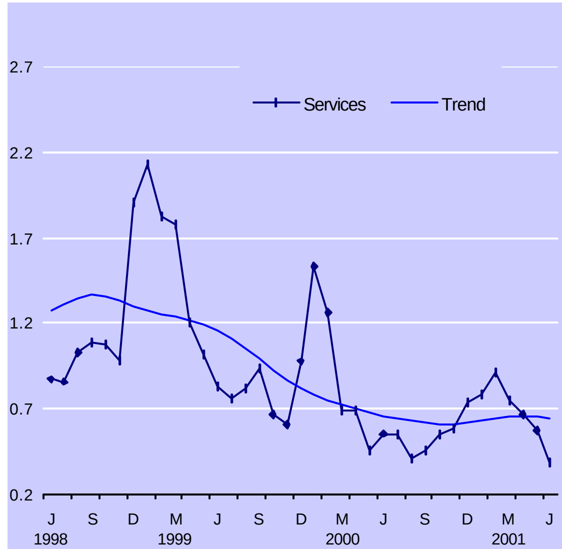
At the close of the quarter under analysis, the trend series for the monthly core inflation of goods declined vis-à-vis the previous quarter. In contrast, the monthly core inflation of services rebounded slightly during the period (Chart 4).

[1] Calculated using the X12 ARIMA statistical procedure. This method softens the original series by means of moving averages.

Chart 4 **Core Price Indices for Goods and Services**

Monthly percentage change





II.1.3. National Producer Price Index

The annual inflation of the INPP excluding oil and services fell significantly in the April-June period of 2001. At the end of the quarter, the annual growth rate of this index was 4.46 percent, while in March it had been 6.94 percent. This is the most considerable decrease reported by this indicator since 1999. Noteworthy among the factors that helped to limit increases in the index are the appreciation of the exchange rate and the seasonal reduction of electricity prices.

During the period covered by this Report, the INPP excluding oil and services fell by 0.23 percent, due to the fact that the prices of exports are included in the measurement of this index. Export prices are normally quoted in dollars (or in the dollar equivalent of other currencies) and the appreciation of the exchange rate in the second quarter of the year caused their prices in pesos to fall 4.92 percent. On the other hand, the INPP's domestic demand component —which includes the prices of consumer and investment goods— rose 0.28 percent only.

Statistical evidence shows that variations in the domestic demand sub-index of the INPP excluding oil and services anticipate changes in the INPC's core sub-index for goods. Therefore, the INPP's recent path points towards a further reduction of inflation over the medium term.

II.1.4. Transitory Factors that Affected Inflation

In the April-June quarter the sub-index for prices of agricultural and livestock products posted an accumulated increase of 2.96 percent, 1.99 percentage points higher than overall inflation during the period. Thus, there was a partial reversal of the significant reduction that these prices had shown in the previous quarter. The products whose prices reported the largest increases in the second quarter of 2001 were: tomatoes (22.05 percent), beans (17.79 percent) and poultry meat (3.62 percent).

II.2. Main Determinants of Inflation

II.2.1. External Environment and the Exchange Rate

During the second quarter of 2001, the evolution of the external variables that have an impact on output and employment in Mexico continued to be unfavorable. Although the price of the Mexican crude oil mix for export was higher than in the previous quarter, it was considerably lower than last year's. In addition, the world economy continued to decelerate as the impact of lower growth in the United States intensified.

Table 3

IMF's Economic Growth Forecasts for 2001

Percent

	Forecasts made in March 2001	Change over forecasts made in October 2000
World GDP	3.2	-1.0
Developed Countries	1.9	-1.3
United States	1.5	-1.7
Japan	0.6	-1.2
Euro Zone	2.4	-1.0
Developing Countries	5.0	-0.7
Asia	5.9	-0.7
Midddle East and Europe	2.9	-1.2
Latin America and the Caribbean	3.7	-0.8

SOURCE: IMF, World Economic Outlook, May 2001

Finally, uncertainty over the situation in Argentina affected investors' country risk perceptions regarding emerging economies. Nevertheless, country risk indicators for Mexico improved as a more optimistic outlook for the national economy began to emerge. This, in turn, contributed to an improvement in the performance of the country's financial variables.

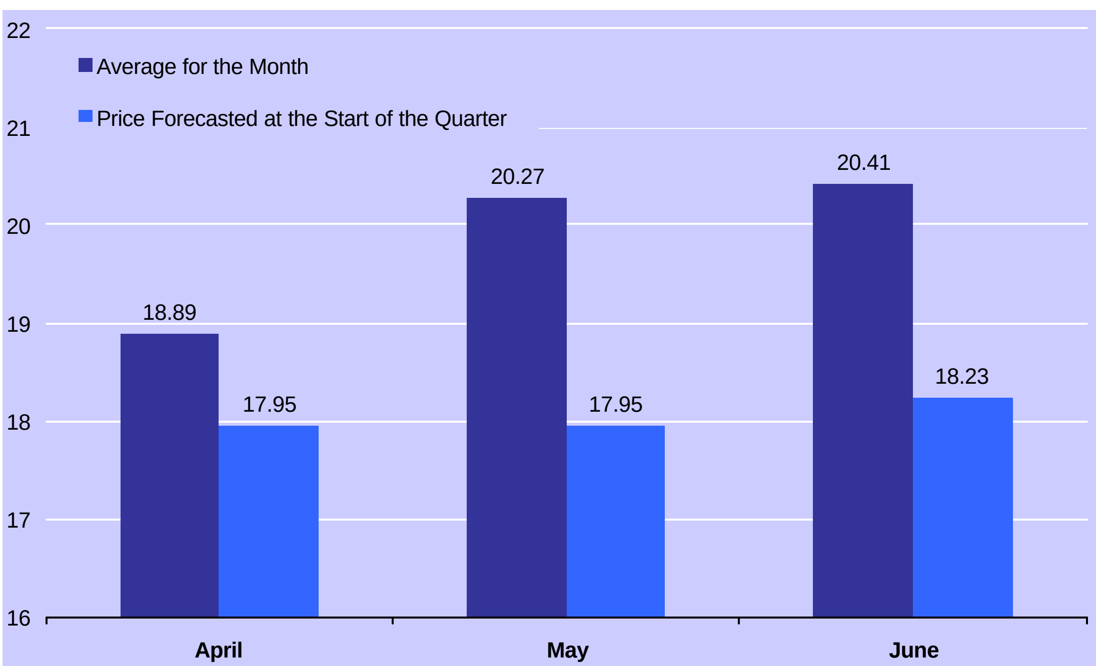
II.2.1.1. Oil Prices

In the second quarter of 2001, the average international oil price[2] was 27.96 dollars per barrel, 85 cents less than that observed in the previous quarter. Although the slowdown of the United States' economy and Iraq's return to the market exerted downward pressure on oil prices during the quarter, this was offset by various other factors. Among the latter, the following are noteworthy: the seasonal increase in the demand for crude oil and its derivatives —particularly gasoline— associated with the proximity of the summer vacation period; the intensification of hostilities in the Middle East; and the decision of the OPEC countries to ratify the previously agreed production quotas.

In the second quarter of 2001 the average price of the Mexican crude oil mix for export was 19.86 dollars per barrel. It is worth mentioning that in every month during the period this price was higher than forecasts implicit in the futures contracts negotiated at the start of the quarter (Chart 5).

Chart 5 **Price of Mexico's Crude Oil Mix for Export in 2001**

Dollars per barrel



SOURCE: Observed price, Pemex. The forecasted price is based on WTI´s futures prices and the difference between the said futures prices and that of Mexico's crude oil mix for export in the period from October 2000 to March 2001.

Although international oil prices fell during the period covered by this Report, the price of the Mexican mix rose. This

[2] The reference international oil price is that of the West Texas Intermediate (WTI).

behavior can be explained by the fact that the Mexican mix is mainly composed of heavy oils, whose international prices have risen in the last few months. On the other hand, the prices of light oils have tended to decline[3] due to technical and market factors. The increase in the price of the Mexican crude oil mix during the quarter was favorable to the country's external accounts and public finances.

II.2.1.2. Developments in the United States' Economy

Economic growth in the United States was 1.2 percent[4] in the first quarter of 2001. This was slightly above the 1 percent figure registered in the fourth quarter of 2000, and as a result there is still uncertainty concerning a rapid recovery of economic activity in that country.

The slowdown of the United States' economy has been characterized by:

(a) the contraction of investment by firms —especially in technology— after having grown at very high rates over the last few years; and

(b) the slight downward adjustment of private consumption. This was a reflection of falls in the most important stock market indices, the interest rate hikes observed in 1999 and 2000, and the high oil prices that prevailed during the period.

The above had a negative impact on manufacturing output and caused a significant reduction of industrial activity.

Indicators of investment and industrial output in the United States continued to deteriorate in the second quarter. However, although consumer spending grew at a lower rate than in previous years, it continued to expand at high enough rates to prevent a fall in GDP. The stock market's recovery in the United States, the persistent strength of the real estate market and the reduction of interest rates were favorable to consumer spending during the quarter covered by this Report. The aforementioned factors explain why consumer confidence levels were sustained in the face of reductions in both wages and employment.

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[3] The factors that had maintained the high prices of light oils included: the adoption of stricter environmental standards in some industrialized countries (which were reflected in the demand for higher quality gasoline) and the combination of low inventories of gasoline and a limited crude oil refining capacity in the world market.

[4] Annualized quarterly growth from seasonally adjusted figures.

Figures published during the second quarter of 2001 confirmed that the slowdown of industrial activity in the United States has continued. A leading indicator of industrial activity[5] in that country has already accumulated ten observations below fifty points, suggesting a contraction of the manufacturing sector. In a similar way, the index for industrial output declined in April and May and thereby completed eight months of downward variations. The weakening of the manufacturing sector was reflected in labor market statistics: the unemployment rate continued to rise while wages decreased. Unemployment benefits claims have already surpassed levels that are characteristic of a recession. All of the above has increased the likelihood of a further deceleration of consumption. Besides, there has been a significant decline in orders for durable goods, which suggests that demand for capital goods has continued to be depressed.

Faced with confirmation of an increasingly severe slowdown in economic activity, on April 18th and ahead of the pre-established schedule for Federal Open Market Committee meetings, the Federal Reserve announced a 50 basis points cut in its federal funds rate. This measure was followed by a further reduction of 50 basis points on May 15th, and another of 25 basis points on June 27th. Thus, the aforementioned rate has so far been lowered by 275 basis points in the year and is at present 3.75 percent. The last time the United States' central bank cut this rate by more than 200 basis points was in 1991, but that was over a ten-month period. The speed at which the monetary policy stance was loosened in the first semester of 2001 is a clear sign of the monetary authority's sense of urgency to confront the deceleration in an environment where inflationary pressures are under control.

Despite the above, during the last week of June there were some indications of an upturn in the industrial sector. Orders for manufactured goods registered their highest increase in eleven months. Furthermore, the NAPM index rose in June while claims for unemployment benefits fell. Finally, the consumer spending indicator for May rose more than it had in the previous two months.

In conclusion, recent indicators of economic activity in the United States do not provide a clear picture of how the economy will perform in the remainder of the year. At the time of publishing this Report, analysts believe that economic growth in the United States in the second quarter of 2001 will be 1.14 percent and 1.6 percent for the year as a whole[6]. Although this forecast

[5] The National Association of Purchasing Managers Index (NAPM).

[6] SOURCE: Consensus Forecast. The forecast for the second quarter corresponds to the annualized quarterly growth from seasonally adjusted figures.

assumes a certain degree of recovery in output during the second half of the year, it is very likely that it will continue to be weak.

II.2.1.3. Developments in the Rest of the World's Economies

In the April-June quarter of 2001, economic activity in the rest of the world continued to be dominated by the influence of the United States' economic slowdown. Regarding the Euro zone, the International Monetary Fund (IMF) reduced its 2001 growth forecast to 2.4 percent. The increase in fuel prices and agricultural goods explains why inflation within the European Monetary Union (EMU) is above the European Central Bank's (ECB) 2 percent target. However, faced with evidence that the global downturn has begun to affect some of the EMU member countries, the ECB decided to cut its reference interest rate by 25 basis points in the second week of May. In the United Kingdom, economic expansion has continued despite the difficulties faced by its agricultural and livestock sector. Nevertheless, in the second quarter the performance of its manufacturing sector was less favorable, which is indicative of the effect of the global economic deceleration.

The contraction registered in Japan during the first quarter has led to a correction in forecasted growth for this country, from 1.8 to 0.6 percent in 2001. In addition to the deterioration of investment indicators, there has been a fall in exports due to the slowdown of demand from the United States and the rest of Asia. Although the yen has depreciated vis-à-vis the dollar over the year, the stimulus has not been strong enough to rescue the Japanese economy from its current recession. In the emerging economies of Asia, the weak technology sector in the United States and low growth in the Japanese economy continue to hamper the performance of their industrial sectors. As a result, expected growth for these countries has been revised downwards.

Regarding Latin America, the increasing uncertainty stemming from the situation in Argentina has been compounded with the slowdown in the United States' economy and the fall in the prices of raw materials. All this has had a negative impact on exports and capital flows into some countries in the region. Consequently, projected growth for the region has been revised downward to 3.7 percent.

During the second quarter, measures were taken in Argentina in order to improve its financial situation. Notwithstanding, the markets continue to show concern over the country's fiscal weakness and its unfavorable growth prospects. The behavior of the net yields on Argentinean bonds was proof of markets' skepticism concerning the measures proposed by the government. Thus, a significant increase in country risk perceptions ensued after a law was proposed in April to link exchange rate parity to a basket of currencies in which the dollar and the Euro were equally represented. However, this effect was partly reversed when the government successfully exchanged short term public debt for longer maturity instruments. The country risk rose again in June upon the implementation of a package of measures, among which the decision to carry out foreign trade transactions at a special exchange rate is noteworthy. Although the likelihood that the Argentinean government will default on its loan payments has decreased, uncertainty remains over its long term economic prospects. This was seen in both the downward adjustment of expected growth for the year, to 0.6 percent, and the high net yields on Argentinean bonds.

The economic outlook also deteriorated for Brazil due to smaller capital inflows, reduced exports, the impact of the Argentinean situation and the energy crisis. The weakening of Brazil's external accounts has continued to put pressure on the real, which depreciated 8 percent during the quarter. This depreciation, together with the rise in energy prices, caused expected inflation for the year to rebound and at present it is very close to the upper limit of the central bank's target band. In response to this, the central bank raised its reference interest rate by 250 basis points in the quarter. Difficulties caused by the electric energy shortage have been added to the aforementioned factors, all of which have led to a revision in economic growth forecasts for Brazil in the year, from 3.8 percent in March to 2.8 percent in June.

II.2.1.4. The Impact of the International Environment on the Domestic Economy

The two most important factors that have influenced the evolution of economic activity and domestic financial markets during the first six months of the year have been:

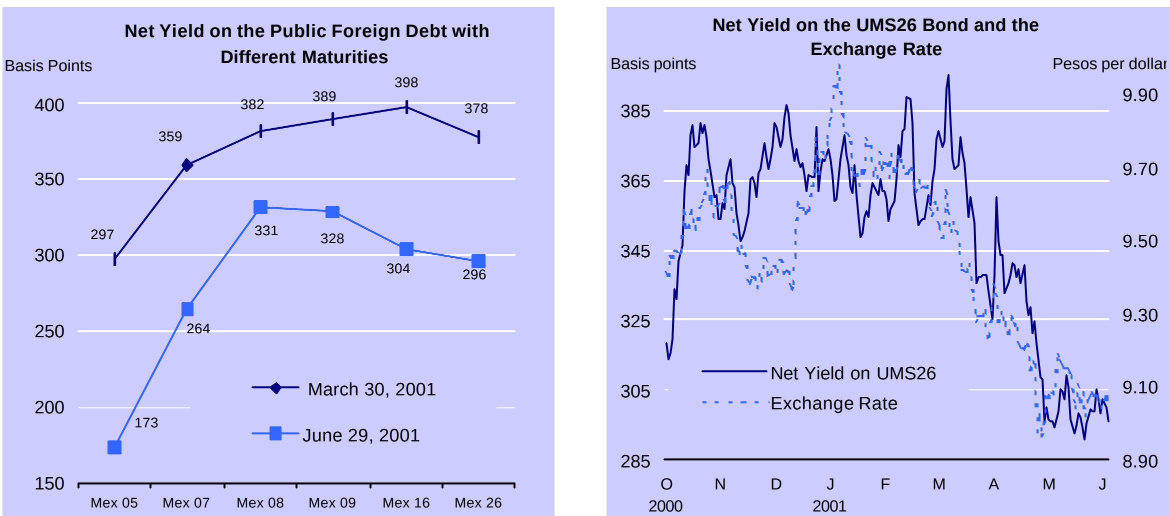
(a) the slowdown of the United States' economy that has had a negative impact on Mexican GDP growth; and

(b) the significant improvement of country risk perception that has stimulated an abundant supply of foreign capital.

The decline in demand from the United States has been accompanied by slower domestic demand growth rates compared to those of output. As a result, the trade deficit has increased less than expected, and hence the country has required smaller amounts of external financing.

On the other hand, capital inflows have been large enough to make net yields on Mexican bonds fall considerably during the second quarter of 2001. Improved country risk perception and a greater supply of external resources caused reductions in domestic interest rates and the appreciation of the exchange rate (Chart 6). In mid-May, these trends intensified with the announcement of Citigroup's purchase of Banacci. In the April-June quarter the average nominal exchange rate was 9.18 pesos per dollar, which implied a 5.23 percent appreciation over the average for the previous quarter. The aforementioned factors contributed to the fall of inflation during the first half of the year.

Chart 6 **Country Risk Indicators and the Exchange Rate**

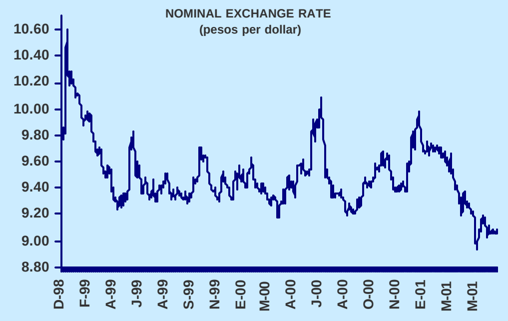


SOURCE: Bloomberg and Banco de México.
Note: The net yield on the UMS26 bond is the spread between its gross yield and that on a U.S. Treasury bill with a similar maturity.

Factors that have Contributed to the Appreciation of the Exchange Rate during 2001

In the first six months of 2001, the average level of the nominal exchange rate was 9.44 pesos per dollar, practically the same as the average figure for the previous year, 9.46 pesos per dollar. In each month of the current year, except January, the exchange rate has been lower than the corresponding private sector forecast. In the first half of 2001 its nominal appreciation was close to 7 percent (Chart 1).

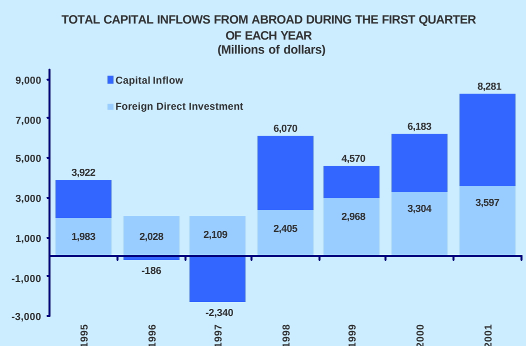
Chart 1



The combination of a greater supply of external resources and a reduction in the demand for them has caused the exchange rate to appreciate.

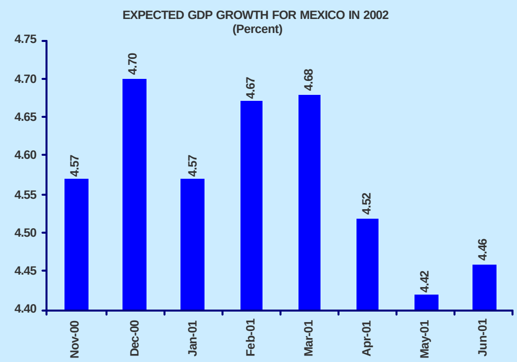
Firstly, there was an abundant supply of external capital in the January-March period. In the first quarter the flow of foreign direct investment (FDI) was higher than the amounts received over the same period in previous years. During the period, FDI covered 82 percent of the current account deficit, and was complemented by other long term capital inflows. There were also other inflows of foreign portfolio investment and a reduction in the Mexican residents' holdings of financial assets abroad. The sum of these items implied a larger capital inflow than for the same period in previous years (Chart 2).

Chart 2



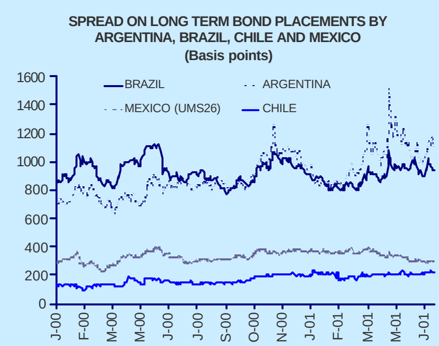
The increased inflow of foreign investment has been based on favorable expectations for Mexico's medium term economic outlook. Thus, although the growth forecast for the Mexican economy has been revised downward, the expansion estimated for year-end 2002 has remained practically constant during the last eight months (Chart 3).

Chart 3



Despite the adverse external shocks caused by the downturn in the United States' economy and rising uncertainty over the situation in Argentina, favorable expectations for the Mexican economy over the medium term have helped investors to differentiate Mexico from other emerging economies. In the first semester, the spread on the Mexican Government's long term bond placements on international markets fell, while the spread paid on similar securities issued by other emerging economies rose (Chart 4).

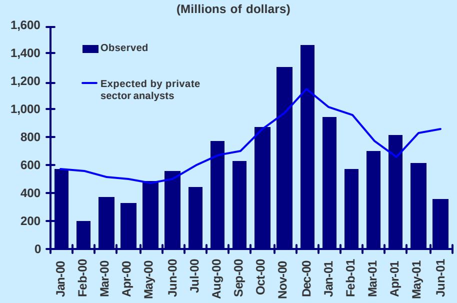
Chart 4



Secondly, in the first semester the current account deficit will undoubtedly be lower than had been expected at the start of the year. As a result, private sector analysts adjusted their estimates downward for this deficit at year-end, from 22.037 billion dollars in December 2000 to 20.866 billion in June 2001. This correction is justified by the fact that the slowdown of the United States' economy has not affected Mexico's trade account as much as had been anticipated. The trade deficit was narrower than the corresponding forecast for every month during the period, except April. This meant that the trade deficit accumulated between April and June was considerably less than had been foreseen (Chart 5).

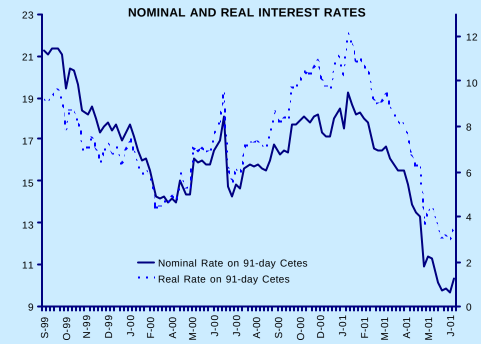
Chart 5

TOTAL TRADE DEFICIT
(Millions of dollars)



It has been argued that the appreciation of the exchange rate has been caused by a restrictive monetary policy stance. Nevertheless, since late January nominal and real interest rates have fallen by approximately 800 basis points while the exchange rate has appreciated (Chart 6).

Chart 6



In the context of a considerable reduction of domestic and external interest rates, as well as significant advances in the reduction of inflation, the medium term outlook for the Mexican economy is favorable. This has helped to curb a possible deterioration of country risk perception in the face of events in Argentina.

II.2.2. Compensations, Wages and Employment

As mentioned in previous Inflation Reports, wages and employment are two of the main factors that influence the behavior of inflation. Below is a brief description of how these variables performed during the first quarter of 2001.

II.2.2.1. Compensations

Figures available for April 2001 show that nominal compensations per worker rose at annual rates between 4.5 and 15.1 percent. In the same month, compensations in the manufacturing and in-bond industries registered significant real increases of 3.2 and 7.5 percent, respectively. In the commerce sector, however, real compensations fell (Table 4).

As a result of the close correlation between productivity and the economic cycle, output per worker has declined considerably in most sectors. During the economic deceleration phase output generally contracts more than the number of employees (the payroll does not adjust immediately or in the same proportion as output). This translates into lower productivity. This is happening in various sectors of the Mexican economy. For example, recent figures for the manufacturing industry indicate that growth in output has fallen more than employment and productivity has thus declined considerably in that industry (Chart 7).

Table 4 **Compensations per Worker**

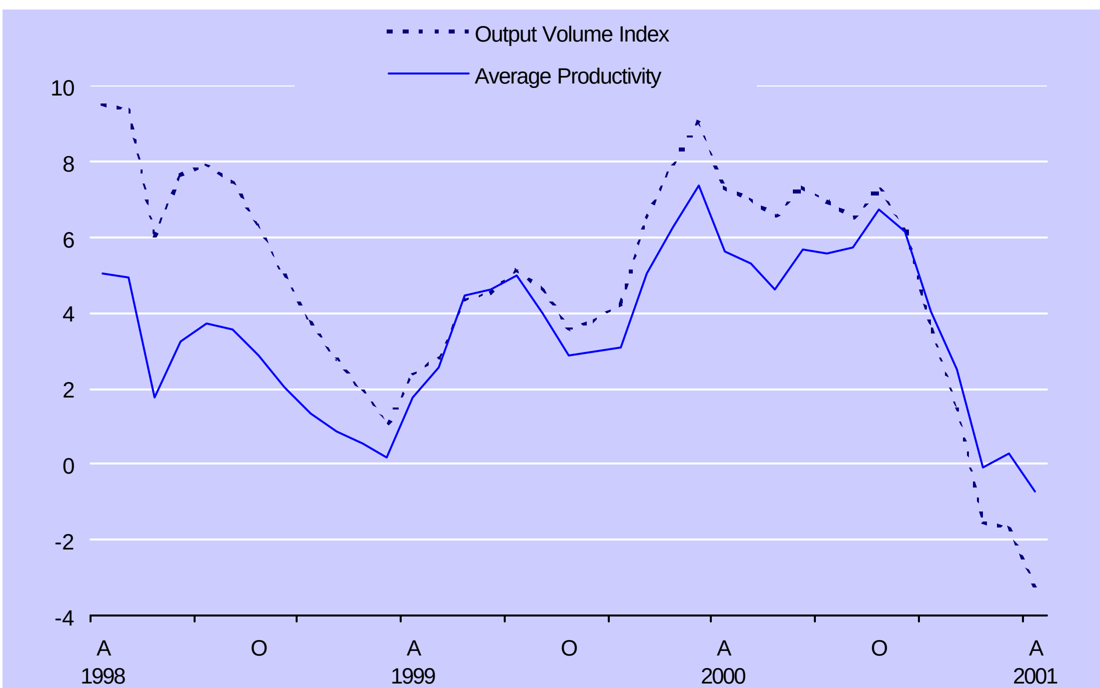
Annual percentage change

	Nominal							Real						
	2000			2001				2000			2001			
	Oct	Nov	Dec	Jan	Feb	Mar	Apr	Oct	Nov	Dec	Jan	Feb	Mar	Apr
Manufacturing Industry	14.7	15.8	14.6	15.8	12.2	12.3	10.5	5.3	6.4	5.1	7.1	4.8	4.8	3.2
In-Bond Industry	17.1	19.8	15.2	14.4	13.0	13.5	15.1	7.5	10.0	5.8	5.8	5.5	5.9	7.5
Construction Industry	10.5	11.3	19.3	15.3	21.0	n.d.	n.d.	1.5	2.2	9.5	6.7	13.0	n.d.	n.d.
Commerce Sector	15.9	18.9	16.1	8.8	6.4	5.9	4.5	6.5	9.2	6.5	0.7	-0.7	-1.2	-2.5

SOURCE: Prepared with information from INEGI.

Chart 7 **Output and Average Productivity in the Non-In-Bond Manufacturing Industry**

Annual percentage change of the 3 month moving average



SOURCE: Prepared with information from INEGI.

Real wage increases above productivity gains have caused unit labor costs to rise. Thus, in the last quarter of 2000 and in the first four months of 2001, the growth rate of these costs remained at high levels in most sectors. Regarding the in-bond industry, in the April-June period of the current year unit labor costs grew 8.3 percent on average (Table 5).

Table 5 **Unit Labor Costs and Output per Worker**

Annual percentage change

	Output per Worker							Unit Labor Costs						
	2000			2001				2000			2001			
	Oct	Nov	Dec	Jan	Feb	Mar	Apr	Oct	Nov	Dec	Jan	Feb	Mar	Apr
Manufacturing Industry	7.8	5.3	-1.1	3.2	-2.4	0.1	0.2	-2.3	1.0	6.3	3.7	7.4	4.7	3.0
In-Bond Industry	1.7	2.6	3.4	-1.3	-4.5	1.9	-3.6	5.8	7.2	2.3	7.2	10.4	3.9	11.5
Construction Industry	-7.7	-5.2	-12.5	-3.8	-1.9	n.d.	n.d.	9.9	7.9	25.1	10.9	15.2	n.d.	n.d.
Commerce Sector	4.1	0.1	-4.2	1.2	-8.1	-5.2	-5.2	2.3	9.1	11.2	-0.5	8.1	4.2	2.9

SOURCE: Prepared with information from INEGI.

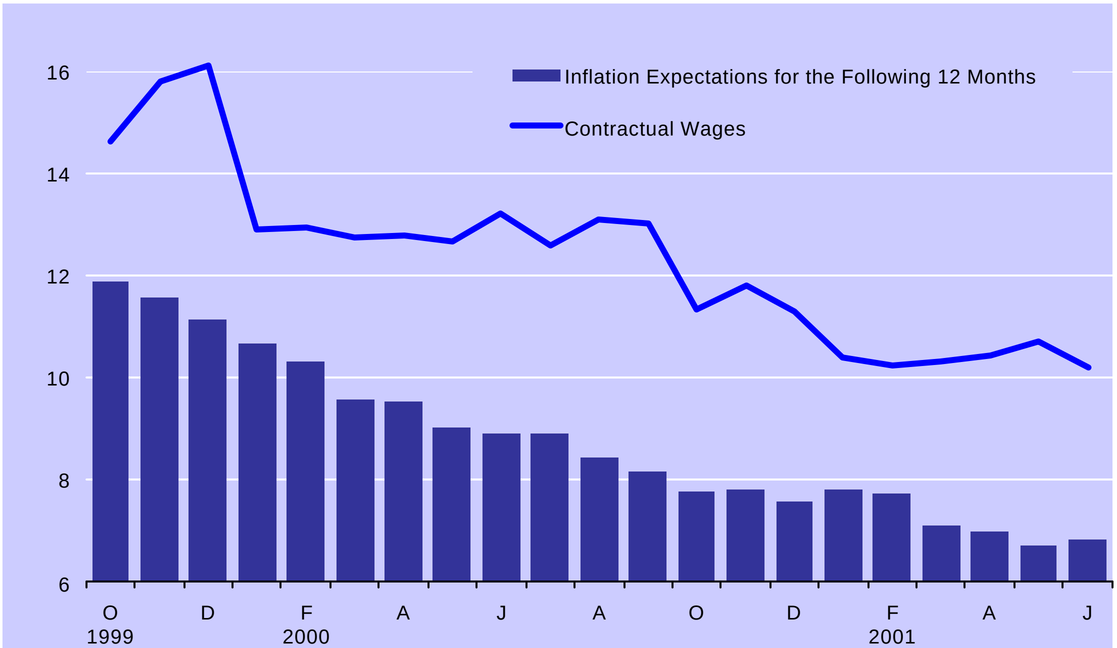
Significant increases in unit labor costs, in the context of economic deceleration, tend to aggravate the contraction of employment. Furthermore, real wage increases that are above productivity gains are not only a factor contributing to the loss of competitiveness but also an important source of inflationary pressure.

II.2.2.2. Contractual Wages

Since February 2001 the nominal growth of contractual wages has remained practically constant. Despite improvements in the private sector's inflation expectations, the gap between them and contractual wage increases remains wide (Chart 8).

Chart 8 **Contractual Wages and Inflation Expectations for the Following 12 Months**

Annual percentage change



SOURCE: Survey of the Expectations of Private Sector Economic Specialists, Banco de México and Ministry of Labor.

The developments described above have appeared in the manufacturing sector as well as in other sectors of economic activity. Contractual wage increases in the manufacturing industry declined from 10.7 to 10.1 percent between February and June 2001. In comparison, for the remaining economic sectors as a whole, the growth rate of contractual wages went up from 9.8 to 10.2 percent in the same period (Table 6).

Table 6 **Contractual Wages by Sector**

Annual percentage change

	2000			2001					
	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun
Manufacturing	12.7	13.3	10.8	11.1	10.7	10.8	10.9	10.8	10.1
Other Sectors	11.2	11.4	12.9	10.0	9.8	9.9	10.3	10.5	10.2

SOURCE: Prepared by Banco de México using information provided by the Ministry of Labor.

The downward rigidity of nominal contractual wage growth during 2001 deserves careful attention, especially because it hampers the preservation of employment levels, job creation and the consolidation of the disinflation process.

The negative effects on employment of real wage increases that are incompatible with feasible medium term productivity gains have been further reinforced by two additional factors: the deceleration of the United States' economy and less vigorous investment in Mexico. This is due to the fact that in the context of an economic downturn, producers find it more difficult to transfer higher costs to the prices of their products. Thus, in the medium term, the adjustments necessary to accommodate higher production costs would have to be made through reductions in employment and in firms' profits.

II.2.2.3. Employment

In the first semester of 2001, there was a general deterioration of conditions in the Mexican labor market due to the deceleration of both the Mexican and the United States' economies. The economic environment is clearly less favorable than in the recent past and it has had a negative impact on the main employment and unemployment indicators.

In the second quarter of 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 almost 105,000 people compared to its level in March 2001 (Chart 9a). Therefore, from November 2000 to June 2001 the employment level decreased by 3.4 percent, its largest fall in the last five years.

Recent Evolution of Employment and Unemployment in Mexico

The recent deceleration of the Mexican economy has brought about a less favorable outlook for the labor market. From November 2000 to June 2001, formal employment (measured by the number of permanent and temporary employees affiliated to the IMSS) fell by 430,000 jobs[1]. This represents a 3.4 percent loss of these jobs. In most sectors of the economy, formal employment has declined considerably (Table 1). In particular, in May 2001 the deterioration of employment in the manufacturing and construction industries accounts for 92 percent of the total reduction in jobs. Within the manufacturing industry, the contraction of employment has mainly been in the area of metallic products and machinery, as well as in textiles and apparel. These sectors are mostly exporters, which illustrates the significant recessionary effect that lower demand from the United States has had on employment in Mexico.

Table 1
EVOLUTION OF EMPLOYMENT BY SECTOR
(Total Temporary and Permanent Employees Affiliated to the IMSS)

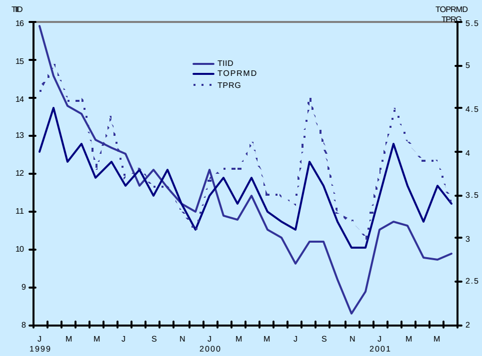
Sectors	Changes in Employment Nov 00-May 01	
	Total*	Percentage
Total	-394.3	-3.04
Agriculture, Livestock, Beekeeping, Hunting and Fishing	63.7	10.88
Extractive Industries	-5.3	-7.49
Manufacturing Industries	-271.8	-6.01
Construction	-89.5	-9.20
Electricity and Potable Water	1.1	0.74
Commerce	-33.8	-1.14
Transport and Communications	-5.1	-0.78
Financial and Real Estate Services	-5.3	-2.06
Social and Community Services	3.0	0.11
Other	-49.4	-4.98

*Thousands

In the first semester of the year, the overall open unemployment rate rose by 0.38 percentage points. Notwithstanding, a higher increase in this rate might have been expected in light of the significant reduction that was registered in the number of workers affiliated to the IMSS. It is worth mentioning that information from the National Urban Employment Survey (*Encuesta Nacional de Empleo Urbano*) —from which open unemployment rates are calculated— also includes workers employed in the informal sector. Thus, employment could have increased in this sector during the first half of the year considering that in this period there was greater participation by those employed in the commerce and service activities, in jobs without benefits and in establishments that have between one and five workers.

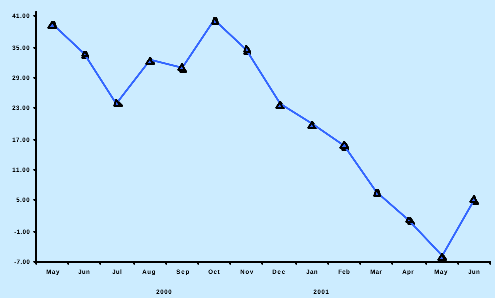
Furthermore, alternative indicators of unemployment confirm the deterioration in the labor market. The Rate of Earnings below the Minimum and Unemployment (*Tasa de Ingresos Inferiores al Mínimo y Desocupación*, TIID)[2] rebounded significantly at the start of 2001. Meanwhile, the Overall Pressure Rate (*Tasa de Presión General*, TPRG)[3] and the Rate of Temporary Employment for Market Reasons and Unemployment (*Tasa de Ocupación Parcial por Razones de Mercado y Desocupación*, TOPRMD)[4] posted strong increases in the first few months of the year. This behavior is confirmed by the seasonally adjusted series for these indicators[5] (Chart 1).

Chart 1
ALTERNATIVE UNEMPLOYMENT RATES
(Percent)



Finally, according to the Survey of the Conjunctural Economic Situation (*Encuesta de Coyuntura*) that Banco de México prepares periodically, there is evidence of greater flexibility in the labor market. In particular, the competition that firms face when hiring qualified personnel has fallen in the areas of production, administration and sales. Since October of last year, the proportion of firms surveyed that had experienced higher competition when hiring qualified personnel, minus the percentage of those that had experienced lower competition, has fallen (Chart 2).

Chart 2
COMPETITION BETWEEN COMPANIES WHEN HIRING QUALIFIED PERSONNEL
(Percent)



If the economic slowdown worsens it will have a very unfavorable impact on employment. Unemployment could increase, not only because of the downturn itself, but also because contractual wage increases might not be moderated. The latter have been much larger than the sum of expected inflation and sustainable gains in labor productivity. Thus, in order to mitigate the impact on employment of a weaker domestic economic activity induced by the slowdown in the United States, in the next few months a downward movement in wage increases seems necessary.

[1] The IMSS also takes into account temporary rural employees affiliated to that Institute, although the corresponding data is published with a lag. Table 1 presents formal employment figures for May that include temporary urban and rural employees as well as permanent employees.

[2] Measures the percentage of the economically active population that is unemployed and employed but earn less than the minimum wage.

[3] Registers the percentage of the economically active population that is unemployed and those who are employed but looking for another job (in order to change jobs or find additional employment).

[4] The percentage of the economically active population that is unemployed or work less than 35 hours a week for market reasons.

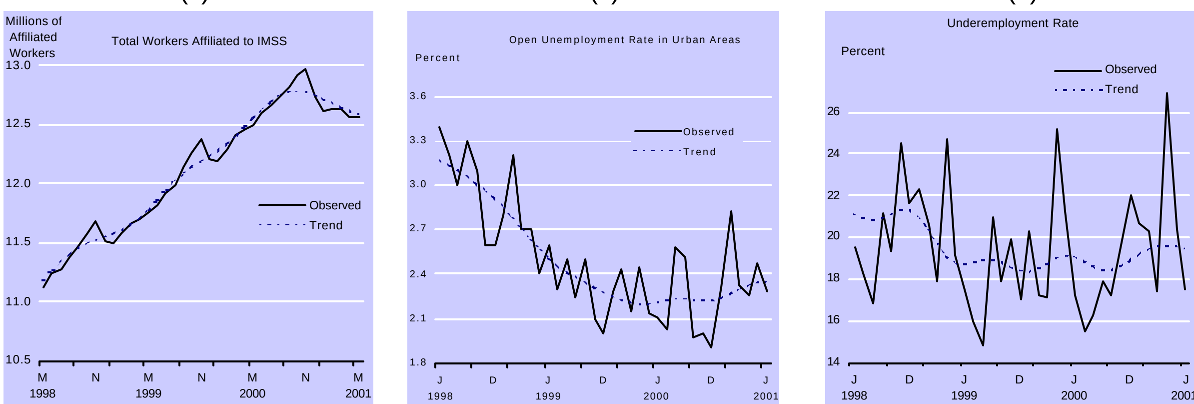
[5] In regional terms, from November 2000 to May 2001, the total reduction of employment was concentrated in the northern states, Mexico City, the State of Mexico and Jalisco. The most significant decreases in employment were for the most part in the northern Mexican states and in Durango.

The open unemployment rate for June was 2.28 percent, very similar to the 2.33 percent posted in March. Nevertheless, the trend series for this variable shows that unemployment has risen continuously since the beginning of the year (Chart 9b). Regarding the underemployment rate, its trend series has also rebounded significantly since September 2000 (Chart 9c).

Chart 9 **Employment and Unemployment Indicators**

Trend Series

(a) (b) (c)



SOURCE: IMSS and INEGI.

II.2.3. Aggregate Supply and Demand

The economic slowdown that began in the last quarter of 2000 intensified in the first half of 2001. It has been characterized by a considerable reduction of growth in the following three aggregates: exports, imports, and private sector investment. Although the annual growth rate of private consumption declined in the first quarter of the year, it remained at high levels. However, it is estimated to have slowed considerably in the second quarter.

The downward adjustment of economic growth in the United States has had a rapid impact in Mexico. Although the United States' economy is not officially going through a recession, its manufacturing sector has contracted during the last nine months. Due to the close integration between the manufacturing sectors of both countries, this has been the main transmission channel for the deceleration. It has had an unfavorable impact on exports, industrial production and employment in Mexico, which in turn have affected private spending.

The annual rate of expansion of real GDP decreased from 5.1 percent in the fourth quarter of 2000 to 1.9 percent in the first quarter of 2001. This is the largest fall in the last five years and is due to the fact that the growth rates of all the components of aggregate demand, except public investment, have also been lower. Due to the large import content of the main components of aggregate demand, the expansion of imports of intermediate and capital goods has diminished substantially. This has helped to mitigate the deceleration of GDP and the widening of the trade deficit.

Private investment reacted very quickly to the weakening of economic activity, confirming that this component of aggregate demand is the most sensitive to changes in GDP. Although the growth rate of private consumption has suffered a downward adjustment as well, this correction has been more moderate than what could have been expected in light of the decline in real GDP growth and employment. There were two factors that helped to avert a more rapid slowdown of consumption during the first quarter. The first came from an improvement in real wages due to the fact that observed inflation was below what had been expected. The second was the rebound in consumer credit[7]. Regarding the behavior of public expenditure, the higher growth rate of investment expenditure is noteworthy. In contrast, public expenditure on consumption has fallen. This partly reflected the reduction of these outlays that usually occurs in the first few months of a new Administration.

Table 7 **Aggregate Supply and Demand in 2000 and 2001**

Real annual percentage change

	2000					2001
	I Qtr.	II Qtr.	III Qtr.	IV Qtr.	Annual	I Qtr.
Aggregate Supply	11.7	11.2	11.4	8.0	10.5	3.0
GDP	7.7	7.6	7.3	5.1	6.9	1.9
Imports	24.9	22.3	23.2	16.1	21.4	6.3
Aggregate Demand	11.7	11.2	11.4	8.0	10.5	3.0
Total Consumption	8.9	9.4	10.0	6.6	8.7	5.3
Private	9.6	10.2	10.5	7.6	9.5	6.5
Public	3.9	4.6	6.1	0.6	3.5	-3.0
Total Investment	10.9	10.5	11.1	7.6	10.0	0.4
Private	12.8	8.9	10.8	8.2	10.2	-0.7
Public	-4.5	26.0	13.1	5.3	8.6	11.3
Exports	17.3	15.8	16.9	14.1	16.0	4.7

SOURCE: INEGI

[7] Evidence of this is presented in section III.2.3.

All of the above caused domestic spending to rise in the first quarter of the year by 2.5 percent at an annual rate, higher than that for GDP. A reasonable conclusion could be that, although both imports and exports decelerated substantially, imports continued to grow at higher annual rates than exports. Therefore, the trade deficit widened in the first quarter of 2001 compared to that for the same period of 2000.

When analyzing the recent changes of any variable, the most relevant indicator may be the quarterly growth of its seasonally adjusted data. The study of these figures shows that during the first quarter of 2001, private and public consumption registered quarterly increases of 1.4 and 0.8 percent, respectively. In contrast, investment contracted by 1.6 percent from the level reported for the previous quarter. The latter resulted from the combination of a 2.7 percent decline in private investment and a 5.6 percent increase in public investment. The evolution of both components was reflected in the 0.9 percent quarterly growth of domestic demand. Seasonally adjusted GDP decreased 0.4 percent compared to that observed in the fourth quarter of 2000. Thus, seasonally adjusted figures confirm the drastic loss of momentum in economic activity and private investment, while private consumption remains relatively vigorous.

Information available for the evolution of aggregate demand in the second quarter indicates the following:

(a) The rate of expansion of consumption has leveled off. In the April-June quarter sales to all stores reported by the National Association of Self-Service and Department Stores (*Asociación Nacional de Tiendas de Autoservicio y Departamentales*, ANTAD) rose at an average annual rate of 8.2 percent, 0.3 percentage points less than in the first quarter. Figures for commercial establishments, prepared by INEGI, show that the real annual growth of retail sales fell from 9.5 percent in January to 3.5 percent in May, while wholesale sales continued to contract. In contrast, although the growth rate of imports of consumer goods did not level off in April and May, it did so in June. Thus, the annual growth rate of increase of this variable was 21.6 percent in the second quarter, lower than the 29.1 percent posted during the January-March period. The expansion of imports of consumer goods until May can be explained to a great extent by large imports of gasoline, which have responded to a reduction in the domestic supply of this fuel while maintenance work was being conducted on some of the country's refineries. If gasoline was excluded from total imports of consumer goods, the annual growth of this class of imports would have fallen from 27 percent in the first quarter to 13.1 percent in the second;

(b) Private sector investment continued to show signs of weakness. In April, gross fixed investment registered an annual change of -1.6 percent. Furthermore, the growth of imports of capital goods fell from 7.5 percent in the January-March quarter to -0.8 percent in the April-June period; and

(c) Slower growth of the United States' economy explains why the annual increase in Mexican non-oil exports was 0.8 percent in the second quarter, significantly less than that registered in the first quarter. In its seasonally adjusted series, this situation implied a quarterly reduction of 0.9 percent.

Based on the above information, Banco de México estimates that the annual growth rate of private consumption was below 4 percent in the second quarter, while total investment diminished by close to 4 percent. This would be compatible with an aggregate demand expansion of around 0.4 percent. It is also worth mentioning that higher growth in consumption than in GDP implies a reduction in the rate of domestic saving.

Information available for the components of aggregate supply shows the following:

(a) in April the Global Index of Economic Activity (*Indice Global de la Actividad Económica*, IGAE) grew 1.2 percent in real annual terms. This rate was slightly less than that observed in the first quarter of the year and implied a 0.06 percent monthly increase of its seasonally adjusted figure;

(b) industrial production contracted 3.3 percent at an annual rate in the April-May period; and

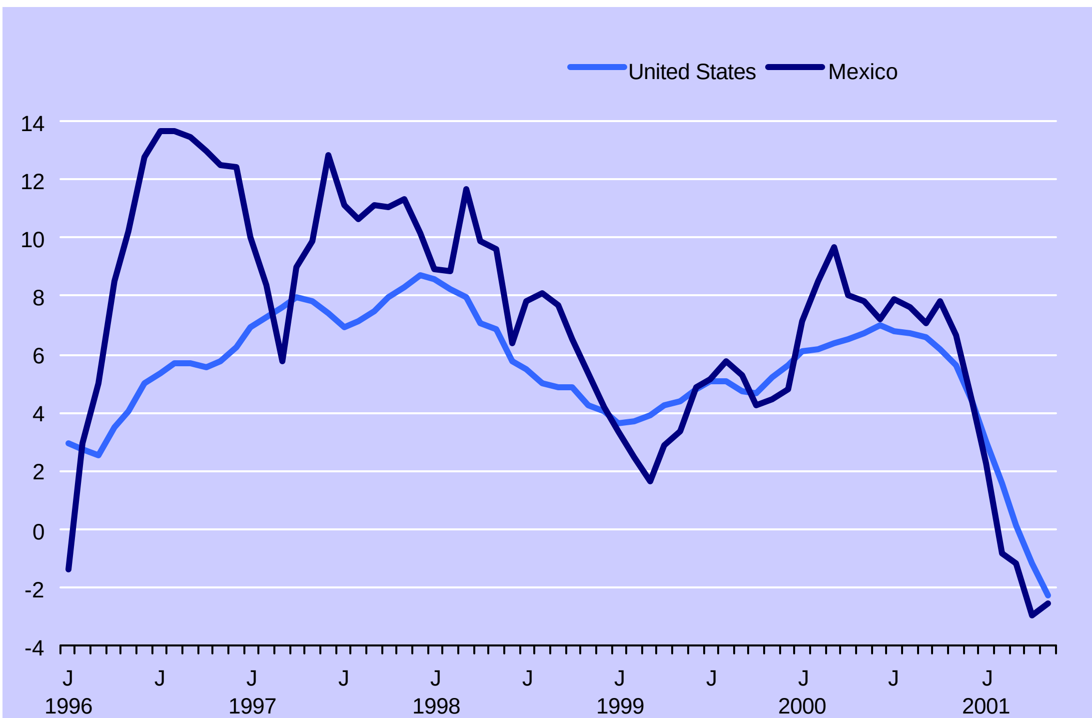
(c) the annual growth rate of merchandise imports fell from 6.7 to 0.1 percent between the first and second quarters of the year. The imports which suffered an annual contraction were those of intermediate goods (from 4.0 to -2.3 percent) and of capital goods (from 7.5 to -0.8 percent).

Taking the previous information into account, Banco de México estimates that in the second quarter of 2001 the annual growth rate of real GDP might have been below 1 percent, and very likely to be less than 2 percent for the year as a whole.

It is clear that the slowdown of the Mexican economy can be fundamentally explained by weakening economic activity in the United States. This is made obvious by the close relationship between the behavior of manufacturing indicators in the United States and Mexico. The present economic situation in the United States has affected Mexico through the considerable fall in the demand for Mexican exports. This has had a negative impact on employment and output in the industrial sector, especially in the manufacturing area. The rapid and substantial reduction of aggregate demand growth, mainly private investment, in response to the deceleration of GDP, was somewhat more surprising.

Chart 10 **Manufacturing Industry Output in Mexico and the United States**

Annual percentage change of the 3 month moving average



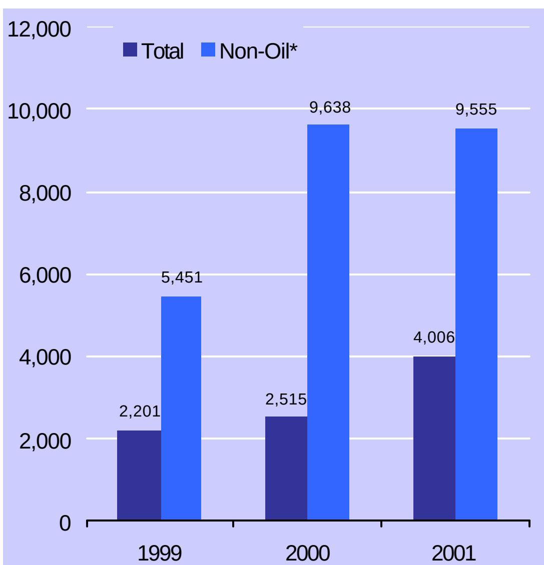
SOURCE: Bloomberg and Banco de México.

As a consequence of the fall in private investment and the high imported content of Mexican exports, the growth of imports also fell considerably. In this way the contraction of output was mitigated and the trade deficit widened less than expected. It is important to emphasize that although the trade deficit accumulated during the first half of the year is 59 percent higher than that for the same period of 2000, trend data show that there has been a reduction in both the total and non-oil trade deficits since January. In fact, the second quarter trade deficit (1.786 billion dollars) was lower than in the first quarter (2.221 billion). This suggests that seasonally adjusted GDP growth was above that of domestic demand in the second quarter. Private sector analysts did not expect this, and they had thus forecasted a trade deficit for the year 9.6 percent higher than the current projection. The aforementioned evolution of the trade deficit has helped to reduce the Mexican economy's demand for external resources and has, thereby, contributed to the appreciation of the exchange rate.

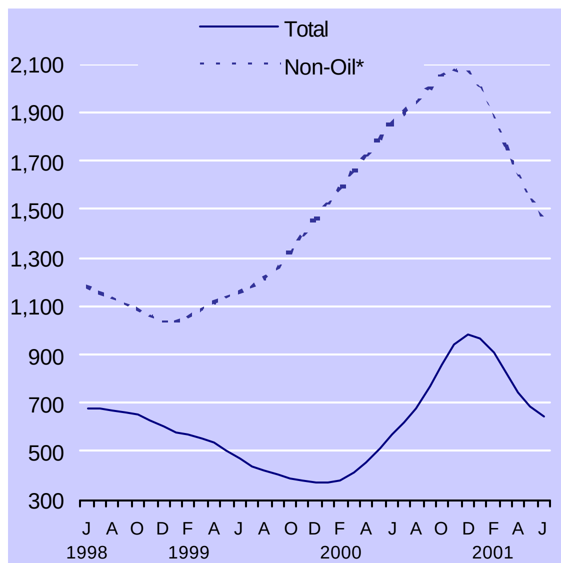
Chart 11 **Total and Non-Oil Trade Deficits**

Millions of dollars

January - June



Monthly Trend



* Excluding imports of gasoline, butane and propane gas.

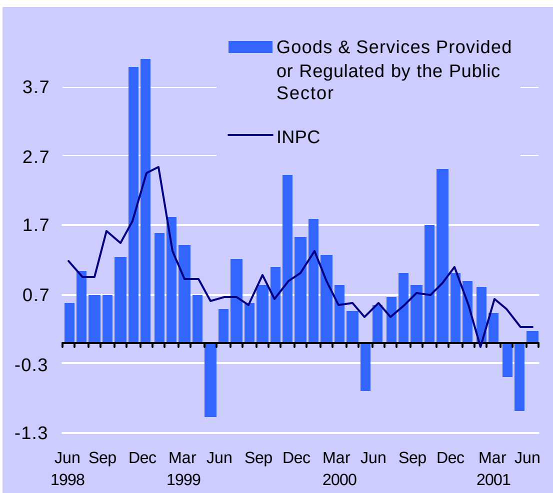
Another factor that helped to prevent exchange rate pressures that had been feared at the start of the year (associated with the downturn of the United States' economy) was the abundant supply of foreign capital in the first quarter. In this period, foreign direct investment reached 3.597 billion dollars, its highest level in a first quarter since 1980 and an amount which covered 82 percent of the current account deficit. Portfolio investment over the same period was 1.182 billion dollars and public and private external indebtedness were 0.412 and 3.090 billion dollars, respectively. Portfolio investment is estimated to have been around 1.4 billion dollars in the second quarter, while inflows of foreign direct investment are estimated to have been similar to those observed during the first quarter.

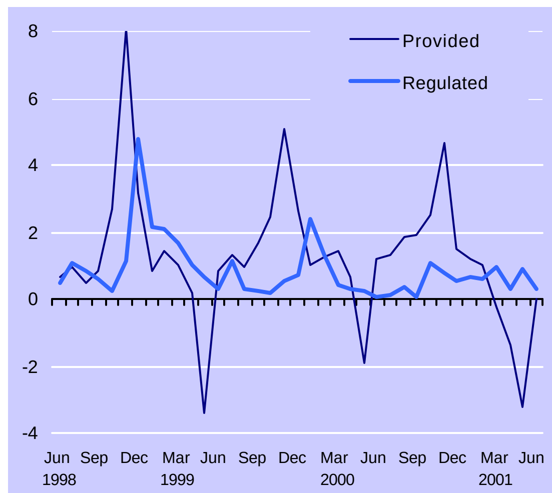
II.2.4. Prices of Goods and Services Provided or Regulated by the Public Sector

In April, May and June the monthly changes in the sub-index of prices for goods and services provided or regulated by the public sector[8] were -0.48, -0.98 and 0.18 percent, respectively. Meanwhile, the INPC growth rates for the same months were 0.50, 0.23 and 0.24 percent (Chart 12).

Chart 12 **Price Index for Goods and Services Provided or Regulated by the Public Sector and the INPC**

Monthly percentage change





The favorable behavior of this sub-index during the quarter under analysis can be fundamentally explained by the evolution of prices of goods and services provided by the public sector, which registered monthly changes of -1.39 and -3.23 percent in April and May and remained constant in June. The sub-index for prices of goods and services regulated by the public sector increased as follows in the same months: 0.29, 0.87 and 0.33 percent. The decline of the growth rate of regulated prices

[8] The prices included in the sub-index for goods and services provided by the public sector are: gasoline, domestic gas and electricity. The products whose prices are regulated by the public sector are: long distance international telephone calls, taxi fares, city bus fares, subway or electric transport fares, inter-city bus services, parking lots fares, automobile ownership taxes, local telephone services, highway tolls, domestic long distance telephone calls, telephone line installation and service fees, oil and lubricants, and duties and licences.

during the second quarter of the year can mainly be attributed to the implementation of summer season electricity prices in 13 cities in the northern part of the country. Thus, the reduction accumulated by this sub-index during the quarter was 13.4 percent. In the same period, prices for inter-city bus services and gas for domestic use declined 1 and 7.4 percent, respectively.

Analysis of the various factors that influence the path of prices suggests that the significant fall in annual inflation observed during the second quarter of the year can be attributed to the following elements that coincided in time:

(a) the appreciation of the exchange rate caused by the greater availability of external resources;

(b) the weakening of domestic output and demand due to the slowdown of the United States' economy; and

(c) the favorable effect of some transitory factors, such as the evolution of prices of agricultural and livestock products and of goods and services provided or regulated by the public sector.

One factor that hampered the abatement of inflation during the period was nominal contractual wage increases, which remain at high levels. This was made evident by the slower rate of decline in core inflation for services.

III. Monetary Policy During the Second Quarter of 2001

The reasons which led Banco de México to modify its monetary policy stance during the April-June quarter will be explained in this section. A complementary analysis of the evolution of inflation expectations as well as nominal and real interest rates is also presented. This is in order to properly evaluate the impact of monetary policy adjustments on these variables, given their importance in revealing the public's perceptions about the inflation process and to examine the monetary conditions prevailing in the economy. Finally, the evolution of the monetary base and other monetary aggregates is reported.

III.1. Monetary Policy Actions

On May 18th, 2001, Banco de México announced a reduction of the "short" from 400 to 350 million pesos, and maintained it at the latter level for the remainder of the quarter. This measure was taken in response to two factors: the favorable evolution of inflation and the mitigation of some of the risk factors that had been identified at the start of the year as potential obstacles to the attainment of the inflation target for 2001.

At the time when the monetary policy stance was modified, the annual inflation of the INPC had fallen from 8.96 percent in December 2000 to 7.11 percent in April 2001, and core inflation had decreased from 7.52 to 6.44 percent over the same period.

As a consequence of the trend shown by the growth of prices, private sector inflation expectations for 2001 had moved from 7.58 percent in December 2000 to 6.87 percent in April 2001.

In the external environment, the downturn of the United States' economy over the year had been greater than expected. The weakening of economic activity in this neighboring country induced a decline of the annual growth rate of Mexico's real GDP, from 5.1 percent in the fourth quarter of 2000 to 1.9 percent in the first quarter of 2001.

The Suitable Level of International Reserves

The optimal level of international reserves (IR) has been widely discussed in economic literature. The generally accepted principles about maintaining reserves have changed over time as the functions of IR have been modified. The IMF states that IR can be used to finance imbalances in external payments and indirectly manage their size through intervention in the foreign exchange market[1]. At the same time, it has been argued in various studies that among the factors that should be considered in order to determine the desired level of IR the following should be included: the size of the current account deficit, the degree of volatility that the economy is subject to, the type of exchange rate regime in operation, the schedule of the debt maturities, the degree of access to international capital markets, and the preferences of the country's financial authorities[2]. Therefore, the desirable level of IR depends on the objectives set for these assets and the different conditions and characteristics of each economy.

Throughout the 20th century it was possible to identify three approaches regarding the functions assigned to IR and each one implies different suitable levels for them. During the time of the gold standard, before the First World War, the role of IR was centered on the need to maintain this standard, as a function of the domestic money supply. The theory was that gold and foreign currencies should be maintained at a certain proportion of the amount of bills in circulation —around 30 percent. This is what could be called the *monetary approach*[3] for the accumulation of reserves. In the years after the Great Depression, the ideal level of IR was far above what had been considered as such under the previous criteria. As a result, in 1957 the IMF carried out studies of the links between IR and international trade. The conclusions that came out of this study were that the level of IR should provide sufficient liquidity to a country so that, should its terms of trade deteriorate, it could be able to maintain the same amount of imports over a certain period. This could be identified as the *commercial approach* to reserves. Thus, in a context where the flows of trade were the dominant force in the balance of payments, the general rule was that IR should cover between 25 and 35 percent of annual imports. In this way, the IR would not only allow imports to increase as the country was growing but would also allow the country to deal with any domestic and external shocks affecting the current account.

However, the validity of the commercial approach has come into question due to the increasing importance of capital transactions in the balance of payments. At present, the flows of capital are much larger than those derived from commerce and for this reason the capital account is the predominant force in the evolution of the balance of payments. In fact, both the size and the speed of capital movements have caused severe problems in many countries.

Economies that enjoy considerable but uncertain access to international capital markets, such as Mexico's, are extremely vulnerable to sudden capital outflows and unexpected constraints in access to external capital. The exposure of these emerging economies to capital movements has been made clear by the Mexican crisis of 1994-95 and by the most recent crises that have affected some emerging markets. During these episodes, the most vulnerable economies were those with lower levels of liquidity in foreign currency.

Obviously, in this new context the role of IR has changed. At present, IR are held to prevent liquidity crises and improve the terms of access to external financing. The stock of IR should be sufficient to reduce the probability of a temporal closure of international capital markets and thereby reduce the risk of a roll-over crisis.

By mitigating the aforementioned risks, an adequate stock of international reserves helps to improve the country's credit rating in international capital markets. The preventive role of IR was evident in the 1997 Asian crisis. Those countries with a lower proportion of reserves to short term debt —like Indonesia, Korea, Malaysia and Thailand— were the hardest hit, while those with higher ratios —such as Singapore and Taiwan— were less affected.

As has been mentioned, one of the factors that has an important influence on determining the necessary level of IR is exchange rate policy. When a floating exchange rate regime is adopted, as in Mexico's case, economic agents must take the exchange rate risk very seriously into consideration when making their credit decisions[4]. International reserves still fulfil an essential preventive role even within a flexible exchange rate regime. An adequate level not only reduces the risk of a roll-over crisis but it also allows the economy to adapt in a smooth and orderly fashion to changes in the balance of payments.

1 IMF, Balance of Payments Manual, fifth edition.

2 See among others, H Grubel (1971). "The Demand for International Reserves: A Critical Review of the Literature", Journal of Economic Literature, 9:4, 1148-1166 and Bank of International Payments (2000) Managing Foreign Debt and Liquidity Risk, Policy Paper N°8.

3 An extreme example and at the time of this focus were the Currency Boards adopted by some countries, where each monetary unit in circulation was backed up one hundred percent by IR.

4 Note that when attempting to maintain a fixed exchange rate, the IR level must be large enough to resist speculative attacks.

For the above reasons, at present many emerging economies that use a floating exchange rate regime still maintain significant stocks of international reserves.

International Reserves in Countries with a Flexible Exchange Rate Regime

	Millions of U.S. Dollars
Brazil	32,502
Colombia	9,000
Korea	95,936
Chile	14,700
Philippines	13,353
Indonesia	22,638
Mexico	35,441
Peru	8,405
Thailand	32,052

*Stocks as of December 2000. Reserves include DEG, foreign currencies, reserve position in the IMF, and gold.
Source: IMF, International Financial Statistics, 2001 and the central bank of each country.

In Mexico's case, due to the low level of reserves prevailing in 1994 and during part of 1995, the Foreign Exchange Commission —made up by officers from the Finance Ministry and Banco de México— decided to introduce a mechanism to accumulate reserves via auctioning options to sell dollars to the Central Bank. This mechanism complemented the accumulation of reserves through the direct purchase of foreign currency generated by Pemex and by the Federal Government. The aforementioned mechanism successfully fulfilled the objectives for which it had been created and allowed Banco de México to accumulate a substantial amount of international assets without creating distortions in the foreign exchange market. Since the mechanism was put into operation in August 1996 and until June 2001, Banco de México was able to accumulate reserves in the amount of 12.117 billion dollars. Thus, the total stock of net international assets at the close of June 2001 was 40.866 billion dollars. Given this historically high level, the Foreign Exchange Commission decided that it was no longer necessary to continue accumulating reserves via the auctions mechanism, and suspended this scheme as of June 29th 2001, until further notice.

There had also been a rapid downward adjustment in growth rate of demand. This was reflected in a reduction in the disparity between the growth rates of domestic demand and supply as well as in a lower than expected trade deficit. The aforementioned situation had affected the labor market as well through job losses and rising unemployment rates. Although contractual wage increases continued to show downward rigidity, the seriousness of the economic slowdown meant it was reasonable to suppose that these revisions would move more into line with the inflation targets and the lower gains in labor productivity.

The positive medium term outlook for the Mexican economy together with falling interest rates in the United States led to a considerable inflow of capital from abroad, especially foreign direct investment. At the same time, participants in financial markets noticed that some of the risk factors that could have generated inflationary pressures incompatible with the target were less likely to occur. For all of the above reasons, from January to May short term domestic interest rates fell by approximately 6 percentage points, reaching levels not seen since 1994.

There are at least three elements that suggest the diagnosis made at the time of the monetary policy stance adjustment regarding the future evolution of the Mexican economy and inflation was the correct one: improvements in inflation expectations; the bleaker outlook for economic growth in the

United States and its impact on domestic output; and the persistently ample supply of foreign capital.

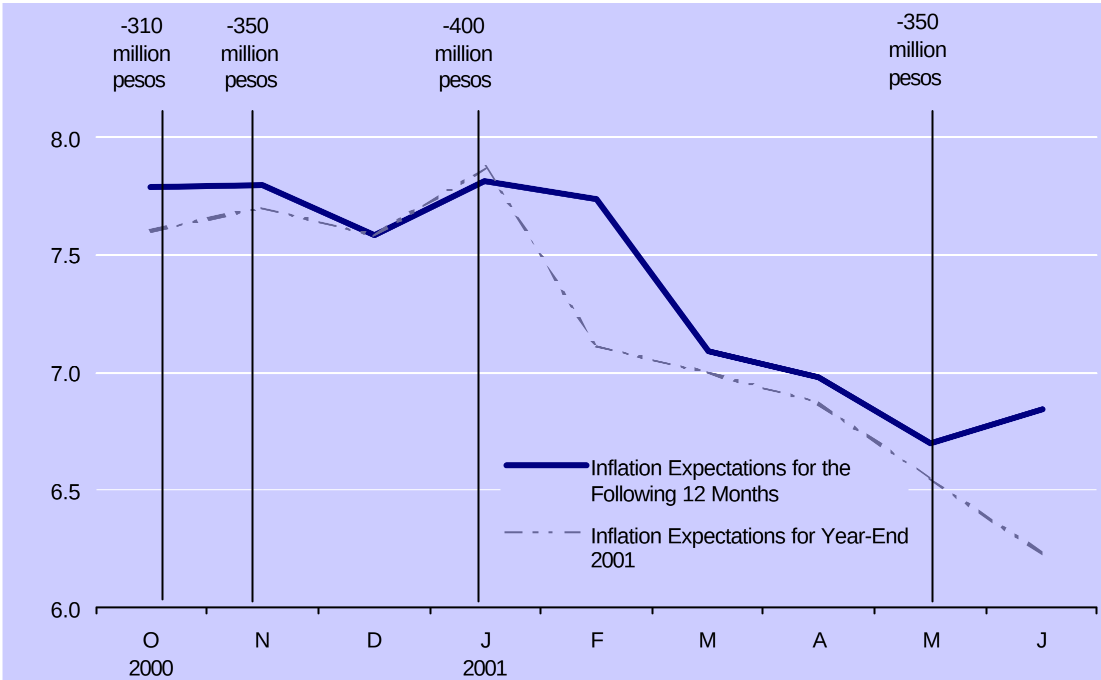
However, some of the risk factors mentioned in previous Inflation Reports have not completely disappeared. In particular, nominal increases in contractual wages have remained above the sum of the inflation target and foreseeable gains in labor productivity.

The evolution of inflation expectations is especially relevant when evaluating the results of monetary policy and attempting to identify the presence of inflationary pressures. The downward trend of these expectations throughout the year is noteworthy, in particular those for year-end 2001. This downward trend was consolidated in the April-June quarter (Chart 13). There were important reductions in May and June which brought these expectations to a level of 6.23 percent by the end of that period. This clearly shows that private sector analysts anticipate that the inflation target will be met. In short, the modification of the "short" was perceived as compatible with attaining said target.

Inflation expectations for the following 12 months have also fallen, from 6.98 percent in April to 6.84 percent in June. Nevertheless, these forecasts are still above expected inflation for 2001. This has been evident since February and seems to be somewhat paradoxical, as expectations for 2002 are also below expected inflation for 2001. This could be in response to the effect that the fiscal reform might have on expected inflation. On the other hand, analysts could be anticipating a certain transitory instability in the absence of the fiscal reform, which would temporarily affect inflation.

Chart 13 **Inflation Expectations and Accumulated Balances Objective ("Short")**

Percent

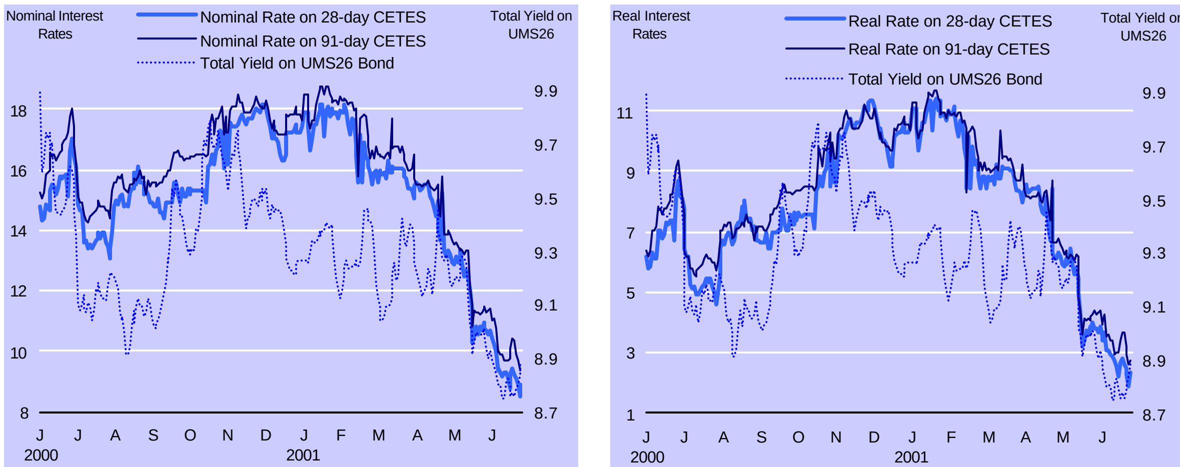


SOURCE: Survey of the Expectations of Private Sector Economic Specialists, Banco de México.

Throughout the quarter under analysis, nominal and real interest rates continued on a downward path (Chart 14). Specifically, some significant downward adjustments were observed during the period. Thus, from April 16th to 30th, the nominal rates on 28-day Cetes fell from 15.5 to 13.15 percent. Moreover, from May 17th to 22nd, these rates went from 12.4 to 10.3 percent. A third important adjustment took place at the end of the quarter, when these nominal rates declined from 10.7 percent on June 5th to 8.9 percent on June 29th. External interest rates fell during the quarter as well, and as a result the differential between nominal domestic and external rates narrowed. The aforementioned evolution has been in response to the following factors: the favorable inflation results obtained, a less stringent monetary policy stance, the reduction of external interest rates, and capital inflows.

Chart 14 **Nominal Interest Rates, Real Interest Rates[1/] and Total Yield on UMS26 Bond**

Percent



1/ Equivalent to nominal interest rates adjusted by inflation expectations for the following 12 months.

In short, in response to the favorable behavior of inflation and the positive effect the present economic situation has had on inflation expectations, nominal and real interest rates decreased 6.43 and 5.94 percentage points in the second quarter of 2001. These less stringent monetary conditions resulted from the markets' automatic adjustment to changes in the expected evolution of inflation as well as from the reduction of the "short" implemented on May 18th.

The adjustment of the "short" validated the reduction of domestic interest rates and the narrower differential between them and external interest rates, both of which had arisen as a result of the change in financial market participants' perceptions. At the same time, the evolution of inflation expectations suggests that this adjustment was considered to be compatible with the attainment of the inflation target set for the year. However, it must be reiterated that some of the risk factors mentioned in previous Inflation Reports have not disappeared. In particular, although conditions in the labor market indicate the possibility of a downward modification in nominal wage increases during the next few months, there was no evidence of this occurring up until June. Another risk factor is that expectations for year-end 2002 and 2003 are still above the corresponding inflation targets.

On June 22nd Banco de México called on Mexican credit institutions to make voluntary deposits at the Central Bank with three year maturities. These deposits will pay interest every 28 days at a rate equal to the arithmetic average of the 28-day

Equilibrium Inter-Bank Interest Rate (*Tasa de Interés Interbancaria de Equilibrio*, TIIE). By means of these deposits, Banco de México will be able to maintain a liquid creditor position vis-à-vis the banking system and thus preserve the monetary policy's effectiveness to influence the evolution of short term interest rates.

Banco de México shall replenish all the liquidity withdrawn by the aforementioned deposits, through its daily open market operations at very short terms. Thus, the total amount of resources in the money market will remain unaltered, and the Central Bank's monetary policy stance will not be modified as a result of this measure.

III.2. Monetary and Credit Aggregates

The evolution of the narrow monetary aggregates in the quarter covered by this Report clearly reflects the slowdown of economic activity. However, in contrast, the broad monetary aggregate M4 expanded at a similar rate to that observed in the previous quarter. The latter can be partly explained by the increased holdings of domestic financial assets by non-residents. In addition, commercial banks' financing to the private sector continued to expand at a modest rate. Although interest rates on government securities have declined considerably, this has not led to an equal reduction in commercial banks' rates.

III.2.1. Monetary Base, Net Domestic Credit and Net International Assets

During the second quarter of 2001, the monetary base stock remained stable and its nominal growth rate continued to decline. In June, the average stock of this aggregate registered a nominal annual increase of 10.4 percent, substantially lower than that observed in the same month last year (32.1 percent). This reduction was significantly larger than expected due to that fact that the expansion of economic activity was slower than what had been assumed in the preparation of the forecast published in the Monetary Policy Program. Thus, in the period under analysis there was an average –3.8 percent deviation from the aforementioned projection. Notwithstanding, the monetary base has risen year to date at a higher rate than economic activity, which implies that the process of remonetization observed since 1997 still continues, but at a slower pace.

From March to June 2001 the stock of net international assets held by Banco de México rose by 521 million dollars, a smaller figure than in the previous quarter (4.716 billion). This was mainly due to the Federal Government's demand for foreign currency that practically absorbed all the resources derived from the Central Bank's operations with Pemex. Therefore, net domestic credit fell by 53 million pesos in the second quarter of the year.

Table 8 **Monetary Base, International Assets and Net Domestic Credit**

Millions

	Stocks		Effective flows January-March 2001	Effective flows April-June 2001	Effective flows accumulated during the year 1/
	As of Dec. 30, 2000	As of Jun. 29, 2001			As of Jun. 29, 2001
(A) Monetary Base (Pesos)	208,943	180,734	-32,833	4,624	-28,209
(B) Net International Assets (Pesos) 2/	342,386	370,686	46,162	4,677	50,839
Net International Assets (U.S. Dollars) 2/	35,629	40,866	4,716	521	5,237
Change in Net International Assets			*4,716*	*521*	*5,237*
Pemex (U.S. Dollars)			*3,820*	*1,234*	*5,054*
Federal Government (U.S. Dollars)			*-238*	*-1,751*	*-1,989*
Purchases through options			*735*	*628*	*1,363*
Others (U.S. Dollars) 3/			*399*	*410*	*809*
(C) Net Domestic Credit (Pesos) [(A)-(B)] 1/	-133,443	-189,952	-78,995	-53	-79,048
Memorandum:					
(D) International Reserves 4/ (U.S. Dollars)	33,555	38,730	4,481	695	5,175

1/ In the estimation of effective flows in pesos of net international assets, the exchange rate applied to the operation generating each flow is considered. The difference between net international asset stocks in pesos does not correspond to the concept of effective flows, due to the fact that the stocks are valued at the exchange rate of the respective date. This also explains why the differential between net domestic credit stocks are not the same as the effective flows reported.
2/ Net international assets are defined as gross reserves, plus credit agreements with central banks with maturities of more than six months, minus total liabilities payable to the IMF, and minus credit agreements with central banks with maturities of less than six months.
3/ Mainly composed of dollar sales operations and interest earned on international assets.
4/ As defined in Banco de México's Law.

On May 18th, 2001, the Foreign Exchange Commission decided to suspend Banco de México's auctions of foreign currency put options until further notice. This came into force after the auction of June 29th, 2001.

This mechanism was considered to have successfully fulfilled the objectives for which it had been created. This mechanism allowed Banco de México to accumulate an important amount of international assets without creating distortions in the foreign exchange market, and helped to improve the terms under which the Federal Government can obtain domestic and external financing. Through this mechanism Banco de México purchased 12.117 billion dollars and as a result on June 29th, 2001, net international assets totaled 40.866 billion dollars. As has been mentioned previously, this is a historically high figure.

Consequently, it has been deemed convenient not to continue accumulating international assets via this mechanism.

In order to preserve the symmetry of the floating exchange rate regime in force, the Foreign Exchange Commission also decided to discontinue contingent dollar sales as of July 2^{nd}. Through the latter mechanism, the Central Bank used to auction 200 million dollars on a daily basis, at an exchange rate at least 2 percent higher than that observed on the previous business day.

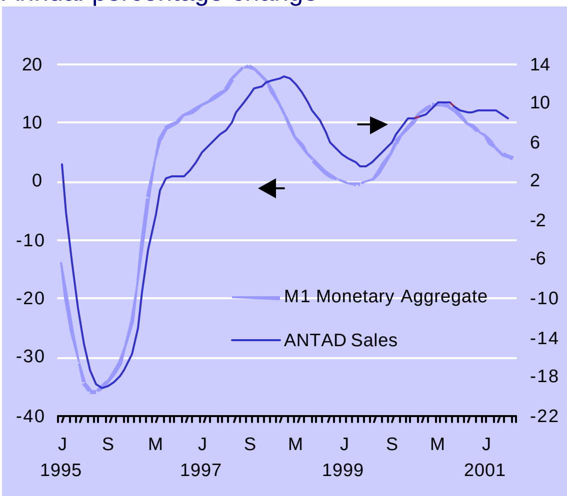
III.2.2. Monetary Aggregates M1 and M4

The growth rate of the narrow monetary aggregate M1 decreased during the second quarter of the year. This evolution is compatible with that for consumption (Chart 15), due to the fact that this monetary aggregate reflects the public's demand for liquidity, which to a great extent responds to their need to carry out transactions. In addition, the behavior of checking accounts denominated in foreign currency reflected a less vigorous foreign trade.

During the period under analysis, the real growth rate of the broad monetary aggregate M4 was very similar to that observed in the first quarter of 2001. One component of M4 that continued to expand vigorously was holdings of government securities by non-residents, which rose by 9.5 thousand million pesos from December 2000 to June 2001 (a 51.5 percent increase). The growth of investment by non-residents in government securities can be explained, to a great extent, by improvements in Mexico's country risk perception.

Chart 15 **Narrow Monetary Aggregate and Economic Activity**

Trend of the M1 Monetary Aggregate and ANTAD Sales
Annual percentage change



Trend of the Stock of Checking Accounts in Foreign Currency and Foreign Trade (Imports plus Exports)

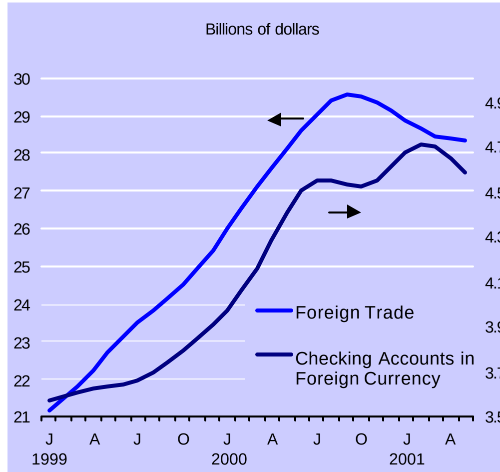


Table 9 **Monetary Aggregates**

Real annual percentage change

	2000				2001	
	I	II	III	IV	I	II
M1	**11.17**	**13.54**	**12.25**	**7.87**	**6.75**	**3.43**
Bills and Coins held by the Public	15.19	20.49	16.21	8.58	7.35	3.13
Checking Accounts 1/	9.44	10.66	10.64	7.56	6.48	3.57
M4	**7.86**	**8.07**	**6.91**	**6.20**	**6.44**	**6.49**
Bills and Coins Held by the Public	15.19	20.49	16.21	8.58	7.35	3.13
Bank Deposits	-3.76	-4.22	-9.64	-11.48	-10.32	-7.33
Public Securities 2/ 3/	42.24	34.25	41.59	41.06	37.08	30.39
Private Securities 3/	-0.01	16.99	33.02	33.08	19.99	10.58
Retirement Funds (excluding Siefores) 4/	14.32	15.44	17.23	17.23	18.26	17.26

1/ Including current account deposits.
2/ Including securities issued by the Federal Government, BPAS and BREMs.
3/ Including securities held by Siefores (specialized retirement funds).
4/ Including housing funds and Banco de México's retirement funds.

III.2.3. Financing Granted to the Private Sector

The incipient recovery of bank credit that began at the end of the previous year continued in the second quarter of 2001. This can be seen in the evolution of the performing loan portfolio[9], which is growing at positive real annual rates (Chart 16). This is partly a reflection of the granting of new credit by commercial banks. Furthermore, when the performing loan portfolio is divided by type of credit, it can be seen that credit for consumption is

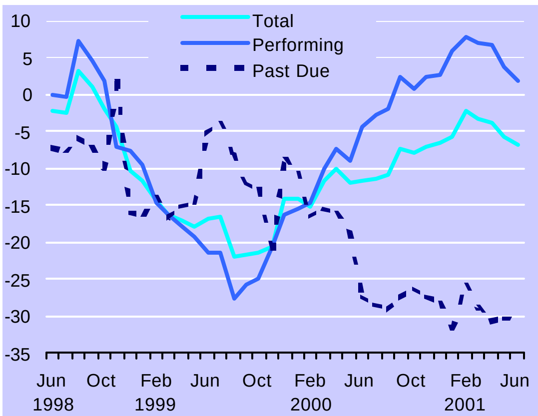
[9] Refers to the commercial banks' own portfolio, which excludes loans related to the IPAB-Fobaproa notes and Cetes-UDIS.

expanding at high real rates while that granted to firms and individuals with entrepreneurial activities is rebounding.

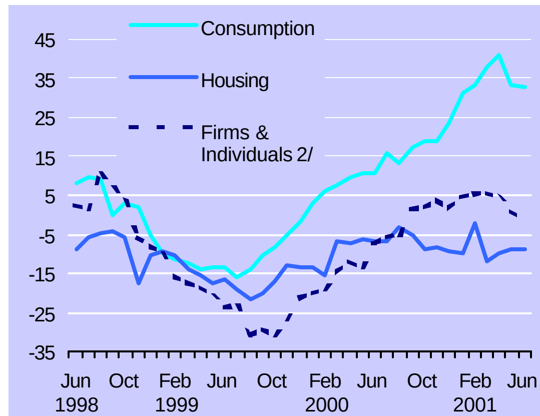
Chart 16 **Credit Granted by Commercial Banks to the Private Sector**

Real annual percentage change

Total Credit, Performing and Past Due



Performing Loan Portfolio by Destination 1/



1/ Refers to commercial banks' own portfolio that excludes the portfolio associated with debtor support and bank restructuring programs. (IPAB-FOBAPROA and Cetes-UDIs).

2/ Firms and individuals with entrepreneurial activities. Does not include credit granted to non-bank financial intermediaries.

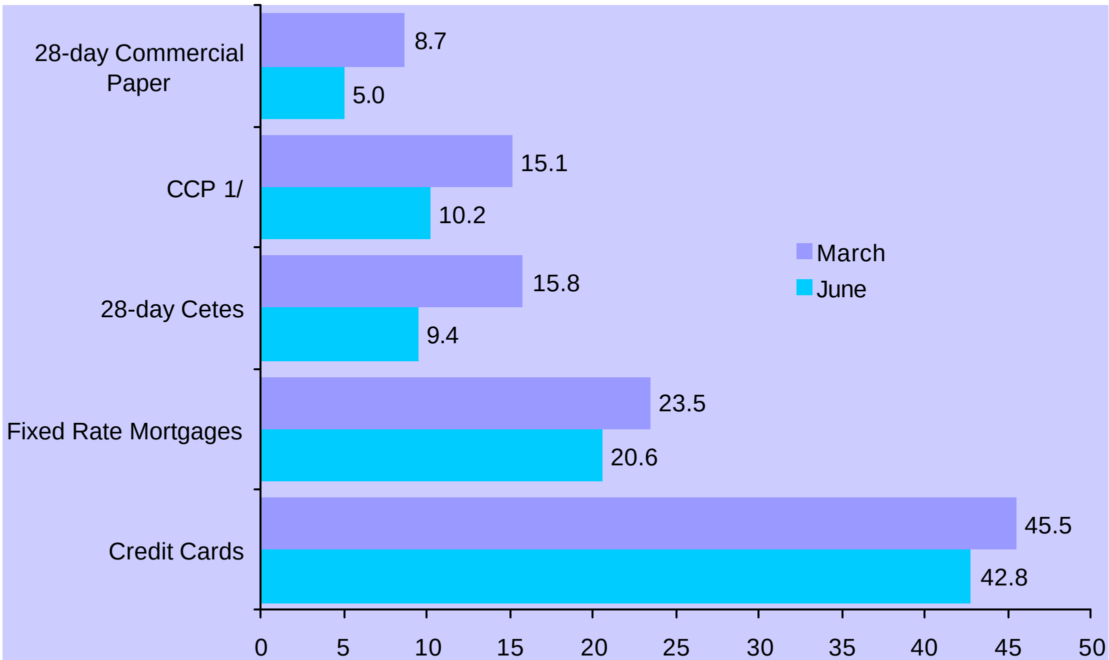
The most vigorous component of consumer credit is credit cards. Credit granted by commercial banks for housing remains practically at the same levels that prevailed at the start of the year. This is in contrast to financing granted by SOFOLES. During the January-May period the latter institutions channeled 5,379 million pesos towards housing, which implied an annual growth rate of 19.2 percent.

Interest rates on government securities decreased considerably in the second quarter of the year but this has not led to an equal reduction in commercial banks' lending interest rates, especially those applied to credit cards. In March and June the latter were at levels of 45.5 and 42.8 percent, respectively[10]. Commercial banks' lending interest rates still incorporate significant differentials vis-à-vis market rates on deposits, and in some cases are higher in real terms than the rates observed in the previous year (Chart 17).

[10] SOURCE: Infosel.

Chart 17 **Interest Rates in 2001**

Simple monthly average in annual percent



1/ The Average Cost of Term Deposits (*Costo de Captación a Plazo*, CCP) includes the interest rates on term deposits denominated in domestic currency and payable by commercial banks. It excludes convertible subordinated debt, guarantees and inter-bank operations.
SOURCE: Banco de México and Infosel.

IV. Private Sector Outlook for 2001[11]

IV.1. Forecasts for the Main Determinants of Inflation

The estimations of private sector analysts concerning the evolution of the external economic environment for the rest of the year did not change significantly during the quarter. The following forecasts deserve special mention:

(a) Mexican analysts' forecast for the annual growth of the United States' economy in 2001 was revised slightly downward, from 1.8 percent in March to 1.6 percent in June, while the average forecast by analysts from the United States for GDP growth in the second quarter of 2001 was 1.14 percent and 1.6 percent for the year as a whole[12]. The latter analysts expect that the United States' economy will grow 1.5 and 2.7 percent in the third and fourth quarters of 2001, respectively.

(b) Analysts' predictions for the average price of the Mexican crude oil mix for export in 2001 is 19.49 dollars per barrel. Taking into account WTI oil futures prices of 27.20 dollars per barrel (on June 29th) and the differential vis-à-vis the Mexican crude oil mix, an average price of 19.70 dollars per barrel can be expected for Mexican oil in 2001.

Expectations for the exchange rate were adjusted downward throughout the second quarter of 2001. Analysts also expect there will be a reduction in nominal contractual wage increases.

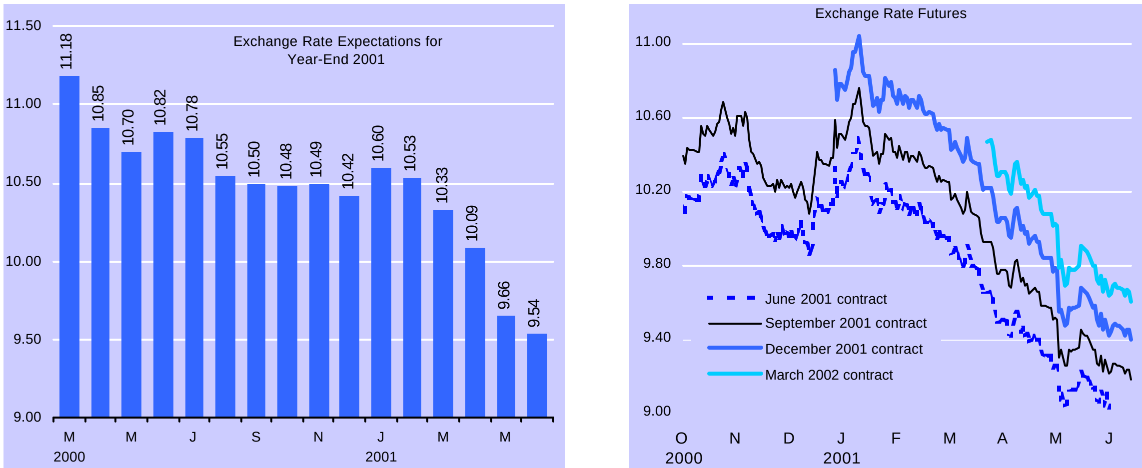
At the end of June the private sector anticipated an exchange rate of 9.54 pesos per dollar in December 2001, while on June 29th the peso futures prices for year-end 2001 were at 9.40 pesos per dollar (Chart 18).

[11] Unless otherwise stated, the forecasts reported in this section are taken from the Survey of the Expectations of Private Sector Economic Specialists conducted each month by Banco de México.

[12] SOURCE: Consensus Forecast. The forecast for the second quarter refers to the annualized quarterly growth of the seasonally adjusted series.

Chart 18 **Futures Prices for the Peso and Exchange Rate Expectations for Year-end 2001**

Pesos per dollar



SOURCE: Bloomberg and Survey of the Expectations of Private Sector Economic Specialists, Banco de México.

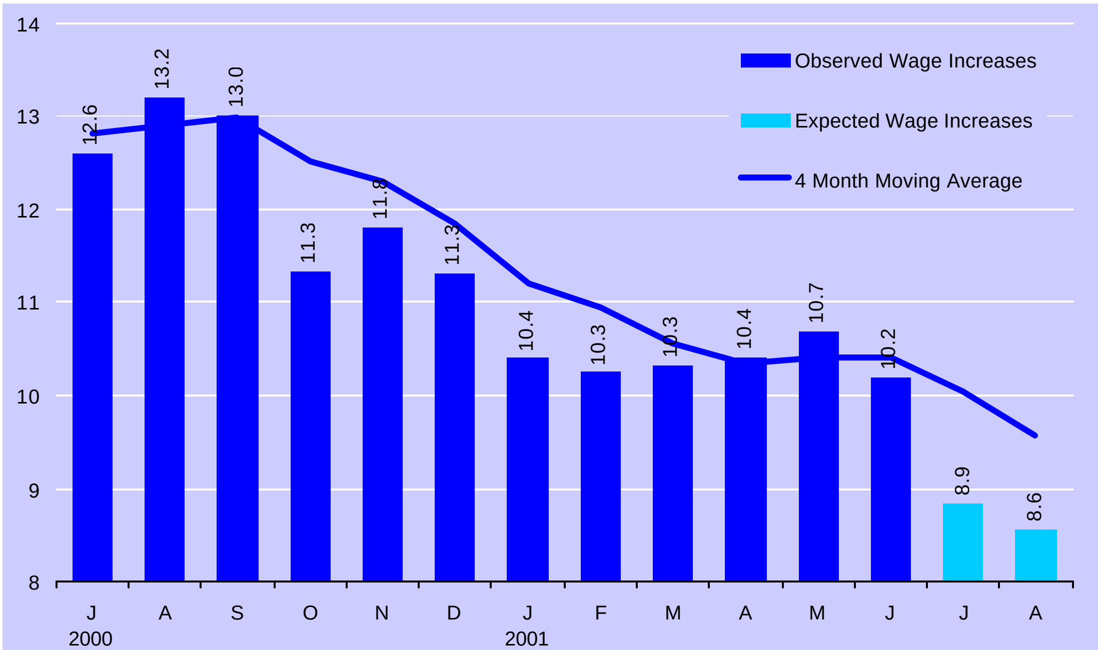
Analysts forecasted that nominal contractual wage increases would be 8.9 and 8.6 percent in July and August 2001, respectively (Chart 19).

Regarding the expected evolution of the prices of goods and services provided or regulated by the public sector, analysts anticipate that those prices shall adhere to the program established in this year's Economic Policy General Criteria (*Criterios Generales de Política Económica*).

Analysts who took part in the survey expect Mexico's real GDP growth rate to be 2.07 percent in 2001, below the 3.28 percent estimate reported in March. In turn, the June survey reported trade and current account deficits below those estimated in March; thus, the trade deficit forecast fell from 12.013 to 11.359 billion dollars, while the current account deficit did so from 21.956 to 20.866 billion dollars. In addition, analysts estimate a 6 percent increase in non-oil exports and a 16.5 percent decline in oil exports for 2001. Regarding imports, an expansion of 6.7 percent is foreseen over the same period. Finally, the analysts surveyed revised their estimates of foreign direct investment inflows for the year upwards, from 13.274 billion dollars in March to 17.615 billion in June.

Chart 19 **Contractual Wage Increases**

Percent



SOURCE: Ministry of Labor. For April and May of 2001, information was taken from the forecasts reported in Banco de México's Survey of the Expectations of Private Sector Economic Specialists.

Both the business climate and business confidence indicators are still not very optimistic, although in June there was a slight improvement vis-à-vis those registered in March. Seventeen percent of the analysts who took part in the survey considered that the business environment will be favorable over the next few months, while 52 percent thought it will remain unchanged and the rest believed it will deteriorate.

According to the results of the survey, the four main factors that could hamper Mexican economic activity over the following six months are as follows: weaker external markets and world economy (30 percent of all responses); the appreciation of the real exchange rate (13 percent); the shortage of domestic financing (12 percent); and the weakness of the domestic market (8 percent).

IV.2. Private Sector Inflation Expectations

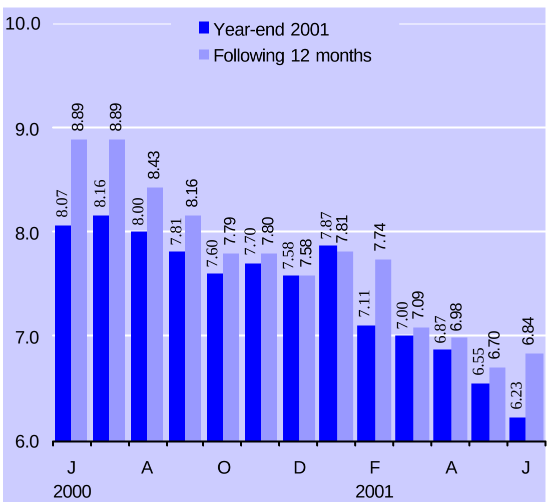
In the survey conducted in June, monthly inflation forecasts for July, August and September were 0.41, 0.48 and 0.78 percent, respectively. This implies that annual inflation will remain practically stable during the quarter.

Analysts also adjusted their inflation expectations for the following 12 months from 7.09 percent in March 2001 to 6.84 percent in June, and from 7 to 6.23 percent for year-end 2001. Taking into account the likely effects of an eventual approval of the Fiscal Reform in the current year, the consultants have estimated a 7.95 percent inflation rate for the following twelve months and 7.64 percent for the end of this year. Annual inflation for 2002 is forecasted at 5.64 percent, lower than the 5.91 percent reported in March (Chart 20).

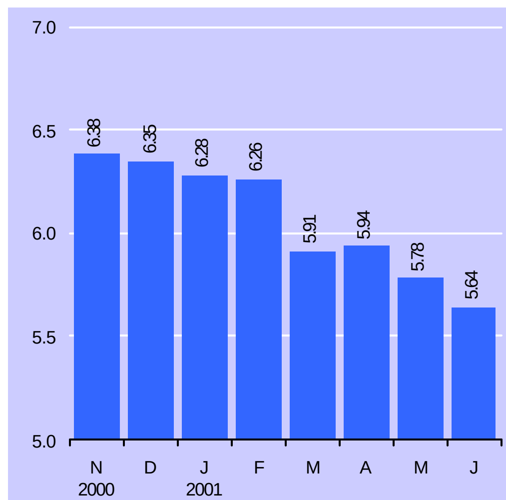
Chart 20 **Evolution of Inflation Expectations**

Annual percentage change

Year-end 2001 and the Following 12 months



Year-end 2002



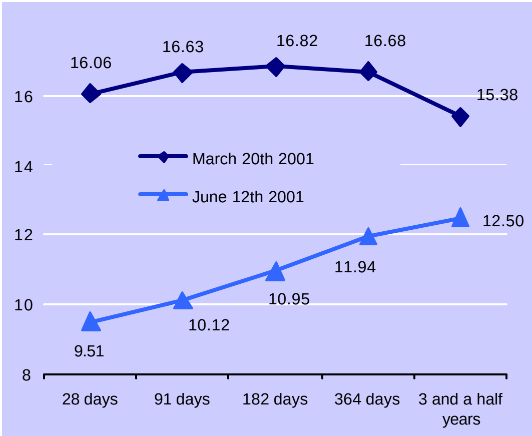
SOURCE: Survey of the Expectations of Private Sector Economic Specialists, conducted by Banco de México.

Finally, the nominal Cetes yield curve confirms that there has been a significant downward adjustment of inflation expectations (Chart 21).

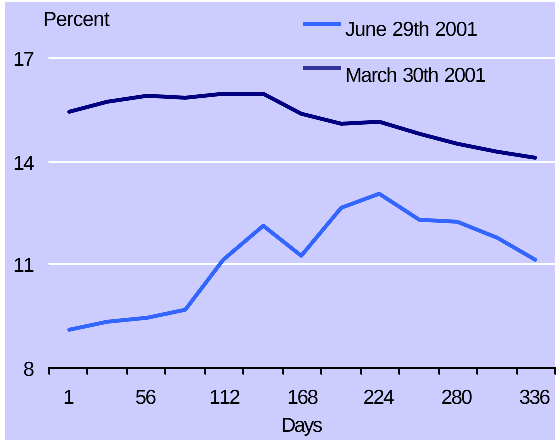
Chart 21 **Nominal Cetes Yield Curve and Forward Rates**

Percent

Primary auction rates for Cetes *



Forward rates



* The 3 and a half year instrument is a bond issued with fixed-rate coupons.

V. Balance of Risks and Conclusions

As anticipated in the Monetary Program for 2001, in the first six months of the year the evolution of the Mexican economy and inflation was determined by the following three factors:

(a) the slowdown of the United States' economy and its repercussions on the world economy;

(b) weaker domestic demand; and

(c) the availability and favorable terms of external financing.

The decline in the rate of economic growth in the United States has been greater than originally foreseen and its impact on Mexican exports and industrial output has also been more severe. As previously mentioned in this Report, the close integration of the Mexican and the United States' manufacturing sectors explains the strong correlation between industrial activity levels in both countries as well as the rapid transmission of the effects of the economic downturn in the United States.

The growth rate of almost all the components of aggregate demand fell considerably due to the weakening of Mexico's industrial sector. Using seasonally adjusted figures, available information suggests that domestic demand growth was less than that of domestic supply in the first half of the year. As a result, the trade deficit was smaller in seasonally adjusted terms. These factors have also translated into lower than expected demand for external resources.

During the first quarter, Mexico received a plentiful supply of external resources, which reflected various factors among which the following are noteworthy:

(a) favorable market perceptions regarding the Mexican authorities' firm commitment to strengthening macroeconomic stability;

(b) the recent slowdown of economic activity has not affected the medium and long term outlook for the Mexican economy;

(c) expectations of a successful outcome for the fiscal reform and that progress will be made in the area of structural reform in the near future; and

(d) the reduced financial vulnerability of the national economy.

The combined effect of a smaller demand for external resources and an increased supply thereof has led to the appreciation of the exchange rate and has contributed to the stability of the main financial variables.

It can therefore be said that the Mexican economy has entered the trough of the economic cycle in an orderly fashion. This phase has been transmitted from the United States to the world economy and has had a greater effect in those nations that are more closely linked commercially to that country. This environment has contributed to the decline of domestic inflation and partly explains why both core and overall inflation fell in the second quarter of the year.

Furthermore, due to the fact that the inflationary pressures that had been anticipated at the start of the year did not materialize, domestic interest rates dropped considerably during the quarter. The decline was validated by the monetary authority when it modified the "short" on May 18th. In this way the orderly insertion of the Mexican economy into the downward phase of the economic cycle has allowed a substantial abatement of both real and nominal interest rates.

The Mexican economy's evolution over the last few months suggests that annual growth will be lower than that reported in the previous quarter's Inflation Report. It is also likely that the inflation target for 2001 will be met. The main elements that make up Banco de México's base scenario for the evolution of the domestic economy for the remainder of the year are shown below. In terms of the international environment, a very similar evolution to that seen in the previous Report is expected:

(a) Forecasts for the expansion of the United States' economy for 2001 fall within an interval of 1.2 and 1.8 percent. In quarterly terms, said economy is expected to have grown at a lower rate in the second quarter than in the first quarter, and that it will rebound in the last two quarters of the year;

(b) Based on WTI oil futures prices and the differential between this price and that of the Mexican crude oil mix for export registered in June, it is estimated that the average price of the Mexican mix in 2001 will be 19.70 dollars per barrel (higher than March's estimate of 18.30 dollars); and

(c) The evolution of foreign capital inflows suggest that the current account will be mainly financed with long term resources in 2001. On the other hand, events in Argentina could have a transitory effect on portfolio investment flows.

Based on the above and on the leading indicators available to date, a forecast for the paths of the main macroeconomic variables for the rest of the year was prepared. The main results of this prognosis are presented below:

(a) The annual growth rate of real GDP will be significantly lower in the second quarter than it was in the first. It is also estimated that GDP growth will be below 2 percent for the year as a whole. This scenario anticipates a recovery of the annual growth rate in the last two quarters of the year;

(b) Inflationary pressures will be weaker than had been originally expected due to the observed appreciation of the exchange rate, the deceleration of output and weak demand in the labor market. A further reduction of both overall and core inflation is expected in the third quarter, and it is very likely that annual INPC inflation will be below core inflation; and

(c) The slowdown of aggregate demand will be compatible with the expected reduction in the current account deficit in 2001. As a result, the current account deficit will probably be around 3 percent of GDP.

The base scenario assumes that nominal contractual wage increases will decline in the next few months in response to weaker economic activity, the deterioration of conditions in the labor market and the improvement of inflation expectations. However, contractual wage revisions carried out in June (10.2 percent increase) do not point towards the fulfillment of the aforementioned assumption. Thus, real wage increases to date continue to be incompatible with the evolution of productivity gains. Although the unfavorable effect that rising unit labor costs have on inflation might be to some extent mitigated, they would hinder the recovery of employment. It is very likely that some of the job losses that have already been reported could have been a consequence of contractual wage revisions incompatible with the inflation target and expected productivity.

It is foreseeable that as the world economy recovers throughout the year 2002, real GDP growth rates in Mexico will return to levels similar to its potential. In order for this scenario to materialize as fast as possible, far reaching structural reforms to make the economy more flexible and increase the supply of infrastructure and inputs essential for a more efficient production process will be instrumental. This flexibility will allow the domestic production base to become more competitive in the global economy and allow companies to make the necessary adjustments to face changes in relative prices.

The main external risks considered in the base scenario are:

(a) a more pronounced deceleration (or a slower recovery) of the United States' economy;

(b) a drastic fall in international oil prices; and

(c) a disorderly outcome to the situation in Argentina, which could call into question the ability of international financial authorities to manage crises in emerging markets.

The consensus among analysts that follow the United States' economy is that growth will recover in the third quarter of 2001. Despite this, the likelihood that the recovery might be delayed cannot be ignored and depends largely on the evolution of private consumption in that country. Should the aforementioned delay occur, economic growth in Mexico in 2001 would be lower than that assumed in the base scenario and there would be a greater loss of jobs. In this context, inflation would be expected to decline faster than originally foreseen. This projection is supported by the high degree of synchronization between economic activity and domestic demand in Mexico and economic activity in the United States —this synchronicity would curb the growth of the current account deficit as well as the inflationary pressures associated with disorderly movements of the exchange rate.

Both the fall of oil prices and the transmission of the crisis in Argentina towards Mexico could lead to an unexpected depreciation of the exchange rate. Depending on how disorderly the depreciation could be, and the extent to which the latter could unfavorably affect the formation of inflation expectations, a more restrictive monetary policy stance could be required in order to attain the proposed inflation targets.

Upon the publication of this Report, the main domestic risk factors that could lead to changes in the base scenario are:

(a) The rejection of the fiscal reform bill —or the passing of a version with a tax collection impact lower than what has been anticipated by the markets— could lead to a drastic deterioration of expectations; and

(b) If the slack currently observed in the labor market were not promptly reflected by contractual wage revisions more in line with the inflation target for 2002 and with foreseeable gains in labor productivity.

Recent crises in some 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 the fiscal reform by the Mexican Congress would strengthen public finances, diminish their dependence on oil revenues and reduce the Government's financing requirements. Thus, this reform is needed to make an important contribution to the disinflation process and assure its success.

As has been reiterated on many occasions, nominal contractual wage increases that are incompatible with the sum of the inflation target and foreseeable gains in labor productivity not only generate inflationary pressures but also have a negative impact on job creation and corporate profits. If this gap continues, the monetary policy stance would have to be tightened in order to induce compatibility between those variables, increase the likelihood of attaining the medium term inflation targets, and help employment recover more swiftly.

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The above base scenario presents a more optimistic view of the possible evolution of overall inflation than in previous Reports, while the risks that could threaten this scenario are more balanced. In light of this outlook, the Board of Governors of Banco de México believes that the less restrictive monetary conditions prevailing at present —as a result of the substantial reduction in real interest rates— are compatible with the short and medium term inflation targets.

Notwithstanding, the Board of Governors does not underestimate the importance of the transitory factors that have led to a swifter fall of overall inflation as compared to core inflation. For example, the favorable effect on overall inflation of the sub-indices for agricultural and livestock products and for prices of goods and services provided or regulated by the public sector. Yet, the Board is also aware of the almost complete cancellation of the positive effect of the appreciation of the exchange rate on core inflation caused by the downward rigidity of nominal wage increases.

The moderation of wage increases is essential to recover the jobs that have been lost and generate new ones on a sound basis, once the Mexican economy regains its potential growth rate.

Therefore, inasmuch as the still pending structural reforms are implemented and the attainment of inflation targets is pursued, macroeconomic stability will become increasingly robust. As a result, the economy will have a greater capacity to respond and recover when faced with external and domestic shocks, while the possibilities for long term growth would be improved. Nothing should be more urgent than the removal of those factors that continue to interfere with the consolidation of an environment conducive to continuous improvements in the well being of the population. The opportunity to achieve this is at hand and should not be wasted.