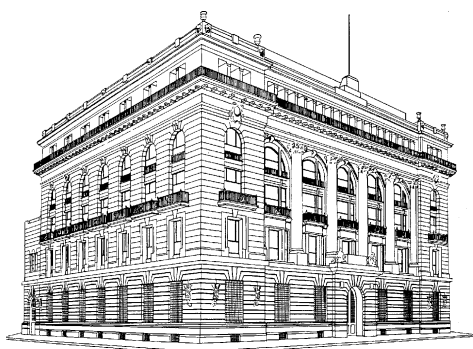


Inflation Report

April – June 2000



BANCO^{DE}MEXICO

JULY, 2000

BOARD OF GOVERNORS

Governor

GUILLERMO ORTIZ MARTÍNEZ

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FOREWARNING

Unless otherwise specified, this document is prepared using data available as of July 19, 2000. Figures are preliminary and subject to change.

Banco de México has always given the utmost importance to the publication of information that will help decision-making and allow the public to evaluate the execution of its policies. This text is provided only as a convenience to the reader, and discrepancies could eventually arise from the translation of the original document into English. The original and unabridged Inflation Report in Spanish is the only official document.

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I. Introduction

The performance of the Mexican economy over the last six months surpassed both public and private sector's expectations. A stronger than anticipated growth resulted from a dynamic external demand and a quite vigorous domestic spending. Although the drop in inflation this year has been greater than expected, price growth is still significantly higher than in industrialized countries. The current inflation level and the still insufficient downward adjustment in inflation expectations for the year 2001 are the main reasons why the Board of Governors of Banco de México has maintained—and even tightened—the monetary policy restrictive stance.

World economic growth has also proved to be stronger than forecasted when the Inflation Report January-March 2000 was published. Growth in emerging market and European economies has accelerated, while the pace of economic expansion in the United States has yet to provide conclusive evidence of slowing down. On the other hand, Japan is still caught up in a delicate situation.

The current pace of global economic expansion implies a potential risk of inflationary pressures. This is especially true for the United States' economy, in which the evidence of a slowdown is still tentative. Besides, owing to the sharp increase in international oil prices, consumer prices have risen in most oil importing countries.

These events stress the need to closely watch the evolution of the various risk factors, both external and internal. In this regard, it is worth to mention the events that could have an effect on the conduction of monetary policy and, particularly, lead to a more restrictive stance. Firstly, the vigorous expansion in Mexican aggregate demand could continue outpacing forecasts, especially within the current context characterized by economic agents' confidence and optimism. Secondly, although the latest data are reassuring, the eventual accumulation of inflationary pressures in the United States may not be discarded. Lastly, the capacity shown by the Mexican economy to produce goods and services without worsening inflationary pressures could be coming to an end.

This document intends to provide a response to these questions and their implications. The purpose is to share with the

public the outlook that serves as the basis for decision-making regarding economic policy.

II. Recent Evolution of Inflation

This section gives an account of the most noteworthy aspects of the performance of inflation for the second quarter of the year 2000, and the main factors determining it.

II.1. Quarterly Performance of Inflation

Inflation performed favorably during the period. This assertion is based on the analysis of the various price indices, whose major results are as follows:

- (a) the annual inflation trend has kept falling since February last year, having attained a rate below 10 percent several months in advance;
- (b) the decline in overall annual inflation has toned down owing to a rebound in the rate of inflation of agricultural and livestock products and goods provided or regulated by the public sector;
- (c) the various measurements of medium-term inflation trend showed a downward trend for the quarter;
- (d) the annual core inflation continues to decline at a rate similar to the one observed over the last few months, and is now below the inflation rate of the National Consumer Price Index (INPC); and
- (e) the annual core inflation rate for goods has been the lowest over the last 78 months and considerably lower than core inflation for services. This performance suggests that exchange rate adjustments observed during the quarter have not affected price growth.

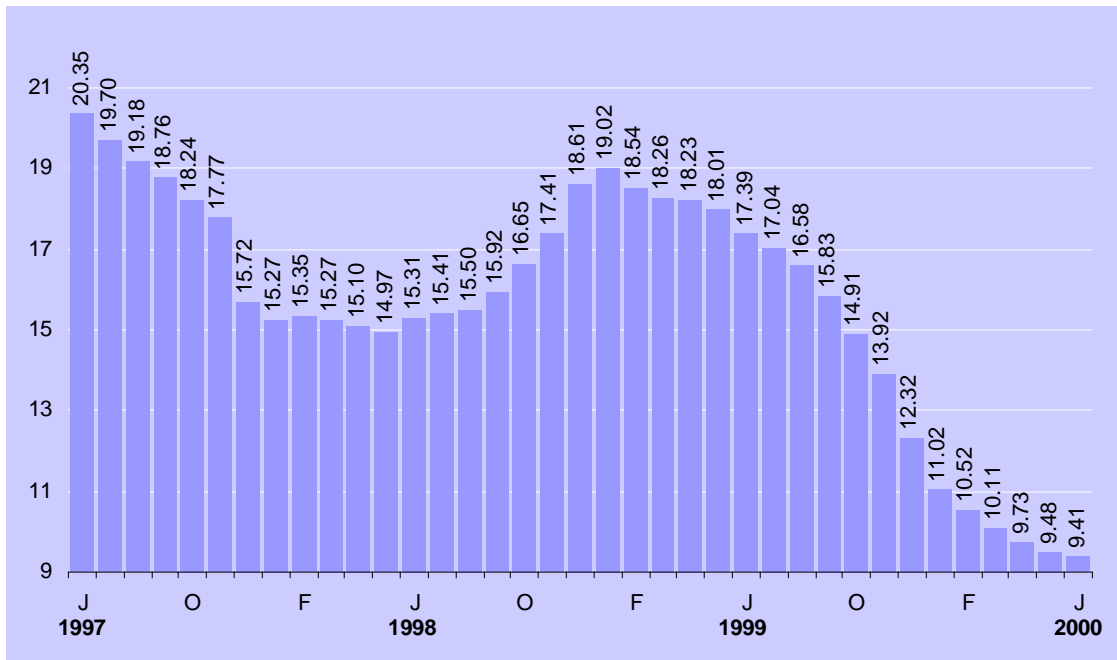
On the other hand, the annual growth rate of the National Producer Price Index (INPP) excluding crude oil and services rose over the second quarter.

Following is a description and analysis of the evolution of the various price indices over the April-June period.

II.1.1. National Consumer Price Index

As anticipated in the Inflation Report January-March 2000, annual inflation significantly decreased in the second quarter of the year. Furthermore, accumulated inflation was lower than that observed over the same period in 1999 and in the first quarter of 2000. In June of this year annual inflation closed at 9.41 percent (Graph 1).

Graph 1 National Consumer Price Index (INPC)
Annual change in percent



The general price level growth posted in April and May was below the figure expected by private sector analysts (Table 1). In contrast, inflation in June outpaced forecasts due to the increase in the prices of agricultural and livestock products, mainly fruits and vegetables.

Table 1

Observed and Expected INPC Inflation in the April-June Period

Change in percent

	2000		1999	
	Monthly Inflation		Monthly Inflation	
	Observed	Expected 1/	Observed	Expected 1/
April	0.57	0.66	0.92	0.95
May	0.37	0.53	0.60	0.86
June	0.59	0.52	0.66	0.78

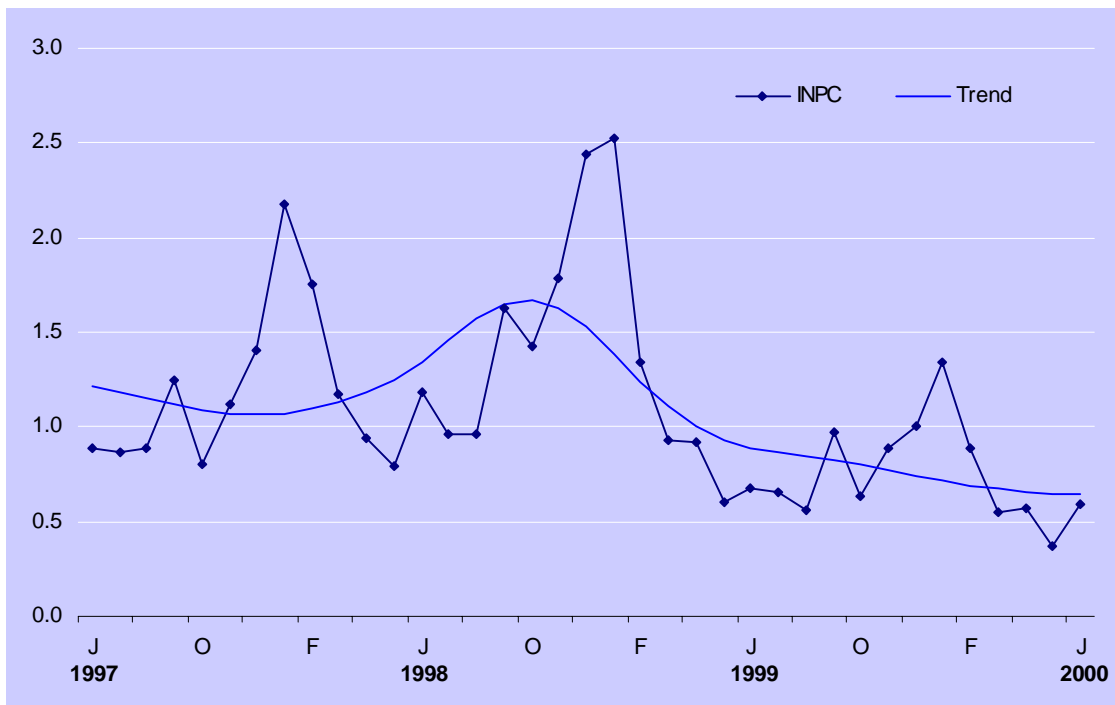
1/ Inflation rate expected at the end of the preceding month, according to Banco de México's Survey of the Expectations of Private Sector Economic Specialists.

During the April-June period, monthly inflation continued on its downward trend (Graph 2). Although quarter results were strengthened by favorable seasonal factors, the trend¹ series for this indicator showed a clear drop as well.

Graph 2

National Consumer Price Index (INPC)

Monthly change in percent

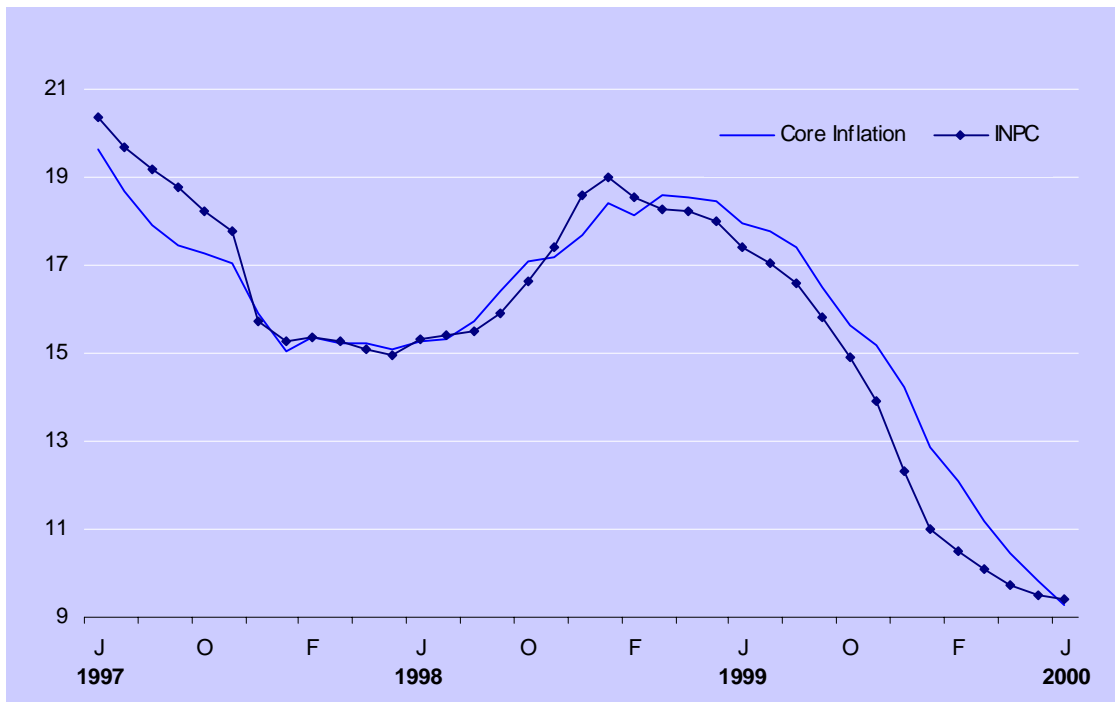


¹ Calculated using the X12 ARIMA statistical procedure. This method smoothes the original series by using moving averages.

II.1.2. Core Inflation

An indicator used by Banco de México to identify medium-term inflationary pressures is core inflation². During the second quarter, this indicator had a sharper decline than INPC inflation. The trend of core inflation confirms that the disinflation process that started in early 1999 reflects the performance of most of the prices of the various goods and services included in the INPC basket rather than the slower growth of only a subset of them. In June 2000, the annual growth rate of the core price index came in at 9.29 percent, while in March it had been 11.16 percent (Graph 3).

Graph 3 National Consumer Price Index (INPC) and Core Price Index
Annual change in percent



- (a) annual inflation for agricultural and livestock product prices closed in June at only 3.91 percent (Table 2). Nevertheless, upon examining the corresponding index's quarterly growth, it can be seen that their favorable performance was interrupted in the April-June period, in which the accumulated growth rate came to 4.60 percent and surpassed the INPC's growth rate (1.54 percent);
- (b) quarterly inflation for the prices of goods and services provided or regulated by the public sector was below that reported in the first quarter of the year owing to the seasonality of electricity fares; nevertheless, the rate was higher than in the same period of the previous year. Therefore, the annual growth rate of these prices' index rose between March and June of this year; and
- (c) the annual rise in education prices declined slightly during the quarter. Nonetheless, the high rate reported still reflects increases in education services that took place in September 1999.

Recent trends of the prices of goods and services provided or regulated by the public sector, as well as agricultural and livestock products, are the major reason why the decline in general inflation has slowed down, since the reduction in core inflation has kept its pace. This has led to a situation where the core inflation rate is at a lower level than overall inflation.

Table 2 Price Indices: INPC, Core Inflation, Agricultural and Livestock Products, Education, and Prices of Goods and Services Provided or Regulated by the Public Sector

Change in percent

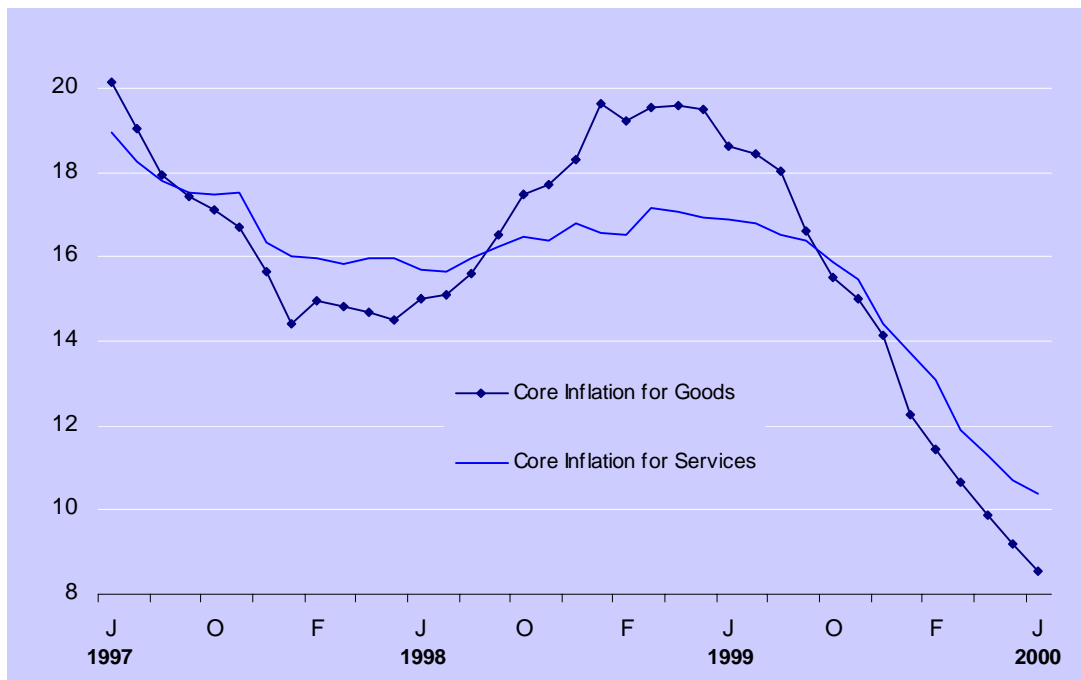
	Annual Change			Quarterly Change		
	June 2000 /	March 2000 /	June 1999 /	June 2000 /	March 2000 /	June 1999 /
	June 1999	March 1999	June 1998	March 2000	Dec 1999	March 1999
INPC	9.41	10.11	17.39	1.54	2.81	2.19
Core Inflation	9.29	11.16	17.94	1.38	3.21	3.12
Agricultural & Livestock	3.91	-0.17	13.88	4.60	-0.84	0.49
Education	17.66	17.98	17.52	0.71	1.82	0.99
Provided & Regulated by Public Sector	12.54	12.31	17.91	0.32	3.96	0.11

In order to more accurately identify the main causes of higher prices, it is useful to divide the core inflation index basket

into two categories: goods and services³. In the April-June period, annual core inflation for goods was lower than for services (Graph 4). This result reflects the influence of a stable exchange rate on the recent decline in inflation. Annual core inflation for goods came in at 8.55 percent as of June 2000, compared to 10.67 percent at the end of the previous quarter. The downturn in inflation is also evident in the services sector, where prices have followed the trend of goods prices. In June 2000 the annual core inflation rate for services was 10.39 percent, compared to 11.89 percent reached in March 2000. The evolution of prices in the services sector has been positive and shows a clear downward trend, although its growth rate is still above 10 percent owing to the effects of the yet incomplete convergence of inflation expectations with the announced target, which had an impact on contractual wage revisions.

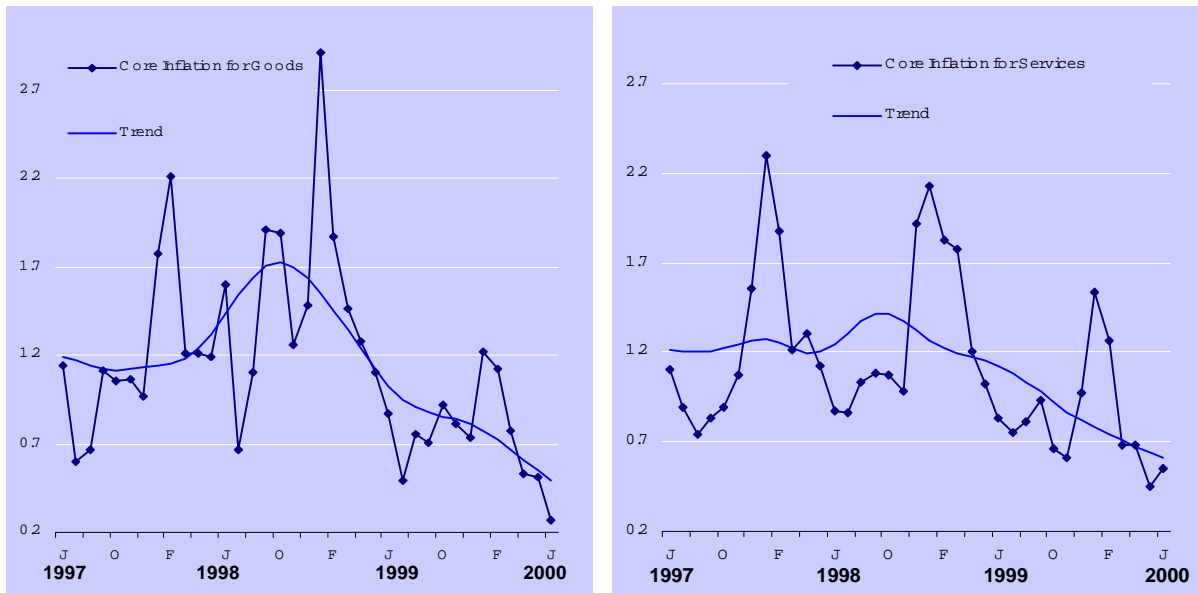
The outlook for monthly core inflation for both goods and services is similar. In June they reached 0.22 and 0.55 percent, respectively. During the second quarter, these two inflation indicators continued along their downward trend (Graph 5).

Graph 4 Core Inflation for Goods and Services
Annual change in percent



³ The prices of goods are very sensitive to exchange rate fluctuations since they are by large traded internationally. Conversely, since services are essentially non-tradables, their prices reflect mainly inflation expectations and the evolution of wages.

Graph 5 **Core Inflation for Goods and Services**
Monthly change in percent



II.1.3. National Producer Price Index (INPP)

Changes in the INPP excluding oil and services may be an advanced indicator of inflationary pressures. Consequently, the recent rise in this index's annual inflation, from 7.53 percent in March to 8.59 percent in June, is a warning signal regarding the possible future evolution of overall inflation (Graph 6). Although the rebound in the INPP inflation excluding oil and services is accounted for mainly by an increase in the prices of agricultural and livestock products, the annual growth rate of producer prices in the manufacturing industry also rose from 8.16 percent in March to 8.47 percent in June, which could have been due to hikes in the prices of certain production inputs, such as fuel and labor. If this were the case, it would be one of the first signs of aggregate demand pressures resulting in higher prices.

In brief, during the second quarter annual consumer inflation was below 10 percent, for both the overall and core price indices. Therefore, the target proposed for the year as a whole will likely be attained with a certain margin to spare. During the April-June period, the downward trend in inflation consolidated, confirming that the disinflation process had covered the various goods and services comprised in the INPC basket. Over the period under analysis, however, three unfavorable phenomena occurred:

electoral process in Mexico, gave rise to a sharper than expected depreciation of the domestic currency. Nevertheless, the depreciation observed in June was completely reversed after the July 2 elections had been carried out normally;

- (b) contractual wage revisions did not fully incorporate the downward adjustment in inflation expectations;
- (c) the still vigorous growth in aggregate demand is a component increasing the vulnerability of the disinflation process; and
- (d) inflation has been negatively affected by higher prices for domestic gas and agricultural and livestock products.

II.2.1. External Environment and the Exchange Rate

The evolution of international financial markets determines to a large extent the terms and amounts of external financing available to the Mexican economy. In addition, the economic situation prevailing in Mexico's major trading partners and the international prices for raw materials are some of the factors affecting Mexican exports. The availability of external financing and the performance of exports affect the supply of foreign currency, which together with the demand for it determine the exchange rate. The latter variable is among the most important to influence the course of inflation.

In the second quarter of 2000, the evolution of the external environment was less favorable than that prevailing over the previous quarter. Several factors, positive as well as negative, were critical in determining said environment. On the one hand, high international oil prices continued to boost the Mexican trade balance. On the other hand, more expensive oil and the economic momentum of the main developed countries heightened uncertainty regarding the possible emergence of inflationary pressures and, consequently, regarding the actions the Federal Reserve and the European Central Bank could take. This situation affected international financial markets and had repercussions for domestic markets. Although the robust growth of the United States' economy has continued, some indicators of its performance released in the second half of the quarter indicate that the economic activity in that country has begun to ease off. Should this trend be confirmed, it

would be more likely that the United States' economy could perform a "soft landing" toward its long-term growth rate, which has been estimated between 3.5 and 4 percent. Although in the short-run this outcome would decelerate the Mexican economy, the most desirable scenario for the world economy as well as for the Mexican economy would be for the United States to return to a sustainable economic growth rate without falling into a recession.

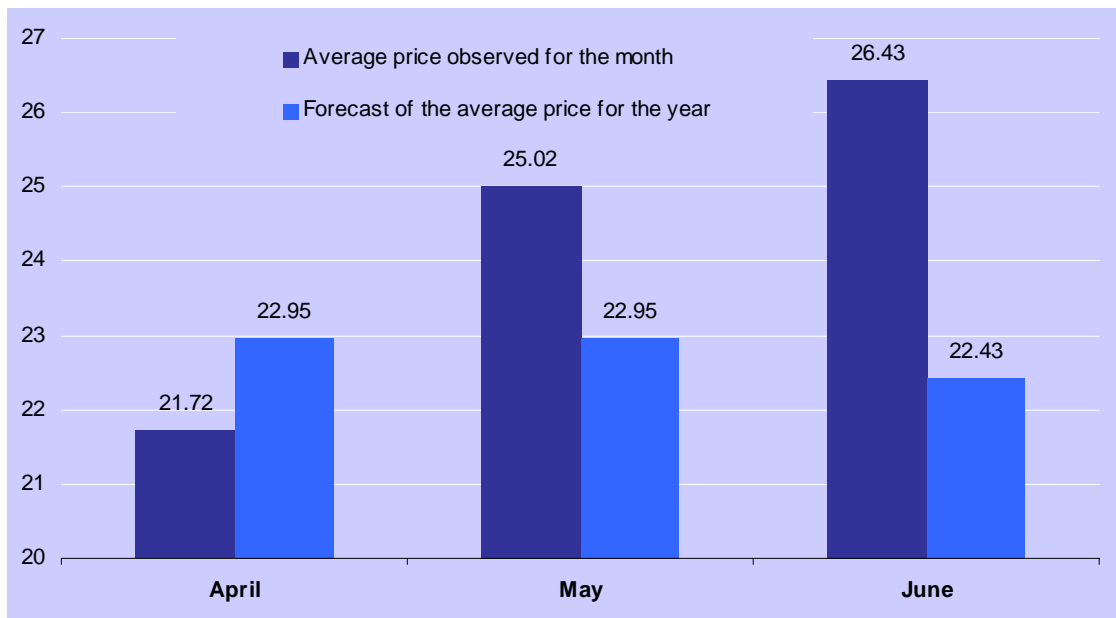
II.2.1.1. Oil Price

During the second quarter of 2000, the price of Mexico's oil export mix was higher than the average price that had been anticipated at the beginning of the quarter, and above the price used in preparing the federal budget as well. From the historic high reached in March, the average price came to 21.72 dollars per barrel in April, and subsequently increased considerably to 26.43 dollars per barrel in June (Graph 7). High oil prices account for the 99.6 percent annual growth in oil exports posted in June. This result contributed to contain the expansion of the trade deficit and provided stability to the exchange rate, as will be explained further below. However, the negative effects of high oil prices on world economic growth and on inflation have an impact on international interest rates, which in turn influence capital flows to emerging market economies. Through this second mechanism, oil price hikes unfavorably affect the domestic economy. Nonetheless, thus far the effect of the increase in oil prices has been positive for the Mexican economy.

Graph 7

Price of the Mexican Oil Mix for Export in 2000

Dollars per barrel



Source: Pemex for the observed price. The oil price forecast is estimated using the WTI 's futures price and the spread between the latter and the Mexican mix for export.

II.2.1.2. Evolution of the United States' Economy

In the first quarter of the year the United States' economy grew 5.5 percent in real terms. This high expansion rate was significantly influenced by a 7.7 percent annual increase in private consumption. Indicators of this economy's performance released during the third week of May revealed that the vigorous expansion observed in the first quarter continued. Although a slight slowdown was anticipated —resulting essentially from the reversion of seasonal phenomena— over the following months uncertainty about the possible surge of inflationary pressures in the United States and an eventual reaction by the Federal Reserve unfavorably influenced stock markets in that country and worldwide. The NASDAQ index, which measures the evolution of stock prices of advanced technology firms, was the most affected, falling over 33 percent between late March and mid April. Moreover, concern about a possible overheating led the Federal Reserve to raise the target level for the federal funds rate by 50 basis points at its May 16 meeting.

It was until late May when signs of a slowdown in the expansion rate of aggregate demand in the United States were finally

reported⁴. This led the Federal Reserve to leave the target for the federal funds rate unchanged at its June 28 meeting. Nevertheless, signs of such deceleration are still ambiguous. Therefore, only the economic growth estimate for the second quarter has been revised, whereas the forecast for year 2000 as a whole has remained practically unaltered. Analysts' current expectations are that the U.S. economy will grow at an annualized rate of 3.6 percent in the second quarter and 4.7 percent for the full year.

A greater likelihood that the U.S. economy might gradually approach a sustainable growth rate has slightly reduced concern about the surge of significant inflationary pressures in the future. Although additional rises in the target for the federal funds rate cannot be discarded, the probability of a sudden and severe correction in U.S. economic expansion and financial markets has diminished.

II.2.1.3. Evolution of Other Main Economies

The recent economic evolution in the rest of the world has been by and large favorable. In Europe the expected rate of expansion for year 2000 has been revised upward, from 2.8 percent in October 1999 to 3.2 percent at present. As a result of this, combined with a weak euro and high fuel prices, inflationary pressures in the region have ensued. Hence, the European Central Bank has raised its target interest rate by 125 basis points during the year, while main financial analysts expect additional increments in the second quarter. In Asia, recently industrialized economies have maintained their vigorous expansion, whereas Japan is still caught in a delicate situation and is expected to grow at a rate close to one percent in the year 2000. Finally, Latin American economies have reverted to acceptable growth rates, although the recovery has not been widespread. Nonetheless, contrary to past experiences, in 1998 and 1999 —when the region confronted significant external shocks— inflation continued along its downward trend.

⁴ The real annualized growth rate of consumption in April and May was nearly 3 percent, far below the 7.7 percent average for the first three months of the year. Furthermore, auto sales fell one percent in May as compared to the previous year. Finally, employment significantly declined during the month.

Inflation in Latin America

In the seventies and early eighties, various institutional and structural problems led to serious macroeconomic imbalances in several Latin American countries. Consequently, it was quite hard for central banks in the region to maintain price stability.

Thus, during the eighties and early nineties, Latin American countries were characterized by high inflation levels and even by hyperinflation in some extreme cases. Argentina was one of the latter, posting a 750 percent average inflation in the eighties and reaching 20,266 percent in March 1990. Brazil is another illustrative example. Average annual inflation in that country was 665 percent in the nineties, having reached a maximum of 6,821 percent in April 1990. Peru found itself in the same situation, with an annual inflation of 12,378 percent in

These developments created the conditions for some Latin American central banks to be granted autonomy, with the primary mission of seeking price stability.

As a result of the aforementioned reforms, inflation in Latin America considerably fell over the last few years. This trend has continued to the point where an average inflation below 10 percent was reached in 1999. It is worth stressing that those countries with the highest inflation records (Argentina, Brazil, Chile, and Peru) now enjoy greater stability as well as the lowest inflation expectations for this year. By contrast, inflation expectations for year 2000 in Mexico, Colombia, Venezuela, and Ecuador —countries that had not registered extreme price growth levels— are far higher than the 7.85 percent average expected for all Latin American countries.

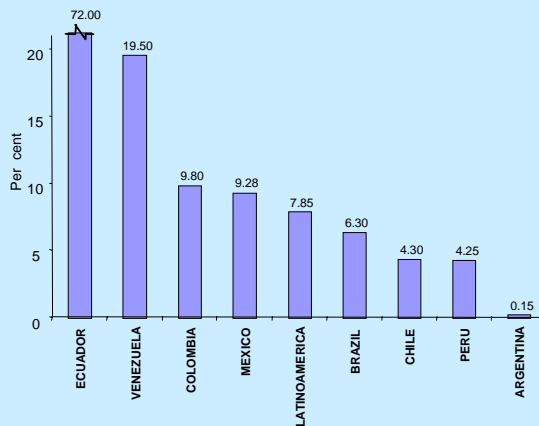
**Table 1
AVERAGE ANNUAL INFLATION**

	1970s	1980s	1990s	1999
LATIN AMERICA	32.04	102.11	110.03	9.57
ARGENTINA	136.21	750.36	145.75	-1.81
BRAZIL	37.83	431.74	665.39	8.63
CHILE	178.59	20.70	10.77	2.31
COLOMBIA	20.08	23.29	21.74	9.77
ECUADOR	12.06	35.75	39.82	60.71
MEXICO	15.50	69.73	20.21	12.32
PERU	29.10	527.60	793.88	3.73
VENEZUELA	7.72	23.93	46.36	20.03

August 1990 and averaging 794 percent for the decade.

During the 1988-1995 period, most of the region's countries adopted aggressive structural reform programs, which deeply influenced their central banks' transformation. Some of the factors that fostered such transformation are worth mentioning. Firstly, the growing evidence on the high costs of inflation in terms of economic growth, income distribution and financial system soundness. Secondly, the correction of the public finances' structural imbalance and the strengthening of fiscal institutions diminished pressures on central banks to monetize public deficits. Finally, trade and financial liberalization was also significant.

**Graph 1
INFLATION EXPECTED FOR THE YEAR 2000 ***



* Average inflation expected by J.P. Morgan, Goldman-Sachs, Deutsche Bank, and Credit Suisse.

Although Mexican inflation has decreased from 52 percent in 1995 to 9.4 percent in June of this year, this rate is still high. Therefore, Banco de México has adopted the medium-term goal of bringing inflation into line with that prevailing in the economies of the country's main trading partners by the year 2003.

II.2.1.4. Impact of the External Environment on the Domestic Economy

As mentioned above, the effects of the external environment on the domestic economy manifest themselves mainly through the

performance of domestic exports and capital flows. The rise in international oil prices and the expansion of the United States' economy positively influenced Mexican exports. Thus, as of June, total, oil, and manufactured exports grew at accumulated annual rates of 24.3, 115.7, and 19.1, percent respectively.

Following is an analysis of the impact of conditions prevailing in international financial markets on the domestic economy. In this regard, it is worth stressing that the market for the Mexican government debt denominated in foreign currency is quite deep and liquid. Consequently, the evolution of the yield on such securities is a good indicator of changes in the supply of external financial resources for Mexico. When the latter become scarce the situation may have undesirable effects on the exchange rate.

The depreciation of the exchange rate in the first two weeks of April and in May was related to rises in the net yield of the Mexican debt, which was driven by NASDAQ's fall. Lately and for reasons not yet fully identified, this stock market has shown a high correlation with emerging economies' financial markets⁵. Thus, its decline negatively affected the net yield paid by Mexico's debt, which abandoned its historic minimum and rose in March to above 300 basis points over the following three months (Graph 8). In May, the increase in the aforementioned net yield was also related to the volatility of international financial markets caused by the anticipation of a subsequent rise in the interest rate target by the U.S. Federal Reserve.

⁵ Among the hypothesis that have been suggested to explain this correlation are the following: a) insofar as the NASDAQ index reflects the public's perception regarding the stronger economic growth that the U.S. economy may register in the medium-term, a rise in this index will positively influence emerging markets' economic prospects; b) the great significance of telephone companies and communication media on emerging countries' securities markets; and c) volatility in the NASDAQ index has affected investors' risk tolerance, thereby influencing the prices of assets with risk characteristics similar to those of the NASDAQ index.

Impact of International Financial Volatility on Domestic Markets

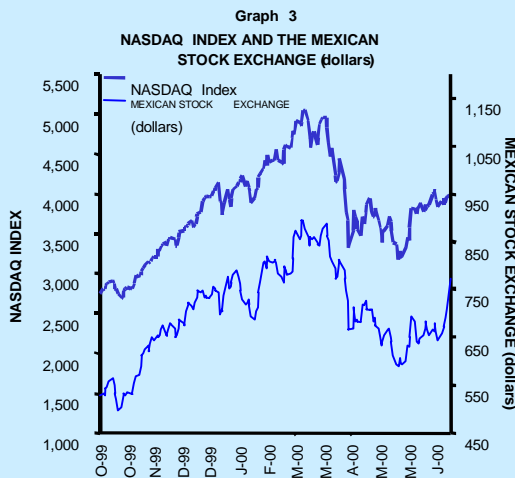
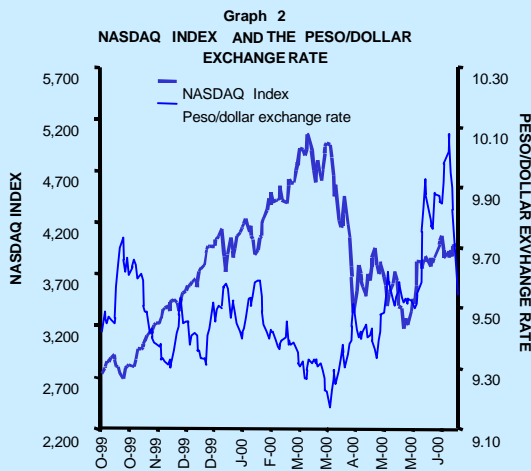
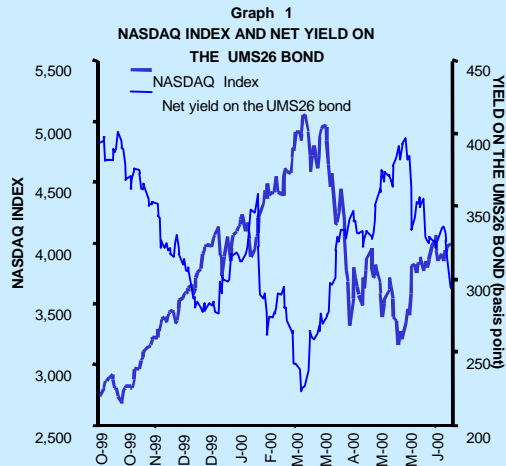
In the nineties, the NASDAQ became the world's fastest growing stock market in terms of capitalization. The stocks of the largest technology and Internet companies are traded on said market. During the first ten months of 1999, this index continuously and moderately rose until late October, when it began to grow at an extraordinary pace. Thus, in only 5 months—from October 1999 to February 2000—said index soared 71.6 percent, reaching a historical high of 5,048 points on March 10, 2000. Since then, after the courts had ruled against Microsoft alleged monopolistic practices, uneasiness for technological issuers' stock intensified and resulted in the collapse of the NASDAQ index, which fell an accumulated 37.3 percent as of May 23, when a new upturn began.

Since late 1999, the correlation between the NASDAQ index and the performance of certain emerging markets' financial variables has strengthened. In the case of Mexico, such index is related to the net yield on the Mexican debt denominated in dollars, to the exchange rate, and to the Mexican Stock Exchange index. The relationship between the NASDAQ index and the first two variables is inverse, whereas in the case of the third one the relationship is strong and positive. Therefore, the recent volatility of said index had a significant impact on the aforementioned variables of the Mexican economy.

By the same token, during the period of NASDAQ's decline, the net yield on the 30-year Mexican bond denominated in dollars due in the year 2026 (UMS26) rose by 165 basis points. In other words, due to the events mentioned above, the spread between the yield on UMS26 and on an equivalent U.S. Treasury coupon bond with similar maturity widened.

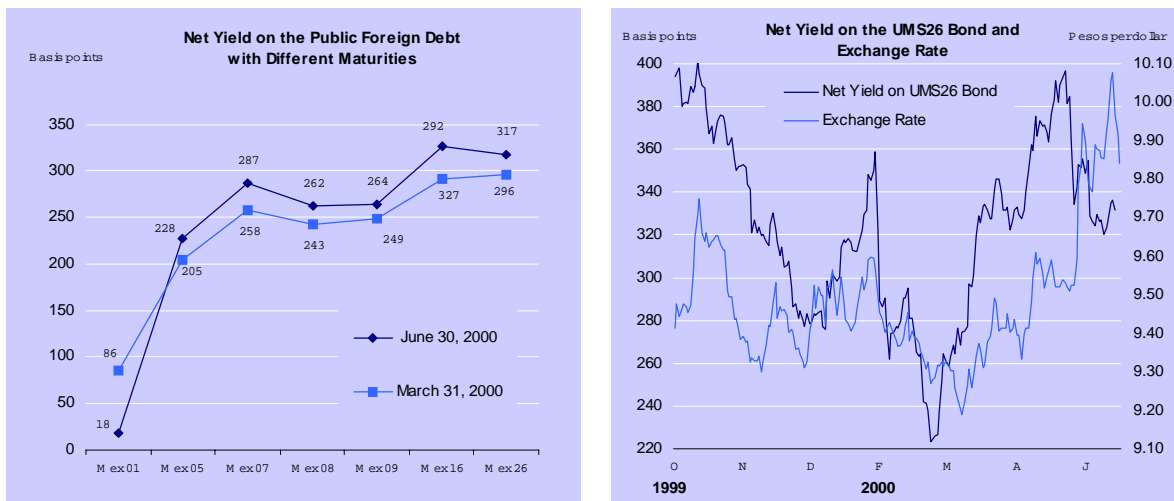
In turn, after the drop in the NASDAQ index the exchange rate—which had appreciated since early 2000—depreciated by 2.7 percent between March 10 and May 23.

Finally, the Mexican Stock Exchange index, which is closely and positively related to the NASDAQ index, followed the latter's upward trend at the beginning of the year, growing 15.54 percent from January 3 to March 10. This correlation was also apparent when the NASDAQ suddenly dropped between March 10 and May 23, bringing the Mexican Stock Market index down by 31.6 percent. In the May 23 - June 30 period, both the NASDAQ and the Mexican Stock Market indices recovered by 25.3 and 24.2 percent, respectively.



The fluctuations the peso reported in June were neither linked to a rise in the net yield on the Mexican foreign debt nor to any other external phenomena, but undoubtedly reflected the uncertainty prevailing with regards to the results of the July 2 elections. Nevertheless, the level reached by the exchange rate at that time was substantially lower than the one observed in September 1998 and January 1999 (10.58 and 10.60 pesos per dollar, respectively). The June variability was transitory, since after the elections were carried out in an orderly manner the exchange rate returned to a range between 9.30 and 9.55 pesos per dollar.

Graph 8 Country-Risk Indicators and the Exchange Rate



Source: Bloomberg and Banco de México.

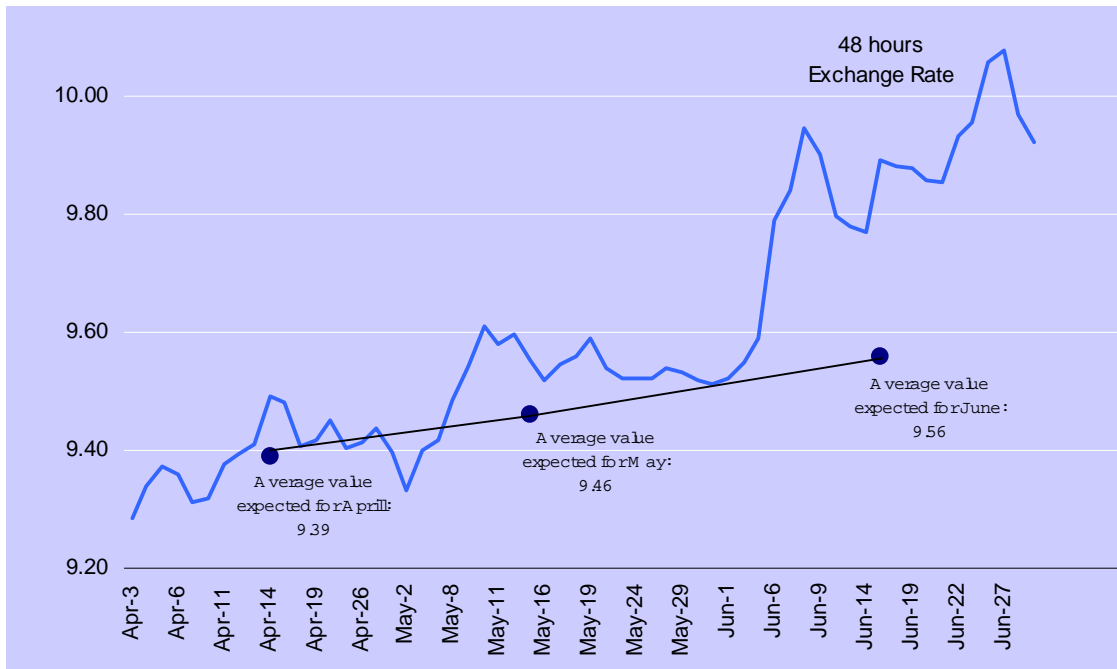
Note: The net yield on the UMS26 bond is the spread over the yield on a United States' Treasury Bond with similar maturity.

The events described above caused the observed exchange rate to surpass the levels forecasted by private sector analysts for May and June⁶ (Graph 9).

In sum, during the quarter under analysis, the external environment volatility and uncertainty regarding the domestic elections were reflected by the behavior of the exchange rate. Although the depreciation accumulated in the quarter was greater than anticipated, it did not affect the inflation rate. The monthly core inflation for goods—which encompasses the prices that would be more rapidly affected by the depreciation of the domestic currency— was 0.22 percent, the lowest reported in the last 78 months.

⁶ Obtained from the Survey of the Expectations of Private Sector Economic Specialists, conducted in March 2000 by Banco de México.

Graph 9 Observed and Forecasted Exchange Rate: April-June 2000
Pesos per dollar



II.2.2. Labor Compensation, Wages and Employment

The evolution of wages is one of the main determinants of prices in the economy. Changes in labor compensation and wages, combined with productivity improvements, determine the course of unit labor costs. The latter, in turn, affect the inflation trend. In addition, the study of employment and unemployment indicators gives information on pressures in the labor market, which could eventually be reflected in wage rises inconsistent with productivity gains and inflation targets.

II.2.2.1. Labor Compensation

In April, the annual growth of nominal labor compensation ranged between 12.2 to 18.4 percent, depending on the production sector examined⁷. The sector with the lowest nominal increase was the in-bond industry, while retail commerce posted the largest growth (Table 3).

⁷ Data for the construction sector is available only for January, February, and March 2000.

Table 3 **Nominal and Real Wages per Worker**
Annual change in percent

	Nominal Change						Real Change					
	1999		2000				1999		2000			
	Nov	Dec	Jan	Feb	Mar	Apr	Nov	Dec	Jan	Feb	Mar	Apr
Manufacturing Industry	16.9	18.4	16.0	15.8	14.2	16.6	2.6	5.4	4.5	4.8	3.7	6.3
Non-bond Industry	17.0	9.8	16.1	16.3	16.3	12.2	2.7	-2.2	4.6	5.2	5.6	2.3
Construction	20.5	7.4	8.5	5.8	1.7	nd.	5.8	-4.4	-2.3	-4.3	-7.6	nd.
Wholesale Commerce	14.5	13.0	16.7	19.2	18.3	18.3	0.5	0.6	5.1	7.9	7.4	7.8
Retail Commerce	18.6	16.6	15.9	18.3	17.1	16.3	4.1	3.8	4.4	7.1	6.4	6.0

Source: Prepared using information provided by the Ministry of Labor (*Secretaría del Trabajo y Previsión Social, STPS*) and INEGI (National Institute of Statistics, Geography and Information Technology, *Instituto Nacional de Estadística, Geografía e Informática*).

As stated in the Inflation Report January-March 2000, since late 1998 inflation expectations systematically higher than observed inflation have been used as a benchmark for contractual wage revisions. Thus, in April 1999 contractual wage revisions ranged between 17 and 18 percent, while inflation for the period wage revisions would be in effect —from April 1999 to April 2000— was 9.73 percent. This phenomenon explains why in April real wages rose more than 6 percent in almost all economic activity sectors. As illustrated by Tables 3 and 4, in April 2000 increases in real wages did not necessarily maintain a close relationship with productivity gains in the various sectors. Therefore, the evolution of real wages has been reflected by higher unit labor costs in three out of the four sectors for which information is available to date (Table 4).

The only sector reporting a drop in unit labor cost was retail commerce. According to this result, productivity gains in this sector more than offset the significant rises in labor compensation —productivity grew 8.4 percent in April, whereas average productivity gains in this sector had been close to 0.4 percent during the 1997-1998 period. Thus, the significant rise in productivity this year may result from cyclical factors and may not be sustainable in the medium-term. Therefore, should rises recently observed in real labor compensation continue, it would ultimately impinge upon unit labor costs in this sector.

Table 4 **Unit Labor Costs and Product per Worker**
Annual change in percent

	Unit Labor Costs						Output per Worker					
	1999		2000				1999		2000			
	Nov	Dec	Jan	Feb	Mar	Apr	Nov	Dec	Jan	Feb	Mar	Apr
Manufacturing Industry	-2.2	1.4	-2.5	-3.4	-3.1	4.1	4.7	3.9	7.2	8.5	6.9	2.1
Non-manufacturing Industry	2.6	1.0	3.1	1.7	5.5	0.8	0.1	-3.1	1.5	3.4	0.1	1.5
Construction	0.4	10.4	13.9	17.3	nd.	nd.	5.4	-13.5	-14.2	-18.5	nd.	nd.
Wholesale Commerce	-2.6	0.5	0.8	-0.8	5.1	9.0	3.3	0.0	4.3	8.7	2.2	-1.1
Retail Commerce	-4.5	-2.2	-2.7	-6.2	6.8	-2.2	9.1	6.1	7.3	14.2	-0.4	8.4

Source: Prepared using information provided by INEGI.

Although the rise in unit labor costs so far observed in almost all sectors has not affected consumer prices, should this trend persist inflationary pressures inconsistent with the purpose of reducing inflation could eventually ensue.

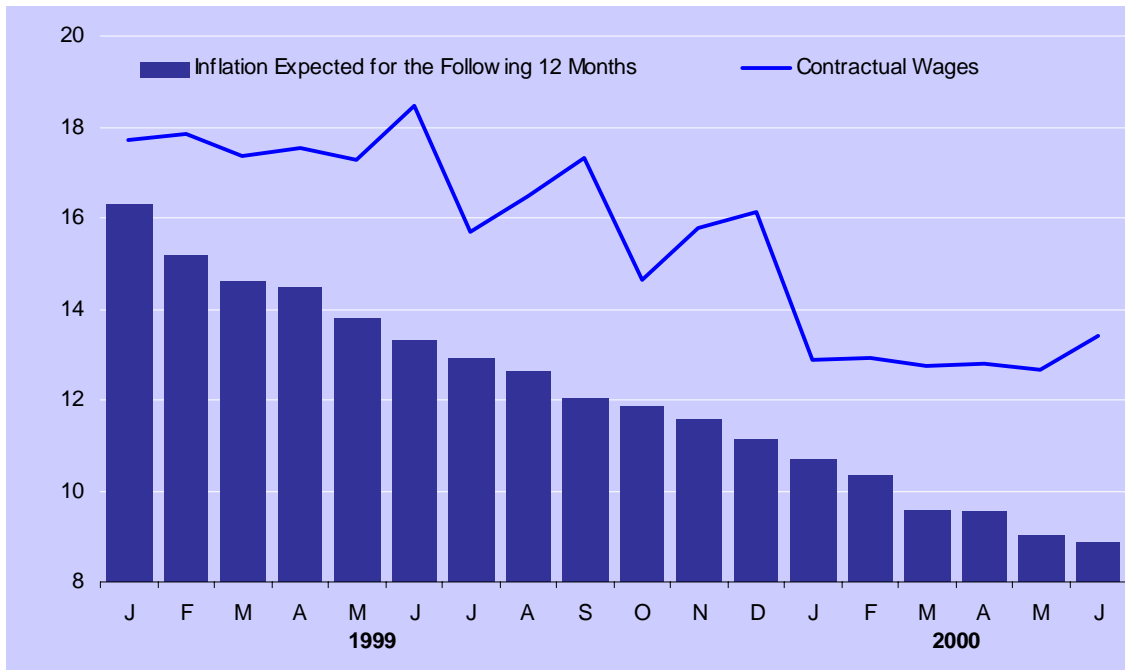
II.2.2.2. Contractual Wages

Statistics on labor compensation in the various economic sectors are published with a considerable delay. At the time this Report went to press, the only information available for the second quarter 2000 corresponded to contractual wage revisions. As already discussed, wage increases generally affect the growth in labor compensation during the 12 months following the respective contractual revision. In the first 5 months of 2000, the nominal increase in contractual wages stabilized around 12.7 percent, whereas the most recent information shows that the corresponding rate rose to 13.2 percent in June (Graph 10).

During the year 2000 the growth in wages —both in sectors that produce manufactured goods traded internationally as well as in other sectors that produce essentially non-tradable goods and services— has been considerably smaller than that observed at year-end 1999 (Table 5). Nonetheless, as of January there have been no significant declines in the rates of wage increases obtained in the corresponding contractual revisions.

Graph 10 Contractual Wages and Inflation Expected for the Following 12 Months

Annual change in percent



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

Table 5 Contractual Wages per Sector
Annual change in percent

	1999	2000					
	Dec	Jan	Feb	Mar	Apr	May	Jun
Manufacturing Sector	16.2	13.4	13.6	13.3	14.0	13.8	13.8
Other Sectors	16.1	12.5	12.2	12.3	12.3	12.1	12.6

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

In brief, there are three aspects in the recent evolution of contractual wages that must be closely watched:

- (a) nominal wage increases granted in April, May, and June were higher than those expected by private sector analysts⁸;
- (b) the improvement in inflation expectations in the second quarter was not accompanied by a parallel moderation in wage growth; and

⁸ Reported in Banco de México's Survey of the Expectations of Private Sector Economic Specialists.

- (c) the spread between nominal growth in contractual wages and expected inflation—in the manufacturing sector as well as in other sectors— seems to be wider than the rise in productivity observed in the same sectors over the medium-term. This could negatively affect production costs and eventually translate into higher prices for the end consumer.

It is worth underscoring that when real wages rise in excess of productivity gains, unit labor costs go up. In turn, firms try to pass their higher production costs on to the prices for their products. This process could generate an inflationary spiral that might result in higher interest rates, lower investment, and a weaker demand for labor. The latter would eventually impinge upon real wages and job creation.

II.2.2.3. Employment

During the period under analysis, employment levels showed significant progress, although in recent months the growth in this variable has been less vigorous than in the second half of 1999 and early 2000. The number of workers (permanent and temporary urban workers) affiliated with the IMSS (Mexican Social Security Institute, *Instituto Mexicano del Seguro Social*) rose by 403,180 from late December to the end of June, thus totaling 12'420,100 workers⁹ (Graph 11a). During the first half of 2000, the open unemployment rate ranged between 2.14 and 2.45 percent and has remained stable in seasonally-adjusted terms (Graph 11b). The trend in partial employment and unemployment rate¹⁰ went from 18.05 percent in January to 18.87 percent in May (Graph 11c).

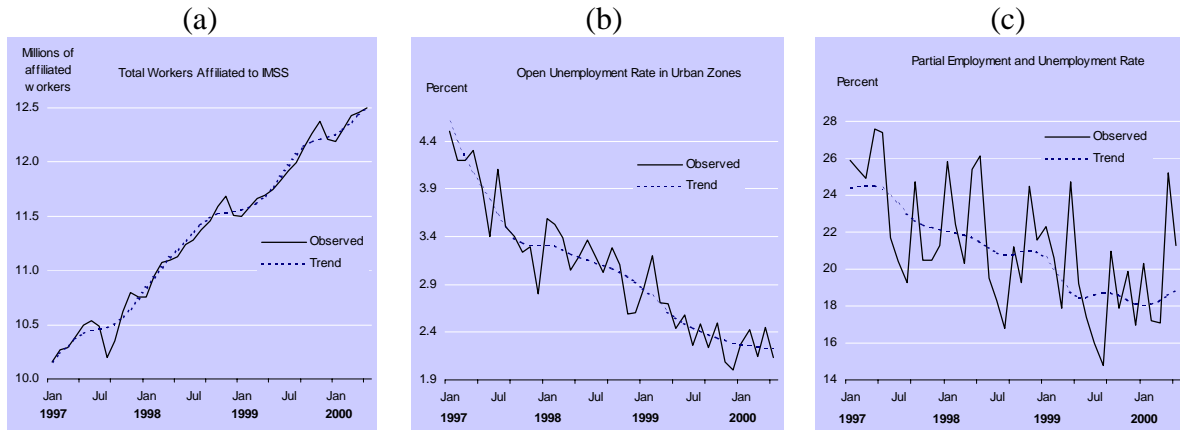
In short, based on available information, the labor market has shown mixed results in the period under analysis. The momentum of employment indicators has become more moderate and they appear to be reaching equilibrium levels. Thus, job creation is converging toward a rate that allows the incoming labor force to be incorporated into the productive sector and maintain the historically low unemployment and underemployment rates so far achieved. Despite the fact that employment has continued to

⁹ Preliminary figures.

¹⁰ This indicator measures the ratio of unemployed individuals plus those employed less 35 hours per week due to market reasons.

expand, the unemployment rate has remained stable and the trend of partial employment and unemployment rate has rebounded. Behind the evolution of employment nationwide lies a wide range of regional labor markets with different characteristics; while some regions are reporting a shortage in labor force supply, high rates of unemployment prevail in others.

Graph 11 Employment and Unemployment Indicators



SOURCE: IMSS and INEGI

Concerning real wages, almost all sectors have reported increases larger than productivity gains. In particular, in the first months of 2000 growth in real wages in wholesale commerce and in the manufacturing industry has far surpassed the rate of growth in productivity¹¹. During the first half of 2000, contractual wage revisions were close to 13 percent and did not fully incorporate the downward adjustment in inflation expectations. As has been said previously and is worth to reiterate, this situation is incompatible with the average growth in productivity, which has ranged between 0.3 and 3.6 percent in recent years depending on the sector. Therefore, wage negotiations and the evolution in unit labor costs must be carefully monitored in order to continuously evaluate if the increases in these variables are being passed on to consumer prices, to detect in advance the presence of inflationary pressures, and be able to act accordingly.

II.2.3. Aggregate Supply and Demand

When aggregate demand grows at a faster rate than aggregate supply over a long period, inflationary pressures may

¹¹ Especially significant was the rise in unit labor costs in the manufacturing industry and in wholesale commerce registered in April 2000.

ensue. This is due to at least two reasons. Firstly, an excess demand for tradable goods manifests itself through an expansion in the trade deficit. This phenomenon could make the disinflation process more vulnerable to external and domestic shocks. Secondly, an excess demand for non-tradable goods could be reflected in price increases. Therefore, the evolution of aggregate supply and demand, as well as of external accounts, must be analyzed to anticipate a possible surge of inflationary pressures.

In the first quarter of 2000, both GDP and aggregate demand posted strong annual expansions of 7.9 and 11.9 percent, respectively¹² (Table 6). The strength in aggregate demand was bolstered by several factors: a) the extraordinary growth in the United States' economy; b) vigorous private spending (consumption and investment) stimulated by employment growth, the recovery in real wages, and optimistic expectations on the future course of the Mexican economy; and c) an increase in public spending. The latter element has been due, among other reasons, to a change in the scheduling of spending and special expenses associated with the census and the electoral process.

Table 6 **Aggregate Demand and Supply in 1999 and 2000**
Real annual change in percent

	1999					2000
	I Qtr.	II Qtr.	III Qtr.	IV Qtr.	Annual	I Qtr.
Aggregate Supply	2.4	5.0	7.2	8.3	5.8	11.9
GDP	1.8	3.1	4.3	5.2	3.7	7.9
Imports of Goods & Services	4.5	11.4	16.6	17.9	12.8	25.6
Aggregate Demand	2.4	5.0	7.2	8.3	5.8	11.9
Total Consumption	2.1	3.1	3.4	6.7	3.9	8.7
Private	2.2	3.3	4.0	7.6	4.3	9.2
Public	1.8	1.6	-1.3	1.4	1.0	5.0
Total Investment	3.8	6.1	5.2	8.1	5.8	11.6
Private	5.0	8.5	9.3	13.2	9.0	12.8
Public	-7.8	-18.2	-22.9	-12.5	-15.3	-2.0
Exports of Goods & Services	7.8	14.2	18.8	14.6	13.9	17.0

Source: Mexican National Accounts System (*Sistema de Cuentas Nacionales de México*, INEGI).

Domestic production was flexible during the period and no price hikes inconsistent with the inflation target for the year were detected. In addition, the expansion of the trade deficit was significantly curbed by the response of production and the increase

¹² GDP growth in the first quarter of 2000 was influenced by a greater number of business days than in the same period of the previous year. Upon adjusting for this phenomenon, the aforementioned rate ranges between 7.1 and 7.3 percent.

in international oil prices. Nevertheless, there are short- and medium-term limits to the sustained expansion of the domestic supply.

Available information suggests that during the second quarter aggregate demand continued to expand rapidly, particularly in the case of private consumption. Despite the fact that the rate of expansion of aggregate demand was less vigorous than in the first quarter—which was more evident for investment spending—the risk that a strong aggregate demand may eventually translate into higher prices for non-tradables and a widening of the trade deficit persists.

With regard to the evolution of consumption, statistics on stores' sales and consumption of certain goods gathered by Banco de México in May showed high growth rates, although lower than in the first quarter. The annual growth rate of total store sales¹³ reported by the National Association of Self-Service and Department Stores (ANTAD) fell from 8.5 percent in the first quarter to 5.2 percent in May, whereas in the March-April period said rate stood at 11.1 percent.

A significant item of the demand for durable goods is automobiles. Domestic auto sales grew at an annual rate of 33.8 percent in the second quarter, which is still high although lower than the rate reported in the first quarter (48.7 percent).

Another consumption indicator that has shown a marginal slowdown from the high levels observed in the first quarter is the annual growth rate of the value of imported consumer goods, which has declined from 43.7 percent in January-March to 39.4 percent in April.-June (Graph 12). This year, automobile imports have expanded rapidly, posting a 104.9 percent annual growth rate in the first quarter and 85.4 percent in the second quarter. Although automobile imports were spurred by the strength in domestic demand, it was also determined by the fact that the Mexican automotive industry has specialized further in the production of vehicles for export. Consequently, models produced abroad had to be imported to meet the domestic demand.

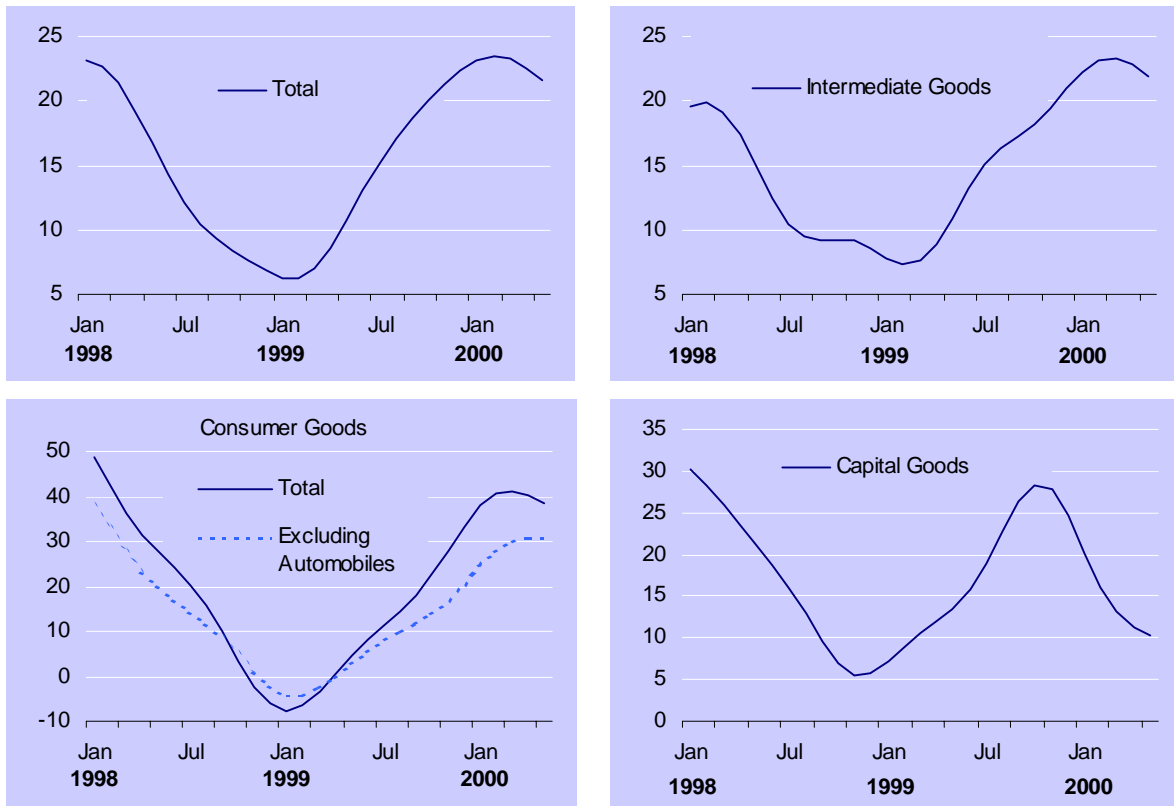
An additional sign consistent with a more moderate expansion in consumption and production is the downturn in the growth rate of the imports of intermediate goods trend series.

¹³ Includes the sales of all stores affiliated to the ANTAD, including those which opened for business during this year.

The growth rate in investment spending eased off earlier than that of consumption. This became apparent during the first four months of 2000, when the annual growth rate of investment declined continuously, from 15.9 percent in January to 6.8 percent in April. The steep deceleration in the growth of imported capital goods—which declined from 18.5 percent in the first quarter to 11.8 percent in the second quarter— suggests that the downward trend of investment spending may have continued in June.

Graph 12 Imports of Goods: Trend Series

Annual change in percent



Available information also points to a lower expansion rate in domestic supply. The growth rate of industrial production fell from 8.7 percent in the first quarter to 7 percent in the April-May period. It is worth mentioning that in April the manufacturing sector’s production growth rate contracted to less than one half the rate achieved in the first quarter. In this regard, the GDP annual growth is estimated to have been close to 6 percent in the second quarter. Should the trends observed in the first quarter continue, GDP might expand by around 6 percent for the year as a whole.

As it has been said above, one of the first signs of an excess growth in aggregate demand is the widening of the trade deficit. However, in the April-June period there were no signs of this phenomenon taking place, since the average monthly trade deficit (487 million dollars) was slightly above the figure reported for the January-March period (446 million). From April to June, the growth in the demand for tradable goods was practically the same as the rise in the domestic supply of those goods and, therefore, no additional pressures on the trade balance ensued.

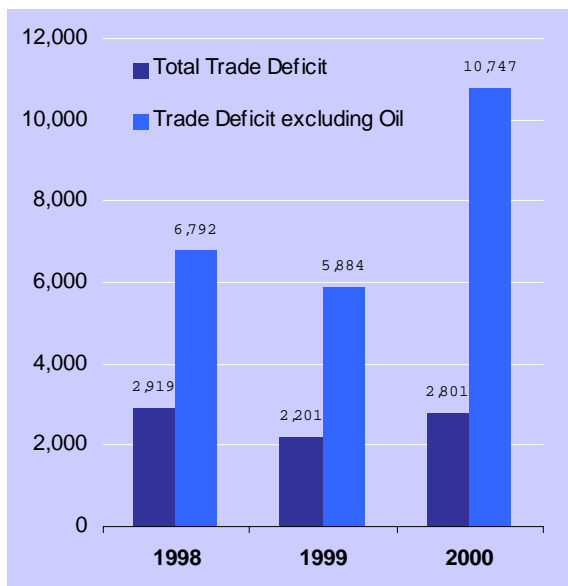
An analysis of the trade balance shows that the deficit accumulated in the first six months of the year was 27.3 percent larger than that posted in the same period of the previous year. In addition, if crude oil exports are excluded from this calculation, the deficit recorded in the first half of 2000 would rise by approximately 82.6 percent, although this increment is slightly below the one observed in the first quarter of the year. Consequently, between April and June, the non-oil trade deficit did not deteriorate further.

The monthly trade deficit indicates, however, a less favorable situation (Graph 13). While the trend of the total trade deficit remains low, the trend of the non-oil deficit rose considerably in late 1999. Although over the first few months of 2000 the rate of increase of such trend slowed down, it is still at high levels and posting positive growth rates.

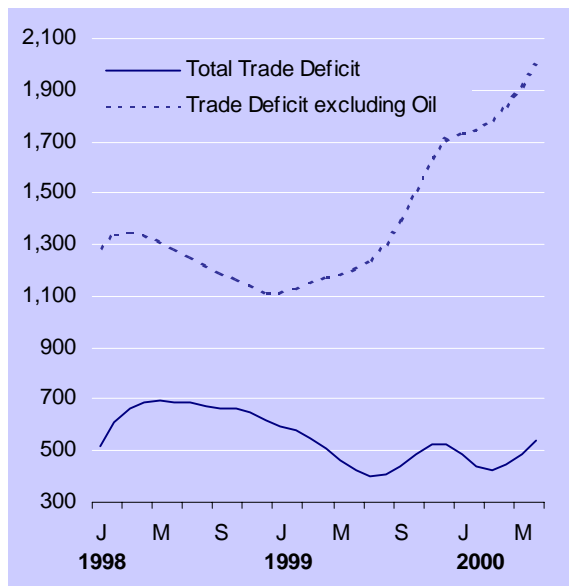
Graph 13

Trade Deficit: Total and Excluding Oil
Millions of Dollars

January - June Period



Monthly Trend



The evolution of the external accounts in the April-June period indicates that no pressures other than those anticipated in the Inflation Report January-March 2000 have occurred. Therefore, it is worth reiterating that, although the total trade deficit has remained at levels similar to those prevailing over the last two years, said result has reflected the fact that aggregate demand pressures on imports have been offset by higher oil export revenues and the vigorous growth in non-oil exports. The latter element has been supported by the expansion of the United States' economy. Consequently, the larger non-oil trade deficit observed during the first half of the year 2000 makes the Mexican economy and the disinflation process more vulnerable to a possible fall in international oil prices or a reduction in the United States' economic growth rate.

Although an excessive expansion in aggregate demand may bring forth inflationary pressures in the non-tradable goods and services sector, so far the prices of these goods and services has continued to decline at rates similar to those shown in the last six months. This suggests that the expansion in aggregate demand has not yet affected the downward trend of inflation measured by the core inflation for services. Wage pressures, rises in unit labor costs in several economic sectors, and the rise in the INPP annual inflation rate excluding services and oil, could nonetheless push consumer prices up and hamper future progress on the fight against inflation.

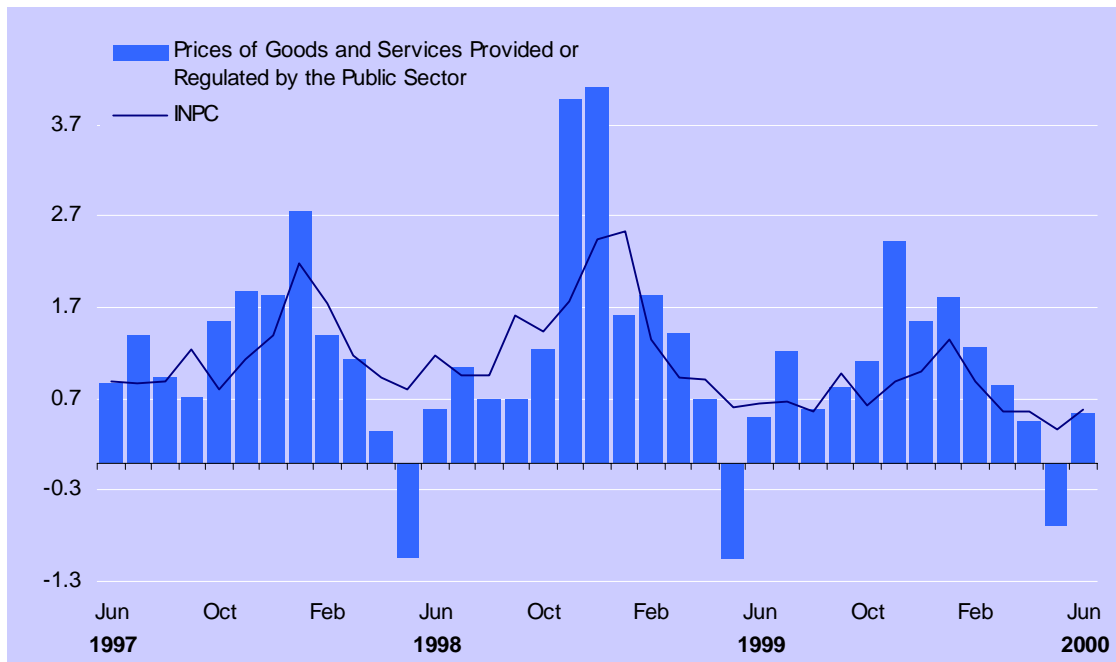
II.2.4. Prices of Goods and Services Provided or Regulated by the Public Sector

The prices of goods and services provided or regulated by the public sector have a significant impact on inflation —they not only affect it directly but also indirectly as economic agents adjust their inflation expectations in response to changes in those prices.

The policy for the prices of goods and services provided or regulated by the public sector in the year 2000 was defined at the beginning of the year in accordance with the General Criteria for Economic Policy (*Criterios Generales de Política Económica*) and the Federal Revenues Law. In addition, the strategy for the prices of goods and services provided or regulated by the public sector responds to considerations other than the inflation target, such as maintaining sound public finances, correcting distortions in relative prices and determining certain prices based on their international references.

Monthly changes in the price sub-index for goods and services provided or regulated by the public sector were 0.46, -0.68 and 0.54 percent in April, May and June respectively (Graph 14). In April and May, said variations were lower than that of the INPC because the electric fares for the summer season went into effect in 12 cities in April and 13 cities in May —the weighted reduction in electric fares was 2.45 percent in April and 12.05 percent in May. The influence of electricity fares on overall monthly inflation was -0.04 and -0.22 percentage points in the respective months. On the other hand, adjustments to the price of domestic gas —by 7.38 percent in the second quarter and an accumulated 15.28 percent in the first half of the year— have negatively affected inflation. The net result of these factors was unfavorable, since the annual inflation rate for goods and services provided or regulated by the public sector rose from 12.31 percent in March to 12.54 percent in June.

Graph 14 Price Index for Goods and Services Provided or Regulated by the Public Sector and INPC
Monthly change in percent



In brief, in the first half of 2000 the prices for goods and services provided or regulated by the public sector have grown at a rate higher than the inflation target and, therefore, have become an additional inflationary pressure. Moreover, it is cause for concern

that annual inflation for this sub-index rose in the second quarter of the year.

II.2.5. Public Finances

During the first half of 2000 public finances have behaved in line with their program. In the first quarter, the public sector posted a surplus of 5,809 million pesos, 25.2 percent higher in real terms than the figure for the first semester of the previous year. This result is consistent with the public deficit annual target of one percent of GDP. Consequently, the sound fiscal stance has been a continued factor in favor of the reduction in inflation.

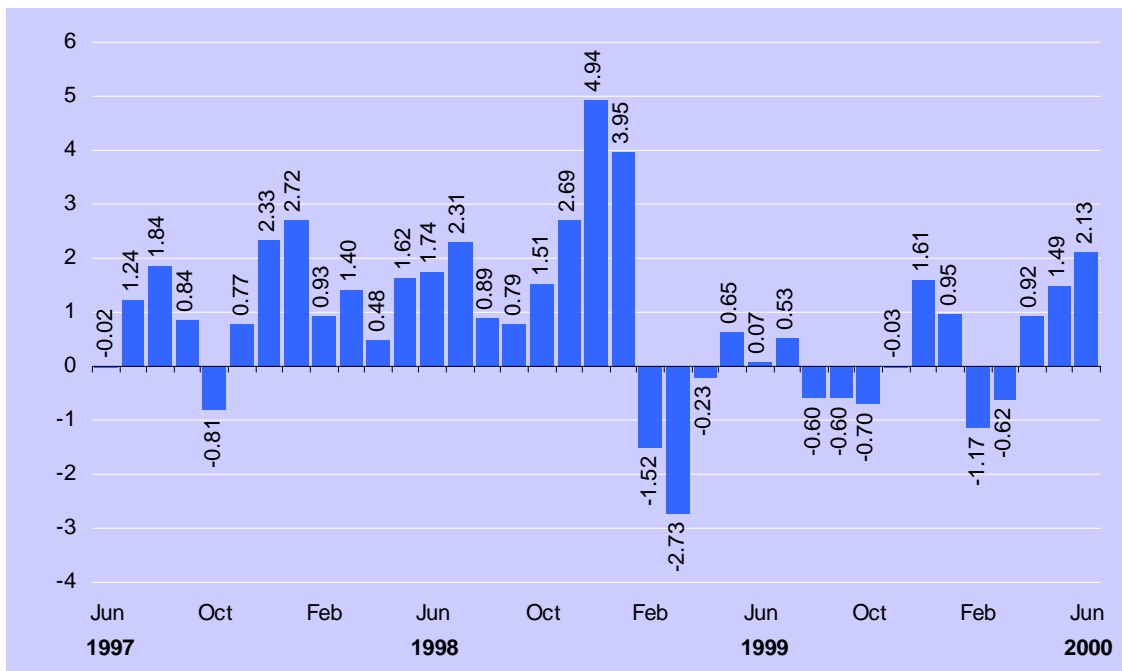
II.2.6. Transitory Phenomena that Affected Inflation

In the April-June 2000 period, the evolution of the prices of agricultural and livestock products was adverse to the disinflation effort (Graph 15). In April, May, and June, monthly growth of this sub-index outpaced that of the INPC and reached 0.92, 1.49 and 2.13 percent, respectively —accumulating the largest quarterly increase since 1999. Partly due to the epidemic that affected the poultry sector in the Lagunera Region, the prices of chicken meat and egg were prominent among the fastest growing prices of agricultural and livestock products —besides those of fruits and vegetables.

Graph 15

Agricultural and Livestock Goods Price Index

Monthly change in percent



II.3. Summary of the Recent Evolution of Inflation

Throughout the April-June period inflation continued to decline faster than expected at the beginning of the year. Various indicators of the inflation trend analyzed in this section show a clear reduction—in particular the evolution of annual core inflation, which fell 1.87 percentage points during the quarter and stands currently at 9.29 percent.

By analyzing the performance of the main determinants of inflation some events worth closely monitoring stand out. Firstly, wage increases granted during the period under contractual negotiations were higher than anticipated. In addition, contractual wage increases did not reflect the drop in inflation expectations observed in the quarter. Secondly, the growth in real compensation in most productive sectors has led to higher unit labor costs. Thirdly, the rebound in the INPP annual inflation excluding oil and services is a sign of possible future inflationary pressures. The aforementioned phenomena may represent early indications that the expansion of aggregate demand is starting to affect the prices of the main production factors. Although during the quarter all these elements did not contribute to a higher INPC inflation, their effects

may become apparent in the future. Moreover, during the quarter covered by this Report, the annual growth rates of prices of goods and services provided and regulated by the public sector and of agricultural and livestock products rose, negatively affecting the INPC inflation. These phenomena have been reflected by inflation expectations for 2001, which have remained practically unchanged in the last month and are still at high levels.

Lastly, it must be emphasized that throughout this year the expansion of aggregate demand has caused a considerable widening of the non-oil trade deficit. This has made the disinflation process vulnerable to any or a combination of the following possibilities: a fall in international oil prices, a slowdown in the United States' economy, or a contraction in the supply of external financing.

III. Monetary Policy During the Period

Because monetary policy affects the evolution of prices with a considerable lag, its implementation entails a careful and timely analysis of inflationary pressures. It is also important to evaluate whether adjustments in nominal and real interest rates as well as changes in monetary conditions have been conducive to attaining short- and medium-term inflation targets. Therefore, following is an explanation of monetary policy measures implemented during the period and the evolution of real and nominal interest rates. The paths of the monetary base and other aggregates that may be used as a general reference for assessing inflationary pressures are also examined.

III.1. Monetary Policy Actions

During the second quarter of the year, Banco de México reinforced the restrictive stance of monetary policy twice: on May 16 and on June 26. On the first date, the “short” was widened from 180 to 200 million pesos, and to 230 million pesos on the second date. Similarly to the widening of the “short” implemented in January, these measures were taken with two complementary purposes. First, to consolidate the conditions prevailing in the financial, labor, and goods and services markets so as to attain an inflation rate below 10 percent in the year 2000. Second, to reinforce the downward trend in domestic inflation and bring it into line with the rates prevailing in the economies of Mexico’s main trading partners by the year 2003.

The decision to widen the “short” was based on pre-emptive criteria, and responded to some factors that arose during the quarter and have been identified by the Board of Governors as possible sources of future inflationary pressures. The main considerations behind these actions were as follows:

- (a) although inflation expectations for 2000 are below 10 percent, analysts do not anticipate a significant decline in inflation for the year 2001. For example, in Banco de México’s June Survey on the Expectations of Private Sector Economic Specialists, the inflation forecast for this

year was 9.21 percent while the forecast for 2001 was still at 8.07 percent;

- (b) the momentum of aggregate demand could result in price increases for non-tradable goods, wage pressures, and a larger trade deficit —this would complicate the future decline in inflation;
- (c) recent increases in the prices of some fruits and vegetables could hinder the disinflation process in the next few months and affect the evolution of inflation expectations;
- (d) in June, inflation expectations for the July-September period and for the year 2000 rebounded slightly. This could taint the evolution of medium-term expectations and hamper the attainment of the convergence target to bring domestic inflation in line with that of Mexico's main trading partners by the year 2003; and
- (e) inflationary pressures in the main developed economies have worsened owing to the vigorous economic growth observed in those countries, which has resulted in higher international interest rates.

Based on the above diagnosis, the reinforcement of the restrictive monetary policy stance has several purposes:

- (a) to limit the expansion of aggregate demand in order to diminish the risk of inflationary pressures caused by excessive growth in domestic spending;
- (b) to reduce the likelihood that a more severe monetary restriction worldwide could create a disorderly adjustment in domestic financial markets, which could in turn deteriorate inflation expectations and affect the evolution of prices;
- (c) to prevent recent increases in certain prices (agricultural and livestock products and domestic gas) from contaminating the inflation expectations formation process;
- (d) to inhibit the influence of the June upward revision of short-term inflation forecasts on medium- and long-term expectations; and

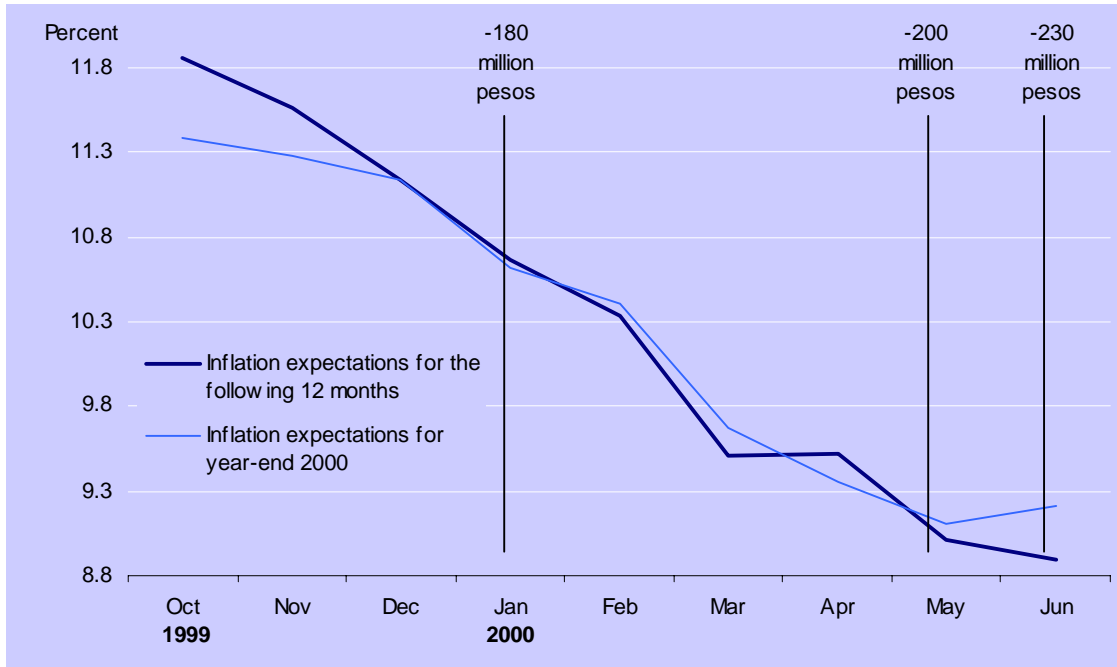
- (e) to reaffirm Banco de México's commitment to its medium-term inflation target, in order to strengthen the downward trend of expectations for the year 2001 and achieve the convergence with the inflation of Mexico's main trading partners by the year 2003 at the lowest possible cost.

An important element to identify inflationary pressures and, thereby, to determine suitable monetary policy measures is to analyze the evolution of inflation expectations. Inflation expectations for 2000 have fallen from 9.67 percent in March to 9.11 percent in May, and rose slightly to 9.21 percent in June¹⁴. The responses gathered by the April survey aroused concern because the inflation expected for the following twelve months (April 2000–April 2001) turned out to be higher than the inflation expected for the year 2000 (Graph 16). This implied that private sector analysts anticipated that the disinflation process would come to a halt at some point. Consequently, one of the reasons for having widened the “short” on May 16 was to restore the downward trend of medium-term inflation expectations. Responding to the measure taken, the expectations for the following twelve months significantly improved in May. However, in June, after inflation for the first two weeks of the month had been made public —reporting a higher rate than expected by the market— inflation expectations for the year 2000 and for the third quarter were adjusted upward. Undoubtedly, this could have been the prelude to a deterioration of longer-term expectations. To avoid the materialization of such scenario and considering the other inflationary pressures mentioned in the previous section, the “short” was widened again, this time to 230 million pesos. Subsequently, short- and medium-term inflation forecasts¹⁵ have fallen, suggesting that the aforementioned monetary policy actions have reinforced the medium-term inflation expectations downward trend, and that short-term expectations have been affected by transitory phenomena such as price increases in agricultural and livestock products.

¹⁴ According to Banco de México's Survey of the Expectations of Private Sector Economic Specialists.

¹⁵ According to surveys conducted by the private sector.

Graph 16 Inflation Expectations and Accumulated Balances Objective



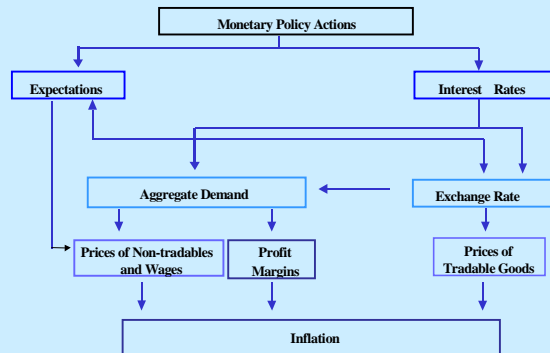
SOURCE: Banco de México's Survey of the Expectations of Private Sector Economic Specialists.

With regards to the effectiveness of the measures taken, interest rates have gone up after each of the increases in the “short”. For example, the day following the first widening of the “short” in the quarter, the government’s funding rate rose 84 basis points. Moreover, the June 26 increase in the “short” induced a one percentage point rise in said interest rate. Therefore, these measures and the response of market participants did contribute to maintaining higher real interest rates in the second quarter than those observed in the first three months of the year.

Monetary Policy Transmission Mechanism

Similarly to many other central banks, Banco de México's primary objective is to pursue the stability of the domestic currency's purchasing power. In a context of high inflation, Banco de México's Board of Governors has put forward a strategy to gradually and enduringly curb price growth, whose medium-term goal is to bring domestic inflation in line with that of the country's main trading partners by the year 2003. To achieve the proposed goals, the Central Institute continuously evaluates inflationary pressures. If inflation results are found to be inconsistent with those goals, the Central Bank modifies the accumulated balances objective for the current accounts it holds for commercial banks. This instrument influences interest rates in the first place and ultimately inflation expectations.

The Central Bank's monetary policy actions have a delayed effect on price growth and affect this variable by different channels. The transmission mechanism of monetary policy may be illustrated with the following diagram:



By implementing a "short", Banco de México induces higher interest rates. In a context of free capital flows, interest rate movements also influence the evolution of the exchange rate. Given external interest rate levels and the perception of Mexico's country-risk,

an increase in domestic interest rates stimulates an appreciation of the exchange rate, which in turn reduces the prices of tradable goods. In addition, an appreciation of the exchange rate leads to a decline in the demand for exports and a rise in imports, thereby easing off aggregate demand pressures on domestic prices. Finally, the exchange rate influences inflation expectations, which affect price growth through their impact on price adjustments and wage negotiations.

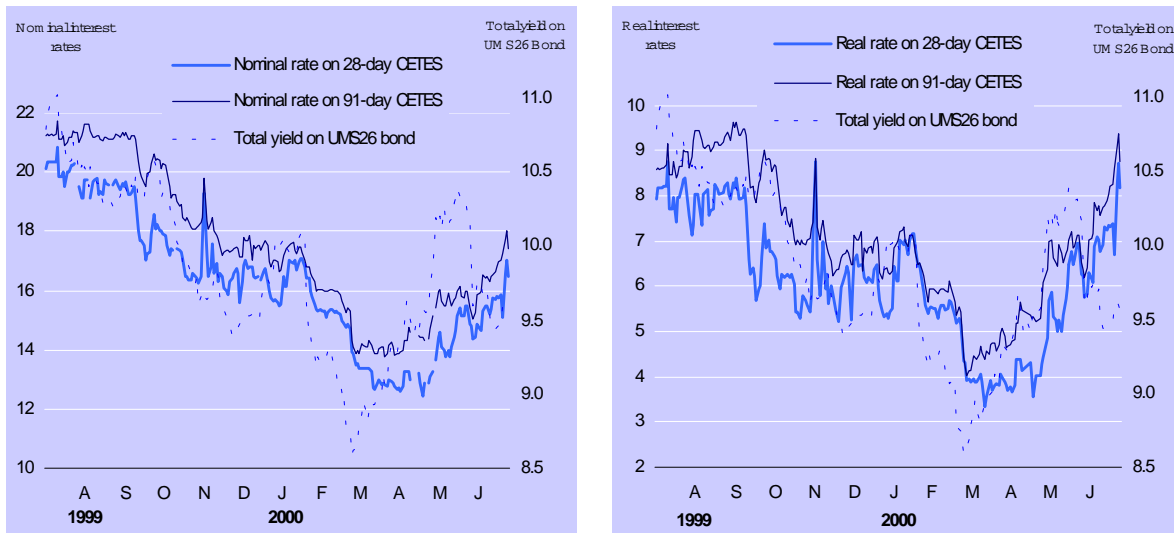
Changes in interest rates directly affect aggregate demand as well, as they determine the conditions under which consumer and investment credit is granted. The effect of interest rates on these variables combines with that of the exchange rate to determine pressures on aggregate demand. A weaker increase in aggregate demand causes a lower growth in the demand for both tradable and non-tradable goods and for labor. In turn, the equilibrium of these economic forces determines the rise in wages, firms' profit margins and changes in the prices of non-tradables.

Finally, monetary policy actions directly influence inflation expectations, which shape price revisions and wage negotiations between employers and workers. Thus, changes in the monetary policy stance are transmitted to the general price level through inflation expectations.

In sum, monetary policy actions are transmitted by multiple channels, directly or indirectly affecting the inflation rate with different lags. The relative importance of each of these monetary policy transmission channels depends on factors like trade liberalization, capital mobility, credit granted by commercial banks, the inflation expectations formation process, etc. The influence of all these elements differs in the various economies and over time. Therefore, in order to evaluate the effectiveness of monetary policy, each of the transmission channels must be continuously monitored.

During the second quarter, nominal and real interest rates in Mexico were also affected by external interest rates as well as by the country-risk perception. As a result of NASDAQ's drop in April and May, the perception of Mexico's country-risk significantly deteriorated and was reflected by a rise in the total yield on the bonds denominated in foreign currency issued by the Mexican government (UMS26) (Graph 17). Domestic financial markets were affected as nominal and real rates on Cetes went up and reached levels similar to those observed at the beginning of the year. In late May and early June, nominal rates on Cetes showed a slight downward trend that was interrupted by the effect of the exchange rate depreciation observed in the second week of June and by the widening of the "short" on June 26. Although real interest rates closed the quarter at levels much higher than those reported in late March, they posted significant reductions in the days following the elections.

Graph 17 **Nominal Interest Rates, Real Interest Rates, and Country Risk**
Percent



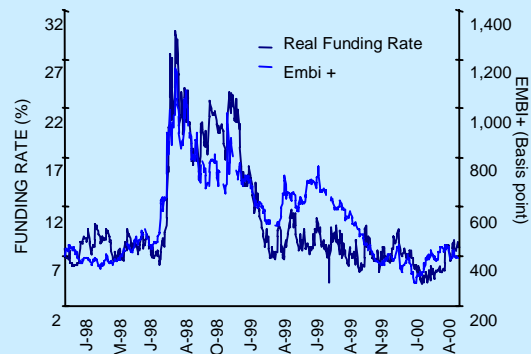
Two Determinants of Interest Rates in Mexico: Monetary Policy and Country Risk

Monetary policy and country-risk perception are among the main determinants of interest rate levels in Mexico. A restrictive monetary policy induces higher interest rates, while in an economy with free capital flows a rise in country-risk perception results in higher domestic interest rates as well. In the nineties, the Mexican economy was characterized by free capital flows and, since the floating exchange rate regime was adopted, by market-determined interest rates. The behavior of interest rates from 1995 to 1999 illustrates how the two aforementioned factors have affected their level.

Since 1995, monetary policy in Mexico has been implemented by means of a target level for the accumulated balances of the current accounts held by commercial banks with Banco de México¹. A negative objective (known as a “short”) means that monetary policy has a restrictive bias; whereas a positive objective (known as a “long”) implies lax monetary conditions. In general, the more restrictive the monetary policy stance the greater upward pressure on nominal interest rates. A recent study conducted by this Central Institute found that an increase of 20 million pesos in the “short” pushes interest rates up between 50 and 100 basis points². In addition, monetary policy has an effect on interest rates’ structure. Short-term interest rates are more sensitive to changes in the monetary policy stance than longer-term interest rates. In this regard, it has been observed that a widening of the “short” reduces the slope of Cetes’ yield curve for the various maturities, indicating that a more restrictive monetary policy generates an expectation of a decline in inflation³. Consequently, as a larger “short” induces both a rise in nominal interest rates and a decline in inflation expectations, real interest rates also increase after this measure is implemented.

Country-risk perception is usually measured by the spread between the yields on a domestic bond denominated in foreign currency and the yield on a foreign bond with equal maturity denominated in the same currency. One of this measurements is the Embi+ index (Emerging Market Bond Index Plus)⁴, which indicates the total yield on the debt traded abroad and denominated in foreign currency. It has been proved that there is a clear relationship between domestic real interest rates and country-risk perception⁵ (Graph 1). The effect of the Russian crisis of August 1998 is noteworthy, as the country-risk perception increased for all emerging economies and domestic interest rates rose substantially. Another instability period was triggered by the Brazilian crisis in early 1999, when risk-country perception worsened again and domestic interest rates consequently increased. Econometric research has found that in the 1998-1999 period, a 10 basis point rise in country-risk perception would cause an increment of approximately 18 basis points in real interest rates in Mexico.

Graph 1
REAL BANK FUNDING RATE AND EMBI+



Although the two aforementioned factors are not the only ones that affect domestic interest rate levels, they are indeed instrumental in determining them.

¹ For a complete description of how monetary policy is implemented through the accumulated balances objective, see Appendix 4 Banco de México’s 1996 Annual Report.

² “The Effect of the “Short” on the Structure of Interest Rates”, *Research Document 2000-1*. Banco de México, June 2000.

³ An indicator of inflation expectations is the difference between nominal yields on similar instruments with different maturities. Particularly, a reduction in the slope of the yield curve implies an expectation of lower price growth.

⁴ This indicator is produced by J.P. Morgan for a group of emerging economies.

⁵ Real interest rates were calculated using the inflation expected for the following 12 months.

The rise in domestic interest rates —associated to increases in external rates, the volatility of international and domestic markets and a tighter monetary restriction— favored the necessary monetary conditions for Banco de México to remain capable of achieving its short- and medium-term inflation targets. Although the above has been reflected by a decline in the inflation expected for the year 2001, such expectation is still at levels inconsistent with the objective to bring domestic inflation into line with that of the Mexico's main trading partners by the year 2003.

III.2. Evolution of Monetary Aggregates

As set forth in the Monetary Policy Program for 2000 and in the previous Inflation Report, the relationship between the growth in monetary aggregates and prices becomes more uncertain as inflation diminishes. Therefore, the path of monetary aggregates is currently used only as a reference and complements the examination of other variables that affect price behavior.

III.2.1. The Monetary Base and its Components

When the evolution of the monetary base is compared against its forecast published in the Monetary Policy Program for 2000 (Graph 18), it is clear that in April the monetary base stock was significantly higher than the estimate, and that said difference considerably diminished in May. The deviation occurred in April is mainly accounted for by the fact that the seasonal effect of Easter on the demand for bills and coins had been underestimated. In June, the gap extended anew to reach 4.7 percent at the end of the second quarter. The fact that the observed monetary base was generally above its anticipated path has in part been due to the economy's stronger than expected expansion —a more vigorous economic growth induces a greater demand for bills and coins in order to carry out transactions.

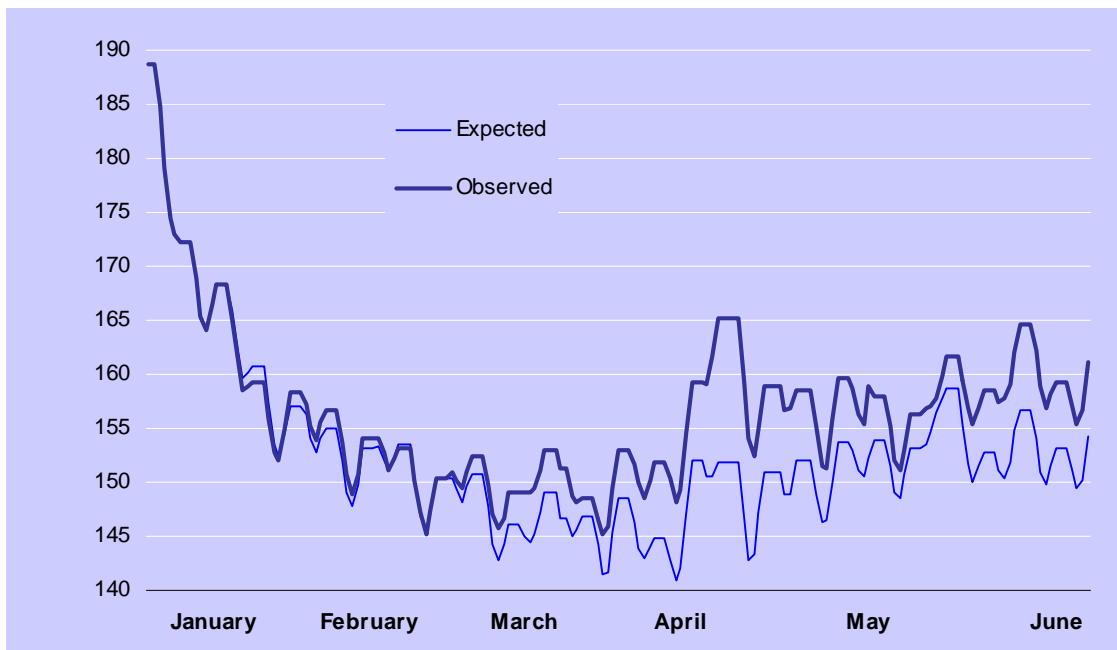
As the first semester concluded, the limit for the variation in net domestic credit was complied with as well as the commitment not to diminish the level of net international assets. Thus, in the first half of the year, the accumulated change in net domestic credit was -43,739 million pesos, below the -30,647 million peso pre-established ceiling¹⁶.

¹⁶ The negative limit means that net domestic credit is expected to fall by at least the amount specified.

Graph 18

Evolution of the Monetary Base in the First Semester of 2000

Thousands of millions of pesos



In the aforementioned period net international assets rose by 2.224 billion dollars, out of which 445 million dollars stemmed from foreign exchange operations with the Federal Government and Pemex, and 872 million with credit institutions (922 million dollars in purchases through the options scheme¹⁷ and 50 million dollars sold by means of the established automatic mechanism)¹⁸.

III.2.2. Monetary Aggregates: M1a and M4a

Demand for liquidity —measured through the evolution of money supply (M1a)¹⁹— is positively related to economic activity and negatively related to interest rates (which represent the opportunity cost of maintaining liquid monetary balances). Thus, in times of robust economic growth and declining interest rates —as was the case in the January-April 2000 period— a strong demand for means of payment is to be expected.

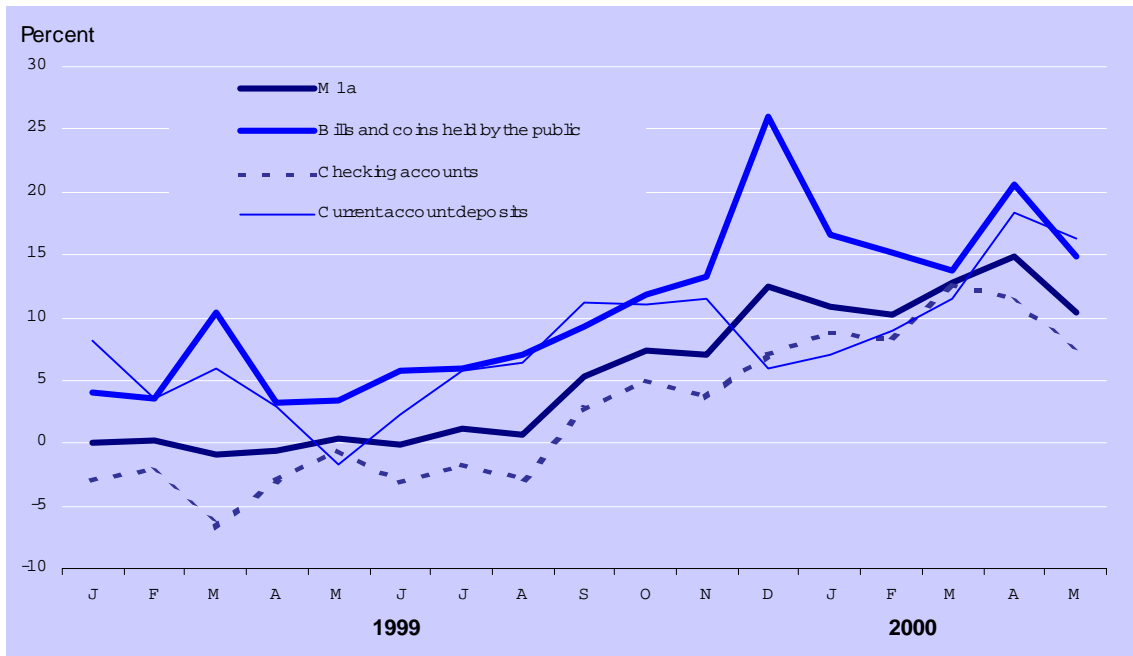
¹⁷ The Central Bank auctions dollar put options among banking institutions.

¹⁸ Through this mechanism, on a daily basis Banco de México auctions 200 million dollars among the banking institutions that, at a specified time of the day, present their bids at an exchange rate at least 2 percent above on the exchange rate observed the previous business day.

¹⁹ Composed mainly of checking accounts in domestic currency and bills and coins held by the public.

In the first quarter of this year, the monetary aggregate M1a grew at an annual average rate of 12.2 percent in real terms. Nevertheless, preliminary figures for May show that the growth rate of said aggregate has declined to 10.3 percent in real annual terms, similar to the figure observed in the January-February period. Moreover, the growth rates for all the components of the M1a aggregate slowed down in the April-May period (Graph 19).

Graph 19 Evolution of Money Supply (M1a)
Real annual change in percent

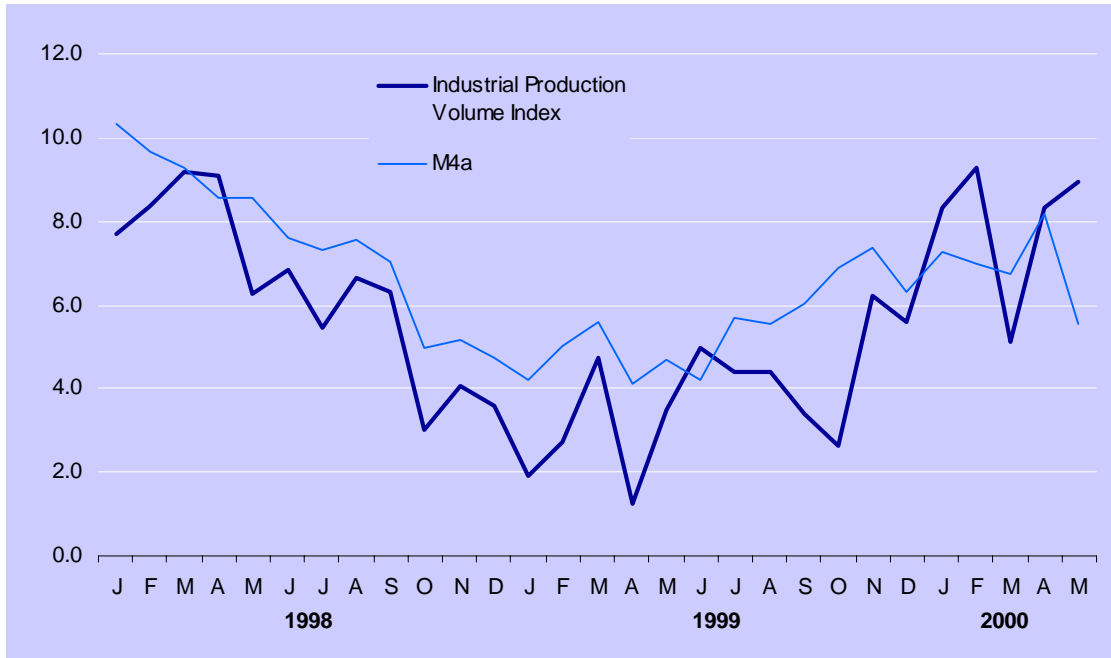


In April and May the broad monetary aggregate M4a expanded to an annual average real rate of 6.9 percent, almost matching the figure posted in the first quarter. Growth rates of M4a continue to be consistent with the pace of economic activity (Graph 20).

Graph 20

Monetary Aggregate M4a and Economic Activity

Real annual change in the seasonally adjusted series in percent



The evolution of bank deposits stands out among the main components of M4a, as said deposits maintained their negative trend and contracted at an average annual real rate of 3.9 percent in the first five months of the year. This contraction reflected banks' weaker financial intermediation. It is worth to point out, however, that the decline in bank deposits has been offset by the increase in the placement of other instruments composing M4a, outstanding among which are government securities²⁰.

Because of current definitions of monetary aggregates, the amount of domestic liabilities held by economic agents residing abroad may be quantified. Said liabilities may also be measured by the currency in which they are denominated. In this regard, it may be seen that the amount of non-residents' savings in domestic financial instruments and the deposits in Mexican banks' agencies abroad —considered to be the most volatile components of financial

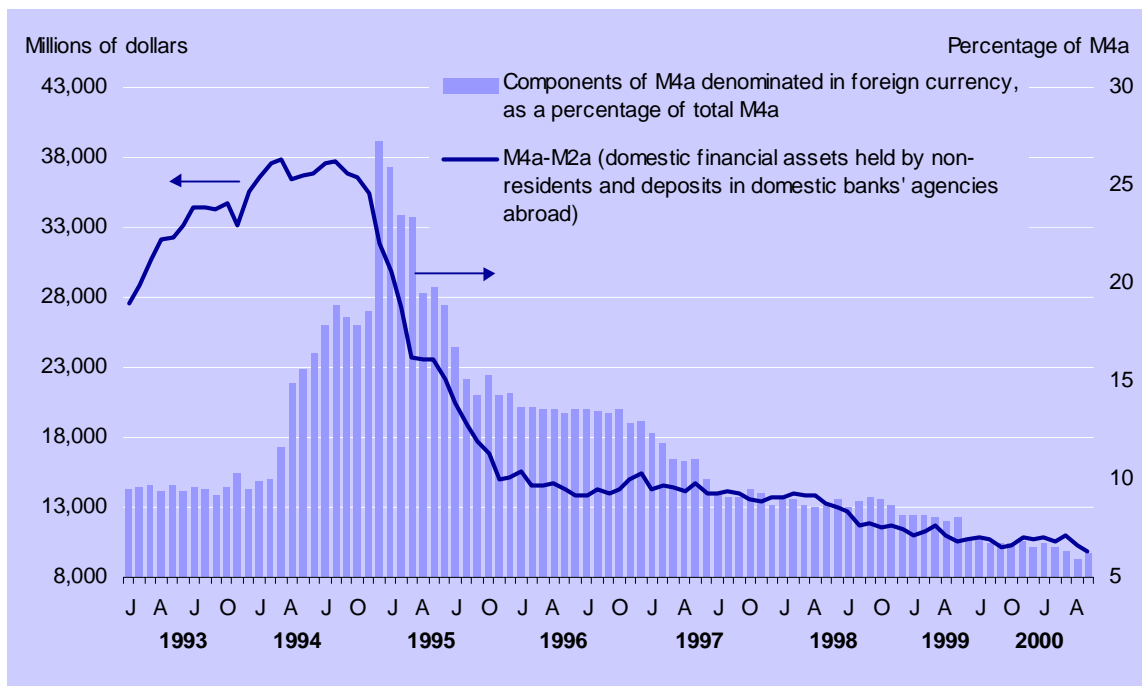
²⁰ The holding of government securities include those placed with purposes of monetary regulation.

savings— fell from 36.756 billion dollars in May 1994 to 9.840 billion in May 2000. In turn, the components of M4a denominated in foreign currency and measured as a percentage of this aggregate's stock have shown a substantial reduction from a maximum of 27.3 percent in December 1994 to 6.2 percent in May 2000 (Graph 21). This evidences the Mexican financial intermediation process' reduced vulnerability to possible domestic and external shocks.

Graph 21

Financial Savings Indicators

Stocks in millions of dollars and percentages of M4a



IV. Private Sector Outlook

After having declined in April and May, inflation expectations for the year 2000 slightly rebounded in June, mainly due to the fact that the inflation rate observed in that month was higher than the anticipated figure. However, the downward trend of inflation expectations for the following 12 months and for the year 2001 that has been shown for some time continued. It is worth stressing that this trend was not affected by the impact of international financial markets' volatility on domestic markets nor by the uncertainty prevailing in the weeks previous to the July 2 elections. The consolidation of the downward trend in medium-term inflation expectations within a volatile environment is attributable to the following: the favorable perception of the Mexican economy's fundamentals, the generally positive evolution of the main external variables affecting the domestic economy, and the timely monetary policy reactions.

IV.1. Forecasts for the Main Determinants of Inflation

At the time this Report went to press, most analysts continue to envisage that the main external variables that influence the performance of the Mexican economy will continue to be favorable. The following forecasts are noteworthy:

- (a) a 3.6 percent annual growth in the United States economy for the second quarter. The growth expectation for the Mexican economy in the year 2000 went from 4.3 percent in March to 4.7 percent in June; and
- (b) a 22.40 dollars per barrel forecast for the average price for Mexico's crude oil mix for export for the third quarter, and 20.54 dollars per barrel for the remainder of 2000.

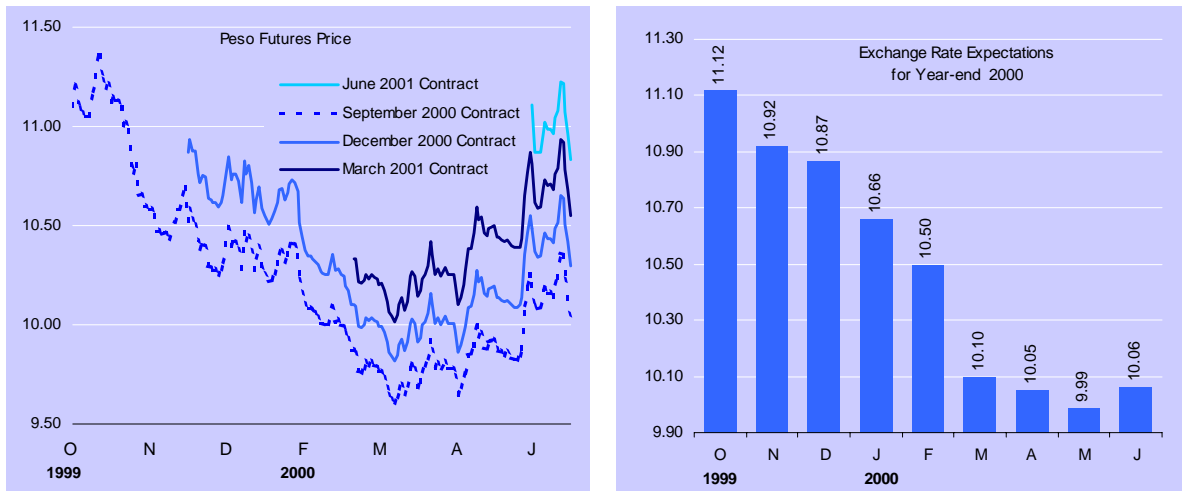
Year-end 2000 exchange rate forecasts have been revised downward according to the April and May surveys. Nevertheless, the volatility experienced by the spot exchange rate in June pushed this expectation slightly up to 10.06 pesos per dollar (Graph 22). In turn, the peso futures price was affected early in the quarter by fluctuations in the NASDAQ, giving rise to a slight increase in said price. Furthermore, the June volatility caused a significant upward revision in the peso futures price, which was reverted early in July.

Thus, at the time this Report went to press, the peso futures price for December 2000 was 9.72 pesos per dollar. According to Banco de México's June survey, the private sector anticipates that the exchange rate for July, August, and September will be at 9.81, 9.77 and 9.82 pesos per dollar, respectively.

Graph 22

Peso Futures Price and Exchange Range Expectations for Year-end 2000

Pesos per dollar

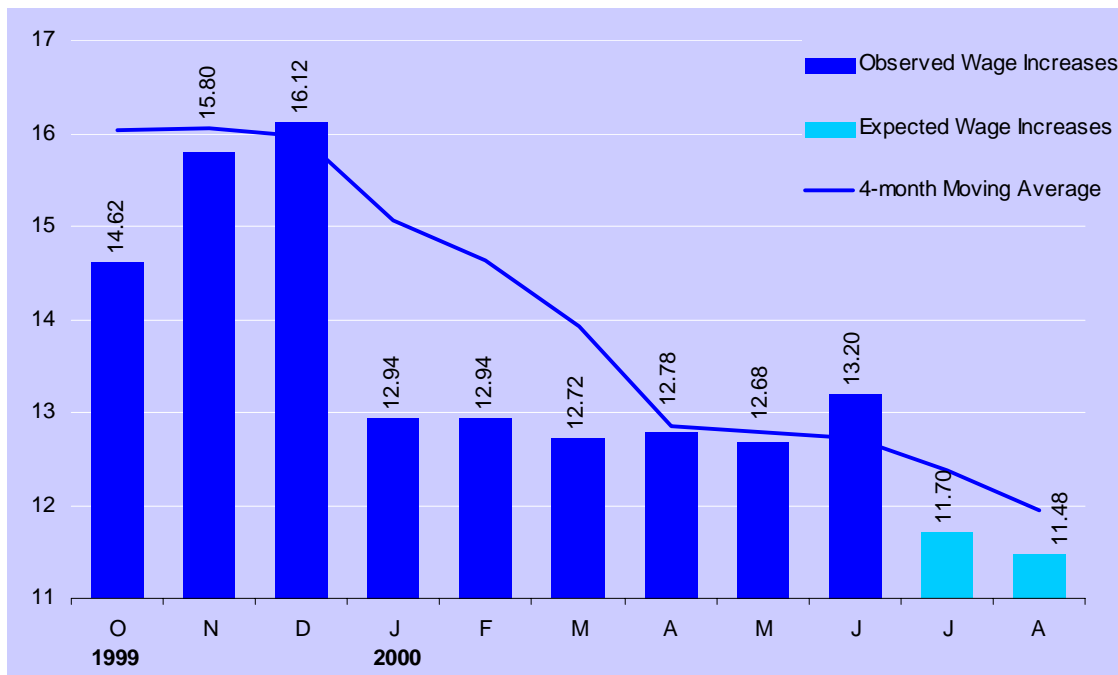


SOURCE: Bloomberg and Banco de México's Survey of the Expectations of Private Sector Economic Specialists.

Another variable significantly affecting inflation forecasts is wage increases. Analysts consulted through Banco de México's surveys anticipate that wage increases to be granted in July and August will reach 11.70 and 11.48 percent, respectively (Graph 23).

Another factor having a significant effect on the inflationary process and thereby on inflation expectations are the adjustments in the prices of goods and services provided or regulated by the public sector. In this regard, the survey conducted in late March indicates that analysts anticipate the attainment of fiscal targets established by the Federal Government. In other words, no deviations from the public price program announced in early 2000 are expected.

Graph 23 **Increases in Contractual Wages**
Percent



SOURCE: Ministry of Labor. Data for June and July correspond to private sector forecasts obtained through Banco de México's Survey of the Expectations of Private Sector Economic Specialists.

The forecasts on GDP annual growth have been revised upward from 4.8 percent in the March survey to 5.53 percent in the June survey. Although indicators on the business climate and confidence level compiled through Banco de México's survey show a favorable scenario, these indicators have deteriorated as compared to the March survey. Thus, the ratio of consultants who believe that the business climate will improve in the following six months fell from 89 to 20 percent, while those expecting the worsening of such climate rose from 0 to 27 percent. This result is partially accounted for by the economic slowdown expectation that normally arises after a period of rapid growth such as the one experienced by the Mexican economy in the first half of the year.

According to the consultants surveyed, the main factors that could hamper economic activity in the coming months include: political uncertainty (28 percent of responses); possible increases in external interest rates (12 percent of responses); and the availability of external financing (11 percent of responses).

IV.2. Inflation Expectations

Analysts' monthly inflation forecasts for July, August and September were revised downward in April and May, and slightly upward in June. Those projections show that annual inflation will decline from 9.41 percent in June to 9.12 percent in September (Table 7).

Table 7

Monthly and Annual Inflation Expectations

Percent	Monthly	Annual
July	0.55	9.29
August	0.54	9.26
September	0.83	9.12

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

According to surveys conducted by Banco de México, in April and May inflation expectations for the years 2000 and 2001 declined respectively from 9.67 and 8.76 percent in March to 9.11 and 8.08 in May. Likewise, inflation projections for the following 12 months decreased from 9.51 percent in March to 9.01 percent in May. In June observed inflation was higher than anticipated, and the expectations for July, August, September and for the full year 2000 (9.21 percent) were revised upward. Nevertheless, specialists considered this phenomenon to be transitory, since the expectations for the following 12 months and for 2001 remained on their downward trend. According to the aforementioned surveys, inflation forecasts for the following 12 months and for the year 2001 declined from 9.01 and 8.08 in May to 8.89 and 8.07 percent in June (Graph 24). It is worth stressing, however, that the speed at which these expectations have been declining has become much more moderate, and the inflation level anticipated for 2001 is still inconsistent with the objective of achieving the inflation of Mexico's main trading partners by year-end 2003.

Graph 24

Evolution of Inflation Expectations

Annual change in percent



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

It should be mentioned that exchange rate variations in June did not affect the evolution of medium-term inflation expectations.

The information incorporated into some financial instruments does not reflect the drop in inflation expectations. This is attributable to the rise in interest rates for all maturities and a marginal expansion in the spread between Cetes and Udibonos interest rates (Graph 25) caused by adjustments in country-risk perception, exchange rate volatility and a more stringent monetary policy stance. Nevertheless, a flatter Cetes yield curve evidences the expectation that both inflation and nominal interest rates will go down.

In sum, the recent behavior of private sector inflation expectation suggests that the unexpected inflation rate and the exchange rate volatility observed in June affected inflation expectations for the year 2000 only—in particular those for the third quarter—while medium-term expectations continued to decline. Nevertheless, said expectations remain at levels inconsistent with the path required to make domestic inflation converge with the rates observed in the economies of Mexico's main trading partners by the year 2003. Although the decline in these expectations continues, it has taken place at a slower pace than in the past.

Relationship between Inflation Expectations and the Spread between Cetes and Udibonos Rates

Cetes are securities issued by the Mexican federal government and placed at discount; their yield is paid at maturity. Savers always seek a yield that covers both a real rate reflecting the opportunity cost of their funds and expected inflation to offset the erosion in the security's real value caused by the growth prices.

Udibonos are securities issued by the Federal Government as well. However, Udibonos have coupons—in other words, they pay interest at certain intervals before maturity, based on the value of the principal and a fixed interest rate. The value of the principal is updated in line with the evolution of the INPC, and therefore the buyer knows that the security's real value does not change as a result of unexpected variations in the inflation rate. Whereas the yield on Cetes has to compensate for the inflation expected by the holder, in the case of Udibonos the buyer will only demand a yield that covers the real opportunity cost of the invested funds.

Therefore, the Udibono yield provides information on the real interest rates paid in Mexico. In turn, the spread between the yields of these two types of securities gives an estimate of the inflation rate expected by Cete holders. Expected inflation is calculated by deducting the Udibono real yield from Cetes nominal yield.¹

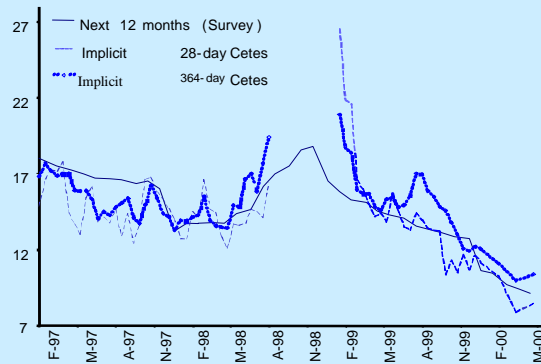
However, in practice some problems arise in interpreting this estimation. The maturity of a bond is another component that determines its yield. If everything else remains constant, a longer maturity implies a higher yield, as the holder is required to postpone using his or her funds for a longer period. Because Udibonos generally have longer maturities than Cetes, yields on Udibonos can be expected to be higher than on Cetes. Consequently, the aforementioned spread would underestimate expected inflation.

Another component of the spread between the yields on Cetes and on Udibonos is a risk premium, as Cete holders demand it to compensate for uncertainty regarding future inflation rates. When investors deem probable that the economy may be exposed to shocks leading to an inflation rate different from the expected one, they will demand a greater compensation. This would generally imply that spread between the yields on Cetes and on Udibonos would be larger than the expected inflation rate. In other words, the effect of this risk premium would be contrary to that of the differences in maturities; in other words, it would tend to overestimate expected inflation.

Finally, in an economy open to international capital flows, the buyer of a peso-denominated bond requires its nominal yield to cover for the external nominal yield plus the expectation for the exchange rate depreciation. If the purchasing power parity is maintained—i.e., if the domestic currency depreciation equals the difference between domestic and external inflation—the above calculation would be correct. However, if the purchasing power parity is not maintained, this calculation would not properly reflect inflation expectations. Due to the fact that deviations in the purchasing power parity tend to be more significant in the short-run than in the long-run, it is likely that their effects would be greater on the Cetes yield than on the Udibonos yield. This implies that in times when the expected depreciation of the domestic currency exceeds the expected difference between domestic inflation and external inflation, this calculation may overestimate expected inflation. The contrary would occur in the opposite case.

¹ The exact calculation is $\pi^e = (1 + i) / (1 + r) - 1$, where π^e is the expected inflation rate, i is the nominal interest rate on Cetes, and r is the real interest rate on Udibonos. When interest rates are low, approximately the same result may be obtained by subtracting one rate from the other.

Graph 1
INFLATION EXPECTATIONS FOR THE FOLLOWING TWELVE MONTHS AND EXPECTED INFLATION IMPLICIT IN THE SPREAD BETWEEN CETES AND UDIBONOS YIELDS



Graph 1 includes the evolution of inflation expectations calculated from the spread between the Cetes and Udibonos yields, as well as the public's inflation forecasts for the following twelve months obtained from the Survey of the Expectations of Private Sector Economic Specialists conducted by Banco de México. The former calculation was obtained using yields on 28- and 364-day Cetes as well as the yield on the 5-year Udibono (the bond most regularly issued).

This graph shows that inflation expectations implicit in the spread between yields tend to be higher than inflation expected by surveyed analysts. This suggests that the effect of the risk premium paid by Cetes owing to unexpected changes in the inflation rate prevails over the effect of the longer maturity of Udibonos.

The graph also reveals that the gap between inflation expectations obtained from the survey and those inferred from the spread between the yields on Cetes and Udibonos is not constant. This gap tends to widen when investors expect larger depreciations of the domestic currency which are not matched in the short-run by higher expected inflation. In such periods, the expected inflation inferred from the spread between yields overestimates actual inflation.

Despite of the above problems, the graph shows that both indicators behave very similarly. Therefore, when financial volatility does not represent a significant concern, inflation expectations obtained from the spread between the yields on Cetes and Udibonos are an indicator that complements well the figures on inflation expectations gathered through surveys.

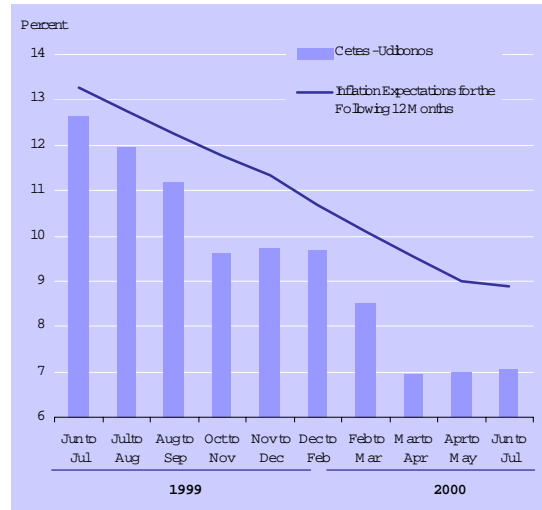
Graph 25 Nominal Cetes Yield Curves and Yield Spread between Cetes and Udibonos

Primary auction rates

Nominal Cetes* Yield Curves



Spread between the yields on Cetes and Udibonos



*The 3-year Cete is issued with fixed-rate coupons.

Table 8 Summary of Private Sector Expectations

Exchange Rate (year-end 2000)	10.06 (pesos/dollar)	Oil Price (IV Qtr. 2000)	18.68 (dollars per barrel)
Exchange Rate (July average)	9.81 (pesos/dollar)	Real Growth in the U.S.A.* (III Qtr. 2000)	3.70%
Exchange Rate (August average)	9.77 (pesos/dollar)	Real Growth in the U.S.A. (2000)	4.70%
Exchange Rate (September average)	9.82 (pesos/dollar)	Annual Inflation in Mexico (end of September)	9.12%
Wage Increases (July)	11.70%	Annual Inflation in Mexico (year-end 2000)	9.21%
Wage Increases (August)	11.48%	Real Growth in Mexico (II Qtr. 2000)	5.90%
Oil Price (III Qtr. 2000)	22.40 (dollars per barrel)	Real Growth in Mexico (2000)	5.53%

SOURCE: Survey of the Expectations of Private Sector Economic Specialists and Bloomberg.
* Annualized quarterly growth rate.

V. Assessment of Risks and Conclusions

During the second quarter of this year, the downward trend displayed by inflation since early 1999 strengthened, whether it is measured by the overall index (INPC) or by the core inflation index.

The above outcome is accounted for essentially by the combination of the following factors:

- (a) since January nominal increases in contractual wages have been lower than those negotiated in 1999;
- (b) the external environment continued to be favorable in spite of intermittent episodes of volatility;
- (c) the domestic supply of goods and services has been very flexible, especially during the first quarter of the year;
- (d) monetary authorities' proactive approach to maintain inflation expectations in line with medium-term targets.

In May, annual inflation reached a level below 10 percent, which had been anticipated to take place a few months later. If the prices of agricultural and livestock products and of the goods and services provided or regulated by the public sector had not grown as much as they did, a further decline in inflation would have been feasible.

In the last weeks of June and early in July, the growth in the prices of agricultural and livestock products decelerated. On the contrary, the prices of goods and services provided or regulated by the public sector kept growing at high rates. This suggests that in the coming months the later prices will continue to exert pressure on overall inflation.

In the period analyzed, there were additional signs that the vigorous growth in aggregate demand —mainly in private consumption— is already affecting the prices of production inputs. In this regard, at the time this Report went to press the following issues are cause for concern:

- (a) the growth in unit labor costs in various sectors of economic activity;
- (b) the fact that contractual wage revisions have not fully incorporated the improvement in inflation expectations. Consequently, ex-ante increases in real contractual wages are still inconsistent with gains in labor productivity foreseeable in the long-run;
- (c) the shortage of skilled labor in some regions; and
- (d) an upturn in the INPP annual growth rate excluding oil and services.

Although these events do not endanger the attainment of short-term inflation targets, they suffice to maintain the restrictive bias of monetary policy in order to achieve in 2001 an inflation rate consistent with the medium-term goal: to reach an inflation rate similar to that prevailing in the economies of Mexico's main trading partners by year-end 2003.

The base scenario for the remainder of the year 2000 is based on a careful consideration of risks implicit in the evolution of external and domestic environments.

The main external factors that could hamper the future decline in inflation are the following:

- (a) an abrupt slowdown in the United States' economy;
- (b) a much greater than expected increase in international interest rates;
- (c) a collapse in the United States' securities market; and
- (d) a steep fall in international oil prices.

Signs of an economic slowdown in the United States during the second quarter sufficed for the Federal Reserve not to rise its interest rate target at its June 28 meeting. Nevertheless, the evidence that the growth of aggregate demand in that country is moving toward a sustainable rate is still tentative and preliminary. In any case, the probability of an abrupt slowdown in the United States' economy has diminished marginally since the first quarter.

The United States' economy is still growing at a vigorous pace and the slowdown observed in the second quarter may have been due to seasonal and climatic phenomena only. Therefore, a scenario where economic activity accelerates in the second half of the year along with inflation may not be discarded. Under such circumstances, an increase in interest rates far greater than expected may be required, which may induce an abrupt contraction of economic activity in the United States and a sudden drop in that country's securities market. Finally, regarding the feasibility of a drop in international oil prices and in that country's securities market, some analysts believe that both stand at excessively high levels. Thus, it would not be prudent to reject the likelihood of the aforementioned events actually occurring.

As it was mentioned in the Inflation Report January-March 2000, should any of the aforementioned possibilities materialize, the exchange rate would probably depreciate in response to a weaker supply of foreign exchange. Under this situation, the corresponding correction in the nominal exchange rate would lead to a higher real equilibrium exchange rate. Since exchange rate movements have caused higher inflation in the past, any correction in the exchange rate would lead to the deterioration of inflation expectations and would thereby affect all kind of contract negotiations. This is why the monetary authority will react immediately should there be evidence that exchange rate adjustments could be causing a significant upward revision of medium-term inflation expectations and affecting the evolution of prices for non-tradable goods.

Monetary policy actions would not be geared to protecting a specific exchange rate level, however. One of the main advantages of a floating exchange rate regime is having the necessary flexibility for the real exchange rate to move towards another equilibrium level in response to external shocks (such as changes in the terms of trade and in capital flows) or internal shocks (for example, changes in the level of public spending). Nevertheless, a higher real exchange rate may result from various combinations of nominal depreciation and inflation. In such a scenario, Banco de México's interventions would focus on achieving the adjustment required in the real exchange rate at the lowest possible cost in terms of inflation.

Concurring with the opinion of most private analysts, Banco de México estimates that the pessimistic scenario described above is not likely to occur. Therefore, the Central Bank's base

scenario for the external environment during the second semester includes the following forecasts:

- (a) a gradual deceleration of the American economy; and
- (b) international oil prices slightly below the average level registered in the first semester.

A gradual and orderly slowdown of the United States' economy would indeed act in favor of stability in international and domestic financial markets. Nevertheless, if and when this adjustment takes place, the growth of Mexican exports —oil and non-oil exports alike— could be weakened.

The balance of the aforementioned events would be a reduction in the growth rate of aggregate demand and a widening of the trade deficit, which would very likely continue to be financed mainly by foreign direct investment. Consequently, no inflationary pressures additional to those already mentioned in this Report are anticipated.

Regarding domestic risk factors, the following should be taken into consideration. Throughout the second quarter, there were signs that the rapid growth in aggregate demand could be pushing unit labor costs up along with contractual wage revisions and the producer price index (INPP). Even though there is preliminary evidence that the growth of aggregate demand has diminished marginally, this has occurred together with a slight deceleration in domestic supply growth. Consequently, the trade balance has remained relatively stable. In sum, available information suggests that an excessively strong expansion of aggregate demand may be taking place —particularly in private consumption.

This situation could become more complicated in the future in response to recent developments in financial markets. Projections for the Mexican economy were favorably reassessed in the early weeks of July, after the elections had taken place without disruption. Accordingly, the exchange rate appreciated, interest rates fell considerably and the Mexican stock market index soared. These events may indicate that the markets are expecting larger short-term capital flows coming into Mexico. If such inflows were to materialize, together with consumers' and firms' stronger confidence on the future course of the domestic economy, a scenario of greater optimism could ensue and this would further stimulate the

expansion of aggregate demand. The outcome would be additional pressures on the prices of non-tradable goods.

The progress so far made to curb inflation has been very significant. However, private sector expectations suggest that a certain degree of skepticism remains with regards to the feasibility of a continued reduction in price growth in order to reach the target established for year 2003. This is corroborated by the fact that analysts anticipate merely a 1.14 percentage point reduction in inflation for 2001, which would represent a relative setback when compared to the results obtained in the last few years. This relative pessimism stems from the inflationary pressures that have been recorded in the last few months and described throughout this Report. Furthermore, such expectations are also the result of the array of domestic and external risks which, should they materialize, could complicate the future abatement of inflation.

After having weighed all the aforementioned elements, Banco de México estimates that price growth in the third quarter will be below that posted in the same period of 1999, and annual inflation will thus maintain its downward trend. Although annual inflation rates will decline between June and September, it is likely that such reduction will be less significant than the one attained in the second quarter. Finally, inflation in the third quarter will surpass that reported for the second quarter, mainly as a result of seasonal factors. In this regard, it is worth mentioning that September is usually a month of relatively high inflation caused by rises in tuition fees.

The challenge faced by monetary policy is to create the necessary conditions to consolidate the progress made so far in reducing inflation. A moderation of aggregate demand growth is a key element of this undertaking, inasmuch as it should not exceed the limits imposed by installed capacity.

Restrictive macroeconomic policies are essential to contain the expansion of aggregate demand. Accordingly, Banco de México has tightened the monetary policy stance several times during the year. However, more stringent monetary conditions could induce, at least initially, a greater appreciation of the exchange rate, which would in turn stimulate spending on tradable goods and bring forth a larger trade deficit. The resulting increase in the external deficit would likely be financed by short-term capital inflows. The latter outcome would nonetheless magnify the vulnerability of the

disinflation process and subsequently weaken monetary policy's effectiveness to contain inflationary pressures. Therefore, fiscal restraint would be the most effective means to temper aggregate spending. By increasing public saving, such a policy measure would have a direct effect on the domestic economy's total saving, and would thus inhibit the continued expansion of aggregate demand while reducing the need for external financing.

Looking forward, it is essential to implement a fiscal reform that could substantially boost the federal government's capability of collecting non-oil revenues. This, in order to maintain sound public finances even within a less favorable context and support both the sustainability of the economic growth process and the continued decline in inflation.

In short, the optimum economic policy response to contain the aggregate demand pressures currently affecting the Mexican economy would entail a coordinated implementation of monetary and fiscal policies. This would allow for the simultaneous deceleration of domestic spending while limiting the deterioration of the country's external accounts. A moderation of the expansion of aggregate demand becomes even more significant within the context of the expected slowdown in the United States' economy, which by itself would likely trigger a larger Mexican trade deficit. The latter would widen further should domestic spending keep on growing at its current pace.

The implementation of more restrictive monetary and fiscal policies would help maintain the Mexican economy's external financing requirements within the limits imposed by sustainable long-term capital inflows, and would forestall inflationary pressures incompatible with the stated targets even if the external environment conditions were to deteriorate.