Inflation Report

April - June 2001

Summary

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

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

Although the adjustment of the Mexican economy to this unfavorable external environment has had negative effects —as shown by slower growth of exports, the contraction of industrial output and the loss of jobs— it has nevertheless been an orderly process.

It is likely that economic expansion of both the Mexican and the United States' economies in the second quarter will be lower than had been originally expected. Consequently, the Mexican economy will continue to register growth rates below those of its potential GDP. This suggests that inflationary pressures will tend to tone down over the remainder of the year.

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

Recent Developments in Inflation

Price developments during the second quarter of the current year were compatible with the objective of attaining an annual inflation rate below 6.5 percent in December 2001. In June, annual inflation —as measured by changes in the INPC— was 6.57 percent, while in March it had been 7.17 percent.

Moreover, the annual growth rate of the core price index was 6.36 percent in June. Although core inflation was lower than overall consumer inflation, the April-May period was the second quarter in which the differential between the two indicators narrowed.

During the quarter, core inflation of goods was slightly higher than that of services. This can be partly explained by the appreciation of the exchange rate, which helped to curb increases in the prices of goods. The slower decline of core inflation for services was fundamentally due to the fact that real wages rose more than productivity.

The behavior of prices for goods and services provided or regulated by the public sector contributed to the fall of overall inflation. These prices declined by 1.27 percent in the quarter.

Regarding the National Producer Price Index excluding oil and services (*Indice Nacional de Precios al Productor*, INPP) its annual inflation rate fell significantly in the April-June 2001 period, having reached 4.46 percent by the end of the quarter. Since changes in the INPP can be a leading indicator of inflationary pressures on the INPC, its recent path points to a further reduction of overall inflation over the medium term.

Main Determinants of Inflation

During the second quarter of 2001, the evolution of the external variables that affect the behavior of the Mexican economy continued to be unfavorable: the price of the Mexican crude oil mix for export was considerably lower than in the previous year; the world economy continued to decelerate as the impact of lower growth in the United States began to intensify; and the uncertainty over the situation in Argentina affected investors' country-risk perceptions regarding emerging economies.

In the second quarter of 2001, the average international oil price was 27.96 dollars per barrel (85 cents less than that observed over the previous quarter).

There is still uncertainty concerning a rapid recovery of economic activity in the United States. At present, analysts believe that its growth rate will reach 1.14 percent in the second quarter and 1.6 percent for the year as a whole.

The International Monetary Fund (IMF) reduced its 2001 growth forecast for the euro zone to 2.4 percent. The contraction registered in Japan during the first quarter has led to a correction in the forecasted growth for this country, from 1.8 to 0.6 percent. Regarding Latin America, the increasing uncertainty stemming from the situation in Argentina, together with the effects of the slowdown in the United States' economy and the fall in raw materials' prices have meant that projected growth for the region has been revised downward to 3.7 percent. It is worth mentioning, nonetheless, that the medium term outlook for the Mexican economy has improved, and this has contributed to differentiate investors' perceptions of Mexico's country risk from the situation in Argentina.

Figures available for April 2001 show that compensations per worker rose at annual rates between 4.5 and 15.1 percent. In turn, contractual wage increases in the manufacturing industry behaved in a slightly more moderate manner, having moved from 10.7 to 10.1 percent between February and June 2001. In comparison, for the remaining economic sectors as a whole, growth in contractual wages went up from 9.8 to 10.2 percent in the same period.

In the first quarter of 2001 there was a deterioration of conditions in the Mexican labor market due to the deceleration of both the Mexican and the United States' economies. From November 2000 to June 2001 the employment level decreased by 3.4 percent, the largest fall in the last five years.

Real wage increases above productivity gains have already caused unit labor costs to rise. In the present context of economic deceleration, this has aggravated the contraction of employment and constitutes an important inflationary pressure.

The economic slowdown that began in the last quarter of 2000 intensified in the first quarter of 2001. The downward adjustment of economic growth in the United States has had a rapid impact in Mexico due to the close integration between the manufacturing sectors of both countries. Banco de México estimates that the annual growth of Mexican real GDP in the second quarter of 2001 might have been lower than 1 percent and is likely to be less than 2 percent for the year as a whole.

The reaction of private investment spending to the weakening of economic activity has been extremely fast. Although the growth rate of private consumption has suffered a downward adjustment as well, this correction has been more moderate than what could have been expected in light of the decline in real GDP growth and employment. Due to the large import content of the main components of aggregate demand, the expansion of imports of intermediate and capital goods has diminished substantially. This has helped to mitigate the slowdown of GDP and the widening of the trade deficit.

Another factor that helped to avert the exchange rate pressures that had been feared at the start of the year was the abundant supply of foreign capital prevailing during the first quarter. Foreign direct investment in the period totaled 3.597 billion dollars, the highest level registered during a first quarter since 1980, and enough to finance 82 percent of the country's current account deficit. It is estimated that the flow of foreign direct investment in the second quarter was similar to that posted during the previous quarter.

Monetary Policy in the Second Quarter of 2001

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

There are at least three elements that suggest the diagnosis made at the time of the monetary adjustment regarding the future of the Mexican economy and inflation was the correct one: improvements in inflation expectations; the bleaker outlook for economic growth in the United States and its impact on domestic output; and the persistently ample supply of foreign capital.

Nominal and real interest rates declined by around 6 percentage points in the second quarter of 2001. The less stringent monetary conditions resulted from the markets' automatic adjustment to changes in the expected future evolution of inflation as well as from the reduction of the "short".

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

On June 22nd Banco de México called on Mexican credit institutions to make voluntary deposits at the Central Bank with three year maturities. This will enable the Central Bank to maintain a creditor position vis-à-vis the banking system and preserve the monetary policy's effectiveness to influence the evolution of short term interest rates. Banco de México will replenish all the liquidity withdrawn by the aforementioned deposits, and therefore the monetary policy stance will not be modified as a result of this measure.

On May 18th, 2001, the Foreign Exchange Commission decided to suspend Banco de México's auctions of foreign currency put options until further notice. This mechanism was considered to have successfully fulfilled the objectives for which it was created.

In order to preserve the symmetry of the floating exchange rate regime in force, the Foreign Exchange Commission also decided to discontinue contingent dollar sales, by which the Central Bank used to auction 200 million dollars on a daily basis.

Private Sector Outlook for 2001

Private sector analysts' estimations concerning the evolution of the external economic environment for the rest of the year did not change significantly during the quarter. The forecast for the annual growth of the United States' economy in 2001 was revised slightly downward (1.6 percent), while the average price of the Mexican crude oil mix for export is expected to be 19.49 dollars per barrel in 2001.

Expectations for the exchange rate were adjusted downward throughout the second quarter, while analysts expect there will be a reduction in nominal contractual wage increases.

The behavior of prices of goods and services provided or regulated by the public sector is expected to be in accordance with the program set out in the General Economic Policy Criteria (*Criterios Generales de Política Económica*) for the year.

Monthly inflation forecasts for July, August and September are 0.41, 0.48 and 0.78 percent, respectively.

Analysts' predictions for inflation over the following twelve months were modified from 7.09 percent in March 2001 to 6.84 percent in June, while inflation expectations for year-end 2001 declined from 7 to 6.23 percent. Based on the assumption that the fiscal reform will be passed during the current year, consultants have estimated a 7.95 percent inflation rate for the following twelve months and 7.64 percent for year-end 2001. Annual inflation for 2002 is expected to be 5.64 percent, lower than the 5.91 percent figure reported in March.

Balance of Risks and Final Remarks

During the first six months of the year inflation was conditioned by the following three factors:

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

(b) weaker domestic demand; and

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

The decline in the rate of economic growth in the United States has been greater than originally foreseen and its impact on Mexican exports and industrial output has also been more severe.

During the first quarter, Mexico received a plentiful supply of external resources. This, together with lower demand for such resources, has resulted in the appreciation of the exchange rate and the stability of financial variables.

It can therefore be said that the Mexican economy has entered the trough of the economic cycle in an orderly fashion. This environment has contributed to the reduction of inflation and domestic interest rates. The decline of the latter was validated by the monetary authority when it reduced the "short" on May 18th.

The main elements that make up Banco de México's base scenario for the evolution of the domestic economy for the remainder of the year are shown below.

In terms of the international environment:

(a) Forecasts for the expansion of the United States' economy for 2001 fall within an interval of 1.2 and 1.8 percent;

(b) The average price of the Mexican crude oil mix for export in 2001 will be 19.70 dollars per barrel; and

(c) The current account will be mainly financed with long term resources.

Based on the above and on the leading indicators available to date, a forecast for the main macroeconomic variables for the rest of the year was prepared:

(a) The annual growth rate of real GDP will be significantly lower in the second quarter than it was in the first;

(b) Inflationary pressures will be weaker than had been originally expected; and

(c) The current account deficit will be around 3 percent of GDP.

The main external risks considered in the base scenario are:

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

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

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

The main domestic risk factors that could lead to changes in the aforementioned base scenario are:

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

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

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

Notwithstanding, the Board of Governors does not underestimate the importance of the transitory factors that have led to a swifter fall of overall inflation than core inflation.

Therefore, inasmuch as the still pending structural reforms are implemented and the attainment of inflation targets is pursued, macroeconomic stability will become increasingly robust. Nothing should be more urgent than the removal of those factors that continue to interfere with the consolidation of an environment conducive to continuous improvements in the well being of the population.