Inflation Report

January-March 2002

Summary

During the first quarter of 2002, the United States economy grew at a much faster rate than expected. As a result, growth forecasts for 2002 have been revised upwards. Although evidence pointing to a recovery in Mexico has not been as conclusive as in the United States, there are some signals that suggest a rebound in economic activity.

The weakness of the economy and the appreciation of the exchange rate were two factors that helped to maintain inflation at levels consistent with the medium-term objective. This is evident as core inflation continued to descend, reaching a level close to targeted inflation for 2002.

In this regard, the evolution of the economy and the current monetary policy stance are consistent with the objective of attaining at year-end 2002 a Consumer Price Index (CPI) inflation that does not exceed 4.5 percent.

Recent Developments in Inflation

In general, the path of annual inflation during the January-March quarter proved to be in line with what was foreseen in the previous Inflation Report. Thus, CPI yearly inflation increased while core inflation continued to decrease. Nonetheless, the performance of both indices proved to be compatible with the target. In this respect, the following results are noteworthy:

(a) Annual CPI inflation was 0.26 percentage points higher than the level registered at the closing of the previous quarter. In contrast, core inflation diminished 0.54 percentage points.

(b) Annual core inflation of goods fell. That pertaining to services posted an increase during the first two months of the quarter, which was partially reverted in March.

(c) The luxury tax had a limited effect on inflation.

(d) Inflation of agricultural and livestock goods' prices exhibited great volatility. In addition, its contribution to annual CPI inflation was higher.

(e) Annual inflation of the sub-index of prices provided or regulated by the public sector rose substantially. This can be explained by the sharp upward movement in Mexico City's subway, urban transportation and electricity prices as well as in fees for licenses and other official documents.

The upturn in annual CPI inflation during the present quarter reflects the volatility of the prices for goods and services excluded from core inflation estimates. This emphasizes the importance that the latter has acquired as a reliable indicator of inflationary trends.

Behavior of Several Inflation Indicators

The CPI registered a 4.66 per cent annual growth at the end of the first quarter of 2002. In contrast, core inflation remained on a downward trend, reaching 4.54 percent in March.

Inflation turned out to be 0.92, -0.06 and 0.51 percent in January, February and March, respectively. Although CPI inflation experienced a substantial increase in January 2002 compared to the same month in 2001, its statistical trend registered a marked fall. This can be explained by the significant reduction in monthly inflation during the fourth quarter of 2001 and in February 2002.

Annual inflation of the Producer Price Index (PPI) excluding oil and services was 1.66 percent in March 2002, while in December 2001 it had been 2.61 percent. The slow growth of this index during the January-March quarter can be attributable mainly to the appreciation of the exchange rate. This behavior suggests that tradable goods inflation could weaken even further in the medium term.

During the first quarter of 2002, the agricultural and livestock price sub-index accumulated a –4.5 percent variation. However, the behavior of prices included in this sub-index at a monthly rate was characterized by severe fluctuations. One product which has a high incidence on this indicator (due to a weight in the CPI close to 1 percent) and whose price experienced high volatility was tomato. Other agricultural goods that registered substantial quarterly price variations were green tomato (-21.91 percent), onion (-27.49 percent) and carrot (-20.47 percent).

Main Determinants of Inflation

The external variables that influence the Mexican economy had a more favorable behavior during the first quarter of 2002. The price per barrel of the Mexican crude-oil export mix went up from 15.85 dollars at the onset of the year to 22.23 dollars at the end of March. Likewise, indicators for economic activity in the United States continued strengthening, a development which will probably lead to a recovery of Mexican exports. Finally, country risk perceptions for Mexico continued to improve, a fact that may translate into lower costs of external financing.

United States' GDP growth rate during the last quarter of 2001 was 1.7 percent, a result that confirms that the recession in 2001 was the shortest-lived in recent history. During the first quarter of 2002, evidence of the recovery of economic activity strengthened, in light of the general improvement in industrial sector indicators and the persistent vigor of private consumption. The economic policy measures applied have been crucial in rapidly overcoming the recession. In fact, some analysts have begun to advance the idea that part of the stimulus which has driven the economy needs to be reverted.

Although the United States rebound seems to be robust and has occurred earlier than expected, employment has remained sluggish. Hence, between February and March, statistics on the non-agricultural payroll barely showed signs of improvement while several other indicators only recovered slightly. During most of the first quarter of 2002, unemployment claims remained stagnant at nearly 370 thousand per week (a figure similar to the one registered in the previous year) although they seemed to have increased towards the end of the quarter. Likewise, the unemployment rate rose to 5.7 in March, significantly above the estimated level for the non-inflationary rate of unemployment.

The slowdown experienced by the European Union countries apparently ended during the first quarter of 2002. Since December 2001, some leading indicators of economic activity have suggested that an upturn is imminent.

As for Japan, real GDP is expected to have grown 1.1 percent during the first quarter of 2002, compared to the 4.5 percent reduction it experienced in the last quarter of 2001. Estimates are for an initially moderate upturn due to the unfavorable behavior of consumption and employment, and the relatively austere fiscal policy stemming from the difficulties experienced by local governments. Nevertheless, the IMF still expects a one percent contraction of real GDP during 2002.

Economic recovery in the United States has yet to impact Latin American exports. Although the crisis in Argentina deepened at the beginning of 2002, it has not severely affected the rest of the countries of the region. Since mid-February, Venezuela became a new source of instability for Latin America, a fact which might have contributed to volatile international oil prices.

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During January-March 2002, increases in compensations and real wages eased, although they are still far from being totally aligned with the decrease in expected inflation and with productivity gains not associated with cyclical factors.

This, together with the recently higher demand for Mexican products from the United States, helped to improve (albeit marginally) the prevailing conditions in the labor market.

In January 2002, in sectors for which information is available, nominal remunerations per worker showed annual variations between 7.7 and 14.7 percent. During the previous year, nominal remunerations posted average growth between 5.7 and 14.9 percent, thus implying real increases of between –0.5 and 8 percent.

Labor productivity experienced variations between –4.2 and 5 percent in January while rises in unit labor costs fluctuated between 3.2 and 7.3 percent.

The average increase in nominal contractual wages during the first quarter of 2002 was 6.5 percent. It should be mentioned that during this period, the slower pace of wage increases that had long been expected due to the slack in the labor market, materialized. Thus, the average rise in contractual wages stabilized during the quarter at between 6.1 and 6.9 percent. The spread between contractual wages and expected inflation for the next twelve months was 2 percent and turned out to be narrower than the 2.8 percent observed last year.

Employment continued falling. At the end of March the number of workers (permanent and temporary urban employees) affiliated to the Mexican Social Security Institute (IMSS) was 12,129,368 persons, 34,269 less than the total registered at year-end 2001. It should also be mentioned that in February and March nearly 95 thousand jobs were created. On the other hand, the seasonally adjusted series for permanent and temporary urban employees affiliated to IMSS recorded an increase of 3,642 jobs during the first quarter of 2002, hence implying a moderation of the fall in employment.

Although the labor market continued showing weaknesses during the first quarter, it has begun to display some signs of improvement. In regards to labor income, increases in contractual wages have tapered off to between 6.5 and 7 percent. On the other hand, although employment has started to present some signs of recovery, accumulated job losses are still noteworthy. Therefore, Banco de México reiterates the need to ease the downward rigidity of wage increases.

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During the first months of 2002, data on economic activity in Mexico produced ambiguous signals. While the number of positive ones grew, some variables continued to show weaknesses and others displayed fluctuations, not allowing to conclude that a sustained improvement is taking place.

Banco de México estimates that real GDP contracted at an annual rate of 1.6 percent during the first quarter of 2002. After adjusting for the effect of the Easter holiday and other seasonal phenomena, the estimate for GDP's annual decrease would be closer to 0.7 percent, while the quarterly variation of seasonally adjusted data would register a positive figure. The annual variation rate of private consumption during the referred period is expected to be 1 percent whereas total investment is anticipated to have suffered a 6 percent reduction.

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The accumulated total and non-oil trade deficits decreased by 16 and 19 percent, respectively, in the quarter. Based on this information, the current account deficit is expected to have been close to 4.2 billion dollars.

The availability of external capital aided in stabilizing the main financial variables. The capital account surplus is estimated to have amounted to 5.5 billion dollars. Just as in previous quarters, Foreign Direct Investment (FDI) most likely expla ined a substantial proportion of this surplus.

Finally, the exchange rate appreciated 1.4 percent, closing at 9.02 pesos in March due to the favorable behavior of country risk indicators registered during the quarter.

The appreciation of the peso has not had a discernible link to monetary policy. It is important to mention that during the recent period of exchange rate appreciation, interest rates fell to historic minimum levels. In the hypothetical case that the monetary authority would have tried to appreciate the exchange rate in order to support the disinflationary process, such strategy would have required an increase in interest rates. Recent financial stability has resulted from capital market's expectations of a substantial real GDP growth and increases in productivity levels in the Mexican economy. This has led to high capital inflows to the country, consequently revaluating Mexico's assets and appreciating the exchange rate.

The process outlined has similarities with the one experienced by other countries (Spain and Portugal, for example) that underwent a period of macroeconomic convergence with their more developed trading partners.

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During the quarter, monthly inflation of the prices of goods and services provided or regulated by the public sector was 1.53, 1.86 and 1.05 percent, which compares unfavorably with that registered in the same months of the previous year.

The rise in electricity tariffs for residential use had an adverse effect on overall inflation. Thus, such measure had a direct effect of 0.27 percentage points in February, 0.10 in March and 0.37 percentage points for the year as a whole.

Monetary Policy during the First Quarter of 2002

Monetary Policy Actions

On February 8th, the Board of Governors of Banco de México decided to raise the "short" from 300 to 360 million pesos, maintaining it at that level throughout the rest of the quarter.

This measure was adopted to prevent the deterioration of inflation expectations and the consequent contagion of the process of price formation, resulting from the partial elimination of the subsidy on electricity announced by the Federal Government on January 29th and which went into effect on February 8th. Unlike other elements which where anticipated in the Monetary Program for 2002 and which might have caused an increase in inflation during the first quarter of the year, the referred measure was not considered in the Monetary Program.

The increase in the "short" was effective in containing the adverse effects of the reduction in the ele ctricity subsidy on inflation expectations.

During the reported quarter, expected inflation for 2002 decreased 0.34 percentage points. In line with these estimates, inflation forecasts for the following twelve months and for year-end 2003 also fell 0.48 and 0.37 percent percentage points, respectively.

During the first quarter of 2002, nominal and real domestic interest rates behaved differently from external interest rates, thus indicating that the former were mainly determined by national events.

During the last week of January, nominal and real interest rates posted a substantial increase in anticipation of the foreseeable inflationary effect stemming from the partial elimination of the electricity subsidy. Once again, in the second week of February, interest rates increased at the time the "short" was modified (February 8th.) As inflation forecasts evolved favorably and the seasonal effects associated with the Easter vacation period began to ease, interest rates started to decrease towards the end of the quarter.

Monetary and Credit Aggregates

At the closing of the first quarter of 2002, the stock of the monetary base amounted to 216,309 million pesos, 8,906 million pesos higher than expected. The deviation from the forecasted stock was 4.3 percent, above the upper limit of the confidence interval of the estimation model (3 percent). This can partly be explained by the high seasonal demand for cash due to the proximity of the March 21st and Easter holidays.

Accumulated international assets during the quarter amounted to 1.45 billion dollars. In order to maintain the supply of base money in line with the demand from the public, Banco de México sterilized the monetary impact of this accumulation via increases in the Central Bank's non-monetary liabilities. This, along with a seasonal reduction in the demand for base money led to a contraction of net domestic credit of 22,769 million pesos.

Preliminary figures indicate a marginal decrease in the annual variation rate of the broad monetary aggregates during the first quarter of 2002. On the other hand, the narrow money aggregate (M1) has persistently increased at higher rates than the broad aggregates.

During the same period, bank financing was mainly influenced by two factors: the continuing process of canceling commercial banks' overdue portfolio and the contraction in financing to the private sector.

The behavior of total financing has been determined by that of the performing credit and especially by the decline in credit granted to firms. Up to March 2002, the latter experienced a reduction of 17.1 billion pesos. Nonetheless, the stock of consumer credit has continually risen while credit for housing has remained practically unchanged.

Private Sector Outlook[1]

During the January-March 2002 period, economic analysts modified their forecasts on the performance of the main macroeconomic variables for the present year, with the following outcomes: higher GDP growth, an increase in oil prices and a moderate decrease in inflation.

Forecast on the Main Determinants of inflation for 2002

Private sector expectations regarding economic activity in the United States for 2002 increased considerably, from an annual rate of 1.1 percent in December 2001 to a 2 percent annual rate in March of 2002.

The average price of the Mexican crude-oil export mix for 2002 is expected to be 16.9 dollars per barrel.

Exchange rate forecasts for year-end 2002 went from 9.94 pesos per dollar in December 2001 to 9.52 pesos per dollar in March.

Analysts estimate that nominal increases in contractual wages during April and May will be 6.2 and 6 percent, respectively.

Forecasts of real GDP growth for 2002 were adjusted slightly upwards, from 1.42 percent in December 2001 to 1.57 in March 2002.

According to the surveyed analysts, the main elements that could hinder economic activity within a six month horizon are the following: the weakness of the external markets and of the world economy (23 percent of the responses), the real exchange rate appreciation (14 percent of the responses), the level of oil prices (19 percent of the responses), the weakness of the domestic market (10 percent of the responses), the current fiscal policy and higher wage costs. (8 percent each).

[1] Unless otherwise stated, the forecasts reported in this section are obtained from the Survey of Private Sector Economic Analysts' Expectations carried out by Banco de México.

Inflation Expectations

Monthly inflation expectations for April, May and June were 0.37, 0.22 and 0.24 percent, respectively. These forecasts imply that annual inflation will drop from 4.66 percent in March to 4.52 by June.

Annual inflation estimates for the following twelve months posted a reduction, from 4.92 percent in December 2001 to 4.44 percent in March of this year. Year-end inflation for 2002 was modified downwards, from 4.92 percent in December 2001 to 4.58 in March 2002. Finally, inflation expectations for 2003 were revised slightly downwards, from 4.15 percent in December to 3.78 in March.

Balance of Risks and Final Remarks

During the first quarter of 2002, the following factors had a negative impact on price behavior:

(a) The rise in prices of goods and services provided or regulated by the public sector;

(b) The slightly upward effect of the current fiscal reform on prices; and

(c) Although the pace of contractual wage rises has adjusted downwards, this has not been reflected yet in the core inflation of services.

Given that the first two elements have not contaminated either the expectations formation process or the determinants of the growth of contractual wages, it is likely that they will have a transitory effect on the growth of prices. As for the third factor, it is reasonable to assume that a slower rate of growth of contractual wages throughout the year, will likely lead to a downward movement in annual inflation of the core services sub-index.

For the remainder of the year, it is fair to say that the evolution of the country's economy will again be conditioned by the external and domestic factors previously mentioned in this report. Particularly, economic growth expectations for the United States as well as leading indicators for the Mexican economy suggest that real GDP growth will rebound by the second quarter of 2002. Likewise, annual core inflation is expected to continually decrease and overall inflation to converge to the target. Nevertheless, given the volatility of the subindices excluded from the core inflation calculations, in some months there will probably be transitory deviations from the downward medium-term trend. In the second quarter annual core inflation is expected to fall below 4.5 percent and CPI inflation to remain relatively unchanged. The latter result would be affected in case of significant rises in prices of goods and services provided or regulated by the public sector as well as of those of agricultural and livestock products.

The main assumptions regarding the international environment for 2002, and which are included in Banco de México's base scenario are the following:

(a) Forecasts of economic growth in the United States for 2002 have been adjusted upwards from 0.7 percent (in the Monetary Program for 2002) to 2.2 percent at present.

(b) The price of the Mexican crude-oil export mix for 2002 is forecasted to be approximately 19 dollars per barrel; and

(c) Recent developments in financial markets allow to foresee that the terms and availability of external financing during the second quarter will be comparable to those prevailing in the first quarter. Estimates for the second half of the year are that international interest rate rises will slightly limit the flow of resources to emerging markets. Nonetheless, in a context of rising international interest rates, economies whose debt has already been granted an investment grade status (such as Mexico's) will be less affected by the contraction of capital inflows.

Considering the aforementioned as well as available information on the performance of the Mexican economy during the first quarter of 2002, Banco de México revised its projections for the evolution of the main macroeconomic variables in 2002. The most relevant results are the following:

Economic Growth: Estimates for real GDP growth were modified upwards from 1.5 percent in January to 1.8 percent at the time of publishing this Report.

Current Account: The expected trade deficit for 2002 (as a percentage of GDP) fell from 3.2 percent in January to 3 percent at present, due to the following factors:

(a) Expectations of higher revenues from oil exports; and

(b) The decrease in the trade deficit triggered by higher growth in the United States together with the limited expansion of domestic demand.

Inflation: Recent developments in CPI and core inflation and the current stance of monetary policy are compatible with the target for the year. Nonetheless, the volatility of the agricultural and livestock products' sub-index could cause unforeseen variations in annual CPI inflation.

The main external risks that could affect the base scenario are the following:

(a) A much weaker than expected recovery of economic activity in the United States; and

(b) A substantial contraction of capital flows to emerging markets as a result of international interest rates rising above the level implicit in futures prices and long-term interest rates.

The materialization of either scenario would undermine economic growth in Mexico. In the first case, the effect would be transmitted via the current account in the form of a drop in exports and weaker economic activity. As to the second, the shock would derive from the capital account, limiting the amount of foreign financing available, raising interest rates, and consequently leading to a contraction in domestic demand.

These scenarios would have an ambiguous effect on inflation because slow economic growth would probably be linked to an easing of inflationary pressures. Nonetheless, in the first scenario, the unfavorable influence on exports and on overall economic activity in Mexico would widen the external deficit and also lead to lesser demand for the country's assets. These factors could cause an exchange rate depreciation, which in turn would give rise to additional inflationary pressures.

Should depreciation have an adverse effect on the formation of inflationary expectations, the monetary policy stance would need to be restrictive.

The main domestic risk element that could modify the base scenario is the worsening of medium-term growth expectations for the Mexican economy. This scenario could occur if economic activity recovers strongly in the United States, while the growth of the Mexican economy remains lackluster.

Although world economic activity seems to be recovering, the economies of Mexico's main trading partners are expected to expand at lower rates than those registered from 1995 to 2000. Therefore, for Mexico to attain the growth rates needed to create sufficient jobs for its increasing population and simultaneously raise the standard of living, it is imperative to advance the agenda of pending structural reforms. These will lead to higher productivity, vigorous job creation, sustainable gains in real wages and higher GDP growth. Among these reforms, the following are crucial: macroeconomic stability consolidation; energy sector reform; labor reform, furthering of the deregulation process of the economy; promotion of capital market development as well as higher rates of domestic saving; stimulus for investment in infrastructure, education, health and technology; and the significant upgrading in the realms of physical safety, protection of assets, and legal certainty.

Although the United States economy is currently undergoing a process of recovery, it is still very uncertain that this situation will immediately translate into robust economic activity in Mexico, that would allow the necessary job creation in order to satisfy the demands of new entrants to the labor force and replace jobs lost.

This brings to the fore the urgent need to attain visible results, at least in two areas. First, in the pending structural reforms which would lead to a proper investment environment and new opportunities for investment. Second, when nominal contractual wages are revised, employees and firms must seek settlements consistent with expected inflation and sustainable gains in labor productivity. The creation of numerous, lasting, and better remunerated jobs necessarily depends on higher levels of productivity which transcend strictly cyclical considerations.

To further contribute to macroeconomic stability, the Board of Governors of Banco de México reiterates its intention to ensure the monetary conditions consistent with attaining an annual inflation for December of this year not higher than 4.5 percent and converging with an annual inflation of approximately 3 percent in year-end 2003. This, together with the expected upturn in economic activity will help to significantly improve the well being of the Mexican population

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Statistics produced by Banco de México are subject to a continuous process of quality improvement and update. Therefore, once the latest results from the National Survey on Income and Expenses of Families became available, it was decided to start the process to change the base year of the CPI. From 1995 on, this index has been calculated with reference to the year 1994. This project will conclude with the adoption of the second half of June 2002 as the new base of comparison for the prices of goods and services that form the CPI's basket. In the next days, Banco de México, through a press release, will provide a thorough and detailed explanation of the methodology employed for this base year change.