BANCO DE MÉXICO

Inflation Report

January - March 2005

Summary

World economic activity grew at a favorable pace during the first quarter of 2005. The U.S. economy and Asian emerging economies continued to be the main driving forces of world economic expansion. Under such environment, oil prices rose significantly. Nonetheless, the main analysts continue to anticipate that world economic growth, particularly in the U.S., will slow down during 2005 as compared with the previous year.

During the first quarter of the year, U.S. aggregate demand grew vigorously -although exhibiting some weakening towards the end of the period- thus widening the external deficit and increasing industrial capacity utilization. Under such context, increases in producer prices of intermediate goods and in commodity prices generated concerns that such pressures could eventually be passed on to consumers. On another front, confidence over the conduct of monetary policy by U.S. authorities, the recent weakening of some economic activity indicators in that country and the prevision that the economy will slow down have contributed to contain inflation expectations.

During the last months, the outlook for inflation in the U.S. has become more complex. The same has been true regarding the corresponding reaction of the Federal Reserve, thus increasing the volatility of long-term interest rates in the U.S.

Under such context, international markets have become cautious regarding riskier debt instruments. Such reaction has responded, on the one hand, to the greater inflation uncertainty in the U.S. and, on the other, to the downgrade in credit ratings of certain U.S. corporations, which increased risk aversion in international financial markets. Consequently, emerging markets' access to financing in both external and domestic markets worsened, especially for sovereign and private debt issuers with lower credit ratings.

Domestic economic activity grew significantly during the first quarter of 2005. This was mainly attributed to the different components of aggregate demand, both domestic and the demand for Mexican exports. Consumption continued to grow significantly at an annual rate, while investment also improved. Among the factors driving the expansion of domestic expenditure, both consumption and investment, is the ample availability of resources. Such conditions have responded to both the higher external revenues from oil exports and workers' remittances, as well as to the increasing availability of domestic financing.

Recent Developments in Inflation

Annual headline CPI inflation was 4.39 percent at the end of the first quarter of 2005, 0.80 percentage points below the figure recorded in December of the previous year.

During 2004, annual headline CPI inflation in Mexico was affected by several supply shocks, such as: i) those associated with the rise in different international commodity prices; ii) those resulting from government's administrative decisions regarding the determination of local tariffs for certain goods and services regulated by the public sector; and, iii) those stemming from certain agriculture production problems in Mexico and in the United States. In the three cases, such shocks directly affected CPI's non-core subindexes. In the first case, the effect was also transmitted to the prices of foods included in the core inflation subindex.

In 2004, the abovementioned supply shocks affected non-core CPI inflation significantly. Some of these shocks have reverted in 2005, while others have been doing it gradually. Therefore, during the first quarter of 2005, annual non-core CPI inflation decreased 2.16 percentage points. Such reduction was driven by the lower growth rates of the agriculture price subindexes (from an annual variation of 10.11 percent in December 2004 to 5.73 percent in March 2005), and of the price subindexes of goods and services administered and regulated by the public sector (from 7.51 to 5.70 percent in the same period).

Regarding administered prices, their annual growth rate fell 1.62 percentage points as compared with the end of 2004. Such result was due to the following factors: i) electricity tariffs contributed significantly to the decrease in the annual variation of the subindex; such contribution is explained by the unification of the two household tariffs for high consumption (*Tarifas Domésticas de Alto Consumo, DAC*) since February 2005, and the decline in the prices of certain inputs used for electricity generation; ii) gasoline prices exhibited smaller monthly variations as compared with the same period of the previous year; and iii) prices of propane gas for 2005 were scheduled to increase every month between 0.75 and 1.75 percent based on a 12-month moving average of its international reference. If the monthly variation of the latter falls outside such interval, the nearest margin (either the highest or the lowest) is considered. Thus, during the first three months of the year, propane gas prices increased according to the lowest margin of the interval.

The annual variation of the subindex of regulated prices fell from 5.13 to 3.19 percent between December 2004 and March 2005. This reflects the lower incidence of urban public transportation fare increases during the first quarter of 2005, as compared with the same quarter of 2004. Such result is attributed to the lower increases in public transportation fares, and that these changes occurred in cities that have a lower weight in the CPI.

From December 2004 to March 2005 the annual growth rate of the price subindex of agriculture goods fell 4.38 percentage points. As for livestock goods' prices, these have moderated their annual variation due to the following factors: i) towards the end of 2004, prices of feed grains for livestock production fell; ii) meat product supply in the U.S. normalized; and iii) egg supply increased. As for fruits and vegetables, their annual price variation contracted during the referred period 1.78 percentage points, influenced by tomato prices, which during the first six weeks of the year reversed the price increases exhibited in the second half of 2004. Nonetheless, such result was partially reverted in the weeks following such period.

During the first quarter of the year, the annual variation of core CPI inflation dropped 0.19 percentage points, due to both merchandise and services' subindexes. The annual variation of the merchandise subindex fell from 3.87 to 3.61 percent during the analyzed period. Such subindex was characterized by two opposite trends: i) a reduction in the annual variation of food prices from 7.04 to 5.90 percent, which reflects that some pressures associated with the international prices of different food commodities have begun to revert; and ii) an increase in the annual variation of the rest of merchandise prices, from 1.69 to 2 percent.

Annual core services' CPI inflation fell from 3.72 to 3.61 percent from December 2004 to March 2005. Such reduction was due to the 0.64 percentage points decline in the growth rate of the housing price subindex during such period, as a result of the significant decline in construction costs' growth rate (associated with steel prices). As for the prices of the rest of the services, their annual growth rate rose by 0.54 points during the period. Such prices have been affected by the increase in 2004 in the international prices of commodities used as inputs in their production process. In addition, such subindex was also affected by the seasonal effect of tourism services' prices, given that the Easter holiday took place in March, were as in 2004 it did so in April.

Main Determinants of Inflation

World economic activity continued to grow at a favorable pace during the first quarter of 2005, after having exhibited in 2004 its highest growth rate in 28 years. U.S. GDP is expected to have grown above its potential rate during the quarter. The increase in industrial capacity utilization and the higher oil prices at record levels, among other factors, created greater uncertainty regarding the outlook for inflation in the United States. Under such context, long-term interest rates in that country have exhibited higher volatility. Furthermore, the downward trend of emerging economies' sovereign debt margins began to revert in March due to the greater inflation uncertainty in the United States and the Federal Reserve's corresponding reaction, and the increase in risk perception by investors.

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During the first quarter of 2005 GDP grew significantly at an annual rate, albeit more moderately than in 2004 as a whole.[1] In general terms, the economy benefited from favorable external conditions. In particular, external demand continued to grow, which was reflected in further annual increases in goods and services' exports. Nonetheless, exports' growth rate slowed as compared to 2004. Other factors also contributed to increase the availability of resources during the period in support of domestic expenditure. In particular, significant revenues from oil exports and workers' remittances were observed. Moreover, consumption and mortgage credit continued to grow at a considerable pace, and credit to enterprises began to recover. Overall, the above scenario contributed to maintain consumption expenditure vigorous and to raise investment.

[1] It will be difficult to evaluate economic figures for March and April 2005 accurately. This is due to the fact that in 2005 the Easter holiday (which reduces the number of working days) took place in March, while in 2004 it did so in April. Consequently, fewer working days were observed in March 2005 as compared with March 2004.

Two additional aspects marked the performance of economic activity during the first quarter of 2005. First, the expansion of both aggregate demand and GDP raised imports of goods and services. The fact that domestic demand grew at an annual rate higher than GDP also fostered the increase in imports. Second, the recent behavior of the different components of aggregate demand and expectations of their performance throughout the present year suggest that domestic expenditure, rather than external demand, will be the main contributor to growth.

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During the first quarter of 2005, Mexico's external sector was characterized by the following: a) non-oil exports grew at a slower pace than in the second half of 2004; b) the value of oil exports rose significantly; c) imports grew at a slower rate than that observed in the second half of 2004; this, in turn, was the result of a slower growth rate of intermediate good imports, while those of capital and consumer goods remained high; d) moderate trade and current account deficits; e) higher revenues from workers' remittances; f) a moderate capital account surplus; and, g) a moderate accumulation of international reserves.

Monetary Policy Actions

Several supply shocks generated considerable upward pressures on the different CPI subindexes during 2004. Although these types of shocks usually do not affect prices in a widespread manner (in most cases they reflect adjustments in relative prices), the monetary authority must assure that such shocks do not induce further increases in prices and in wages. Such consideration gains relevance if the economy is undergoing a disinflation process where the long-term inflation target has still not been fully incorporated into the country's price determination, such as in the case of Mexico.

Given the number and intensity of supply shocks observed in 2004, medium-term inflation expectations rose significantly. Accordingly, and taking into consideration the above mentioned factors, the Board of Governors of

Banco de México tightened its monetary policy stance throughout 2004 and in the first quarter of 2005.

As expected, during the first quarter of 2005, inflation pressures associated with the increase in international commodity prices began to dissipate. Also, supply conditions of certain agriculture products which had been affected by adverse weather conditions normalized. All of the above led to a reduction in annual headline CPI inflation, from 5.43 percent in November 2004 to 4.39 to percent in March of this year. Consequently, expectations for headline CPI inflation for 2005 and 2006 were revised downward since January. Nonetheless, the following deserves mention:

a) Core CPI inflation and inflation expectations still remain high with respect to the 3 percent inflation target.

b) Core services' inflation excluding housing has rebounded as a result of food and energy price increases that took place in the previous months.

c) Both the levels and volatility of international energy prices and of its futures have increased recently.

d) Despite the fact that available information does not allow for identifying considerable inflation pressures from aggregate demand, the risk that these could materialize as the economy transits through the high phase of its cycle could increase.

Considering the above, during the first quarter of 2005, the Board of Governors of Banco de México continued to tighten its monetary policy stance, mainly through two channels:

a) By increasing the *corto* (short position) on three occasions: on January 28, from 69 to 75 million pesos; on February 25, to 77 million pesos; and, on March 23, to 79 million pesos.

b) As stated in the press releases on monetary policy, the Board of Governors continued to point out that, until deemed necessary, domestic monetary conditions should reflect, at least, the greater monetary astringency observed in the United States.

As a result of such actions, short-term interest rates continued to increase (the daily bank funding rate rose from 8.75 percent on December 31, 2004 to 9.51 percent at the end of March).

In general terms, during the first months of the year, international financial market conditions continued to be relatively favorable. Nonetheless, appetite for risk began to diminish towards the end of the first quarter. This was partly associated with two elements: i) the greater uncertainty regarding the outlook for inflation in the U.S. and the corresponding reaction of the Federal Reserve; and, ii) the credit rating downgrade of certain U.S. debt issuers which is leading to a restructuring in investment portfolios towards lower risk instruments.

As expected, in Mexico such situation prompted an increase in the yield curve, particularly for the longer terms. Technical factors such as the reduced liquidity in long-term debt instruments that usually prevails in periods of greater uncertainty, and episodes when domestic risk perception has increased also contributed to such behavior.

One of the main objectives of Banco de México's monetary restriction during 2004 and in the first quarter of 2005 has been to contain any upward revisions in inflation expectations and to prevent them from contaminating wage settlements. Up to now, monetary policy has been effective in reducing inflation risk premia, which are usually discounted from fixed income instruments. In this regard, less uncertainty associated with the future development of inflation leaves domestic financial markets in better shape to cope with a more volatile environment. Nonetheless, it is important to point out that inflation expectations for the medium and long terms continue to be at levels above the inflation target.

Private Sector Outlook: 2004-2005

In the survey conducted in March, private sector economic analysts' forecasts were as follows: i) GDP is expected to grow 3.88% in 2005 (in the survey conducted in December 2004 such figure was 3.74 percent), and 3.64 percent for 2006; ii) in 2005 and 2006, 403 and 432 thousand jobs, respectively, are expected to be created in the formal sector; iii) expectations regarding interest rates for the next months were revised upward; iv) the expected levels of the peso exchange rate for the following months and for the end of 2005 were adjusted slightly downward; v) headline CPI inflation for 2005 is expected to be 3.95 percent, figure lower than that anticipated at the end of December 2004 (4.32 percent); vi) core CPI inflation for 2005 is expected to be 3.67 percent (in December 2004 it was 3.76 percent); and, vii) between December 2004 and March 2005, inflation expectations for 2006, 2007 and for the annual average for 2006-2009 were revised downward, from 4.09 to 3.96 percent; from 3.95 to 3.84 percent; and from 3.91 to 3.84 percent, respectively.

Balance of Risks and Final Remarks

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

GDP Growth: GDP growth is expected to remain at levels between 3.5 and 4.0 percent.

Employment: Approximately 400 thousand jobs are expected to be created in the formal sector.

Current Account: A moderate current account deficit of the balance of payments of approximately 2 percent of GDP is expected.

Inflation: Annual headline CPI inflation at the end of the year is expected to fall within the variability interval set around the inflation target.

The inflationary effect of the supply shocks that took place in 2004, which affected mainly CPI's non-core component and foodstuffs from the core merchandise subindex, have started to revert. Such reduction in annual headline CPI inflation and the perception that this process will continue, are based on the following considerations:

a) International prices of different agriculture and livestock commodities, which rose significantly in 2004, have begun to exhibit a more favorable behavior (prices of some grains and cereals as well as other agriculture commodities have fallen, and meat product prices have stabilized). In addition, contracts for these goods in futures' markets anticipate a relatively stable behavior for the remainder of 2005.

b) CPI food inflation in the United States has declined.

c) Production of several nondurable goods, such as tomato, normalized in Mexico and in the U.S. Nonetheless, prices of these goods are highly sensitive to an ample variety of supply shocks, therefore enhancing their inflation volatility.

d) International energy prices and energy futures' prices rebounded during the first quarter of the year. Despite the fact that such prices have increased significantly, futures' markets do not anticipate them to continue following the upward trend recently observed. Nevertheless, it is a risk factor that might affect the development of inflation.

e) Several goods and services regulated by the public sector, such as public transportation fares in different cities of the country, are expected to exhibit lower price increases.

f) Prices of several goods which are used as housing construction materials and as inputs for other products (steel and its by-products, and other metals) have fallen significantly. However, prices of such goods are, in general terms, volatile.

g) As the effects of supply shocks have begun to dissipate and Banco de México's monetary policy stance has tightened, inflation expectations for different time horizons have begun to be revised slightly downward.

h) Supply shocks that affected headline CPI inflation in 2004 have apparently had a limited effect on wage negotiations.

Based on the previous considerations, the outlook for inflation in the following months is as follows:

Regarding non-core CPI inflation:

a) The recent and future price quotes of certain grains and cereals, and of meat products, suggests that livestock goods' annual inflation for 2005 will decline significantly as compared with the previous year.

b) Regarding the subindex of administered prices, inflation of the different goods and services included in such subindex will be lower in 2005 as compared with 2004. Such prevision is based on the fact that: i) the federal government has adopted different measures to moderate the increases in electricity rates; ii) gasoline prices at the border have matched those of the rest of the country; therefore, they can only be raised according to the increase determined for domestic gasoline prices; and, iii) given the relatively stable behavior of propane gas futures' prices, prices of such energy good are expected to increase at a rate close to the lower margin of the interval determined by the authorities (0.75 to 1.75 percent per month).

c) The annual growth rate of the price subindex of regulated goods and services is expected to continue to decline for the remainder of the year.

As for core CPI inflation:

d) The annual growth rate of merchandise prices is expected to continue to decline. On the one hand, annual food inflation is anticipated to continue following a downward trend, in line with the behavior of these prices in international markets. On the other, the annual growth rate of the rest of the merchandise prices is expected to follow a lateral trend.

e) Core services' inflation excluding housing has rebounded, due to the increase in the prices of several commodities used as inputs in these services' production. Such trend is expected to stabilize in the next months. The annual growth rate of housing services' prices has declined as a result of lower construction costs (mainly steel), and the higher supply of housing. During the following two quarters, annual housing inflation is expected to follow a lateral trend and then, by the end of the year, rebound slightly as a result of the previous year's base of comparison.

Based on such considerations, annual headline CPI inflation for the following months is expected to continue to exhibit some volatility, reaching levels slightly above those observed at the end of the first quarter of the year. Such behavior would be mainly reflecting the unusual low prices of different nondurable goods observed in 2004. Afterwards, during the third quarter, headline CPI inflation would begin to follow a downward trend, falling within the variability interval by the end of the year. As for core CPI inflation, it is expected to exhibit a relatively stable behavior for the rest of 2005.

As previously discussed, the main elements contributing to the reduction in inflation are associated with the reversal of the effects of the supply shocks that took place in 2004. This is reflected in the significant contribution of CPI's non-core component to disinflation, and in the lower price increases in manufactured foods included in the core merchandise price subindex.

The convergence of inflation to its target still poses significant challenges. First, core CPI inflation and its expectations are still at relatively high levels, thus suggesting that the 3 percent inflation target has still not been incorporated in a widespread manner into the price determination process. Second, international energy prices and their volatility rebounded in the first quarter of the year. Although such developments have not affected inflation yet, Banco de México monitors them carefully. Finally, despite the fact that available information does not allow to identify considerable inflation pressures from aggregate demand, the economy is currently at the high phase of its cycle, and there is a higher risk that such pressures could arise.

Under such environment, Banco de México will continue to conduct its monetary policy so that monetary conditions propitiate the convergence of inflation to its target.

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The main risk factors that could affect the baseline scenario are as follows:

First, energy prices could continue to remain high or increase in the near future. This could make the U.S. economy slow down further than expected. Such scenario, as well, could imply higher prices on the prices of the items included in the subindex of administered prices.

Second, the deterioration of credit quality of some U.S. debt issuers could worsen and become more widespread than anticipated. This could lead to significant adjustments in investment portfolios worldwide, consequently affecting emerging markets' access to international financing.

Third, current global disequilibria could put world growth sustainability at risk. The high and escalating deficit of the U.S. current account, which has reached unprecedented levels, is a cause of concern. If such disequilibria should correct suddenly, strong recession pressures would arise worldwide and international financial markets would be subject to significant volatility, thus curtailing emerging markets' access to financing.

Finally, many analysts have pointed out that political uncertainty in Mexico could increase as the 2006 elections near. This could have two sequels: on the one hand, financial markets would exhibit higher volatility; on the other, the necessary consensus to advance in the agenda of structural changes required by the country could become more difficult.

Nonetheless, it is important to note that the Mexican economy's current fundamentals make it more resilient to the abovementioned risk factors and the different scenarios that could derive from them. The economy has a strong macroeconomic anchorage, of which monetary policy plays a key role. However, it is essential that efforts towards macroeconomic stability are complemented with other policies and measures that foster a more balanced, vigorous and sustainable growth.

The international experience confirms that a more efficient and modern framework for economic activity strengthens the domestic sources of growth, raising productivity and increasing the demand for jobs, which is also reflected in higher growth rates. Many countries whose per capita GDP was similar or below that of Mexico some decades ago, have now surpassed it due to the vigorous and consistent implementation of reforms. Thus, every year that such changes are postponed, Mexico's position in today's competitive world economy is more at risk, loosing the opportunity to strengthen growth, reduce social inequality and strengthen the basis for future progress.

Banco de México will continue to make its greatest effort to accomplish its constitutional mandate of price stability, thus helping to foster an environment of certainty that will allow Mexico to face any external and domestic challenges, and take advantage of its growth potential.