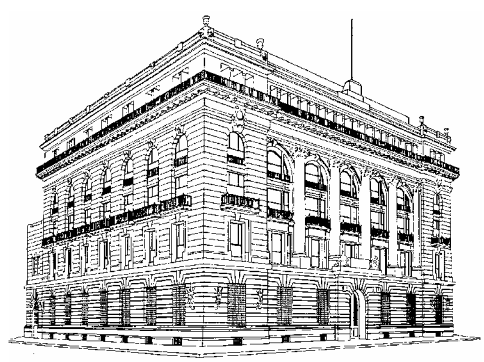
Inflation Report

January – March 2004



BANCO DE MEXICO

APRIL 2004

FOREWARNING

Banco de México has always given the utmost importance to publish information that aids decision-making and allows the public to assess the execution of its policies. This text is provided for the reader's convenience only, and discrepancies may eventually arise from the translation of the original document into English. The original and unabridged Inflation Report in Spanish is the only official document.

Unless otherwise stated, this document has been prepared using data available as of April 26, 2004. Figures are preliminary and subject to change.

INDEX

I. Introduction

During the first quarter of 2004, the world economy's cyclical recovery gained strength. This condition has been more evident in the United States, whose economy exhibits robust growth and reveals a promising outlook for 2004 and 2005. Growth in this country has been more balanced, either by the components of expenditure or by its sectorial structure. Non-residential investment has been a strong force behind spending while consumption has remained vigorous. As for production, manufacturing has also gained strength through a greater number of divisions. Finally, most recent available information points to an upturn in employment, thus diminishing the uncertainty over the soundness of the U.S. recovery.

The favorable external environment has added to the recovery, also cyclical, of the Mexican economy, as evidenced by the country's increased pace of industrial and manufacturing activity. This has been due mainly to the higher external demand for Mexico's non-oil exports. On the domestic expenditure side, consumption has remained strong and investment has begun to pick up, after having grown negatively for three consecutive years. Formal sector employment has also recovered since September 2003 with seasonally adjusted data. In addition, job creation seems to be improving, as confirmed by the gradual increase in the number of workers insured by the Social Security Institute (*Instituto Mexicano del Seguro Social, IMSS*).

The main challenge for disinflation has been the different supply shocks to some goods and services of the non-core price subindex (livestock goods and goods and services with prices administered by and concerted with the public sector) during the first months of the year.

In this regard, the following events deserve mention:

(a) The annual inflation rates of livestock products, in particular, beef, poultry and eggs, have risen, as a result of both the increase in their international references and the temporary ban on beef and poultry imports from the United States, due to the different diseases that struck this country.

(b) Price variations in goods and services both administered by and concerted with the public sector have also been significant. Regarding the former, gasoline prices in border cities rose (due to the increase in gasoline's international reference), while in the first quarter, domestic gas prices did so but at a rate higher than the inflation target (partly mirroring the increase in the international reference of gas). As for the latter, increases in urban transportation fares (particularly in Mexico City and in Estado de México) and in water and property taxes in some municipalities were also significant.

Despite the fact that at the beginning of 2004 Banco de México had warned about the possible presence of supply shocks during certain months of the year, which could bring inflation temporarily above 4 percent, these have been greater than expected in both magnitude and length.

Although indicators for inflation expectations do not anticipate that the observed supply shocks will affect inflation significantly in the medium and long terms, the worsening of inflation expectations for 2004 could jeopardize the convergence of inflation to its 3 percent target. This could take place if other prices in the economy, especially wage negotiations, are affected (second round effects). It is important to mention that contractual wages in the first quarter of the year (period in which most wages are revised) were above those agreed in the last quarter of 2003.

In light of these developments, and in order to prevent supply shocks from affecting the process of price determination of the economy, Banco de México's Board of Governors tightened its monetary policy stance by increasing the *corto* (short position) on two occasions. Such decision was aimed at inducing the proper monetary conditions to attain the 3 percent inflation target.

The path of inflation for the following twelve months will depend significantly on the effects of the aforementioned shocks on CPI inflation. Moreover, it will be subject to the development of the prices of different goods and services that were affected by such shocks:

(a) On the one hand, the recent price increases in livestock products could revert as the supply of such goods normalizes, thus eliminating the initial impact of inflation. This scenario is expected to materialize considering that trade restrictions on different beef imports from the United States (boned beef as well as chicken and ground turkey for cold cuts) have been lifted and the stock of egg-producing poultry is increasing.

(b) On the other hand, except for those goods with international references, price increases in goods and services administered by and concerted with the public sector tend to have a permanent effect on the CPI, therefore scaling annual inflation for twelve months. It is important to point out that no additional adjustments in the prices of goods and services concerted with the public sector are expected for the remainder of the year.

Given the magnitude of the supply shocks during the first quarter of 2004 it is foreseeable that CPI inflation will converge to its target more slowly and gradually. Nonetheless, this will largely depend on how fast the shocks to livestock product prices revert, and also that prices of goods administered by and concerted with the public sector do not exhibit additional increases above the inflation target.

Core inflation, which is a better reference for analyzing inflation pressures in the medium term, rose at an annual rate of 3.52 percent in March, following a slight downward trend throughout the quarter. Nevertheless, this measure of inflation has remained relatively stable for a long period, a condition that contrasts with the slack prevailing in the goods and labor markets. As the economic recovery gains strength, the convergence of core inflation with the CPI inflation target could become more challenging. Therefore, Banco de México will keep a strict surveillance of the economic conditions to detect in time any inflation pressures that could arise from the greater dynamism of aggregate expenditure and, thus, act accordingly.

The recovery observed since the end of 2003 is expected to gain strength. GDP growth is anticipated to fall in the upper limit of the 3 to 3.5 percent interval mentioned in the previous Inflation Report. Hence, the Mexican economy would thus grow higher than in 2003, although still below its potential.

II. Inflation Report January-March 2004

II.1. Recent Developments in Inflation

At the end of the first quarter of 2004 annual CPI inflation was 4.23 percent, figure higher than that of the previous quarter (3.98 percent), but lower than that registered in the same period of 2003 (5.64 percent). Consumer prices rose in January and February of 2004 at an annual rate of 4.20 and 4.53 percent, respectively, and then fell in March.

The main factor limiting the disinflation process has been the supply shocks to the non-core subindex in the first months of the year. Thus, while annual non-core inflation rose 1.12 percentage points during the first quarter, core inflation dropped 0.14 points.

In this regard, the following events deserve mention:

(a) Annual non-core inflation exhibited high volatility throughout the quarter, rising significantly in January and February and then falling in March. Such behavior was determined by fruits and vegetables' annual price variations and by the higher annual inflation rates of livestock goods and of goods and services administered by and concerted with the public sector.1

(b) Prices of fruits and vegetables differed from their historical seasonal pattern, in which such quotes usually fall sharply in February. Monthly inflation was slightly negative in January and February and declined sharply in March.

(c) Prices of livestock goods rose as a result of the hike in their international references and the temporary ban on beef and poultry imports from the United States done, respectively, on the last week of December 2003 and February of this year. Such restrictions were implemented in response to the different diseases that struck that country. Nonetheless, they were partially lifted for both

[1] Livestock goods that make up the subindex known as Other Agricultural are eggs, beef, poultry, fish, pork and other meats.

beef and poultry on March 3rd and March 8th 2004, respectively.

(d) Prices of goods and services administered by and concerted with the public sector increased in the following items: urban transportation (particularly in Mexico City and in Estado de México); water and property taxes in some municipalities; and gasoline in border cities. Gas prices have also risen above the inflation target.

(e) Annual core inflation dropped due to the reduced price variations in services. In particular, the lower inflation in entertainment and travel, food services, and health and personal care is noteworthy.

(f) The housing price subindex decreased at a slower annual growth rate than that of the other services of the core subindex. Such results responded to lower home rent increments (due to a greater supply of housing), which were offset by the higher costs for residential construction. The latter was due partly to the rise in the international references of different construction materials (rod, metal products, etc.).

(g) In January and February, annual core merchandise inflation remained on the slight upward trend observed since the last quarter of 2002. Nevertheless, such trend could ease, as evidenced by the fall in food and other merchandise prices in March as compared to February.

(h) The Producer Price Index (PPI) of final goods and services excluding oil increased at an annual rate higher than in the previous quarter. This mirrors the price hikes in agriculture, forestry and fishing, mining, manufacturing (basic metal industries), and construction.

II.2. Inflation Indicators

II.2.1. Annual Inflation

In March 2004, annual CPI inflation was 4.23 percent, an increase of 0.25 percentage points compared to December 2003. As for annual core inflation, during the first quarter of 2004, it fell to 3.52 percent (0.14 percentage points). The rise in CPI annual inflation during the same period stemmed from an increase in its non-core component (Graph 1). The difference between annual CPI inflation and core inflation widened from 0.32 percentage points in December 2003 to 0.71 points in March 2004 (Table 1).

Graph 1 **CPI, Core and Non-core Price Indexes**

Annual percentage change

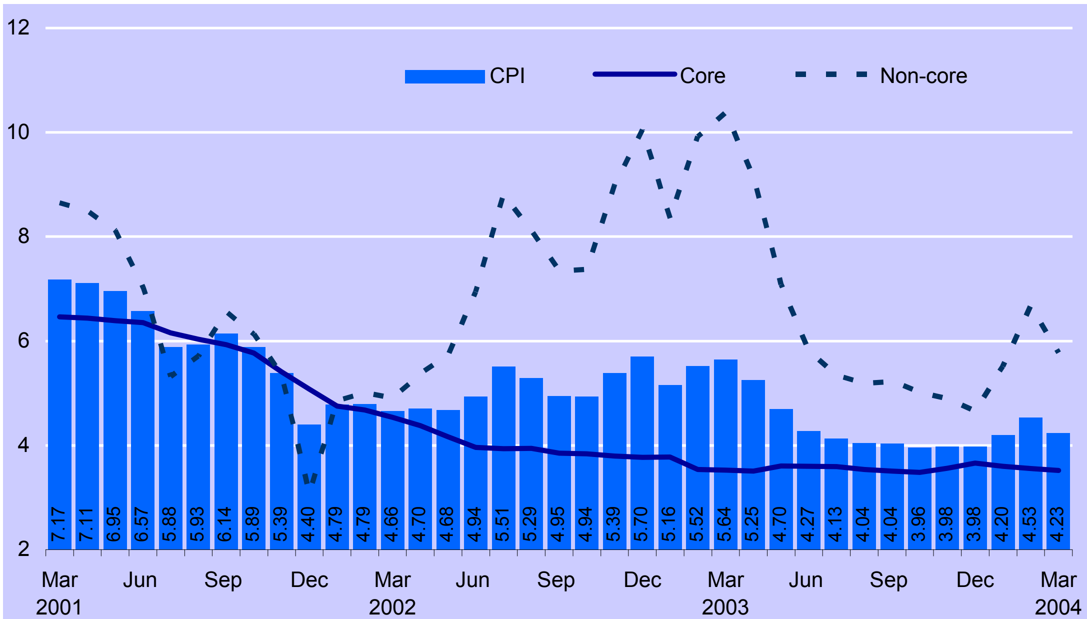


Table 1 **Price Indexes: CPI, Core and Non-core**

Percent

	Annual Variations			Quarterly Variations		
	Mar-2003/ Mar-2002	Dec-2003 Dec-2002	Mar-2004/ Mar-2003	Mar-2003/ Dic-2002	Dec-2003 Sep-2003	Mar-2004/ Dec-2003
CPI	5.64	3.98	4.23	1.32	1.63	1.57
Core	3.53	3.66	3.52	1.43	0.87	1.29
Merchandise	2.03	2.62	2.78	1.09	0.90	1.25
Services	5.40	4.84	4.35	1.81	0.83	1.34
Non-core	10.37	4.66	5.78	1.07	3.34	2.16
Agriculture	13.42	3.65	6.46	-0.77	4.39	1.92
Fruits and Vegetables	28.90	-2.36	-2.15	-6.55	4.85	-6.34
Other	4.37	8.34	12.50	3.73	4.06	7.72
Education	10.24	8.59	8.20	1.17	0.03	0.80
Administered by/Concerted with the Public Sector	8.22	3.91	4.71	1.93	3.96	2.72
Administered	15.02	6.11	5.16	3.09	8.09	2.16
Concerted	2.60	1.90	4.29	0.88	0.33	3.24

Table 2 shows the incidences of some items from the non-core price subindex on CPI inflation during the first quarter of 2004. Price variations in livestock products and in goods and services administered by and concerted with the public sector accounted for nearly 55 percent of the quarter's accumulated inflation, even though their weight in the CPI is only 22 percent.

Table 2 **Quarterly Variations in CPI and Main Components March 2004 – December 2003**

Percent and percentage points

		Incidence	
	Variation	Absolute	Percentage Structure
CPI	1.57	1.566	100.0
Core	1.29	0.882	56.3
Merchandise	1.25	0.447	28.5
Services	1.34	0.435	27.8
Non-core	2.16	0.684	43.7
Agriculture	1.92	0.162	10.3
Fruits and Vegetables	-6.34	-0.221	-14.1
Other Agriculture	7.72	0.382	24.4
Beef	8.12	0.188	12.0
Eggs	13.39	0.090	5.7
Other 1/	5.32	0.105	6.7
Education	0.80	0.046	2.9
Administered by/Concerted with the Public Sector	2.72	0.476	30.4
Administered	2.16	0.184	11.8
LP Gas	2.94	0.062	3.9
Gasoline	2.51	0.088	5.6
Electricity	1.18	0.034	2.2
Concerted	3.24	0.292	18.6
Privately-owned public transportation	10.22	0.176	11.2
Taxi	5.27	0.030	1.9
Property taxes	5.03	0.009	0.5
Water usage taxes	4.79	0.035	2.3
Long and short-distance intercity bus services	2.20	0.011	0.7
Urban and suburban bus services	2.19	0.029	1.8
Other 2/	0.07	0.003	0.2

1/ Includes poultry, fish, pork, and other meats.
2/ Includes telephone services, subway and electric transportation fares, oil lubricants, automobile ownership taxes, highway tolls, parking lots, and duties and licenses.

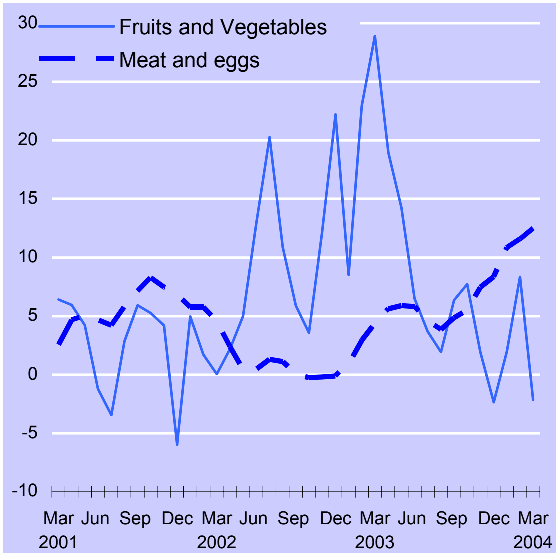
Inflation pressures coming from price increases in livestock products could revert in the next months due to the following events: a) the lifting of trade restrictions on different beef imports from the United States (trimmed beef and poultry and ground turkey for cold cuts), and b) a higher stock of egg-producing poultry. These effects could be reinforced once price increases of some agriculture commodities start to revert.

Price increments in goods and services administered by and concerted with the public sector (urban transportation, for example) tend to have a permanent effect on the CPI level, therefore scaling annual inflation for twelve months (Graph 2).

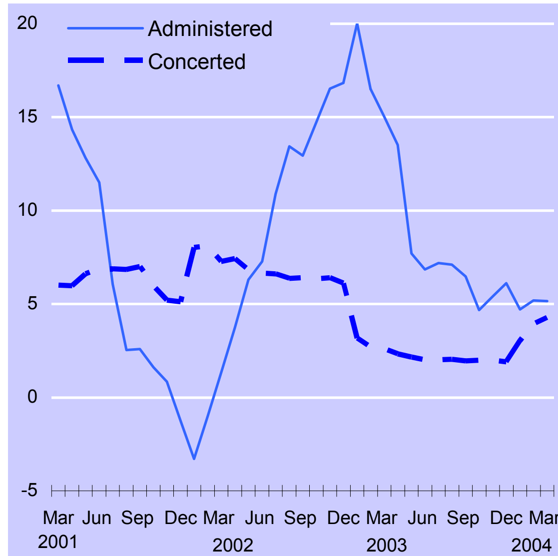
Graph 2 **Non-core Price Indexes of Agriculture Goods and of Goods and Services Administered by and Concerted with the Public Sector**

Annual percentage change

a) Agriculture Goods



b) Goods and Services Administered by and Concerted with the Public Sector



Despite the fact that the abovementioned shocks concentrated on the non-core price subindex, they were partially transmitted to the core merchandise subindex, particularly to the group of processed foods, beverages and tobacco. Price increases in other commodities have also affected the prices of some services. The most evident case is that of housing services, as residential construction costs were affected by the increase in steel and steel-related products' international references.

Notwithstanding the above, during the first quarter of 2004, annual inflation fell slightly due to the fall in its core services component, which more than compensated the rise in merchandise inflation. At the end of the quarter, core merchandise annual inflation was 2.78 percent, while its accumulated inflation in the first three months of the year was 1.25 percent as a result of accumulated price increments of 2.33 percent in foods and 0.51 percent in non-food merchandise. During the reference period, accumulated price increases in foods accounted for nearly 76 percent of merchandise price increases. Just as in the previous quarter, certain items explain the higher accumulated inflation in the group of processed foods, beverages and tobacco as only six (beer, cigarettes, sweet rolls and pastries, milk, corn tortillas, and vegetable oils and fats) accounted for 58 percent of the rise in this group's accumulated inflation (Graph 3). The increase in the special tax on production and services (*Impuesto Especial sobre Producción y Servicios, IEPS)* also affected cigarette prices.[2]

During 2004-I, core services inflation annual growth rate decreased 0.49 percentage points compared to December 2003. Such result is explained by the favorable behavior of most of the items of the core services subindex. Housing prices fell slightly. The annual growth rate of services inflation, excluding housing, dropped 0.93 percentage points during the first quarter of 2004. The fall in items such as entertainment and travel, food services, and health and personal care was significant (Graph 3). Annual housing inflation fell 0.12 percentage points during the quarter due to both the moderation in housing rents (due to a greater supply) and the higher costs of residential construction, which is an indicator used for estimating the costs faced by a sector of privately-owned housing.[3] During 2004-I, the residential construction cost index (*Índice del Costo de la Construcción Residencial, ICC)* rose 8.71 percent due to price increases in wire (63.26 percent), metal (18.23 percent) and cement (6.03 percent) products.

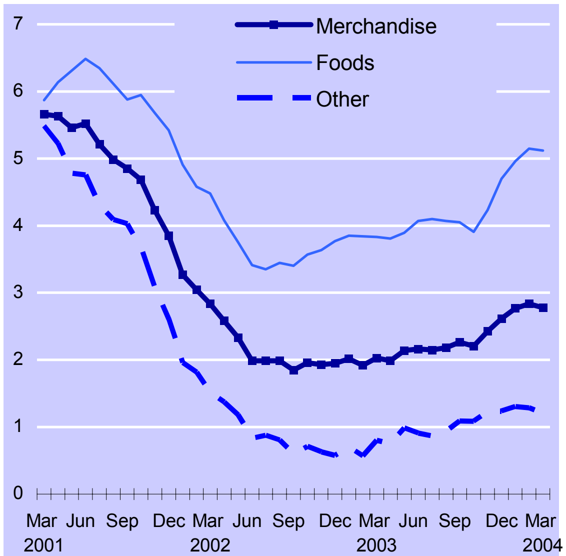
[2] The increase in the *IEPS* for cigarettes for 2002-2005 was approved in the fiscal package for 2002. The *IEPS* for filter cigarettes rose from 107 to 110 percent, and from 80 to 100 percent for non-filter cigarettes. The weighted price increase for both types of cigarettes in 2004-I was 6.81 percent. This accounts for 2.64 percent of the variation in CPI's accumulated inflation during this period despite the fact that its weight in the CPI is only 0.60 percent.

[3] CPI' s item Privately-owned Housing is constructed using three levels of monthly income from households: up to three minimum wages, from three to six minimum wages, and more than six minimum wages. The residential construction cost index *(Índice del Costo de la Construcción Residencial, ICC)* is used as a reference for household costs for the first level of income.

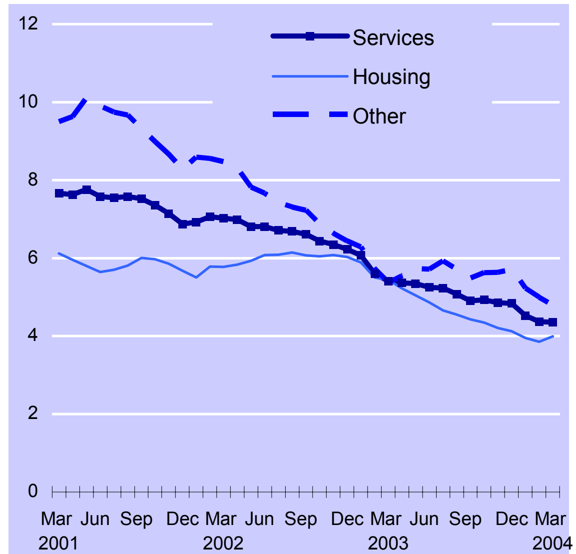
Graph 3 **Core Price Indexes (Merchandise and Services)**

Annual percentage change

a) Merchandise



b) Services



II.2.2. Monthly Inflation

In January and February, observed monthly inflation was above the previous quarter's private sector forecasts. March forecasts were similar to observed figures.

Monthly CPI inflation rose in January and February of this year (as compared with the same period of 2003) due to upward pressures on non-core inflation. In March, the variation in non-core inflation decreased, thus bringing down monthly CPI inflation significantly. In 2004-I, the average monthly variation of the core price subindex was 0.43 percent, compared with 0.47 percent during the same period of 2003. Such result is explained by the rise in core merchandise inflation and the decline in core services inflation.

Table 3 **Observed and Expected Monthly Inflation**

Percent

	2003			2004		
	Observed		Expected 1/	Observed		Expected 1/
Month	Core	CPI	CPI	Core	CPI	CPI
January	0.47	0.40	0.59	0.40	0.62	0.48
February	0.51	0.28	0.30	0.48	0.60	0.26
March	0.44	0.63	0.33	0.41	0.34	0.35

1/ Expected inflation at the end of the previous quarter according to the Survey of Private Sector Economic Analysts' Forecasts undertaken by Banco de México.

II.2.3. Producer Price Index (PPI)

At the end of the first quarter of 2004, the PPI of final goods and services excluding oil exhibited an annual variation of 5.10 percent, figure above that of December 2003 (4.52 percent). Such result was mainly due to the increase in the reference prices of the following items: construction (rod, wire rod, piping and cement); transport and communications (taxi fees, toll roads and mail); and agriculture and fish products (fruits, vegetables, poultry, eggs, seafood and fish). As for intermediate goods, these posted a variation of 5.90 percent in March, figure higher than that of December 2003 (5.32 percent). In this regard, the subindexes for basic metal industries (both ferrous and non-ferrous), metal products, machinery and equipment (electric engines, alternators, radiators, screws and nails), and agriculture and fish products (cattle, eggs, poultry, coffee, and honey) exhibited significant price increases.

The above was due to the following factors: a) price increases in different commodities, b) reduced supply of meat products due to the sanitary controls on beef and poultry imports from the United States; and c) the exchange rate’s performance.

II.3. Main Determinants of Inflation

II.3.1. International Environment

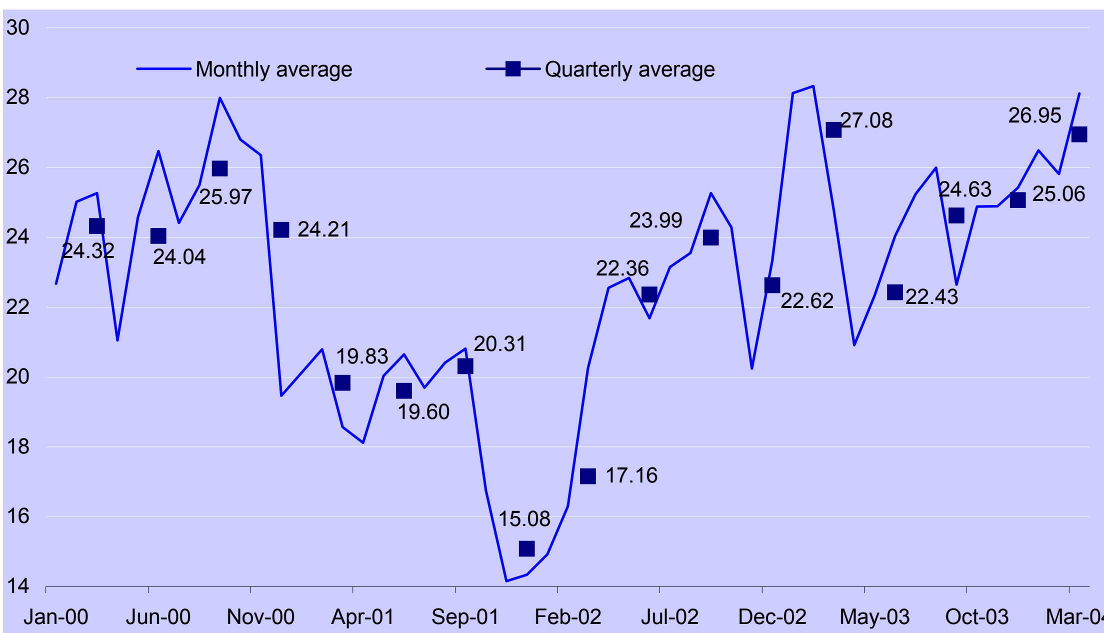
During the first quarter of 2004, global demand was spurred by a combination of expansive macroeconomic policies, stimulative financial conditions and improved confidence. World economic growth, undeterred by surging oil prices and driven by a solid expansion of the U.S. and Asian economies, fueled international trade and brought about sharp increases in commodity prices. Such context provided a favorable external environment for the Mexican economy. On the one hand, the recovery of industrial production in the United States, despite having been delayed, has fostered an incipient rebound of Mexican exports. On the other, the rise in the Mexican crude oil export mix price and the fall in sovereign spreads, which were below 200 basis points during most of the quarter, contributed positively to the performance of the domestic economy.

II.3.2. Oil Prices

Oil prices made further gains during the first three months of 2004 over the already high levels of the last quarter of 2003. The price of the West Texas Intermediate (WTI) reached 35.29 US dollars per barrel, 4.10 US dollars more than that observed during October-December 2003. This was even higher than the prices posted in the days ahead of the Iraq war. Oil price increases were due mainly to the greater demand of some countries for crude oil, the low gasoline inventories in the United States, geopolitical uncertainty, and the expected reduction of oil production quotas among OPEC's members since April 2004. As for the price of the Mexican crude oil export mix, it reached an average of 26.95 US dollars per barrel, 1.89 US dollars above the previous quarter's figure.[4]

Graph 4 **Mexican Crude Oil Export Mix Price**

US dollars per barrel



Source: PMI.

[4] On April 21st the price for the WTI was 36.68 US dollars per barrel, above the average observed during the first quarter of the year. On that same date, the Mexican crude oil export mix price was 28.22 US dollars per barrel.

II.3.3. Developments in the U.S. Economy

The most recent information available suggests that the U.S. economy continued growing well above its potential rate during the first quarter of 2004. An accommodative monetary policy stance, the tax rebates scheduled in the 2003 fiscal stimulus package, and the increase in corporate earnings spurred the expansion of demand.

U.S. GDP grew at an annualized quarterly rate of 4.1 percent in October-December 2003. Consumption rose at a smaller rate than in July-September 2003, as anticipated. Nonetheless, it continued growing and, coupled with an expansion in fixed investment, boosted domestic demand significantly. The increase in expenditures on software and equipment is noteworthy as it recorded a double-digit rate for a second quarter in a row. Inventories made a positive contribution to GDP growth, after having contributed negatively during the previous four quarters.

During the first quarter of 2004, the Federal Open Market Committee (FOMC) kept its federal funds target rate unchanged at the historical low level of 1 percent, established in June 2003. Interest rates on 10-year U.S. Treasury bonds, which averaged 4.27 percent in the last quarter of 2003, fell to around 3.83 percent by the end of March. Interest rates rose again in April following the announcements of a strong recovery of employment in March and of an increase in inflation.[5]

During the reference period, the US dollar halted a depreciation trend that had prevailed since February 2002. Robust economic activity in the United States and expectations of a possible reduction in interest rates in Europe, among other factors, contributed to the appreciation of the US dollar versus other main currencies since March. At the end of the first quarter, the US dollar nominal effective exchange rate *vis-à-vis* the main currencies had slightly appreciated compared to its value at the end of 2003.[6]

Regarding aggregate demand, available information points to a swift recovery in consumer spending during the first quarter of 2004 stimulated by the tax rebates that went into affect during that quarter. The behavior of new orders for capital goods (excluding defense and aviation) suggests that investment in software and equipment expanded during the first quarter of the

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[5] On April 21st the yield on 10-year Treasury bonds was 4.39 percent.

[6] In the last quarter, the nominal effective exchange rate against the main currencies (euro, yen, sterling pound, Swiss franc, Canadian dollar, Australian dollar, Swedish crown) appreciated 0.5 percent. Nonetheless, from the last day of March to April 22nd the US dollar appreciated more sharply (4.1 percent).

year at a pace similar to that exhibited during the previous quarter. Furthermore, the process of inventory adjustment has continued and, therefore, a positive contribution of inventories to GDP growth during the first quarter of 2004 is likely. As for the external sector, the trade deficit in January-February was similar to the average exhibited in October-December 2003. Such results are consistent with private sector economic analysts' forecasts, which anticipate a more moderate pace of deterioration of net exports during the quarter. In this setting, private sector analysts expect GDP growth for the first quarter of 2004 to have been around 4.5 percent (annualized quarterly rate) [Table 4].

Table 4 **Forecasts for GDP Growth and Industrial Production in the United States in 2004**

Annual percentage change

	At end 2003-IV				More recent data			
	2004-I[1/]		2004		2004-I[1/]		2004	
	GDP	Ind.prod.	GDP	Ind.prod.	GDP	Ind.prod.	GDP	Ind.prod.
Consensus Forecasts[2/]	4.1	5.7	4.4	4.5	4.5	6.4	4.6	5.0
Blue Chip Economic Indicators[3/]	4.1	5.1	4.4	4.3	4.3	6.5	4.6	4.9

1/ Quarterly annualized percentage change (seasonally adjusted series).
2/ *Consensus Forecasts* (December 8th 2003, March 8th 2004 and April 5th 2004 issues). Industrial production annualized quarterly variation figures are calculated based on the annual variation reported in both publications.
3/ Blue Chip Economic Indicators (December 10th 2003 and April 10th 2004).

Despite the fact that industrial production recorded a slight month-to-month decline in March, interrupting the phase of expansion observed since the second half of 2003, figures for January-March 2004 were above private sector analysts' forecasts. The industrial sector grew 6.6 percent at an annualized quarterly rate (before March data was published, April's estimates by Consensus Forecasts pointed to an increase of 6.4 percent), the highest since the second quarter of 2000. It is important to underline that U.S. manufacturing production, which is of great importance for Mexico due to its impact on the demand for the country's exports, also picked up significantly. Thus, during the first quarter of the year, industrial sector's capacity utilization reached its highest level (76.5 percent, on average) since the third quarter of 2001. In addition, the Institute for Supply Management Manufacturing Index (ISM) remained above 60 points, thus suggesting that industrial production will grow steadily in the coming months.[7]

The labor market has given signs of improvement. During the first three months of the year, the nonfarm payroll increased by

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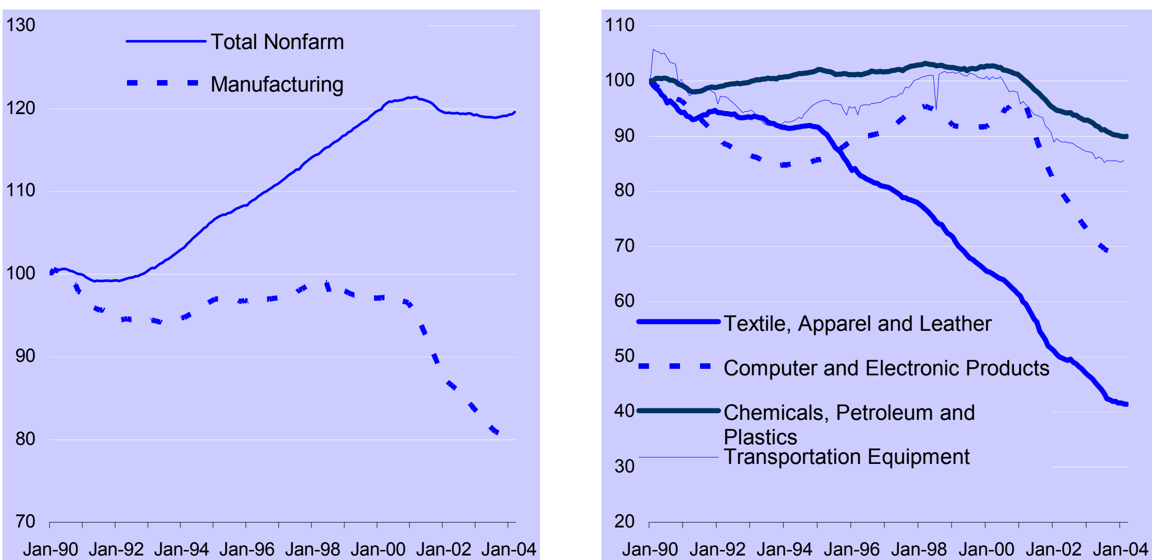
7 A value of the ISM Index above 50 points for a long period usually indicates an expansion in the manufacturing sector.

513 thousand jobs. March's figure was particularly encouraging. During that month 308 thousand jobs were created in the nonfarm sector, the highest figure since May 2000. Employment growth was generalized throughout all sectors of the economy and, for the first time since August 2000, the manufacturing payroll did not fall (Graph 5). From July 2000 to March 2004, 3.02 million jobs have been lost in this sector. The nondurable goods sector, in particular textiles, has been the most affected. It is worth stressing that the higher employment figures in March could be biased upwards to some extent due to both the end of a labor dispute in California's retail sector and some positive events in the construction industry linked to an improvement in weather conditions. Nonetheless, the unemployment rate stood at 5.7 percent at the end of the first quarter the, the same level as in December 2003.

Graph 5 **U.S. Nonfarm Payroll**

Index, January 1990 = 100



Source: U.S. Department of Labor, BLS.

CPI inflation reached annual rates below 2 percent in the first three months of 2004 (1.98, 1.69 and 1.74 percent in January, February and March, respectively) due to both significant productivity gains and weak resource utilization. Core inflation reached minimum levels in December 2003 (1.09 percent) and has increased since (1.14, 1.25 and 1.56 percent in January, February and March, respectively). In light of these developments, inflation forecasts for 2004 have been revised upward, although they remain below 2 percent.

Summing up, the outlook for growth in the United States in 2004 is optimistic. Analysts anticipate economic activity will expand at an annual rate of 4.6 percent, its highest pace since 1984. The economy is also expected to record stronger growth in the first half of the year.

In general, analysts foresee that the U.S. economy will exhibit balanced growth and low inflation rates in the medium term. However, risks associated with the high external and fiscal deficits remain. Projections made by the Congressional Budget Office (CBO) point to a reduction in the fiscal deficit from 4.2 percent of GDP for fiscal year 2004 to 2.1 percent for fiscal year 2006. Should the above scenario materialize, the risks associated with such deficits would ease, thus favoring the sustained expansion of the U.S. economy.

II.3.4. Developments in the Other World Economies

During the fourth quarter of 2003, the euro area GDP recorded an expansion for a second consecutive quarter (at an annualized quarterly rate of 1.2 percent), although at a lower pace than in the previous one (1.6 percent) and below the region's potential rate of growth. Economic growth in the area was driven by the recovery of investment and by inventory accumulation. Private consumption remained stagnant, reflecting continued low levels of consumer confidence and the persistence of adverse conditions in the labor market. Net exports had a negative impact on economic activity as a result of the euro's appreciation throughout the year. During the first quarter of 2004, available indicators suggest that the economy continued to recover, albeit at a slow pace, as there are no indications yet of a significant strengthening of consumption. Moreover, there is still uncertainty over the effects of the recent terrorist attacks on economic activity. The European Commission expects growth to be between 1.2 and 2.8 percent (annualized quarterly rate) during the first two quarters of 2004. Weak economic activity and the absence of inflation pressures have raised expectations that the European Central Bank may reduce its interest rates.

Table 5 **GDP Growth Forecasts for the Main Industrialized Economies in 2004**

Annual percentage change

	At end 2003-IV		More recent data	
	2004-I[1/]	2004	2004-I[1/]	2004
Canada	3.2	3.0	4.5	2.7
Euro area	2.0	1.8	1.6	1.6
Japan	4.1	2.1	1.2	3.0
United Kingdom	2.8	2.7	2.8	3.1

1/ Annualized quarterly change (seasonally adjusted series).
Source: *Consensus Forecasts* (December 8th 2003, March 8th 2004 and April 5th 2004 issues).

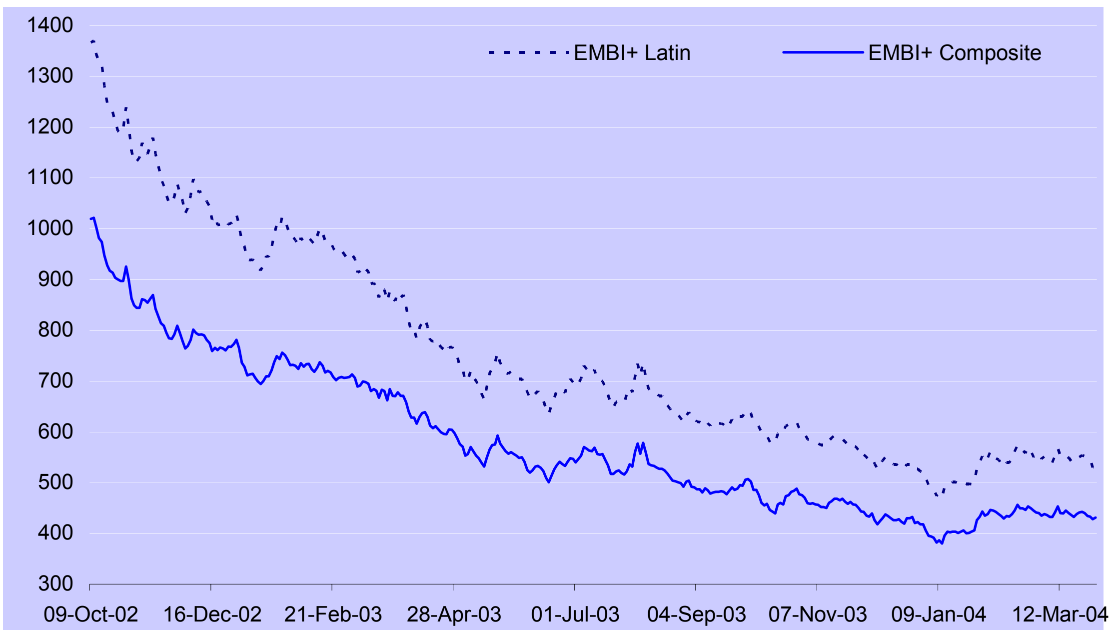
The U.K. economy grew 3.7 percent during the third quarter of 2003 (annualized quarterly rate), driven by an increase in consumption and by a strong recovery in investment. High frequency indicators point to a consolidation of growth in January-March. In particular, the behavior of labor earnings suggests that consumption maintained the pace observed in the previous quarter.

During the fourth quarter of 2003, the Japanese economy grew at an annualized quarterly rate of 6.4 percent. This stemmed from the strength of both private investment and exports, particularly those to the other Asian countries. Recent indicators suggest that the recovery continued throughout the first quarter of 2004, especially in export-related sectors. Furthermore, the strength of consumer confidence points to an eventual improvement in consumption spending. Investment continued expanding significantly as a result of high corporate profits and a better outlook for both domestic and external demand. Under such conditions, growth forecasts have been revised upward. Analysts expect GDP to have grown at an annualized quarterly rate of 1.2 percent in the first quarter of 2004 and forecast an expansion of 3.0 percent for the entire year.

External financing conditions for developing countries continued to improve during the last quarter of 2003, when there was an increase in the amount of debt instruments (mostly bonds) placed in international capital markets by these countries. As a result, net flows of private capital to the emerging economies rose to nearly 131 billion US dollars in 2003, their highest level since 1997. Nonetheless, foreign direct investment fell again. Favorable global financial conditions drove emerging markets to continue issuing debt at the beginning of 2004, covering most of bond placements scheduled for this year. During the quarter, country risk (measured by J.P. Morgan's Emerging Markets Bond Index Plus, EMBI+) dropped 25 basis points compared to the previous quarter's average. Nonetheless, expectations of an increase in interest rates in industrialized countries (particularly in the United States) introduced greater volatility in bond markets. These developments affected the behavior of the EMBI+; in January its prolonged downward trend came to an end, and has remained relatively stable since the end of that month. Despite the fact that sovereign spreads are still close to historical low levels, the possibility that they will increase still constitutes and outstanding risk, especially for highly indebted countries.

Graph 6 **Sovereign Spreads for Emerging Countries and Latin America**

Basis points



Source: J.P. Morgan.

Developing and emerging Asia contributed significantly to world's economic expansion in 2003. GDP growth for this group of countries was 7.8 percent. Such dynamism apparently continued at the beginning of 2004. In particular, the Chinese economy, after having grown 9.1 percent in 2003 as a result of a significant boost in investment, increased its pace of expansion during the first quarter of 2004, period in which its GDP grew at an annual rate of 9.7 percent. Analysts surveyed by Consensus Forecasts expect China will grow 8.3 percent in 2004. Recently-industrialized Asian economies have also shown signs of having increased their pace of growth at the beginning of 2004.

The economic situation in Latin America continues to recover, as a result of more favorable external conditions and the stabilization efforts implemented by some countries in the region. Growth forecasts for the entire region in 2004 are slightly above 4 percent as compared with 1.5 percent in 2003. Argentina's economy grew 8.7 percent in 2003 compared with the 10.9 percent contraction experienced in 2002. Inflation has fallen sharply (in March, the annual rate of inflation was 2.3 percent). Brazil has undergone significant stabilization and structural reform efforts. Although its economy's GDP fell 0.2 percent in 2003, signs of recovery emerged in the last months of the year, which have gained strength in the first months of 2004. Inflation is at one-digit levels and the Central Bank has gradually brought down its reference interest rate as inflation pressures have receded. Analysts expect the Argentinean and Brazilian economies will grow 6.7 and 3.4 percent, respectively.

II.3.5. Earnings and Employment

During the first quarter of the year, increases in contractual wages were above those registered in the last quarter of 2003. This is particularly relevant considering that a significant number of workers negotiate contractual wages during the first quarter of the year.

II.3.5.1. Earnings

In January 2004, increases in real average earnings were positive in both *maquiladora* and non-*maquiladora* industries, 2.3 and 1.0 percent, respectively. In contrast, the commerce sector exhibited a reduction of 0.4 percent in that month (Table 6).

Table 6 **Earnings per Worker**

Annual percentage change

	Nominal								Real							
	2003						Average Jan-Dec	2004	2003						Average Jan-Dec 2003	2004
	Jul	Aug	Sep	Oct	Nov	Dec		Jan	Jul	Aug	Sep	Oct	Nov	Dec		Jan
Manufacturing industry [1/]	7.7	5.0	6.5	5.4	4.6	4.2	5.8	5.2	3.4	0.9	2.4	1.3	0.6	0.2	1.2	1.0
Maquiladora industry	4.7	1.7	3.7	6.4	5.1	5.3	4.5	6.6	0.6	-2.3	-0.3	2.3	1.1	1.3	0.0	2.3
Commerce	10.1	5.3	6.7	6.7	4.7	1.3	7.3	3.8	5.8	1.2	2.5	2.6	0.7	-2.6	2.7	-0.4

1/ Non-*maquiladora*.
Source: Prepared by Banco de México with data from INEGI.

In January 2004, labor productivity exhibited positive annual variations in the abovementioned sectors. Unit labor costs dropped in the manufacturing and commerce sectors, while slightly increasing in the *maquiladora* industry (Table 7).

Table 7 **Output per Worker and Unit Labor Costs**

Annual percentage change

	Output per Worker								Unit Labor Costs							
	2003						Average	2004	2003						Average	2004
	Jul	Aug	Sep	Oct	Nov	Dec	Jan-Dec	Jan	Jul	Aug	Sep	Oct	Nov	Dec	Jan-Dec 2003	Jan
Manufacturing industry 1/	0.8	-0.7	2.9	1.8	2.0	6.8	1.8	4.0	2.6	1.7	-0.6	-0.5	-1.3	-6.2	-0.9	-2.9
Maquiladora industry	-0.5	-3.4	0.9	-0.9	2.3	4.2	-0.1	1.6	1.1	1.1	-1.2	3.2	-1.1	-2.8	0.0	0.7
Commerce	6.3	5.9	6.4	8.1	7.0	7.1	3.8	5.8	-0.5	-4.4	-3.6	-5.1	-5.9	-9.0	-0.8	-5.8

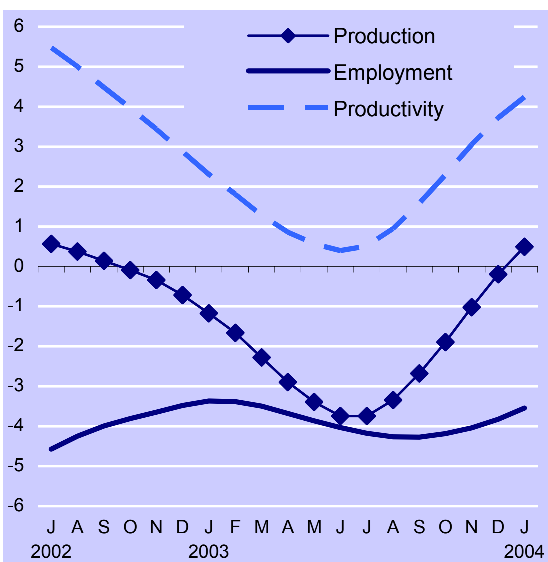
1/ Non-*maquiladora*.
Source: Prepared by Banco de México with data from INEGI.

Non-*maquiladora* manufacturing production exhibited an annual positive variation from December 2003 to January 2004. Nonetheless, such recovery did not bring about higher employment. As a result, productivity rose significantly and unit labor costs fell during such period. As the recovery consolidates, job creation in this sector will probably continue, thus moderating productivity growth and the fall in unit labor costs (Graph 7).

Graph 7 **Non-*maquiladora* Manufacturing Industry**

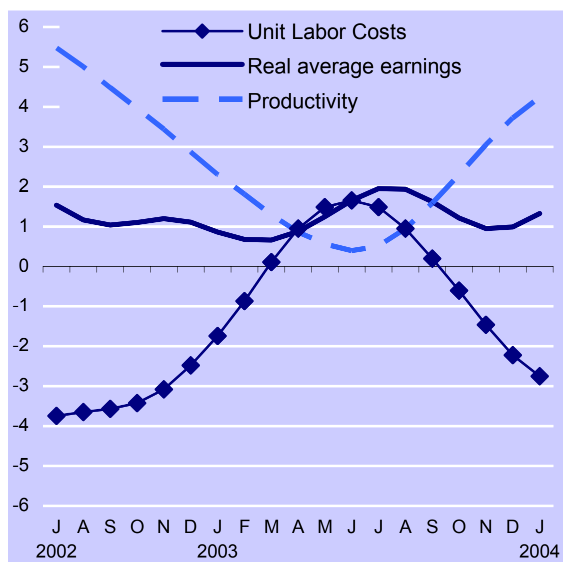
a) Production, Employment and Productivity

Trend (Annual percentage change)



b) Unit Labor Costs, Real Average Earnings and Productivity

Trend (Annual percentage change)



Source: Prepared by Banco de México with data from INEGI.

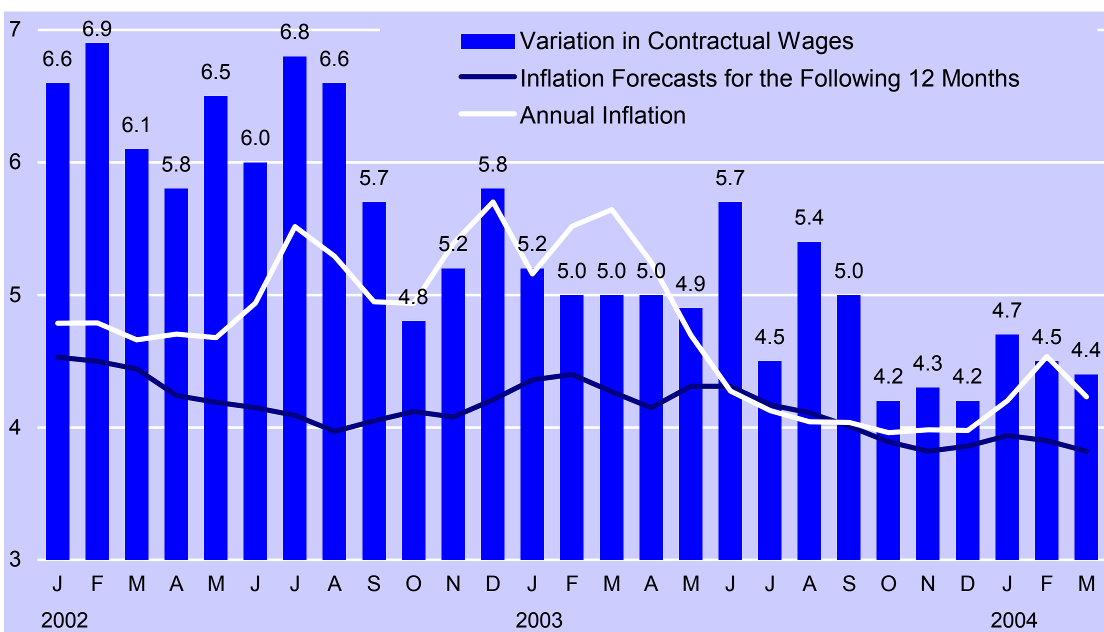
II.3.5.2. Contractual Wages

During the first quarter of 2004, contractual wages negotiated by workers in enterprises under federal jurisdiction exhibited an average increase of 4.5 percent weighted by the number of benefited workers. Such variation was above the wage increase negotiated in the fourth quarter of 2003. This is the first time since early 1996 in which wage increases in the first quarter of the year are above those registered in the last quarter of the previous year. As for contractual wages in private enterprises, these exhibited nominal increments significantly higher than those in public ones (0.7 percentage point gap) [Table 8].

Contractual wage increases during the first quarter of 2004 might have been influenced by the increases in expected inflation for the year. However, while several supply shocks that affected prices during the first quarter of the year were temporary, increases in contractual wages are permanent. This could raise firms' labor costs, thus hindering the disinflation process, the creation of employment and efforts to raise productivity (Graph 8). In addition, the fact that wage negotiations are not reflecting the slack that still prevails in the labor market further limits job creation.

Graph 8 **Contractual Wages and Inflation**

Percent



Source: Banco de México and Ministry of Labor.

Table 8 **Contractual Wages by Sector and Type of Business**

Annual percentage change weighted by number of workers

	2003					2004			
	I	II	III	IV	Average Jan-Dec 1/	Jan	Feb	Mar	Average Jan-Mar 1/
Total	5.1	5.1	4.8	4.2	4.7	4.7	4.5	4.4	4.5
Manufacturing	5.3	5.5	4.7	4.5	5.0	4.6	4.4	4.6	4.5
Other Sectors	4.9	5.0	4.8	4.2	4.6	4.7	4.6	4.2	4.5
Public Enterprises	4.3	4.3	4.3	4.0	4.1	3.8	3.5	4.0	3.9
Private Enterprises	5.2	5.4	5.2	4.6	5.1	4.9	4.6	4.5	4.6

Source: Prepared by Banco de México with data from the Ministry of Labor.
1/ Weighted average by number of workers.

II.3.5.3. Employment

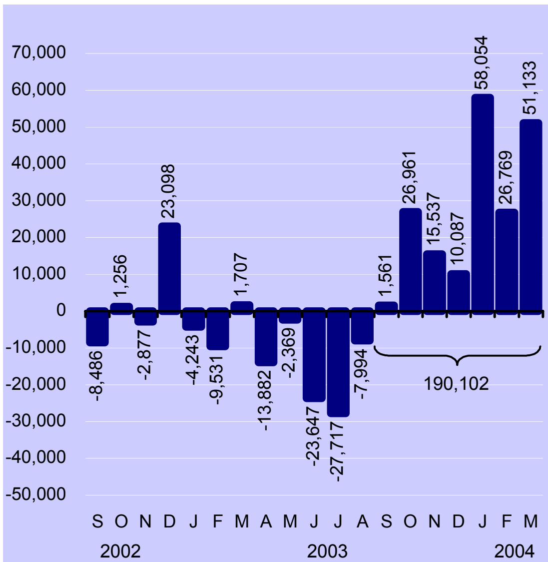
The improvement in economic activity by the end of 2003 and in the first quarter of 2004 led to an increase in formal employment. Nonetheless, the recovery of production was not sufficiently robust to prevent the deterioration of some labor market indicators such as the unemployment rate.

Thus, at the end of March 2004, the number of workers insured by the IMSS (permanent and temporary in urban areas) was 12,319,815 individuals, 129,023 workers higher than the figure at the end of December 2003. The annual increase in the number of workers insured by the IMSS in March compared to that in December was 112,516 individuals. It is important to note that after seasonally adjusting such figures, formal employment has recovered significantly by accumulating in March seven consecutive months of growth in the number of insured workers. Thus, from September 2003 to March 2004, 190,102 urban jobs were created (106,787 permanent and 83,315 temporary jobs).

Graph 9 **Workers Insured by the IMSS: Permanent and Temporary in Urban Areas and Open Unemployment Rate**

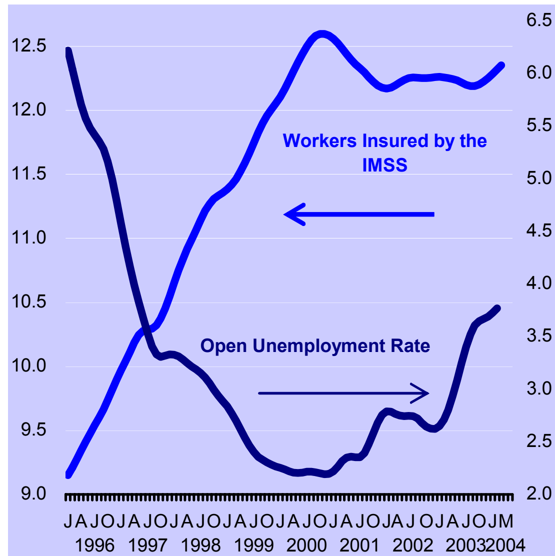
Annual variation by number of workers

a) Workers Insured by the IMSS
Seasonally adjusted data; monthly variation



Source: IMSS. Seasonally adjusted figures by Banco de México.

b) Workers Insured by the IMSS and Open Unemployment Rate
Trend Series



Source: INEGI and IMSS. Trend series by Banco de México.

In the first three months of the year, job creation in the formal sector expanded through a greater number of activities. Employment in services, construction, and manufacturing exhibited a recovery with seasonally adjusted data. The latter included mainly the divisions of metal products, machinery and equipment, chemical and plastic products, and food, beverages and tobacco. On the contrary, formal employment continued weakening in the textiles and apparel division.

In contrast with the abovementioned, the open unemployment rate in urban areas increased with both original and seasonally adjusted data. This probably reflected why the additional supply of jobs observed in the first quarter of 2004 was not absorbed by both the higher demand for formal employment and job creation in the informal sector. Thus, in such period, the average open unemployment rate was 3.86 percent, figure higher than the previous quarter's one (3.46 percent). Such rate rose slightly from 3.63 to 3.77 percent with seasonally adjusted data. Since the beginning of 2003, the unemployment rate measured with seasonally adjusted data has followed an upward trend. The partial occupation rate for less-than-35-weekly working hours and unemployment (*Tasa de Ocupación Parcial Menos de 35 Horas*

Semanales y Desocupación), another indicator of employment, also rose in the first quarter. On average, such indicator accounted for 22.13 percent of the economically-active population as compared with 20.77 percent during the previous quarter.

II.3.6. Aggregate Supply and Demand

During the first quarter of 2004, economic activity exhibited some improvement, following the recovery observed since the fourth quarter of 2003. Such results were observed in indicators for both domestic and external demand and for production. A relevant aspect of aggregate demand was that its expansion was more balanced than in the fourth quarter of 2003, as confirmed by the slight increase in investment. Such conditions fostered the recovery of labor demand in the formal sector. In particular, domestic demand is expected to have grown in 2004-I at a rate very similar to that of GDP. Such results led to a moderate deficit in the current account of the balance of payments.

Summing up, the most relevant aspects of aggregate supply and demand during the first quarter of 2004 were the following:

(a) Domestic demand was characterized by the continuing growth in private consumer spending and the incipient recovery of investment. Sales indicators reveal an increase in consumer spending. During the first two months of the year, retail sales rose at an annual rate of 3.6 percent, thus accumulating fourteen consecutive months of positive growth. Sales from the National Retailers Association (*Asociación Nacional de Tiendas de Autoservicio y Departamentales, ANTAD*) grew at an annual rate of 8.6 percent, above those recorded in the fourth quarter of 2003 (7 percent). Domestic car retail sales also increased at an annual rate of 9.4 percent due mostly to the higher sales of imported units.

(b) After having exhibited weak results during 2001-2003, investment showed some improvement in the first quarter of the year. This was due mainly to increases in its component of machinery and equipment given that construction had already increased throughout 2003. In January, investment grew at an annual rate of 1.7 percent, thus accumulating three consecutive months with monthly positive variations with seasonally adjusted data. During the first two months of 2004, construction investment grew significantly at an annual rate of 4.1 percent. Such results, just like in 2003, responded partly to construction in housing and in public infrastructure. As for imports of capital goods, these rose at an annual rate of 5.9 percent during the quarter.

(c) External demand continued to improve in the first quarter of 2004 as confirmed by both the annual growth in non-oil exports and the increase in U.S. imports from Mexico.

(d) As for production, during the first two months of the year, the Global Indicator of Economic Activity (*Indicador Global de la Actividad Económica, IGAE*) grew at an annual rate of 2.7 percent due to increases in all of its components. Significant increases were observed in the agriculture and services sector, while the industrial one grew slightly at an annual rate. Such indicator is expected to have grown in March at a higher annual rate than in January and February.

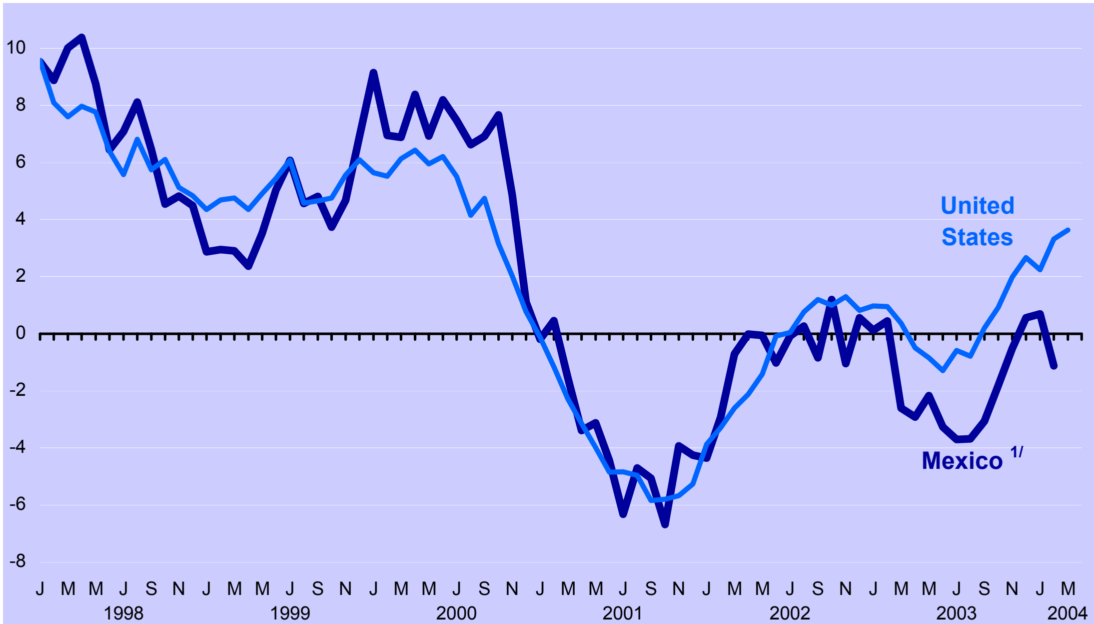
(e) In February, industrial and manufacturing production grew at an annual rate of 2.2 and 1.2 percent, respectively. During that month manufacturing was affected by the significant annual fall in automotive production. Nevertheless, by the end of the month, industrial and manufacturing production had reached in the last five months accumulated increases of 2 and 1.9 percent, respectively. Nonetheless, the recovery of manufacturing in the last months has been less robust than that observed in the United States (Graph 10).

(f) During the first quarter of the year, the different business confidence indicators improved significantly, compared to their levels exhibited in the previous quarter. The Private Sector Economic Analysts' Business Confidence Index was above, on average, 18.4 percent its level registered in the previous quarter. The Manufacturing Business Confidence Index rose 5.9 percent. The Consumer Confidence Index, which had weakened in the second half of 2003, grew at an annual rate in February-March.

(g) Mexico's leading indicators from Banco de México and the Conference Board kept increasing in the first two months of 2004. Their annual variations allow to anticipate that economic activity will continue recovering in the following months.

Graph 10 **Manufacturing Production in Mexico and the United States**

Annual percentage change (seasonally adjusted data)



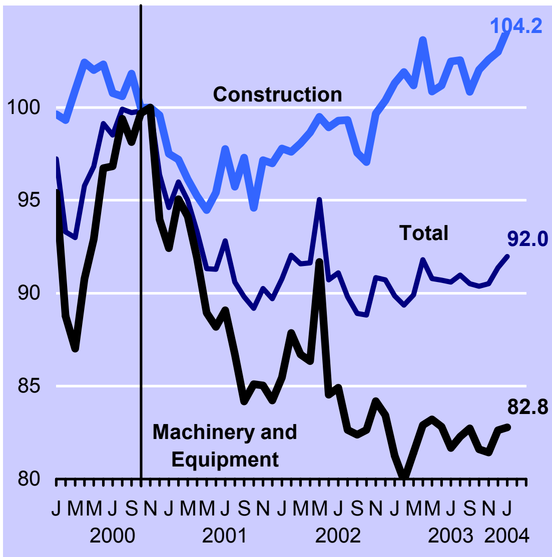
1/ March, April and May 2003 figures for Mexico are 2-month moving averages.

The broad number of indicators with recent positive results suggest that, in the first quarter of 2004, both GDP and aggregate demand grew at annual rates above those observed in the previous quarter. As for domestic demand, the increase in consumer expenditure was driven by the following factors: lower interest rates; a greater availability of credit from commercial banks and chain stores; continuing real increases in average wages in both *maquiladora* and non-*maquiladora* industries; and, by the annual increase in the Consumer Confidence Index's level in February-March. Consumer expenditure was fueled additionally by the significant amount of remittances from Mexicans workers abroad, which are mainly destined for consumption.

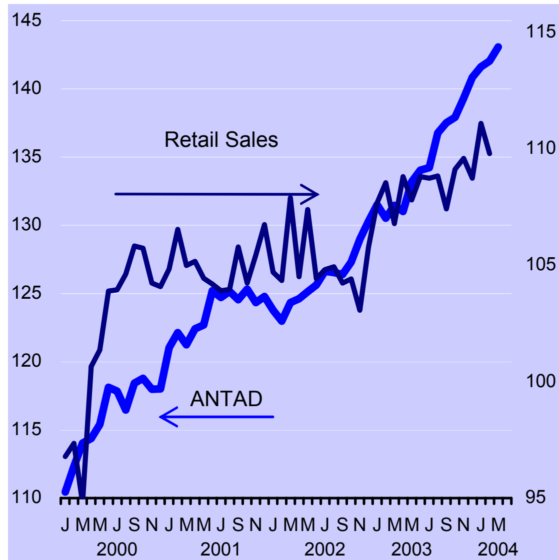
Graph 11 **Investment and Consumer Expenditure Indicators**

Seasonally adjusted data

a) Gross Fixed Investment
November 2000=100



b) Retail sales
1994=100



Source: INEGI and ANTAD. Seasonally adjusted figures by Banco de México.

The increase in domestic sales in different sectors during the first quarter of the year, and the improvement in external demand and in business climate and consumer confidence indicators fostered the recovery, albeit incipient, of investment expenditure. Nonetheless, the main factor that seems to be delaying the stronger recovery of private investment is the lack of progress in implementing structural reforms. The different surveys periodically undertaken by Banco de México on manufacturing businesses, foreign direct investment firms, and on private sector economic analysts concur that the abovementioned is the main factor limiting the expansion of both investment and economic activity.

During 2004-I, exports of goods and services gained strength due to the improvement in external demand, both from the United States and other markets. Once figures for aggregate supply and demand for the first quarter of 2004 are published, it will be evident that exports of goods and services rose significantly at an annual rate, thus representing a second consecutive quarter with positive growth.

Based on the above considerations, GDP is expected to have grown in the first quarter of 2004 at an annual rate of nearly 3 percent, while for the entire year it is anticipated to do so between

3 and 3.5 percent (probably falling in the upper limit of such range).[8]

II.3.7. Balance of Payments and Capital Flows

In the first quarter of 2004, the development of Mexico's external sector (the foreign trade sector in particular) was influenced by the improvement in external demand. Such conditions translated into higher exports of manufactured goods and, therefore, into higher imports of intermediate goods used for their production. Imports also rose due to the recovery of production for the domestic market. Such results meant that the trade deficit widened slightly in 2004-I compared with the same period of 2003, while the current account deficit narrowed slightly. The decrease in the current account deficit was due to the higher revenues from remittances from Mexican workers abroad and from a reduction in net interest paid abroad. Additionally, both deficits were below the ones observed in the previous quarter due to seasonal factors.

During the first quarter of the year, merchandise exports rose at an annual rate of 10.6 percent due to the increase in oil-related and non-oil exports (3.2 and 11.7 percent, respectively). Imports rose during the period 11.5 percent as compared with the same period of 2003. Such growth was the result of annual increases in intermediate, capital and consumer goods (13.6, 5.9 and 4.6 percent, respectively).

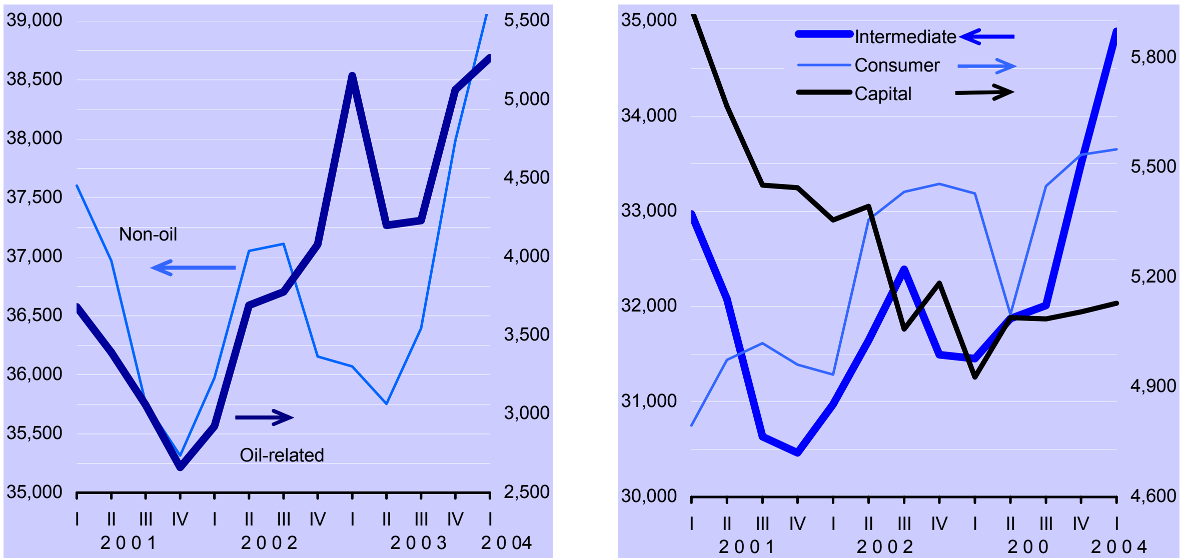
The trade deficit was 427 million US dollars, above the 75 million figure of the same quarter of 2003 and, due to seasonal factors, far below the 2,648 million figure observed in the fourth quarter of 2003.

[8] The latest available information on GDP and aggregate demand corresponds to the fourth quarter of 2003. In such period, both exports and total consumption (particularly private consumption) exhibited significant annual increases. Gross capital formation grew modestly, thus reflecting the annual fall in private investment as well as the sharp rise in public investment.

Graph 12 **Foreign Trade**

Seasonally adjusted series, US million dollars

a) Exports b) Imports



Source: Banco de México.

Merchandise exports exhibited a favorable behavior in the first months of 2004 with seasonally adjusted data, following the recovery observed since the last months of 2003. Such behavior largely reflected the positive development of non-oil exports, in particular, manufactured goods' exports. As for merchandise imports, these rose during the first quarter due mainly to the higher purchases of intermediate goods. Purchases of capital goods barely recovered while those of consumer goods did not increase significantly (Graph 12).

In the last months of 2004, Mexican exports to the United States rose. However, their level was below that exhibited by other U.S. trading-partners. During the first two months of 2004, the share of Mexican products in U.S. imports was 10.94 percent, below the 11.4 percent figure observed in the same period of 2003. Such results were due to the fact that total U.S. imports increased 8.96 percent while Mexican exports only did do at an annual rate of 4.58 percent. This was partly determined by the reduction in Mexican oil exports to the United States. Excluding oil exports to the United States, the outlook for Mexican products in the U.S. market barely improves, as confirmed by figures on non-oil Mexican exports to the United States in the first two months of 2004, which rose 5.76 percent, below the 8.44 percent increase exhibited by total U.S. imports. As the abovementioned results suggest, the deterioration in the relative performance of Mexican exports to the U.S. market apparently has not moderated and could be reflecting Mexico's loss of competitiveness.

It is important to point out that some of the structural change measures that have not been attained in Mexico have already been implemented by several emerging economies which are Mexico's competitors in the international markets. Therefore, the postponement of both structural measures and reforms could be eroding Mexico's competitiveness, undermining the country's capacity to take full advantage of the preferential access it is entitled to from the different trade agreements it has signed, and, finally, weakening its export activity.

Table 9 **U.S. Imports**

Percent

	Share				Annual Percentage Change: Jan-Feb 2004				
			Jan-Feb						
	2002	2003	2003	2004	Total	Oil	Total excluding Oil	Automotive	Total excluding Oil and Automotive
Total	**100.00**	**100.00**	**100.00**	**100.00**	**8.96**	**15.10**	**8.44**	**5.95**	**8.99**
Total excluding Mexico	**88.41**	**89.04**	**88.60**	**89.06**	**9.52**	**19.08**	**8.77**	**6.37**	**9.24**
1. Canada	18.00	17.80	18.51	18.21	7.23	32.57	5.71	5.37	5.85
2. China	10.78	12.10	11.00	12.18	20.63	40.81	20.61	0.00	20.61
3. Mexico	**11.59**	**10.96**	**11.40**	**10.94**	**4.58**	**-4.33**	**5.76**	**4.19**	**6.48**
4. Japan	10.46	9.37	9.73	9.31	4.19	0.00	4.19	-6.17	11.93
5. Germany	5.38	5.40	5.11	5.32	13.42	0.00	13.42	14.95	12.60
6. United Kingdom	3.51	3.39	3.38	3.24	4.24	0.00	4.24	4.48	4.21
7. South Korea	3.06	2.94	2.88	3.09	16.85	0.00	16.85	19.72	15.73
8. Taiwan	2.77	2.51	2.57	2.36	0.01	0.00	0.01	-0.41	0.03
9. France	2.43	2.32	2.40	2.17	-1.76	0.00	-1.76	0.00	-1.76
10. Malaysia	2.07	2.02	1.85	1.92	13.14	20.67	13.11	0.00	13.11
Total 10 countries	70.05	68.81	68.83	68.73	8.80	12.44	8.67	3.79	10.14

Source: Prepared by Banco de México with data from the U.S. Department of Commerce.

According to preliminary data, in 2004-I, revenues from remittances from Mexican workers abroad were 3.276 billion US dollars (an annual increase of 19.5 percent), comprised of 10.2 million transactions for an average 321 US dollars each. Such figure accounts for nearly 75 percent of Mexico's total crude oil exports during the quarter.

The abovementioned results from both trade balance and remittances, together with partial available information on other items, allow to estimate that in the first quarter of 2004 the current account deficit was nearly 1.7 billion US dollars. Such amount is slightly below the deficit reported in the same period of 2003, although significantly lower than that observed in the fourth quarter of 2003 due to the presence of seasonal factors.

During the first quarter of the year, the capital account of the balance of payments (including errors and omissions) recorded net inflows of nearly 3.3 billion US dollars. These mainly originated from the high levels of FDI coming from the purchasing of BBVA-Bancomer stock by the BBVA bank. It is important to point out that the total purchasing value of this stock (nearly 4 billion US dollars) did not fully translate into a revenue to the country because such transaction also implied a negative flow of portfolio investment, due to the fact that a significant part of this stock (approximately 2.1 billion) was owned by foreigners.

Summing up, the main results of the balance of payments in the first quarter of 2004 were as follows: a reduced current account deficit of nearly 1.7 billion US dollars; a capital account surplus of 3.3 billion (including errors and omissions); and an increase of 1.614 billion US dollars in international reserves.

II.4. Monetary Policy During the First Quarter of 2004

II.4.1. Monetary Policy Actions

Banco de México's monetary policy is conducted based on an inflation targeting framework. As mentioned in previous Inflation Reports, one of the most important elements of inflation targeting is the systematic approach for analyzing the current economic conditions and identifying the origin and characteristics of inflation pressures. When pressures come from the demand side they tend to be generalized, in which case the monetary authority usually tightens its monetary policy stance. Nonetheless, when pressures come from the supply side, it usually adopts an accommodative stance by trying to "accommodate" such pressures, allowing the level of prices to increase only once, thus affecting inflation temporarily. The monetary authority must keep a strict surveillance of the price increases originated by supply shocks (first round effects) so that they do not affect inflation expectations and, therefore, the process of price determination of the economy (second round effects).

Under such setting, although the slack in labor and goods markets leads to believe that the current increase in aggregate demand is not affecting prices significantly, core inflation has not fallen at the pace that would be expected under the abovementioned conditions. Therefore, Banco de México will continue keeping a strict surveillance of the development of the economy to detect in time any inflation pressures that could arise from the current recovery and, thus, act accordingly.

Regarding inflation pressures coming from the supply side, during the first quarter of 2004 certain prices increased significantly, mostly those of the non-core price subindex (see section II.2). One way of analyzing the origin of such pressures is to evaluate the distribution of the changes in relative prices.[9, 10] Graph 13a shows the distribution of the quarterly variation in relative prices of 315 CPI items. These are arranged according to the percentage changes exhibited by their relative prices, and weighted by their incidence in the CPI. Such analysis allows to identify if increases in the CPI come from a generalized increase in the different items that make up this index (in which case, observations concentrate in a narrower range), or else, to changes in certain products (in which case, observations are more spread out from the average and, therefore, the range where the total number of observations lie is comparatively wider). The same exercise is done separately for the 232 items that make up the core price subindex (Graph 13b) and the 83 items of the non-core price subindex (Graph 13c).

Such exercise reveals that changes in relative prices in the core subindex are distributed in a narrower range than those observed in the non-core subindex. In addition, shocks to relative prices of some products included in the non-core subindex are reflected in the distribution tails of CPI inflation (compare Graph 13a and Graph 13b). Therefore, both the standard deviation as well as the bias of the variations in the relative prices of those items of the CPI are mainly explained by those corresponding to the distribution of the non-core component.

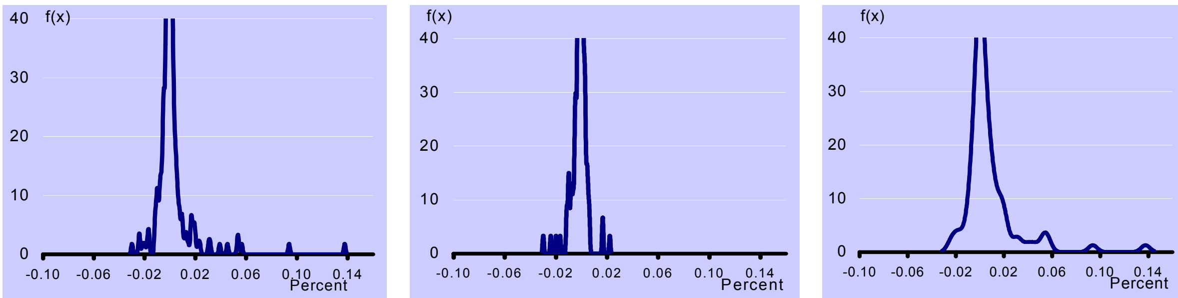
[9] Relative prices are defined as each group's price index (seasonally adjusted) divided by the CPI (seasonally adjusted).

[10] To be more precise, to carry out an approximation of the density function of such variations.

Graph 13 **Distribution of Quarterly Variations in Relative Prices**

a) CPI | b) Core Price Subindex | c) Non-core Price Subindex

Variations weighted by incidence | Variations weighted by incidence | Variations weighted by incidence



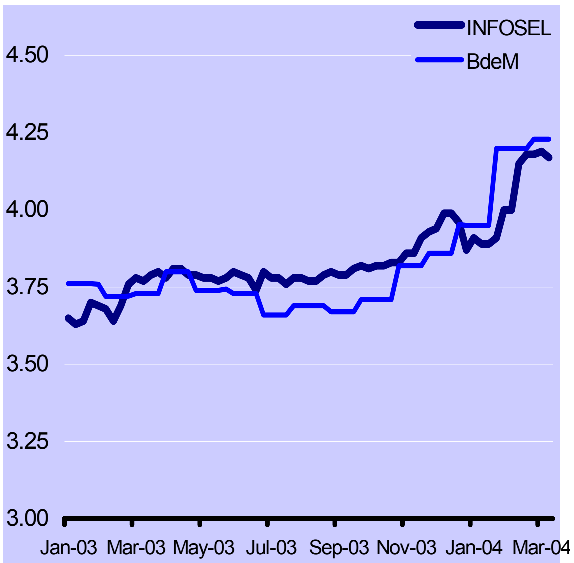
At the beginning of 2004 it had already been anticipated that supply shocks could take place during certain months of the year and affect annual inflation temporarily by raising it above 4 percent. Nonetheless, such shocks have been greater in magnitude and length than expected. This led to a significant upward revision in inflation expectations for the short term (end of 2004) [Graph 14].

Increases observed in certain relative prices during the first quarter of the year should affect inflation only temporarily. Given these shocks, inflation expectations for the medium (following twelve months and end of 2005) and long terms (average 2005-2008) were revised upward moderately (Graph 14).

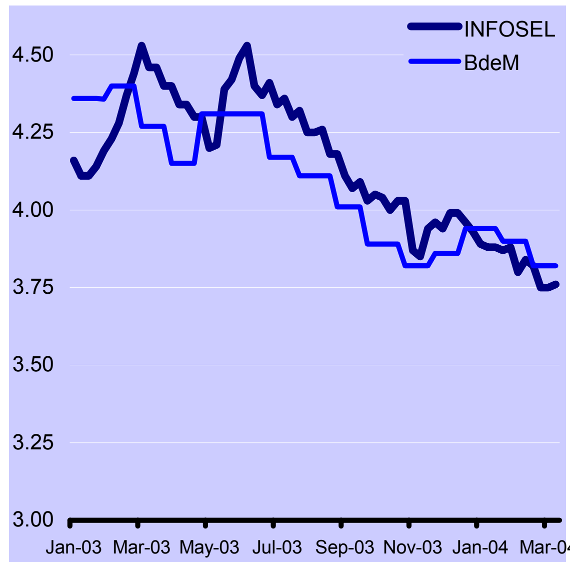
Graph 14 **Inflation Expectations**

Annual percent

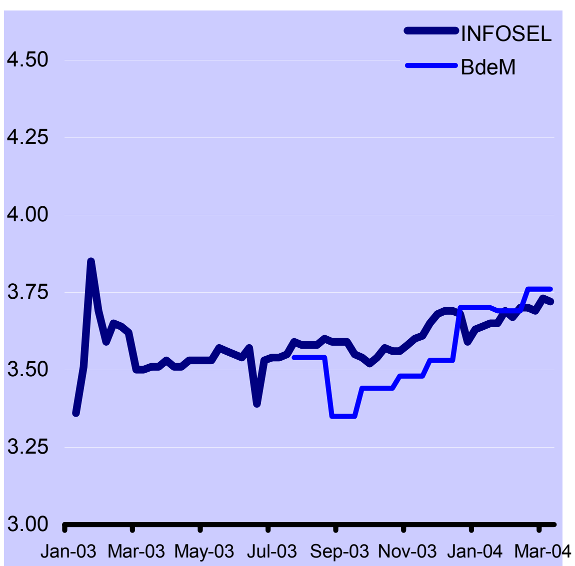
a) Expected Inflation for 2004



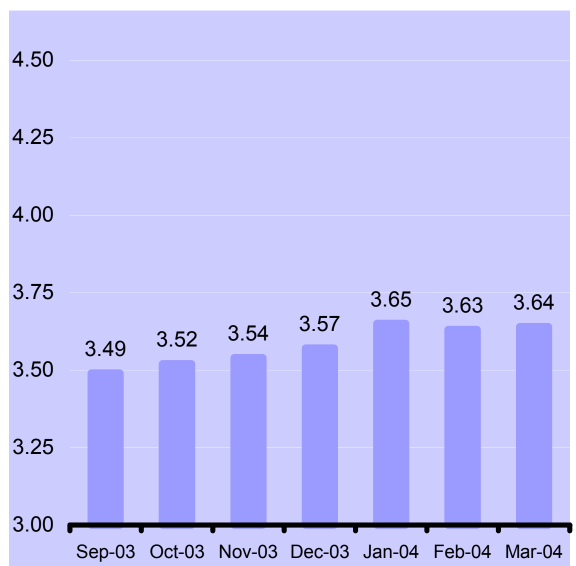
b) Expected Inflation for the following 12 months



c) Expected Inflation for 2005



d) Average Inflation for 2005-2008: Banco de México Survey



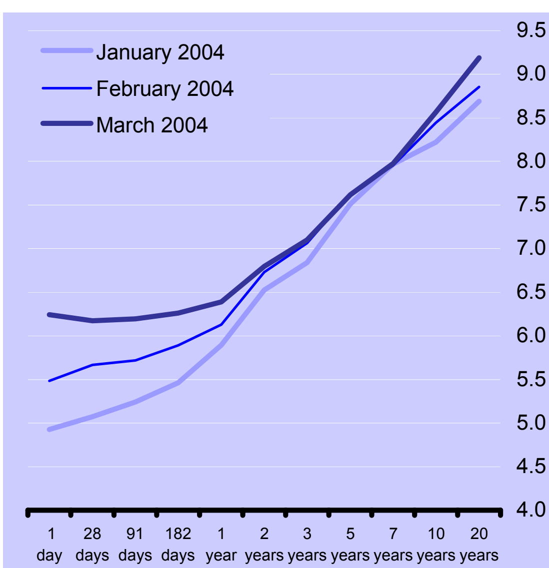
Although indicators for inflation expectations do not anticipate that the observed supply shocks will affect inflation significantly in the medium and long terms, the worsening of inflation expectations for 2004 could jeopardize the convergence of inflation to its 3 percent target. This could take place if the determination of other prices in the economy, especially wage negotiations, are affected (second round effects). In this regard, it is important to mention that contractual wages in the first quarter of the year were above those agreed in the last quarter of 2003 (see section II.3.5.2). This is particularly relevant given that most wage revisions are negotiated in the first months of the year.

In light of these developments, and in order to prevent supply shocks from affecting the process of price determination of the economy, Banco de México's Board of Governors tightened its monetary policy stance by increasing the *corto* on two occasions: on February 20th, from 25 to 29 million pesos per day, and on March 12th, from 29 to 33 million pesos. These actions were aimed at inducing the proper monetary conditions to attain the 3 percent inflation target. As a result, short-term interest rates rose significantly (Graph 15), while long-term ones did so but not as markedly. Such flattening of the yield curve reflects, among other factors, that interest rates are being affected by short-term inflation expectations while long-term ones are better anchored.

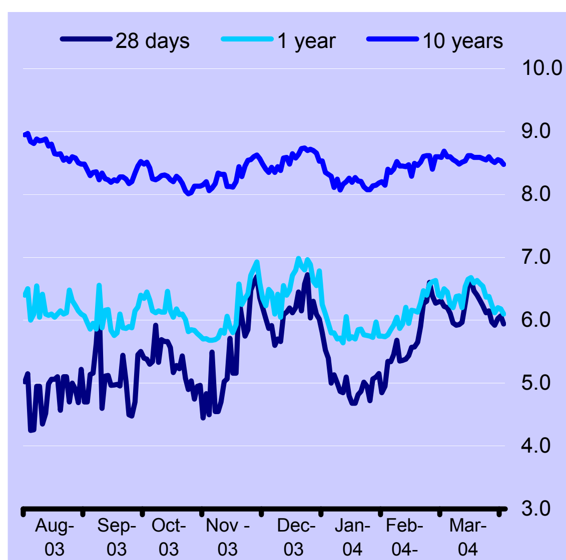
As for the exchange rate, overall, it remained relatively stable during the quarter. For some weeks, its volatility increased. Nonetheless, it was lower than that exhibited by the US dollar/euro (Graph 16). Finally, it is important to point out that although the exchange rate has depreciated gradually since 2002, it has affected inflation only moderately.

Graph 15 Government Securities Interest Rates

a) Yield Curve
Percent

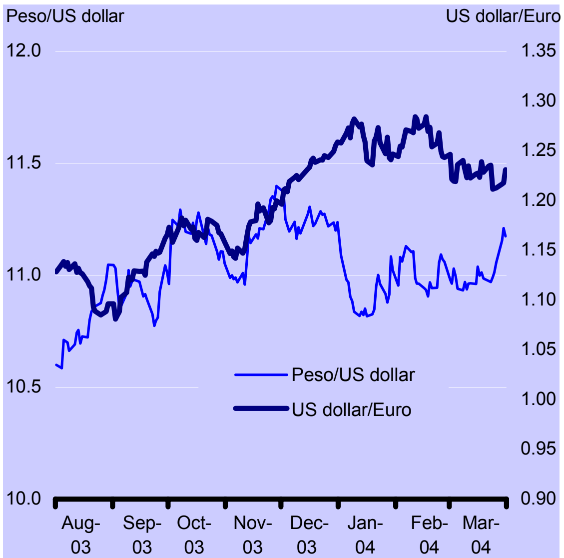


b) Secondary Market
Percent



Graph 16 Exchange Rate and Volatility

a) Exchange Rates
Peso/US dollar and US dollar/Euro



b) Implicit Volatility for 3-month Exchange Rate Options
Percent

II.5. Monetary and Credit Aggregates

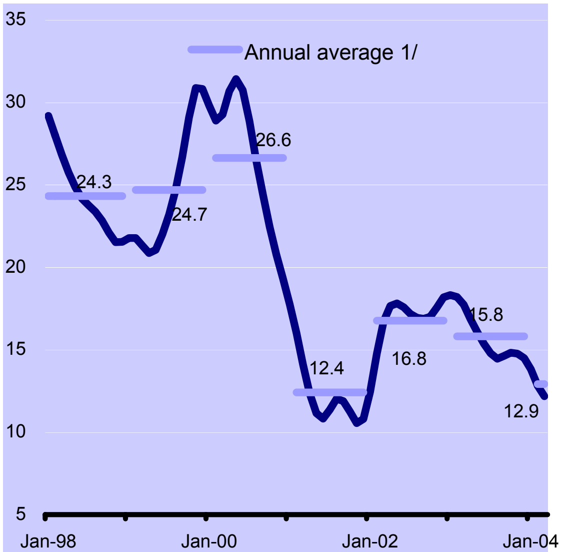
II.5.1. Monetary Base, Net Domestic Credit, and Net International Assets

During the first quarter of 2004, the monetary base increased on average at an annual rate of 13.2 percent, figure below that observed in the previous quarter (annual variation of 14.5 percent in October-December 2003).[11] Although its velocity of circulation continues decreasing, it is doing it at a slower pace. As mentioned in previous Reports, such process has stemmed mainly from the significant reduction in interest rates observed in the last years (Graph 17).

[11] Variations calculated on the basis of average daily stocks.

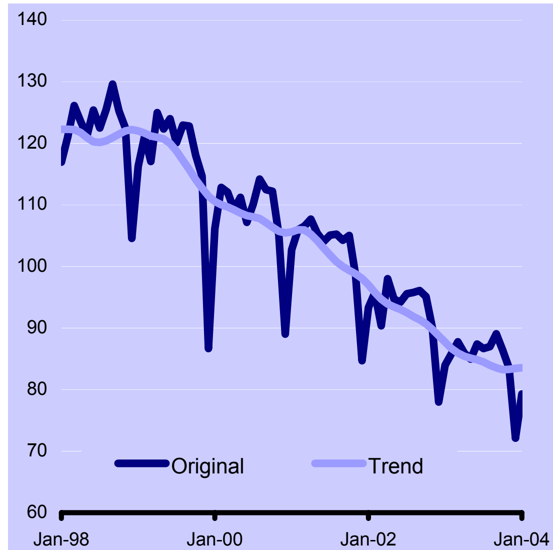
Graph 17 **Monetary Base**

a) Annual Variation of Monetary Base's Trend Series
Percent



1/ For 2004, the quarterly average for January-March is considered.

b) Velocity of Circulation of Monetary Base 2/
(1994=100)



2/ Calculated as the ratio IGAE / monetary base.

According to its seasonal behavior, during the first three months of the year the monetary base fell by 36.2 thousand million pesos. On the other hand, international assets rose by 2.6 billion US dollars, reaching 61.7 billion at March 31st 2004. As a result, Banco de México's net domestic credit fell by 64.9 thousand million pesos in the first quarter of the year.

Table 10 **Monetary Base, Net International Assets and Net Domestic Financing**

Millions

	Stocks		Flows Accumulated
	At Dec. 31st 2003	At March 31st 2004	at March 31st 2004
(A) Monetary Base (Pesos)	303,614	267,425	-36,190
(B) Net International Assets (Pesos) 1/ 2/	663,657	689,543	28,771
Net International Assets (US dollars) 2/	59,059	61,705	2,646
(C) Net Domestic Credit (Pesos) [(A)-(B)] 1/	-360,043	-422,119	-64,960
(D) International Reserves [(E)-(F)] 3/ (US dollars)	57,435	59,049	1,614
(E) Gross International Reserves (US dollars)	59,028	61,659	2,631
PEMEX			3,268
Federal Government			879
Sale of US Dollars to Banks 4/			-1,938
Other 5/			421
(F) Liabilities with less than six months to maturity (US dollars)	1,593	2,610	1,017

1/ In the estimation of cash flows of net international assets in pesos, the exchange rate applied to the transaction of each flow is considered.
2/ Net international assets are defined as gross reserves plus credit agreements with central banks with more than six months to maturity, minus total liabilities payable to the IMF as well as credit agreements with central banks with less than six months to maturity.
3/ As defined by Banco de México's Law.
4/ Corresponds to the daily offering of US dollars made according to the mechanism to reduce the pace of accumulation of international reserves (see Exchange Commission's Press Release of March 20th 2003).
5/ Includes yields on net international assets and other transactions.

In 2004-I, the main sources of international reserves were PEMEX (3.268 billion US dollars) and the Federal Government (879 million US dollars). As for its uses, 1.938 billion US dollars were sold through the mechanism to reduce the pace of accumulation of international reserves. On March 12th the Exchange Commission announced changes to this mechanism.[12] Although the procedure of daily auctions has been successful, the amount of US dollars sold each quarter has exhibited significant variations, thus creating some uncertainty in the exchange market.[13] Consequently, and in order to procure a more stable amount of daily US dollars sales throughout the year, the Exchange Commission decided to adequate the mechanism by modifying the schedule of US dollar sales while keeping the total amount of US dollars to be auctioned unchanged.[14] Therefore, the amount of US dollars to be sold will continue being 50 percent of the accumulated net reserves from the previous period, after deducting total sales in

[12] See Exchange Commission's press release of March 12th 2004. The Exchange Commission is in charge of determining the country's exchange rate policy. It is integrated by officials from both the Ministry of Finance and Banco de México.

[13] From May 2nd to July 31st 2003 32 million US dollars were sold daily. Such amount decreased to 14 million from August 1st to October 31st 2003, and to 6 million from November 3rd 2003 to January 30th 2004. From February 2nd to April 30th 2004 45 million US dollars were sold daily.

[14] See Telefax 18/2003 Bis, available at Banco de México's web page.

that period. Such amount will be sold in equal parts during the following four quarters.[15]

II.5.2. Monetary Aggregates and Financing

There are two trends in demand deposits in pesos that deserve mention. On the one hand, the high rate of growth of such instruments, which means that the remonetization process has included both the monetary base as well as other liquid instruments (Graph 18).[16] On the other, the higher number of contracts in this type of accounts (from 31.7 million in December 2002 to 36.4 million at the end of 2003). Despite the above, people are using very few instruments other than cash as a means of payment since debit cards are used mainly for cash withdrawals in automatic teller machines. Thus, from the total amount of transactions carried out with credit and debit cards, cash withdrawals accounted for 88 percent.

As for the broad monetary aggregates, they have increased more vigorously since the second quarter of 2003. Such recovery has been more evident in households' voluntary financial savings, which has exhibited wider cycles than M2 and is also closely linked to productive activity (Graph 19).[17]

During the first two months of 2004, lending to households remained as vigorous as in 2003. Such conditions have also been fostered by reduced interest rates and the introduction of new specialized instruments, many of which are issued at a fixed rate, and have been widely used due to the lower inflation risk perceived by borrowers and lenders in the market (Table 11). In February 2004, commercial bank's direct performing credit for consumption and housing exhibited real annual variations of 45.9 and 9 percent, respectively. This behavior differs from that of commercial bank's credit to firms, which exhibited a real annual variation of -4.4 percent in that same month. Despite the fact that economic activity began to recover since the last quarter of 2003, it has still not been reflected in an expansion of bank credit to firms (Graph 20a).

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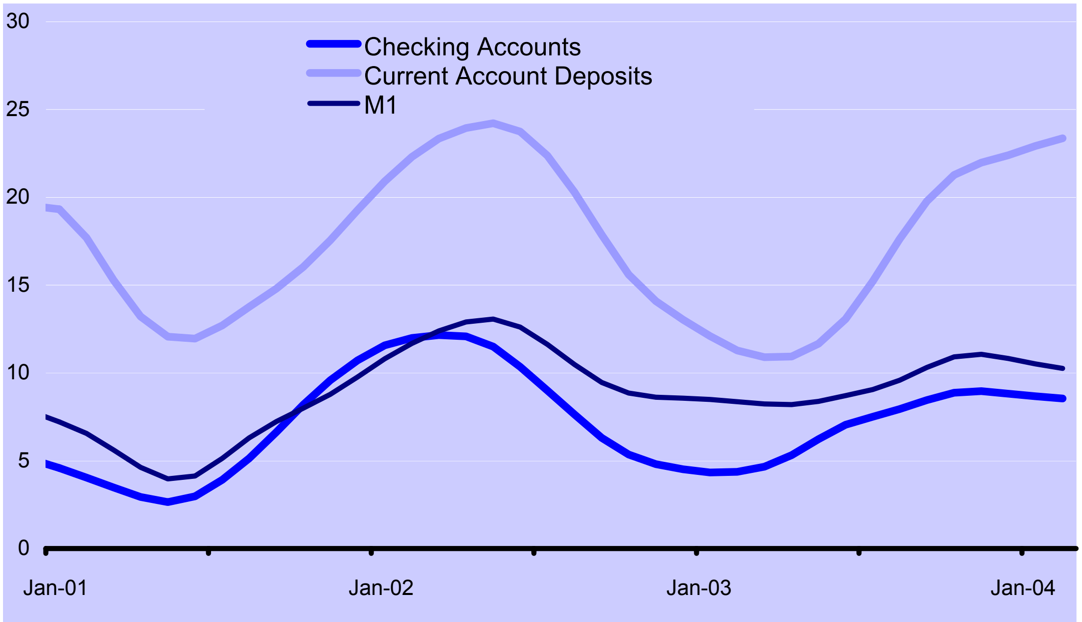
[15] Banco de México announced that from May 3rd to July 30th 2004 22 million US dollars would be sold daily (see Banco de México's press release of April 20th 2004). This quantity already reflects the recent adjustments to the US dollar sale mechanism mentioned in this Inflation Report.

[16] Checking accounts in pesos and current account deposits.

[17] Including bills and coins held by the public, bank deposits, public securities, and private securities held by individuals (M2 households), excluding SAR resources.

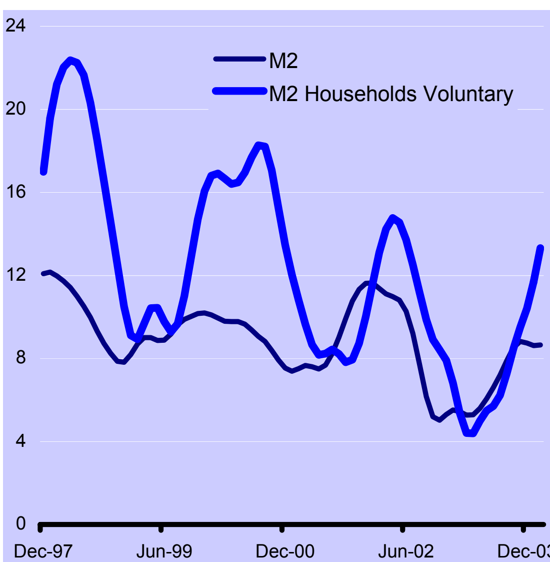
Graph 18 **Monetary Aggregate M1 in Pesos**

Annual percentage change of trend series



Graph 19 **Monetary Aggregate M2**

a) M2
Annual percentage change of trend series



b) M2 and Economic Activity
Annual percentage change of trend series

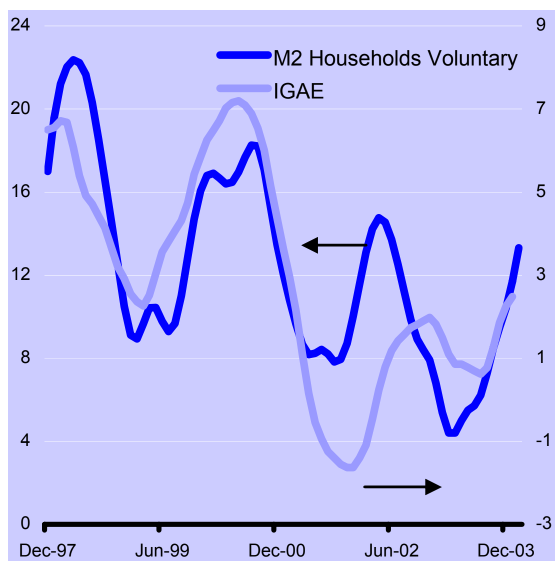


Table 11 **Lending and Deposit Interest Rates**
Annual percentage at December

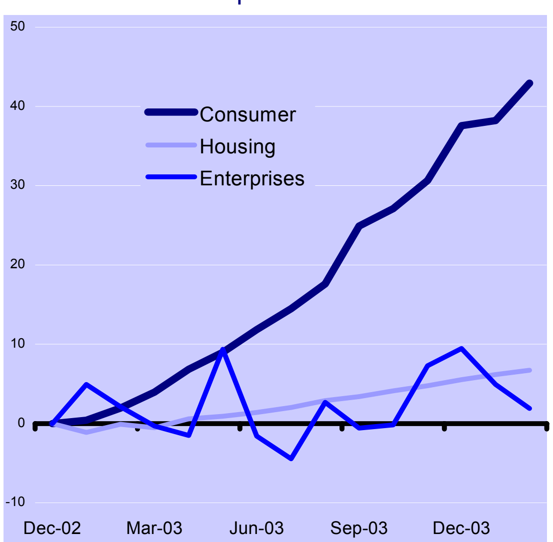
	2000	2001	2002	2003
Lending Rates				
Credit Cards	44.88	35.64	33.91	32.52
Fixed-rate Mortgage 1/	n.a.	18.43	16.56	15.69
Short-term Private Securities	18.08	7.73	8.53	6.78
Highest Ratings 2/	18.11	7.45	8.40	6.48
Lower Ratings 3/	18.04	8.34	9.27	7.63
28-day CETES	17.05	6.29	6.88	6.06
Deposit Rates				
CCP (Pesos)	15.55	6.49	6.21	4.66
28-day Bank Promissory Note	9.44	3.08	3.14	2.43
Checking Accounts	5.53	2.38	2.10	1.61

1/ Average rate of loans with 15 years to maturity.
2/ It includes the emissions of short-term debt instruments with the highest credit rating.
3/ It includes the emissions of short-term instruments that have received credit rating lower than the highest scale.
n.a. Not available.
Source: Banco de México and INFOSEL.

A source of resources for the private sector that gained strength during the first quarter of the year was the net placement of debt instruments in the domestic market, which rose 15 thousand million pesos during the period. Furthermore, firms and public institutions, as well as states and municipalities, have also participated actively in the domestic debt market by issuing securities for 33 thousand million pesos during the first quarter (Graph 20b). Most of the new issuance has been done through stock certificates, which are characterized by their low issuance costs (see Box 1).

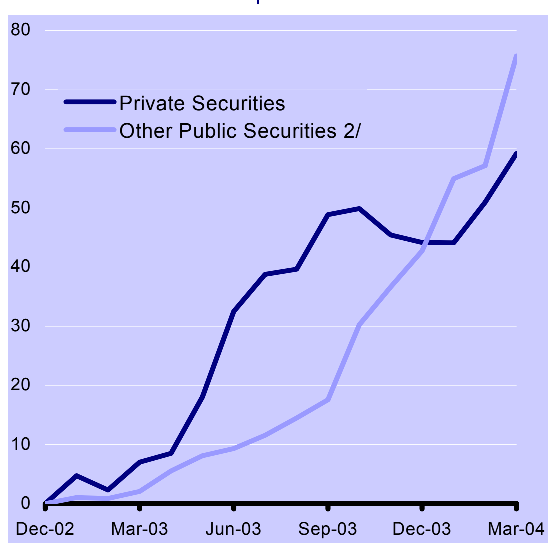
Graph 20 **Performing Loans Granted by Commercial Banks 1/ and Securities**

a) Lending to the Private Sector
Accumulated flows since Dec-2002
Thousand million pesos



1/ Does not include debt-restructuring programs.

b) Private and Other Public Securities
Accumulated flows since Dec-2002
Thousand million pesos

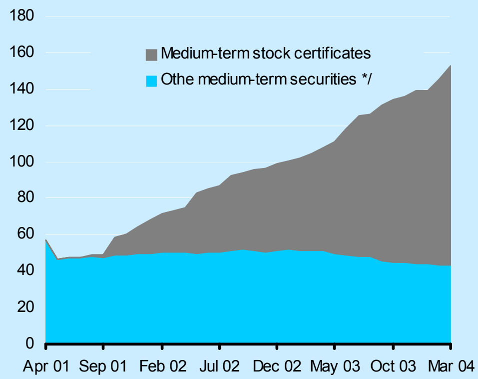


2/ Includes securities from Public Institutions and Enterprises, and from FARAC and State and Municipal Governments.

Box 1
Stock Certificates

Stock Certificates (*Certificados Bursátiles*) began to be placed in the Mexican stock market (*Bolsa Mexicana de Valores, BMV*) on August 10th 2001. These instruments have become an important alternative source of financing for firms, institutions, public enterprises, states, and municipalities.

Medium-term Private Securities
Stocks in thousand million pesos



*/ Includes debentures, participation certificates, and medium-term promissory notes.

Among the advantages this type of securities offer in comparison to other financing instruments placed through the BMV are:

1. **Easier issuance**
   a. They are authorized through specific programs. Thus, several emissions can be issued during a certain term.
   b. They do not require the approval of the Board of shareholders nor need to be registered as an instrument in the Public Commerce Registry, thus reducing time and issuance costs.
2. **Flexibility**
   a. They can be issued for short (less than 1 year), medium, and long terms.
   b. The emissions pertaining to a specific program can be issued at any type of rate (fixed or variable rate, UDIs, etc.).
   c. They are the first strippable private debt instruments.
   d. They can also operate through a trust, thus allowing the securitization of assets and other flows.

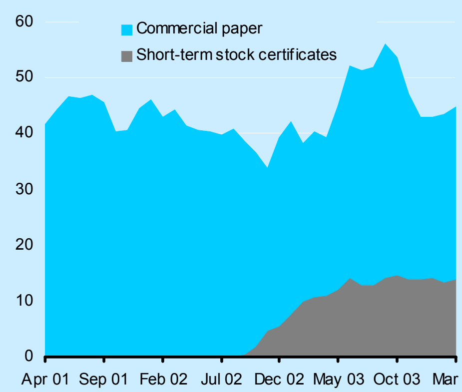
On March 2004, stock certificates accounted for 71.4 percent of the total stock of medium-term private securities in the market. Among the most significant emissions were those of América Móvil, CEMEX, Coca-Cola FEMSA, TELMEX, and BIMBO. Altogether, these companies have issued medium-term stock certificates for 45,404 million pesos (41.7 percent of total outstanding medium-term stock certificates). Resources obtained from the placement of these securities have consolidated as an alternative source of financing in pesos with longer terms and competitive interest rates.

An additional feature that has allowed the development of the debt market through this type of instruments is the securitization of firms' assets, particularly of mortgage SOFOLES (*Sociedades Financieras de Objeto Limitado*/ limited purpose financial companies). Up to date, 6 SOFOLES have engaged in these operations via the placement of 15 securities (14 securitize credit to construction firms and one mortgage loans), for a total of 6,464 million pesos. Securities placed by the National Workers Housing Fund Institute (*Instituto del Fondo Nacional de la Vivienda para los Trabajadores, INFONAVIT*) on March 19th for 751 million pesos for a 12-year term (this emission is backed by 5,916 mortgage loans granted by this institution) also deserve mention.

Up to March 2004, public enterprises as well as states and municipalities issued stock certificates for 53,619 million pesos to diversify their sources of financing. Among the current placements are those done by PEMEX and CFE for 32,672 and 6,665 million pesos, respectively. States and municipalities have also made placements through Management and Payment Trusts to securitize their income from both local taxes and federal revenues.

Stock certificates have also become a very important source of financing in the short-term private debt market. At the end of March 2004, these accounted for 30.9 percent of the total short-term debt instruments in the market.

Short-term Private Securities
Stocks in thousand million pesos



III. Private Sector Outlook for 2004[18]

III.1. Forecasts for Economic Activity and for Different Determinants of Inflation

During the first quarter of 2004, private sector economic analysts' forecasts were the following: i) expected GDP growth for 2004 remained practically unchanged (3.23 percent in March compared with 3.22 in December 2003) [Table 12]; ii) expected increase in private consumption for 2004 also remained unchanged in March at 3.4 percent (the same figure as in December 2003), while private investment growth estimates were revised downward from 5 to 4 percent; iii) GDP growth for 2005 is expected to be 3.7 percent; iv) 314 thousand jobs are anticipated to be created in the formal sector in 2004 and 427 thousand in 2005; v) estimates for U.S. GDP growth were revised upward; vi) domestic interest rates are expected to remain low during the next months; vii) exchange rate expected figures for the end of 2004 remained unchanged; and viii) trade and current account deficits in 2004 and 2005 are anticipated to be below those forecasted in December 2003.

Other aspects from private sector economic analysts' forecasts that also deserve mention are: a) a significant increase in Banco de México's Private Sector Economic Analysts' Business Confidence Index, and b) the insistence on the need to advance in structural reforms in order to foster higher levels of investment in the country.

[18] Unless otherwise stated, forecasts reported in this section are drawn from the monthly Survey on Private Sector Economic Analysts' Forecasts undertaken by Banco de México.

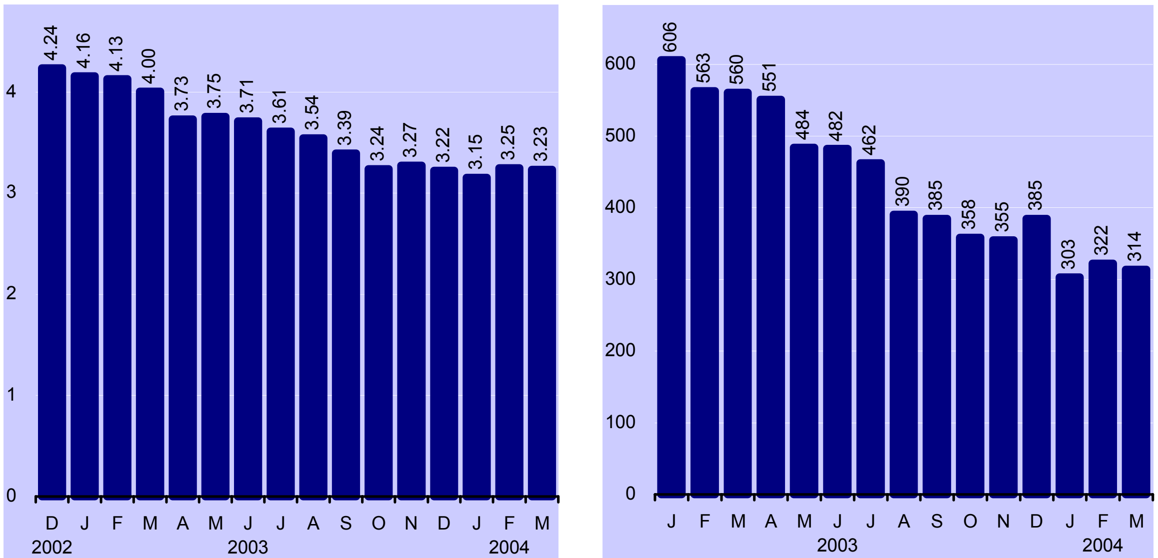
Graph 21 **Private Sector Economic Analysts' Forecasts for GDP Growth and for Number of Workers Insured by the IMSS in 2004**

a) Real GDP Growth

Percent

b) Increase in the Number of Workers Insured by the IMSS

Thousand workers



Source: Survey of Private Sector Economic Analysts' Forecasts, Banco de México.

Table 12 **Private Sector Economic Analysts' Forecasts: December 2003 and March 2004** [1/]

	Dec. 2003	Mar. 2004		Dec. 2003	Mar. 2004
Real GDP Growth in Mexico			**Exchange Rate (Pesos/US dollar, year-end)**		
2004	3.22%	3.23%	Banxico Survey 2004	11.47	11.43
2005	3.73%	3.70%	Futures[2/]	11.83	11.57
			Banxico Survey 2005	n.a.	11.81
Trade Deficit (Million US dollars)			**Mexican Oil Mix (Average US dollars per barrel)**		
2004	8,777	8,018	Banxico Survey 2004	20.49	23.52
			Wage Increases		
Current Account Deficit (Million US dollars)			February 2004	4.51%	n.a.
2004	14,416	12,897	March 2004	n.a.	4.63%*
			Business Climate		
Foreign Direct Investment (Million US dollars)			Will improve	71%	94%
2004	13,094	13,626	Will remain unchanged	19%	6%
2005	n.a.	13,725	Will worsen	10%	0%
Real GDP and Industrial Production Growth in the U.S. in 2004 and 2005					
GDP Growth in 2004			**GDP Growth in 2005**		
Banxico Survey	3.93%	4.46%	Banxico Survey	n.a.	3.73%
Consensus Forecasts[3/]	4.4%	4.6%	Consensus Forecasts[3/]	n.a.	3.7%
Blue Chip Economic Indicators[4/]	4.4%	4.7%	Blue Chip Economic Indicators[4/]	n.a.	3.8%
Industrial Production in 2004			**Industrial Production in 2005**		
Blue Chip Economic Indicators[4/]	4.3%	4.9%	Blue Chip Economic Indicators[4/]	n.a.	4.9%

n.a. not available.

1/ Unless otherwise stated, data is drawn from the monthly Survey of Private Sector Economic Analysts' Forecasts undertaken by Banco de México.

2/ Exchange rate futures of December 31st 2003 and April 2nd 2004.

3/ *Consensus Forecasts* (December 8th 2003 and March 8th 2004).

4/ Blue Chip Economic Indicators (December 10th 2003 and March 10th 2004).

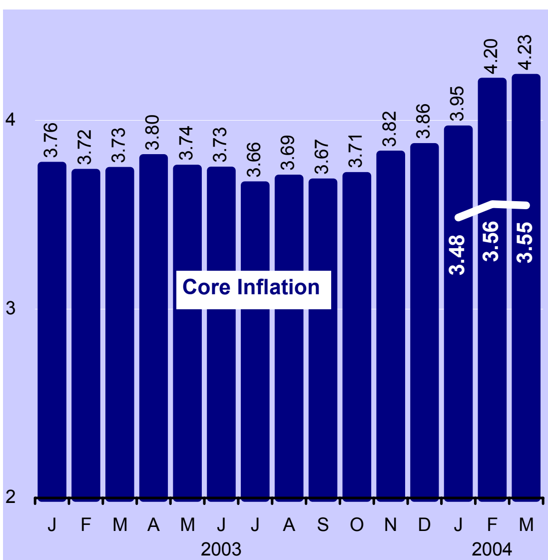
*/ Data from February 2004 Survey.

III.2. Inflation Forecasts

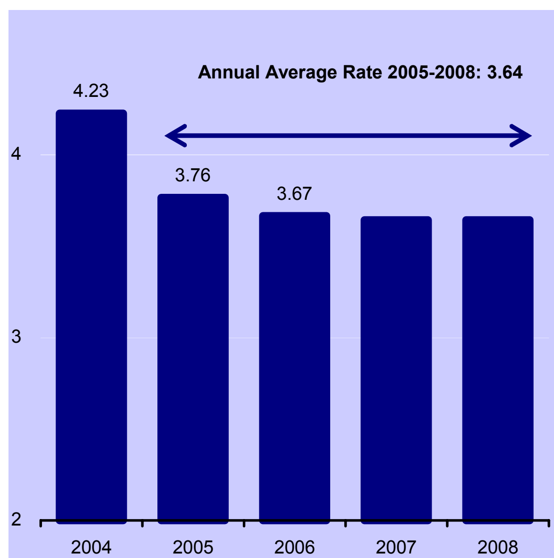
Forecasts for CPI inflation in 2004 were revised upward during the first quarter of 2004. CPI inflation expectations for the end of 2004 were 4.23 percent, figure higher than that forecasted in December 2003 (3.86 percent). In March, core inflation estimates for the end of the year were 3.55 percent. On the other hand, forecasts for CPI inflation for the following twelve months, and for 2005, 2006, and average 2005-2008 were 3.82, 3.76, 3.67 and 3.64 percent, respectively. Inflation expectations for the longer term, despite being still high, have not been revised upward significantly compared to their levels at the beginning of the year. Such results indicate that analysts do not expect CPI inflation to worsen in the medium term and, therefore, that the recent supply shocks to prices in the non-core subindex should only affect annual inflation temporarily.

Graph 22 **Private Sector Economic Analysts' Forecasts for Inflation in 2004-2008**

a) CPI and Core Inflation for 2004
Percent



b) CPI Inflation for the Short and Long terms
Percent



Source: Survey of Private Sector Economic Analysts' Forecasts undertaken by Banco de México.

IV. Balance of Risks and Final Remarks

The continuing improvement of Mexico's external sector has increased the demand for non-oil exports. Consumption has remained strong while investment has begun to increase slightly. Thus, job creation has picked up. There has been an improvement in the structure of employment, reflected in the gradual increase in the number of workers insured by the IMSS.

Banco de México's expected baseline scenario for the following months considers the following assumptions:

(a) Annual U.S. GDP growth expectations for 2004 are kept unchanged at 6 percent, while industrial production is expected to increase 4.9 percent (Source: Blue Chip Indicators).

(b) Mexico is expected to continue having access to external financing under favorable conditions.

(c) The average crude oil export mix price for 2004 is expected to be 23 US dollars per barrel.

Based on the abovementioned and on most recent available information on the development of the Mexican economy, Banco de México's forecast for the main macroeconomic variables in 2004 is as follows:

Economic Growth: Estimates for real GDP growth for 2004 are kept unchanged at between 3.0 and 3.5 percent (probably falling in the upper limit of such interval).

Employment: Nearly 400 thousand jobs are expected to be created in the formal sector during the year.

Current Account: The current account deficit of the balance of payments is expected to be less than 2 percent of GDP.

Inflation: The main challenge for the current disinflation process is the magnitude and persistence of the changes in relative prices in the CPI's non-core component.

At the beginning of the year, Banco de México warned about the probability of having supply shocks that could make annual inflation rise above 4 percent in certain months of the year. As already mentioned, such shocks have been greater than expected in both magnitude and length. As a result, CPI inflation is expected to converge more slowly and gradually to its target.

In order to determine more accurately the impact of such shocks on inflation expectations for the next months, the behavior of the different goods and services whose prices were affected must be analyzed. Price increases in livestock products would tend to revert as the supply of such goods normalizes. This implies that, in the future, such prices could drop and therefore contribute to the reduction of inflation. On the other hand, price increases in goods and services administered by and concerted with the public sector that do not have international references, overall, tend to have a permanent effect on inflation, therefore scaling annual inflation for twelve months.

Consequently, and based on the previous considerations:

(a) At the margin, annual core inflation is expected to contribute to the reduction of CPI inflation during the next months.

(b) Merchandise core inflation is anticipated to ease its upward trend observed since the last quarter of 2002. Nonetheless, for this to occur, agriculture commodities' international references must also exhibit generalized lower inflation rates.

(c) Core services inflation excluding housing is expected to continue contributing to the permanent reduction of inflation. Such subindex is the one that best captures domestic inflation conditions. It is evident that inflation abatement would consolidate as wage negotiations moderate. However, these do not seem to correspond to the slack prevailing in the labor market.

(d) As for the housing subindex, two effects are taking place simultaneously. On the one hand, there have been some recent upward pressures coming from higher residential construction costs due to price increases in metal products, filler wire, rod, cement and ready-mixed concrete. On the other hand, such subindex is expected to continue its declining trend, following the moderate increases in housing rents over the last years due to a greater supply of housing (with a growing access to financing). The latter trend accurately illustrates how structural reforms can have beneficial effects on inflation.

In this case, the positive effect of such policies comes from the combination of the different financial reforms implemented, which have raised the certainty and competitiveness of the housing sector, in addition to the perception that the economy operates under low and stable inflation equilibrium.

(e) As for non-core inflation, the volatility of its different subindexes, and the unexpected supply shocks that affect it, make the assessment of its outlook for the next months more difficult. Nonetheless, there are two opposite factors that could take place. On the one hand, the effects of shocks to livestock goods' prices have started to revert, due to the lifting of restrictions on different meat imports from the United States. On the other, given the present recovery of the world economy, pressures over international energy prices could be more lasting and therefore affect domestic prices of energy goods. Despite the above, non-core annual inflation is expected to decline gradually in the following months.

When inflation is subject to shocks like those registered in the first months of the year, a more detailed assessment of its main components is required. In this regard, core inflation has remained relatively stable for a long period. Such behavior has stemmed from the opposite trends followed by its two main components. On the one hand, the food component of core merchandise inflation has recently been subject to pressures which mirror the increase in food commodities' international references. On the other, core services inflation keeps following a downward trend. The effect of both trends have led to stable core inflation.

Should the international references of commodities begin to decrease in a generalized manner, the downward trend followed by core services inflation would probably extend to total core inflation. Furthermore, the relative stability exhibited by the monthly variation of total core inflation is reflecting, for the most part, its own seasonality.

As mentioned repeatedly in this Report, several components of the non-core price subindex have undergone significant adjustments that have translated into high and volatile inflation.

Therefore, by analyzing the effect of both price subindexes on the CPI level (which is nothing but the weighted average of both subindexes) it can be inferred that both the level and variability of CPI inflation are reflecting, at the margin, the supply shocks to its non-core component.

Under such setting, when the economy is subject to supply shocks, as those exhibited in 2002, when the electricity prices rose sharply, core inflation becomes a more relevant indicator for analyzing medium-term inflation pressures. The purpose of measuring core inflation is to have an indicator that excludes extreme variations in relative prices, which should only affect the inflation rate temporarily and not its trend for the medium-term. Core inflation thus becomes a useful reference for analyzing CPI's inflation most representative trend in relation to its objective.

Although core inflation is not a monetary policy objective by itself, it is a very useful reference for analyzing inflation and communicating with the public. It constitutes a better reference for analyzing inflation pressures because it excludes those items from the CPI that due to their volatility are not representative of the changes that have a permanent effect on CPI's inflation trend.

In this regard, at the end of the first quarter of 2004, core inflation was 3.52 percent, following a slight downward trend during the period. However, as has already been reiterated, core inflation is converging slowly to CPI inflation's 3 percent target.

Before analyzing some of the most important risks surrounding the described macroeconomic scenario, some observations should be made.

The macroeconomic scenario largely reflects that the economy of our main trading partner is recovering more vigorously, therefore increasing the demand for Mexican exports. However, it does not foresee an improvement in the domestic sources of growth that could translate into a swift recovery of investment. In fact, forecasts for growth and employment are far from being the required ones to alleviate poverty and address other social problems efficiently.

It is evident that in order for the economy's growth potential to materialize, its competitiveness must be raised. Moreover, and as reiterated on several occasions, progress must be made in implementing the structural reforms required by the economy.

As already pointed out, the expected macroeconomic scenario is subject to several risks.

Regarding the external ones, those discussed in previous Inflation Reports concerning the probability of having a disorderly adjustment in the U.S. fiscal and current account deficits still prevail. Nonetheless, given the recent developments in the U.S. economy it is very unlikely that such scenario would materialize in the short term.

In contrast, the consolidation of the world economy's recovery, particularly that of the United States, is expected to tighten international monetary conditions by increasing international interest rates. This could lead to a significant contraction in the demand for emerging markets' debt instruments, thus raising their costs for both external and domestic financing. It is important to note that yield spreads on debt instruments have fallen significantly in the last years.

As for the domestic risks, which are those related with the convergence of inflation to its target, the following deserve mention:

(a) The disinflation process could be halted by the presence of new supply shocks or by a greater contagion of those registered during the first months of the year on prices. This could also take place if increases in different commodities' international references do not moderate.

(b) As for medium and long-term risks, the inflation outlook remains vulnerable given the likely revisions on prices of goods and services administered by and concerted with the public sector. As long as these prices continue to deviate from both their opportunity costs and the prevailing market conditions, risks surrounding the attainment of disinflation will prevail.

Banco de México will keep a strict surveillance of the potential inflation pressures that could arise from the supply shocks that affected the disinflation process during the first quarter of 2004 and, should it be the case, act accordingly to make inflation converge to its target. This would also apply to inflation pressures that could originate from the greater dynamism of aggregate demand.

The main challenges faced by disinflation, in particular those regarding price determination of goods and services administered by and concerted with the public sector, brings to the fore the need to advance in the agenda of structural reforms. For example, progress in the energy and fiscal reforms would make most prices of these goods and services fully reflect their opportunity costs so that their determination is not based on other considerations such as to increase government's revenues.

Moreover, by raising the profitability of investment projects, such reforms would significantly boost investment in strategic sectors. This would spark factor productivity, thus raising the economy's growth potential and, finally, strengthening the disinflation process. Such conditions would provide a greater margin to alleviate poverty and other social problems and create more job opportunities.

Summing up, the agreements to advance in the agenda of pending structural reforms are essential to obtain the complete benefits of the previous reforms. This would significantly increase firms' competitiveness as well as the profitability of investments. Additionally, it would enable the country's economy to take full advantage of the current expansion of the world economy in order to improve Mexicans' welfare.

Therefore, as in other Reports, Banco de México reiterates the convenience of reaching the agreements to both implement the required structural reforms and strengthen Mexico's institutions.