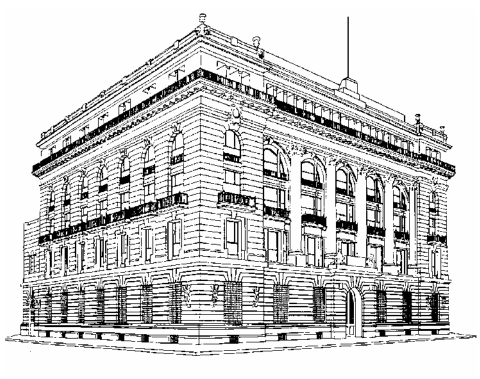
Inflation Report

July – September 2003



BANCO DE MEXICO

OCTOBER 2003

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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 October 24, 2003. Figures are preliminary and subject to change.

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I. Introduction

In this issue, Banco de México describes the performance of inflation and its main determinants during July-September 2003. The monetary policy actions implemented, the reasons behind these actions, and the macroeconomic outlook for the remainder of the year and for 2004, are also mentioned.

At the end of the third quarter of 2003, annual inflation decreased, as compared to the end of June figures. Thus, its path was in line with the attainment of the 3 percent target (with a variability interval of plus/minus one percent) for the end of the year and for the long term. As for inflation expectations for the end of the year, these were revised downward significantly to a level within the referred variability interval.

The fall in annual headline inflation during July-September 2003 was due to the significant decline in the non-core component of the Consumer Price Index (CPI). In addition, annual core inflation dropped marginally. Within the CPI, the annual rate of growth of the services subindex decreased, while that for merchandises increased slightly.

During the third quarter, the performance of the Mexican economy was conditioned by different factors. Among the external ones, the economy faced a more favorable international environment. Economic activity of the main countries of the world, especially of the United States, improved as a consequence of better financial conditions. Output, as well as several components of spending in that country, seem to be consolidating their recovery. Nonetheless, the industrial sector and, in particular, manufacturing industry, are still at an early stage of recovery, and job creation is still insufficient to offset the significant job losses of previous quarters.

On the domestic front, economic activity grew moderately. The services sector had a positive performance, while agriculture and industrial sectors (particularly the manufacturing branch) remained weak.

Under such conditions, and given the gradual trend of inflation towards its target, Banco de México maintained the “short” unchanged during the third quarter. The conduct of monetary policy has allowed monetary conditions in Mexico to orderly reflect the high liquidity environment prevailing in global financial markets.

Furthermore, fiscal and monetary discipline over the past years, together with the financial reforms that have been implemented, have fostered the development of capital markets in Mexico. These markets have deepened and become more liquid. Consequently, the level of domestic financing has increased and has allowed, for the first time, the issuance of securities by the private sector with long-term maturities and favorable interest rate conditions.

Thus, in an environment characterized by low interest rates and deeper and more robust capital markets, the Central Bank's policy has contributed to facilitate the recovery of domestic demand in Mexico. On the one hand, private consumption has continued to expand, fostered by favorable financial conditions and by a greater availability of credit; on the other, businesses have improved their financial positions, which, together with low interest rates, sets the ground for them to increase their investments. These events have taken place under a strict surveillance of inflation and of inflation expectations.

The previous Inflation Report mentioned the Exchange Commission's decision to reduce the pace of accumulation of international reserves. As a result of this measure, during this quarter it was not necessary to place a significant amount of liabilities for monetary-regulation purposes, therefore increasing, at the margin, the availability of resources for the economy.

The Board of Governors of Banco de México considers that, for the remainder of 2003, annual headline inflation will continue converging towards its 3 percent target, considering a variability interval of plus/minus one percent. Furthermore, core inflation will remain firmly within the variability interval for headline inflation. This supports the convergence of CPI inflation to its target. Nevertheless, such scenario is subject to the following risks:

(a) Core inflation is currently at historically low levels and has decreased in the last four months. However, its decline has been minimal, so that it has remained between 3.5 and 3.6 percent for eight consecutive months;

(b) A sudden rise in the price index for agriculture products cannot be discarded. Such event could make inflation deviate from its target for the end of year, although this would not affect the medium-term objective;

(c) Despite the slight decline in real wage increases, these still seem to be inconsistent with the slack in labor market conditions and with gains in productivity; and

(d) Despite the fact that so far there is no evidence of a pass-through of exchange rate fluctuations to prices, the exchange-rate depreciation could still have some effects in the future.

As for economic activity, its recovery in Mexico will depend, to a great extent, on how strongly it reflects the current recovery of the United States economy. In particular, the Mexican economy is expected to grow around 1.5 percent in 2003. This scenario, as well as that foreseen for 2004, are subject to a high degree of uncertainty.

In this context, the most significant risk for Mexico in the immediate and medium terms is the impact of the country's loss of competitiveness over the last years. The postponement of the structural reforms has affected the economy negatively on its capacity to compete in global markets. This has started to materialize in the fact that during 2003 Mexican exports have lost market share against those of China in the United States. If this situation is not reverted, the Mexican economy will hardly be able to create the jobs required by its society.

From a broader perspective, two main trends have emerged in the world economy, both representing a great challenge for Mexico. On the one hand, the significant economic slowdown in the United States (and in the rest of the world), with a sharp contraction in production and employment in the manufacturing sector (which is closely linked to the Mexican economy). On the other, China's new role as major participant in the world economy, as confirmed by its rapid integration to global trade and by the increasing share of its products in world markets. Mexico's economy has not reacted swiftly to mitigate the impact from these events. In addition, the boost to growth it received from the North American Free Trade Agreement during the second half of the nineties has been diminishing. Thus, Banco de México, as has done in other Inflation Reports, reiterates the need to implement the structural reforms that will enable the country to adapt to an increasingly competitive external environment.

This issue of the Inflation Report includes the calendar for the announcements on monetary policy decisions for 2004. This mechanism, which has improved Banco de México's communication with the public, emphasizes the medium-term outlook for monetary policy decisions, therefore increasing its effectiveness.

II. Recent Developments in Inflation

During the third quarter of 2003, annual CPI inflation followed a downward trend, compatible with its 3 percent target, with a variability interval of plus/minus one percentage point for the end of the year and for the long term.

The previous result reflects mainly the fall in non-core inflation. As for the main CPI subindexes, the following should be highlighted:

(a) Annual CPI inflation dropped 0.23 percentage points, as compared to the end of previous quarter;

(b) Annual core inflation declined 0.09 percentage points compared to June due to the reduction in core inflation of services, which more than offset the slight rebound in that of merchandises;

(c) The annual variation in the core subindex for merchandises rose for a second consecutive quarter, mostly as a result of the atypically low levels registered by this indicator during the previous periods of 2002;

(d) Annual non-core inflation remained on the same downward trend observed since the first quarter of 2003;

(e) Within the price subindex for education, the annual variation of school fees dropped, as compared to the end of the previous quarter. However, the growth rate of the price subindex for education is still high, as compared to figures for headline inflation for this year and those estimated for 2004;

(f) Annual inflation of goods and services with prices administered by and concerted with the public sector continued falling, ending, for a second consecutive quarter, below annual CPI inflation; and

(g) The annual growth in the Producer Price Index (PPI) excluding oil and services was lower than that observed at the end of the previous quarter.

II.1. Inflation Indicators

II.1.1. Annual Inflation of the Consumer Price Index and Core Price Index

At the end of September 2003, annual CPI inflation was 4.04 percent, 0.23 percentage points lower than in June (Graph 1). This rate is the lowest registered since January 1969 (when the CPI began to be computed).

The reduction in annual CPI growth during the quarter is explained mainly by the declines in non-core inflation (0.57 percentage points) and, to a smaller degree, in core inflation (0.09 percentage points). The latter mainly responded to the drop in services inflation (0.34 percentage points). Within the non-core inflation component, the variation in the subindexes for education, for goods and services with prices administered by and concerted with the public sector, and for agriculture products also fell at an annual rate (Table 1).

When analyzing the path of inflation, the behavior of both core inflation and of its two subindexes (merchandise and services) deserves special attention. The subindex for merchandises has a share of 53 percent while that for services, 47 percent. Foods (excluding agriculture products)[1] have the highest share in the merchandise subindex (39.7 percent), while prices related to housing have a share of 54.9 percent in the subindex for services.[2]

[1] The price subindex for agriculture products is included in the non-core subindex and has a share of 8.1 percent in the CPI.

[2] Includes the following items: owner-occupied homes, home leasing, household domestic service, and services and materials for household maintenance.

Graph 1 **Consumer Price Index, Core and Non-core Price Indexes**

Annual percentage change

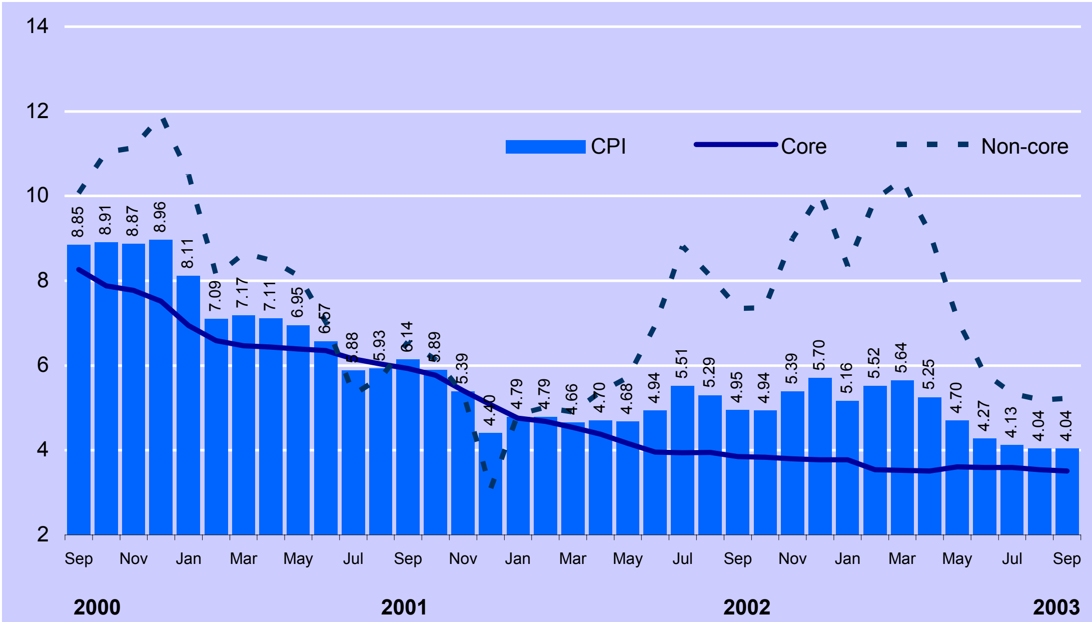


Table 1 **Price Indexes: CPI, Core and Non-core**

Percent

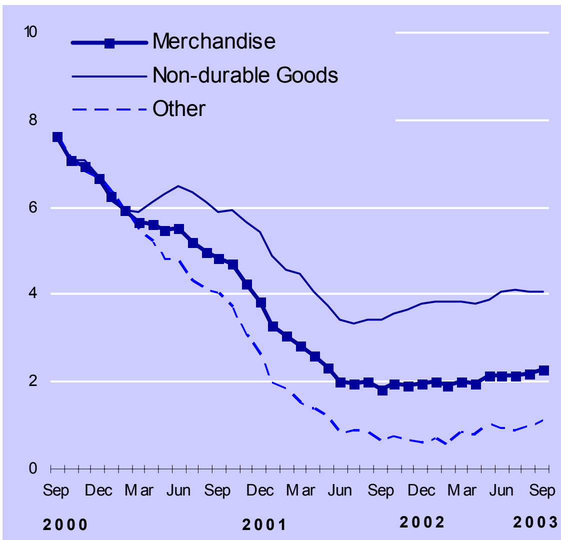
	Annual Variations			Quarterly Variations		
	Sep-2003/ Sep-2002	Jun-2003/ Jun-2002	Sep-2002/ Sep-2001	Sep-2003/ Jun-2003	Jun-2003/ Mar-2003	Sep-2002/ Jun-2002
CPI	4.04	4.27	4.95	1.04	-0.07	1.27
Core	3.51	3.60	3.85	0.54	0.78	0.63
Merchandise	2.27	2.16	1.85	0.27	0.34	0.17
Services	4.91	5.25	6.61	0.84	1.28	1.17
Non-core	5.23	5.80	7.34	2.17	-1.93	2.74
Agricultural	5.47	6.09	2.38	1.63	-1.54	2.23
Fruits and vegetables	6.36	6.49	5.90	3.67	-3.88	3.79
Other	4.86	5.81	0.04	0.25	0.11	1.15
Education	8.57	10.31	10.10	7.03	0.26	8.76
Administered by/Concerted with the Public Sector	4.02	4.21	9.23	0.88	-2.80	1.06
Administered	6.47	6.86	12.93	1.48	-6.16	1.85
Concerted	1.96	2.01	6.41	0.35	0.33	0.41

For a second consecutive quarter, annual core inflation for merchandises rose from 2.16 percent (end of 2003-II) to 2.27 percent (end of 2003-III). This behavior is mainly explained by the atypically low inflation rates registered in the second and third quarters of 2002, which were even below 2 percent. Additionally, during 2002, supermarkets offered price discounts, which affected the CPI directly (mostly, the subindex of foods), while in 2003, these stores modified their business strategy and offered conditional discounts, whose effects cannot be captured by the index.[3] This situation is confirmed by the behavior of the core inflation for merchandises, particularly the subindex of foods, which reached an annual rate of inflation of nearly 3.4 percent at the end of the second and third quarters of 2002, and then jumped to slightly above 4 percent during the same periods of 2003 (Graph 2a).

Graph 2 Core Price Indexes (Merchandise and Services)

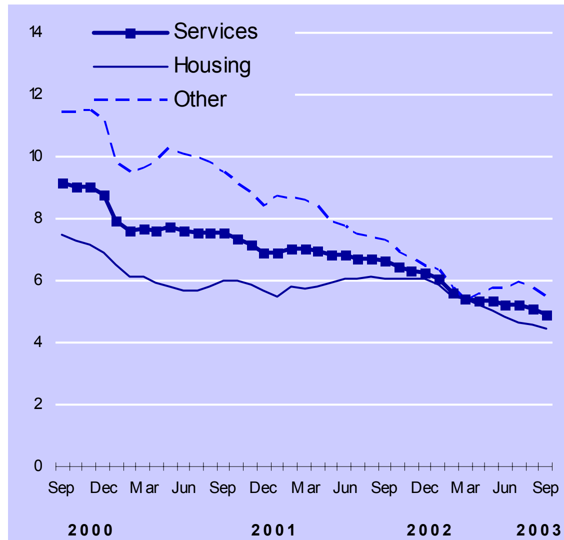
a) Core Subindex (Merchandise)

Annual percentage change



b) Core Subindex (Services)

Annual percentage change



As for the core subindex for services, during the third quarter of 2003 the price subindex for housing rose 0.85 percent, 0.42 percentage points lower than during the same period of 2002. Consequently, from the second to the third quarter of 2003, the annual rate of growth of the subindex for housing dropped from 4.86 to 4.43 percent, thus contributing to the decline in the core inflation of services (Graph 2b).

II.1.2. Monthly Inflation of the Consumer Price Index and of the Core Price Index

During July-September 2003, monthly CPI inflation fell compared to the same period in 2002. Private sector analysts'

[3] Conditional discounts are those that require the purchase of several goods to obtain one of the same kind free of charge or purchases of goods on interest-free credit with payment by installments. CPI's quotation rules consider the price of a given product individually, including taxes and applicable discounts, when the payment is in cash.

forecasts for CPI inflation posted mixed results: observed inflation during July and August was lower than expected, whereas in September it was higher (Table 2).

Table 2 **Observed and Expected Monthly Inflation**

Percent

	2003			2002		
	Observed		Expected [1/]	Observed		Expected [1/]
Month	Core	CPI	CPI	Subyacente	CPI	CPI
July	0.14	0.14	0.27	0.14	0.29	0.22
August	0.23	0.30	0.33	0.28	0.38	0.32
September	0.17	0.60	0.53	0.20	0.60	0.50

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.

Monthly headline inflation rose during the quarter mainly due to seasonal factors. As for the core price subindex, this exhibited an average monthly variation of 0.18 percent in July-September 2003, compared to 0.21 percent during the same period of 2002. Considering the aforementioned, and excluding those components whose prices are subject to high volatility, as well as CPI's seasonal factors, inflation has remained in a trend compatible with the 3 percent target, taking into account its variability interval.

II.1.3. Producer Price Index (PPI)

For a second consecutive quarter, the Producer Price Index (PPI) exhibited a decrease in its annual growth rate. By the end of September, such rate reached 5.62 percent as compared to 5.71 percent at the end of June. This result stemmed from the rise in prices of goods and services geared to satisfy both domestic demand and external markets (5.37 and 7.91 percent, respectively). Export prices are affected immediately by exchange rate fluctuations. Thus, they reflected the depreciation that took place during the quarter.

II.1.4. Outlook for Inflation

It is important to point out that some business cycle factors have favored the convergence of inflation to the 3 percent target set by the Central Bank (considering the variability interval of plus/minus one percent). In this regard, the weakness of demand, both in Mexico and in the rest of the world, together with an absence of significant supply shocks during recent periods, have contributed to mitigate price increases.

As for structural factors, these are part of Mexico's transition towards an environment of low inflation, with more robust financial markets, a greater remonetization of the economy, and a lower pass-through from exchange-rate fluctuations to prices. Many of these factors stem from the fact that inflation expectations for the long term are now better anchored than in the past. In this regard, Banco de México's monetary policy actions in the last years have contributed to attain a low inflation macroeconomic environment. The Central Bank has fostered macroeconomic stability through both, a preventive monetary policy, which has countered inflationary pressures decisively, and a communication policy geared towards increasing its transparency and accountability.

In contrast, wages have not been consistent with the contraction in the labor market, therefore limiting a further reduction of inflation, in particular, core inflation of services.

II.2. Main Determinants of Inflation

II.2.1. International Environment

During the last years, including the third quarter of 2003, the macroeconomic world scenario has been mostly characterized by a factor shared by the three major world economic regions (the United States, Japan, and the Euro Zone): the implementation of active policies (with different degrees of intensity) to stimulate aggregate demand. In this context, several external factors affected the performance of the Mexican economy. On the one hand, despite the strength of the recovery in the United States, the lack of dynamism of its industrial sector limited the expansion of Mexico's manufacturing exports. On the other, the combination of both, the high price of the Mexican crude oil export mix and more favorable conditions in world financial markets, had a positive impact on the Mexican economy.

II.2.1.1. Oil Prices

The price of the West Texas Intermediate (WTI) averaged 30.28 US dollars per barrel during July-September, 1.23 US dollars higher than in the previous quarter. This was mainly due to the reduction in oil inventories throughout the world, and to the sudden cut in OPEC's oil production in mid-September.

During the same period, the price of the Mexican crude oil export mix averaged 24.55 US dollars per barrel, 2.09 dollars higher than in the previous quarter, and 6.2 US dollars higher than the price budgeted by the Federal Government for the entire year. During the third quarter of 2003, the average spread between the price of the Mexican crude oil export mix and the WTI was 5.73 US dollars, 0.85 US dollars lower than in the second quarter.

II.2.1.2. Developments in the United States Economy

The recovery of the U.S. economy seems to have gained momentum during the third quarter of 2003. This stemmed both from the fiscal stimulus, which has induced a significant increase in disposable income, and from favorable conditions in financial markets. On July 25th the Federal Reserve announced an additional reduction in its target for the federal funds rate (25 basis points), bringing it down to historically low levels (1 percent). In later meetings, the Federal Open Market Committee (FOMC) announced that an accommodating monetary policy could be maintained for a long period. As for long-term interest rates, these were subject to volatility during the quarter. On July they started an upward trend, which reverted temporarily in September due to the uncertainty regarding the strength of the recovery.[4] Regarding risk premia over corporate bonds, these reached their lowest level since the beginning of the recovery. The depreciation of the U.S. dollar and the rise in stock markets since March have contributed to the favorable financial conditions for the expansion of demand.

After having exhibited modest growth during the first quarter (attributed, to a certain extent, to the uncertainty regarding the war in Iraq), the U.S. economy registered a greater than expected recovery during the second quarter of the year (3.3 percent, at quarterly annualized rates). During this period, households' expenditure, driven by an increase in their indebtedness, continued to be a significant force behind the economic recovery. Nevertheless, as compared to previous quarters, consumption was not the only engine of growth. On the one hand, government expenditure (in particular, defense-related expenditure) contributed to nearly half of GDP growth. On the other, fixed investment exhibited its highest rate of growth since 2000 (7.1 percent, at quarterly annualized rates).

[4] Once forecasts for growth began to be revised upward in October, long-term interest rates rose again to levels similar to those observed in August.

The following indicators suggest that the recovery of the U.S. economy gained momentum during the third quarter of 2003:

(a) The strength of consumption. Despite the significant fall in mortgage refinancing, tax rebates have expanded households' disposable income. This has favored the increase in consumption, which rose, on average, 6.1 percent (at quarterly annualized rates) in July and August, compared to the previous quarter.

(b) Gross investment. The placement of new orders for capital goods (excluding defense and commercial aviation) increased, on average, 6.5 percent (at quarterly annualized rates) in July and August, therefore suggesting a continued recovery of investment in equipment and software.

(c) The improvement in the external sector's accounts during July and August.

In this context, analysts have revised their forecasts for GDP growth for the third quarter in more than one percent, in an interval from 5 to 6 percent, at quarterly annualized rates (Table 3).

Table 3 **Forecasts for GDP Growth in the United States in 2003**

Annual percentage change

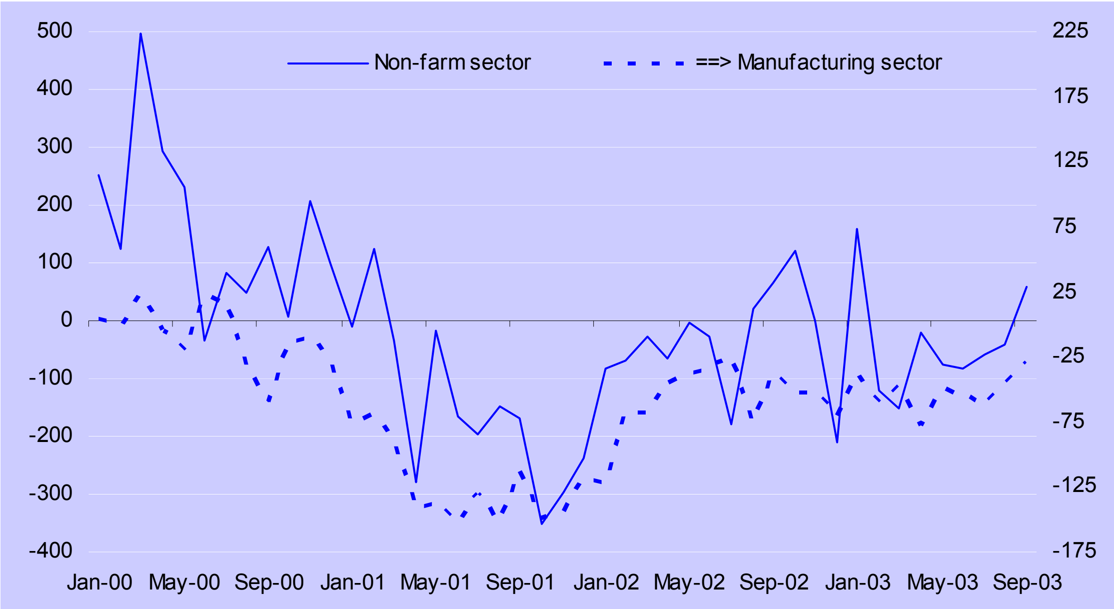
	At end 2003-II				Most Recent data			
	2003-III [1/]		2003		2003-III [1/]		2003	
	GDP	Ind. Prod.	GDP	Ind. Prod.	GDP	Ind. Prod.	GDP	Ind. Prod.
Consensus Forecasts [2/]	3.6	2.9	2.3	0.6	4.9	3.8	2.7	0.1
Blue Chip Economic Indicators [3/]	3.5	3.2	2.4	0.7	4.9	2.9	2.7	0.1
Economic Analysts (Average) [4/]	3.5	n.a.	2.3	n.a.	5.6	n.a.	2.8	n.a.

1/ Quarterly annualized percentage change of seasonally adjusted series.
2/ June 9th, September 8th and October 13th 2003 issues of the *Consensus Forecasts*. The quarterly annualized variation is calculated based on annual variation figures reported on the June 9th and September 8th 2003 issues.
3/ Blue Chip Economic Indicators (June 10th and October 10th 2003).
4/ Average of 5 brokerage firms (June 27th and October 17th 2003).
n.a. not available.

The economic expansion in the United States has not led to a significant reduction in the rate of unemployment, which currently exceeds 6 percent. Payroll employment fell by 336 thousand persons during the first nine months of 2003 (Graph 3). This situation reflects businesses' significant restructuring process, which has led to substantial gains in productivity. Nonetheless, the increase in the non-farm payroll in September (the first in the last eight months) could point to a slight improvement in labor market conditions and to a more long-lasting recovery.

Graph 3 **Non-farm Payroll**

Monthly Absolute Variation (Thousand Workers)



Source: U.S. Department of Labor, Bureau of Labor Statistics (BLS).

GDP growth has not led to a similar expansion of industrial production (the latter began to grow at a monthly rate only until July). In September, industrial output continued falling at an annual rate of -0.06 percent, while output volume remained at levels similar to those of January. Manufacturing output has had a less favorable behavior (Box 1). During the first two quarters of the year, it fell 0.9 percent and 3.2 percent (at annualized rates), respectively. Despite having grown 3.5 percent (annualized rates) during July-September, average manufacturing output for the first 9 months of the year ended 0.7 percent below the figures observed in the same period of 2002. Job losses in the manufacturing sector have been quite significant. Up to September of 2003, 464 thousand job positions were lost and employment has been dropping continually for 38 months. The difficult situation faced by the manufacturing sector has led to reduced Mexican manufacturing exports to the United States.

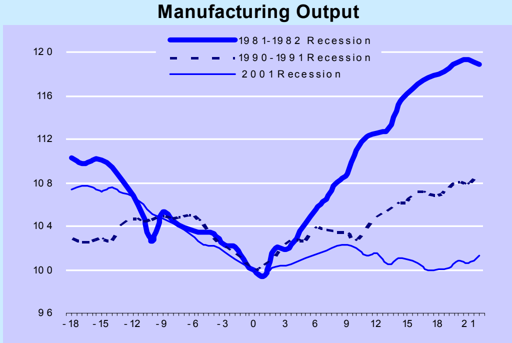
Box 1

Developments in the U.S. Manufacturing Sector

GDP growth in the United States during 2003 has not led to a similar expansion of this country's industrial sector. The latter's weak performance has mirrored the negative conditions of the manufacturing industry, which accounts for 80 percent of total industrial output.

Manufacturing output has grown at a much more slower pace during the current recovery, compared with previous business cycles. Considering figures at September, the index for manufacturing output exceeded its level in November 2001 by only 1.3 percent, the official date for the end of the last recession. This largely contrasts with this sector's performance during the previous stages of economic recovery. Thus, for example, 22 months after the end of the 1981-1982 recession, manufacturing output expanded 18.9 percent while during a similar period after the end of the 1990-1991 recession, it did so by 8.8 percent.

Graph 1[1]
Manufacturing Output

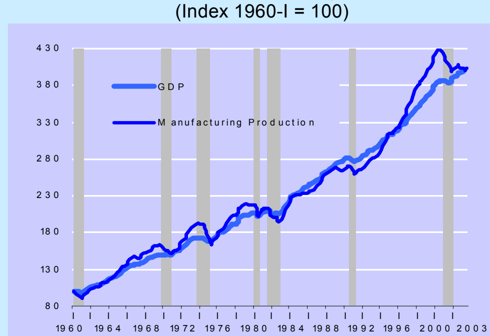


Source: Federal Reserve System.

The sluggish recovery of the manufacturing sector compared to that of GDP could respond to the difference between their respective cycles. In fact, the cycle for manufacturing output is wider than that of GDP, growing faster during the stages of recovery and contracting at higher rates during recessions. Another important issue is the fact that during the previous stage of expansion, manufacturing output grew at a higher rate than GDP. Thus, the slower recovery experienced by the manufacturing sector could mean, to a certain extent, a return to its secular pattern.

The performance of the manufacturing sector has led to a significant reduction of employment. July 2000 was the last date in which the manufacturing payroll expanded. From that moment on, 2.76 million jobs have been lost in this sector. This behavior contrasts with that observed during previous recoveries. In fact, during the so-called "jobless recovery", which took place at the end of the 1990-1991 recession, the manufacturing payroll contracted significantly less than today. It is important to point out that the significant increase in labor productivity in the United States reflects the relative behavior between manufacturing output and employment.

Graph 2
GDP and Manufacturing Output
(Index 1960-I = 100)



Note: Shaded areas represent recessions.
Source: U.S. Department of Commerce, Bureau of Economic Analysis (BEA); and Federal Reserve System.

The aforementioned could respond to structural changes within the manufacturing sector. A study by the Federal Reserve Board of New York on the possible effects of structural changes on employment shows evidence of modifications in two characteristics of employment during the recent recession: more job losses in permanent than temporary positions, and changes in the patterns of employment relocation by sectors.[2] The likely presence of structural change factors could be delaying the cyclical recovery of employment, given that job creation is a slower process than job reopening.

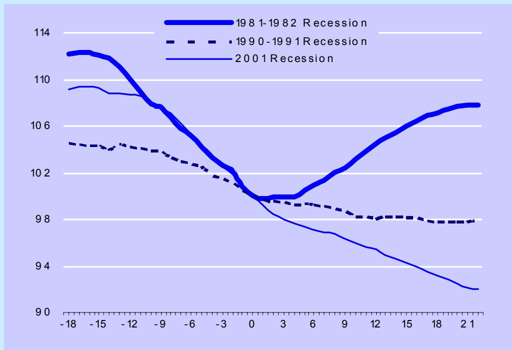
Moreover, companies could also be taking advantage of the lower phase of the business cycle to acquire new technology, especially in the field of data

[1] Variables in graphs 1 and 3 have been normalized to a value of 100 for the date of the respective business cycle trough (November 1982 for the 1981-1982 recession, March 1991 for the 1990-1991 recession, and November 2001 for the recession in 2001). The horizontal axis represents a time period of 18 months prior to, and 22 months after, the end of the recessions, which are represented as "0".

[2] Groshen, Erica L. and Simon Potter, "Has Structural Change Contributed to a Jobless Recovery?, *Current Issues in Economics and Finance*, Federal Reserve Bank of New York, August 2003.

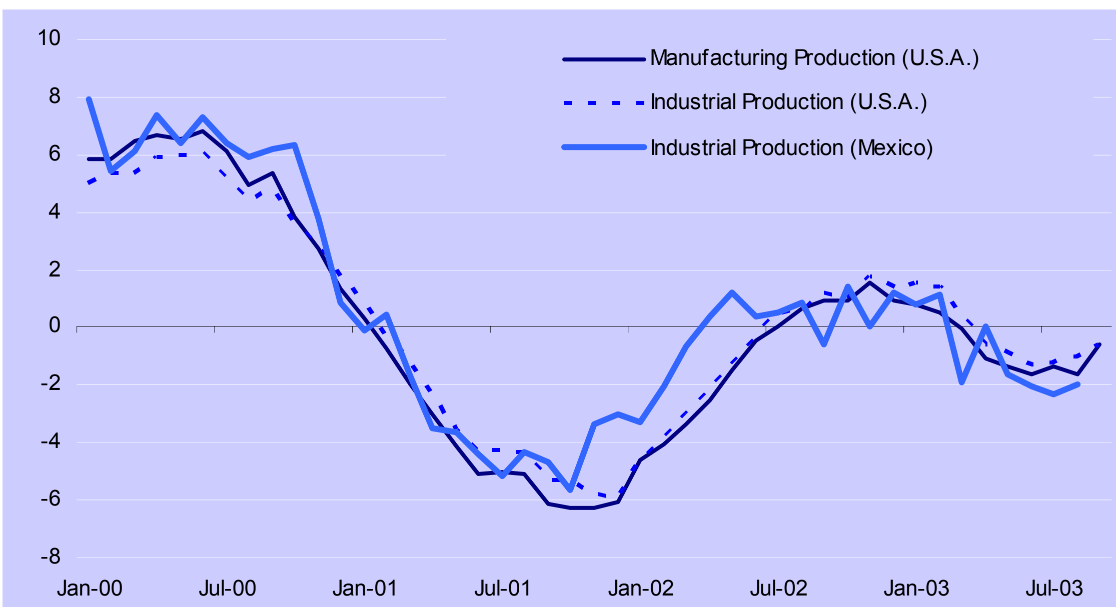
processing, which would also be consistent with the observed increases in productivity.

Graph 3
Employment in the Manufacturing Sector



Graph 4 **Industrial and Manufacturing Production in the United States, and Industrial Production in Mexico**

Annual percentage change (seasonally adjusted series)



Source: Federal Reserve System and Banco de México.

Although manufacturing production has expanded at a slower pace than the rest of the economy, several indicators point to a recent recovery in this sector. In September, manufacturing production rose at a monthly rate of 0.7 percent (seasonally adjusted figures), its highest increase since March 2000. Moreover, the inventory-to-sales ratio in this sector is currently at historically low levels. Additionally, the component of new orders of the Institute for Supply Management Index (ISM), which recorded 60.4 percent in September and since May has remained above 50 percent, improves expectations of a future recovery in manufacturing production.[5]

Despite the expansion in several components of spending, price increases have diminished significantly throughout the year. Core CPI inflation continues falling. In September it was 1.2 percent (at an annual rate), 1.1 percentage points lower than in September 2002. Under such conditions, expectations for lower inflation in the next months confirm, to a great extent, that the United States economy has been below potential for a long period. In this regard, the FOMC stated in its press releases of August and September that the probability, though minor, of an unwelcome fall in inflation exceeds that of a rise in inflation.

At the end of the third quarter of 2003, the United States economy seems to be consolidating its recovery. Expected GDP growth for the year has been revised to 2.7 percent (Table 3). Likewise, the outlook for the medium term has improved due both to higher corporate profits and rapid increases in productivity (since 2000, figures for productivity growth have almost doubled those averaged during the nineties).

Nonetheless, there are still certain factors that could limit the speed of economic expansion. First, the asymmetry of the recovery among the main economies could affect the U.S. external balance negatively. Compared with the growth of the nineties, when increases in the current account deficit resulted mainly from the expansion of private investment, recently, these have stemmed from both the higher fiscal deficit in the United States and the slow growth of its main trading partners. A second risk factor is the significant deterioration in the U.S. fiscal position. According to the IMF, the U.S. Federal Government's deficit will reach nearly 6 percent of GDP in 2003. The deterioration of the U.S. fiscal position could affect forecasts for economic growth. High levels of public deficit for a long period could eventually put pressure on interest rates and limit the recovery of investment spending, a key factor to guarantee long-lasting economic growth. Finally, the

[5] Surveys on manufacturing production undertaken by the Federal Reserve Banks of New York and Philadelphia in October point to an improvement in this sector. The highest figure during the actual stage of recovery published by the Index of the Federal Reserve Bank of New York was reached in October 2003. The highest figure by the Index of the Federal Reserve Bank of Philadelphia was also reached in this month (since July 1996). In both cases, the leading indicators included in these indexes suggest that the manufacturing industry will continue its recovery during the next months.

weakness in the labor market could limit the expansion of household expenditure.

II.2.1.3. Developments in the Rest of the World Economies

After the fall in GDP in April-June (-0.2 percent, at annualized rates), the Euro zone economy slightly recovered during the third quarter of 2003. The European Commission has kept its estimates for quarterly growth during the third quarter of 2003 (as compared to the second) in an interval from 0 to 0.4 percent (not annualized), and from 0.2 to 0.6 percent for the fourth quarter. Signs of an upturn in the rest of the world, an increase in confidence indexes (both business and consumer), and the improvement in stock markets since the end of the first quarter, could boost economic activity within the region. Furthermore, in June, monetary policy actions led to a fall of 50 basis points in the main reference interest rates. Such measures should gradually expand credit and, thus, domestic spending. Long-term interest rates exhibited similar volatility to those in the United States. In general, economic analysts consider that the economic rebound could be weakened by both the appreciation of the euro and its effect on exports and industrial output, and the persistently high rate of unemployment.

As for Japan, recent data suggests that this country is at an early stage of recovery. Nonetheless, these are not conclusive enough to affirm that such recovery is sustained. The Tankan Business Survey for the third quarter of 2003 suggests an improvement in business confidence (the index for large manufacturing enterprises recorded its first positive figures since the third quarter of 2000). In contrast, the appreciation of the yen, together with the persistently high rate of unemployment, are factors that could negatively affect the recovery of the Japanese economy. According to analysts surveyed by Consensus Forecasts, during the third and fourth quarters of 2003 Japan's GDP is expected to grow at an annual rate of 1.6 and 1.4 percent, respectively.

The economic conditions in the advanced economies have created, in general, more favorable conditions for the emerging economies. Low interest rates in industrialized countries and a higher appetite for risk among investors have narrowed the spreads on many of these countries' sovereign debt. Such spreads kept narrowing during the third quarter of 2003.[6] The latter, together

[6] During July-September, the margins for emerging market debt sovereign spreads, measured by the EMBI+ indicator, fell by 41 basis points while those for Latin American

with an improvement in the macroeconomic fundamentals of some emerging economies, have facilitated an increase of net inflows to these countries.[7] In particular, during 2003, a larger number of bonds from several Latin American countries have been placed in world financial markets. Among the most important ones are those from Mexico, Brazil, Chile, Colombia, and Peru. It is anticipated that, in 2003, the low level of capital outflows from private net financial flows will offset the fall in net foreign direct investment to the region (Graph 5).

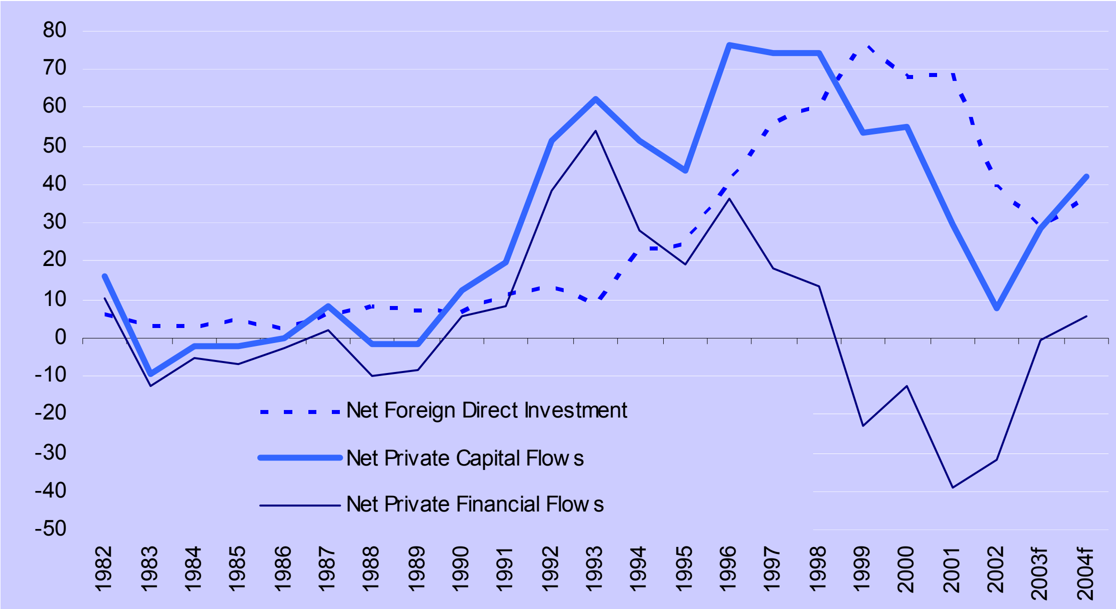
After the recessive stage of the business cycle that started in 2001, Latin America is expected to reach a point of inflection. Domestic efforts regarding the stabilization process and structural reforms, as well as a more favorable external environment, have contributed to this perception. In Brazil, industrial output rose from 0.9 to 1.5 percent in July and August, respectively (using seasonally adjusted data as compared to the previous month). These results have motivated expectations regarding the recovery of economic activity during the second half of the year (in the second quarter GDP fell at an annual rate of 1.4 percent). Economic Analysts surveyed by Consensus Forecasts expect that GDP growth will be 0.7 percent in 2003. As for Argentina, this country is expected to have grown 6.6 percent during the second quarter of 2003 (compared to the same period of the previous year), and to attain 5.5 percent during the entire year. It is important to point out that high growth rates for 2003 come mainly from the rebound in economic activity after its sharp fall in 2002. Uncertainty regarding Argentina's debt restructuring is still a risk factor for this country's growth potential.

countries (EMBI+ Latin) did so by 56 basis points. High yield U.S. corporate spreads also dropped. From the end of June to October 23rd, both the EMBI+ and the EMBI+ Latin fell 72 and 83 basis points, respectively.

[7] According to the IMF, net private capital flows to the emerging economies will be over 100 billion US dollars (for Latin America 28 billion US dollars are expected).

Graph 5 **Net Private Capital Flows to Latin America**

Billion US dollars



f/ forecast.
Source: *World Economic Outlook*, IMF, September 2003.

In general, Latin America is expected to exhibit sluggish growth for this year and concerns regarding the presence of risks prevail. Consequently, economic analysts surveyed by Consensus Forecasts revised downward their growth forecasts for the region in 2003, from 1.5 percent in June to 1.2 percent in September.

II.2.2. Earnings and Employment

Although demand for labor was affected negatively by the prevailing weakness of the Mexican economy, during the third quarter of 2003 real wages kept rising. The weighted average of nominal contractual wage increases for the overall economy was 4.8 percent, and 5.2 percent for the private sector. As for employment, a continued weakness of labor demand in the formal sector and the higher rate of unemployment (compared to the previous quarter) is noteworthy.

II.2.2.1. Earnings

In July 2003, real earnings in the manufacturing industry (excluding in-bond plants) and in the commerce sector rose at an annual rate of 4.2 and 5.8 percent, respectively. In contrast, in the export in-bond industry they fell 0.5 percent. These results confirm the trend of these variables during the first half of the year.

Table 4 **Earnings per Worker**

Annual percentage change

	Nominal								Real							
	2003							Average	2003							Average
	Jan	Feb	Mar	Apr	May	Jun	Jul	Jan-Jul	Jan	Feb	Mar	Apr	May	Jun	Jul	Jan-Jul
Manufacturing Industry	6.2	6.2	6.6	5.6	5.2	6.8	8.5	6.5	1.0	0.7	0.9	0.3	0.5	2.4	4.2	1.4
In-bond Industry	6.5	5.3	4.2	3.6	2.0	3.1	3.6	4.0	1.3	-0.2	-1.4	-1.5	-2.5	-1.2	-0.5	-0.9
Commerce	12.8	10.1	9.5	7.2	9.3	8.8	10.1	9.7	7.3	4.4	3.6	1.8	4.4	4.3	5.8	4.5

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

According to available information, labor productivity rose in the three abovementioned sectors during July. After analyzing average figures for the first seven months of the year, the manufacturing and in-bond industries, as well as the commerce sector, exhibited a positive variation in productivity of 1.2, 1.0 and 1.5 percent, respectively. These gains are explained, for the most part, by adjustments to the labor force aimed at reducing costs.

Table 5 **Output per Worker and Unit Labor Costs**

Annual percentage change

	Output per Worker								Unit Labor Costs							
	2003							Average	2003							Average
	Jan	Feb	Mar	Apr	May	Jun	Jul	Jan-Jul	Jan	Feb	Mar	Apr	May	Jun	Jul	Jan-Jul
Manufacturing Industry	2.4	3.3	5.5	-4.0	-0.1	0.5	0.5	1.2	-1.4	-2.6	-4.3	4.5	0.6	2.0	3.7	0.4
In-bond Industry	1.3	1.1	3.3	0.1	-1.0	0.1	2.1	1.0	0.0	-1.3	-4.5	-1.6	-1.6	-1.2	-2.6	-1.8
Commerce	-0.3	0.1	3.2	-2.0	-0.6	3.8	6.3	1.5	7.5	4.2	0.4	3.9	5.1	0.5	-0.5	3.0

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

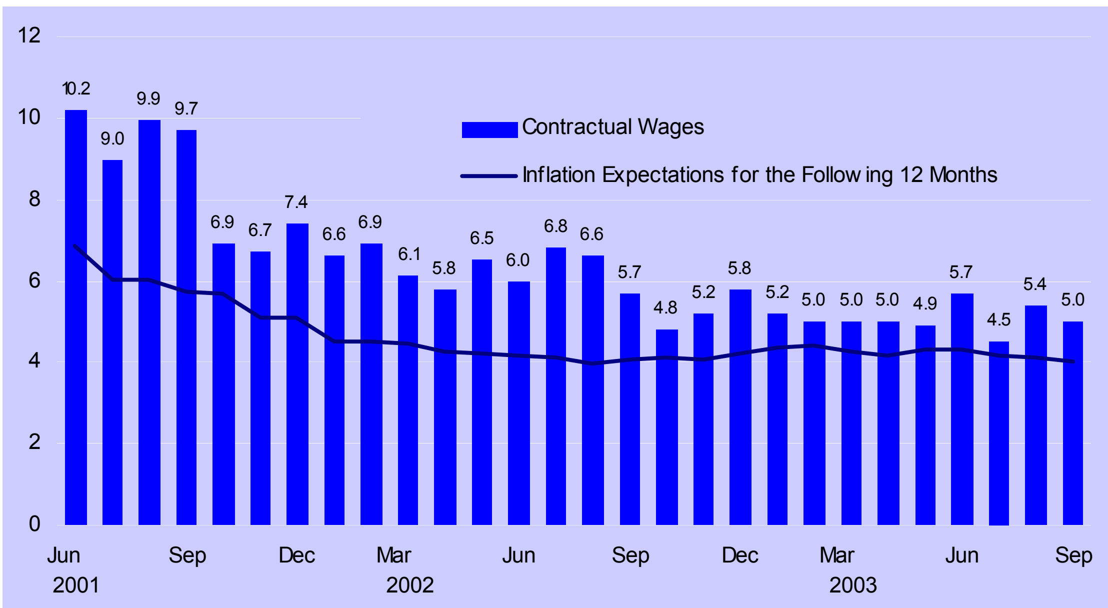
In July, unit labor costs in the manufacturing industry exhibited a positive annual variation, while those in the commerce sector and in the in-bond industry dropped slightly. From January to July this variable rose, on average, 0.4 and 3.0 percent in the manufacturing and commerce sectors, respectively, while falling 1.8 percent in the in-bond industry. It is important to mention that the behavior of unit labor costs is not consistent with the slack in labor market conditions. Its performance could also respond to the probable lack of competition in the final markets of some specific sectors, which does not provide incentives for cost reduction in those sectors of the economy.

II.2.2.2. Contractual Wages

During the third quarter of 2003, contractual wages in businesses under federal jurisdiction rose, on average (weighted by number of wage earners), 4.8 percent compared to the first and second quarters of the year (5.1 percent). Nevertheless, such increase was strongly influenced by wage agreements between PEMEX and its trade union in July. The results of these negotiations translated into wage increases of 4.3 percent for nearly 156,000 workers (half the number of workers that entered into contractual wage negotiations from July to September). Excluding PEMEX's wage negotiation, average wage increases during the quarter were 5.1 percent.

Graph 6 **Contractual Wages and Expected Inflation for the Following 12 Months**

Annual percentage change



Source: Ministry of Labor and Banco de México.

Wage agreements in August and September led to average contractual wage increases of 5.4 and 5.0 percent, respectively.

During the third quarter of 2003, average wage increases in private and public enterprises were 5.2 percent and 4.3 percent, respectively. Overall, wage increases granted by private enterprises were higher than those by public enterprises. Wage settlements in the manufacturing industry and in the rest of the sectors exhibited a similar behavior (Table 6).

Table 6 **Contractual Wages by Sector and Type of Business**

Annual percentage change weighted by number of workers

	2003									Average Jul-Sep 2003 1/	Average Jan-Sep 2003 1/
	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep		
Total	5.2	5.0	5.0	5.0	4.9	5.7	4.5	5.4	5.0	4.8	5.0
Public Enterprises	4.3	4.3	4.3	4.3	5.0	5.7	4.3	4.3	3.7	4.3	4.3
Private Enterprises	5.4	5.0	5.3	5.4	4.9	5.7	5.1	5.5	5.1	5.2	5.3
Manufacturing Sector	5.4	5.0	5.5	5.7	5.3	5.6	4.5	5.3	5.5	4.7	5.1
Other Sectors	5.1	4.9	4.6	4.8	4.7	5.8	4.6	5.5	4.2	4.8	4.9

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

In general, contractual wage revisions have continued to be inconsistent with the slack in the labor and goods markets. This situation has raised real unit labor costs in several sectors and, therefore, has limited the recovery of employment and production.

II.2.2.3. Employment

During the third quarter of 2003, the demand for labor in the formal sector remained weak. This reflected the modest output growth and its sectorial composition. As previously mentioned, employment has been affected by contractual wage increases. During this period, the main aspects that characterized employment were the following:

(a) A slight increase in the number of workers insured by the IMSS as compared to December 2002. Nevertheless, considering seasonally-adjusted data, these figures posted a negative variation;

(b) The weakness of other employment indicators such as that of retail sales and of the manufacturing industry (both in-bond and non in-bond);

(c) A significant rise in the open unemployment rate in urban areas; and

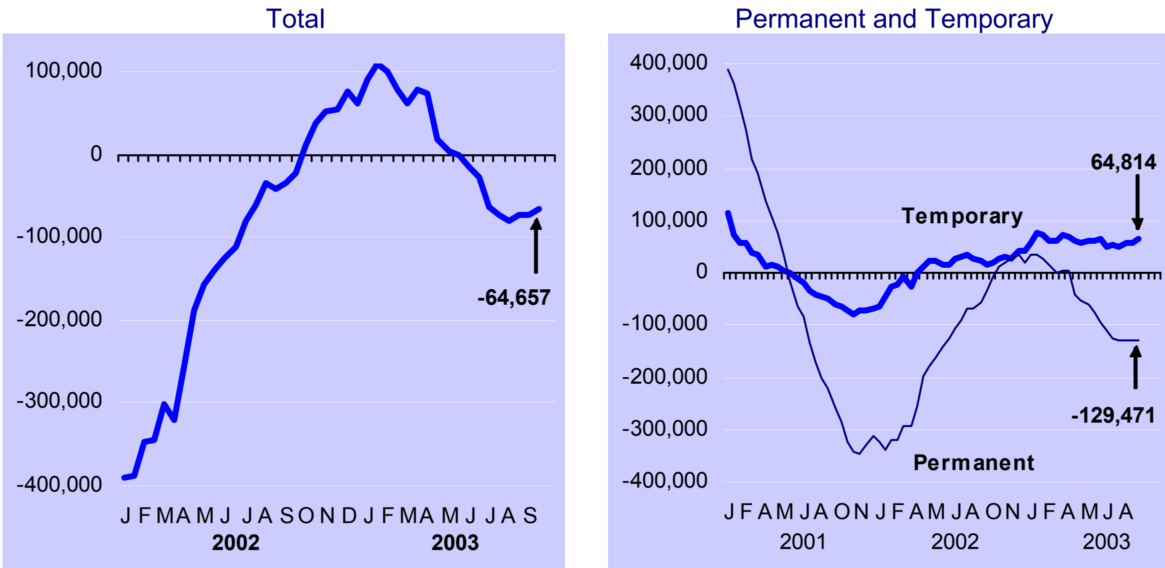
(d) A higher share of informal employment in total employment.

At the end of September 2003, the number of wage earners insured by the IMSS (permanent and temporary urban workers) was 12,239,929 individuals, 34,689 more than in June. Nonetheless, this increase was mostly seasonal. As confirmed by seasonally adjusted figures, employment fell by more than 48,000 workers. After comparing the number of workers insured by the

IMSS in September with those during the same month of 2002, employment fell by 64,657 individuals. During that 12-month period, the structure of formal employment continued changing towards temporary rather than permanent wage earners (Graph 7).

Graph 7 **Urban Workers Insured by the IMSS: Permanent and Temporary**

Annual variation by number of workers



Source: IMSS.

During 2003-III, the share of services in formal employment rose while that of the industrial sector fell. This phenomenon may be affecting other sectors of the economy and inducing migration from formal to informal employment, therefore cutting overall average productivity. These changes in the structure of demand are partly due to the severe conditions prevailing in the labor market. This has translated, at the margin, into a higher concentration of newly-created jobs in non-benefit positions and in microbusinesses without a permanent location.[8]

During the third quarter of 2003, the main indicators of unemployment rose. The open rate of unemployment in urban areas averaged 3.78 percent, while in the previous quarter it reached 2.99 percent. In fact, in August-September the rate of unemployment reached, on average, its highest level since August 1997. Given that informal employment is included in the measurements for overall employment, such increase is particularly relevant.

[8] See quarterly results of the Survey on Employment, undertaken jointly by INEGI and the Ministry of Labor.

II.2.3. Aggregate Supply and Demand

The behavior of aggregate supply and demand between July and September together with the results of the current account of the balance of payments point to an absence of inflationary pressures.

According to available information at the time this Report is published, economic activity during the third quarter of 2003 was characterized by the following:

(a) The expansion of consumption, which was reflected in the results of retail sales. In July-August, these sales rose at an annual rate of 3.5 percent, accumulating an annual increase of 2.7 percent during the first eight months of the year (Graph 8). This compares with 2002, when retail sales exhibited no growth. According to the National Retailers Association (*Asociación Nacional de Tiendas de Autoservicio y Departamentales, ANTAD*), in July-September total retail sales rose by an annual rate of 6.9 percent;

(b) A lower annual increase in car retail sales (0.6 percent). This resulted from higher sales of imported units and a reduction in those manufactured domestically (Box 2);

(c) The weakness of investment spending. This component of aggregate demand fell in July at an annual rate of 0.6 percent. Such decline resulted from the fall in the component of machinery and equipment (3.9 percent), since that of construction rose at an annual rate of 3 percent. Regarding imports of capital goods, these increased slightly at an annual rate of 1.3 percent during the third quarter;

(d) Regarding production, the Global Indicator for Economic Activity (*Indicador Global de la Actividad Económica, IGAE*) exhibited an annual variation of 0.1 percent during July-August due to the increase in the services sector, while the industrial and agriculture ones contracted. During the third quarter of 2003, agriculture production was negatively affected by weather conditions, after having grown during the second quarter, and even in July, at an annual rate;

(e) During July-August, industrial output declined at an annual rate of 2.5 percent due to the fall in manufacturing activity. Meanwhile, construction, mining and the electric industry recorded positive annual variations. Sluggish manufacturing production has resulted mainly from weak external demand. Nonetheless, during August it exhibited a monthly positive variation (using seasonally adjusted data) and it is expected to have also increased in September;

(f) Confidence and business climate indicators weakened during the third quarter. Confidence Indicators from Consumers, from Private Sector Analysts, and from Manufacturing Enterprises fell 3.1, 2.2, and 0.2 percent, respectively, as compared to June; and

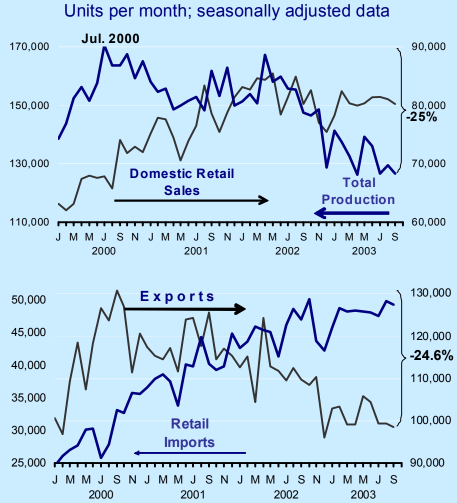
(g) A positive aspect from the information of the third quarter is that cyclical leading indicators improved. Indicators from Banco de México and The Conference Board rose, thus suggesting that economic activity will recover at an annual rate in the last quarter of the year.

Box 2
Recent Developments in Mexico's Automotive Industry

The Mexican automotive industry has exhibited an unfavorable performance during 2003. In fact, some of its components had already shown signs of weakness since the second half of 2000. The recent performance of this industry has been characterized by the following aspects:

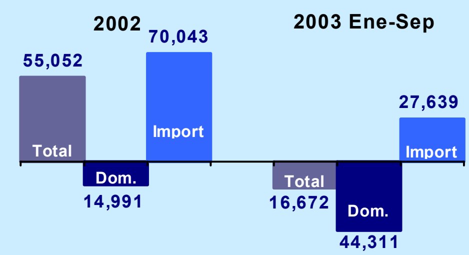
i) **A weakness of domestic sales.** During the first nine months of 2003, domestic car retail sales fell at an annual rate of 2.4 percent, after having grown in 2001 and 2002, 12.8 and 6 percent, respectively (Graph 1). This fall translated into a significant decline in sales of domestically-manufactured units (13.7 percent), while imported units rose 7.2 percent. In fact, domestic car retail sales have been dropping at an annual rate since 1998;

Graph 1
Car Sales and Production
Units per month; seasonally adjusted data



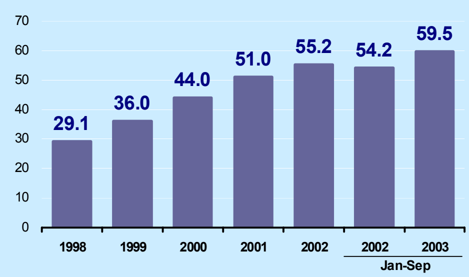
ii) **An increasing share of imported units in Domestic Sales.** Despite the weakness of domestic sales in 2003, the level of imported units has increased, translating into a lower share of domestic units in total domestic sales. Consequently, during the first nine months of 2003, domestic sales exhibited a reduction of 16,672 units compared to the previous year. Sales of domestically-manufactured vehicles declined by 44,311 units, while those of imported units rose by 27,639 (Graph 2). The share of imported cars in domestic retail sales has increased over the last years, from 29.1 percent in 1998 to 44 percent in 2000, and to 59.5 percent in the first nine months of 2003 (Graph 3);

Graph 2
Domestic Retail Sales (Annual Variation)
Number of units in 2002 and in January-September 2003



iii) **The significant contraction in domestic automobile production.** Considering seasonally adjusted figures, domestic production of vehicles (cars and trucks) dropped 25 percent (accumulated figures) from July 2000 to September 2003 (Graph 1). This decline stemmed from the sharp fall in both domestic (25.9 percent) and export-oriented (24.6 percent) production;

Graph 3
Share of Imported Units in Domestic Retail Sales
Percent



iv) **Despite the weakness of external markets, the share of export-oriented production in total vehicle production is still very high.** During the first nine months of 2003, the corresponding share was 75.3 percent, figure very similar to that observed during 2000-2002; and

Table 1
Manufacturing and Automotive Production
Seasonally adjusted data; July 2000=100

	Manufact.	Manufact. Excluding Automotive Industry	Automotive Industry	Sector branches*	
				Vehicles**	Autoparts***
Jul. 2000	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
Dec. 2001	92.2	92.8	88.0	87.4	88.8
Dec. 2002	92.8	94.9	78.2	76.5	80.3
Jul. 2003	90.2	90.8	85.4	85.4	85.3

* Weights for branches 56 and 57 represent 5.56% and 5.38%, respectively, of total manufacturing production.
** Division 56.
*** Division 57.

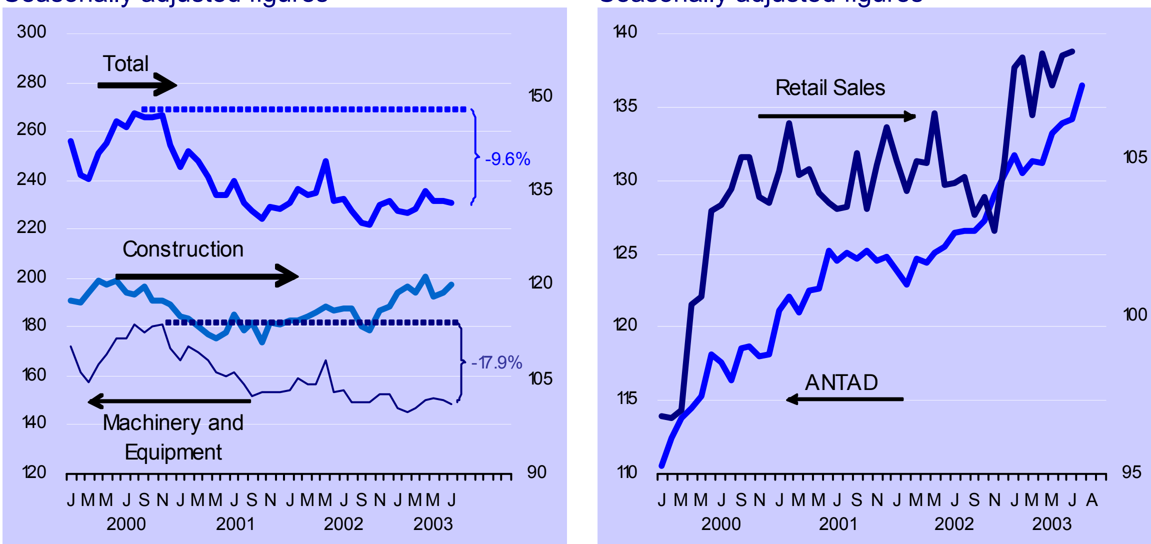
v) **The fall in the number of domestically-manufactured units, which has been greater than the figures included in the Index for Automotive Sector Production.** Using seasonally adjusted data, the Index for Automotive Sector Production (composed of manufacturing sector's divisions 56 and 57) fell 14.6 percent from July 2000 to July 2003, while the number of manufactured units rose 25 percent (Table 1). The latter indicates that the structure of domestically-manufactured vehicles has changed, at the margin, towards units with higher output value.

Summing up, The unfavorable performance of the Mexican automotive sector has responded to several factors such as a) the weakness of external demand for vehicles; b) the specialization of domestic production in a reduced number of car models, which have not performed well in external and domestic markets recently; c) a greater demand, at the margin, from the U.S. (Mexico's most important export market) for car models from countries outside the NAFTA region; d) a higher share of imported units in domestic sales, despite the prevailing weakness of domestic sales; and e) a probable loss of competitiveness of the domestic automotive industry due to the country's lack of progress in the agenda of structural reforms, as compared to different competitor countries, which have already been implementing them.

The performance of the different indicators on economic activity allows foreseeing that both GDP and aggregate demand grew slightly during the third quarter of 2003. As for the components of domestic demand, private domestic expenditure kept growing at an annual rate. This was favored by annual increases in real earnings in many sectors, by lower interest rates, and by a greater availability of credit from both commercial banks and chain stores. It is worth mentioning that in recent years households have maintained a significant net creditor position with the domestic financial system, therefore suggesting that financing for consumption could continue to increase, both as a result of credit expansion and of a decumulation of its own assets.

Graph 8 **Investment and Consumer Expenditure Indicators**

Gross Fixed Investment 1993=100 Seasonally adjusted figures	Retail sales 1993=100 Seasonally adjusted figures



Source: INEGI and ANTAD.

During July-September 2003, investment expenditure was the least dynamic component of domestic spending, as confirmed by the weakness of private investment. The weakness of external demand and domestic sales in several sectors, together with the lack of progress in structural reforms, have limited the expansion of investment expenditure (Table 7). As stated further below, the private sector has gradually modified the structure of its liabilities; first, by substituting external by domestic liabilities denominated in pesos and, second, by extending its terms to maturity. This improvement in the private sector's financial position sets the ground for it to increase its investments once the demand for its goods and services recovers.

Exports of goods and services are expected to have barely expanded at an annual rate during the third quarter of 2003. These results have responded to: a) the weakness of external demand, which has mirrored the cyclical stage of the world economy and, in particular, that of the United States; and b) the lack of dynamism of exports due, partially, to the loss of competitiveness of the Mexican economy (as evidenced by the higher unit labor costs in many sectors), originated by the lack of progress in implementing structural reforms.

Based on the previous considerations, annual GDP is expected to have grown less than one percent during the third quarter of 2003.

The performance of both GDP and aggregate demand did not generate inflationary pressures or affect the external accounts, particularly, the current account.

Table 7 **Aggregate Supply and Demand**

Annual percentage change

	2002	2003				
	Annual	I sem	I	II	I*	II*
Aggregate Supply	**1.1**	**0.2**	**1.9**	**-1.3**	**0.5**	**-0.1**
GDP	**0.9**	**1.2**	**2.3**	**0.2**	**1.0**	**1.4**
Imports	**1.6**	**-2.4**	**0.8**	**-5.2**	**-1.2**	**-4.1**
Aggregate Demand	**1.1**	**0.2**	**1.9**	**-1.3**	**0.5**	**-0.1**
Total Consumption	**0.9**	**2.2**	**3.3**	**1.1**	**2.2**	**2.0**
Private	1.2	2.2	3.6	0.9	2.4	2.0
Public	-1.3	2.0	1.1	2.8	0.5	1.8
Total Investment	**-1.3**	**-1.6**	**0.6**	**-3.6**	**-1.8**	**0.1**
Private	-2.8	-4.6	-1.6	-7.4	-4.8	-4.4
Public	7.3	19.5	16.7	22.1	14.6	23.5
Exports	**1.4**	**0.0**	**3.9**	**-3.5**	**3.0**	**-1.2**
Domestic Spending**	**0.5**	**1.4**	**2.8**	**0.2**	**1.4**	**1.6**

* Annual percentage change of seasonally adjusted series.
** Excluding variation in inventories.

Available information on aggregate supply and demand corresponds to the second quarter of 2003. During that period, annual decreases in investment and exports of goods and services, as well as increases in total consumption were significant. The fall in gross capital formation resulted from the decrease in private investment, which offset the rise in public investment. Using seasonally adjusted data, private investment fell 14.4 percent from 2000-IV to 2003-II.

II.2.4. Balance of Payments, Capital Flows, and Exchange Rate

The performance of the external sector was similar to the one observed in the first half of the year. In general, the behavior of foreign trade and of the current account of the balance of payments reflected the weakness of both external and domestic demand. The former negatively affected non-oil exports while the latter limited the demand for imports. Thus, both the trade balance and the current account registered small deficits. These results have reflected the natural and orderly adjustment of the Mexican economy to the world economic slowdown and also confirm the absence of exchange-rate pressures from the external accounts.

During the third quarter of 2003, the external sector was characterized by the following aspects:

(a) Slight annual increases of exports and imports of merchandises. The higher levels of the former responded to the significant hike in oil exports as a result of rising international crude oil prices. In contrast, non-oil exports declined. Nevertheless, in September, both merchandise exports and imports exhibited positive annual rates, with the exception of imports of non in-bond intermediate goods;

(b) A decline in the share of Mexican exports in U.S. imports, which partly reflects Mexico's loss of competitiveness due to the lack of progress in implementing measures to promote structural change. This caused Mexico to move from second to third position as a supplier of goods to the United States;

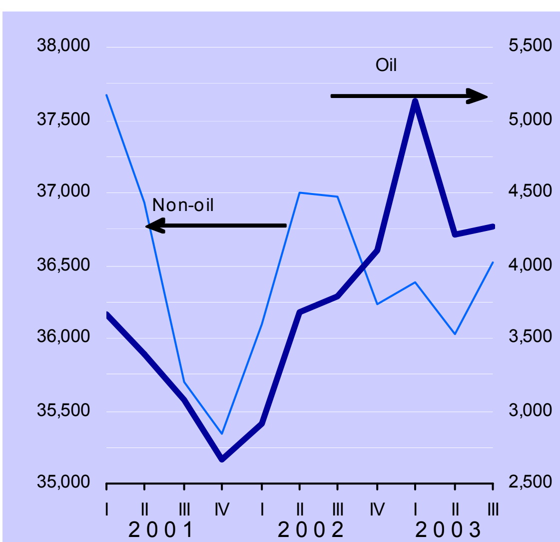
(c) A significant inflow of resources coming from remittances from Mexican workers abroad;

(d) Narrower trade and current account deficits; and

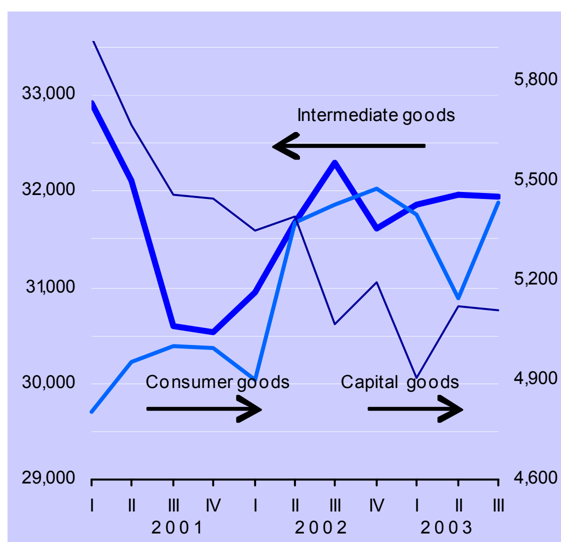
(e) A small capital account surplus and a slight decrease in the stock of international reserves.

Graph 9 Exports and Imports: Seasonally Adjusted Series

Million US dollars (quarterly figures)



Million US dollars (quarterly figures)



During July-September, exports of goods registered a slight increase of 0.3 percent compared with the same period of 2002. This behavior resulted from both rising oil exports (12.7 percent) and the fall in non-oil exports (1.1 percent). The latter reflected the weakness of external demand for manufactured goods. As for imports, these increased by a mere annual rate of 0.1 percent. Imports of intermediate goods fell 0.3 percent, while those of consumer and capital goods increased slightly, at an annual rate of 1.7 and 1.3 percent, respectively.

Seasonally adjusted figures of foreign trade show that non-oil exports exhibited a mixed behavior during the third quarter of 2003, despite posting a higher average level than in the previous quarter. Regarding imports, those of intermediate and capital goods did not increase, while those of consumer goods rose.

During July-August 2003, the performance of Mexican exports in the U.S. market remained unfavorable. Despite the fact that U.S. imports rose at an annual rate, those coming from Mexico declined. Overall, other U.S. trade partners increased their share of exports in the U.S. market. Consequently, Mexico's export share in total U.S. imports contracted. Nonetheless, foreign trade figures for Mexico in September show that U.S. non-oil imports from Mexico rose at an annual rate. This result has not been observed since April 2003.

Table 8 **United States Imports**

Percent

Country of Origin:		Annual Variations				Share in Imports			
			2003				2003		
		2002	I	II	Jul-Aug	2002	I	II	Jul-Aug
	Total	**1.78**	**14.32**	**6.59**	**3.63**	**100.00**	**100.00**	**100.00**	**100.00**
	Total excluding Mexico	**1.69**	**15.18**	**7.72**	**4.43**	**88.41**	**88.72**	**89.01**	**89.27**
1.	Canada	-3.32	11.34	3.42	3.13	18.00	18.73	18.15	16.62
2.	China	22.40	31.41	19.74	13.69	10.78	10.48	11.46	12.92
3.	**Mexico**	**2.50**	**8.00**	**-1.83**	**-2.59**	**11.59**	**11.28**	**10.99**	**10.73**
4.	Japan	-3.99	1.22	-2.32	-4.98	10.46	9.73	9.44	9.19
5.	Germany	5.80	13.21	18.80	-0.01	5.38	5.36	5.63	5.19
6.	United Kingdom	-1.51	11.05	-0.65	-3.37	3.51	3.42	3.40	3.28
7.	South Korea	1.11	2.06	0.49	3.59	3.06	2.83	2.87	2.87
8.	Taiwan	-3.67	2.21	-5.78	-6.08	2.77	2.49	2.51	2.58
9.	France	-7.13	-0.17	2.33	-3.54	2.43	2.33	2.29	2.24
10.	Malaysia	7.47	-0.04	3.01	1.49	2.07	1.84	2.00	2.17
Total (10 countries)		1.93	10.37	4.41	1.59	70.05	68.49	68.73	67.79

Source: U.S. Census Bureau.

Mexico's trade balance deficit during the third quarter of 2003 was 1.424 billion US dollars, 4.5 percent lower than that observed during the same period of 2002. As for the accumulated trade deficit in the first nine months of the year, this was 3.011 billion US dollars, 33.7 percent lower than in the same period of 2002. Results show a significant trade deficit with China (Box 3).

Revenues coming from remittances from Mexican workers abroad have expanded in 2003. Preliminary figures show that during the third quarter of 2003, resources from Mexicans abroad amounted to 3.738 billion US dollars. Thus, during the first nine months of the year, revenues from these remittances rose 9.937 billion US dollars, 36 percent more than in the same period of 2002. These results stemmed from 31 million transactions averaging 321 US dollars. It is important to point out that the sharp increase in remittances from Mexicans abroad reflects, to a large extent, an improvement in the compilation of information on this component by Banco de México.

Box 3

Mexico's Trade with China[1]

In recent years, Mexico's trade with China has gained momentum, exhibiting significant changes in the structure of goods traded between both countries. In general, the main aspects that have characterized trade between both countries are the following:

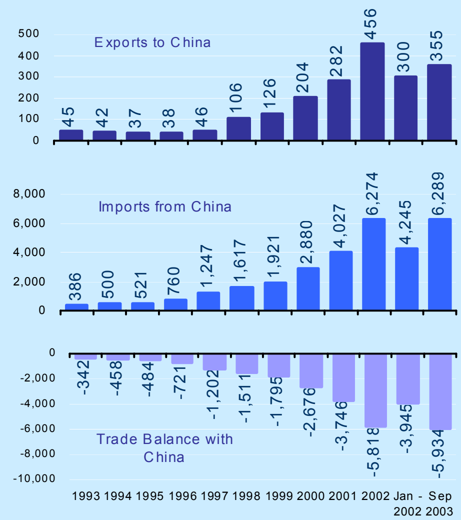
i) **A rapid increase of Mexican exports to China notwithstanding a small base of comparison.** From 1997 to 2002, Mexican exports to China expanded by a factor of 10. However, its volume is small (Graph 1). During the first nine months of 2003, exports to China accounted for only 0.29 percent of total Mexican exports, and 0.33 percent of non-oil exports. Exported goods include, to a large extent, manufactures, mainly **metallic goods, machinery and equipment**. During the first nine months of 2003, Mexico's exports to China grew at an annual rate of 18.6 percent;

ii) **Mexican imports from China have expanded significantly.** During 1997-2002 imports from China grew by a factor of 5, reaching 6.274 billion US dollars in 2002 and 6.289 billion in the first nine months of 2003 (Graph 1);

iii) **In 2003, Mexico's demand for imported goods declined but that for Chinese goods rose.** In fact, during the first nine months of 2003, Mexican imports grew slightly (0.4 percent), while those coming from China did so at an annual rate of 48.2 percent;

iv) **Products currently being imported from China are of a wide variety, and consist, mainly, of capital and intermediate goods.** The main imported goods are electric and electronic goods and appliances, followed by machinery and special equipment for different industries (Table 1);

Graph 1
Trade Mexico-China
Million US dollars



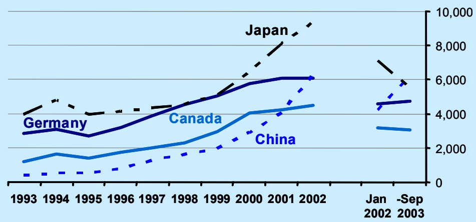
v) **China has rapidly upgraded its position as Mexico's supplier of goods.** In 1993, China ranked 11th as a supplier of goods to Mexico. Since then, it moved from 6th position in 2000 to third in 2002 (following the United States and Japan), and will probably reach second position in 2003, replacing Japan (Graph 2). It is important to point out that foreign trade statistics show that some foreign-direct investment businesses that currently import Chinese goods (mainly raw materials) used to buy them from other Asian countries;

Table 1
Main Goods Imported from China
(Million US dollars in January-September 2003)

	Million US dollars	Share %	Annual Percentage Change
1. Electronic Goods and Appliances	2,207	35.1	40.6
2. Machinery and Special Equipment	2,196	34.9	108.3
3. Textiles and Apparel Products	328	5.2	10.0
4. Other Manufacturing Industries	267	4.3	11.8
5. Rubber and Plastic Products	264	4.2	19.8
6. Chemical Products	264	4.2	37.5
7. Photographic, Optics, and Watchmaking Appliances	149	2.4	-9.8
8. Transport and Communications Machinery and Equipment	114	1.8	8.3
9. Non-metallic Mineral Products	104	1.7	72.3
10. Iron and Steel Industry	101	1.6	52.4
11. Paper and Publishing Industry	53	0.8	48.5
12. Oil Derivatives	41	0.7	5.9
13. Lumber and Wood Industry	40	0.6	103.9
14. Agriculture and Forestry	37	0.6	28.2
15. Professional and Scientific Equipment	28	0.4	8.3
16. Mining and Metallurgy	19	0.3	80.9
17. Other Extractive Industries	18	0.3	-73.7
18. Foods, Beverages, and Tobacco	17	0.3	64.9
Total (1 to 18)	**6,246**	**99.3**	**48.5**
Total Imports	**6,289**	**100.0**	**48.1**

[1] In the estimation of Mexican imports from China only legal purchases are considered.

Graph 1
Mexico: Imports from Selected Countries
Millions US dollars



vi) **The absolute increase in imports from China has significantly surpassed that of Mexican exports to that country, therefore leading to a higher trade deficit with China.** As observed in Graph 1, this deficit has widened rapidly (from 5.818 billion US dollars in 2002 to 5.934 billion in the first nine months of 2003);

Table 2
Trade Balance Mexico-Main Trade Partners
(Million US dollars)

	2001	2002	2003 Jan-Sep
TOTAL	**-9,954**	**-7,916**	**-3,011**
1. United States	26,530	36,491	30,181
2. Canada	-1,165	-1,674	-882
3. Germany	-4,576	-4,830	-3,444
4. Spain	-574	-793	-379
5. Japan	-7,465	-8,884	-5,133
6. China	**-3,746**	**-5,818**	**-5,934**
7. South Korea	-3,322	-3,742	-2,923
8. Taiwan	-2,844	-4,036	-1,777
9. Brazil	-1,516	-2,084	-2,017

vii) **The trade balance between Mexico and China is the highest bilateral deficit registered by Mexico.** Table 2 includes Mexico's trade balance with its main trade partners. As can be seen, Mexico has a high surplus with the United States and a high deficit with China, which already exceeds Mexico's total trade balance;

viii) **Finally, China is not only the most export-dynamic economy in the world, but also the one with the fastest growing imports of merchandises.** The latter means that there is high potential for Mexican competitive products to be exported to China. It is important to point out that Mexican exports to China in 2002 and in the first quarter of 2003 only accounted for 0.15 and 0.19 percentage points of this country's total imports.

The previous results of the trade balance and of revenues from remittances from Mexicans abroad, together with partial available information on other items from the current account, allow to foresee that the latter could have ended the third quarter with a deficit of approximately 2.2 billion US dollars. Thus, during the first nine months of 2003, the accumulated current account deficit would have been 5.8 billion US dollars, figure lower than that observed during the same period of 2002 (9.3 billion).

During 2003-III, the capital account exhibited a slight inflow of foreign direct investment and small outflows of portfolio investment. During this period, the Federal Government made an early payment for the remaining balance of Brady Bonds for 1.267 billion US dollars. This transaction cancels the outstanding balance of these bonds, which were issued as part of Mexico's external debt restructuring program in 1990. Additionally, the private sector made three external liability issuances totaling 496 million US dollars, for an average maturity of 7.3 years.

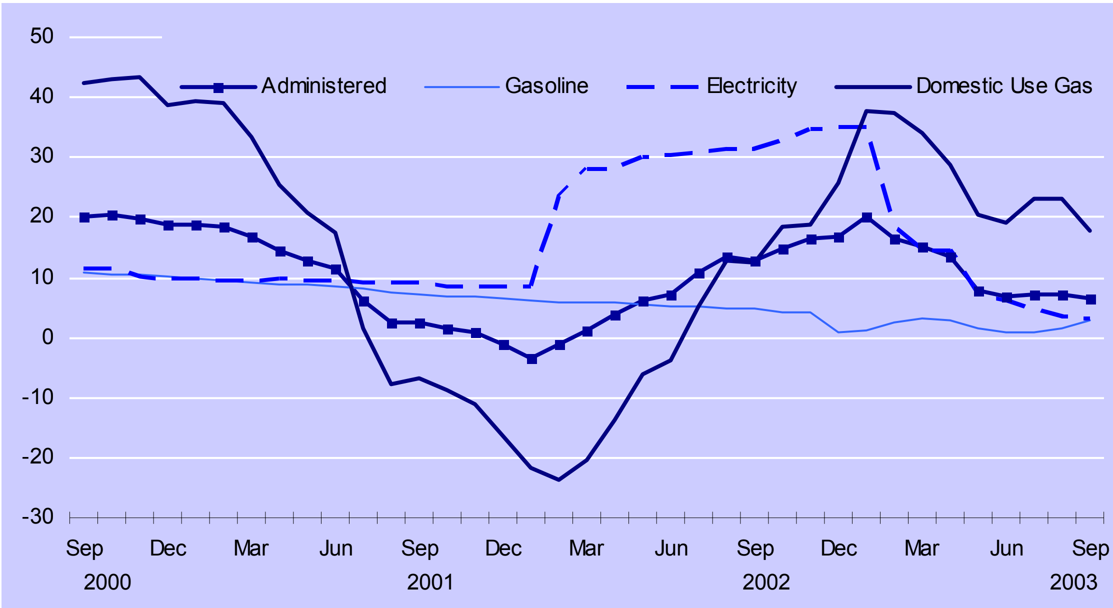
Summing up, it is foreseen that, during the third quarter of 2003, the balance of payments exhibited the following results: a 2.2 billion US dollars deficit in its current account, a surplus of 0.9 billion in its capital account (including errors and omissions), and a reduction in the stock of international reserves of 1.280 billion US dollars. The surplus in the capital account, together with that observed during the first half of the year, would yield a positive accumulated balance of 9.9 billion US dollars. Adding to these results, total accumulated international reserves during the first nine months of the year increased by 4.1 billion US dollars.

II.2.5. Prices Administered by and Concerted with the Public Sector

In September 2003, the annual variation of the subindex of prices of goods administered by and concerted with the public sector was 4.02 percent, marginally lower than that of headline inflation. Within this subindex, administered prices rose at an annual rate of 6.47 percent, 0.39 percentage points lower than at the end of June. These results were affected by the practically nil increase in electricity tariffs during the quarter (0.03 percent) due to the reduction in high consumption tariffs in July and August. During the quarter, the price of commercial propane gas (LP) rose 1.07 percent. The annual variation in prices of this product (17.73 percent) at the end of September resulted from the increase observed during September 2002-January 2003. Ever since, prices of LP gas have exhibited a low monthly variation. Among those goods with prices administered by the public sector, gasoline was the one that increased the most (2.67 percent). This behavior reflected the rise in prices of low octane gasoline in the country's northern cities, which was driven by the variations in this fuel's international reference rate.

Graph 10 **Price Indexes of Goods Administered by the Public Sector**

Annual percentage change



Prices of goods and services concerted with the public sector rose at an annual rate of 1.96 percent in September. Within this component, the increase in water supply rights, and in public transportation fares, particularly in inter-city and city bus fares (7.01 percent and 4.25 percent, respectively) and taxi fares (3.45 percent), was significant. The impact of such increases was partially offset by the behavior of telephone line installation and service fees, which remained practically constant.

II.2.6. Temporary Factors that Affected Inflation

The third quarter of 2003 was affected by the seasonal effects of the new school term. During such period overall education prices rose 7.03 percent, thus contributing with 0.39 percentage points to quarterly headline inflation (1.04 percent). Furthermore, at the end of September, the annual variation of the price subindex for education reached 8.57 percent, 1.74 percentage points lower than at the end of the previous quarter. As seen in Table 9, tuition fees in all levels of education rose sharply during the quarter.

Table 9 **Price Indexes for Education**

Annual percentage change

Level of Education	Annual variations			
	September			
	2000	**2001**	**2002**	**2003**
Private Education	15.08	14.06	10.10	8.57
Kindergarden and nursery school	15.16	14.26	11.84	9.91
Preschool	n.a.	n.a.	n.a.	9.56
Elementary	16.07	14.55	11.85	9.81
Junior High School	16.05	14.30	11.67	9.84
High School	15.87	14.91	10.92	8.81
University/ College	16.57	12.89	9.74	7.24
Vocational/Technical	10.05	13.38	9.48	7.38
Continuing Education	n.a.	n.a.	n.a.	5.69

n.a. not available.

III. Monetary Policy During the Third Quarter of 2003

III.1. Monetary Policy Actions

Monetary policy followed by Banco de México has moved to an inflation-targeting regime (formally adopted in 2001). One of the key elements of inflation targeting is the systematic approach for analyzing actual business cycle conditions and inflationary pressures. It is important to distinguish when inflationary pressures stem from aggregate supply or demand shocks. Inflation targeting suggests that when inflationary pressures come from the aggregate demand side, monetary policy should become more restrictive. On the other hand, when inflationary pressures originate from supply shocks, a once-and-for-all increase in prices should be allowed, i.e., an increase that affects inflation only temporarily. In this case, monetary policy would only act to prevent supply shocks from spreading over to inflation expectations, thus impeding any subsequent increases in prices (second round effects).

During 2002 and, to a smaller extent, during the first quarter of 2003, the Mexican economy faced several supply shocks that affected the disinflation process and, in particular, the non-core component of headline inflation.[9] In response to those events, and in order to reduce the impact of the shocks on inflation, Banco de México increased the "short" on several occasions at the end of 2002 and in the first quarter of 2003. Monetary policy actions allowed these shocks to be absorbed and prevented any significant or lasting contagion on inflation expectations. Thus, headline inflation was affected only temporarily. According to Banco de México's survey undertaken in September, annual inflation expectations for the end of 2003 and 2004 were 3.78 and 3.67 percent, respectively (Graph 11). These figures fall within the variability interval of plus/minus one percentage point around the 3 percent target, and imply a significant reduction compared to April figures, when it reached its maximum level.

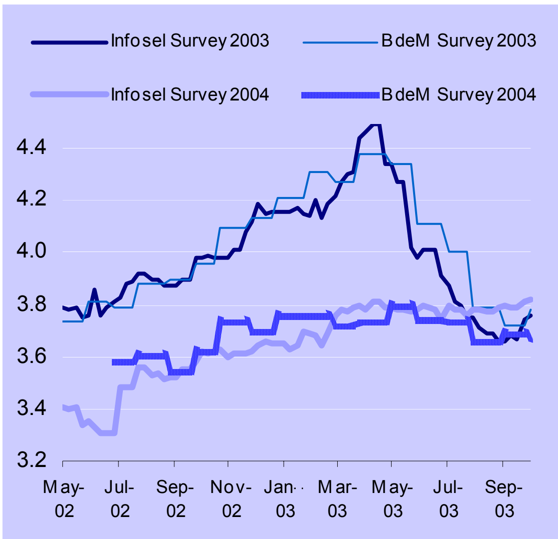
[9] Due mainly to the rise in prices of agriculture products and in goods and services administered by the public sector.

Graph 11 **Inflation Expectations**

Annual percent

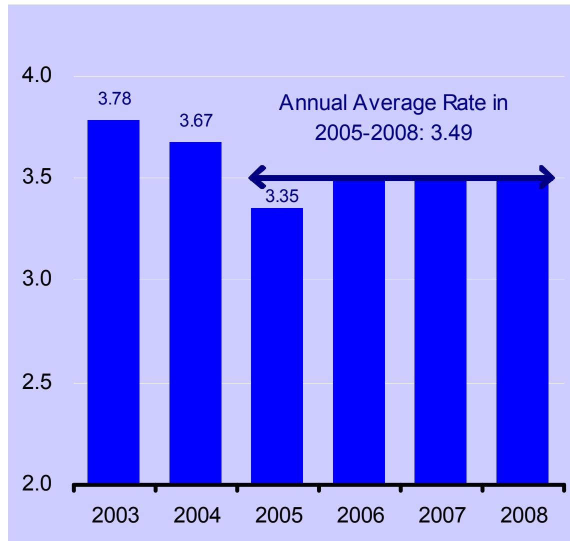
Expected inflation for 2003 and 2004

Percent



Headline Inflation in the Short and Long Terms

Percent



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

During 2003-III, the exchange rate experienced a moderate depreciation and an increase in its volatility (Graph 12a). This behavior has not differed from that observed in the main currencies, which have also fluctuated due to the uncertainty surrounding the recovery of the different economies. As for Mexico, additional specific factors such as some concern over the lack of response to the greater competition in world markets has also put pressure on the peso. Nevertheless, its is important to point out that the exchange rate adjustment has taken place in an orderly manner, with a low pass-through to prices and a small impact on interest rates.

Concerning aggregate demand, its behavior has reflected economic activity worldwide and, therefore, has been compatible with the disinflation process.

As a result, during the third quarter of 2003, conditions remained appropriate to attain the year-end and long-term inflation targets. Thus, the Board of Governors decided to maintain the level of the "short" unchanged at 25 million pesos daily.

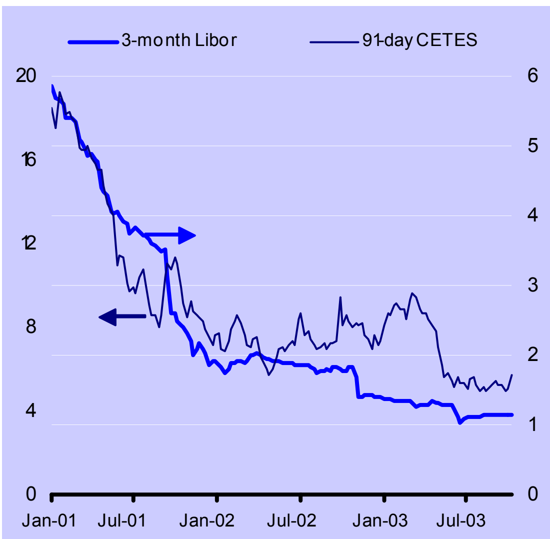
It is important to point out that the abatement of inflation in Mexico has taken place in an unusual international environment. The monetary policy loosening by the world's main central banks has created coordinated conditions to encourage spending not often seen in recent history (Graph 12b). Moreover, uncertainty regarding the recovery of the world economy and weak investment have created a lower demand for medium and long-term financing. Altogether, this has led to reduced interest rates in world financial markets throughout the entire yield curve.

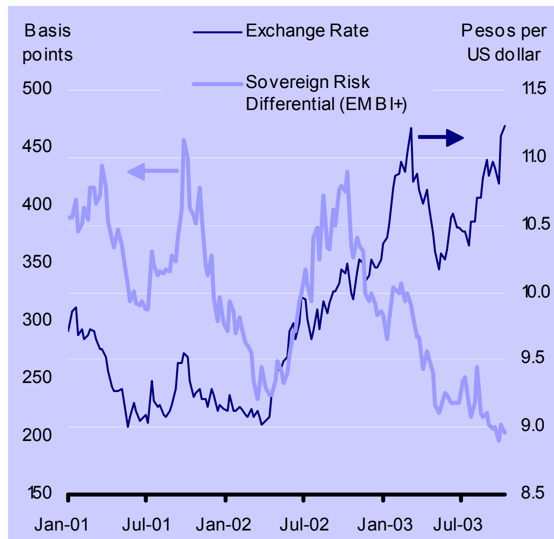
Graph 12 **Exchange Rate, Differential for Mexico's Sovereign Risk (EMBI+), and Interest Rates**

a) Differential for Mexico's Sovereign Risk (EMBI+) and Exchange Rate

b) Interest Rates (91-day CETES and 3-month Libor)

Annual percentage





In this context, there have been certain factors that have also contributed to loosen monetary policy and financial conditions in Mexico. In particular:

a) Monetary policy has allowed a significant reduction in short-term interest rates. This has taken place in a context in which inflation is expected to converge to its long-term target, therefore translating into a smaller inflationary risk and a reduction of long-term interest rates. Thus, during the third quarter of 2003, the yield curve reached, on average, historically low levels (Graph 13). According to Banco de México's Survey on Private Sector Analysts' Forecasts, which, for the first time, includes average inflation for 2005-2008, expected inflation for this period is 3.49 percent.

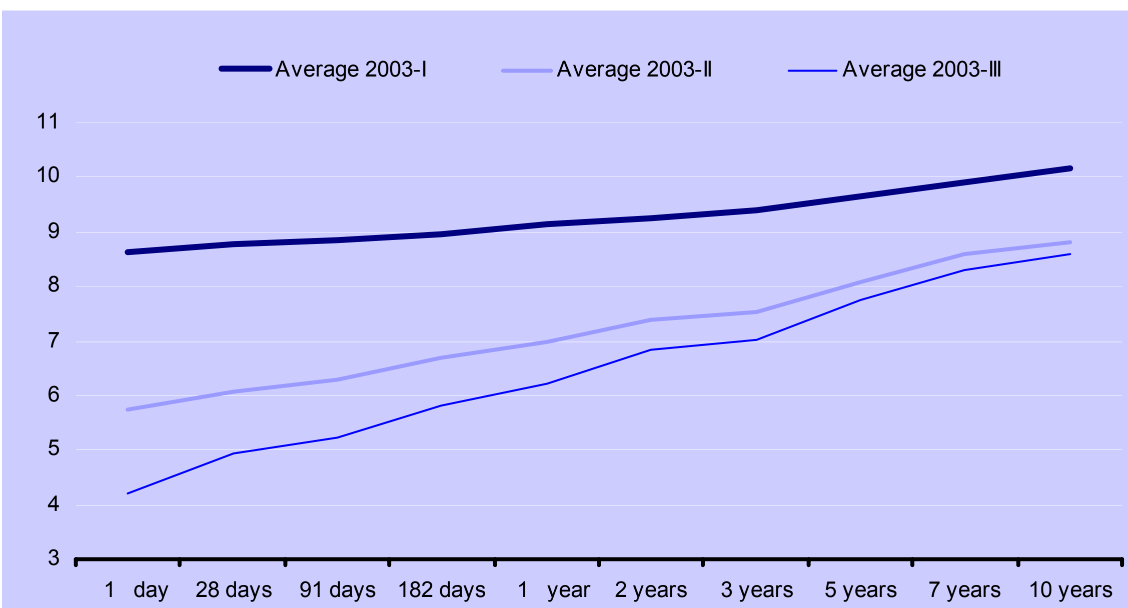
b) As in other economies, Mexico's macroeconomic adjustment to its cyclical phase has led to a reduction in long-term interest rates due to the temporary perception of lower rates of return on investment; and

c) As previously mentioned, global liquidity conditions, which were reflected in interest rates close to historically low levels, have favored a change in the structure of portfolios towards riskier assets. Thus, given the increased demand for emerging markets securities, like those from Mexico, and the environment of macroeconomic stability that prevails, the greater availability of external financing has been reflected in domestic financial markets.

Summing up, given the environment of high liquidity in world financial markets, the conduct of monetary policy during the downward stage of the business cycle has allowed a reduction of interest rates along the entire yield curve. This has been a crucial factor in creating the appropriate conditions for the recovery of the different components of spending, both consumption and investment, without jeopardizing the inflation target.

Graph 13 **Yield Curve of Government Securities**

Annual percentage



In addition, the development of macroeconomic stability and the approval of the different financial structural reforms[10] have allowed the economic agents to have greater access for long-term credit denominated in pesos. In this regard, two events deserve mention: a) the Ministry of Finance's announcement regarding the auctioning of 20-year fixed nominal rate peso denominated bonds by the Federal Government at the end of October[11]; and b) private sector's substitution of external liabilities by domestic securities denominated in pesos. The improvement in firms' structure of indebtedness has upgraded their financial position, thus setting the ground for them to increase their investments once the demand for their goods and services recovers.

III.2. Monetary and Credit Aggregates

III.2.1. Monetary Base, Net Domestic Credit, and Net International Assets

During July-September, the monetary base grew at an annual rate of 14.7 percent.[12] This expansion is consistent with the Monetary Program for 2003 (Graph 14a). The monetary base has expanded at a high rate compared with the inflation target and GDP. This reflects that the remonetization process that began in 1997, as a result of both lower interest rates and inflation, is still underway. However, when comparing the increase in the monetary base against private consumption, such process is smaller (Graph 14b). As mentioned in section II.2.3, this result is due to the recent asymmetry in the components of aggregate demand since consumption and, hence, the demand for cash for transactional purposes, have increased above GDP growth rates.

[10] Among the most important laws that were reformed are the Retirement Savings System Law, the Securities Market Law, the Law to Promote Bank Lending, the Guaranteed Credit Competition and Transparency Law, the Credit Institutions Law, the Investment Companies Law, the Popular Savings and Credit Law, the National Banking and Securities Exchange Commission Law, and Development Banks' Laws.

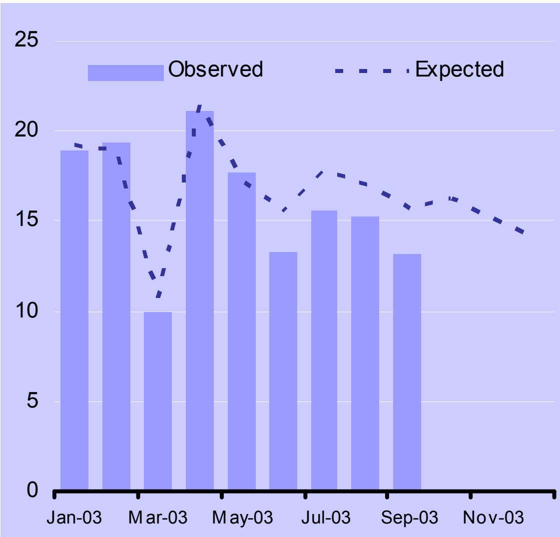
[11] Ministry of Finance Press Release (September 25th 2003).

[12] Variation calculated on average for end of the month stocks.

Graph 14 Monetary Base

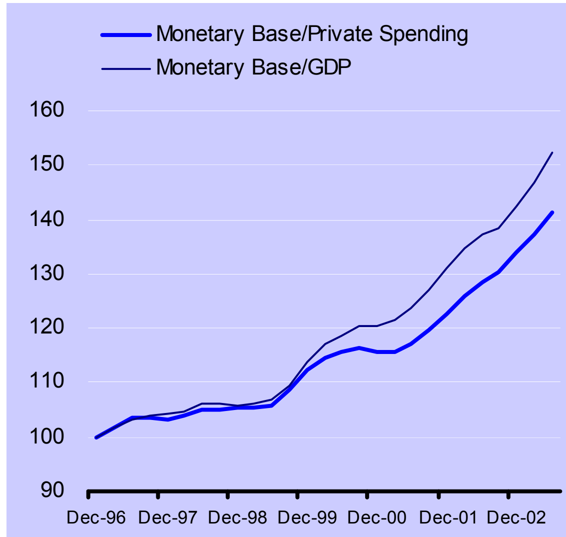
a) Annual Variation of End-Month Stocks

Percent



b) Monetary Base /GDP and Monetary Base/Private Spending 1/

Index December 1996=100



1/ Trend Series.

From January to September 2003, Banco de México's international assets rose by 4.173 billion US dollars. This accumulation exceeded the expansion of the monetary base, thus explaining the decrease in domestic credit by 70,347 million pesos. This is due to the sterilization process, which comes from the accumulation of international assets done by the Central Bank, via the placement of bonds and other monetary-regulating liabilities.

Although international reserves have increased significantly, the mechanism to reduce its pace of accumulation[13] led to sales of 2.640 billion US dollars from May 2 to September 30, 2003. As a result of these auctions, it was not necessary to place 27,716 million pesos of central bank's monetary-regulating liabilities. Thus, these resources became available in the domestic market.

[13] See Exchange Commission's Press Releases (March 7th and 20th 2003).

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

Millions

	Stocks		Flows in 2003			
	Dec. 31 2002	Sep. 30 2003	1st Quarter	2nd Quarter	3rd Quarter	Accumulated at Sep. 30 2003
(A) Monetary Base (Pesos)	263,937	238,703	-26,087	2,168	-1,315	-25,234
(B) Net International Assets (Pesos) 1/ 2/	529,503	604,576	35,442	13,649	-3,978	45,113
Net International Assets (US dollars) 2/	50,722	54,895	3,280	1,312	-420	4,173
(C) Net Domestic Credit (Pesos) [(A)-(B)] 1/	-265,566	-365,873	-61,529	-11,481	2,663	-70,347
(D) International Reserves [(E)-(F)] 3/ (US dollars)	47,984	52,117	4,004	1,409	-1,280	4,133
(E) Gross International Reserves (US dollars)	50,674	54,861	3,279	1,313	-405	4,187
PEMEX			2,901	3,522	4,331	10,754
Federal Government			-78	-1,684	-3,525	-5,287
Sale of Dollars to Commercial Banks 4/				-1,280	-1,360	-2,640
Other 5/			456	755	149	1,360
(F) Liabilities with less than six months to maturity (US dollars)	2,690	2,743	-726	-96	875	53

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 Releases of March 7th and 20th 2003).
5/ Includes yields on net international assets and other transactions.

III.2.2. Monetary Aggregates and Credit

The supply of financial savings from residents came mainly from households (81.7 percent of M2) and, to a lesser extent, from firms. The strength of households' savings is explained, to a large extent, by the resources linked to retirement savings (SAR),[14] which in August accounted for 26.5 percent of households' financial savings and contributed with 44.7 percent of households savings' annual variation.

As for households' indebtedness, this has been characterized by a significant increase in bank's consumer credit, which has expanded at real annual rates of above 20 percent in the last three years. As for credit for housing, credit granted by mortgage SOFOLES rose while bank credit remained stagnant (Graph 15a).

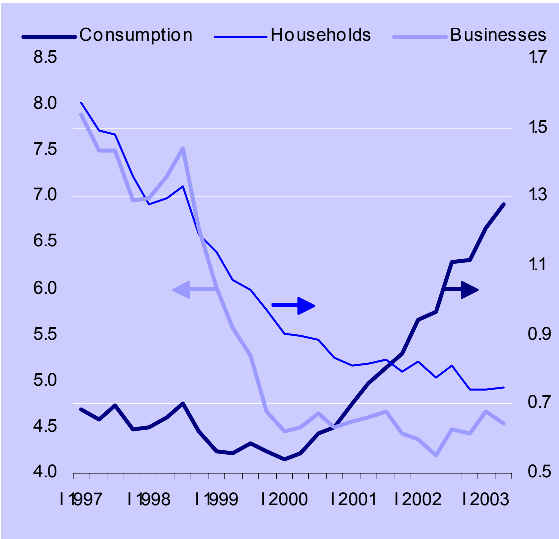
Summing up, despite the increase in their indebtedness, households still maintain a significant net creditor position with

[14] Including housing and retirement funds.

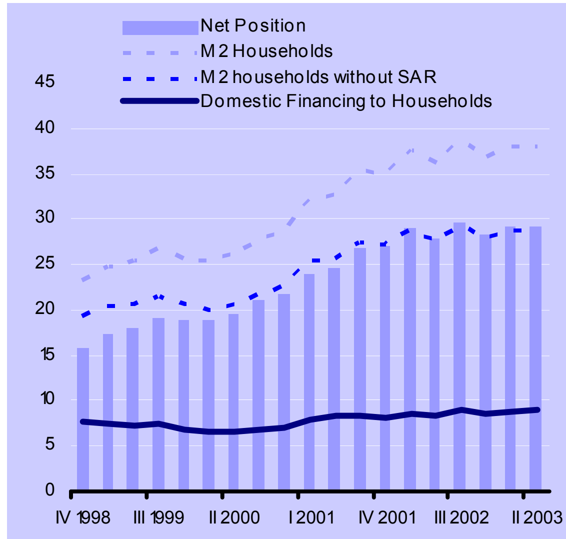
the domestic financial system,[15] which accounts for nearly one fourth of GDP (Graph 15b).

Graph 15 **Commercial Banks' Performing Loans and Net Creditor Position of Households**

a) Bank credit
GDP Percentage



b) Households' Net Credit Position [1]
GDP Percentage



1/ The net creditor position is obtained by subtracting households' domestic credit from M2 Households (total domestic financial assets).

Although commercial banks' performing loans exhibited a real annual variation of 8.2 percent in August, their stocks are still very low (4.5 percent of GDP). The issuance of private securities in the domestic market has shown great dynamism as it increased at a real annual rate of 36.7 percent during that month. Nonetheless, these resources have been mainly destined to substitute external liabilities (Graph 16). This process has been driven by lower domestic interest rates, the greater depth of domestic financial markets, and the increasing demand of SIEFORES for long-term instruments denominated in domestic currency (Box 4).

[15] The net credit position equals total household financial assets minus total household liabilities. Data is drawn from the Survey on Mexico's Financial System and Monetary Aggregates published by Banco de México.

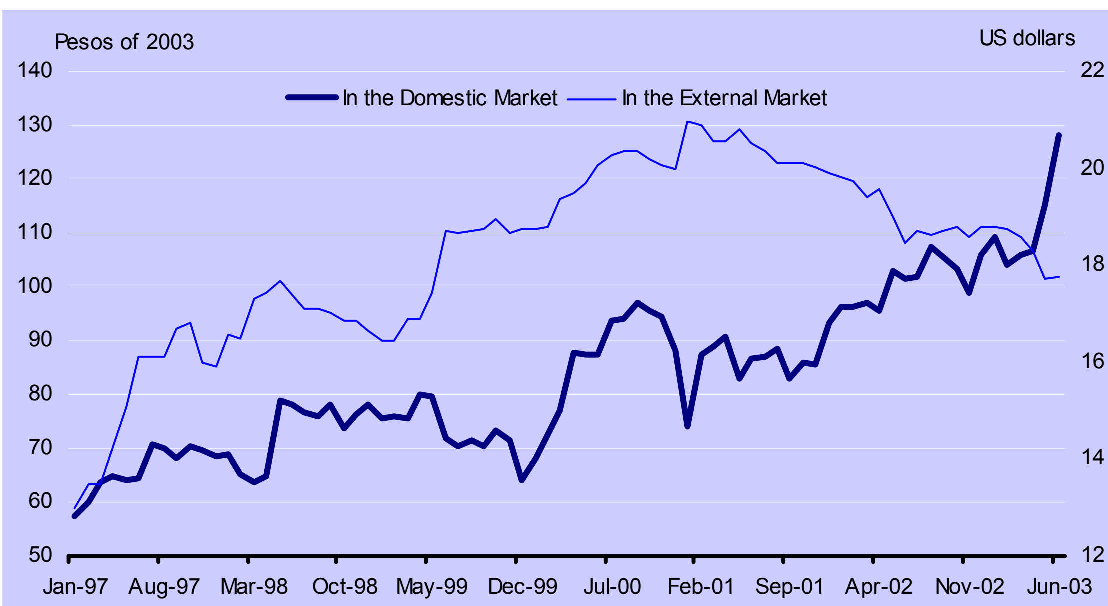
Table 11 **Credit Granted to the Non-Financial Private Sector**

	Stocks in t.m.p.*					Annual Real Growth Rate (%)	
	Mar-02	Jun-02	Dec-02	Mar-03	Jun-03	Mar-03	Jun-03
Total Credit	**1,437.3**	**1,508.0**	**1,603.9**	**1,623.5**	**1,610.3**	**6.9**	**2.4**
External	**495.6**	**538.4**	**558.6**	**570.9**	**538.1**	**9.0**	**-4.2**
Foreign Direct Credit 1/	318.2	350.6	359.8	368.3	352.0	9.6	-3.7
Debt Issued Abroad	177.4	187.8	198.9	202.5	186.0	8.1	-5.0
Domestic 2/	**941.8**	**969.6**	**1,045.3**	**1,052.6**	**1,072.3**	**5.8**	**6.1**
Granted by Commercial Banks 3/	638.8	645.1	676.8	674.0	665.9	-0.1	-1.0
Granted by Development Banks 3/	90.2	94.5	112.8	115.2	113.8	20.9	15.5
Granted by Non-bank Intermediaries 4/	120.9	132.8	151.2	157.5	164.4	23.3	18.7
Debt Instruments Issuance	91.9	97.2	104.5	106.0	128.2	9.2	26.5
Memo:							
External Credit (thousand million US dollars)	55.0	54.1	53.5	52.9	51.6	-3.7 5/	-4.7 5/

*/ thousand million pesos.
1/ Including foreign suppliers of companies listed in the Mexican Stock Exchange (*Bolsa Mexicana de Valores, BMV*), credit granted by foreign commercial banks, and other creditors such as the Paris Club and bilateral institutions financing foreign trade programs.
2/ Including issuance of private securities and credit granted by commercial and development banks, and by non-bank financial intermediaries.
3/ Including total credit portfolio, accrued interests, and portfolio related to debt-restructuring programs (UDIs and share flows in IPAB-FOBAPROA).
4/ Limited Purpose Financial Companies (*Sociedades Financieras de Objeto Limitado, SOFOLES*), Savings and Loan Companies (*Sociedades de Ahorro y Préstamo*), Financial Leasing Companies (*Arrendadoras Financieras*), Financial Factoring Companies (*Factorajes Financieros*), and Credit Unions (*Uniones de Crédito*).
5/ Nominal variation.

Graph 16 **Securities Issued by the Non-Financial Private Sector**

Stocks in thousand million



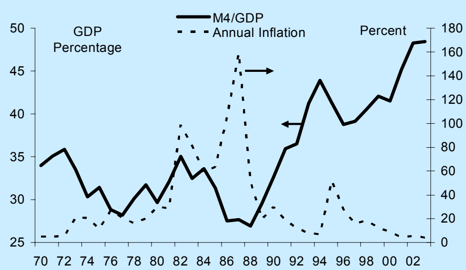
Box 4

The Benefits of Lower Inflation on Mexico's Financial System

The effects of inflation on economic activity are transmitted, partially, through financial intermediation. Once inflation declines and stabilizes in low levels, uncertainty and risks associated with both the granting and contracting of credit diminish and financial resources are allocated more efficiently. These conditions foster economic growth.

During the last years, the abatement of inflation in Mexico has contributed to the greater depth of its financial system. In 2003, inflation fell to its lowest level in the last three decades, while the broad monetary aggregate M4 reached 48 percent of GDP, its highest figure.

Monetary Aggregate M4 and Inflation
(Percent)

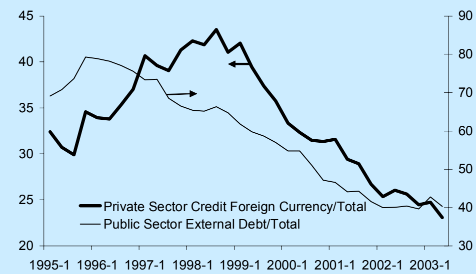


The environment of less uncertainty over inflation that has recently prevailed has allowed for a significant reduction of interest rates and also widened the horizon of several contracts in the economy. This has yielded in benefits to the public and private sectors, as they have been able to:

a) substitute external for domestic debt, thus lowering their exposure to foreign exchange risk, and
b) increase the average maturity of their debt instruments, thus reducing their debt service burden.

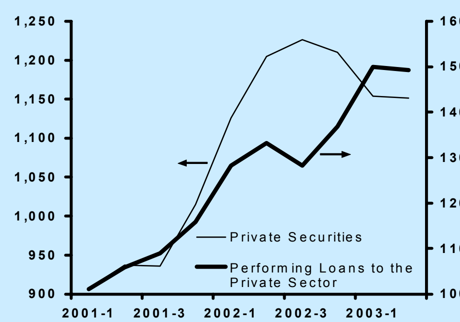
Although this phenomenon has benefited the issuance of securities significantly, bank credit has also improved its terms and maturity profile (despite its low stocks).

Credit to the Private Sector in Foreign Currency and Public Sector's External Debt [1/]
(Total percentage)



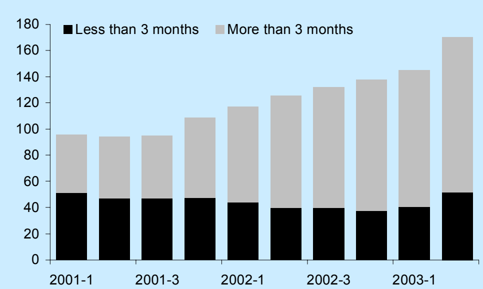
1/ Performing loans in foreign currency granted by commercial banks to the private sector as a percentage of total credit. Federal Government's gross external debt as a percentage of total Government's debt (Source: Ministry of Finance, *SHCP*).

Average Weighted Maturity of Private Securities and of Commercial Bank's Performing Loans to the Private Sector
(Days)



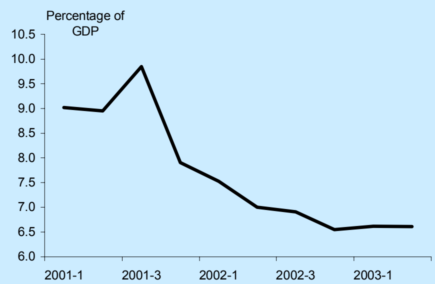
The issuance of private securities has increased, reaching a real annual variation of 36.7 percent during August 2003. These results are due both to the prevailing low interest rates, and to an improvement in the maturity profile of such securities.

Private Securities
(Thousand million pesos)



It should be pointed out that lower interest rates, together with a lengthening in credit maturities, have allowed for a reduction in private sector's domestic debt service. Furthermore, these conditons have also made the private sector less vulnerable to sudden shocks to financial markets, and have reduced firms' costs.

Private Sector's Domestic Debt Service [1/]
(Percentage of GDP)



1/ Debt service indicator. Includes repayments and interest payments during the quarter.

Finally, it is important to mention that both the creation of the Retirement Savings System (*Sistema de Ahorro para el Retiro, SAR*), due to its impact as a source of domestic financial savings, and the numerous financial reforms approved over the last years, have been crucial in the development of the domestic financial system.

IV. Private Sector Outlook for 2003[16]

IV.1. Forecasts for Economic Activity and for the Different Determinants of Inflation

Expectations of a further decline in inflation and modest growth in 2003 were the two main aspects pinpointed by private sector economic analysts in their forecasts reported during the third quarter of 2003. Economic activity is anticipated to recover in 2004. Among the aspects addressed by these analysts (Table 12), were the following: i) GDP growth in 2003 was revised downward, from 2.16 in June to 1.60 in September; ii) in line with the above, forecasts for annual increases in domestic demand (especially in consumption and private investment) were also adjusted downward; iii) forecasts for job creation in the formal sector at the end of 2003 were lowered; iv) interests rates are expected to remain low for the remainder of the year; v) a smaller deficit in the balance of payments' trade balance and current account is expected for the rest of the year, consistent with revisions on domestic demand and GDP; vi) a smaller inflow of foreign direct investment resources is anticipated as compared to June; and vii) a slight drop in the average level of Private Sector Economic Analysts' Confidence Index undertaken by Banco de México is foreseen compared to June's figures.

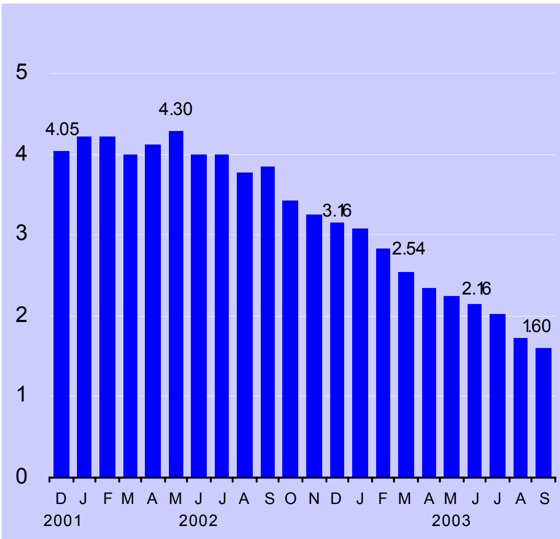
As for expected GDP growth in the United States in 2003, forecasts were revised upward, thus implying U.S. economic activity will continue its recovery during the fourth quarter of the year.

[16] 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 17 Private Sector Analysts' Forecasts for GDP Growth and for the Number of Workers Insured by the IMSS in 2003

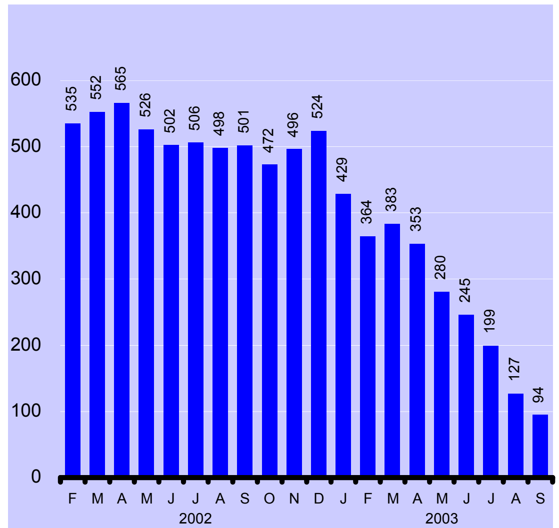
Real GDP Growth

Percent



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 Forecasts: June and September 2003[1/]

	Jun. 2003	Sep. 2003		Jun. 2003	Sep. 2003
Real GDP Growth in Mexico			**Exchange Rate (Pesos/US dollar, year-end)**		
2003	2.16%	1.60%	Banxico Survey 2003	10.68	10.88
2004	3.71%	3.39%	Futures[2/]	10.73	11.08
			Banxico Survey 2004	11.03	11.19
Trade Deficit (Million US dollars)			**Mexican Oil Mix (Average US dollars per barrel)**		
2003	7,708	6,550	Banxico Survey 2003	22.19	24.07
			Increases in Contractual Wages		
Current Account Deficit (Million US dollars)			July 2003	n.a.	4.71
2003	14,716	12,042	August 2003	n.a.	4.71
			Business Climate		
			Will improve	68%	67%
Foreign Direct Investment (Million US dollars)	12,906	12,193	Will remain unchanged	23%	30%
2004	14,117	13,505	Will worsen	9%	3%
Real GDP Growth and Industrial Production in the U.S. in 2003					
GDP Growth					
Banxico Survey	2.3%	2.6%	II Q. Brokerage Firms (Average)[6/]	3.5%	5.6%
Consensus Forecasts[3/]	2.3%	2.7%	III Q. Brokerage Firms (Average)[6/]	3.2%	3.8%
Blue Chip Economic Indicators[4/]	2.3%	2.7%			
Brokerage Firms (Average)[5/]	2.3%	2.8%			
Industrial Production					
Blue Chip Economic Indicators[4/]	0.5%	0.2%			

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 June 30th and September 30th 2003.

3/ July 14th and October 13th 2003 issues of the *Consensus Forecasts*.

4/ Blue Chip Economic Indicators (July 10th and October 10th 2003).

5/ Average forecasts of Deutsche Bank, Merill Lynch, Lehman Brothers, Goldman Sachs, and JP Morgan brokerage firms at June 27th and October 17th 2003.

6/ Annualized quarterly variation.

Regarding other variables, private sector economic analysts' forecasts were as follows: i) Mexico's anticipated exchange rate for year-end 2003 was revised upward during the third quarter; ii) nominal increases in contractual wages in October and November 2003 are expected to be slightly below the figures registered in the previous months; iii) among the main factors that could limit the speed of economic activity in the next months are the absence of structural changes, the weakness of the domestic and external markets, and the uncertainty regarding the country's economic and political conditions.

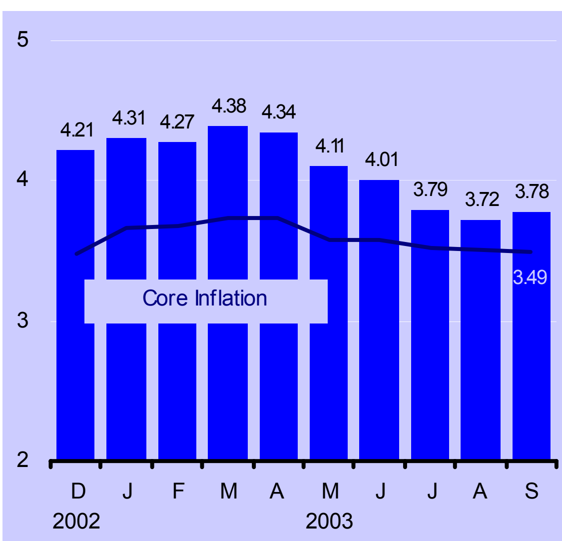
IV.2. Inflation Forecasts

During 2003-III, inflation expectations were revised downward. Forecasts for headline inflation for the end of 2003 declined from 4.01 percent in June to 3.78 percent in September. During that period, forecasts for core inflation dropped slightly, from 3.58 percent in June to 3.49 percent in September. Private sector analysts anticipate a scenario of low and stable inflation in the coming years: 3.67 percent in 2004 and 3.49 percent (on average) in 2005-2008.

Graph 18 **Economic Analysts' Forecasts for Inflation in 2003**

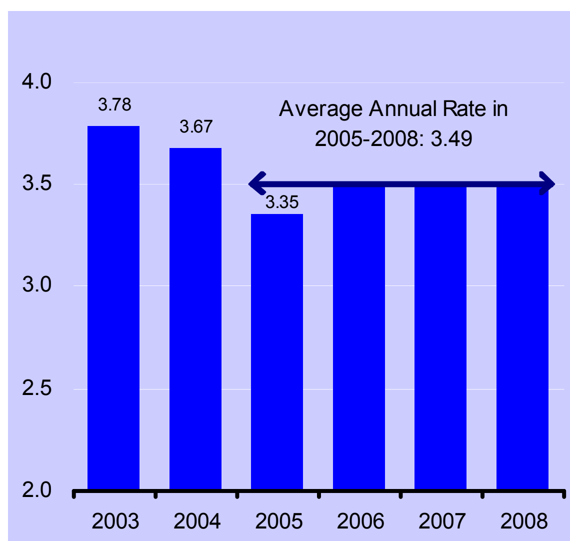
CPI and Core Inflation

Percent



Headline Inflation for the Short and Long Terms

Percent



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

V. Balance of Risks and Concluding Remarks

During the third quarter of 2003, the performance of the Mexican economy was influenced by both an external demand that only showed a gradual recovery, and a weak domestic demand. As for the structure of domestic expenditure, consumption kept a moderate dynamism while investment has remained weak for a long period. Regarding aggregate supply, the aforementioned behavior has translated into a higher share of the services sector in domestic production and employment, while that of industrial activity has contracted. Moreover, the labor market remains stagnant, as confirmed by the scarce job creation in the formal sector.

Given the aforementioned conditions, Banco de México's base scenario for the end of 2003 and for 2004 rests upon the following assumptions:

(a) Although forecasts for average annual GDP growth in the United States for 2003 were revised upward (from 2.3 to 2.7 percent), annual average growth of industrial output in that country for 2003 is expected to be 0.1 percent (consistent with private sector economic analysts' forecasts) rather than the previous 0.6 percent. This revision already considers the expected recovery of industrial output during the second half of the year. Real GDP and industrial output are expected to grow 3.9 and 4.2 percent, respectively, in 2004;[17]

(b) The price of the Mexican crude oil export mix is expected to be, on average, 24 US dollars per barrel in 2003 and 18 US dollars in 2004; and

(c) For the remainder of the year and throughout 2004, the conditions for Mexico's access to external financing are anticipated to remain favorable.

Based on these assumptions, as well as on the latest available information on the performance of the Mexican economy, Banco de México's forecasting exercise for the main macroeconomic variables for the remainder of 2003 is as follows:

[17] Based on Blue Chip estimates of October 2003.

Economic Growth: Annual GDP growth for 2003 was revised downward to around 1.5 percent.

Employment: During 2003, there will be no job creation in the formal sector of the economy (in net terms). This comes from the downward revision on expected GDP growth and the fact that increases in contractual wages continue to forestall the hiring of labor.

Current Account: The current account deficit of the balance of payments is expected to be below 2.0 percent of GDP.

Inflation: For the remainder of 2003, inflation is expected to converge towards the 3 percent target, considering a variability interval of plus/minus one percentage point. Annual core inflation is also estimated to continue its downward trend within the variability interval for headline inflation, thus supporting the convergence of general inflation to its target. As for core price subindexes, the behavior of prices of goods is anticipated to remain stable, while that of services will further contribute to the reduction of CPI inflation. Nevertheless, the magnitude of the latter's contribution will depend, to a large extent, on the path of wage increases. The outlook on the path of non-core inflation for the coming months is, in general terms, consistent with the inflation target, in absence of unexpected shocks.

The base scenario considers that the Mexican economy will grow at a faster pace in 2004. This expectation is based on the assumption that private consumption will maintain its relative dynamism, supported by the favorable conditions in financial markets and by the impulse of bank credit. In line with the recovery of industrial activity in the United States (and the likely expansion of Mexican exports), private investment is expected to increase slightly, fueled by the low interest rates that prevail both in Mexico and worldwide, and by the improvement in the private sector's financial position. The simple arithmetical effect of having a relatively low base of comparison is also expected to contribute to higher growth in 2004. Specifically, real GDP growth in Mexico for 2004 is expected to be between 3.0 and 3.5 percent.[18] It is important to mention that the above scenario is basically inertial in nature since it considers the latest available information and is also based on trends regarding the future developments in the economy. It is difficult to foresee exactly the type of shocks (either positive

[18] Following the practice of other central banks (the Federal Reserve System, the European Central Bank, and the Bank of Japan, among others) from 2004 onward, Banco de México will announce an interval for its growth estimates, which reflects the presence of uncertainty and the confidence intervals inherent to any statistical projection.

or negative) that could affect the mentioned scenario in a five quarter horizon.

As for inflation in 2004, the exercise indicates that the current stance of monetary policy is compatible with a path of inflation that keeps converging towards the long-term objective. This consideration is based on both actual business cycle and structural factors. Among the first ones, the weakness of aggregate demand and the absence of anticipated supply shocks point to reduced inflationary pressures from these sources. As for structural ones, these are part of Mexico's transition towards an environment of low inflation, with more robust financial markets, a greater remonetization of the economy, and a lower pass-through from exchange-rate fluctuations to prices. In this regard, Banco de México's monetary policy actions in the last years have fostered the attainment of a low inflation macroeconomic environment. The Central Bank has enabled macroeconomic stability both through a preventive monetary policy that actively contains inflationary pressures, and a policy for communicating with the public geared towards increasing the Bank's transparency and accountability.

The abovementioned scenario for the end of 2003 and for 2004 is subject to several risks. Among the external ones, the most important would be that the recovery of the U.S. economy does not consolidate. This could have a negative effect on Mexico, particularly if the lack of strength of the U.S. economy comes from manufacturing output and non-residential investment. It is important to reiterate that the main link between the Mexican and U.S. economies is the relationship between their respective manufacturing industries. Therefore, if productive activity in the United States does not recover at a vigorous and sustained pace, external demand for Mexican exports will hardly increase.

As for domestic risks, the following deserve mention:

(a) The possibility that the loss of competitiveness of the Mexican economy could be such that, despite a rebound in industrial activity in the United States, industrial production and employment in Mexico do not exhibit a strong recovery. In this regard, the decline in market share of Mexican exports against those from China in the United States in 2003 is a cause for concern;

(b) The lack of competitiveness of the domestic industry is also a potential hazard for the economy in the medium term. Competitiveness has implications on the economy's growth potential and is necessary to sustain low inflation in a longer horizon. An economy with no productivity growth creates more pressure in overall prices. In particular, in a hardly competitive economy pressures could arise and induce an exchange rate adjustment, which would also affect inflation. Consequently, it is extremely important to reach the necessary political and social consensuses to prevent further delays in the agenda of structural reforms;

(c) Although core inflation fell during the third quarter of 2003, its reduction was barely significant;

(d) Wage increases are still incompatible with the slack in labor market conditions and with expected gains in productivity; and

(e) Headline inflation may deviate from its anticipated path if the non-core component is affected by supply shocks. Agriculture prices and, to a lesser extent, some prices administered by the public sector which are set according to international references, such as gas for home use, are subject to high volatility.

As it can be seen, the recovery of the Mexican economy still faces numerous risks. Nonetheless, on the external side, the increased dynamism of the world economy in the near future, as well as favorable worldwide financial conditions, are factors that support the upturn of economic activity in Mexico. On the domestic side, the presence of interest rates at historically low levels, favored by the conduct of monetary policy, should also add to the recovery.

Under such context, fiscal and monetary discipline, together with social security and financial sector reforms, have had a positive effect on the development of domestic capital markets. Over the last few years, Mexico’s capital markets have become stronger and more liquid, at the same time that maturities have increased. The soundness of the Mexican financial system has been a key factor in maintaining the relative strength of private consumption during the current business cycle, since the increase in the availability of credit has contributed to overcome liquidity restrictions.

A sound financial system is also an important element to encourage the expansion of private investment under a more favorable scenario, as the one anticipated. In fact, the private sector has placed significant issuances of long-term instruments denominated in domestic currency, thus improving its balances in terms of maturity profile and currency denomination. Given the above conditions, and in the presence of lower interest rates, the private sector is now in a much better position to increase its investments.

The foreseen macroeconomic scenario deserves special attention. Even in the presence of more favorable conditions, the macroeconomic outlook for 2004 does not envision economic growth to be robust enough to significantly improve the welfare of the majority of Mexicans. Real GDP growth between 3.0 and 3.5 percent in 2004 would mean four consecutive years of lower than potential growth, which translates into lack of job creation for Mexicans, and in a failure to eradicate poverty and address social problems diligently. Therefore, the necessary actions to boost the recovery of the Mexican economy can no longer be postponed. The structural reforms are designed to attain such goal. As they increase the flexibility and ability to respond of the Mexican economy, they will also create new opportunities for economic development.

After all, the structural reform has implications for both economic growth and sustainable inflation in the medium term. First, it allows for higher investment returns, which in turn encourage capital formation, raise productivity, and boost economic growth. These actions would also promote an enduring increase in real wages and employment, thus contributing to end both poverty and unequal income distribution. The implementation of these reforms could foster high growth in Mexico in the short term (2004) and, certainly, increase the country's growth potential in the long term. Second, the greater flexibility and productivity that can be achieved by the structural reforms would also contribute to the attainment of the long-term inflation objective.

Institutional reforms would also have similar effects on the economy. Reforms to reduce legal uncertainty on many activities, and aimed at creating the proper incentives for the different economic agents, would increase confidence and promote the flow of resources to savings and to productive investments. The latter suggests that institutional strengthening must be a continuous process, which should comprise all economic relationships.

Summing up, in order to materialize and consolidate the growth potential of the Mexican economy, it needs to be modernized. The structural reforms currently being discussed, as well as deeper deregulation, would allow Mexico to adjust successfully to an increasingly competitive international environment. Global trade conditions have changed very rapidly over the last years with the entrance of China's robust and dynamic economy to the World Trade Organization. The mere presence of China as the most important emerging competitor worldwide posts a significant challenge for Mexico as well as for the rest of the emerging economies. Transportation costs have fallen significantly worldwide, but Mexico's limited infrastructure in this sector has not allowed for savings in transportation to be materialized. While other countries have addressed these challenges by increasing their productivity and their economies' flexibility (through investment in infrastructure and by escalating in value chains), our country has lagged. Such lag is not only a statistical phenomenon but also translates into a loss of share of Mexican products in international markets, lack of competitiveness of many enterprises, and in scarce job creation.

As confirmed by the international experience, a stable environment together with an institutional framework that fosters investment and raises firms' competitiveness and labor productivity, guarantee the successful insertion of a country in the world economic scenario. For this reason, and as stated in previous reports, Banco de México reiterates the need to reach the necessary agreements to implement the structural changes required by our economy.

Finally, Banco de México envisions the convergence of headline inflation towards the year-end target. It should be pointed out that the long-term target was set at 3 percent (with a variability interval of plus/minus one percent). This objective does not apply only for year-end inflation, it will operate continuously. The purpose of the variability interval is to set a margin to accommodate positive and negative shocks to relative prices. In this regard, the inflation target should be considered more as an average objective throughout a certain period than a precise target for a given point in time.

Following this line, it is important to emphasize that the convergence of inflation towards its objective in 2003 (considering its variability interval) does not guarantee the consolidation of price stability. This achievement is only the first step in a long process, which requires maintaining low inflation for several years in order for society to perceive that inflation has been eradicated. Once inflation reaches its target the Central Bank will continue following closely the path of inflation in order to consolidate price stability. Thus, the design and conduct of monetary policy will be geared towards maintaining headline inflation in its long-term objective. This is the Central Bank's best contribution to economic development.

VI. Calendar of Announcements for Monetary Policy Decisions in 2004

The Board of Governors of Banco de México determined that, from January 2003 onward, announcements on monetary policy would be given on preestablished dates and published in the Inflation Report of the third quarter of the previous year. The calendar of announcements for monetary policy decisions, monthly press releases, and inflation reports in 2004 is exhibited below:[19]

Table 13

Calendar of Announcements for Monetary Policy Decisions in 2004

Month	Announcements on Monetary Policy	Press Releases	Publication of Inflation Reports
January	9, 23	23	28 1/
February	6, 20	20	
March	12, 26	26	
April	7 2/, 23	23	28
May	14, 28	28	
June	11, 25	25	
July	9, 23	23	28
August	13, 27	27	
September	10, 24	24	
October	8, 22	22	27
November	12, 26	26	
December	10	10	

1/ Includes the Monetary Program for 2004.
2/ Corresponds to the previous working day to the date set by the guidelines for the determination of the calendar dates for monetary policy announcements.

[19] The Inflation Report of July-September 2002 includes the criteria and guidelines for determining calendar dates for monetary policy announcements and monthly press releases.