Inflation Report

July - September 2004

Summary

The world economy continued to recover during the third quarter of the year, albeit at a lower rate than at the end of 2003 and the beginning of 2004. The world economy, particularly that of the U.S., is expected to have already exhibited the highest growth rates associated with the current economic cycle. Thus, inflation pressures, associated with the expansion phase of the economic cycle have apparently eased throughout the world. In particular, expectations of a gradual easing of aggregate demand expansion in the U.S. have reduced long-term interest rates significantly with respect to those observed at the end of the second quarter of the year.

Under such setting, during the third quarter of 2004, the development of the external environment had a significant effect on the Mexican economy, concerning both growth and inflation. Regarding the former, during the third quarter, aggregate expenditure benefited from a greater availability of foreign financial resources as well as a considerable amount of oil revenues and workers' remittances. Regarding external demand, oil and non-oil exports remained robust. As for domestic demand, consumption remained vigorous while investment began to increase. Such developments fostered the recovery of industrial and manufacturing production, which also led to higher job creation.

The external environment also had a significant effect on domestic inflation. Although it is true that cyclical inflation pressures have eased worldwide, in the last years the world economy has undergone structural changes in production and demand for inputs, which have affected inflation in many countries. In particular, there has been a significant increase in several commodity prices in relation to those of manufactured goods.

The Chinese economy has played a key role in such process by expanding the international demand of energy and metals, and, at the same time, by increasing significantly its food imports. As a large economy, its demand has contributed, since mid-2003, to raise the prices of this type of goods in international markets.

Such phenomenon has significantly affected inflation in Mexico. In particular, increases in several commodity prices have influenced production costs considerably (supply shocks). These shocks have been transmitted to different items of the CPI, mostly in the non-core component and in the food core merchandise subindex.

The supply shocks to the CPI have been more numerous and stronger than those expected at the beginning of the year, affecting more components of the CPI than in previous years. Given their nature, these shocks should only have a temporary effect on inflation. However, due to the high level of CPI inflation, they have already affected inflation expectations. The Mexican economic cycle has probably facilitated such deterioration.

Since observed inflation and its expectations are currently above Banco de México's inflation target, the Central Bank has adopted several measures to tighten its monetary policy stance in order to prevent any contagion on wage negotiations and on the entire price determination process. In addition, it has

announced that monetary policy will maintain a restrictive stance as long as pressures on inflation and its expectations continue. Through these actions, the Board of Governors of Banco de México reiterates its intention to make inflation converge to its 3 percent target as soon as possible.

Recent Developments in Inflation

At the end of the third quarter of 2004, annual CPI inflation was 5.06 percent, 1.08 percentage points above that at the end of 2003. During the same period, annual core inflation was 3.76 percent, 0.10 percentage points above that at the end of 2003.

CPI inflation has been subject to continuous pressures from its non-core component throughout the year; however, these worsened during the third quarter. The 1.08 percentage point difference between annual CPI inflation in September 2004 and at the end of 2003 is explained in 92.6 percent (1 percentage point) by the higher annual rate of growth of the non-core component. The agriculture price subindex contributed with 0.51 percentage points to the increase in inflation, while the subindex of administered and regulated prices did so with 0.53 points. The core component contributed barely with 0.08 percentage points to the increase in inflation.

During the year, the most significant inflation pressures have stemmed from the increase in international prices of many food, energy, and metal commodities. This has been mainly due to the increased demand for this type of products worldwide, and to the fact that the supply of these goods expands slowly. This situation worsened during the third quarter when prices of fruits and vegetables reverted the downward trend recorded in the first half of the year.

In this regard, the following should be considered: i) the increase in commodity prices has led to higher inflation in many countries; and ii) the possibility of a significant increase in fruits and vegetables prices in Mexico was anticipated in the previous Inflation Report, given that such prices had recorded unusual negative monthly variations for six months in a row.

Price increases in beef, pork meat, poultry and eggs accounted for most of agriculture's subindex contribution to CPI inflation. International prices of these products have increased significantly due to: i) a larger world demand for such goods; ii) the considerable fall in production throughout the world due to phytosanitary measures established in the main international markets; and, iii) the increase in grain forage for cattle, hogs, and poultry (grain prices, which rose significantly throughout the year, have began to ease recently).

The upward trend followed by the annual growth rate of the subindex of administered and regulated prices during the year has also affected the path of CPI inflation in 2004: a) regarding regulated prices, the most important contributions stemmed from the increase in public transportation rates in Mexico City and in Estado de México during the first quarter of the year; and, b) regarding administered prices, the increase in electricity and gas prices stands out, given that their annual growth rates rose by 5.64 and 6.53 percentage points, respectively, from December 2003 to September 2004.

Annual core inflation rose by 0.10 percentage points from December 2003 to September 2004. This upward movement mainly took place in the third quarter of 2004. Such result was due to two opposite factors: i) the increase in merchandise's annual variation, mostly due to the increase in the international references of different commodities which are used as inputs in many processed foods; and, ii) the decline in the annual variation of services, which partially offset the increase in merchandise's annual variation. Services other than housing were the items that exhibited the lowest annual variation.

On another front, expenditure growth could likely generate inflation pressures. This phenomenon could arise at different stages throughout the economy's cyclical recovery, depending on the pace at which the slack in different sector's production capacity narrows. An environment where aggregate demand grows vigorously enables the referred supply shocks to affect the formation of inflation expectations.

Main Determinants of Inflation

The world economy exhibited a favorable behavior during the third quarter of 2004, despite the increase in oil prices. Nonetheless, its rate of growth for the next quarters is expected to be below that observed in the second half of 2003 and at the beginning of 2004.

Expectations regarding a slower rate of growth, together with moderate inflation pressures in the main world economies have led to a reduction in their long-term interest rates. Such developments have taken place despite the increase in commodity prices that occurred as a result of the recent changes in worldwide patterns of production and demand for inputs. In this context, emerging economies have benefited from more favorable conditions in international financial markets. On the other hand, the downturn risks on worldwide economic performance have intensified due to the prevalence of unusually high oil prices.

During the third quarter, the external conditions continued to have a positive effect on the Mexican economy. The dynamism of external demand was reflected in an expansion in non-oil exports during the quarter (13.9 percent). This allowed for an increase in both industrial and manufacturing production as well as in job creation, thus encouraging domestic spending. Furthermore, the high value of oil exports and the considerable amount of workers' remittances have helped to maintain consumption growth and foster investment.

Thus, during the third quarter of 2004, economic activity continued to gain strength and was characterized by the following: i) GDP grew significantly at an annual rate; ii) all aggregate demand components recovered; iii) domestic expenditure grew at an annual rate above that of GDP, due to the significant increase in consumption and investment expenditure; iv) investment grew more vigorously than in the first half of the year; v) external demand was the strongest component of aggregate demand; vi) industrial production recovered at a higher pace; vii) manufacturing growth included more divisions and was fostered by the improvement of export production; and viii) business climate and business confidence indicators weakened.

Such developments allow to foresee that GDP would have grown at an annual rate of 4 percent during the third quarter of 2004.

During the reference period, the external sector was mainly characterized by the following: i) a significant annual increase in merchandise exports (both oil and non-oil); ii) imports' rapid increase at an annual rate, and the noteworthy recovery in capital good imports; iii) moderate trade and current account deficits; iv) higher oil prices, which, in turn, raised the value of Mexican oil exports considerably; v) significant workers' remittances; vi) a reduced surplus in the capital account; and vii) a small reduction in net international reserves.

Monetary Policy Actions

Throughout the year, monetary policy has faced different challenges such as:

(a) Containing the effects of price increases in many commodities to inflation expectations and wage negotiations.

(b) Limiting inflation pressures that could originate from the economy's cyclical recovery.

(c) Fostering an orderly adjustment of the economy to an environment of tighter global monetary conditions.

During the third quarter some of these factors increased their effect on prices, while others diminished. Nonetheless, the net effect of these factors led to a significant increase in CPI inflation (5.06 percent annual inflation in September).

The rise in inflation is mainly attributed to the different supply shocks that have affected several CPI subindexes throughout the year. Such shocks have been mainly external and, given their nature, should only have a temporary effect on inflation.

When inflation pressures arise from the supply side they usually reflect changes in relative prices, which affect inflation temporarily. In this case, the stance of monetary policy should not change and monitor that the referred shocks do not contaminate the process of price determination in the economy (second round effects). For an economy that has still not achieved its long-term inflation target, this recommendation must consider that monetary policy has to maintain a more restrictive stance to foster the reduction of inflation. On the other hand, when pressures originate from the demand side, the monetary authority should tighten monetary policy to prevent an overall upward price movement of goods and services.

As expected, given the nature of the referred shocks, prices of the subindexes of administered and livestock goods, and of the food component of the core subindex have been affected the most. It must be noticed, that despite the fact that prices of the other CPI subindexes have not been affected significantly, inflation expectations for the medium and long terms have been revised upward.

The monetary authority must act in a timely manner to contain the effects of such pressures on inflation expectations; otherwise, the price formation process in the economy could be affected. Additionally, the fact that the Mexican economy is at the expansion phase of its economic cycle could facilitate the transmission of external pressures to other prices.

Consequently, the Board of Governors of Banco de México has restricted the monetary policy stance throughout the year. During July-September it increased the *corto* on three occasions: on July 23, from 37 to 41 million pesos; on August 27, to 45 million pesos, and on September 24, to 51 million pesos. In addition, the Central Bank announced that, until deemed necessary, domestic monetary conditions are expected to at least mirror the higher astringency conditions that prevail in the U.S.

As a result of such actions, short-term domestic interest rates increased significantly (at the end of the quarter, the bank's funding rate reached 7.62 percent, 289 basis points above its lowest level during the year), while longer-term yields have decreased as compared with those observed at the end of the second quarter. Thus, in the last months, the yield curve has "flattened".

Although external financial conditions, which have fostered capital flows to Mexico, partially explain the increased demand for long-term instruments and the decline in their corresponding yields, Banco de Mexico's efforts to restrict its monetary policy stance and thus anchor inflation expectations have been key in this process.

Private Sector Outlook for 2004

In September, private sector economic analysts' forecasts were as follows: i) CPI inflation for 2004 is expected to be 4.64 percent, figure above that of June (4.08 percent). Inflation expectations for the following twelve months, for 2005, 2006, and for the average in 2005-2008, have been revised upward: 4.04, 4.05, 3.93 and 3.87 percent, respectively; ii) GDP is expected to grow 4.02 percent in 2004 (rate higher than the 3.93 percent expected in June) and 3.74 percent in 2005; iii) 380 and 451 thousand jobs are expected to be created in the formal sector in

2004 and 2005, respectively; and iv) the average level of Private Sector Economic Analysts' Business Confidence Index of the third quarter fell compared with that of the previous quarter.

Balance of Risks and Final Remarks

Based on the macroeconomic context previously described, and on most recent information on the development of the Mexican economy, Banco de México's scenario for the end of 2004 and for 2005 is as follows:

Economic Growth: Real GDP growth estimates for 2004 remained unchanged: between 3.75 and 4.25 percent. For 2005, a rate of growth between 3.5 and 4.0 percent is expected.

Employment: Approximately 380 and 460 thousand jobs are expected to be created in the formal sector in 2004 and 2005, respectively.

Current Account: The current account deficit will continue to remain at moderate levels, close to 1 percent of GDP in 2004 and between 1.5 and 2.0 percent of GDP in 2005.

Inflation: Given inflation's behavior during the year, and in order to evaluate its outlook for the short and medium terms, it is necessary to analyze the likely behavior of commodity prices (which have recently exhibited significant increases).

Certain factors might contribute to create more favorable conditions for commodity prices in international markets in the following months, such as the reduction in the prices of some grains and cereals. This should enable the prices of different processed foods and livestock goods to decline.

Nonetheless, it is still very difficult to assess the outlook for prices in these markets mainly because of two factors. On the one hand, recent indicators on the Chinese economy suggest that it has been slowing its rate of growth only moderately. Thus, the fact that its demand for inputs could continue pressuring commodity prices should not be discarded.

On the other, despite the perception that the world economy will slow down in 2005, oil prices in spot and futures' markets have not declined. This is due to the fact that oil markets have been significantly affected by supply factors, such as reduced idle capacity and geopolitical risks.

Summing up, the high level of some commodity prices, together with the perception that the world economy will grow more slowly and with information from futures' markets, indicate that the outlook for inflation associated with commodity prices will slightly improve, at the margin, in 2005 with respect to 2004.

It is important to highlight that the outlook for inflation in Mexico for the following months will also depend on the interaction of supply shocks and aggregate demand. As idle capacity in different sectors narrows, it is more feasible that producers will be able to raise their prices more easily. In this regard, it is clear that vigorous domestic expenditure growth facilitates the contagion of inflation expectations due to the increase in prices originated by supply shocks.

Thus, the outlook for inflation must consider monetary policy's reactions to such conditions. As mentioned in other sections, the Central Bank has been tightening its monetary policy stance throughout the year and, under the current environment, it will maintain such stance for as long as it is necessary.

Based on the above considerations, the expected scenario for the following months for the different CPI subindexes is as follows:

(a) Annual merchandise core inflation is expected to continue to be affected by the increase in food prices. Although food inflation apparently is easing in some countries, food prices in Mexico have a lagged response to international price increases and therefore are likely to continue to rise for sometime.

(b) The annual variation of services core inflation is expected to decrease slightly and then follow a horizontal path. In order for this to materialize, the temporary increases in CPI inflation as a result of supply shocks should not contaminate wage negotiations.

Based on the above, in the following months, the annual variation of the core price index is expected to follow a slightly upward trend but remaining below 4 percent, and then, by the beginning of the second quarter of 2005, resume its downward trend. Since the annual variation of the services core subindex is expected to exhibit smaller reductions, the path of total core inflation will depend on a greater scale on the development of merchandise core inflation.

As for the non-core price subindex, the significant price increases of some perishable goods (such as tomato) and in certain items of the subindex of goods and services regulated by the public sector (which took place at the beginning of the year) are expected to revert in the following months.

Nonetheless, in order for non-core inflation to decline more markedly, international prices of livestock and energy must ease. Regarding the latter, it is important that administrative decisions concerning the determination of certain energy prices consider the inflation target. If gas prices and higher domestic consumption electricity tariffs remain on their current trend, they will reach in December 2004 an annual rate of growth of 18.64 percent and 19.71 percent, respectively. Finally, it is necessary that prices and tariffs of goods and services regulated by the public sector do not increase sharply at the beginning of 2005.

In light of the above, CPI inflation is expected to remain at levels close to those observed during the last months, in line with the latest forecasts from private sector analysts, and to resume its downward trend by the second quarter of 2005.

The magnitude and intensity of supply shocks have raised inflation above its 3 percent target, affecting medium and long-term inflation expectations. As previously mentioned, in the following months, total core inflation is expected to be determined mainly by the behavior of merchandise core inflation, given that services inflation is anticipated to follow a horizontal path. In light of such developments, Banco de México's Board of Governors has adopted several measures to restrict its policy stance in order to prevent wage negotiations and the price determination process from being contaminated by such shocks. Moreover, should further inflation pressures arise or the effects of current shocks intensify, the Board of Governors will continue to act accordingly.

The main risk faced by the Mexican economy is that U.S. growth weakens more than currently anticipated by the main economic analysts. Among other factors, the higher prices of crude oil and oil by-products, which are likely to prevail, could contribute to such risk. Under such conditions, the Mexican economy could be affected in two ways: on the one hand, the demand for Mexican exports would be reduced, thus affecting the outlook for growth and employment; on the other, inflation pressures from electricity, gasoline and gas prices would worsen.

Another external risk factor is that inflation pressures from aggregate demand intensify in the U.S. and throughout the world. Such scenario would lead to two problems: on the one hand, a new international cycle of rising interest rates would generate higher volatility in international financial markets, affecting once more emerging economies' conditions to access external financing; on the other, such scenario would imply that the higher demand for primary goods (energy-related and others) would continue, therefore raising their international prices.

Until now, the development of the world economy has fostered Mexico's cyclical recovery. However, no significant progress has been made in strengthening the domestic sources of growth, and, therefore, the country's potential has not been used to its full capacity. Mexico's downgrade in different international indicators of country's competitiveness and attractiveness to investors reveals the high cost of postponing the required economic and institutional reforms. Therefore, it is necessary to create public awareness that as several nations have aggressively inserted themselves into the new globalized economy and implemented significant changes in their economies, the first generation of reforms must be renewed to increase the flexibility and competitiveness of the productive sector. The failure to do so will lead to a loss of share of Mexican products in international markets, therefore reducing Mexico's allure as an investment receptor, and mostly, canceling the opportunity to create more stable and better-paid jobs.

Finally, regarding domestic risk factors, as the expansion phase of the business cycle consolidates, wage agreements and the price determination process of the economy are more likely to be affected by the referred supply shocks.

Consequently, Banco de México has adopted a restrictive monetary policy stance. The Central Bank's objective is to secure price stability and, in turn, ensure the basic conditions of certainty needed for production and investment. The consolidation of price stability is a gradual process and, therefore, the temporary shocks that have affected inflation must be evaluated in a medium-term horizon. Therefore, although the persistent and unexpected supply shocks during this year have complicated the reduction of inflation, Banco de México reiterates its commitment to abate it, and make prices resume their downward path towards the inflation target. Only that way it would be possible to lay the groundwork for permanent stability, which together with the structural and institutional reforms, will contribute to make investments safer and more profitable, raise productivity, and improve Mexicans' welfare.

Calendar of Announcements for Monetary Policy Decisions in 2005

Month	Announcements on Monetary Policy	Press Releases	Publication of Inflation Reports
January	14, 28	28	31 [1/]
February	11, 25	25	
March	11, 23 [2/]	23	
April	8, 22	22	27
May	13, 27	27	
June	10, 24	24	
July	8, 22	22	27
August	12, 26	26	
September	9 y 23	23	
October	14, 28	28	31
November	11, 25	25	
December	9	9	

1/ Includes Monetary Program for 2005.
2/ Corresponds to the previous working day to the date set by the guidelines for determining the calendar dates for monetary policy announcements.