

Inflation Report
October - December 2002
Monetary Program
for 2003

Summary

In 2002 the evolution of the Mexican economy was less favorable than anticipated at the beginning of the year. Moreover, annual CPI inflation rose from 4.4 percent at the end of 2001 to 5.7 percent in December 2002.

Given this scenario, monetary policy was focused on preventing any contagion effects on inflation expectations and core inflation. It should be mentioned that the efforts carried out over the last few years on the inflation and fiscal fronts have allowed real interest rates to come down to nearly minimum historic levels. The latter has influenced significantly the recovery of credit for consumption and, therefore, the increase of this type of expenditures. This has been the main factor supporting economic growth in the last two years.

The slow expansion of the economy in 2002 was accompanied by practically no job creation. Furthermore, the unemployment rate continued on an upward trend, which indicates that underemployment and informal employment as well as the desertion of workers from the labor force could not offset the impact of scant job creation in the formal sector.

Regarding the course of annual inflation in 2003, CPI inflation is expected to decrease as of the second quarter, narrowing the gap that currently exists with core inflation and with the medium and long-term inflation targets. Although the Board of Governors of Banco de México considers that the current stance of

monetary policy is consistent with the attainment of the target, the risks are upward biased. In response to this, the monetary authority will assess continually the strength of inflationary pressures and will act decisively should it anticipate or detect any shocks that could make inflation deviate from the objective.

Inflation Report: October-December 2002

Recent Developments in Inflation

During the reported quarter, the most important events regarding price behavior were the following:

- (a) A significant increase in annual CPI inflation;
- (b) Annual core inflation decreased slightly. As for its components, the rise in the annual rate of change of prices of tradable goods was offset by the fall in that of services;
- (c) Annual inflation of goods and services with prices administered and regulated by the public sector rose due to the drastic increase in prices of residential electricity and domestic gas; and
- (d) The prices of agricultural products showed their distinctive volatile behavior, therefore reverting the low levels of annual inflation displayed by this item during the preceding quarter.

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Main Determinants of Inflation

During the fourth quarter of 2002, the evolution of the external variables that influence the performance of the Mexican economy was, in general, not very benign. The weak pace of economic activity in the United States and Europe, and external political events –tensions in the Middle East, elections in Brazil and anti-government demonstrations in Venezuela- contributed to a climate of instability. Moreover, international oil prices were highly volatile in the last quarter of the year, although their average did not differ substantially from that of the previous quarter.

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During October-December 2002, indicators of wages, salaries and employment posted mixed results. On the one hand, increases in contractual wages returned to the downward trend observed during the first half of the year. On the other hand, formal employment fell while the different unemployment rates remained at levels close to those seen during the previous quarter.

As expected, during the fourth quarter the annual growth rate in productivity decreased while unit labor costs rose.

During the mentioned quarter, employment indicators displayed an unfavorable behavior compared to the previous period. Throughout the year, employment in Mexico was characterized by the slow expansion of formal employment and the worsening of the main indicators of unemployment compared to their levels in 2001.

Under the current situation, characterized by high uncertainty regarding future developments in productivity, Banco de México reiterates the convenience of easing the pace of growth of nominal wages so they can act as the adjustment variable in the labor market.

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During the third quarter of 2002, aggregate supply and demand grew at an annual rate of 2.9 percent. This was the second positive variation after having experienced three consecutive quarters with contraction.

Preliminary data on domestic demand and production during the fourth quarter of 2002 suggests that economic recovery continues although at a slower pace. As for production, evidence from available indicators implies that the growth rate was not robust.

On the basis of this information it is expected that during the fourth quarter of 2002 real GDP grew at an annual rate of around 2 percent. As a result, the annual average increase of real GDP for the year as a whole would be close to one percent.

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The current account deficit for the fourth quarter of 2002 is estimated to be 5.4 billion US dollars and approximately 15 billion for the entire year. This deficit accounted for 2.4 percentage points of GDP in 2002 compared to 2.9 points in 2001.

Thus, the sharpest decline in imports in relation to exports as well as the low levels of the public and private debt service contributed to moderate the demand for external financing.

As for the capital account, the surplus of this component (including errors and omissions) is expected to have been close to 8.4 billion US dollars during the fourth quarter. It should be pointed out that in 2002 the evolution of capital flows to the Latin American countries and Mexico reveals that the Mexican economy maintained a privileged position in the context of a difficult external environment.

The depreciation of the peso vis-à-vis the US dollar during the last quarter of 2002 was accompanied by a depreciation of the US dollar against the euro of 6.3 percent. The correlation between the peso/US dollar and US dollar/euro rates could be associated with the substantial flow of financial resources from the United States to Mexico. Fluctuations in the peso/dollar exchange rate might have also responded to fundamental factors that affect the behavior of real variables, which in the long run, determine the equilibrium level of the exchange rate in real terms, e.g., the intense competition faced by Mexican exports in the United States. In this regard, the increasing

share of Chinese-made goods in non-oil imports of the United States is noteworthy. During January-November the share of U.S. imports from China grew 1.7 percentage points whereas that corresponding to Mexico did so in only 0.2 percentage points. Furthermore, the competitiveness indicators for the Mexican economy calculated by several institutions reveal a decline in the last years.

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Just as in past quarters, the rise in the annual inflation of the subindex of prices administered and regulated by the public sector is explained by the increase in administered prices, mainly those pertaining to residential electricity and domestic gas.

During October, November and December electricity tariffs registered monthly increases of 4.93, 16.81 and 0.85 percent, much higher than those observed during the same months of 2001. Thus, the rise in tariffs of electricity for residential use determined by the Federal Government in January of 2002 resulted in higher headline inflation from February onwards. In addition, the price of domestic gas increased at a monthly rate of 6.70, 1.25 and 2.26 percent during October, November and December.

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During October-December of 2002 the annual inflation of the subindex of agricultural prices went up 6.27 percentage points. This is attributed mainly to the increase in the annual inflation of fruits and vegetables.

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In conclusion, the price behavior of prices in a reduced number of non-core goods hindered the attainment of the inflation target in 2002. If prices administered and regulated had grown at an annual rate of 4.5 percent, CPI inflation in December would have ended in 4.6 percent.

Monetary Policy During the Fourth Quarter of 2002

On December 6, 2002 the level of the “short” was raised from 400 to 475 million pesos. This monetary policy measure, like the increase in

the “short” from 300 to 400 million pesos adopted at the end of September, was taken with a forward looking approach. The decision to tighten monetary policy responded to the following motives: to induce a downward movement in inflation expectations in the medium run and foster the monetary conditions necessary so that annual increases in consumer prices converge with the inflation target of 3 percent for 2003.

Domestic interest rates increased in the days following the monetary policy action. The upward movement took place differentially according to the maturity of the instrument. Thus, during the mentioned quarter, although nominal and real interest rates decreased in line with the improvement in country-risk perceptions, the decline was smaller than that suggested by the historical relationship of both variables. The latter is attributed to the intensification of the monetary restriction during the last months of the year.

Monetary and Credit Aggregates

By the end of 2002 the stock of the monetary base was 263.9 thousand million pesos, indicating an annual increase of 17 percent and a remonetization of 9.5 percent. Compared to the forecast published in the Monetary Program, base money posted a year-end deviation of 6.4 percent. (4.6 percent on average during the year).

During the fourth quarter of 2002, the stock of net international assets of Banco de México rose 3.985 billion US dollars, ending the year at a level of 50.722 billion.

Although the annual variation of bills and coins remained relatively stable during the fourth quarter of 2002, the real growth rate of M1 in domestic currency fell from 13.3 to 8.1 percent during the second semester. Particularly, the increase in checking accounts in domestic currency slowed down significantly.

Likewise, the growth rate of the broad monetary aggregate M2 declined markedly throughout 2002 (annual real increase of 5.6 percent in December). This is mostly explained

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by the fall in the yield of domestic financial instruments.

During the second half of 2002, the stock of performing credit granted by commercial banks to the private sector experienced a slight upturn. Nonetheless, total financing to the private sector currently accounts for only 11.7 percent of GDP, its lowest level since 1989.

Private Sector Outlook for 2003

During October-December of 2002, private sector analysts revised their forecasts on the main macroeconomic variables for 2003 as follows: lower GDP growth and higher inflation.

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Private sector financial analysts estimate GDP in the United States will expand at an annual rate of 2.7 percent. They also reduced their estimates for real GDP growth in Mexico in 2002 and 2003, from 1.6 to 1.1 percent and from 3.8 to 3.2 percent, respectively.

Estimates for the exchange rate at the end of 2003 were modified upward. Compared to December 2002, a slight decline in nominal increases in contractual wages in January and February of 2003 is also expected.

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Forecasts for monthly inflation in January, February and March of 2003 were 0.59, 0.30 and 0.33 percent, respectively. As for year-end annual inflation, estimates went from 3.96 percent in September to 4.21 in December. Expectations regarding core inflation at year-end 2003 were 3.48 percent.

Monetary Program for 2003

Elements of the Monetary Program

The main components of the Monetary Program for 2003 are:

- (a) The inflation target;
- (b) The framework for the implementation of monetary policy;
- (c) The framework for the analysis of the economic situation and inflationary pressures; and

- (d) The policy for communicating with the public.

The long-term objective is to attain from December 2003 onwards an annual inflation of 3 percent. This target was established along with a variability interval of plus/minus one percentage points.

The challenge for monetary policy throughout 2003 will be centered on the evolution of the core inflation of services. Banco de México estimates that from the second quarter of 2003 on non-core inflation will begin to converge rapidly towards core inflation levels. This, along with a gradual decline in core inflation will place consumer prices in a path consistent with the 3 percent target by the end of 2003.

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Monetary policy in Mexico is conducted in an environment where the exchange rate and interest rates are determined freely in the financial markets.

In some occasions the interest rate determined by the market may not be consistent with the attainment of the inflation targets. In such circumstances, Banco de México would tighten the stance of monetary policy by increasing the “short”.

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The monetary policy actions implemented by the Central Bank influence the behavior of prices with a considerable lag and a high level of uncertainty. Therefore, in order to attain its objectives, the monetary authority bases its decisions on a very careful and continuous assessment of inflationary pressures. This analysis is made public via the different publications of Banco de México.

Outlook for 2003 and Balance of Risks

Following is a forecast of the external conditions and of the path of the main macroeconomic variables of Mexico in 2003. The elements of risk that are foreseen are also outlined. Should they materialize, the expected base scenario would indeed be affected.

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Forecasts regarding the consolidation of an upturn in economic activity in the United States in 2003 are based on the following factors:

- (a) The significant monetary and fiscal measures implemented in 2002 oriented to prompt a more vigorous recovery of economic activity;
- (b) The soundness of the fundamentals of the United States economy during the phases of downturn and slow recovery in 2001 and 2002, respectively; and
- (c) The fact that inflationary pressures in the United States are currently under control.

The world economy is also expected to recover after the second quarter of 2003.

The reference scenario is subject to risks among which the following deserve mention:

- (a) The possibility that the war could turn out to be more complicated than expected;
- (b) The weakness of the labor market in the United States is a factor of vulnerability that forestalls the upturn in consumption;
- (c) The negative effects on consumption of an increase in the personal savings rate due to the loss of wealth;
- (d) The lag in the recovery of investment spending and new hires by companies; and
- (e) The harmful effects a sudden correction of the external disequilibria in the United States economy could have on the international financial markets.

According to the base scenario, an eventual war between the United States and Iraq will have moderate and transitory effects on the price of oil. Notwithstanding, the evolution of oil prices will be subject to a high degree of uncertainty.

The future course of the Mexican economy during 2003 will be strongly conditioned by the following factors:

- (a) The pace of the recovery of the U.S. economy, especially of its industrial sector, and the intensity with which this recovery is transmitted to the industrial and export sectors in Mexico;

- (b) The evolution of oil prices;
- (c) The conditions of external financing for Mexico; and
- (d) The advance in the agenda of pending structural reforms required by the Mexican economy.

Based on the described scenario and on available information on the evolution of the economy in the fourth quarter of 2002, Banco de México prepared the following forecasting exercise of the main macroeconomic variables for 2003:

Economic Growth: The annual change of GDP will be approximately 3 percent.

Employment: Since increases in contractual wages have eased only slightly, the recovery of economic activity will not be accompanied by a substantial improvement in employment.

Current Account: In light of estimates that foresee that the initial impulse for GDP expansion will originate from the external sector, the recovery of domestic spending will only induce a modest widening of the current account, which will reach nearly 3 percent of GDP.

Inflation: As for the expected path of CPI inflation and its subindexes, the following developments are noteworthy:

- (a) Headline inflation will likely converge towards core inflation and the inflation target in the second quarter.
- (b) Inflation of the core subindex of tradable goods will very unlikely experience further reductions in 2003 given the low levels it has already reached; and
- (c) The path of inflation of the non-core subindexes is subject to a large degree of uncertainty. As seen in 2002, it is crucial that the setting of administered and regulated prices be in line with the inflation target.

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The base scenario reveals an unusual degree of uncertainty due to the presence of several risks. Among the external ones are:

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- (a) A slower than expected recovery of the United States economy or, in an extreme case, another recession; and
- (b) A contraction of capital flows to the emerging economies, especially to Latin American countries.

The main domestic risks that could affect the base scenario are:

- (a) Slow progress in the implementation of structural reforms in 2003 could lead to downward revisions in growth expectations in the medium and long terms;
- (b) The absence of the downward inflection in wage increases needed to induce a significant fall in the core inflation of services;
- (c) A more moderate than expected job creation in the formal sector of the economy;
- (d) A significant recovery in the intensity of the passthrough of fluctuations in the exchange rate to prices.

The lack of progress in the agenda of structural reforms required by the Mexican economy has negative effects on domestic and foreign investment and at the same time jeopardizes the future growth of productivity, employment and real wages. Besides, such delay limits the country's economic capacity to generate

domestic sources of growth and prevents the authorities from implementing countercyclical policies, which are extremely important in the context of a weak world economy.

The latter, together with the worsening of the perception on the soundness of public finances in an environment of slower than expected growth, could make the Mexican economy vulnerable to episodes of speculative pressures that could threaten the recovery of growth.

During the following months the Board of Governors of Banco de México will continue to assess carefully the behavior of the main determinants of inflation. Based on these considerations and on short and long-term inflationary pressures that might be identified, the Board will timely determine the monetary policy actions deemed necessary to attain the inflation target for 2003 and the coming years.

Final Remarks

The forecasts presented in this document point to an upturn of economic activity in 2003. Nonetheless, growth and job creation will be modest. Under such scenario it is worth stressing the importance of resuming, as soon as possible, the modernization process of the country's economic structure in order to improve in a significant and lasting manner the well-being of the population.