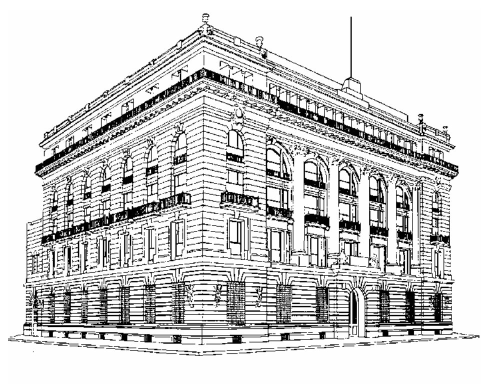
Inflation Report

April – June 2004



BANCO DE MEXICO

JULY 2004

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FOREWARNING

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

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I. Introduction

The recovery of the world economy continued during the second quarter of 2004. U.S. industrial production gained strength through a greater number of divisions and is expanding at a higher rate than that of GDP. Thus, the outlook for industrial production remains optimistic for the second half of 2004 and for 2005.[1] On another front, the vigorous recovery in expenditure, together with the persistent increases in different commodity prices (energy goods, among others), have led to an upward revision in inflation expectations.

These factors have brought international interest rates up, while the Federal Reserve has began to revert the monetary accommodation prevailing over the last years.

The Federal Reserve actions to tighten monetary policy has affected investors' attitude in international markets and, consequently, asset prices and interest rate spreads. Such process of portfolio rebalancing has taken place in an environment of lower appetite for risk, which has been reflected in a decline in prices of those type of assets.

This has raised both the level and volatility of interest rate spreads in emerging economies, therefore deteriorating their financing conditions.

The magnitude of such adjustment is partly explained by the reversion of the significant fall in interest rate spreads due to the slackened monetary conditions prevailing in international markets. In the recent past, higher liquidity conditions led to greater appetite for risk and fostered the purchasing of higher short-term risk assets at a low cost.

Consequently, the change to tighter monetary conditions worldwide; i.e., higher interest rates, has reverted investors' attitude in international markets, which, in turn, has led to an unleverage process in international financial markets. So far, this has taken place in a relative orderly manner.

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[1] Such outlook prevails despite the fact that in June several data suggesting a decline in production were released. Most analysts agree that such results were due to atypical factors.

Given Mexico's strong integration to international goods and capital markets, the economy cannot decouple from the new global financial conditions. As a result, domestic interest rates have risen significantly while the exchange rate has been subject to certain pressures.

Nonetheless, the influence on both interest rates and the exchange rate has been mitigated by the significant increase in oil revenues and in workers' remittances. Both of them have provided ample resources to the economy. In light of these developments, the Mexican economy has continued to gain strength. This has also been influenced by consumption growth and the recent recovery in investment. In addition, the increase in non-oil exports has also reactivated industrial and manufacturing production.

Robust economic activity has translated into higher job creation. Since October 2002, the total number of workers insured by the IMSS with seasonally adjusted data has exhibited positive monthly variations.

On the inflation front, one of the main challenges stems from the persistent increases in different commodity prices, associated with both the cyclical recovery of the world economy and geopolitical uncertainty, and its effects on the future supply conditions of several energy goods. The main commodities affected by such conditions have been the following:

(a) Food, mainly grains and livestock goods.

(b) Metal products (steel, copper, rod, aluminum, etc.).

(c) Energy goods (particularly gas, and crude oil and its by-products).

Commodity price increases have affected production costs of different goods and services directly and, consequently, producer prices. Moreover, such supply shocks have also affected several items of the Consumer Price Index (CPI), especially the food component of the core merchandise subindex and goods with prices administered by the public sector of the non-core subindex.

Despite the recovery of the different components of aggregate demand, there are still no signs of significant inflation pressures from these sources. This is due, among other factors, to the extended period in which the Mexican economy grew below its potential. Nonetheless, if expenditure continues recovering at the same pace, inflation pressures from this source cannot be discarded in the future.

The fact that the economy is undergoing its cyclical recovery enables external supply shocks to pass on to consumer prices more easily and therefore contaminate inflation expectations.

Given the aforementioned environment, conditions surrounding inflation have become more unfavorable. As a result, inflation expectations for the next twelve months have been revised upward in the last weeks while those for the medium and long terms remain above the inflation target. Accordingly, the Board of Governors of Banco de México has taken actions to tighten its monetary stance.

In the following months monetary policy will face significant challenges, such as:

(a) Restraining the effects of price increases in commodities to inflation expectations.

(b) Containing any cyclical pressures on inflation that could originate from the current strength in aggregate demand.

(c) Fostering an orderly adjustment of the economy to global financial conditions characterized by higher interest rates.

Such challenges are associated with an environment of unstable inflation, which is reflected in monetary policy's current restrictive stance.

II. Inflation Report April-June 2004

II.1. Recent Developments in Inflation

At the end of the second quarter of 2004, annual CPI inflation was 4.37 percent, 0.14 percentage points above its level in March. Such results are partly attributed to the increase in several commodity prices, which began in 2003 and intensified in 2004. These shocks add to those that affected livestock goods at the beginning of the year, which originated from import restrictions on several meat products.

The increase in some commodity prices has created inflation pressures worldwide, particularly in food, metal products and energy goods. This phenomenon is associated with the cyclical recovery of the world economy and, particularly, with China's vigorous expansion. Moreover, it also related with geopolitical uncertainty and its effects on the future supply of different energy goods.

Price increases in these commodities have affected production costs of different goods and services directly and, consequently, producer prices. Moreover, such supply shocks have also affected several items of the Consumer Price Index (CPI). In this regard, the following deserves mention:

(a) The higher prices in several food commodities have mainly affected livestock goods included in CPI's non-core component and several processed foods of the merchandise core subindex.

(b) The increase in metal commodities has affected housing construction costs and, therefore, services core inflation.

(c) The increase in fuels' references raised significantly the prices of goods and services administered by the public sector (gas, gasoline at border cities, and electricity).[2]

The aforementioned inflation pressures were partially offset by the significant decline in prices of fruits and vegetables.

2 Gasoline prices at border cities are adjusted every week based on prices observed at the towns/cities closest to the other side of the border. In the rest of the country, such prices are adjusted according to a price increase fixed at the beginning of the year.

The downward path followed by annual core services inflation (excluding housing) suggests an absence of significant pressures from aggregate demand.

Nonetheless, the strength of aggregate demand could make external supply shocks affect inflation expectations.

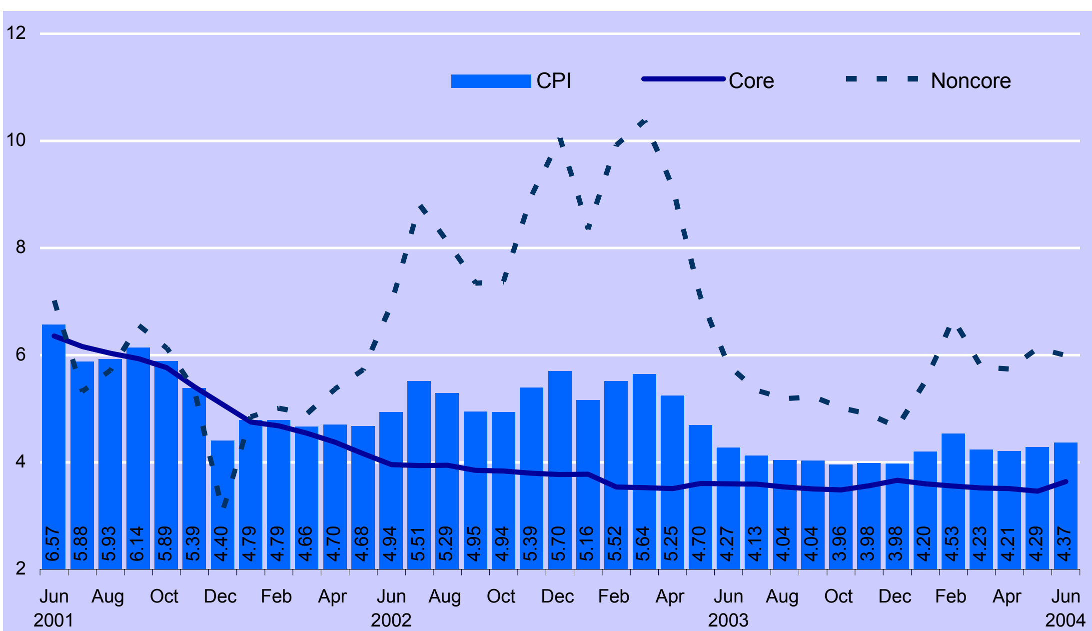
II.2. Inflation Indicators

II.2.1. Annual Inflation

At the end of the second quarter of 2004, annual CPI inflation was 4.37 percent compared with 4.23 percent at the end of the previous quarter. Such rise was mainly due to the persistent increase in different commodity prices, which affected the CPI's core and non-core components. In June, annual core inflation was 3.64 percent, 0.12 percentage points above that exhibited at the end of the previous quarter, while annual non-core inflation stood at 5.99 percent, 0.21 percentage points above that in March (Graph 1).

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

Annual percentage change



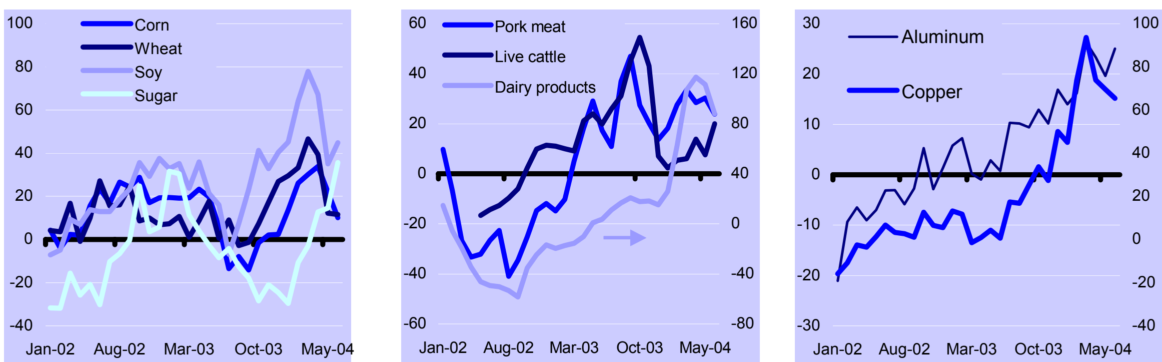
Prices of different commodities began to rise in 2003, escalating in some products in the first half of 2004 (Graph 2). Such developments generated the following inflation pressures:

(a) The higher prices in several food commodities have affected both core and non-core inflation.

Regarding the former, inflation pressures intensified during the quarter, making the food component of the merchandise price subindex rise from an annual rate of 5.12 to 5.83 percent between March and June. This largely explains the increase in the merchandise price subindex during the same period, from 2.78 to 3.26 percent (Table 1).

Graph 2 **Commodity Prices**

Annual percentage change



Sources: U.S. Department of Agriculture (USDA), International Coffee Organization, Coffee, Sugar, and Cocoa Exchange (CSCE), and Metal Bulletin.

As for the latter, the effect of said pressures on livestock goods included in the non-core subindex was mitigated by the gradual reversion of the shocks that affected these products at the beginning of the year. The reduction of trade restrictions on meat imports and the increase in the stock of egg-producing poultry contributed to such process. As a result, the annual variation in livestock good prices dropped from 12.50 to 10.55 percent as compared with March.

It is important to underline that in Mexico CPI inflation is more affected by price increases in food, when compared with other economies, due to the high weight that this item has in the CPI (Box 1).

Box 1
Incidence of Agriculture and Food Prices Inflation in Mexico and the U.S.

Increases in some commodity references have affected agriculture prices in Mexico and the U.S., despite the fact that the decline in fruits and vegetables' prices partially offset the increase in livestock goods' prices. Although inflation by items is very similar in both countries, Mexico has been affected the most because agriculture goods have a higher weight in Mexico's CPI. As shown in Table 1, both countries exhibited very similar annual inflation in March and June 2004. Nonetheless, since agriculture prices have a higher weight in Mexico's CPI, their incidence is higher in this country.

Agriculture goods account for 8.07 percent of Mexico's CPI, while in the U.S. they only equal 2.91 percent. Agriculture goods have a higher weight in Mexico's CPI because they account for most of expenditure in this country, in contrast with the U.S. In order to have a better grasp of such differences, the last columns of Table 1 show inflation's incidence on agriculture products in Mexico using the corresponding weights of the U.S. CPI. Agriculture goods' incidence in June would have thus been of only 0.10 percentage points, compared with the 0.26 percentage points observed.

Table 1: Incidence of Non-core Agriculture Prices Inflation in Mexico and the U.S.

	U.S. Annual Inflation		Weight in U.S. CPI	Incidence in U.S. CPI		Mexico's Annual Inflation		Weight in Mexico's CPI	Incidence in Mexico's CPI		Incidence using U.S. CPI weights	
	March	June		March	June	March	June		March	June	March	June
Beef steak	13.84	21.08	0.29	0.04	0.06	13.18	14.94	1.14	0.15	0.17	0.04	0.04
Ground beef	12.22	13.00	0.27	0.03	0.03	16.46	15.80	0.57	0.09	0.09	0.04	0.04
Eggs	33.22	10.09	0.12	0.04	0.01	32.90	13.01	0.53	0.19	0.08	0.04	0.02
Tomato	-0.07	0.00	0.10	0.00	0.00	-15.66	-17.32	0.50	-0.07	-0.08	-0.01	-0.02
Potato	1.32	2.59	0.08	0.00	0.00	15.58	-24.37	0.23	0.03	-0.06	0.01	-0.02
Apple	8.38	3.47	0.09	0.01	0.00	5.28	7.73	0.21	0.01	0.02	0.01	0.01
Banana	-5.50	-0.54	0.08	0.00	0.00	3.70	5.30	0.18	0.01	0.01	0.00	0.00
Whole chicken	6.47	10.43	0.33	0.02	0.03	2.76	2.64	0.15	0.00	0.00	0.01	0.01
Porkchops	5.97	9.72	0.10	0.01	0.01	9.90	16.55	0.14	0.01	0.02	0.01	0.02
Orange	4.48	-0.06	0.09	0.00	0.00	-5.72	-29.38	0.14	-0.01	-0.05	0.00	-0.03
Lettuce and cabbage	8.70	-16.65	0.07	0.01	-0.01	0.50	-15.93	0.05	0.00	-0.01	0.00	-0.01
SAMPLE *	9.62	9.04	1.60	0.15	0.14	10.57	4.94	3.85	0.43	0.19	0.15	0.06
AGRICULTURE GOODS	7.70	5.54	2.91	0.22	0.16	6.46	3.24	8.07	0.54	0.26	0.19	0.10

* Sample includes CPI's noncore agriculture items that are similar to those of the U.S. CPI. Eleven out of the 55 items that make up such subindex are included (8 items that could integrate such subindex are excluded from the U.S. CPI). Totals may not add due to rounding.

The increase in commodity prices has also translated into higher inflation of food prices included in Mexico's CPI's non-core subindex. Nonetheless, just as with agriculture prices, price increases in certain food items has affected U.S. CPI inflation only slightly due to the low weight of food items on such index. Annual inflation in the U.S. and Mexico, their weights by index, and their respective incidences is shown in Table 2. As can be observed, annual food inflation in the U.S. rose from 1.58 to 2.93 percent between March and June, while in Mexico it did so from 5.12 to 5.83 percent.

U.S. annual food inflation rose 1.64 percentage points between March and June, while its incidence did so from 0.10 to 0.20 percentage points. Mexico's annual food inflation rose 0.71 percentage points, while its incidence in CPI inflation did so from 0.74 to 0.85 percentage points. The last two columns of Table 2 show the incidence of core food inflation in Mexico using the corresponding weights of the U.S. CPI. Food's incidence in June would have thus been of 0.34 percentage points, compared with the 0.85 percentage points observed.

Table 2: Incidence of Non-core Food Prices Inflation in Mexico and the U.S.

	U.S. Annual Inflation		Weight in U.S. CPI	Incidence in U.S. CPI		Mexico's Annual Inflation		Weight in Mexico's CPI	Incidence in Mexico's CPI		Incidence using U.S. CPI weights	
	March	June		March	June	March	June		March	June	March	June
Cereals	-2.73	-0.73	0.23	-0.01	0.00	0.14	-0.06	0.26	0.00	0.00	0.00	0.00
Rice, pasta and corn flour	2.76	2.29	0.13	0.00	0.00	9.88	13.49	0.32	0.03	0.04	0.01	0.02
Wheat flour and dough	-1.11	-1.11	0.05	0.00	0.00	9.28	9.06	0.03	0.00	0.00	0.01	0.00
Bread, cookies and pastries	2.43	2.31	0.79	0.02	0.02	8.91	9.90	1.11	0.10	0.12	0.07	0.08
Cheese	3.52	10.76	0.25	0.01	0.03	4.82	7.35	0.59	0.03	0.04	0.01	0.02
Milk	5.68	27.10	0.32	0.02	0.09	5.87	6.16	2.03	0.12	0.13	0.02	0.02
Ice cream	-2.28	4.73	0.15	0.00	0.01	2.68	3.97	0.05	0.00	0.00	0.00	0.01
Other milk products	2.09	8.13	0.13	0.00	0.01	-1.11	0.25	0.31	0.00	0.00	0.00	0.00
Processed fruits and vegetables	1.58	-0.09	0.26	0.00	0.00	6.48	4.83	0.08	0.01	0.00	0.02	0.01
Non-alcoholic juices and beverages	0.56	0.09	0.63	0.00	0.00	1.21	0.18	1.96	0.02	0.00	0.01	0.00
Coffee and beverage concentrates	-0.20	-1.12	0.28	0.00	0.00	1.98	1.21	0.23	0.00	0.00	0.01	0.00
Sugar and candies	0.49	0.06	0.31	0.00	0.00	13.73	11.64	0.31	0.04	0.04	0.04	0.04
Fats and oils	5.52	9.48	0.25	0.01	0.02	16.86	19.08	0.34	0.06	0.07	0.04	0.05
Alcoholic beverages	1.92	2.53	0.64	0.01	0.02	0.36	1.18	2.20	0.01	0.02	0.00	0.01
Processed fish and seafood	1.05	-0.47	0.13	0.00	0.00	6.36	8.77	0.17	0.01	0.02	0.01	0.01
Cold meats	3.39	3.01	0.24	0.01	0.01	3.45	7.93	0.91	0.03	0.07	0.01	0.02
Other	0.95	0.22	1.21	0.01	0.00	4.83	4.00	0.25	0.01	0.01	0.06	0.05
SAMPLE *	1.63	3.27	5.99	0.10	0.20	4.27	5.04	11.17	0.48	0.57	0.31	0.34
FOOD	1.63	3.27	5.99	0.10	0.20	5.12	5.83	14.67	0.74	0.85	0.31	0.34

* Sample includes CPI's core merchandise subindex items that are similar to those included in the U.S. CPI. Fifty four from the 67 items that make up such subindex are included. Totals may not add due to rounding.

(b) The increase in the housing subindex's annual variation (0.13 percentage points between March and June) stemmed from international price increases in different metal products for residential construction (Graph 3).[3]

(c) International price increases in energy goods' affected the items of the subindex of prices administered by the public sector (gas, electricity and gasoline), which exhibited an annual variation of 8.35 percent at the end of the quarter, 3.19 percentage points above its level in March.[4] This factor largely accounted for the climb in annual non-core inflation during the period (0.21 percentage points).

Table 1 **Annual Variation in CPI and Main Components**

Percent and percentage points

	Mar-2004/ Mar-2003 Variation	Mar-2004/ Mar-2003 Contribution 3/	Jun-2004/ Jun-2003 Variation	Jun-2004/ Jun-2003 Contribution 3/
CPI	4.23	4.23	4.37	4.37
Core	3.52	2.42	3.64	2.52
Merchandise	2.78	1.00	3.26	1.18
Food	5.12	0.74	5.83	0.85
Other	1.20	0.26	1.52	0.33
Services	4.35	1.41	4.07	1.33
Housing	4.00	0.71	4.13	0.74
Other	4.79	0.70	3.98	0.59
Noncore	5.78	1.82	5.99	1.85
Agriculture	6.46	0.54	3.24	0.26
Fruits and Vegetables	-2.15	-0.07	-7.60	-0.25
Tomato	-15.66	-0.07	-17.32	-0.08
Green tomato	105.85	0.10	-19.60	-0.02
Other 1/	-3.66	-0.11	-5.49	-0.15
Other Agriculture	12.50	0.61	10.55	0.51
Egg	32.90	0.19	13.01	0.08
Other 2/	9.70	0.42	10.20	0.44
Education	8.20	0.45	8.45	0.47
Regulated and Concerted	4.71	0.83	6.51	1.12
Regulated	5.16	0.44	8.35	0.67
Low-octane gasoline	3.11	0.10	6.68	0.21
High-octane gasoline	4.95	0.02	8.26	0.04
Electricity	6.50	0.18	8.86	0.21
Gas LP	6.46	0.13	10.25	0.22
Concerted	4.29	0.39	4.92	0.45

1/ Includes other fruits and vetetables.
2/ Includes beef, poultry, fish, pork, and other meats.
3/ Figures may not add up due to rounding.

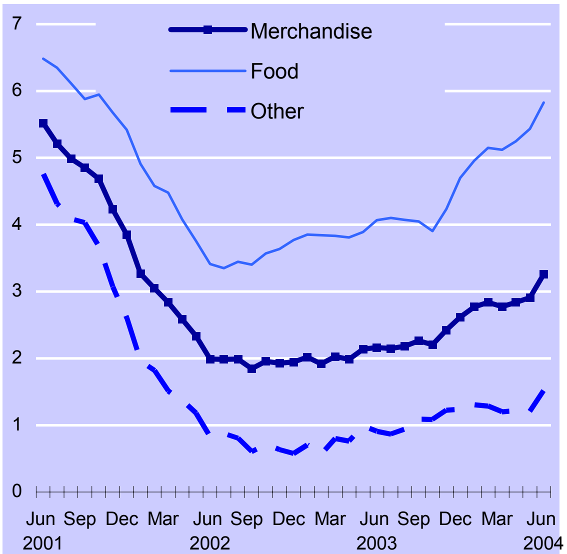
[3] CPI's item privately-owned housing is constructed using three levels of household monthly income: up to three minimum wages, from three to six minimum wages, and more than six minimum wages. Household costs for the first level of income are based on the residential construction cost index *(Índice del Costo de la Construcción Residencial, ICC)*. Household costs for the second and third levels of income are obtained from a sample of house rents.

[4] Gasoline prices at border cities are adjusted every week based on the prices observed at the towns/cities closest to the other side of the border. In the rest of the country, such prices are adjusted according to a price increase fixed at the beginning of the year.

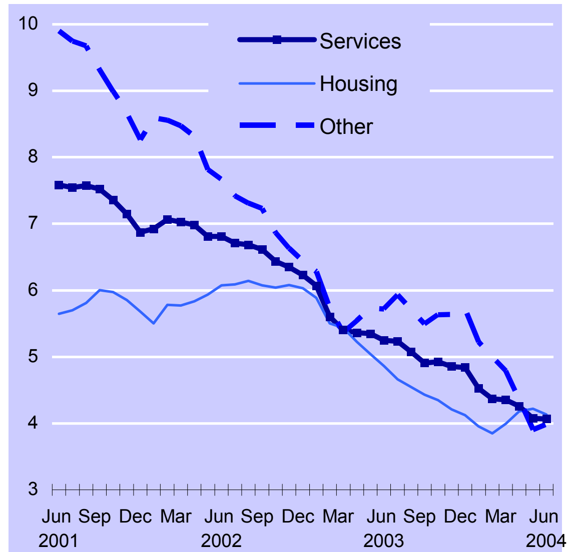
Graph 3 **Core Price Indexes (Merchandise and Services)**

Annual percentage change

a) Merchandise



b) Services



The aforementioned inflation pressures were partially offset by the decline in prices of fruits and vegetables during the quarter (Graph 4). During the analyzed period, fruits and vegetables' contribution to annual inflation fell from -0.07 to -0.25 percentage points (Table 1).[5]

The downward path followed by annual core services inflation (excluding housing) suggests an absence of significant pressures from aggregate demand. Between March and June of 2004, the annual variation of such indicator fell from 4.79 to 3.98 percent. This reduction more than compensated the pressures on the housing subindex. Thus, during the mentioned period, total core services inflation dropped from 4.35 to 4.07 percent (Table 1).

In order to evaluate the outlook for inflation in the coming months, the likely behavior of commodity prices must be analyzed. One of the main factors explaining commodity price increases is the higher demand for this type of goods, due to the vigorous expansion of the world economy, particularly the Chinese economy. Therefore, if the Chinese economy grows at a rate more consistent with its long-term potential, international prices are likely to stabilize (Box 2). This effect could also be reinforced by an increased supply of commodities originated by the higher prices.

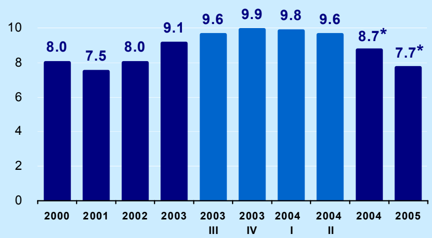
[5] Items tomato and green tomato contributed the most to such results due to their high weight in the CPI and the significant reduction in their prices.

Box 2
China's Economic Growth and Commodity Prices

The Chinese economy has undergone significant changes that have allowed it to grow robustly for a long period. Nonetheless, such dynamism has generated problems, which have recently worsened and, in turn, affected the world economy. The expansion of the Chinese economy has raised the demand for raw materials (commodities) significantly, including energy-related goods (fuels), prompting an increase in their international references and, consequently, affecting other economies. In a certain way, China has recently exported inflation to other countries.

China has become a development center that is changing the international labor division and also trade and capital flows worldwide. In the last years, its contribution to world economic growth (measured through purchasing power parity) has surpassed that of the U.S. According to its size, the Chinese economy is the sixth economy in the world (the second one according to purchasing power parity) and, nowadays, it is the world's main recipient of foreign direct investment. China's development into a main world exporter partly reflects that it has become a production center for Asian economies' foreign trade.

Graph 1
China: GDP Growth
Annual percentage change



*/ Asia Pacific Consensus Forecasts, July 12, 2004.

Chinese economic expansion has been based on an enormous low-paid labor force (744 million workers). Such dynamism has created new employment opportunities. However, the modernization of the public sector and the privatization of many public enterprises have left many workers unemployed. Such condition, together with the new entrants to the labor force, constitutes a significant pressure to continue growing at the same rate.

Table 1
China: Selected Economic Variables
Annual percentage changes

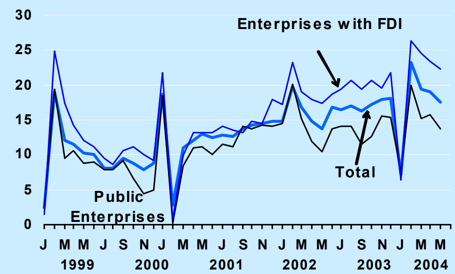
	2000	2001	2002	2003	2004*	2005*
Real GDP	8.0	7.5	8.0	9.1	8.7	7.7
Industrial Production	11.4	9.9	12.6	17.0	15.4	12.7
Consumer Prices	0.4	0.7	-0.8	1.2	3.6	3.5
Industrial Goods' Prices	2.8	-1.3	-2.2	2.3	4.0	2.7
Monetary Supply, M2[1]	12.3	17.6	16.9	19.6	17.4	15.7
1-year Lending Rate for Capital Work[1]	5.9	5.9	5.3	5.3	5.6	6.1
Trade Balance[2]	24.1	22.5	30.4	25.5	6.3	3.5

1 At end of period.
2 Billion US dollars.
* Asia Pacific Consensus Forecasts, July 12, 2004.

China's entrance into the World Trade Organization in November 2001 created new opportunities in international financial markets for this country, therefore boosting its growth. In the first and second quarters of 2004, the Chinese economy grew at an annual rate of 9.8 and 9.6 percent, respectively (Graph 1). The latter figure was below that projected by Asian Pacific Consensus Forecasts (10.2 percent) but still above the Chinese government's target established at the beginning of the year (7.5 percent for the entire 2004). More recent forecasts indicate that GDP will grow 8 percent in the second half of this year.

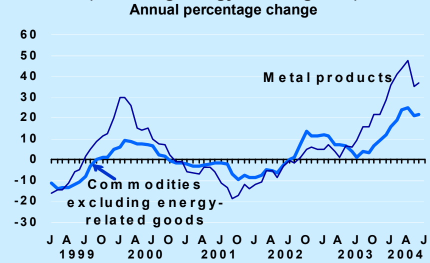
Investment has played a key role in the rapid expansion of the Chinese economy. Fixed investment rose at an annual rate of 24.5 percent in 2003, and of 28.6 percent in the first half of 2004. Cement, aluminum, and iron industries have recorded the highest growth.

Graph 2
China: Industrial Production
Annual percentage change



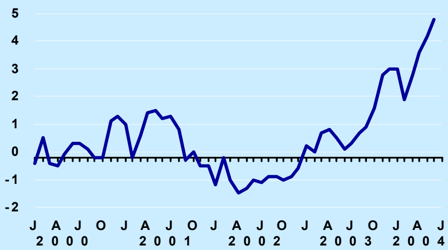
During the last years, Chinese growth has relied on a highly intensive consumption of raw materials and energy-related goods. In 2003, China was the world's main consumer of steel (25 percent of total world steel consumption) and the second of crude oil, after the U.S. (7 percent of total world consumption). In that same year, China accounted for 10 percent of world electricity consumption, 30 percent of world coal consumption, and 50 percent of world cement consumption. In fact, such economy is expected to consume nearly 20 percent of raw materials traded worldwide. China's dependence on international markets to guarantee its supply of raw materials, together with the rapid growth of its economy, has pushed commodity references up.

Graph 3
World Commodity Prices
(Excluding energy-related goods)
Annual percentage change



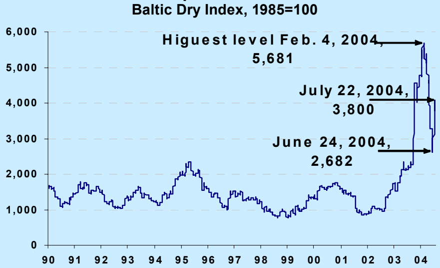
China's high demand for primary commodities and energy-related goods has continued in 2004, therefore making their international references increase (Graph 3). Thus, the Chinese economy has been subject to inflation pressures. In the first half of 2004, consumer prices in China rose at an annual average rate of 3.6 percent (4.4 and 5 percent in May and June), while producer prices did so at an annual rate of 4.7 percent (Graph 4). Prices of raw materials, energy-related goods and electricity rose 9.8 percent in the same period. Nonetheless, in mid-June, China's Bureau of Statistics stated that prices' upward trend had partly weakened.

Graph 4
China: CPI Inflation
Annual percentage change



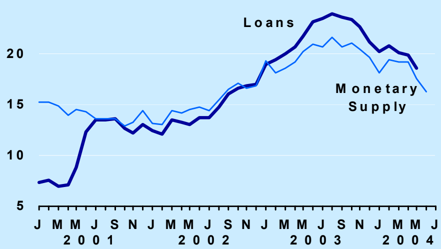
Chinese exports and imports have increased rapidly, raising the demand for sea transportation and, therefore, sea transportation costs. Nonetheless, such costs have been affected by other factors as well. In this regard, the recovery of the world economy has also raised the demand for transportation. The Baltic Dry Index, an international measure of sea bulk loading costs, rose from nearly 1,000 points in September 2002 to a maximum level of 5,681 points in February 2004, and then declined to 3,800 points (Graph 5). Higher sea transportation costs have translated into higher inflation worldwide, as inflation has passed on to all importer countries. Although China has helped to contain international prices of manufactured goods in the last decade by increasing their supply, recently it has created inflation in both commodity and transportation international markets.

Graph 5
Sea Transportation Cost Index
Baltic Dry Index, 1985=100



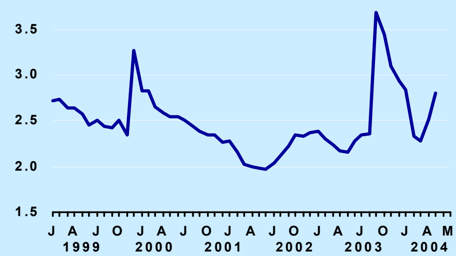
The Chinese economy overheating, which rests on the rapid growth of investment and GDP, has limited the supply of certain production inputs such as coal, crude oil, electricity, and also created transportation problems. The Chinese government has avoided making severe adjustments to prevent higher investment-related growth as these would jeopardize the country's future growth and worsen other problems such as public banks' high level of overdue portfolio.

Graph 6
China: Monetary Supply (M2) and Stock of Performing Loans Granted by Financial Institutions
Annual percentage change



Consequently, in mid-2003 the Chinese government adopted measures to prevent the economy from overheating. Some of these, such as establishing direct public bank lending restrictions in sectors that might have excess capacity in the medium term, are not market oriented. Lending for construction of government buildings and large department stores, among others, has also declined. In addition, capital needs for investment in certain sectors such as the steel, aluminum, and cement industries have increased. In contrast, commercial banks have been encouraged to support investment in sectors with supply restrictions such as the electricity, oil, coal, and water supply industries, and in transportation.

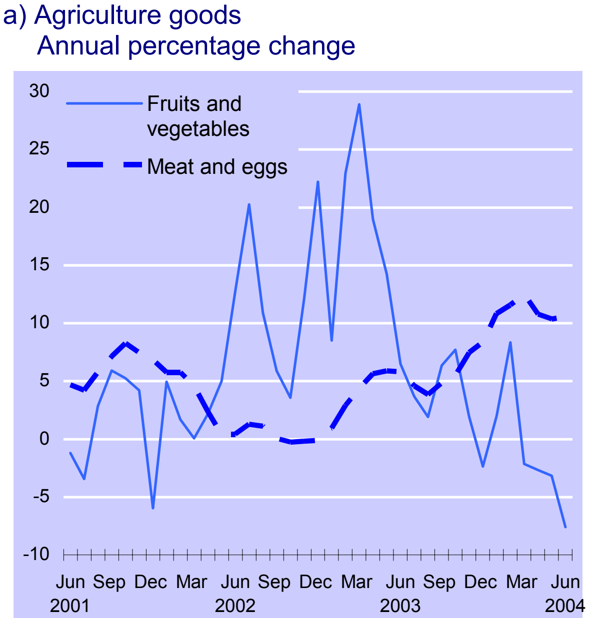
Graph 7
Chinese Government 90-day Bonds
Interest Rate

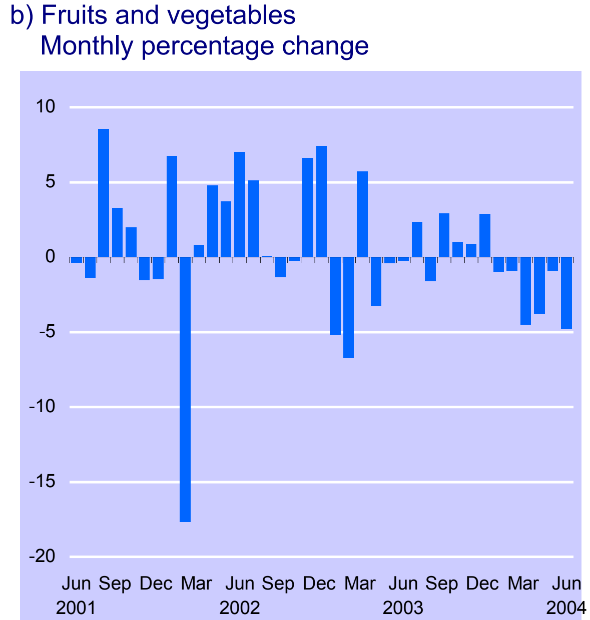


Additional measures have been implemented to slow down investment such as having more rigorous controls on the fiscal deficit and on money-supply growth. Regarding the latter, banks' reserve requirements were raised while a major boost was given to placements of government bonds. As a result, the yield on such bonds began to increase at the end of 2003 and at the beginning of 2004. Government-security repo operations have also been used to reduce liquidity. Nonetheless, despite the risk of economic overheating, the government's fear of inducing further adjustments seems to have driven it to relax some of its policies (excluding exchange rate policies) in the last weeks.

Initial restrictive measures apparently were not bearing the expected results, as growth in investment, GDP, and imports remained at very high levels in the first quarter of the year. This was reflected in some local and provincial authorities' resistance to stop investing. Nonetheless, certain indicators have revealed that lending and investment have increased at a slower rate in the last months. Furthermore, foreign trade figures for May and June indicate that merchandise imports have started to slow down, as imports of some metals such as steel, iron and copper have started to decrease. Thus, the trade balance for May and June recorded a surplus, while from January to April it had exhibited a deficit. Such trend could eventually reduce pressures on the international references of many commodities and on transportation costs. Nevertheless, despite the favorable results of such indicators, Chinese imports are still very high, and up to date, economic analysts have not revised downward their forecasts for growth in this country. On another front, the higher demand of the U.S., Japanese and Euro economies is a factor that could continue pressuring both commodities international references and transportation costs.

Graph 4 **Agriculture Price Subindex**

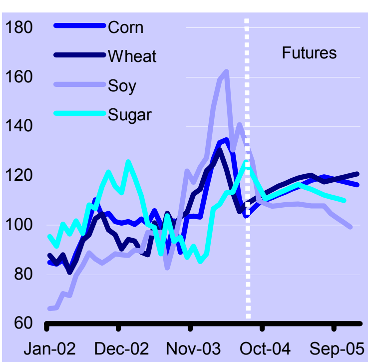


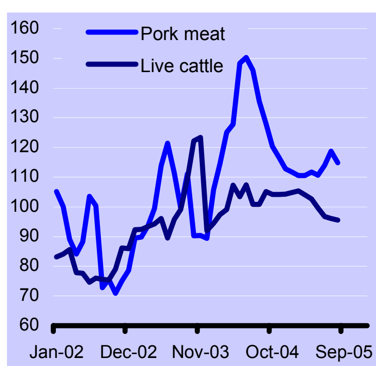


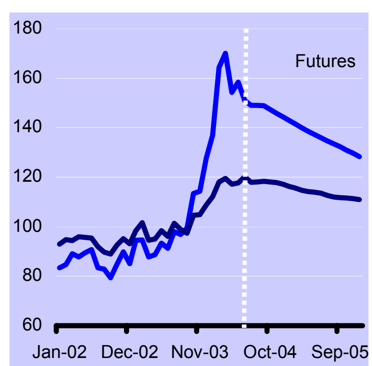
It should be stressed that commodity price increases are probably reflecting a change in relative prices worldwide. Therefore, as this process completes, commodity price inflation would be expected to slow gradually and, in some cases, revert. Such scenario is consistent with the current path exhibited by futures prices of certain commodities (Graph 5).

Graph 5 **Commodity Prices (Cash and Futures)** [1/]

Indexes 2003=100







1/ Futures prices as of July 2004.
Sources: Cash prices: U.S. Department of Agriculture (USDA), International Coffee Organization, Coffee, Sugar, and Cocoa Exchange (CSCE), and Metal Bulletin. Futures prices: Chicago Board of Trade (CBT), Chicago Mercantile Exchange (CME), Coffee, Sugar, and Cocoa Exchange (CSCE), and Commodity Exchange (COMEX).

Banco de México will remain attentive to identify any aggregate demand pressures on inflation and, should it be the case, contain them.

II.2.2. Monthly Inflation

Monthly CPI inflation in April, May and June 2004 was 0.15, -0.25 and 0.16 percent, respectively,[6] below private sector economic analysts' expectations at the end of the first quarter of the year (Table 2). When comparing these results with those of the same months of 2003 (to eliminate any seasonal effects), inflation in April was below forecasts (due to the reduction in agriculture prices and electricity rates). However, in May and June it ended above forecasts.

The latter is mainly attributed to the following factors: i) the increase in higher consumption electricity rates (unsubsidized) due to the rise in fuels and steel, which made deflation in May and June's increase have a higher incidence in regards to that recorded last year; and ii) prices of gas, gasoline in border cities, and food exhibited significantly higher monthly variations during the quarter as compared with last year.

Just as with annual inflation, in April, May and June 2004, the reduction in the prices of fruits and vegetables contained the impact of non-core inflation on monthly CPI inflation.

Table 2 **Monthly Inflation (Observed and Forecasted)**

Percent

	2003			2004		
	Observed		Forecasted	Observed		Forecasted 1/
Month	Core	CPI	CPI	Core	CPI	CPI
April	0.36	0.17	0.36	0.36	0.15	0.23
May	0.30	-0.32	0.24	0.25	-0.25	0.08
June	0.12	0.08	0.29	0.29	0.16	0.18

1/ At the end of the previous quarter according to Banco de México's Survey of Private Sector Economic Analysts' Forecasts.

II.2.3. Producer Price Index (PPI)

At the end of the second quarter of 2004, the annual growth rate of the PPI of merchandise and final goods excluding oil was 6.93 percent, above that of the previous quarter (5.10 percent). Exports recorded the highest annual variation by moving from 4.11 percent in March to 10.28 percent in June. The annual variation of the capital formation subindex rose from 9.52 to 14.21 percent during the same period. In both cases, such increase was affected significantly by the exchange rate depreciation. Private

6 Inflation's negative variation in May was seasonal and mainly attributed to the decline in electricity rates in some northern cities due to the beginning of the summer season.

consumption recorded an annual variation of 5.09 percent in June, above that in March (4.50 percent).

As already mentioned, increases in several agriculture, metal, and energy-related commodity prices affected the development of the items that make up the PPI of final goods and services.

II.3. Main Determinants of Inflation

II.3.1. International Environment

The recovery of the world economy continued to consolidate during the second quarter of 2004. Available information suggests that U.S. GDP continued growing above its potential rate, despite the fact that economic activity was slightly less robust than expected at the beginning of the quarter. The Asian economies, especially the Chinese economy, continued to be a major engine for world economic growth. The euro area economy also exhibited positive results. On another front, the increase in oil and other commodity prices, among other factors, led to higher inflation throughout the world. Under such setting, the Federal Reserve began to revert the monetary accommodation that began since 2000.

II.3.2. Oil Prices

During the second quarter of 2004, the West Texas Intermediate (WTI) price was 38.43 US dollars, 3.19 US dollars more than that observed in January-March. Oil prices were driven mainly by the higher demand for this fuel, political turmoil in the Middle East, and uncertainty regarding OPEC's willingness and capacity to raise oil production. Once Saudi Arabia and United Arab Emirates announced an increase in their oil production, oil prices began to fall, after having reached 40 US dollars per barrel at the end of May and beginning of June. In addition, OPEC also decided to raise its oil production quotas.[7] The Mexican oil export mix price reached 30.07 US dollars per barrel, 3.13 US dollars more than that observed in the first quarter of the year.[8]

7 Two million barrels per day in July and 500 thousand more in August.

8 At July 23 the WTI and the Mexican oil export mix price were 41.71 and 32.02 US dollars per barrel, respectively.

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

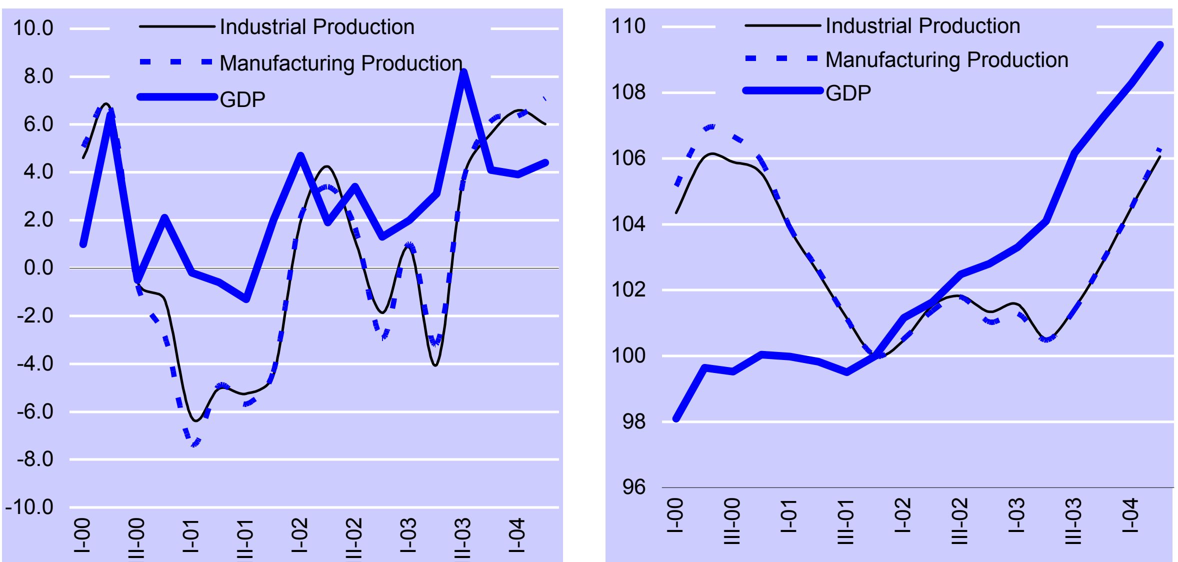
U.S. GDP grew at an annualized quarterly rate of 3.9 percent during the first quarter of 2004 (4.8 percent at an annual rate). Excluding net exports, which exhibited negative growth, all components of aggregate demand contributed to GDP growth. Moreover, the cyclical recovery of the U.S. economy has entailed a continuous change in the structure of aggregate demand. In particular, non-residential private investment grew at a higher rate than private consumption and residential investment.

U.S. labor market and industrial production –sectors which were lagging the most at the beginning of the cyclical recovery- have gained some strength in 2004.

Graph 6 **U.S. GDP and Industrial Production**

a) Annualized quarterly variation
Seasonally adjusted figures

b) Index 2001-IV = 100
Seasonally adjusted figures



Source: BEA and Federal Reserve Board.

Although industrial production began to expand since mid-2003, its rate of growth had been significantly below that of GDP until the end of that year. After that point, industrial production began to grow during the first and second quarters of 2004 at annualized quarterly rates of 6.6 and 6.0 percent, respectively (2.9 and 5.5 percent, at an annual rate), above those of GDP, excluding June's unexpected weak results (Graph 6). Under such setting, at the end of the second quarter of 2004, both industrial and manufacturing production reached nearly the same highest levels of the previous cycle (second quarter of 2000).

Employment had also not shown signs of recovery. Only until March and April, monthly job creation began to grow consistently with the strong expansion undergone by the U.S. economy. During such months, employment grew significantly (353 and 324 thousand jobs were created, respectively). Nonetheless, in June, employment grew at a significantly lower rate than in the previous three months (only 112 thousand jobs were created). Despite the recovery of employment, June's non-farm payroll was also below its highest level of the previous cycle.

Inflation has grown more rapidly than expected by both U.S. authorities and private sector economic analysts. However, it still remains at moderate levels. During April, May and June, CPI grew at an annual rate of 2.29, 3.0 and 3.22, respectively. The significant growth in commodity prices, particularly in energy goods, was the main factor behind the rise in inflation (Box 3). Annual core inflation figures for the same months, which remain below 2 percent (1.77, 1.76 and 1.81 percent, respectively), confirm such results.

The strength of the U.S. economy (particularly, the recovery of employment in April and May), together with the faster growth rate of prices and an upward correction in inflation expectations, were reflected in higher interest rates. Long-term interest rates grew the most, as they began to discount the reversion in the monetary stimulus. The 10-year T-bond reached 104 basis points during the quarter as compared with its level at the end of March.[9]

During April-June, the Dow Jones and NASDAQ Indexes recovered from the negative results exhibited in the previous quarter, reaching very similar levels to those observed at the end of 2003. Despite its mixed behavior, during the same period the US dollar appreciated vis-à-vis the main currencies: 4.4 percent against the yen, 1.3 percent against the pound sterling, 1.8 percent against the Canadian dollar, and 1.0 percent against the euro. The US dollar broad effective exchange rate appreciated 2.17 percent during such period.[10]

[9] Up to July 23, the yield on the 10-year bond was 4.44 percent, below that of June 30 (4.58 percent), and above that at the end of March (3.83 percent).

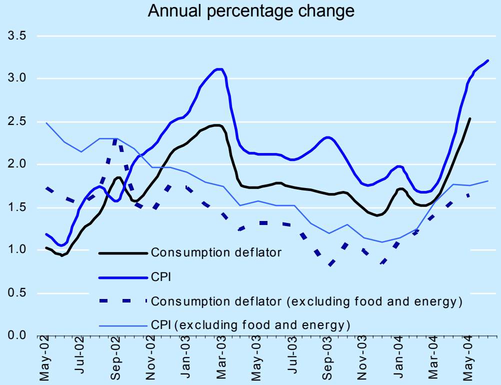
[10] Refers to the US dollar exchange rate vs. 26 currencies weighted according to their significance in U.S. foreign trade. From the end of June to July 23, the US dollar broad effective exchange rate depreciated 0.23 percent.

Box 3
U.S. Inflation: Recent Developments and Expectations

Perceptions regarding the expected path of inflation in the U.S. have changed during the year, as evidenced by Federal Reserve's press releases and by economic analysts' forecasts. In its press release of May 2003, the Federal Open Market Committee (FOMC) expressed, for the first time, its concern over a possible deflation. This stemmed from the simultaneous presence of very low and declining core inflation, and the uncertain outlook for production and employment. In 2003, annual CPI core inflation was consistently below CPI inflation, reaching in December of that year its lowest level since May 1963. Since then, core inflation has increased. Consequently, no reference to deflation was made in the FOMC's press releases of May and June 2004.

Inflation rebounded during the first half of 2004. Such upward trend is mainly explained by the increase in commodity prices, especially of energy-related goods. Core inflation also rose during that period, but at a lower growth rate than that of headline inflation. Most recent information provides mixed evidence of the path of core inflation: on the one hand, since April, CPI's annual growth has stabilized; however, up to May, the growth rate of consumption's deflator was still on an upward trend. It should be noted that core inflation measured by both indexes remains relatively low.

USA: CPI and Consumption Deflator
Annual percentage change

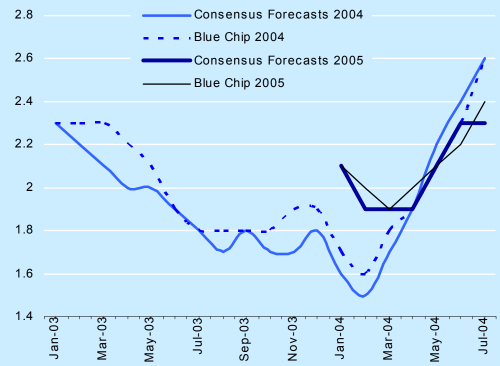


Source: BEA and BLS.

U.S. inflation expectations have also changed. In 2003, average inflation forecasts for 2004 from different surveys were revised downward up to February 2004. However, from March onward, forecasts have been revised upward. According to some analysts, two additional factors must be considered regarding such change. First, that expected inflation for 2004 is affected by temporary factors. Second, that inflation is expected to decline in 2005.

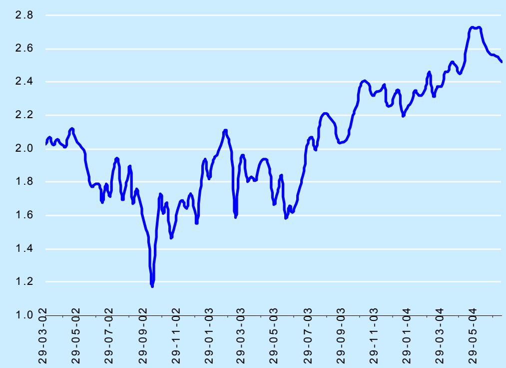
In general terms, available information does not suggest that the recent jump in inflation has affected long-term inflation expectations. Nonetheless, implicit inflation expectations drawn from the difference between the yield on the 10-year nominal bond and the 10-year indexed bond have increased 0.25 percentage points since the beginning of the year. This might suggest that concerns over the outlook for inflation for the longer term prevail. However, since the yield on such bonds could be affected by numerous factors, such indicator could be an inaccurate measure of inflation expectations.

Inflation Forecasts for 2004 and 2005
Annual percentage change



Source: Consensus Forecasts and Blue Chip Economic Indicators.

Yield Spread between 10-year Nominal Bond and 10-year Indexed Bond
Percent



Source: Federal Reserve Bank of St. Louis.

Risk market perception regarding an upsurge of inflation pressures in the U.S. has changed rapidly with the release of new information. Such condition has clearly made the accurate assessment of the inflation trend difficult. Despite the fact that there is no consensus regarding the path of inflation, in general terms most recent data on prices and economic activity has increased confidence that inflation pressures will ease in the following months. Furthermore, labor costs seem to be following a trend consistent with sustained low inflation. The latter, together with Federal Reserve's announcements on monetary policy, have created expectations that the monetary stimulus will be withdrawn gradually.

U.S. economic activity in 2004-II has been affected by, among other factors, oil price increases. Private consumption, especially of durable goods, reduced its growth rate in April and May. Retail sale figures indicate that such trend continued in June. Data on capital good orders up to May suggests that investment in equipment grew less robustly than expected. Furthermore, the average deficit of the goods and services balance of April-May was above that of the first quarter. Under such context, analysts revised downward their forecasts for GDP growth for both the second quarter of 2004 (4.1 percent at an annualized quarterly rate and 5.1 percent at an annual rate) and for the entire year (4.5 percent). According to analysts, the U.S. economic slowdown at the end of the second quarter was due to atypical factors and, therefore, was temporary. Despite GDP forecasts, projections for U.S. industrial production in 2004 and 2005 have been revised upward throughout the year (Table 3).

Table 3

GDP Growth Forecasts for the Main Industrialized Economies in 2004

Annual and quarterly percentage change (annualized)

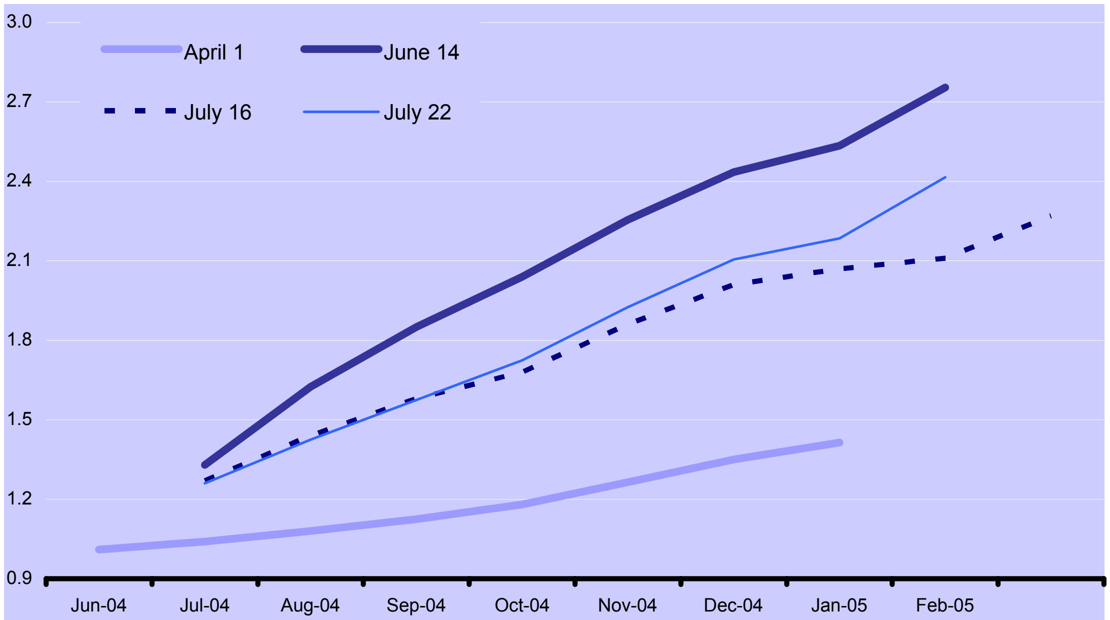
	GDP			
	At the end of I-2004		Most recent data	
	II-2004 1/	2004 2/	II-2004 1/	2004 2/
Consensus Forecasts 3/	4.4	4.6	4.4	4.5
Blue Chip Economic Indicators 4/	4.3	4.7	4.1	4.5
	Industrial Production			
Blue Chip Economic Indicators 4/	6.0	4.9	6.8	5.3

1/ Annualized quarterly change (seasonally adjusted series).
2/ Annual percentage change.
3/ *Consensus Forecasts* (For quarterly forecasts: March 8 and June 14, 2004; for annual forecasts: July 12, 2004).
4/ Blue Chip Economic Indicators (March 10 and July 10, 2004).

Financial markets' perception of future interest rates has changed rapidly as new data has been released. June figures for certain indicators, which have suggested economic activity in that month grew less vigorously than at the beginning of the second quarter, created expectations that the Federal Reserve would raise interest rates more slowly than expected. Alan Greenspan's statements during his presentation of the bi-yearly report on monetary policy to the U.S. Congress were interpreted in the opposite manner. This has been clearly reflected in the path followed by the yield curve for federal funds rate futures (Graph 7). Nonetheless, the Federal Reserve is expected to adopt less restrictive actions than those anticipated in mid-June.

Graph 7 **Yield Curve for Federal Funds Rate Futures**

Annual percentage



Source: Bloomberg.

II.3.4. Developments in the Other World Economies

Euro area GDP rose at an annualized quarterly rate of 2.4 during the first quarter (1.8 percent at an annual rate), above European Commission and private sector economic analysts' forecasts. Both external sector and private consumption were the main engine for growth. GDP grew at different rates throughout the euro area economies. Timely indicators suggest that regional GDP grew in the second quarter of 2004 at a rate similar than that of the first quarter.[11] On another front, the fact that the labor market has not exhibited signs of recovery (in May, the harmonized unemployment rate was 9.0 percent) could affect private consumption. Economic activity could also be affected by the higher oil prices. Such condition has already been reflected, since May, in an annual inflation above 2 percent. Consensus Forecasts' July figures for euro area GDP growth in 2004 were 1.7 percent.

[11] According to European Commissions' forecasts, GDP grew at an annualized quarterly rate between 1.2 and 2.8 percent in April-June.

Table 4 **GDP Growth Forecasts for the Main Advanced Economies in 2004**

Annual and quarterly percentage change (annualized)

	At the end of I-2004		Most recent data	
	II-2004 1/	2004 2/	II-2004 1/	2004 2/
Canada	2.0	2.8	3.6	2.9
Euro area	2.0	1.7	1.6	1.7
Japan	1.2	2.8	1.2	4.2
United Kingdom	2.8	3.1	2.8	3.2

1/ Annualized quarterly change (seasonally adjusted series).
2/ Annual percentage change.
Source: *Consensus Forecasts* (March 8, June 14 and July 12, 2004). The annualized quarterly change is calculated according to annual change forecasts for each quarter as reported in the March 8 and June 14, 2004 issues.

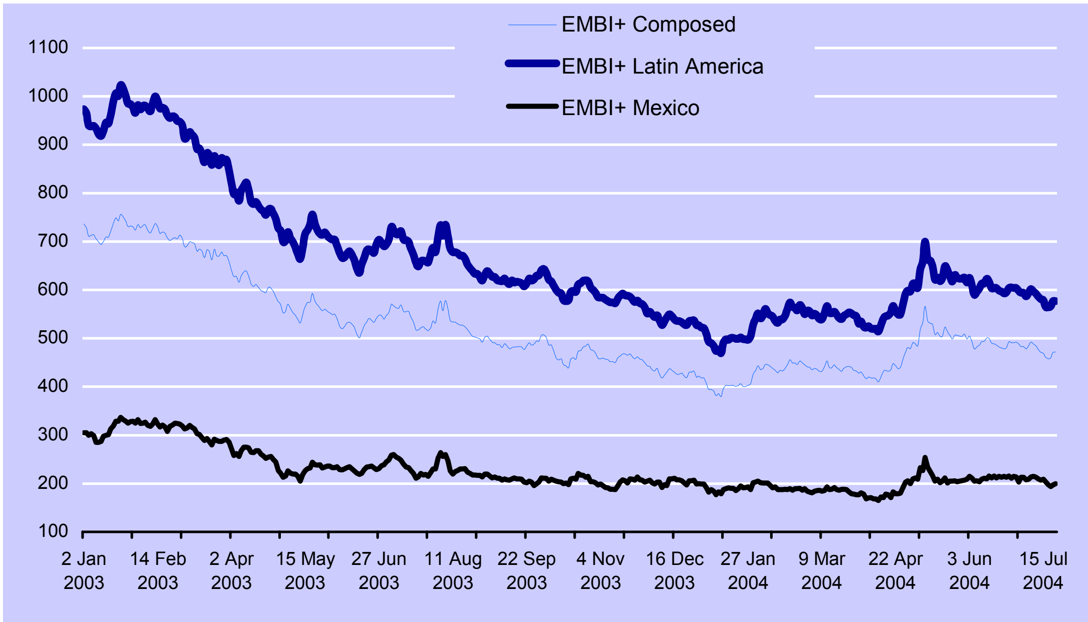
Among the advanced economies, Japan grew the most in the first quarter of 2004 (6.1 percent at an annualized quarterly rate and 5.6 percent at an annual rate), due to the rapid growth of exports, the continuous expansion of investment, and the recovery of private consumption. According to Consensus Forecasts, Japan's GDP is expected to grow 4.2 percent in 2004.

For a second quarter in a row, Asian emerging economies exhibited robust growth. The continuous strength of the Chinese economy together with the recovery of the advanced economies boosted Asian exports.[12] China's higher growth has also brought an increase in commodity prices, which, in turn, has affected world inflation (Box 2). Nonetheless, economic analysts expect the region to slow its rate of growth in the second half of 2004 and in 2005.

During the last year and in the first quarter of 2004, the emerging economies issued a significant amount of bonds. Nonetheless, since the first quarter of 2004, sovereign spreads began to increase (such trend was more pronounced in April and May of this year). In particular, the idea that the Federal Reserve would tighten monetary policy contributed to reduce investors' appetite for higher risk assets, therefore deteriorating developing countries conditions to access international financial markets.

[12] In the second quarter of 2004, the Chinese economy grew at an annual rate of 9.6 percent, similar to that of the first quarter.

Graph 8 **Sovereign Spreads for Emerging Economies and Latin America**
Basis points



Source: J.P. Morgan.

Although investors have slightly increased their exposure to emerging economies' bonds, external financial conditions are tighter than those observed at the end of the first quarter. Moreover, it is clear that perceptions over the magnitude and velocity at which the Federal Reserve will withdraw the monetary stimulus could significantly affect international financial markets in the next months. During April-June, the EMBI+ composed rose 61 basis points.[13]

In general terms, the Latin American economies have benefited from the world economy's recovery and the higher demand for commodities. GDP growth for the region is expected to increase from 1.5 percent in 2003 to 4.6 percent in 2004. Economic analysts expect the Argentine and Chilean economies to grow significantly (7.5 and 5.0 percent, respectively) while the Brazilian one to recover considerably (from -0.2 percent in 2003 to 3.4 percent in 2004). Inflation expectations for these economies have also been revised upward.

[13] From the end of June to July 23, 2004 the EMBI+ fell 21 basis points.

II.3.5. Earnings and Employment

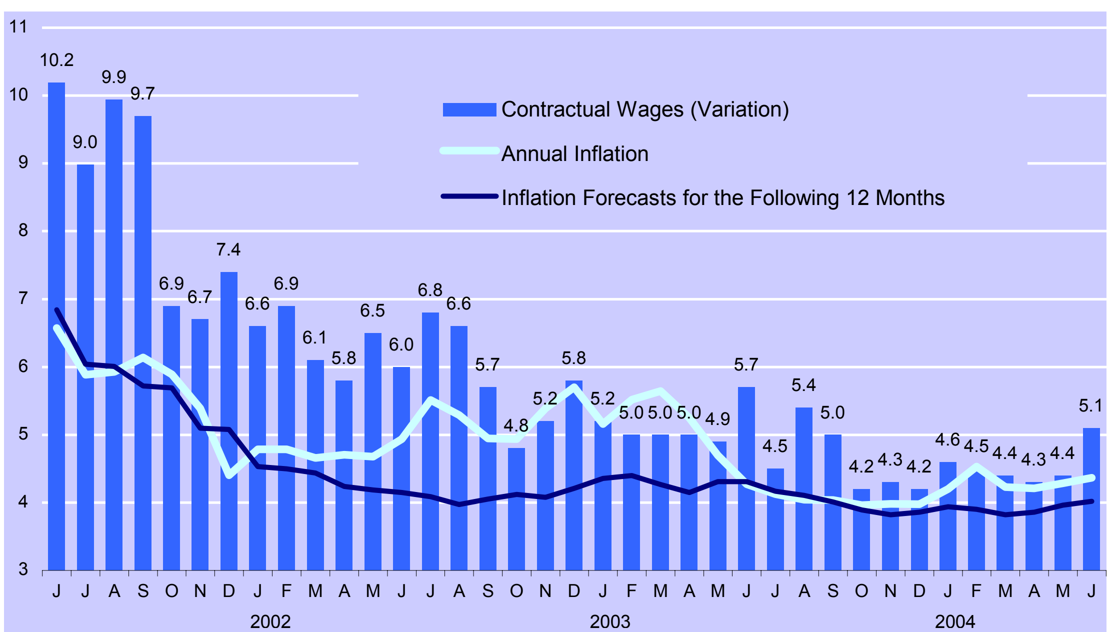
During the second quarter of 2004, nominal contractual wages exhibited similar variations to those observed in the previous quarter. Average productivity in both *maquiladora* and non-*maquiladora* industries and in the retail sector rose significantly, more than compensating the increase in real average earnings. Consequently, unit labor costs in such industries recorded negative variations.

II.3.5.1. Contractual Wages

Contractual wages in enterprises under federal jurisdiction rose, on average, weighted by number of workers, 4.5 percent. Such increase was similar to that observed in the previous quarter. The highest increase was observed in June (5.1 percent). In general terms, wage increases in June were above those of the first five months of the year (Graph 9). This is due to the fact that most workers in the private sector, which negotiate wage increases in that month, work in enterprises that have granted the highest wage increases in the last years. Nonetheless, the above figures do not seem to reflect the slackened conditions that prevail in the labor market.

Graph 9 **Contractual Wages and Inflation**

Percent



Source: Banco de México and Ministry of Labor.

From April to June 2004 contractual wage increases in private enterprises were significantly higher than those in public ones (an average differential of 0.7 percentage points). Contractual wages' breakdown by economic activity shows that wage increases in manufacturing were above those of other sectors (Table 5).

Table 5 **Contractual Wages by Sector and Type of Enterprise**

Annual percentage change

	2003					2004							
	I	II	III	IV	Average Jan-Dec 1/	Jan	Feb	Mar	Average Jan-Dec 1/	Apr	May	Jun	Average Apr-Jun 1/
Total	5.1	5.1	4.8	4.2	4.7	4.6	4.5	4.4	4.5	4.3	4.4	5.1	4.5
Public Enterprises	4.3	4.3	4.3	4.0	4.1	3.8	3.5	4.0	3.9	4.0	3.4	4.0	3.9
Private Enterprises	5.2	5.4	5.2	4.6	5.2	4.9	4.6	4.5	4.6	4.5	4.5	5.1	4.6
Manufacturing	5.3	5.5	4.7	4.5	5.0	4.6	4.4	4.6	4.5	4.6	4.7	5.0	4.7
Other Sectors	4.9	5.0	4.8	4.2	4.6	4.6	4.6	4.2	4.5	4.3	4.0	5.2	4.4

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

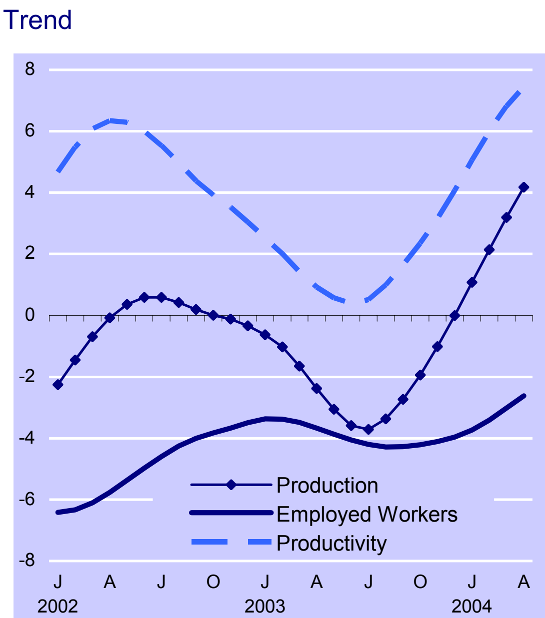
II.3.5.2. Earnings and Productivity

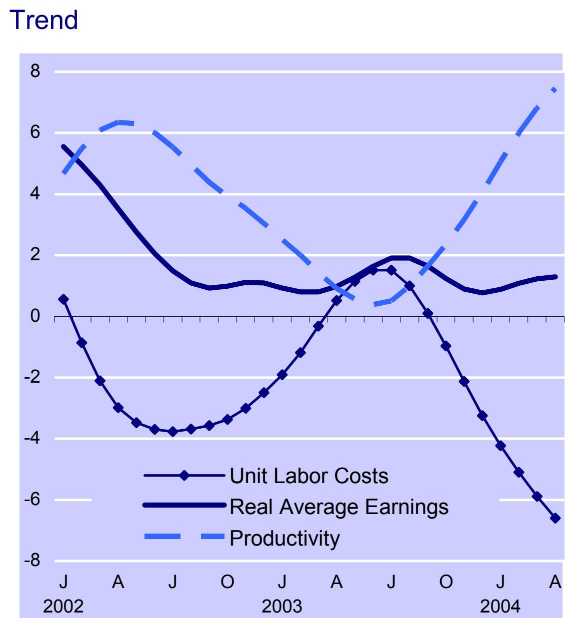
Average labor productivity in both *maquiladora* and non-*maquiladora* industries, and in the retail sector, followed an upward trend, exhibiting an average increase above that of real average earnings. Consequently, unit labor costs (ULC) in such activities recorded negative variations.

Average productivity in the non-*maquiladora* manufacturing industry grew at an annual rate of 6.5 percent during the first quarter of 2004, thus confirming that such indicator has maintained its upward trend since the second half of 2003. Even when real average earnings exhibited positive annual variations during the quarter (1.2 percent), these were compensated by productivity gains. Consequently, during January-April, unit labor costs followed a downward trend by declining, on average, 4.8 percent. Should manufacturing production continue to increase, employment would grow further and average productivity would probably slow down (Graph 10).

Graph 10 **Non-*maquiladora* Manufacturing Industry**

Earnings, Labor Productivity and ULC
Annual percentage change





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

Average productivity in the *maquiladora* industry has exhibited positive growth during the year, averaging 3.6 percent in January-April 2004 (Table 6). Average earnings in such industry continued to increase (2.1 percent at a real rate). Considering productivity figures, unit labor costs decreased, on average, 1.4 percent (Graph 11).

Table 6 **Earnings, Labor Productivity, and ULC by Economic Sectors**

Annual percentage change

	Non*maquiladora* Industry			*Maquiladora* Industry			Retail		
	Labor Productivity	Real Average Earnings	ULC	Labor Productivity	Real Average Earnings	ULC	Labor Productivity	Real Average Earnings	ULC
2003									
Jan-Apr	1.9	0.9	-1.1	-0.3	-0.3	0.0	1.5	4.3	2.7
Jan-Dec	1.8	1.2	-0.9	-0.1	0.0	0.0	5.6	3.0	-2.3
2004									
Jan	3.6	1.0	-2.5	3.2	2.3	-0.9	7.7	-0.6	-7.7
Feb	5.0	1.3	-3.5	3.0	2.0	-1.0	11.6	1.9	-8.7
Mar	10.9	1.3	-8.6	5.3	2.6	-2.6	9.7	2.0	-7.0
Apr	6.4	1.3	-4.8	2.7	1.6	-1.0	9.0	2.1	-6.3
Jan-Apr	6.5	1.2	-4.8	3.6	2.1	-1.4	9.4	1.3	-7.4

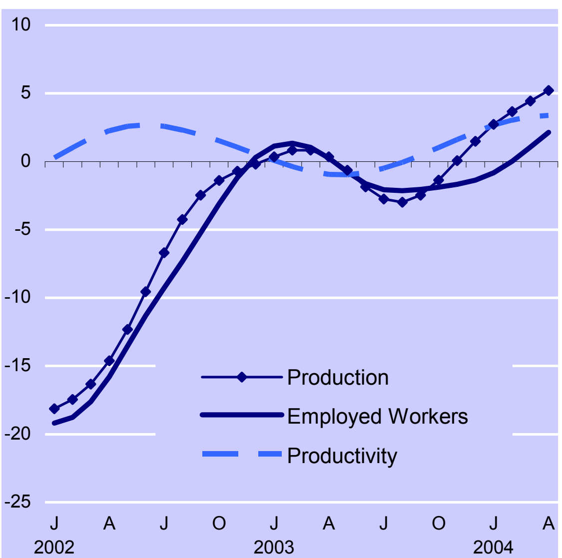
Source: Prepared by Banco de México with data from INEGI.

Graph 11 ***Maquiladora* Industry**

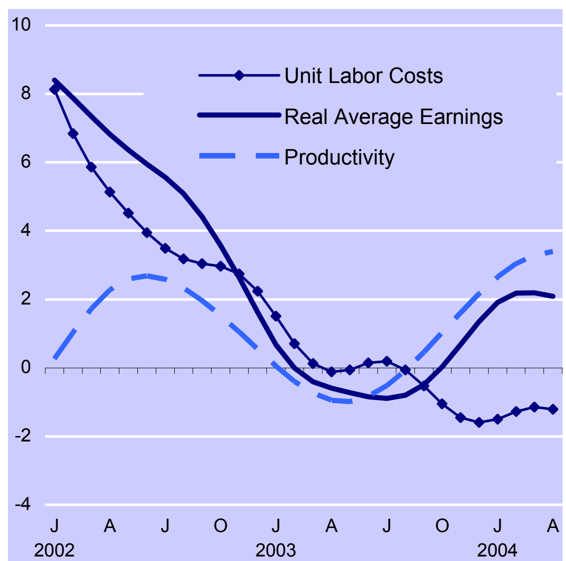
Earnings, Labor Productivity and ULC

Annual percentage change

Trend



Trend



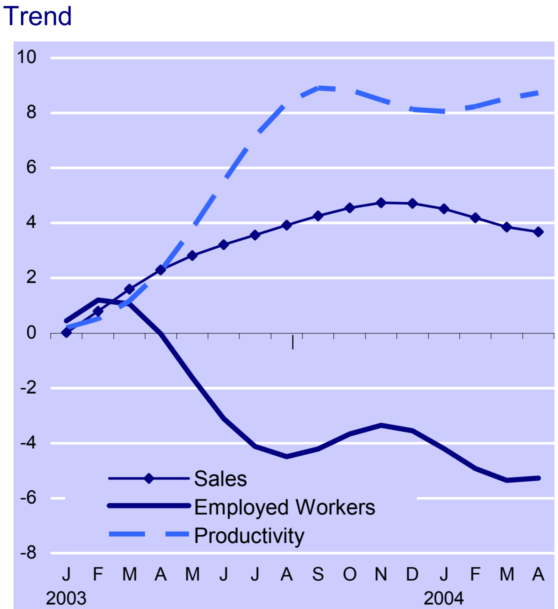
Source: Prepared by Banco de México with data from INEGI.

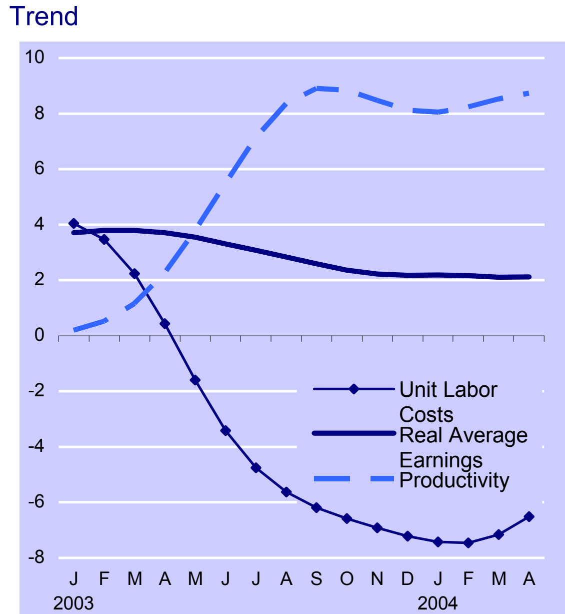
Average productivity in the retail sector remained on the upward trend observed since the beginning of 2003 by increasing 9.4 percent in the first quarter of 2004. Such results are partly attributed to the upward trend followed by real sales, which have been fueled by consumption growth, which, in turn, has benefited from a greater availability of credit. Average productivity gains in the retail sector have been mainly due to structural changes in this sector. During the first quarter of the year, chain stores, supermarket and department stores recorded higher activity than grocery and specialized stores. Consequently, employment has fallen in both grocery and specialized stores. On another front, average earnings per worker grew at a real annual rate of 1.3

percent in 2004-I, 3 percentage points below that of the same period of 2003. Unit labor costs fell, on average, 7.4 percent (Graph 12).

Graph 12 **Retail**

Earnings, Labor Productivity and ULC
Annual percentage change





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

II.3.5.3. Employment

The cyclical recovery favored the continuous expansion of labor demand. During the second quarter of 2004, employment was mainly characterized by: a) according to IMSS figures, an increase in the number of workers (more permanent than temporary) in the formal sector; b) the recovery of formal employment in many sectors (including manufacturing) in most states; and c) a slight reduction in the unemployment rate in urban areas.

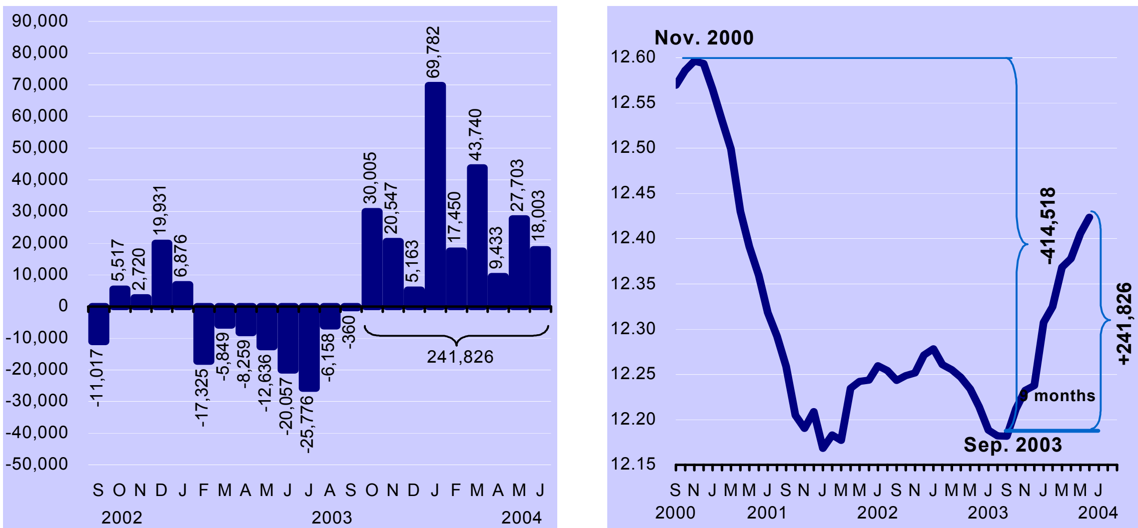
At the end of June 2004, 12,414,814 workers were insured by the IMSS (permanent and temporary in urban areas), 94,999 more than those in March of the same year, and 224,022 more than those recorded at the end of 2003. The latter figure is the highest first-half-of-the-year variation recorded in the last four years. June represented the ninth month in a row with an increase in seasonally adjusted data for the number of workers insured by the IMSS. According to seasonally adjusted data, from October 2003 to June 2004, 241,826 new jobs were created in the formal sector (164,517 permanent and 77,309 temporary jobs in urban areas). However, despite such results, the number of workers insured by the IMSS is still below that registered in 2000 (Graph 13b).

Graph 13 **Workers Insured by the IMSS: Permanent and Temporary in Urban Areas**

Seasonally adjusted figures

a) Workers Insured by the IMSS
Monthly variation

b) Million Workers Insured



Source: IMSS. Seasonal adjustments by Banco de México.

During the first half of the year, formal employment rose in most sectors of the economy, especially in services, construction and manufacturing. Manufacturing employment increased by 96 thousand jobs from the end of December 2003 to the end of June 2004. The following manufacturing divisions accounted for most of the increase in employment: metal goods, machinery and equipment (54 thousand posts); textiles and apparel (13 thousand posts); chemical products and plastics (15 thousand posts); and other industries (9 thousand posts). Despite the positive results, at June, the number of manufacturing jobs was still 762 thousand below its highest level of November 2000.[14]

During the first half of 2004 the number of workers insured by the IMSS rose by 234 thousand in 26 states. In contrast, nearly 10 thousand workers lost their jobs in the other six states. Formal employment opportunities have been more evident in

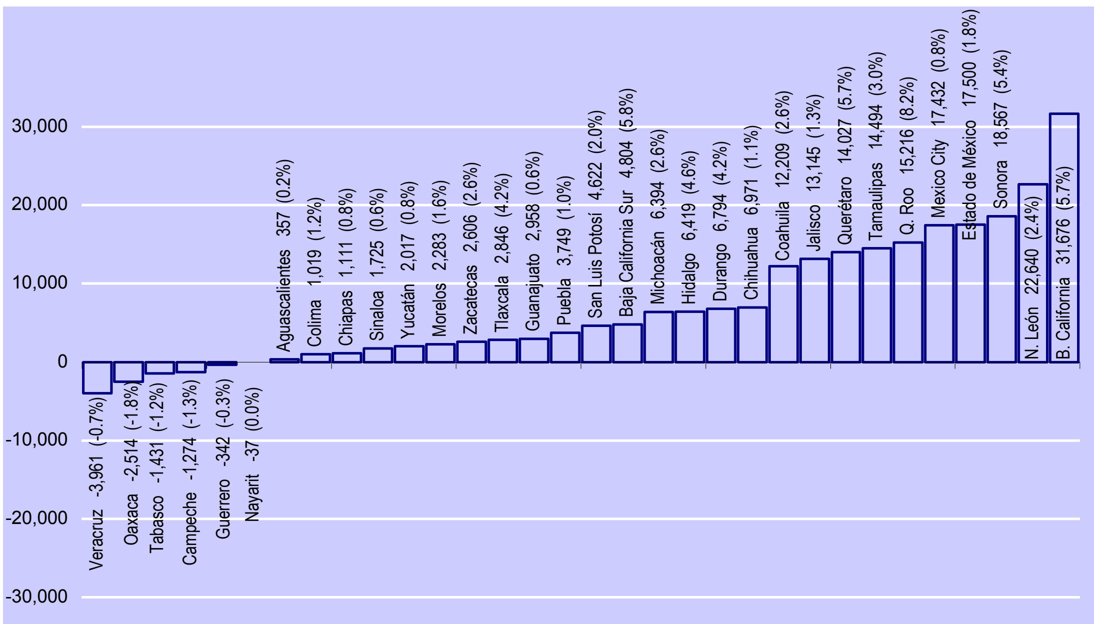
[14] The fact that the number of manufacturing workers insured by the IMSS is below figures from the Bureau of Statistics' (*Instituto Nacional de Estadística, Geografía e Informática, INEGI*) Employment Survey (*Encuesta Nacional de Empleo, ENE*) suggests that the number of manufacturing workers in the informal sector has increased.

northern and midland states. In the former case, such results are attributed to the recovery of export-related activities (Graph 14).

During the second quarter of 2004, employment rose significantly in the *maquiladora* industry due to the recovery of its exports. Considering seasonally adjusted data, from August 2003 (month in which employment in such industry began to recover) to the end of April 2004, *maquiladora* employment rose by 4.6 percent (47,751 jobs).

Graph 14 **Number of Workers Insured by the IMSS by State**

Absolute and percentage change from December 2003 to June 2004



Source: IMSS.

The recovery of economic activity during the second quarter of the year prevented the open unemployment rate in urban areas from increasing. Such indicator fell with original data compared with its average level of the previous quarter; however, it remained practically unchanged with seasonally adjusted figures: during the first and second quarters of 2004, the open unemployment rate in urban areas was 3.86 and 3.61 percent, respectively, with original data, while 3.75 and 3.76 percent, respectively, with seasonally adjusted data. The latter results clearly reflect that in the second quarter of the year both higher demand for employment in the formal sector and higher job creation in the informal sector were able to absorb the additional supply of labor.

II.3.6. Aggregate Supply and Demand

Mexico's economic activity continued strengthening during the second quarter of 2004, as evidenced by indicators for both aggregate demand and production. During such period, consumption remained strong while investment slightly recovered. As for external demand, exports grew more than in the first quarter.

The external environment has influenced significantly the performance of the Mexican economy. The cyclical recovery of the world economy, particularly the U.S., usually entails two opposite effects: a positive one, through external demand, and a negative one, by tightening the financing conditions for emerging economies.

On the one hand, the Mexican economy has benefited from a significant increase in oil and non-oil exports, which in turn has positively affected industrial and manufacturing production and employment; on the other, world financial conditions have translated into higher domestic interest rates throughout the entire yield curve and in exchange rate pressures, therefore restricting the financing conditions for the different components of expenditure.

The balance of the abovementioned developments has fostered the expansion of aggregate demand. This is partly due to the fact that the effects on interest rates and on the exchange rate in today's financial environment have been mitigated by the significant oil revenues and workers' remittances, which have provided the economy with substantial resources (Box 4).

Given the slack prevailing in the goods and labor markets, the growth in expenditure has not created significant inflation pressures.

Summing up, economic activity exhibited the following results:

(a) Consumption expenditure remained vigorous. Retail sales rose at an annual rate of 3.4 percent in April-May, thus accumulating seventeen months of positive growth. According to the National Retailers Association (*Asociación Nacional de Tiendas de Autoservicio y Departamentales, ANTAD*), sales grew at an annual rate of 8.8 percent, similar to that observed in the first quarter (8.6 percent). Domestic car retail sales exhibited better results by increasing at an annual rate of 11.6 percent. This was mainly due to the higher sales of imported vehicles.

Box 4

Economic Activity in Mexico in 2004 and External Environment

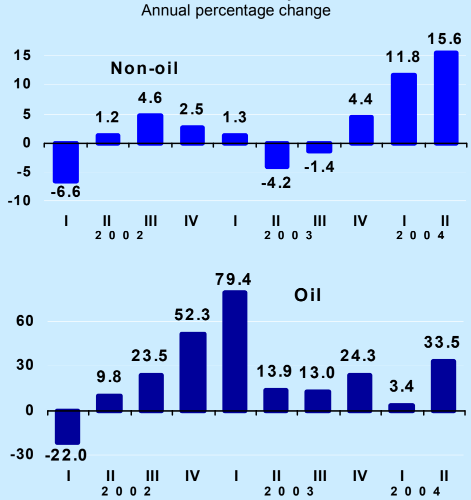
During the first half of 2004, the Mexican economy was surrounded by favorable external conditions, which contributed significantly to GDP and domestic savings' growth, and to job creation. The following external factors had a positive effect on the Mexican economy:

1) The continuous recovery of external demand, which was reflected in non-oil exports and, especially, in manufactured goods' exports.

2) Oil prices persistently high in international markets, which have translated into unprecedented revenues from oil exports, and in an improvement in the terms of trade.

3) Significant revenues from workers' remittances, which has raised the level of income and expenditure of millions of Mexicans throughout the country.

Graph 1
Oil and non-oil exports
Annual percentage change



1. External Demand

External demand, especially from the U.S., began to recover since the second half of 2003. During the second half of 2004 it further strengthened, while demand from other countries improved. Such conditions raised Mexican non-oil exports significantly, especially those of manufacturing goods. This has taken place despite the country's loss of competitiveness in international markets due to the lack of progress in pending structural change measures. During the first half of the year, non-oil and manufacturing exports rose at an annual rate of 13.7 and 13.5 percent, respectively. In 2003 and 2002, such variations were 0 and -0.7 percent, and 0.4 and 0.5 percent, respectively. Foreign demand for services (mainly from foreign travelers visiting Mexico) has also recovered significantly throughout the year.

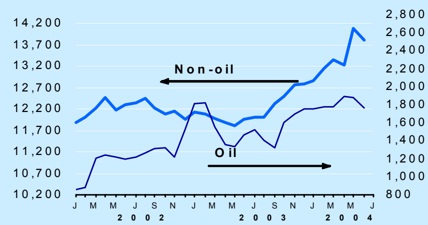
Table 1
Aggregate Demand Components' Contribution to Annual Real GDP Growth
Annual percentage change

Period	Real GDP Growth	Growth Originated by:	
		Domestic Demand [1]	External Demand= Net Exports [2]
	(1) = (2)+(3)	(2)	(3)
2002	0.7	0.4	0.3
2003	1.3	1.2	0.1
2004	4.0	2.0	2.0

1 Net domestic demand (excluding imports).
2 Net exports (excluding imported inputs).

The recovery of external demand in 2004 has contributed significantly to economic activity growth. Central forecasts for economic growth in 2004 stand at 4 percent, and are based on both the higher domestic demand and the expansion of exports of merchandise and services. Inflows from greater oil exports and from workers' remittances, have contributed to the financing of external expenditure. Table 1 shows the contribution of both domestic and external demand (excluding imported inputs) to GDP growth. Thus, in 2004, external demand's direct contribution to GDP would be of 2 percentage points, significantly above that in 2003 (0.1 percentage points).

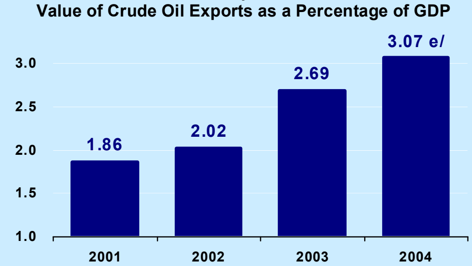
Graph 2
Oil and non-oil exports
Million US dollars
Seasonally adjusted data



2. Oil Exports

The higher oil prices that prevailed in international markets during the first half of the year affected the price of the Mexican crude oil export mix. Such reference averaged 28.56 US dollars per barrel during that period, 4 US dollars above its price of the same period of 2003. During the first half of 2004, the value of crude oil exports was 9.681 billion US dollars, figure above that of the first half of 2002 and of 2003 (5.870 and 8.306 billion, respectively). The value of crude oil exports for the entire 2004 is expected to be nearly 20 billion US dollars, figure above that of 2002 and 2003 (13.1 and 16.8 billion, respectively). In fact, such revenues measured as a proportion of GDP, rose from 2.02 percentage points in 2002 to 2.69 in 2003, and to 3.07 in 2004 (estimated figures).

Graph 3
Value of Crude Oil Exports as a Percentage of GDP

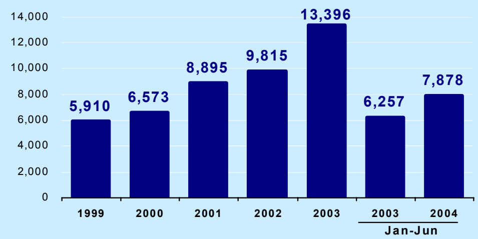


e/ Estimated figures.

3. Revenues from Workers' Remittances

In recent years, workers' remittances have been a very important source of funds for the country. During the first months of 2004, revenues from this item totaled 7.878 billion US dollars, 1.621 million (25.9 percent) more than figures for the same period of 2003. Revenues from remittances could reach nearly 16.3 billion US dollars in 2004 (2.5 percentage points of GDP).

Graph 4
Revenues from Workers' Remittances
Million US dollars



Workers' remittances are a significant source of income for millions of Mexicans. During 2003, income from this source in four states was above one billion US dollars. In Michoacán (where remittances equaled 12.7 percentage points of GDP in 2003) it could reach nearly 2 billion in 2004. Household income from workers' remittances is generally destined to consumption expenditure in durable and non-durable goods, as well as in education, housing, and other productive factors. In 2004, workers' remittances are expected to continue being a source of financing for Mexican households, therefore contributing significantly to GDP growth.

Final Remarks

In the first half of 2004, Mexico was surrounded by favorable external conditions, which contributed significantly to the expansion of economic activity. Such scenario is expected to prevail in the second half of the year, despite the fact that in the last weeks economic analysts and brokerage houses have moderated their forecasts for U.S. growth in 2004. On another front, additional increases in interest rates in international financial markets and in emerging economies' spreads that might take place over the next months are not expected to affect economic activity in Mexico significantly. Such assumption is based on the fact that Mexico's net external borrowing requirements for 2004 are reduced due to the low level of the current account deficit –which partly reflects the greater inflows from oil exports and workers' remittances- which has been financed, as in previous years, mainly by FDI resources.

(b) Investment expenditure increased slightly, after having grown at an annual rate of 4.5 percent during the first quarter. Such results are attributed to the expansion in construction and machinery and equipment, despite the latter's mixed results. In April, investment rose at an annual rate of 5.2 percent, thus accumulating six months of positive monthly variation, with seasonally adjusted data. As for construction expenditure, it continued expanding in April-May (4.8 percent for the entire period and 6.3 and 3.2 percent in April and May, respectively). Just like in the previous quarter and in 2003, such results were mainly due to higher construction in housing and in public infrastructure. Imports of capital goods during the reference period rose at an annual rate of 8.1 percent, above that of the first quarter (6 percent).

(c) Based on non-oil exports and data on U.S. imports from Mexico, external demand increased significantly as compared with the first quarter of 2004.

(d) Regarding production, in April-May 2004, the Global Indicator of Economic Activity (*Indicador Global de la Actividad Económica, IGAE*) grew at an annual rate of 3.5 percent, with increases in all of its components. The

IGAE is expected to have grown significantly at an annual rate in June.

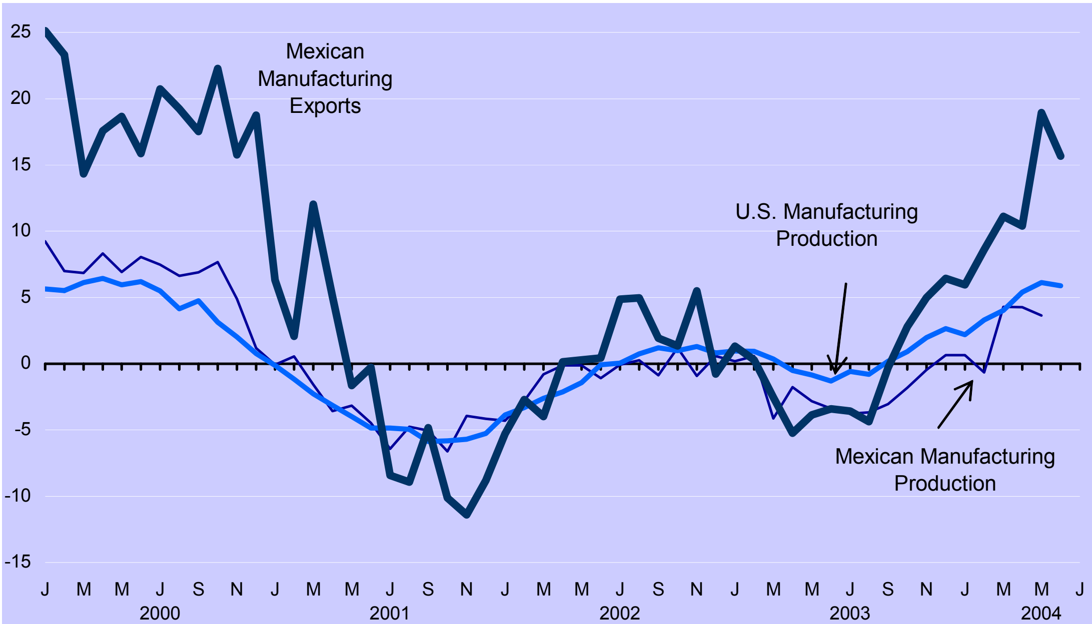
(e) During the same period, industrial and manufacturing production grew at an annual rate of 3.0 and 2.9 percent, respectively, despite the fact that the latter was affected in that period by the annual fall in automotive production.[15] At the end of May, industrial and manufacturing production reached accumulated increases of 4.27 and 4.88 percent in relation to September 2003. Manufacturing production has exhibited less strength than manufacturing exports, thus suggesting that manufacturing production for the domestic market has increased modestly (Graph 15).

(f) Business confidence and business climate indicators exhibited better results. Banco de México's Private Sector Analysts' Business Confidence Index ended 22.7 percent above its level in the second quarter of 2003, while the Manufacturing Business Climate Index recorded an annual increase of 10.1 percent. During the second quarter of 2004, the Consumer Confidence Index rose at an annual rate of 0.3 percent. The average level of the three indicators during the second quarter was above that observed in the previous one.

(g) Banco de México and The Conference Board leading indicators' average level in April and May was above that recorded in the first quarter of the year. The annual variations of such indicators allow for anticipating that economic activity in Mexico will continue recovering in the following months.

[15] Industrial production grew at an annual rate of 2.1 percent in May. Production was influenced downward due to atypical factors such as less working days in May 2004 as compared with the same month in 2003, and holidays, which, in 2003, fell on weekends. In addition, the high level of rain in May reduced the demand for electricity for watering.

Graph 15 **Manufacturing Production in Mexico and the U.S.**
Annual percentage change (seasonally adjusted figures)



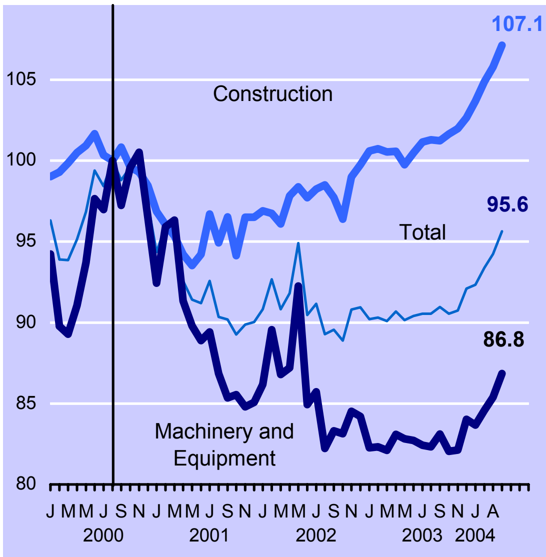
The development of the abovementioned indicators suggests that during the second quarter of the year GDP grew at an annual rate higher than in the first one; thus, GDP is expected to have risen significantly during the quarter with seasonally adjusted data. As for domestic demand, the boost in private consumption expenditure was fueled by the following factors: a greater availability of credit from commercial banks and chain stores; the continuing increases in real average earnings in many sectors; the better results in both formal and informal employment; and the higher level recorded by the Consumer Confidence Index. Workers' remittances also rose significantly at an annual rate. Households use such resources mainly for consumption expenditure.

The higher annual growth in production during the second quarter of the year, the higher domestic sales in many sectors of the economy, the significant rebound in external demand, and the improvement in the different business confidence and business climate indicators, fostered the expansion in investment expenditure. Furthermore, the private sector continued to benefit from the better financial position achieved in recent years by increasing the percentage of debt in pesos and also extending the term of its liabilities. The improvement in private sector's financial balances has increased their investment capacity. The latter contributed to the recovery of investment in the second quarter.

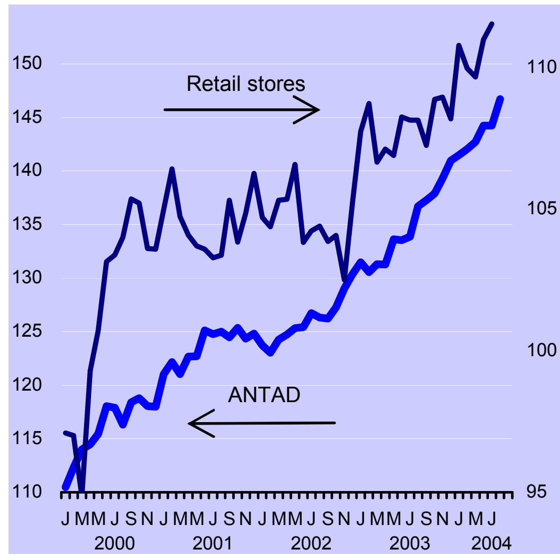
Graph 16 **Investment and Consumption Expenditure Indicators**

Seasonally adjusted figures

a) Gross Fixed Investment
August 2000=100



b) Retail sales
1994=100



Source: INEGI and ANTAD. Seasonal adjustments by Banco de México.

Nonetheless, a factor limiting the stronger recovery of private investment is the lack of advance in structural reforms. Results from Banco de México's surveys on the manufacturing sector, on foreign direct investment enterprises, and on private sector economic analysts, have mentioned repeatedly that such factor is the main obstacle to achieving higher investments (see Box 5). Should such reforms be implemented, the different sectors would increase their productivity and competitiveness and, in turn, take advantage of the favorable international conditions.

During the second quarter of 2004, exports of merchandise and services rose significantly due to a more vigorous demand from the U.S. and other countries. As a result, exports of merchandise and services have exhibited annual positive variations for three quarters in a row.

Considering the above, GDP is expected to have grown at an annual rate of nearly 4 percent during the second quarter.[16]

[16] Federal Government's latest available information on GDP and on aggregate supply and demand corresponds to the first quarter of 2004. During such period, exports of merchandise and services and total consumption rose significantly at an annual rate (10.4 percent and 3.2 percent, respectively). Total consumption continued growing due to private consumption strength (3.7 percent). Gross capital formation exhibited stronger growth (4.5 percent), as reflected by the development of private and public investment, which grew at an annual rate of 4 and 7.1 percent, respectively.

Box 5
Mexico's Competitiveness

At the beginning of the second quarter of 2004, Banco de México and the Ministry of the Economy conducted a survey on Mexico's main enterprises with foreign direct investment (mainly non-*maquiladora*). Its purpose was to draw information of expected Foreign Direct Investment flows (FDI) to Mexico in 2004, and also of several aspects of Mexico's competitiveness. Regarding the latter, the following deserves mention:

a) Surveyed enterprises mentioned that structural change measures are crucial to obtain higher levels of FDI (Table 1). Such statement coincides with those of manufacturing firms and private sector economic analysts drawn from Banco de México's monthly surveys.

Table 1
Policies, Structural Changes, and Measures to Increase Foreign Investment Flows to Mexico
Percentage distribution of responses

	Percentage Structure
Total	100
1. Fiscal reform and tax measures	27
2. Structural reforms	21
Energy sector	9
Labor sector	7
3. Improve public security system	9
4. Administrative simplification	9
5. Raise certainty in the country's legal system	7
6. Eradicate government corruption	6
7. Greater boost to investment and foreign trade	4
8. Improve and increase infrastructure	3
9. Improve legal framework	2
10. Achieve higher growth	2
11. Lower interest rates and improve acces to financing	2
12. Foster exchange rate stability	2
13. Foster political stability	1
14. Other (total of other 12 measures)	5

b) According to responses, the factors that are affecting Mexican enterprises' competitiveness significantly in relation to other countries are, basically, the country's legal framework, bureaucracy inefficiency, government corruption, lack of infrastructure, and the lack of security for enterprises' premises and employees, among others (Table 2).

Table 2
Factors Affecting Mexican Enterprises' Competitiveness Compared With Other Countries
Percentage structure of responses

Factors	Many	Few or zero	Total
1. Legal framework	78	22	100
2. Bureaucracy inefficiency	66	34	100
3. Government corruption	58	42	100
4. Lack of infrastructure (roads, bridges, etc.)	50	50	100
5. Security for enterprises' premises and employees	44	56	100
6. Requirements to set up enterprises	43	57	100
7. Availability of skilled labor	31	69	100
8. Environmental regulations	30	70	100

c) Enterprises stated that costs of certain production inputs, together with financial, electricity, telephone and telecommunications, and transportation costs are higher in Mexico than in other countries that also compete for investment flows (Graph 1).

d) Forty eight percent of surveyed enterprises mentioned that their corporate groups have also invested in Brazil while 43% have done so in China. Thirty eight percent of enterprises with FDI in these countries have pointed out that investments have been channeled to these countries instead of Mexico. The main factors that drew more investments to such countries are, among others, lower production costs, mainly in labor (Table 3); more fiscal incentives; greater certainty in the country's legal system; and domestic market size.

Graph 1
Production Costs in Mexico vs. Other Countries that Also Compete for FDI
Percentage structure

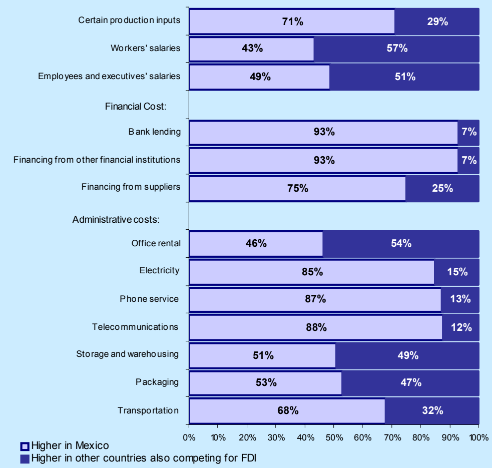


Table 3
Factors Determining Investment in Brazil and China Vs. Mexico
Percentage distribution of responses

Factors	Percentage Structure
1. Lower production costs: low-paid labor	34
2. More fiscal incentives and lower taxes	18
3. Higher certainty on the legal system	12
4. Larger domestic market	10
5. Higher incentives for foreign direct investment	8
6. Higher competitiveness	8
7. Higher returns on investment	4
8. Apparel industry relocation to China	2
9. Higher certainty on Mexico	2
10. Weak demand for exports	2
Total	100

e) Finally, regarding the quality of electricity supply (Table 4), 55.4% of enterprises mentioned that they suffer from frequent voltage variations and blackouts. Consequently, they incur in additional costs such as the purchasing of power plants and voltage-regulation equipment; production line failures; equipment damage; equipment repair; production losses; negative effects on productivity; and higher material waste.

Table 4
Costs Faced by Enterprises due to Voltage Variations and Blackouts
Percentage distribution of responses

Costs	Percentage Structure
1. Purchase of power plants and voltage-regulation equipment	21
2. Production line failures	21
3. Damage to industrial plant hardware	15
4. Repair or replacement of damaged equipment	10
5. Production losses	10
6. Fall in productivity due to production line failures	8
7. Material waste	7
8. Telecommunication systems affected	3
9. Electronic data losses	2
10. Product delivery problems	1
11. Lower quality of final goods	1
Total	100

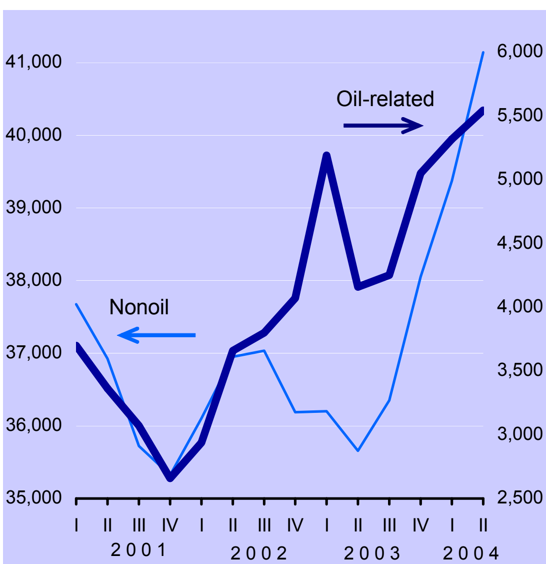
II.3.7. Balance of Payments and Capital Flows

During the second quarter of 2004, the development of the Mexican economy was affected by external and domestic factors. Among the first ones was, on the one hand, the growth of the world economy, mainly that from the U.S. This has fostered a higher growth in manufacturing exports, which, given the level of imported inputs used in their production, also encouraged the purchasing of foreign inputs. On the other, the greater uncertainty that prevailed in the international oil market, which, together with the higher demand for this fuel (due to the increase in economic activity worldwide) led to an increase in international oil prices and in the value of national oil exports. As for domestic factors, the strengthening of economic activity was reflected in higher merchandise imports. Such conditions led to a significant reduction in the trade and current account deficits for the second quarter of the year, as compared with those recorded in the same period of 2003.

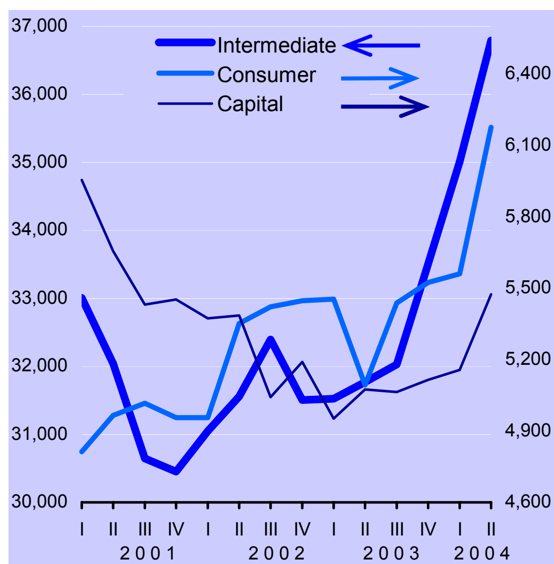
Graph 17 **Foreign Trade**

Seasonally adjusted series, million US dollars

a) Exports



b) Imports



Source: Banco de México.

Merchandise exports grew 17.5 percent in relation to their level in the same period of 2003. This originated from an increase of 15.6 percent in non-oil exports and 33.5 percent in oil exports. During the same period, imports grew at an annual rate of 15.8 percent due to increases in all of their components (intermediate good imports rose 16.1 percent, consumer good imports, 21.8 percent, and capital good imports, 8.1 percent).

Foreign trade seasonally adjusted figures show that merchandise exports and imports rose significantly in the second quarter of the year. Regarding the former, such results reflect their continuous expansion observed since the second half of 2003, especially of non-oil and particularly in manufactured goods' exports. Regarding the latter, intermediate and consumer goods' imports continued growing significantly while capital good imports did so but not as markedly.

In April-May, Mexican exports to the U.S. rose significantly at an annual rate of 12.9 percent. Nonetheless, such increase was below that exhibited by the other U.S. trading partners as a whole (17.98 percent). Consequently, Mexican exports lost share in U.S. imports, from 11 percent in April-May 2003 to 10.83 percent in the same period of 2004. Such results were influenced by the reduced strength of automotive exports.

Table 7 **U.S. Imports**

Percent

	Share				Annual Percentage Change: April-May 2004				
	2002	2003	Apr-May 2003	Apr-May 2004	Total	Oil	Total Excluding Oil	Automotive	Total Excluding Oil and Automotive
Total	**100.00**	**100.00**	**100.00**	**100.00**	**14.70**	**26.55**	**13.71**	**9.33**	**14.73**
Total excluding Mexico	**88.41**	**89.04**	**86.70**	**89.17**	**17.98**	**25.58**	**17.35**	**10.68**	**18.77**
1. Canada	18.00	17.80	18.03	18.09	15.12	16.63	15.02	11.75	16.43
2. China	10.78	12.10	11.37	12.58	26.98	-25.30	27.01	--	27.01
3. Mexico	**11.59**	**10.96**	**11.00**	**10.83**	**12.90**	**32.94**	**10.86**	**3.58**	**14.45**
4. Japan	10.46	9.37	9.44	8.90	8.10	--	8.10	4.50	10.45
5. Germany	5.38	5.40	5.74	5.54	10.70	--	10.70	6.89	13.02
6. United Kingdom	3.51	3.39	3.44	3.42	14.19	--	5.22	7.88	4.69
7. South Corea	3.06	2.94	2.96	3.26	26.30	--	26.30	26.50	26.23
8. Taiwan	2.77	2.51	2.50	2.40	9.98	--	9.98	12.27	9.85
9. France	2.43	2.32	2.26	2.06	4.41	--	4.41	--	4.41
10. Malaysia	2.07	2.02	1.96	1.86	9.24	--	10.05	--	10.05
Total 10 countries	70.05	68.81	68.65	69.05	14.69	38.19	13.64	8.05	15.20

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

Mexico's loss of competitiveness in the U.S. market and, overall, in international markets, has been and continues to be affected by the lack of advance in the pending agenda of structural reforms (see Box 5). As mentioned in previous reports, such condition has limited investment and the modernization of the domestic industry, therefore affecting productivity. Furthermore, under such stagnant setting, Mexico has not been able to take full advantage of the preferential access it is entitled to due to the different trade agreements it has signed.

The trade balance deficit totaled 950 million US dollars. As already mentioned, such amount reflected the rise in international oil prices and the significant increase in external demand for non-oil goods, which, altogether, more than compensated the increase in imports. Such deficit was 1.407 billion US dollars below that of the second quarter of 2003. Nonetheless, the trade deficit excluding oil exports reached 6.644 billion US dollars, figure higher than that of the same period of 2003 (5.673 billion).

Inflows from workers' remittances continued to rise during the second quarter of the year, totaling 4.506 billion US dollars, 29.1 percent more than that of the same period of 2003. In the first half of the year, such inflows totaled 7.878 billion US dollars, an annual increase of 25.9 percent. The latter resulted from 24.3 million transactions, averaging 324 US dollars each. Total remittances accounted for more than four fifths of the revenues from crude oil exports during the second quarter of 2004.

The above results, together with partial data available from other items, suggest that the current account deficit of the balance of payments was nearly 0.5 billion US dollars in the second quarter of 2004. As already mentioned, such result was due to higher oil exports and workers' remittances, and to seasonal factors. Such deficit was below that observed in the same quarter of 2003 and in the first quarter of 2004. Considering the above, in the first half of 2004, the current account deficit would be of nearly 2.3 billion US dollars.

In the second quarter of 2004, the capital account of the balance of payments (including errors and omissions) recorded a surplus of 0.6 billion US dollars. Foreign investment increased moderately due to inflows from foreign direct investment and outflows related with portfolio investment (securities and money market). During the reference period, the federal government carried out an exchange of global bonds in the international markets. Such transaction involved the canceling of liabilities for nearly 3.050 billion US dollars at face value for new bonds worth 2.870 billion. Such operation contributed to reduce the total stock of external debt, improve its maturity profile, generate savings in interest payments and increase the ratio of bonds with collective action clauses to total federal government bonds. The latter is a federal government strategy to reduce the cost of the external debt and improve its maturity profile.

Summing up, during the second quarter of 2004 the balance of payments exhibited the following results: a reduced current account deficit (nearly 0.5 billion US dollars); a modest capital account surplus including errors and omissions (0.6 billion US dollars); and a small accumulation of international reserves (79 million US dollars).

II.4. Monetary Policy

II.4.1. Monetary Policy Actions

Banco de México's monetary policy is based on an inflation targeting framework. As mentioned in previous Inflation Reports, one of the most important elements of inflation targeting is identifying the source of inflation pressures. When pressures come from the supply side, monetary policy usually adopts an accommodative stance by trying to "accommodate" such pressures, allowing the level of prices to increase only once and monitoring that no second round effects arise. On the other hand, when pressures come from the demand side, the monetary authority usually adopts timely actions to prevent an overall general upward price movement of goods and services.

As already mentioned in the previous Inflation Report, different supply shocks affected the prices of some items of the non-core subindex during the first months of the year. Thus, inflation expectations were revised upward, particularly those for the end of 2004 (Graph 18). In light of such developments, the Board of Governors of Banco de México tightened monetary policy by increasing the *corto* (short position) on two occasions: on February 20 (from 25 to 29 million pesos) and on March 12 (from 29 to 33 million pesos).

The effects of monetary policy's restrictive measures led to a flattening in the average yield curve from January to March (Graph 19a). In particular, the bank's funding rate rose considerably, ending the first quarter close to 140 basis points above the minimum level exhibited at the beginning of the year.

During the last months monetary policy has faced significant challenges, such as:

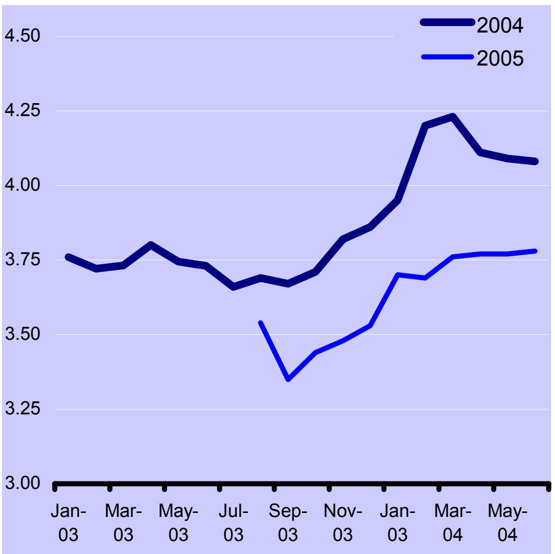
(a) Restraining the effects of price increases in commodities to inflation expectations.

(b) Containing any cyclical pressures on inflation that could originate from the current strength in aggregate demand.

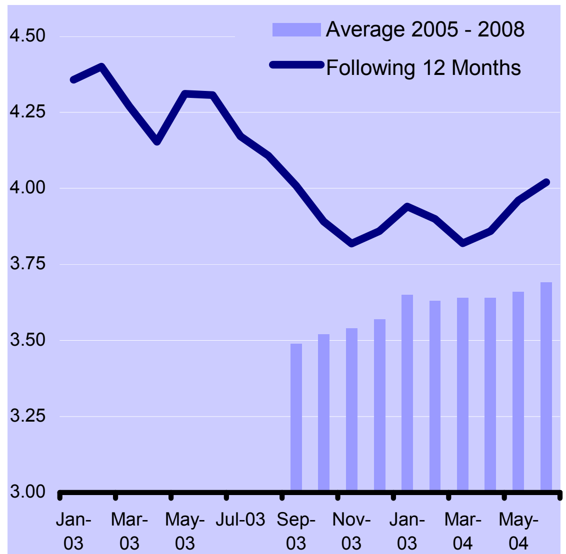
(c) Fostering an orderly adjustment of the economy to global financial conditions characterized by higher interest rates.

Graph 18 Inflation Forecasts: Banco de México's Survey

a) Inflation Forecasts for 2004 and 2005
Annual percentage

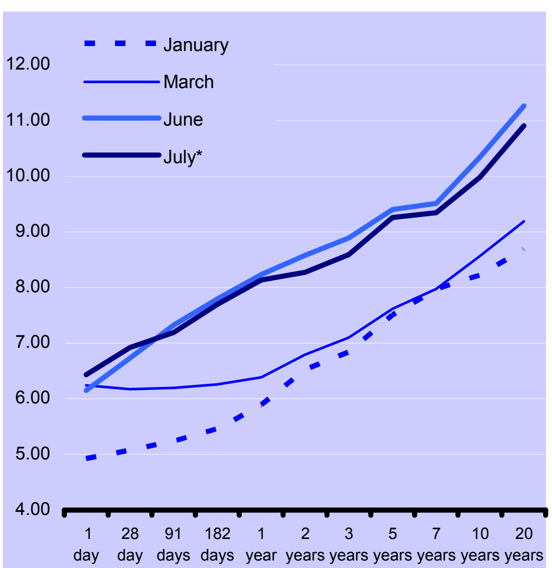


b) Inflation Forecasts for the Following 12 Months and for Average 2005-2008
Annual percentage

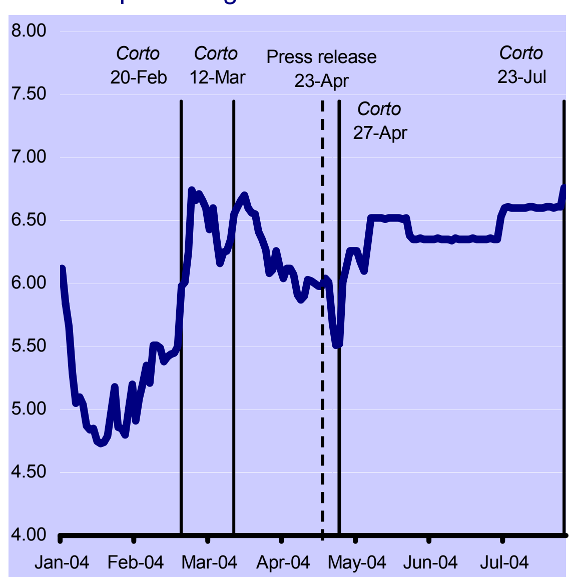


Graph 19 Interest Rates in Mexico

a) Yield Curve (Monthly Average)
Annual percentage



b) Banks' Funding Rate
Annual percentage



* Available information up to July 23, 2004.

Economic information released in early April confirming the soundness of the U.S. recovery began to raise expectations that the Federal Reserve would begin to reduce the accommodative stance of monetary policy more rapidly than previously anticipated. This changed financial conditions considerably, thus making U.S. and world interest rates increase.

The new environment has affected investors' attitude in international markets significantly, creating greater risk aversion and, consequently, a portfolio rebalancing. This has brought about increases in the levels and volatility of interest rate spreads in emerging economies, therefore deteriorating their financing conditions.

International financial conditions over the next months will depend mainly on the outlook on Federal Reserve's actions, as expectations regarding the velocity and magnitude of such actions can change rapidly. For example, the release of different U.S. economic indicators for June, which suggested slower growth in aggregate demand, prompted interest rates to fall by the end of the quarter, and even more sharply at the beginning of July. Nonetheless, after the Federal Reserve announced that the monetary stimulus had become less necessary (press release of July 20), interest rates rose slightly.

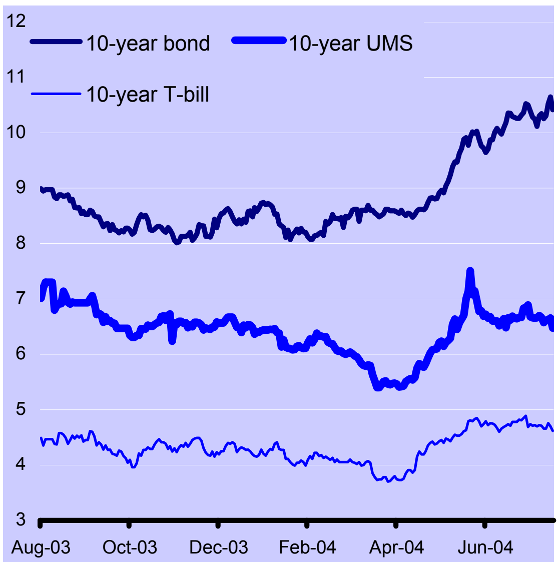
In general terms, international markets nowadays believe that the Federal Reserve will continue withdrawing the monetary stimulus more slowly than anticipated at mid-June, as confirmed by the yield curve on federal funds rate futures during the last weeks (Graph 7).

Given Mexico's strong integration to world's goods and capital markets, the economy cannot decouple from the prevailing international monetary conditions that affect the different accounts of the balance of payments. During the second quarter, this process was reflected in both increases in interest rates throughout the entire yield curve and in certain depreciating pressures over the peso (Graph 19a and Graph 20).

In light of such developments, one of the main challenges of monetary policy is to foster that the economy adjusts in an orderly manner to the prevailing higher interest rates. This gains relevance when considering that higher interest rates, particularly in longer term instruments, may stem from gains in the marginal product of capital, which is reflected in higher real interest rates (characteristic of the current cyclical phase of the world and domestic economies), in long-term inflation expectations, and/or in different risk premia. The assessment of the recent changes in the yield curve is further complicated by the fact that on previous episodes of higher international interest rates, financial instruments had a lower average duration. Thus, it is possible that the increase in long-term interest rate securities is partly reflecting higher risk and liquidity premia.

Graph 20 **Government Securities Interest Rates and Exchange Rate**

a) Interest Rates (Mexico and U.S.)
Annual percentage



b) Exchange Rate
Pesos/US dollar

As monetary policy achieves the convergence of inflation to its target, it is clear that any upward revisions in long-term inflation expectations and/or in risk premia will be mostly contained. In this case, the adjustment of domestic interest rates to the new international monetary conditions will be orderly and of a lesser magnitude, thus mirroring the increases in real interest rates that are inherent to any economy's cyclical recovery.

Under said environment, together with the different inflation pressures that have arisen, Banco de México has been gradually restricting its monetary stance. In its press release of April 23, the Central Bank announced that given the upward revision in inflation expectations and the increase in foreign interest rates, it was not desirable to loosen domestic monetary conditions. Nonetheless, after its publication, the bank's funding rate fell sharply. Consequently, on April 27 the Board of Governors of Banco de México decided to increase the *corto*, from 33 to 37 million pesos. Such measure reverted the downward correction in this rate (Graph 19b).[17]

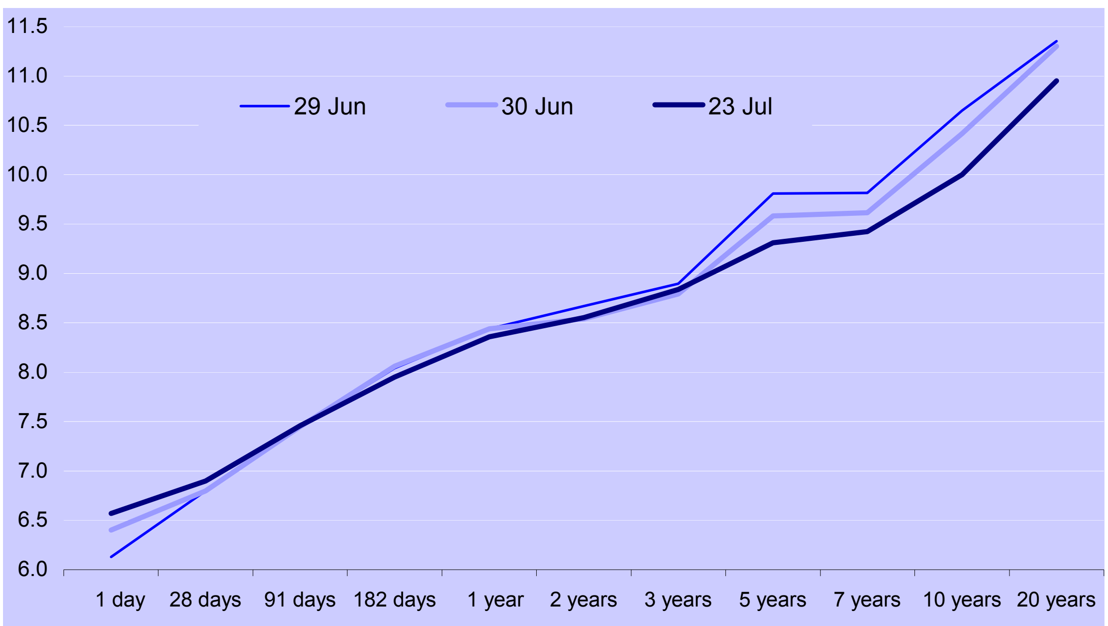
[17] From that date onward, bank's funding rate has reduced its volatility significantly.

Following such event, bank funding rates adjusted on two occasions: first, in response to the Federal Reserve's decision to increase U.S. short-term interest rates, and second, in the week prior to the release of the Inflation Report April-June 2004, in response to Banco de México's decision to tighten the monetary stance. Both adjustments have led to a new flattening in Mexico's yield curve. Such results reflect monetary policy's current restrictive stance (Graph 21).

In light of such developments, Banco de México will remain attentive to take the necessary actions to make inflation converge to its target.

Graph 21 **Yield Curve**

Annual percentage



II.5. Monetary and Credit Aggregates

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

During the second quarter of 2004, the monetary base rose, on average, at an annual rate of 13 percent, 0.2 and 6.3 percentage points below that of the previous quarter and of the second quarter of 2003, respectively.[18] As stated in previous

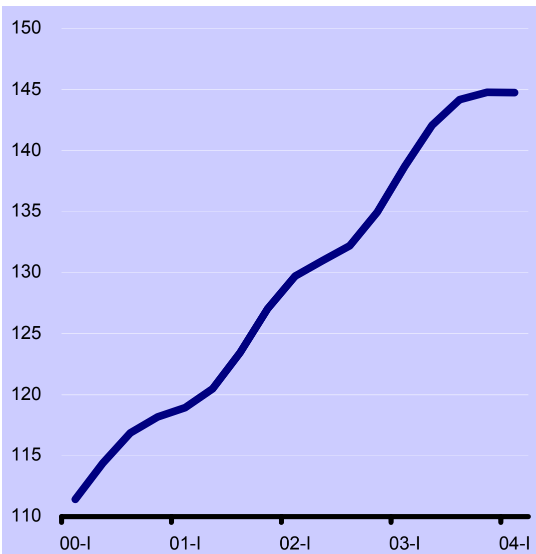
[18] Variations calculated on the basis of average daily stocks.

inflation reports, this was due to the lesser dynamism of remonetization as a result of the sharp downward trend exhibited by interest rates in the last years (Graph 22a).

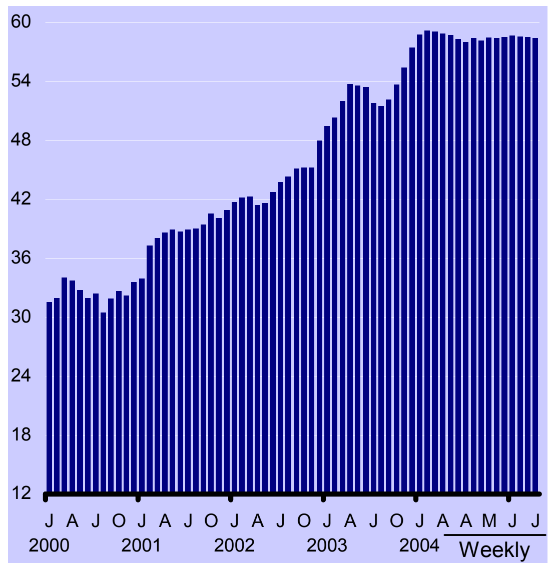
From April to June 2004 the monetary base rose by 11.4 thousand million pesos. During such period, international assets decreased by 1.2 billion US dollars. Thus, their stock at June 30 was 60.5 billion US dollars. Consequently, net domestic credit increased 24.6 thousand million pesos in the second quarter of the year.

Graph 22 Monetary Base and International Reserves

a) Ratio Monetary Base to GDP
Index 1997=100 (trend series)



b) International Reserves
Billion US dollars



As in previous quarters, the main source of international reserves in 2004-2 was PEMEX (2.484 billion US dollars). Throughout the year, PEMEX has placed debt instruments in the domestic market to finance PIDIREGAS,[19] allowing it to diversify its sources of financing and reducing, at the margin, the number of debt instruments traditionally placed abroad (Graph 22b). As for its international reserves uses, 1.892 billion US dollars were sold through the mechanism to reduce international reserve accumulation, while 1.446 billion were bought by the federal government for external debt servicing. Such mechanism has slowed international reserve accumulation (Graph 22b).

[19] Long-term infrastructure investment projects.

Table 8 **Monetary Base, Net International Assets and Net Domestic Credit**

Million

	Stocks		Flows in 2004		
	At Dec/12/2003	At Jun/30/2004	Quarter I	Quarter II	Accumulated at Jun/30/2004
(A) Monetary Base (Pesos)	303,614	278,847	-36,190	11,422	-24,767
(B) Net International Assets (Pesos) 1/ 2/	663,657	697,527	28,771	-13,209	15,562
Net International Assets (US dollars) 2/	59,059	60,519	2,646	-1,186	1,460
(C) Net Domestic Credit (Pesos) [(A)-(B)] 1/	-360,043	-418,680	-64,960	24,631	-40,329
(D) International Reserves (US dollars) [(E)-(F)] 3/	57,435	59,128	1,614	79	1,693
(E) Gross International Reserves (US dollars)	59,028	60,476	2,631	-1,183	1,448
PEMEX			3,268	2,484	5,753
Federal Government			880	-1,446	-567
Sale of US Dollars to Banks 4/			-1,938	-1,892	-3,830
Other 5/			421	-329	92
(F) Liabilities with less than six months to maturity (US dollars)	1,593	1,348	1,017	-1,262	-245

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

II.5.2. Monetary Aggregates and Financing

In the last months, saving in domestic financial markets has expanded more, due to both temporary and structural factors. Regarding the former, the cyclical recovery of the economy deserves mention (Graph 23a). As for the latter, the different financial reforms adopted in the last years and progress in attaining low and stable inflation (which, in turn, has contributed to financial deepening) are also relevant. Thus, during the first five months of the year, monetary aggregates (both narrow and broad) have grown robustly (above 7 percent, at a real annual rate) [Graph 23b].

Lending to households has remained strong, albeit stemming from a reduced base. While direct credit to consumption has exhibited annual real variations above 35 percent for nine consecutive months, housing credit has recovered in the last months, exhibiting an annual real variation of 6.2 percent in May.[20] Bank lending to non-bank financial intermediaries (according to source of financing) accounted for 14.2 and 26.8 percent of the stock of credit channeled by banks to consumption and housing, respectively.[21] Considering commercial bank's direct credit to both

[20] Refers to direct bank lending.

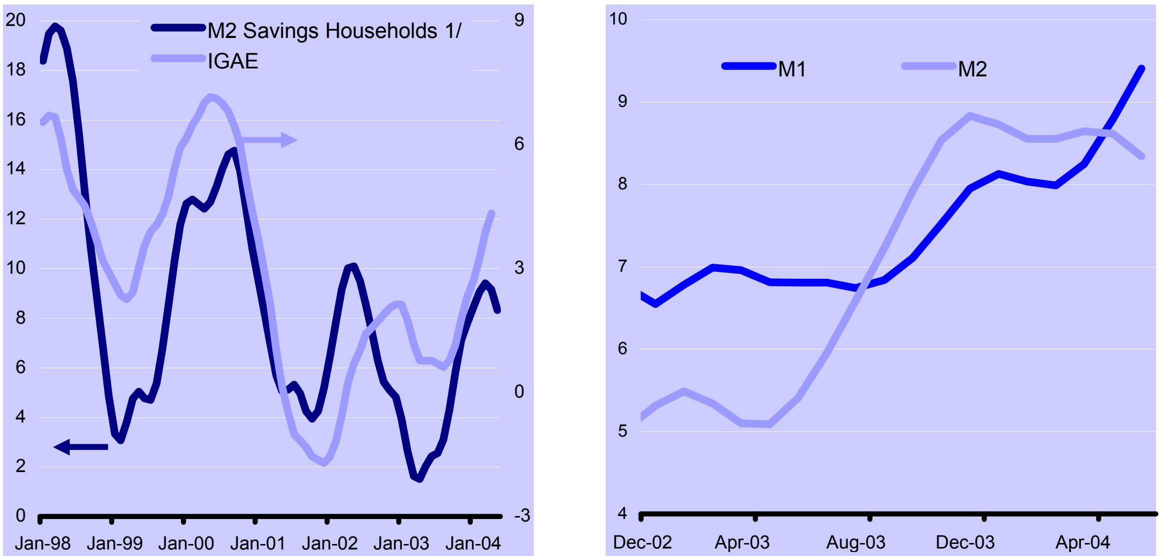
[21] Bank financing to financial intermediaries excluding consumption and housing SOFOLES is very small.

housing and mortgage SOFOLES, lending to households recovered more markedly (Graph 24b).[22]

Graph 23 Monetary Aggregates

a) Annual real percentage change (trend series)

b) Annual real percentage change (trend series)

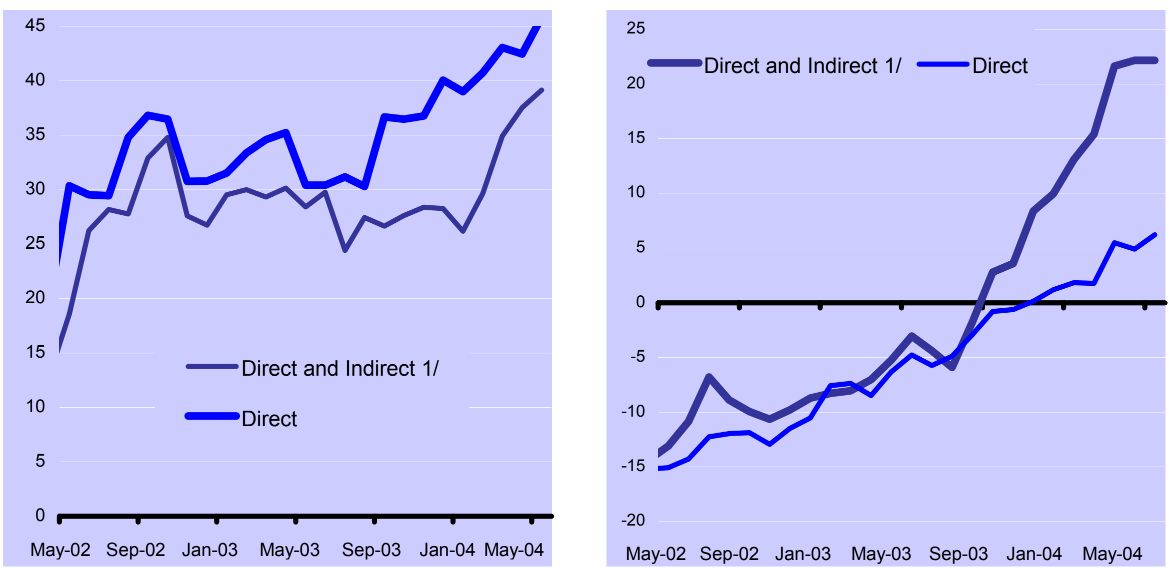


1/ Including bills and coins held by the public, bank term deposits, public and private securities held by households (M2), excluding resources from the SAR.

Graph 24 Bank Lending to Households

a) Consumer Credit
Real annual percentage change

b) Housing Credit
Real annual percentage change



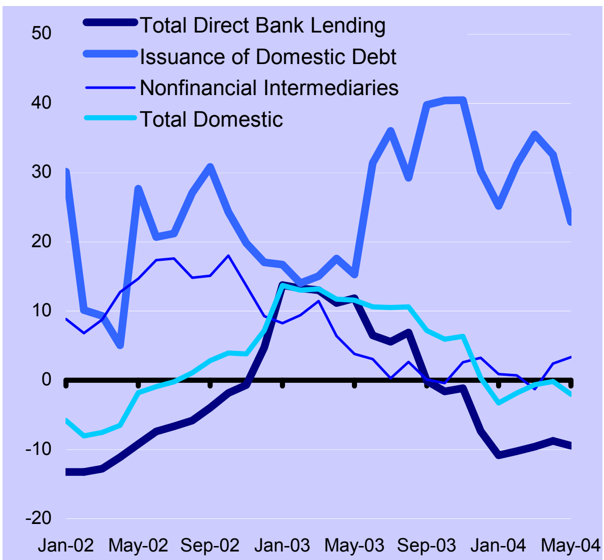
1/ Total financing includes bank's direct lending to housing, consumption, and to mortgage and consumer SOFOLES (excluding debt-restructuring programs).

[22] Up to May 2004, performing portfolio of mortgage SOFOLES exhibited an annual real variation of 28.4 percent, accounting for 62.3 percent of total performing portfolio to housing (excluding portfolio related with debt-restructuring programs).

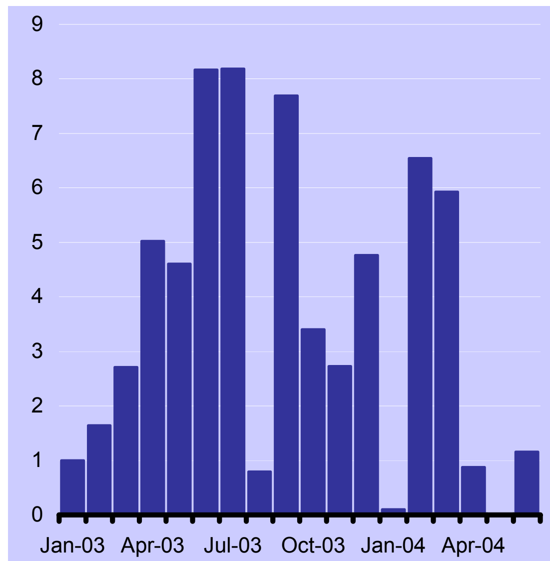
On another front, total financing to firms has not increased significantly. In the last years, the reduction in bank's financing has been partially compensated by the placement of securities (Graph 25a). Nonetheless, given the increase in interest rates in the last months, the issuance of domestic debt instruments has declined significantly: from 15 placements of medium-term flexible securities in the first quarter of 2004 (12.6 thousand million pesos) to 5 placements in the second one (2 thousand million pesos).

Graph 25 **Domestic Financing to Firms**

a) Domestic Financing to Firms
Real annual percentage change



b) Medium-term Stock Certificates
Total issuance in billion pesos



III. Private Sector Outlook for 2004-2005[23]

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

In general terms, private sector economic analysts' forecasts during the second quarter of 2004 were characterized by the following aspects: a) a downward revision in expected inflation for 2004; b) an upward revision in expected GDP growth for the year (and, consequently, in expected formal employment); and c) an improvement in Business Confidence and Business Climate Indicators.

In particular, forecasts were as follows: i) June's expected figure for GDP growth in 2004 was 3.93 percent, above that in March (3.23 percent) [Table 9]; ii) June's expected figures for private consumption growth in 2004 were 4.01 percent, above those in March (3.42 percent). Expected figures for private investment growth during the quarter were also revised upward, from 3.96 to 5.40 percent; iii) 376 thousand jobs are expected to be created in the formal sector in 2004 and 444 thousand in 2005; iv) interest rates expected figures for the following months were revised slightly upward; v) expected figures for the exchange rate at the end of 2004 were also revised slightly upward; and vi) both trade and current account deficits for 2004 and 2005 are expected to be below March's forecasts.

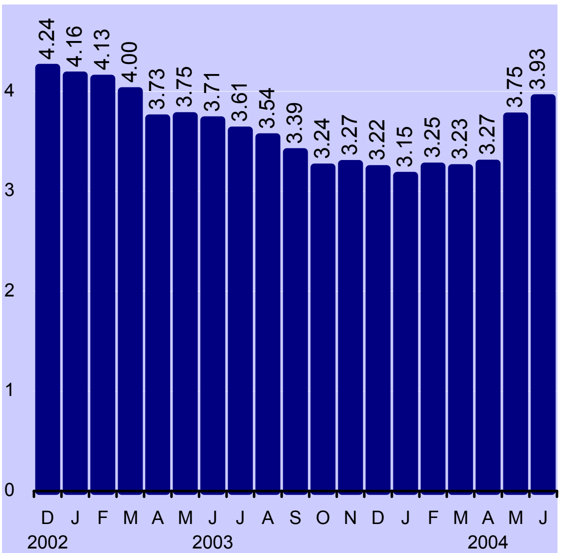
Other aspects from private sector economic analysts' forecasts that also deserve mention are: a) an improvement in the average level of the Business Confidence Index during the quarter, and b) the insistence on the need to advance in structural reforms in order to increase investments in the country.

[23] Unless otherwise stated, forecasts reported in this section are drawn from Banco de México's monthly Survey of Private Sector Economic Analysts' Forecasts.

Graph 26 **Private Sector Economic Analysts' Forecasts for GDP Growth and for Expected Number of Workers Insured by the IMSS in 2004**

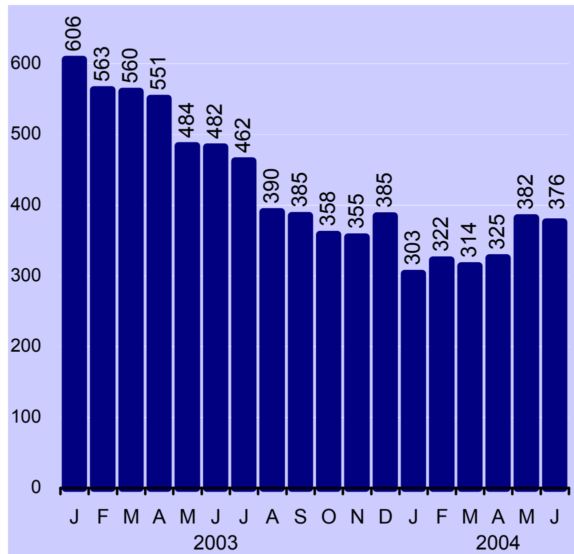
a) Real GDP Growth

Percent



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

Thousand workers



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

Table 9 **Private Sector Economic Analysts' Forecasts: March and June 2004[1/]**

	Mar/2004	Jun/2004		Mar/2004	Jun/2004
Real GDP Growth in Mexico			**Exchange Rate (Pesos/US dollar, year-end)**		
2004	3.23%	3.93%	Banxico Survey 2004	11.43	11.59
2005	3.70%	3.82%	Futures [2/]	11.53	11.74
			Banxico Survey 2005	11.81	11.95
Trade Deficit (Million US dollars)			**Mexican Crude Oil Mix (Average US dollars per barrel)**		
2004	8,018	6,580	Banxico Survey 2004	23.52	27.75
			Wage Increases		
Current Account Deficit (Million US dollars)			May 2004	4.54%	n.a.
2004	12,897	11,215	June 2004	n.a.	4.30%*
			Business Climate		
Foreign Direct Investment (Million US dollars)			1998=100**	152.3	154.2
2004	13,626	15,115			
2005	13,725	13,613			
Real GDP and Industrial Production Growth in the U.S. in 2004 and 2005					
GDP Growth in 2004			**GDP Growth in 2005**		
Banxico Survey	4.46%	4.57%	Banxico Survey	3.73%	3.68%
Consensus Forecasts[3/]	4.6%	4.7%	Consensus Forecasts[3/]	3.7%	3.8%
Blue Chip Economic Indicators[4/]	4.7%	4.7%	Blue Chip Economic Indicators[4/]	3.8%	3.7%
Industrial Production in 2004			**Industrial Production in 2005**		
Blue Chip Economic Indicators[4/]	4.9%	5.0%	Blue Chip Economic Indicators[4/]	4.9%	5.1%

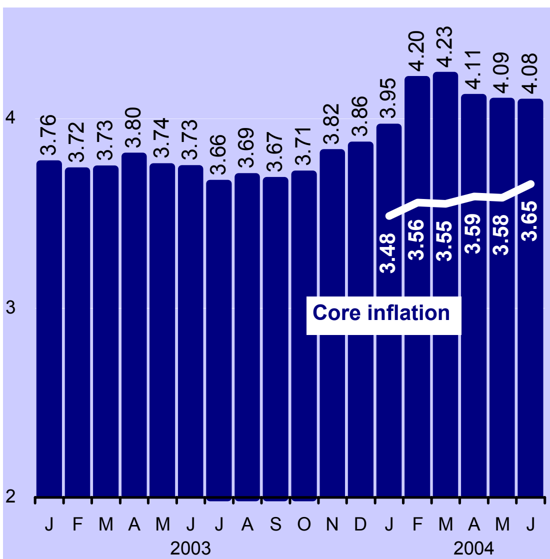
n.a. not available.
1/ Unless otherwise stated, data is drawn from Banco de México's monthly Survey of Private Sector Economic Analysts' Forecasts.
2/ Exchange rate futures of March 31 and July 5, 2004.
3/ *Consensus Forecasts (*March 8 and June 14, 2004).
4/ Blue Chip Economic Indicators (March 10 and June 10, 2004).
*/ Data from May 2004 Survey.
**/ Average level in first and second quarters.

III.2. Inflation Forecasts

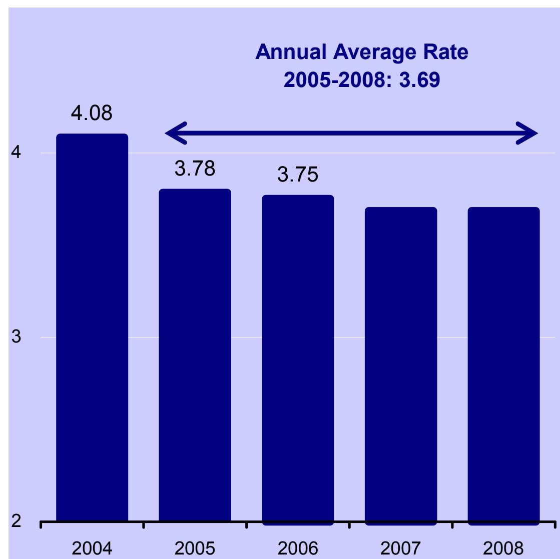
Forecasts for CPI inflation in 2004 were revised downward during the second quarter of 2004. June's figures for this variable in 2004 were 4.08 percent, below those in March (4.23 percent), while for core inflation at the end of the year were 3.65 percent. On the other hand, forecasts for CPI inflation for the following twelve months, 2005, 2006, and for the average in 2005-2008 were 4.02, 3.78, 3.75 and 3.69 percent, respectively. Inflation expectations for the longer term are still high in relation to Banco de México's 3 percent target.

Graph 27 **Private Sector Economic Analysts' Forecasts for Inflation in 2004-2008**

a) CPI and Core Inflation for 2004
Percent



b) CPI Inflation for the Short and Long terms
Percent



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

IV. Balance of Risks and Final Remarks

Banco de México's scenario for the remainder of 2004 is based on the following assumptions:

(a) The recovery of the U.S. economy will continue during the second half of 2004 and in 2005, despite the fact that latest information available has made different analysts to revise slightly downward their forecasts for growth. Currently, forecasts for this variable are, on average, 4.5 percent (figure higher than estimates for potential GDP growth). As for industrial production, it is expected to expand at a higher rate (from 4.9 percent at the end of the first quarter to 5.3 percent nowadays).

(b) The restrictive monetary conditions that are anticipated in international financial markets have raised domestic interest rates throughout the entire yield curve. Nonetheless, the effects of such conditions on expenditure have been mitigated by higher oil revenues and workers' remittances.

(c) The crude oil export mix price for 2004 is expected to be between 28 and 29 US dollars per barrel.

Based on the above assumptions, and on most recent information available regarding the performance of the Mexican economy, Banco de México's baseline scenario for 2004 is as follows:

Economic Growth: Real GDP is expected to grow between 3.75 and 4.25 percent.

Employment: 450 thousand formal jobs are expected to be created.

Current Account: The current account deficit of the balance of payments is expected to be slightly above 1 percent of GDP as a result of higher oil prices and workers' remittances.

Inflation: During 2004, inflation has been subject to numerous shocks; for the next months, three factors (two of which originate from the prevailing external conditions) are expected to affect it.

First, one of the main challenges currently affecting the disinflation process is the increase in different commodity prices, due partly to a probable change in relative prices throughout the world, which has positively affected this type of goods. Nonetheless, as already mentioned, different reasons allow to anticipate that such pressures will eventually ease.

Second, uncertainty about the magnitude and intensity of Federal Reserve's monetary policy actions prevails. Should inflation conditions in the U.S. worsen, volatility in international financial markets, and therefore in Mexico's markets, could increase. Under such setting, one of monetary policy's main challenges is to foster the appropriate conditions so that the economy can adjust in an orderly manner to the current financial environment characterized by higher interest rates.

Third, despite the fact that no significant inflation pressures inherent to the current cyclical phase of the Mexican economy have been detected, these cannot be ruled out if the strength of aggregate demand continues.

Based on the above considerations, the expected inertial scenario for 2004 for the different CPI subindexes is as follows:

(a) The trend for total core inflation is expected to remain nearly constant and then decline gradually. The relatively constant level of this indicator, which is anticipated to continue in the following months, has originated from two opposite trends.

(b) Merchandise core inflation has followed an upward trend, largely determined by the behavior of food prices. Such behavior has been due mainly to the increase in different commodity prices. Despite the fact that futures markets anticipate that this influence will start to recede, food prices are expected to continue moving up for some time. Pressures over merchandise prices (food and other merchandises) could also intensify if the exchange rate passthrough increases, as a result of the cyclical phase undergone by the economy.

(c) The behavior of annual core services inflation (excluding housing) suggests that the economy continues its long-term trend towards inflation abatement. Nonetheless, it is important to stress that real wage increases must reflect the expected gains in productivity.

(d) The outlook for the housing subindex exhibits two opposite trends of similar magnitude: on the one hand, the pressures generated by the international price increases in some materials for residential construction, such as metal products; on the other, the moderate increases in housing rents due to a greater supply of housing with a growing access to financing. As a result of both trends, the variation of such subindex is expected to exhibit some downward resistance.

(e) As for non-core inflation, the volatility in the prices of its different subindexes, together with the unexpected shocks that might affect it, make the assessment of its outlook more difficult. However, there are some factors that deserve mention: i) the effects of shocks to livestock goods' prices, originated from the trade restrictions on meat imports at the beginning of the year, will continue reverting, albeit slowly, in the next months; ii) futures markets suggest a slight reversion in the price increases of energy commodities; and iii) the prices of fruits and vegetables have accumulated six months with negative month-to-month variations. Such unusual phenomenon could revert in the near future. In absence of additional supply shocks, non-core annual inflation is expected to decline towards the beginning of 2005.

The abovementioned scenario confirms that the conditions surrounding inflation have become more unfavorable. This has been clearly reflected in inflation expectations. In the last weeks, inflation expectations for the following twelve months have been revised upward, while those for the medium and long terms remain above the target.

Under such setting, the Board of Governors of Banco de México has adopted different measures to incorporate a restrictive stance in monetary policy. In this regard, the Central Bank has reiterated the need for domestic monetary conditions to tighten.

Banco de México faces significant challenges. On the one hand, it must prevent external supply shocks, i.e., an increase in commodity prices and an unfavorable external environment, from contaminating inflation expectations. On the other, it must remain attentive to contain any cyclical pressures originating from the recovery of aggregate demand that could affect inflation.

The expected macroeconomic scenario is subject to two risk factors, which are opposite by nature: those affecting growth and those affecting inflation.

Regarding the former, most recent information suggests that U.S. aggregate demand has slowed slightly. In this regard, a risk factor would be that the economy of Mexico's main trading partner should weaken significantly, as it would directly affect the demand for Mexican exports.

To assess the repercussions of such scenario, it should be noted that external factors have played an important role in the recent expansion of the Mexican economy (see Box 4). This reflects that, currently, the domestic sources of growth are still insufficient. Therefore, should the former risk factor materialize, forecasts for growth and employment would be affected.

It is important to underline that both economic growth and employment estimates considered in the baseline scenario are far from being the ones required to address poverty and other social problems efficiently. In order to materialize and consolidate the Mexican economy's growth potential, its competitiveness must be raised. The Mexican economy needs to be more flexible to adapt to the world's changing conditions and to growing competition in foreign trade. Therefore, Banco de México reiterates the need to reach the agreements to both implement the required structural reforms and strengthen the country's institutions. As structural changes continue to be postponed, Mexico will become more vulnerable, loosing both market share in international markets and inflows of foreign investment to other emerging economies, and, most of all, wasting the opportunity to take full advantage of the current expansion of the world economy in order to create more jobs and improve Mexicans' welfare.

On another front, several inflation risks could also materialize. The most important would be that inflation pressures in the U.S. escalate, prompting the Federal Reserve to withdraw the monetary stimulus more rapidly and aggressively than expected. This would raise uncertainty in international financial markets, thus bringing about higher volatility in domestic financial markets.

Given the above scenario and risks, Banco de México will remain attentive in order to take the necessary actions to foster the convergence of inflation to its 3 percent target. By maintaining price stability, the Central Bank fosters, according to its constitutional mandate, a suitable environment for the adequate performance of economic activity. Nonetheless, in order for these conditions to translate into sustained growth, they must be complemented with other economic policy and structural reform measures that require both the willingness and responsibility of all of the country's social actors.