Inflation Report

April - June 2003

Summary

During the second quarter of 2003, the path of inflation was in line with the attainment of the 3 percent target (with a variability interval of plus/minus one percent) by the end of December and in the long term. The prevailing financial and monetary conditions and, in general, weak aggregate demand, have contained inflationary pressures. Furthermore, the effects of the different supply shocks on the Consumer Price Index throughout 2002 have finally dissipated, without having had a significant impact on the core price index. Accordingly, the gap between inflation expectations for year-end 2003 and the corresponding target narrowed significantly.

Disinflation has evolved in an environment characterized by weak aggregate demand, both domestic and external, as well as by sluggish economic activity worldwide. Under the present scenario, and given the trend of inflation towards its target, two aspects of monetary policy should be highlighted:

(a) Domestic interest rates have fallen to historic minimum levels, thus reflecting the country's lower inflation and higher liquidity in international financial markets; and

(b) The Exchange Commission's decision to reduce the pace of accumulation of international reserves has increased, at the margin, the availability of resources for financing productive activities.

Thus, the Board of Governors of Banco de México considers that, for the remainder of the year, annual headline inflation will continue its path towards the attainment of the 3 percent target while core inflation will remain within the variability interval for CPI inflation. Nonetheless, this scenario is not exempt from both external and domestic risks.

Recent Developments in Inflation

The behavior of prices during the second quarter of 2003 was in general favorable. In June, annual CPI inflation was 4.27 percent, a reduction of 1.37 percentage points compared to March. This is the lowest rate in three decades. During the same period, annual core inflation rose by a mere 0.07 percentage points, from 3.53 percent in March to 3.60 percent in June. The decline in headline inflation is attributed to the significant fall in the annual rate of increase of prices of agricultural products and of goods administered or regulated by the public sector.

At the end of June 2003, annual core inflation of goods turned out to be 2.16 percent (an increase of 0.13 percentage points compared to March). This rebound is mainly explained by the atypically low increase that this price subindex registered in the same quarter of the previous year. The services annual core inflation rate declined from 5.40 to 5.25 percent during the same period.

Main Determinants of Inflation

During the second quarter of 2003, several external factors influenced the performance of the Mexican economy.

During the reference period, the average WTI oil price was 29.05 US dollars per barrel, five

dollars lower than that registered during the first quarter of 2003.

Despite the reduction of uncertainty in world financial markets once the war in Iraq ended, the United States economy posted mixed results during the second quarter of 2003. Although production has continued to expand, it has not increased sufficiently to overcome idle capacity in many sectors of the economy and thus offset the sharp fall in employment. The meager growth has created slack in the labor market and has also reduced inflationary pressures significantly. Despite the unfavorable labor market conditions, consumption has remained strong, driven by an increase in households' indebtedness and by a recovery in confidence. The pick up in demand continues to rely on household spending, without showing clear signs of an expansion in investment by firms.

During the second quarter, in the United States there was a change in market sentiment. The loosening of monetary policy derived in more favorable financial conditions, given that interest rates diminished to historic minimums, and that the US dollar experienced a significant depreciation. It is important to point out that the reduction in interest rates (especially long-term) can be attributed, at least to some extent, to the lower demand for credit stemming from the weak outlook in capital expenditure.

Under this context, the recovery of the United States economy has still not been fully achieved. On the one hand, the improvement in consumers' confidence, looser financial conditions and the fiscal stimulus point to an upturn in domestic demand in the second semester of 2003. On the other hand, the improvement seen on different U.S. economic indicators did not include either industrial production or non-residential fixed investment. The upturn of the latter is fundamental to ensure a robust and long-lasting economic recovery.

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During the second quarter of 2003, Mexico's labor market continued to remain stagnant. On the one hand, unemployment rose slightly compared to the past quarter, while formal employment contracted. Moreover, sluggish productive activity continued to induce a migration from formal to informal employment. On the other hand, the increase in contractual wages maintained a downward rigidity, ending the quarter averaging slightly above 5 percent.

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During the analyzed period, GDP recorded a real annual increase of 2.3 percent. Nonetheless, this number was influenced by the statistical effect of the Easter holiday which, in 2002, took place in March, while in 2003 it did in April. Using seasonally adjusted data, GDP contracted 0.5 percent in relation to the previous quarter. This resulted from the fact that the quarterly expansion of private consumption and net exports was not able to offset the negative variations of gross capital formation, public expenditure, and of a sharp inventory adjustment. These results also show that the current structure of aggregate demand, where consumer expenditure has been increasing its share in GDP with respect to investment, does not foster the attainment of high and sustained growth, needed to spark the recovery of employment.

Available information on recent economic activity suggests that the Mexican economy grew at a sluggish pace in 2003-II. On the side of production, this is reflected by the performance of the Global Indicator for Economic Activity (*Indicador Global de Actividad Económica, IGAE*), industrial output, exports and imports of merchandises, as well as formal employment. On the domestic demand side, growth apparently was sustained by the expansion in consumption, despite some signs of improvement in certain items of investment spending. These resulted from the growth numbers accruing to retail sales, domestic car sales, credit, imports of capital goods, as well as of that of confidence and business climate indicators.

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During April-June 2003 there was an improvement in Mexico's conditions for gaining access to external financing. Interest rates on the Mexican external debt were close to historic minimum levels. Nevertheless, net inflows to the country were moderate, as observed by the balance of payments' capital account. Reduced demand for external resources originated from weak domestic production and aggregate demand. Moreover, it also stemmed from the restructuring of liabilities by private issuers, which have opted to obtain financing in the domestic market in order to reduce their external debt. In this context, and in contrast to the first quarter, the exchange rate no longer tended to depreciate. The peso registered an appreciation of 2.9 percent in the second quarter.

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During the second quarter, the annual variation of the subindex of prices of goods administered or regulated by the public sector posted a significant reduction, due to the decline in electricity tariffs and in the prices of low octane gasoline. The fall in electricity prices in April and May was due to the beginning of the summer season, when lower rates are charged in many northern cities, and which ends in October and November. As for the annual inflation of agricultural products, this fell by more than half compared to March.

Monetary Policy During the Second Quarter of 2003

During April, May and June 2003 the daily level of the "short" was maintained at 25 million pesos.[1] Prior to this period, actions to restrict monetary policy had been adopted owing to the fact that the economy was facing the effects of supply shocks that could have endangered price stability.

During the second quarter, these actions had taken effect and non-core inflation began to drop markedly. Likewise, the monetary conditions thus achieved also induced a change of trend in private sector analysts' expectations for year-end inflation.

In order to analyze monetary conditions from April to June 2003, a brief description of developments in Mexico's financial markets, in light of the international environment surrounding them, is presented below.

Throughout the quarter, and once the war in Iraq ended, uncertainty in world financial markets diminished. Thus, the demand for higher risk assets increased and the main stock market indices began to pick up. However, estimates of a feeble world economy and the absence of inflationary pressures nurtured expectations regarding the possibility that various central banks would continue to loosen monetary policy (which, in the event, happened). Interest rates fell to very low levels in most industrialized economies. The perception that a world cycle of restrictive monetary policy actions was not foreseeable in the near future also contributed to the overall drop in interest rates.

In a scenario of very low international interest rates and of greater demand for debt instruments of certain developing countries, the yields on Mexico's sovereign bonds continued to fall. As a result, Mexico's country risk declined, on average, by more than 70 basis points (EMBI+) during the first and second quarters of 2003. Falling external interest rates, expectations of a lower exchange rate risk for the coming months, and a higher appetite for risk among investors, allowed domestic interest rates to decline significantly. Thus, the yield curve experienced a marked fall, dropping to very low levels in all terms, especially in those

[1] Since April 10th, the regime of accumulated balances ceased operating and a new one based on banks' daily current account balances at Banco de México went into effect.

instruments with shorter maturity. Interest rates on 28-day and 91-day CETES declined, on average, 255 and 238 basis points between the first and second quarters of 2003, reaching historic minimum levels. As for the average yield on the 10-year bond, this declined 135 basis points during the same period.

The behavior of domestic interest rates has been consistent with the orderly adjustment of the Mexican economy during the downward stage of the business cycle. Under the present circumstances, monetary policy has been focused on two main aspects. On the one hand, it has allowed a strong reduction of interest rates, which constitutes a direct incentive for expenditure. On the other hand, the reduction in the pace of accumulation of international reserves has increased, at the margin, available resources for financing productive activities. In this way, monetary policy has contributed to create the appropriate conditions to foster stronger economic growth, without jeopardizing the attainment of the inflation target.

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During the second quarter of 2003, the monetary base continued to expand at high rates when compared to the inflation target and expected GDP growth. However, it is important to mention that this increase has been similar to that forecasted in the Monetary Program for the same period. Said growth reflects the strong process of remonetization that the economy is undergoing and, thus, it is fully consistent with the attainment of the inflation target.

During the same period, total international reserves rose by 1.409 billion US dollars. In addition, by June 30th 1.280 billion US dollars had been sold via the mechanism to reduce the pace of accumulation of international reserves.

Domestic supply of available financial resources from March 2002 to the same month in 2003, measured through the annual flow of the monetary aggregate M4, amounted to 4.9 percent of GDP. Total financing to the private sector represented 40.4 percent of such flow, of which a significant share was channeled through INFONAVIT and FOVISSSTE. As a result, available domestic financial resources for non-residential investment accounted for a little more than one fourth of total annual saving (25.9 percent).

Private Sector Outlook for 2003[2]

Private sector economic analysts revised downward their forecasts for GDP growth in 2003, from 2.54 percent in March, to 2.16 percent in June. In line with the above, expected growth in domestic demand contracted (particularly consumption and private investment), while the forecasts for employment fell as well as those for the trade and current accounts deficits.

Most economic analysts also revised downward their forecasts for US GDP growth in 2003 and, to a greater extent, for industrial production. Nevertheless, expectations in June regarding economic growth for 2003 in Mexico and the United States point to a significant rebound in economic activity during the second half of the year.

Expected annual headline inflation for 2003 was also reduced considerably during the analyzed quarter, from 4.38 percent to 4.01 percent in March and June, respectively (a decline of 0.37 percentage points).

Balance of Risks

During the second quarter of 2003, the Mexican economy was affected by the weakness of external and domestic demand. Moreover, the structure of domestic spending continued to change towards more consumption and less investment. On the supply side, this resulted in a lesser contribution of the industrial sector to GDP

[2] Forecasts reported in the Survey of Private Sector Economic Analysts' Expectations undertaken by Banco de México.

growth and employment, while that pertaining to services increased.

Given the above context, Banco de Mexico's base scenario for the second half of the year considers the following assumptions: i) average annual GDP growth in the United States in 2003 is expected to remain at 2.3 percent, although it is anticipated that industrial production will have expanded at a lower pace for the year as whole (average annual increase revised from 1.4 to 0.6 percent); ii) the Mexican oil export mix price for 2003 is expected to be, on average, 24 US dollars per barrel; and iii) Mexico's access to external financial markets will continue to be favorable for the remainder of the year.

Based on the previous assumptions and on recent information regarding the course of the economy, the following forecasting exercise was made:

Economic Growth: annual GDP growth in 2003 is expected to be approximately 2 percent, lower than last quarter's forecast of 2.4 percent. This stemmed mainly from the downward revision for industrial production growth in the United States in 2003. Current estimates are also subject to a high degree of uncertainty, due to the risk factors mentioned further below.

The annual variation in real GDP during the second quarter of 2003 is anticipated to have been 0.3 percent. This moderate expansion was influenced by fewer working days compared to the same quarter in 2002. In contrast, economic activity is expected to grow more swiftly during the second semester. This rebound would result from the strength of private consumption, a slight impulse from the external sector, and a moderate recovery in private investment.

Employment: Due to the fact that forecasts for economic growth have been revised downwards and increases in contractual wages continue forestalling new hires, approximately 150 thousand jobs are expected to be created in the formal sector of the economy.

Current Account: The deficit is anticipated to be 2.2 percent of GDP.

Inflation: For the remainder of the year, inflation is expected to follow a path consistent with the attainment of the 3 percent target, with a variability interval of plus/minus one percent. In addition, annual core inflation is foreseen to remain firmly within such interval, falling gradually.

As for the different subindices, annual core inflation of goods is anticipated to remain stable. The slight rebound in this subindex during the summer (owing to the atypically low inflation recorded in the same period of 2002), could be countered by the expectation of continued deflation in tradable goods in the United States. Regarding the core subindex for services, this is expected to further contribute to the abatement of headline inflation. Nonetheless, the magnitude of such contribution will depend, to a great extent, on the path of wage settlements.

The outlook for non-core inflation during the following months is, in general, compatible with the inflation target, in the absence of unexpected shocks. It should be pointed out that the effects coming from adjustments in administered prices in 2002 have practically dissipated, without having had any contagion on core inflation.

The described scenario is subject to different uncertainty factors, among which the external ones are:

(a) The duration and strength of increased industrial production and non-residential investment in the United States could affect the expected course of the economy; and
(b) Volatile oil prices.

As for the main domestic risks that could also affect the base scenario, the following are:

(a) The possible fall in Mexican exports' market share in the United States due to the country's relative loss of competitiveness;

(b) The continuity and intensity of the economic rebound in Mexico will depend, to a great extent, on the restructuring of aggregate demand to favor investment, especially for machinery and equipment and non-residential construction;

(c) Although core inflation has remained clearly within the variability interval, over the last months it has shown some downward rigidity;

(d) Wage increases continue to be incompatible with the slack in labor market conditions;

(e) Headline inflation might be affected by new supply "shocks", which could have an unfavorable impact on non-core inflation, particularly, on agricultural prices. In the short run, these type of shocks could make inflation deviate from its year-end target. Nevertheless, in such event, these would likely be short-lived;

(f) A sharp rise in LP-gas prices (which can also be considered as a supply shock) could also affect the path of non-core inflation and trigger inflationary pressures in the short-term. Nevertheless, it is advisable that these prices reflect their opportunity cost, in terms of improving the public finances and also of reducing any distortions in production and consumption; and

(g) The domestic industry's loss of competitiveness is a potential danger for the economy in the medium term. Competitiveness has a direct influence on the economy's potential growth and is also necessary to sustain low inflation in the medium run. This brings to the fore the urgent need to attain the necessary political agreements to push ahead the pending structural reform agenda.

Therefore, the recovery of the Mexican economy is subject to a certain degree of uncertainty. Nonetheless, on the external side, better global financial conditions (owing to the historical decline in international interest rates and to reduced risk aversion) is a key factor for the recovery. On the domestic side, the decline in interest rates, favored by monetary policy, should also add to the recovery.

Notwithstanding the risks listed above, there are substantial elements that allow to foresee the convergence of headline inflation with the year-end target established by Banco de México's Board of Governors. In fact, should the expected domestic and external economic environment materialize, headline inflation in forthcoming years will be around the 3 percent target. In this regard, the long-term objective will apply permanently and not only for a year-end horizon. Once inflation converges to its target, the long disinflation process will end and a new period aimed at consolidating permanent price stability will begin. Monetary policy would then be oriented to keep headline inflation in line with the long-term objective.

Monetary and fiscal discipline in Mexico have been essential in attaining a stable macroeconomic environment. As a result, the Mexican economy has become more resilient to external shocks, thus decoupling from many other emerging economies. On this count, Mexico has gained a favorable access to international capital markets and has also been less affected by their volatility.

Nevertheless, macroeconomic stability is a necessary, but not a sufficient condition to foster growth in production, income, and employment. Further measures aimed at raising productivity and the level of competitiveness of the Mexican economy are also required. Structural reforms, the deregulation process and, in general, all policies aimed at increasing the country's flexibility and capacity to respond to the changing conditions in the world economy, must be oriented in this direction. Our country cannot afford to fall behind while other countries further advance in their economic development. If the process of economic modernization, necessary to guarantee the well-being of Mexico's population, continues to be postponed, the country will fail to take advantage of the favorable conditions yielded by macroeconomic stability.