Inflation Report

October – December 2003

Monetary Program

for 2004

Summary

At the end of 2003, inflation fell compared to September figures, reaching a level just two basis points below the upper limit of the plus/minus one percentage point variability interval around the 3 percent target. Core inflation's contribution to CPI disinflation declined throughout the year. In fact, core inflation rose in the last quarter of 2003. Thus, the lower inflation in 2003 was mainly the result of the reduction of the non-core component.

Among the factors that conditioned the performance of the Mexican economy during the fourth quarter of 2003, the external environment remained as favorable as observed in previous months. In the domestic front, economic activity recovered. On the supply side, this resulted from the performance of manufacturing production, formal employment, and total imports. As for aggregate demand, the components that showed higher growth were consumption, investment in construction, and non-oil exports. In contrast, investment in machinery and equipment remained weak.

Under such environment, and given the gradual trend of inflation towards its target, Banco de México kept the "short" unchanged during the quarter. This decision was also supported by the behavior of inflation expectations, as both for the short and long terms remained relatively stable, despite being above the target.

The Mexican economy is expected to consolidate its recovery in 2004 and grow at a higher rate than 2003, although still below its potential. Thus, given the slack in both labor market and installed capacity, aggregate supply should be able to satisfy the higher aggregate demand without any difficulties, at least in the short term. Under such conditions, no significant inflationary pressures are expected to arise from the expansion of aggregate expenditure.

Since it is expected that Mexico's economic recovery in 2004 will be cyclical, the secular problems the economy has not been able to overcome should not be forgotten. In particular, Mexican exports have been losing competitiveness in global markets, as evidenced by their lower share in U.S. imports. Furthermore, despite the expected recovery of the economy, GDP growth forecasts for 2004 are below potential. In this regard, the weakness exhibited by gross fixed investment in the last three years is a cause for concern.

Annual CPI inflation in 2004 is expected to decrease towards December, in line with the convergence to the inflation target. Nonetheless, it could rise above 4 percent during certain months of the year, especially in winter and summer. This could occur as a result of temporary supply shocks, which are expected to affect the non-core CPI component. Under such circumstances, Banco de México will keep a strict surveillance of these conditions and, should it be the case, will take the necessary actions to prevent any contagion on inflation expectations so that inflation remains on its downward trend towards the 3 percent target.

Recent Developments in Inflation

At the end of the fourth quarter of 2003, annual inflation was 3.98 percent, below the figures of the previous quarter (4.04 percent) and the same period of 2002 (5.70 percent). This resulted mainly from the reduction of non-core inflation during the quarter (0.57 percentage points), since core inflation rose 0.15 percentage points. The latter's increase was due to the rise in merchandise inflation (0.35 points), which could not be offset by the reduction of services inflation (0.07 points). The increase in merchandise prices was attributed, to a great extent, to the rise in international prices of foods' raw materials. Moreover, the depreciation of the exchange rate during the last two quarters of the year affected, albeit moderately (and despite having a small pass-through coefficient), the core subindex of merchandises.

Main Determinants of Inflation

The Mexican economy was influenced by several domestic and external factors during the fourth quarter of 2003.

The average oil export mix price was 25.05 US dollars. In the United States, the favorable financial conditions observed in previous quarters prevailed, and the US dollar continued its depreciation trend. The U.S. economy kept growing, although at a more moderate pace than in the third quarter. During the fourth quarter, the components of expenditure behaved differently than in previous quarters. The lesser effect of the fiscal stimulus slowed down the growth of consumption, while the persistence of favorable financial conditions fueled investment. This, together with the beginning of the process of inventory accumulation, gives support to estimates that the U.S. economy grew above potential during the fourth quarter of 2003.

Industrial production, whose recovery had fallen behind that of GDP, strengthened throughout October-December and reached more sectors than those during the previous quarter. However, the labor market remained weak, despite its modest improvement since August 2003. The expansion of production together with the weakness in employment has been reflected in productivity increases, which are inherent to the current phase of the business cycle. In addition, despite the recovery of economic activity, inflation dropped throughout the year, while the non-core component exhibited rates not seen since 1963.

Private sector analysts' outlook for economic activity in the United States in the near future remains positive. A fiscal stimulus is expected during the first half of the year, while the accomodating monetary policy could prevail for a long period. Under such environment, GDP is expected to grow more vigorously during the first half of 2004 and remain above its potential throughout the year. Analysts estimate that non-residential investment will be an engine for growth.

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According to available information, during the fourth quarter of 2003, economic activity in Mexico exhibited a cyclical recovery. This was reflected in indicators for both aggregate demand and production. As for domestic demand, private consumption expanded significantly, fostered by the greater availability of credit, lower interest rates, the persistence of real wage increases in different sectors, and by the high volume of remittances from Mexican workers abroad. In contrast, the economic rebound was not a sufficient incentive for the recovery of investment. In fact, capital formation seems to be discouraged, among other factors, by the lack of progress in structural reforms that would trigger a higher profitability of investment projects. Finally, exports of goods and services are expected to have grown during the fourth quarter due to the significant recovery of external demand.

On the production side, the performance of the Global Indicator for Economic Activity (*Indicator Global de Actividad Económica, IGAE*) and the significant recovery of manufacturing production point to a recovery of economic activity.

As for the labor market, this was characterized by the improvement of some indicators such as formal employment (with seasonally adjusted data), while others deteriorated. It is important to point out that wage increases are not fully reflecting the position of the Mexican economy in the current business cycle and the prevailing slack in the labor market.

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The behavior of the external sector was influenced by the following factors: the recovery of external demand, which resulted in more exports of manufactured goods; the rebound of domestic production, which fostered higher imports of intermediate goods; and the seasonal increase in domestic spending, especially in consumption. These explain the higher trade and current account deficits in the fourth quarter of 2003, when compared to those registered in the third quarter of the year. Nonetheless, they were significantly lower than in the fourth quarter of 2002.

Monetary Policy During the Fourth Quarter of 2003

The supply shocks that affected the disinflationary process in 2002 and at the beginning of 2003 were practically assimilated by the end of the year, thus allowing a faster convergence of non-core inflation with core inflation. As a result, year-end inflation expectations fell significantly in 2003. Nevertheless, in the last months of the year these expectations increased slightly, influenced by the rise in CPI inflation in the first half of November. This was mainly attributed to the end of the summer electricity tariffs. In general, inflation expectations for the next twelve months fell, and those for the long term showed that economic analysts anticipate low and stable inflation, although still above the target.

During the fourth quarter, several events increased the volatility in financial markets. This translated into fluctuations in both the exchange rate and the short-term interest rates. Initially, the uncertainty in financial markets resulted from external factors, the depreciation of the US dollar among others. Nonetheless, certain domestic factors gained importance. In particular, the lack of agreement to advance in the agenda of structural reforms has worsened the negative perception over the problems related with the country's lack of competitiveness. Under such context, the exchange rate depreciated throughout the quarter, with some episodes of high volatility that eased by the end of the year. It is important to mention that up to date and, in general, the exchange rate has had an orderly adjustment, with a small pass-through to inflation.

Interest rates reacted to the developments in the exchange-rate market and the uncertainty regarding the performance of the Mexican economy. In particular, during the fourth quarter of the year, short-term interest rates rose more than longer term ones, thus flattening the yield curve. However, medium and long-term interest rates remained close to historically low levels, due to both current economic conditions and structural factors. As for the first ones, the level of interest rates is related to the lower phase of the business cycle, where the lower profitability of capital usually reduces the demand for loans. Regarding the structural factors, the progress made to attain an environment of low and stable inflation should be highlighted, since it tends to reduce permanently nominal interest rates as a result of lower inflationary risk. In balance, the reduction in interest rates is mostly due to the second factor.

During the fourth quarter of 2003, the Board of Governors kept the "short" unchanged, at 25 million pesos. This decision was based on the fact that the behavior of aggregate supply and demand did not imply inflationary pressures either in the last quarter of the year or in the near future, since the economy has been growing below potential for a long period. In addition, supply shocks had been dissipating without contaminating inflation expectations. Based on such considerations, Banco de México estimated that inflation will continue its convergence to the target.

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In line with the Monetary Program for 2003, at the end of the year the monetary base was 303.6 thousand million pesos, thus posting an annual variation of 15 percent (16.4 percent on average of daily figures during the year). Therefore, the process by which the monetary base has increased as a percentage of GDP continued (remonetization), although at a slower pace than in previous quarters.

In the fourth quarter of 2003, international reserves rose by 5.317 billion US dollars. The mechanism to reduce the pace of accumulation of international reserves led to sales of 3.218 billion dollars from May 2 to December 31, 2003.

Lower interest rates together with a greater supply of credit have fostered households to raise their indebtedness. In fact, consumer credit has increased significantly and mortgages have recovered. Furthermore, businesses have taken advantage of better domestic financial conditions by substituting external for domestic debt and increasing the term of their liabilities.

Perhaps the most significant factor when considering the development and the structure of financial savings in the past years is the presence of fewer credit restrictions. Thus, a factor that had traditionally limited economic growth, has been significantly reduced.

Private Sector Outlook

According to the forecasts of private sector economic analysts during the fourth quarter of the year, expected GDP growth in 2003 was revised downward, from 1.60 percent in September to 1.16 percent in December. In addition, estimates for CPI inflation for the end of 2003 went from 3.78 percent in September to 3.99 percent in December. During such period, forecasts for core inflation for the year increased from 3.49 percent in September to 3.60 percent in December. Analysts also anticipate a scenario of low and stable inflation for the next years: 3.86 percent in 2004 and an average of 3.57 percent from 2005 to 2008.

Monetary Program for 2004

The Board of Governors of Banco de México reiterates that monetary policy will be geared towards attaining an annual CPI inflation of 3 percent and permanently maintaining it around that level, with a variability interval of plus/minus one percentage point. The purpose of such interval is to accommodate shocks to relative prices, which usually affect inflation only temporarily. Therefore, from 2004 onward, the inflation target will operate continuously, and not just for the end of the year.

In order to accomplish the inflation target, the decisions of the monetary authority must be based on a careful assessment of the prevailing economic conditions and on the outlook for inflationary pressures. In order to do so, Banco de México systematically analyzes the economic conditions by using a broad array of variables and different models.[1] These allow to identify the factors behind the anticipated developments in inflation and to evaluate their impact on economic agents' inflation expectations.

Banco de México will continue to implement monetary policy through banks' current accounts at the Central Bank. In this regard, a framework of daily balances was adopted since April 10, 2003.

[1] Banco de México's web page (www.banxico.org.mx) presents a monetary base forecast for 2004, which can serve as a reference to analyze the economic conditions.

The monetary policy instrument allows interest rates to be freely determined in the money market. Nevertheless, the Central Bank can influence them whenever monetary conditions are not consistent with the inflation target. Therefore, the instrument allows Banco de México to change its monetary policy stance through variations in the amount of money its supplies at interest rates different from those that prevail in the market.

In order to attain price stability via an inflation targeting framework, the Central Bank must transmit clearly to the public the Bank's objectives, strategy and instruments. Banco de México's transparency in this matter has contributed to strengthen the accountability that is inherent to a democratic system.

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In 2004, the main world economies are expected to continue their expansion, and in general, the favorable external financial conditions faced by Mexico in 2003 are also anticipated to prevail. Banco de México's base scenario anticipates that real GDP and industrial production in the United States in 2004 will grow 4.6 percent and 4.8 percent, respectively. This scenario includes some risks, since both fiscal and current account deficits in the U.S. remain high in relation to its GDP.

The recovery of the Mexican economy is expected to gain momentum in 2004 by exhibiting higher growth than in the previous three years. On the aggregate demand side, exports are expected to continue reflecting the higher growth of the rest of the world economies, especially once the expansion of the U.S. manufacturing sector consolidates. Private consumption is expected to preserve its relative dynamism, owing to both favorable financial conditions and the availability of credit. Private investment is anticipated to recover as external demand consolidates, given the better financial position of firms and the lower interest rates. Moreover, in an environment where there is slack, both in the labor market and in installed capacity, aggregate supply should be able to satisfy the expansion of aggregate demand without any difficulties (at least in the short term).

Under such context, Banco de México's forecast for the main macroeconomic variables in 2004 is as follows:

Economic Growth: Real GDP growth is expected to be between 3.0 and 3.5 percent.

Employment: Around 300 thousand jobs are expected to be created in the formal sector.

Current Account: The current account deficit of the balance of payments is expected to be 2.2 percent of GDP.

Inflation: Annual CPI inflation is expected to fall by the end of the year. This behavior is in line with an eventual convergence of inflation to its 3 percent target, with a variability interval of plus/minus one percent. In this regard, the following should be considered:

(a) Core inflation is expected to contribute slightly to the reduction of CPI inflation;

(b) Core inflation of merchandises is expected to remain in an upward trend at least during the first months of the year due to the increase in international prices of foods' raw materials and the higher exchange rate (despite having a relatively reduced pass-through coefficient). Afterwards, the path of the annual variation of the price subindex for merchandises would be expected to gradually revert as international prices of raw materials return to their historic averages;

(c) Regarding core inflation of services, variations of prices of non-housing items are anticipated to regain its downward trend. Nonetheless, in order to strengthen this trend, contractual wage negotiations must be based on reasonable estimates of labor productivity gains, and on inflation expectations in line with the 3 percent target;

(d) Annual variations in the price subindex for housing are expected to maintain its downward trend;

(e) Non-core inflation is expected to contribute slightly to the reduction of CPI inflation;

(f) Prices of agricultural products had a favorable performance in 2003. Considering the nature of their fluctuations, they are expected to exhibit only a small reduction in their rate of growth;

(g) Price increases have been announced for some goods and services concerted with the public sector (e.g., public transportation, property tax, and water fees in Mexico City). Prices of goods and services administered by the public sector are expected to exhibit a reduction in their rate of growth; and

(h) Finally, regarding prices of education, only a moderate reduction in the variation of school tuition is expected.

The base scenario for 2004 anticipates that inflation will continue its convergence towards its target. This trend is supported by two factors. On one hand it is expected that the current slack in labor and goods' markets will allow an expansion of aggregate demand without implying significant inflationary pressures. On the other, no significant supply shocks are foreseen. Thus, price pressures from this source are expected to be moderate.

The above scenario is subject to several risk factors. As for the domestic ones, the higher growth in Mexico in 2004 is expected to be mainly of a cyclical nature. Therefore, the secular forces observed during the last years, which tend to reduce the economy's growth potential, should not be underestimated. In this regard, it is important to reiterate that Mexican exports have been losing competitiveness in global markets, as confirmed by their lower market share in U.S. imports. Furthermore, despite the expected recovery of the economy, GDP growth seems to be below potential and insufficient to address poverty and other social problems efficiently. In particular, the weakness of gross fixed investment in the last three years is a matter of concern for the long-term outlook for economic growth. The expected recovery in 2004 could weaken the perception that structural reforms are needed to offset the country's loss of competitiveness and productivity. The postponement of such measures would have severe consequences for the welfare of Mexicans.

The results of CPI inflation at the end of 2003 imply the risk that annual price increases could be above 4 percent in certain months of the year. This, together with the presence of additional supply shocks, could negatively affect inflation expectations and, eventually, core inflation. This is particularly significant during the first quarter of the year, given that many wage negotiations take place. Consequently, Banco de México will act in order to avoid the deterioration of inflation expectations and to maintain inflation in its path towards the 3 percent target.

Concluding Remarks

In the last years, Mexico has made significant progress towards price stability. Nonetheless, inflation as well as inflation expectations clearly indicate that such phenomenon has not been eradicated. Therefore, Banco de México considers necessary to continue the efforts needed to reach the 3 percent target.

The attainment of the inflation target does not imply the end of the stabilization effort. The Mexican economy is still subject to different unexpected shocks and also exhibits significant imbalances in some relative prices. The presence of unexpected shocks and the need to adjust some prices can make inflation deviate temporarily from its target. It should be remembered that monetary policy does not influence the path of inflation with absolute certainty and temporal precision. Banco de México is aware that the ongoing disinflation is part of a long and difficult process. At the same time, it reiterates its conviction that stability not only fosters the country's development but also contributes to a better distribution of its benefits.

For three years, the Mexican economy has grown below its potential. As a result, progress to abate poverty, improve infrastructure, create more jobs, foster investment in basic capacities, and prepare new generations, has taken place less rapidly than expected.

Mexico's reduced growth should be analyzed in light of two phenomena that have been present in the last years. On the one hand, it is clear that the Mexican economy has been losing competitiveness in world markets. While we have lagged in the modernization of our economy, other countries have inserted themselves with determination into the global economy. On the other, manufacturing firms are continuously searching for more profitable locations throughout the world to base their production. Thus, manufacturing processes that use labor more intensively have migrated from countries with higher labor costs and bottlenecks in the main sectors of the economy to countries with lower labor costs and a more flexible and efficient economic framework. Therefore, manufacturing production in different sectors has migrated from industrial countries to emerging economies with higher competitiveness. This phenomenon is quite significant considering that Mexico's link with foreign trade is in a sector in which our main trading partner is losing market share in global markets.

Considering these two trends, it can be argued that investment returns in Mexico have fallen when compared with other countries. As a result, Mexico has lost attractiveness for domestic and foreign investors, as confirmed by the behavior of both gross fixed investment and foreign direct investment. Thus, it is unfortunate that given the current economic conditions in which, for the first time in the last decade, credit supply does not seem to be a limiting factor for the expansion of the economy, the country's lack of growth comes from reduced levels of investment.

The fall in the economy's growth potential (as a result of reduced investment) could also affect the handling of inflation in the long run. A non-competitive economy is not able to make the cost reductions necessary to maintain the profitability of firms without increasing its prices. This is particularly significant for goods and services in non-tradable sectors.

In order to materialize and consolidate the Mexican economy's growth potential, its competitiveness must be increased. Our economy needs to be more flexible to adapt to the world's changing conditions. In order for this to occur, progress must be done in different areas. First of all, the government needs more resources to invest in infrastructure and human capital, and to extend the coverage of social welfare. In addition, the productivity and efficiency of the Mexican energy sector must be raised, providing it with the proper legal framework that meets the standards of a highly integrated world. At the same time, the country needs to strengthen its rule of law, consolidate its economic stability, and have more efficient and active markets. Therefore, as in previous reports, Banco de México reiterates the convenience of reaching the agreements to both implement the structural reforms and strengthen the institutional framework required by our country.