Inflation Report

October - December 2000

Monetary Program

For 2001

Summary

Since Banco de México's present Law came into force, the main objective of its monetary policy has been the sustainable reduction of inflation. Increasing the Central Bank's credibility regarding the attainment of its objective has been an important factor in this strategy. To this end, Banco de México has made a continuous effort to disclose its interpretation of the events that affect the country's economy as well as the measures and policies adopted in order to improve its performance. This has moved the Bank to increase the volume and timeliness of the information provided to the public, resulting in the greater transparency of monetary policy.

Introduction

The performance of the Mexican economy during the year 2000 was substantially better than was expected at the beginning of that year. Annual inflation fell from 12.32 percent in December 1999 to 8.96 percent in December 2000. The annual inflation target of less than 10 percent was thus reached by a wide margin. Furthermore, the real increase in GDP over last year is estimated at more than 7 percent, compared with the original forecast of 4.5 percent.

In the year 2000 the six year crisis cycle which had troubled Mexico for more than two decades was finally broken. This was due, among other factors, to the prudent macroeconomic policy implemented over the last two years, to efforts made in order to reduce the domestic economy's vulnerability to sudden changes in the availability of external financing, to a very favorable international environment, and to an orderly election process.

Even though considerable advances have been made in the reduction of inflation, the growth rate of prices in Mexico is still high and constitutes an obstacle to sustained and balanced economic development. The Board of Governors of Banco de México has thus established the convergence towards 3 percent inflation in 2003 as the medium term target and, accordingly, a short term inflation target of less than 6.5 percent for 2001.

The efforts to abate inflation in 2001 will have to be conducted in a less favorable international environment than that of the last two years. Furthermore, the downward rigidity of inflation expectations and the rapid expansion of internal demand could make the fight against inflation more difficult. For these reasons the Central Bank has been tightening monetary policy in recent months. During the year 2000 Banco de México warned, on many occasions, of the need for a fiscal adjustment under the aforementioned circumstances.

In spite of less favorable external conditions, the implementation of restrictive monetary and fiscal policies will allow inflation to continue on its downward path and provide for an orderly adjustment of the economy to the changes that have appeared in the international environment.

Inflation Report: October – December 2000

Recent Developments in Inflation

Price developments during the fourth quarter of the year 2000 allowed for inflation targets to be met for the second consecutive year. The resulting 8.96 percent annual inflation rate was comfortably below the 10 percent target. However the downward trend of overall inflation observed since February 1999 leveled out during the final quarter of 2000.

In contrast with developments in the Consumer Price Index (*Indice Nacional de Precios al Consumidor*, INPC), core inflation continued on its descending path. At year-end 2000, the annual growth rate of the core price index was 7.52 percent. Developments in core inflation during the quarter suggest that the annual growth in the price subindices for education, goods and services provided or regulated by the public sector, and agricultural and livestock products —which are excluded from the core index— have not interrupted the general disinflation process. However, should pressures on such prices continue, the disinflation process would be jeopardized. A first warning in this respect is the slight slowdown in core inflation observed in the last months of 2000.

Main Determinants of Inflation

During the October-December quarter of the year 2000 the behavior of the external variables that influence the Mexican economy was less favorable than that experienced during the previous quarter. This was not reflected in Mexico's external accounts, however, a factor which helped maintain a relatively stable foreign exchange rate.

In the fourth quarter of 2000 international oil prices experienced fluctuations. Nevertheless, the average price for the quarter remained at the same level as that for the year as a whole. Accordingly, the price for the Mexican crude oil export mix was highly volatile as well.

The United States' economy slowed down during the third and fourth quarters of 2000. Analysts currently expect this economy to grow very little in the first quarter of 2001 and around 1.8 percent for the year as a whole.

The evidence of a larger-than-expected slowdown in the United States' economy has weakened expectations of future inflationary pressures in that country. However, the prospect of reduced growth and the fall in corporate profits have increased investors' risk aversion. This has been a contributing factor to the contraction of capital flows to emerging economies.

Throughout the last quarter of 2000 the exchange rate maintained a level of around 9.50 pesos per dollar. In October the uncertainty caused by the situation in Argentina negatively influenced the behavior of the exchange rate. In November it appreciated reaching a level below the average for the year as a whole. Finally, in December the significant fall in oil prices and its impact on the expected behavior of Mexico's fiscal and external accounts caused the exchange rate to depreciate. Ultimately, the exchange rate closed the year slightly above the annual average, yet lower than the level forecasted at the beginning of the quarter.

The downward inflexibility in nominal contractual wage growth and the rises granted at the end of the year continue to be a cause for concern. The ex-ante real increase in contractual wages is most probably above sustainable gains in labor productivity. In fact the difference is already being reflected by rising unit labor costs in some sectors.

Information concerning aggregate supply and demand during the third quarter of 2000 shows that the main components of both continued to experience vigorous growth. However, seasonally adjusted figures show a marked deceleration of domestic supply while domestic demand has remained robust.

The widening of the trade deficit confirms that during the last quarter of 2000 domestic demand continued to grow faster than output. The trade deficit for 2000 was 8.022 billion dollars, 43.7 percent higher than in 1999.

In the domestic realm, the high growth of aggregate demand can be cited among the causes of the weakening of the declining trend of core inflation in services and of the downward inflexibility in the growth of nominal contractual wages.

In the period covered by this Report, the annual increase in the price subindex for goods and services provided or regulated by the public sector was above INPC growth. Therefore, the behavior of these prices was an important inflationary source during 2000, having contributed 2.22 percentage points to the annual increase of the INPC. Furthermore, the downward inflexibility shown by the annual growth of this subindex is another cause for concern, especially as it could negatively affect inflation expectations.

At the end of the fourth quarter of 2000 the annual inflation of agricultural and livestock products was 10.7 percent.

Regarding public finances, the public sector posted an 11,127 million peso surplus in January-September 2000, which contrasts with the 3,909 million peso deficit observed in the same period of 1999. Although public revenues performed well, expenditures increased considerably too.

Monetary Policy in the Fourth Quarter 2000

In the last quarter of 2000 some of the external and domestic risk factors identified in previous Inflation Reports intensified. This has been reflected in inflation expectations which are incompatible with the targets for 2001 and the medium term. It was thus considered necessary to preemptively tighten monetary policy, given the fact that monetary measures have a delayed impact on price developments.

Banco de México reinforced its restrictive monetary policy stance twice during the fourth quarter of 2000. The first occasion was on October 17th when the Central Bank increased the "short" (*corto*) from 280 to 310 million pesos and again on November 10th when it widened the restriction to 350 million pesos.

On both occasions the widening of the "short" was in response to domestic and external factors. Various economic indicators showed that while domestic demand seemed to decelerate it nevertheless maintained a growth rate incompatible with the sustained reduction of inflationary pressures. Also, the following external developments were detected:

(a) clear signs of a slowdown in the United States' economy for the year 2001;
(b) an increase in international capital market investors' risk aversion; and
(c) episodes of financial turbulence in certain Latin American countries.

The widening of the "short" in the fourth quarter prompted domestic interest rates to rise. This measure was undertaken in order to lessen the impact of certain risk elements which have begun to materialize and in order to create the conditions necessary to attain the inflation target for 2001 as well as those for 2002-2003.

At the end of 2000, the monetary base stock had risen to 208,900 million pesos, very close to the Monetary Program estimate (205,900 million pesos). The 1.5 percent deviation was therefore within the +/-3.07 percent confidence interval announced for the monetary base stock projected for December 31st.

Commitments made in the Monetary Program for 2000 were achieved inasmuch as net international assets did not decline and the limits on the variation of net domestic credit were met. Thus, at year-end net domestic credit had contracted by 57,152 million pesos while the maximum limit established in the Monetary Program allowed for an increase of up to 17,144 million pesos. The fundamental reason for this behavior was the accumulation of 8.249 billion dollars in net international assets.

General Overview of the Economy in 2000 and Private Sector Expectations for 2001

In contrast with the year 2000 it is expected that the international environment will deteriorate in 2001 and that this, in turn, will affect the evolution of the domestic economy. Notwithstanding, the robustness of the economy together with preventive monetary and fiscal policy measures will provide for an orderly adjustment process.

Since the publication of the previous Inflation Report, most of analysts' projections have shown a marked deterioration in the main external variables which affect the performance of the Mexican economy:

(a) the expected annual growth rate for the United States' economy in 2001 has been substantially revised downwards from 3.7 percent in September to 1.8 percent at present; and

(b) analysts' estimates for the average price of the Mexican crude oil export mix for 2001 was reduced from 20.85 dollars per barrel in September to 19 dollars per barrel in January.

The survey carried out by Banco de México on January 23rd, 2001, showed that private sector analysts had slightly raised their projections for the exchange rate at the end of the year 2001. According to the analysts surveyed, wage increases for January, February and March 2001 will be 9.9, 9.5 and 9.2 percent respectively. It is anticipated that prices charged by public enterprises and agencies will mainly be adjusted in line with the inflation target for 2001.

Real GDP growth for 2001 expected by the analysts who have taken part in the surveys was adjusted from 4.56 percent in September 2000 to 3.83 percent in January.

Regarding fiscal deficit projections for 2001, the survey carried out in January indicates that it is expected to be equivalent to 0.69 percent of GDP.

Private sector's forecasts of monthly inflation for January, February and March have remained practically the same. These projections imply that annual inflation is expected to fall from 8.96 in December 2000 to 8.55 percent in March 2001. Inflation expectations for the next twelve months were lowered and those for 2001 were slightly raised. It is important to underline the fact that the expected level of inflation for 2001 is still incompatible with the annual target of less than 6.5 percent. Finally, private analysts placed expected inflation for 2002 at 6.28 percent.

Monetary Program for 2001

With the adoption of the floating exchange rate regime, following the balance of payments crisis in 1994-1995, the exchange rate ceased to function as the policy instrument which guided inflation expectations around the authority's targets. In turn, monetary policy became the nominal anchor of the economy.

The monetary policy scheme has been adjusted in order to increase its effectiveness and transparency in light of the changes that the Mexican economy has undergone in the last six years. This evolution has led to a gradual convergence towards an inflation targeting regime.

Recent Developments in Monetary Policy Strategy: The Convergence towards Inflation Targeting

Due to the need to establish a visible and strict nominal anchor, a limit on the growth of the Central Bank's net domestic credit was adopted in 1995 as a guide for monetary policy. This limit was derived from the estimated growth in the demand for monetary base and an assumed null accumulation of international reserves.

In 1997 a projection of the daily path of the demand for base money was introduced in Banco de México's Monetary Program. This was intended to provide economic agents with a reference by which to follow monetary policy more easily.

Inflation fell from 52 percent in 1995 to less than 9 percent in 2000. During this period it was shown that as inflation falls the relationship between prices and money becomes more uncertain. Thus, the usefulness of base money growth projections as a way of influencing the formation of inflation expectations, and to guarantee the attainment of established targets, has been reduced.

Therefore in recent years monetary policy measures in Mexico have been founded on continuous and exhaustive analysis of those variables which influence the behavior of inflation and are useful to project price growth. When the analysis has shown that inflationary pressures are not in line with the targets, monetary policy has been tightened by widening the "short".

Based on the above, in order to evaluate monetary policy actions economic agents have to know the elements which Banco de México uses to carry out its analysis of inflationary pressures and monetary conditions, as well as its short and medium term inflation targets. For this reason, in the year 2000 Banco de México decided to publish quarterly inflation reports with the aim of improving communication with the public. Multi-year inflation targets were also announced. These measures represent a significant effort to implement monetary policy in the most transparent way. Thus, monetary policy in Mexico has converged towards an inflation-targeting scheme.

The main traits of this monetary strategy, which is based on the application of discretional policy measures in order to reach the inflation targets, are the following:

(a) the recognition of price stability as the fundamental objective of monetary policy;
(b) the announcement of medium term inflation targets;
(c) the existence of an autonomous monetary authority;
(d) the transparent application of monetary policy, supported by a communication strategy regarding the objectives, plans and decisions of the monetary authority;
(e) the analysis of all sources of inflationary pressures in order to evaluate future price growth trends; and
(f) the use of alternative inflation measures —such as core inflation— to identify factors that have a transitory affect on inflation and to discern price growth trends.

Countries that have adopted this scheme have obtained, among others, the following benefits:

(a) the lowering of inflation as well as the consolidation of price stability;
(b) a reduction in the exchange rate passthrough effect on domestic prices;
(c) a more transparent and better understood implementation of monetary policy; and
(d) a more accountable monetary authority.

Elements of the Monetary Program

Due to the fact that inflation in Mexico is still high, the Board of Governors of Banco de México has decided that the best way to permanently abate price growth is to do so gradually.

Based on this, the Board of Governors has established as the medium term objective that the annual growth rate of the INPC should fall to 3 percent by December 2003. In order to give short term reference points along the path towards price stability, the Board of Governors of Banco de México established in the July-September 2000 Inflation Report a 6.5 percent annual inflation target for 2001. At the same time it was announced that the inflation target for 2002 —to be made public in due time during this year— should be around 4.5 percent.

At present, inflation expectations in Mexico are above the target. In this context a tight monetary policy is a necessary condition to attain the inflation targets.

Even when the monetary policy stance adopted is the appropriate one, in the short term prices can be influenced by fluctuations in various key prices, such as the exchange rate, wages and the prices of goods and services provided or regulated by the public sector. Should these fluctuations materialize, monetary policy actions might not be able to offset them fast enough to meet the short term inflation target. It is precisely under such circumstances that the medium term target shall play its role as nominal anchor of the system. If a situation like this arose, the monetary authority would announce the time it would take to absorb such fluctuations and would adopt suitable measures in order to reach the medium term target as originally proposed. These measures will be geared at curbing the deterioration in inflation expectations and reestablishing the downward trend of inflation.

Compliance with the fiscal program has been another contributing factor to attaining the inflation targets over the past two years. However, as has been stated on various occasions, the strength of public finances has, in part, been due to high oil revenues. This reveals the vulnerability of the macroeconomic framework and of the downward trend of inflation to sudden declines in oil prices. The excessive dependence of public revenues on oil is one of the most serious deficiencies of the Mexican fiscal structure. It is therefore of the utmost importance to invigorate public finances through a fiscal reform in order to reduce this dependence.

Should fiscal reform lead to upward pressure on prices, a transitory deviation from the inflation targets could be expected to arise in the short term. However, if the preventive action taken by the monetary authority is successful in forestalling the generation of secondary effects, inflation shall return to its originally envisaged path over the following months.

The elements that have been considered necessary in order to reach the short and medium term inflation targets are:

(a) a restrictive monetary policy;
(b) adjustments to the prices of goods and services provided or regulated by the public sector in line with inflation targets;
(c) wage settlements compatible with sustainable productivity gains and with inflation objectives;
(d) the absence of severe external fluctuations —such as reductions in the terms of trade or in the supply of foreign capital— that could lead to a considerable adjustment in the real exchange rate; and
(e) a structurally sound fiscal stance.

In its Inflation Reports to be published throughout 2001, Banco de México will evaluate the possible consequences of one or more of the aforementioned conditions not being fulfilled. If such circumstances were to materialize, monetary policy would probably have to be tightened in order to bring inflation back in line with the medium term targets. In this way the nominal anchor role played by inflation targets would become increasingly important and the contamination of medium and long term inflation expectations could be prevented.

If inflationary pressures were to be detected which are not in line with inflation targets, the Central Bank would use the "short" to restrict monetary policy. These pressures are normally caused by the following situations:

(a) when the public's inflation expectations deviate considerably from the inflation target.
(b) when aggregate demand grows at persistently higher rates than potential output.
(c) when internal and external shocks occur; and
(d) when orderly conditions must be restored in the money and foreign exchange markets.

The "short" has proven to be a very effective instrument to distribute the impact of external shocks between the exchange rate and interest rates. This is an enormous advantage in an economy like Mexico's, which is subject to high volatility and has suffered from large exchange rate passthrough effects on prices. The "short" has also significantly contributed to the process of lowering inflation due to the fact that nominal and real interest rates have reacted very well to movements in the level of this instrument.

It is clear from the above that the "short" is and will in the foreseeable future continue to be the instrument used by Banco de México to induce the necessary movements in interest rates in order to reach proposed inflation targets.

The Outlook for 2001 and Assessment of Risks

One of the risk scenarios that Banco de México had repeatedly warned of in its Inflation Reports did materialize over the last few weeks. Specifically, an important change has taken place in the outlook for the main external variables that influence the Mexican economy.

Banco de México has modified the assumptions included in its projections for the international environment. Among these, it is important to mention the following:

(a) The expected growth rate for the United States' economy has been revised downward from 3.2 percent to an interval between 1.8 and 2.4 percent. It is also anticipated that the economy will weaken further in the first semester but it is expected to recuperate significantly in the second.
(b) Based on the WTI oil futures prices and considering the differential it has maintained vis-à-vis the Mexican crude oil mix, estimates for 2001 are that the average price of Mexican oil will be 18.52 dollars per barrel.

Without a doubt, the deceleration of economic growth in the United States will have a significant effect on the growth of Mexican exports. However, the extent of this impact is very difficult to calculate owing to the commercial integration having recently intensified between the two countries, which has coincided with the longest period of expansion in the economic history of the United States.

Banco de México's base scenario for 2001 also projects a significant deceleration in the growth of domestic demand —particularly in private and public consumption and private investment— as a result of expected high real interest rates, fiscal adjustment and the slowdown of economic activity and job creation.

Regarding fiscal adjustment in 2001, although the approved reduction in the public deficit —down to 0.65 percent of GDP— is undoubtedly a step in the right direction, public finances still suffer from considerable weaknesses. In particular, the real growth of public programmable outlays is a cause of concern as it adds to the already high level of expenditure incurred in 2000. In this regard, it is noteworthy that the Federal Government has expressed its will to make an additional effort to control and rationalize expenditures in order to achieve a 0.5 percent of GDP deficit in 2001. It is advisable that fiscal prudence should also encompass off-budget operations, such as the PIDIREGAS and the financial intermediation of development banks, which in the future could give rise to additional pressures on public finances.

As indicated by available information on industrial production and sales, the deceleration of output growth during the fourth quarter of 2000 has been faster than that of aggregate demand. As a result, the current account deficit is expected to increase in 2001, particularly in the first semester.

The macroeconomic framework for 2001 suggests that the decline in inflation will face more difficult obstacles than in the recent past. In response to this new scenario, on January 14th the Board of Governors of Banco de México decided to widen the "short" from 350 to 400 million pesos. In addition, it is clear that in order to reach the targets it will be necessary to maintain and possibly intensify the monetary restriction.

The base scenario presented is subject to a high degree of uncertainty. Regarding the international environment, the main elements that could affect the development of the domestic economy and the decline of the inflation rate are as follows:

(a) If the United States' economy grew less than anticipated.
(b) If the international price of crude oil were lower than current futures prices; and
(c) If capital flows towards emerging markets were affected by increased risk aversion.

In any of these situations, the nominal exchange rate would have to adjust to facilitate the transition towards a new equilibrium real exchange rate. Under such circumstances, the monetary authority would react promptly in the presence of any indication that exchange rate movements could be causing upward revisions in medium term inflation expectations and affecting the prices of non-tradable goods.

Furthermore, greater fiscal adjustment would be indispensable if any of these three unfavorable possibilities were to materialize.

As previously mentioned, the base scenario projects that over the next few months the growth rate of domestic demand will weaken significantly. This should limit the expansion of the current account deficit, in order to keep it in line with the foreseeable supply of long-term capital.

At the time of the publication of this Report, the main domestic risk factors in the base scenario are as follows:

(a) the growth of domestic private sector demand exceeding that of domestic output by a large margin.
(b) inflation expectations continuing to display the downward rigidity shown to date for a prolonged period; and
(c) contractual wage settlements not resulting in wage levels in line with the inflation targets and sustainable growth in labor productivity.

If these domestic risk factors were to materialize, they would probably do so simultaneously. In this context, macroeconomic policies should become more restrictive in order to correct demand growth and deviations in inflation expectations.

Final Remarks

The evolution of the main macroeconomic variables in 2000 proved more favorable than expected by private and public sector analysts at the beginning of the year.

At year-end 2000, annual inflation declined to 8.96 percent, achieving the target with a comfortable margin and for the second year in a row. At the time of the publication of this Report, it is estimated that real GDP increased over 7 percent last year. Furthermore, in 2000 the Mexican economy was able to create over 529,000 formal jobs and real wages rose by over

6 percent. The behavior of these variables confirms that lower inflation contributes to economic growth, job creation, the recovery in real wages and the decline of economic inequality.

In 2001, the Mexican economy will have to confront at least two negative external factors: the reduction in international oil prices and the slowdown of the United States' economy. These factors will significantly affect the performance of the economy through their impact on Mexico's external and fiscal accounts.

Faced with a complicated international environment in 2001, the national economy has nevertheless several strength factors which will allow it to adjust to the current circumstances and quickly recover the vigor that has characterized it over the last five years:

(a) The floating exchange rate regime and market-determined interest rates inhibit speculative capital flows, contain the accumulation of external accounts imbalances and allow for the swift adjustment of the main financial variables when faced with domestic or external disruptions.

(b) The financial system has made considerable strides in its consolidation and capitalization process. Furthermore, progress in the regulatory and legislative realms has laid the foundations for a prompt reactivation of bank credit.

(c) The comfortable amortization schedule of the external public debt in 2001 and the high level of international reserves shall considerably mitigate the impact of possible international capital market disruptions on domestic financial markets.

(d) The private sector's exposure to sudden changes in international financial market credit conditions is low.

(e) A moderate current account deficit mainly financed by long term capital flows.

Notwithstanding the above, in order to attain high and sustainable economic growth rates in the future it is indispensable to make progress in the area of structural reform, especially in the energy and communications sectors.

Maintaining monetary and fiscal discipline will be crucial to consolidating and strengthening recently gained stability. To preserve credibility in the implementation of macroeconomic policies, it is necessary to seek the attainment of the goals proposed for 2001, even amidst an adverse international environment.

The current fiscal structure still presents considerable weaknesses, amongst which is an excessive dependency on oil revenues. As a result, in the current context, strengthening public revenues through an integral fiscal reform must not be postponed.

The Board of Governors of Banco de México reiterates its strong commitment to using the mechanisms at its disposal, in a timely and effective manner, in order to meet the targets which stem from the current stabilization efforts: inflation is not to exceed 6.5 percent in 2001 and convergence to 3 percent inflation is to be achieved by 2003.