Inflation Report

January – March 2001

BANCO DE MEXICO

APRIL, 2001

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FOREWARNING

Unless otherwise stated, this document has been prepared using data available as of April 23rd, 2001. The figures are preliminary and subject to change.

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TABLE OF CONTENTS

I. Introduction

This document contains a detailed description of the developments in inflation and of the main factors that had an impact on it, as well as an assessment of the economic environment upon which monetary policy actions were based in the first quarter of 2001. The economic outlook foreseen by Banco de México for 2001 and the main risk factors are also included.

During the first quarter of 2001 the growth of the United States' economy weakened even more than had been expected and the price of oil was significantly lower than in the previous year. The economic slowdown in the United States has affected Mexican exports and imports, as well as output and employment.

The less favorable environment did not preclude important gains in the abatement of overall inflation, and especially of core inflation. Although significant reductions in price growth have been registered recently, some factors still remain that could limit future advances in this field. Among these, it is worth mentioning higher unit labor costs and expectations above the inflation targets.

At present three main areas of uncertainty regarding the domestic economy's outlook can be identified: the possibility that the United States could fall into a recession, a further decline in international oil prices and the outcome of discussions over the proposed Fiscal Reform.

In light of the existing risk factors, Banco de México has decided it is prudent to maintain the restrictive monetary policy stance in order to attain the inflation target established for this year and consolidate the credibility of the medium term target.

II. Recent Developments in Inflation

Price developments during the first quarter of 2001 were favorable, as annual inflation resumed its downward trend and accumulated inflation for the quarter was below the figure private sector analysts had expected at the beginning of the period. The performance of inflation was influenced by the transitory effect of a considerable fall in the prices of agricultural and livestock products. Notwithstanding, the reduction of inflation during this period was not sustained by temporary factors alone, as annual core inflation continued to descend and was less than 6.5 percent at the end of March. Goods core inflation was favorably influenced by the stability of the exchange rate, while inflationary pressures on the services sector have been limited by the domestic economy's slowdown.

The behavior of prices in the quarter was compatible with the path necessary to meet the annual inflation target of less than 6.5 percent by December 2001. It is also important to note the following events that took place in the first quarter of 2001:

(a) inflation measured by the National Consumer Price Index (*Indice Nacional de Precios al Consumidor*, INPC) fell noticeably in January and February, although it rebounded slightly in March;

(b) annual core inflation for goods and services continued its downward trend;

(c) the gap between INPC inflation and core inflation narrowed;

(d) annual inflation for the agriculture and livestock products' sub-index was significantly less than that for the INPC;

(e) the annual growth rate of prices for education services and goods and services provided or regulated by the public sector continued to be higher than overall inflation. However, the annual increase in the prices of public goods and services —which had remained relatively constant throughout 2000— declined; and

(f) annual inflation as measured by the National Producer Price Index (*Indice Nacional de Precios al Productor*, INPP) excluding oil and services decreased.

II.1. Inflation Indicators

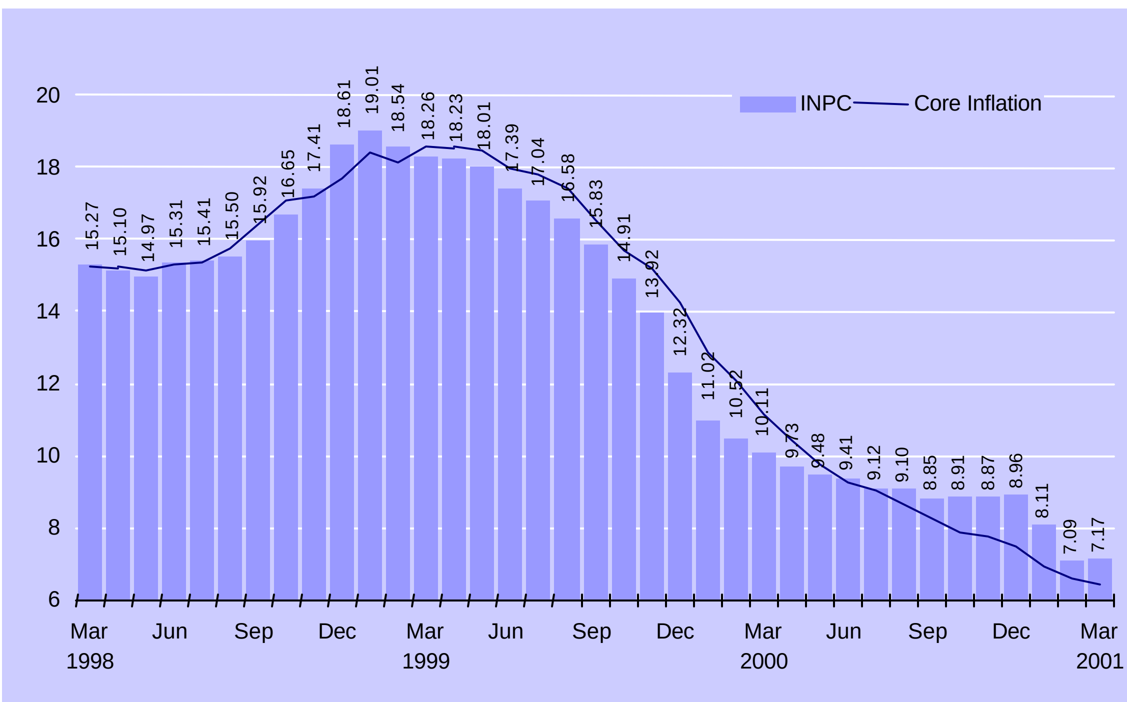
The evolution of various price indexes during January-March of 2001 will be analyzed in the following pages.

II.1.1. National Consumer Price Index and Core Price Index

In March 2001, the INPC annual inflation was 7.17 percent, 1.79 percentage points below the figure posted for last December (Chart 1). This compares very favorably with the 0.11 percentage point increase registered by this index in October-December of 2000.

Chart 1 **National Consumer Price Index and Core Price Index**

Annual percentage change



The January-March 2001 period was the third consecutive quarter in which annual core inflation was lower than overall inflation (Chart 1). In March the annual growth rate of core prices was 6.46 percent, while the previous December it had been 7.52 percent. This reduction of 1.06 percentage points is substantially larger than those registered in the third and fourth quarters of 2000.

In the first quarter of 2001, the gap between annual INPC inflation and core inflation —which had been increasing since the third quarter of 2000— narrowed. This was a result of the partial reversion of the transitory factors that had had an upward effect on the prices excluded from core inflation calculations and that had represented an obstacle to a more marked reduction of overall inflation in the last quarter of 2000. Among these factors it is worth mentioning the lower growth of the price sub-index for agricultural and livestock products. At the end of the quarter covered by this Report, this sub-index posted an annual growth of 3.98 percent, while in the previous quarter it had been 10.07 percent (Table 1). Besides this, a decrease in the annual inflation rate of goods and services provided or regulated by the public sector was also observed. In March 2001 the aforementioned sub-index registered an annual growth of 10.62 percent, which is in contrast to what occurred in 2000, when its growth rate remained around 12.5 percent.

Table 1 **Price Indexes: INPC, Core Prices, Agricultural and Livestock Products, Education, and Goods and Services Provided or Regulated by the Public Sector**

Percentage Change

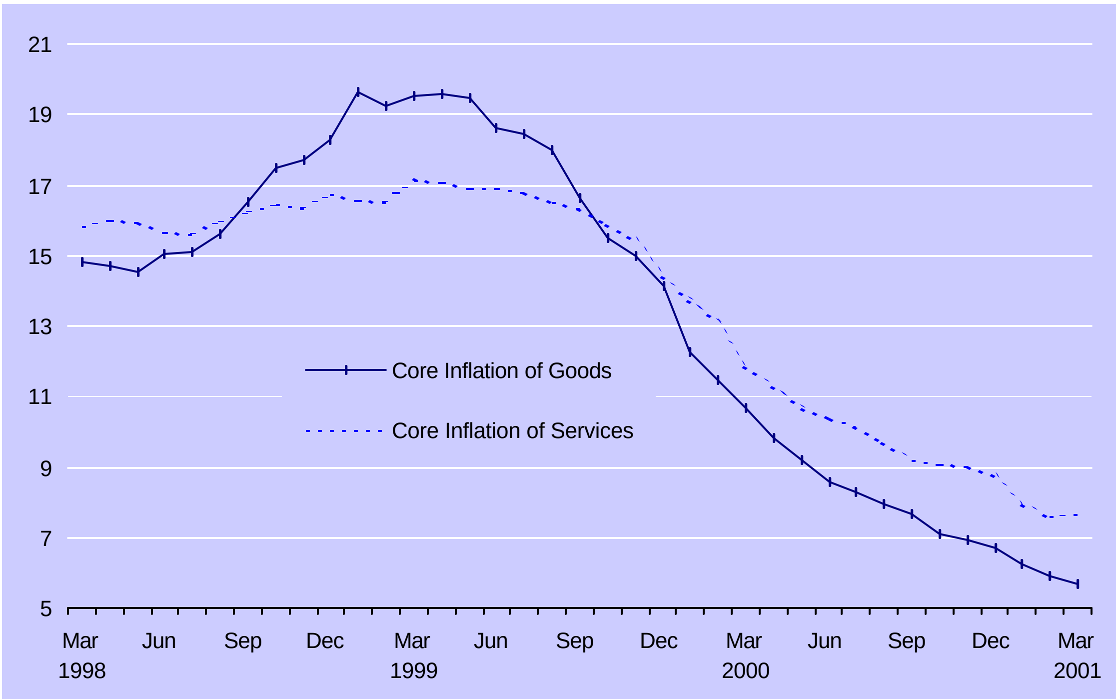
	Annual Changes			Quarterly Changes		
	Mar 2001/ Mar 2000	Dec 2000/ Dec 1999	Mar 2000/ Mar 1999	Mar 2001/ Dec 2000	Dec 2000/ Sep 2000	Mar 2000/ Dec 1999
INPC	7.17	8.96	10.11	1.12	2.65	2.81
Core Inflation	6.46	7.52	11.16	2.20	1.60	3.21
Goods	5.66	6.68	10.67	2.01	1.42	3.00
Services	7.66	8.77	11.89	2.46	1.87	3.52
Agricultural and Livestock Products	3.98	10.07	-0.17	-6.33	5.31	-0.84
Education	14.63	15.16	17.98	1.35	0.09	1.82
Goods and Services Provided or Regulated by the Public Sector	10.62	12.58	12.31	2.15	5.31	3.96

In March 2001 annual core inflation for goods and services was less than that observed in December of the previous year (Chart 2). The annual increase of core prices for goods moved from 6.68 percent at the close of the previous quarter to 5.66 percent at the end of the period covered by this Report. Over the same period, the annual core inflation for services fell from

8.77 percent to 7.66 percent. The appreciation of the exchange rate and the slowdown of the economy were factors that limited inflationary pressures in both the aforementioned sectors[1].

Chart 2 **Core Price Indexes for Goods and Services**

Annual percentage change



II.1.2. Monthly Inflation of the National Consumer Price Index and Core Price Index

The monthly growth rates of the INPC in January and February were significantly lower than had been expected by private sector analysts at the end of the previous quarter. In contrast, monthly inflation was above expectations in March (Table 2).

[1] Since goods are generally traded internationally, their prices are very sensitive to exchange rate fluctuations. On the other hand, services are fundamentally non-tradable; therefore their prices respond primarily to inflation expectations and wages.

Table 2 **Expected and Observed Monthly Inflation**

Percentage

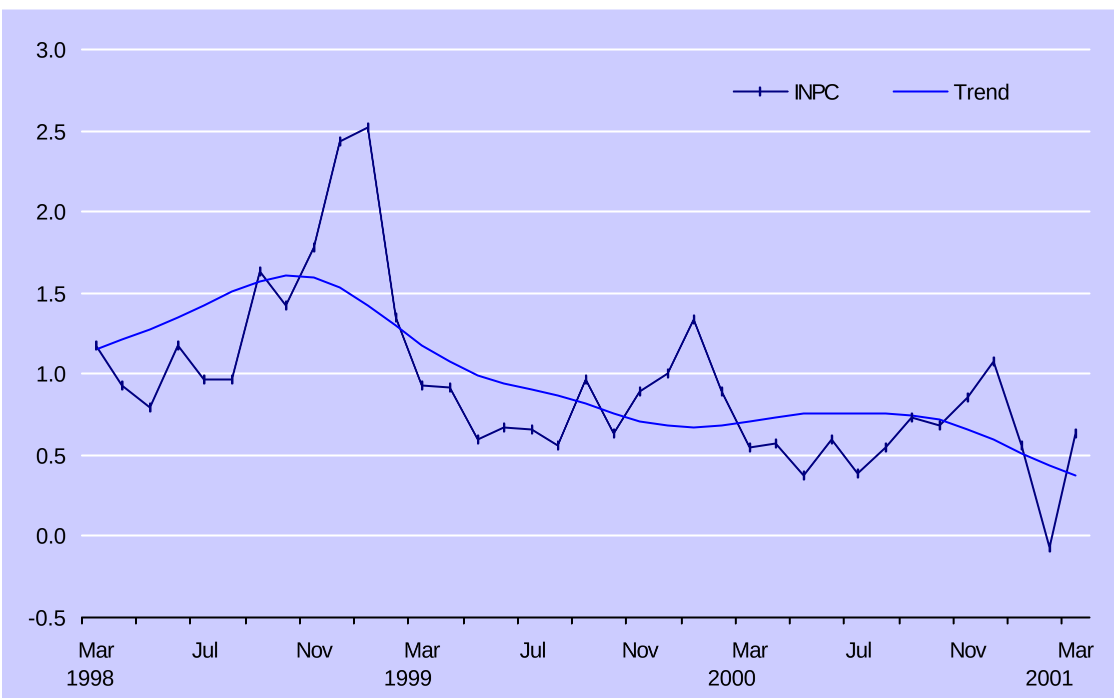
	2001		2000	
	Observed	Expected 1/	Observed	Expected 1/
January	0.55	1.13	1.34	1.56
February	-0.07	0.73	0.89	1.05
March	0.63	0.53	0.55	0.82

1/ Inflation expected in December of the previous year, according to the Survey of the Expectations of Private Sector Economic Specialists carried out by Banco de México.

In January and February 2001 monthly inflation was lower than that registered during the same months of 2000. However, the monthly increase of prices observed in March 2001 was higher than during the same month of the previous year. The latter can be explained mainly by the rebound of agricultural and livestock prices in March (1.42 percent) after having fallen 6.49 percent in February. These results also reflect the influence of seasonal factors. Nonetheless, the trend series[2] for monthly inflation continues on a downward path (Chart 3).

Chart 3 **National Consumer Price Index**

Monthly percentage change

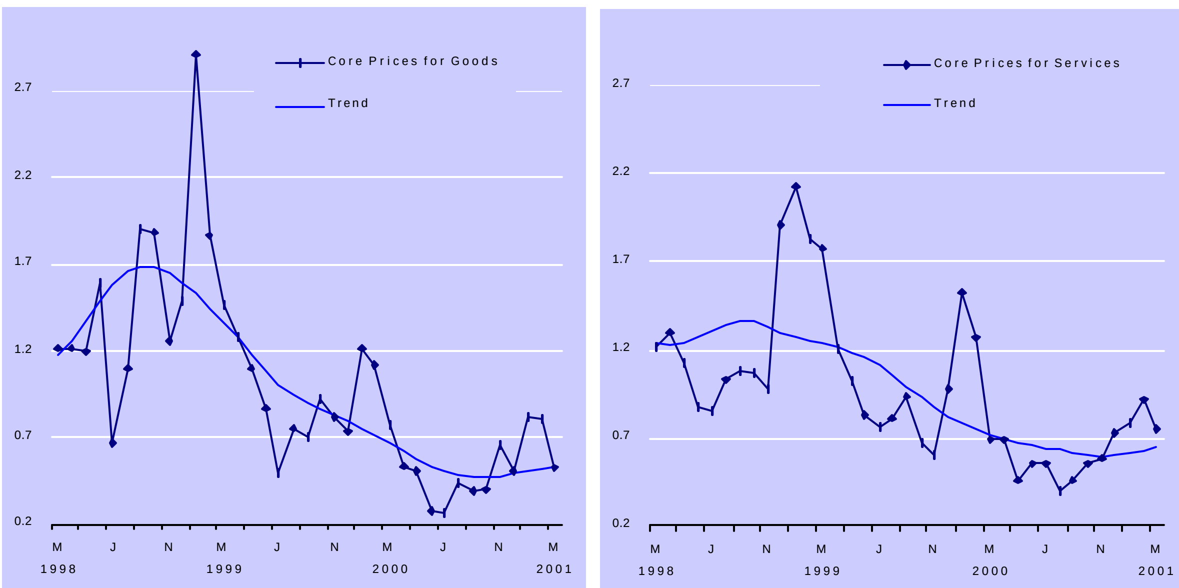


[2] As calculated by the X12 ARIMA statistical process. This method softens the original series by using moving averages.

In contrast to the above, monthly core inflation of both goods and services fell in March. The increases in both price sub-indexes in January, February and March of 2001 were lower than in the same months of the previous year (Chart 4). The rise in monthly core inflation for services in February is noteworthy and can mainly be attributed to a change in the seasonal adjustment of prices that traditionally takes place at the start of every year. The aforementioned phenomenon is to a great extent due to the fact that with lower inflation there is less need to review prices in the first few weeks of the year. At present, adjustments tend to be distributed over longer periods. The trend series of the core sub-indexes for goods and services posted a slight increase as compared to the previous quarter[3].

Chart 4 **Core Price Indexes for Goods and Services**

Monthly percentage change



[3] The X12 ARIMA procedure measures the inflation trends as a 12 month moving average centered on the reference observation. For example, the trend calculated for September of 2000 is the average monthly inflation from April 2000 to March of 2001. Thus, in order to obtain the trend for the latest observations, inflation forecasts for subsequent months are required. These are estimated using the ARIMA model and are highly influenced by data near the end of the series. As a result, at the close of the measurement period the trend series have shown a slight upward bias, due to the increase in monthly core inflation during the last few months.

II.1.3. National Producer Price Index (INPP)

Variations in the INPP excluding oil and services can be an indicator of future inflationary pressures. It is therefore encouraging that during the quarter analyzed in this Report annual INPP inflation resumed its downward trend. The corresponding inflation rate for March 2001 was 6.94 percent compared to 7.38 percent in December 2000. An important factor in the decrease of this growth rate was the 15.44 percent reduction in the price of natural gas in the first quarter of 2001.

II.2. Main Determinants of Inflation

The main factors that influence the evolution of inflation in Mexico are: movements in the exchange rate, wages and prices for goods and services provided or regulated by the public sector, as well as aggregate demand pressures. Inflation is also affected in the short term by transitory factors, such as variations in highly volatile prices like those for fruits and vegetables. In order to obtain a more complete analysis of the recent path of inflation, these factors will be examined in the following pages.

II.2.1. International Environment and the Exchange Rate

During the first quarter of 2001 the evolution of the external variables that influence the behavior of the Mexican economy was not completely favorable. Although international oil prices during the period were higher than had been expected at the start of the year, they were nevertheless 16 percent below the prices prevailing in the last quarter of 2000. Economic activity in the United States continued to deteriorate without giving clear indications of the eventual magnitude and duration of the slowdown in 2001. The exchange rate crisis that affected Turkey and the political uncertainty in Argentina also influenced some emerging markets. Notwithstanding, the impact of these external shocks on internal financial variables was not significant due to the restrictive monetary policy being applied in Mexico and the favorable expectations about the evolution of the domestic economy.

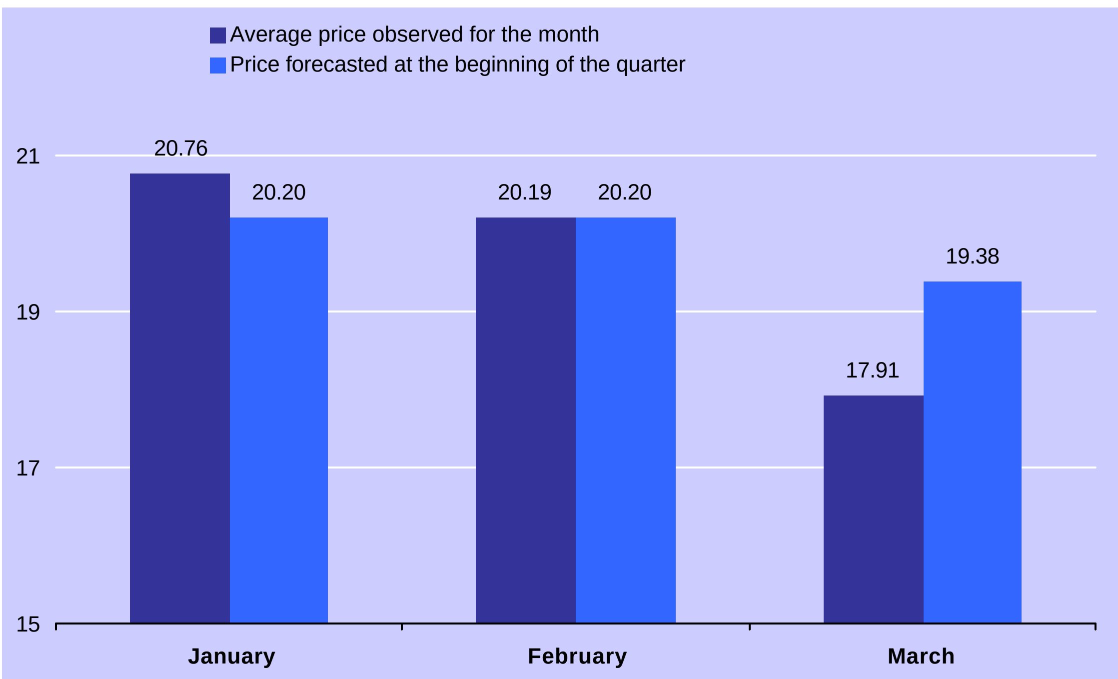
II.2.1.1. Oil Prices

In the January-March period of 2001, the average international price of oil was 28.81 dollars per barrel and was considerably less volatile than it had been during 2000[4]. The latter can be attributed to the combination of two factors. Firstly, the aforementioned price's downward trend due to the slowdown of the United States' economy, the world's largest consumer of this fuel. Secondly, the more frequent production cuts by OPEC countries which managed to maintain oil prices at an interval between 26.02 and 32.24 dollar per barrel.

In the same way as international oil prices, the Mexican crude oil export mix registered its lowest volatility of the last five quarters. In the January-March quarter the average price of the Mexican mix was 19.62 dollars per barrel. In January and February the average price was higher than the price implicit in futures prices in December 2000, while in March it was lower (Chart 5).

Chart 5 **Price of Mexico's Crude Oil Export Mix in 2001**

Dollars per barrel



SOURCE: Observed price, Pemex. The forecasted price is based on WTI´s futures prices and the difference between the said futures prices and that of Mexico's export mix in the July-December period of 2000.

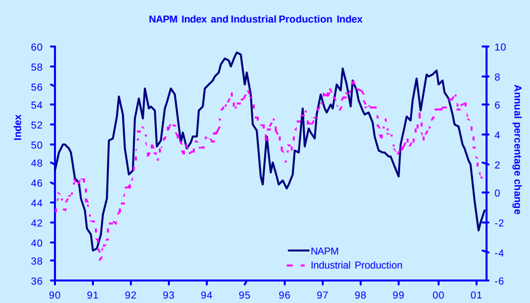
[4] The international oil price referred to is the West Texas Intermediate (WTI).

Evolution of the Main Indicators of the United States' Economy

The slowdown of the United States' economy has been characterized by a contraction of investment and industrial activity as well as weakening in consumption growth. Although the recent decline in some industrial sector indicators has been similar to that seen during the recession in the early 1990's, consumption —which represents more than 60 percent of aggregate demand— continues to grow at rates compatible with economic expansion. In order to shed light on the factors that keep the United States' economy expanding, below is an analysis of the indicators of industrial activity and consumption in that country.

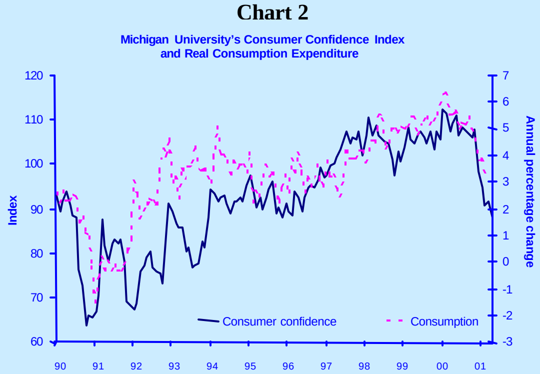
The industrial output index rose in March 2001, thereby interrupting a series of negative results that had been registered since October 2000. Although the annual growth rate of output is still higher than that seen during the recession at the beginning of the 1990's, other indicators are now comparable to the levels prevailing at that time (Chart 1). For example, the National Association of Purchasing Managers Index (NAPM) —a leading indicator of industrial production— almost completed a full year of consecutive monthly decreases. However, in both February and March 2001 it registered a slight recovery. Since August 2000 this index has remained below fifty points, a value compatible with a contraction of the industrial sector and currently very close to its minimum level observed during the aforementioned recession (Chart 1).

Chart 1



Since the second quarter of 2000 the annual growth rate of consumption has practically halved. However, present growth is similar to the average of the last ten years (Chart 2). Furthermore, this rate is still considerably higher than that prevailing during the aforementioned recession.

Chart 2



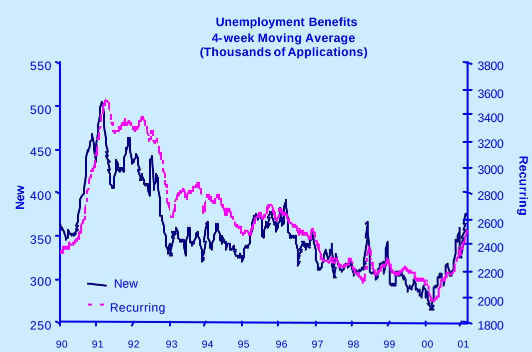
The consumer confidence index is a timely indicator of real consumption growth and has maintained a high correlation with the latter variable over time. This index reached its maximum value in January 2000, after having accumulated, since November of that year, three consecutive falls that amounted to 17 points (Chart 2). In March 2000 the index posted a slight increase that reverted in April.

Among the factors that help to explain the less vigorous growth of consumption, the most noteworthy are the falls that have been observed since March 2000 in the equity value of technology sector companies as well as in other more inclusive stock market indexes. Since then, the NASDAQ index has lost more than 60 percent and has been accompanied by falls of 20 percent in the Dow Jones index (Chart 3) and 25 percent in the Wilshire 5000 index.

Chart 3

The evolution of employment is another factor that helps to explain the recent performance of aggregate consumption in the United States. In April 2000 applications for unemployment benefits were at a minimum of 262 thousand, having increased afterwards to their maximum in December (Chart 4). Although this indicator fluctuated in January and February of 2001, in March it surpassed the maximum level it had reached during the previous quarter. Despite the fact that its current level is higher than in the recent past, it is still far below the figures registered during the recession of the early 1990's.

Chart 4



From the above analysis, it can be concluded that the growth in the demand for consumer goods will be crucial to the future performance of the United States' economy. The fact that the evolution of this aggregate is linked to that of employment and of the stock market means that monitoring the latter indicators will be important for evaluating the outlook for economic growth in the immediate future.

II.2.1.2. Developments in the United States' Economy

During the fourth quarter of 2000 the United States' economy grew one percent[5], the lowest quarterly growth rate in the last five years. It was preceded by growth rates of 4.8, 5.6 and 2.2 percent in the previous quarters. From this data, it is clear that the United States' economy has decelerated considerably.

The heavy investment in technology goods and services that has taken place over the last few years in the United States eventually led to a contraction in demand for such products. This triggered lower sales, profits and investment flows towards the technology sector. The aforementioned prompted a fall in share prices of companies in this sector, which spread to the rest of the economy through weaker aggregate consumption growth. It also had an unfavorable influence on corporate profits in the manufacturing industry and on the stock market, causing reduced industrial output and investment. In short, the economic slowdown in the United States has been characterized by a moderation of consumption growth together with the contraction of investment and industrial output. The negative performance of the latter variables worsened during January-March. Nevertheless, consumer spending —which represents more than 60 percent of aggregate demand in the United States— continues to increase at annual rates between 2 and 3 percent and still contributes to economic expansion.

Indications of a more severe economic downturn in the United States became known at the beginning of the quarter. In early January, a further reduction in the National Association of Purchasing Managers Index (NAPM) —a leading indicator of industrial production— as well as a significant decrease in the growth of automobile sales during December were reported. This information suggested a general deterioration of manufacturing activity, which was confirmed in the middle of the month by the indicator for industrial output. The deceleration of the industrial sector has been associated with pessimistic expectations about corporate profits and consumption growth. Although weaker manufacturing activity in the United States continued in February and March, and was reflected in higher unemployment rates during those months, it did not have a severe impact upon consumer spending. The growth of the latter aggregate continued in January and February and its advanced indicators were not significantly affected during the quarter. Department store sales behaved

5 Annualized quarterly growth from seasonally adjusted figures.

irregularly and the consumer confidence index —which had been falling since last November— improved slightly in March.

Through their combined effect on employment, the drop in corporate profits reported during the quarter, together with the stock market fall and the slowdown of industrial activity, have increased the likelihood that the expansion of consumption will diminish even further. Consequently, a drastic correction in economic growth forecasts for 2001 has taken place in the past three months. At the time of publishing this Report, analysts' expectations gathered through Banco de México's survey are for a growth rate of 1.8 percent for the United States' economy in 2001[6].

Acknowledging that economic conditions had deteriorated in the final weeks of last year, on January 3rd 2001, out of the pre-established schedule for its meetings, the Federal Reserve announced a 50 basis point cut in its federal funds rate objective. This was then followed by a further reduction of equal magnitude on the last day of January, and by an additional downward adjustment of 50 basis points in the third week of March. Thus, the United States' central bank cut rates on federal funds by a total of 150 basis points during the first three months of the year[7]. Weaker inflationary pressures and expectations of easier monetary policy led to reductions in short, medium and long term interest rates during the January-March period.

In short, during the quarter the main macroeconomic aggregates of the United States' economy exhibited differentiated behavior. On the one hand, investment and industrial output showed clear indications of recession. On the other hand, although consumption was less vigorous, it continued to expand. The balance of these trends worsened in the January-March period, leading to downward revisions of economic growth expectations and to the increased likelihood that the economy will suffer a recession.

II.2.1.3. Developments in the Rest of the World's Economies

The evolution of the rest of the world's economies during the quarter was dominated by the impact of the United States' slowdown. The Euro zone continued to grow at a slower rate

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[6] The "Consensus Forecast" anticipates 1.7 percent real GDP growth in the United States for 2001. However, the main brokerages estimate even lower growth. At present, the average forecasted growth rate for 2001 from Goldman Sachs, JP Morgan, Morgan Stanley and Deutsche Bank is 1.1 percent.

[7] On April 18th, after the close of the quarter, the Federal Reserve reduced the federal funds rate by 50 basis points.

during the second half of 2000. At present, the European Union is expected to grow 2.3 percent in 2001, less than the 3.4 percent attained the previous year. The Euro recovered vis-à-vis the dollar at the beginning of the quarter. However, the deterioration of the economic outlook in this region reversed the trend. This, together with continuing high fuel prices, led the European Central Bank to maintain its short term interest rate objective unchanged.

In Japan, evidence of negative growth during the third quarter of 2000 led to a cut in the official discount rate by that country's central bank in February —by March it had reached zero. The weaker economic activity has called into question government estimates of 1.2 percent growth in 2001. This, as well as the stock market's disappointing performance and the wave of corporate restructuring has maintained consumption growth at rates close to zero. As a result, the soundness of the banking system has been put into question again and led Standard & Poor's to reduce its rating for the national debt (from AAA to AA+). The recently industrialized nations of Asia have been hardest hit by the deteriorating outlook for the technology sector in the United States, which caused a severe fall in the growth of their exports.

The slowdown of the United States' economy and the complex situation in Argentina have had an adverse influence on the expectations for Latin America. Argentina's economy has been unfavorably affected by lost competitiveness as a result of three main causes: the devaluation of the Brazilian real, the fall in the prices of raw materials, and the appreciation of the dollar. Last October the Argentinean government asked for the support of the International Monetary Fund in order to be able to settle its external debt commitments. Once calm had returned to capital markets, it was expected that the reduction in external interest rates at the beginning of 2001 and the devaluation of the dollar vis-à-vis the Euro would induce a favorable reaction in this South American country. This did not occur, however, and as the fiscal situation worsened the then finance minister resigned, which led the government to propose the adoption of new austerity measures. The Argentinean Congress did not react favorably to this plan and a political crisis ensued which disturbed the markets once again. The subsequent replacement of the finance minister —only 14 days after his appointment— and better acceptance by Congress of the emergency measures proposed by the new minister have helped to ease the uncertainty in capital markets.

Regarding Brazil, the unfavorable external environment has weakened its economy. The deceleration of the United States' economy and the crisis in Argentina have led to a decline in the flow of direct foreign investment, to reduced exports and to a deterioration of country risk perceptions. The latter has been reflected in a depreciation of the exchange rate, which was above two reals per dollar in March, a value not seen since October 1999.

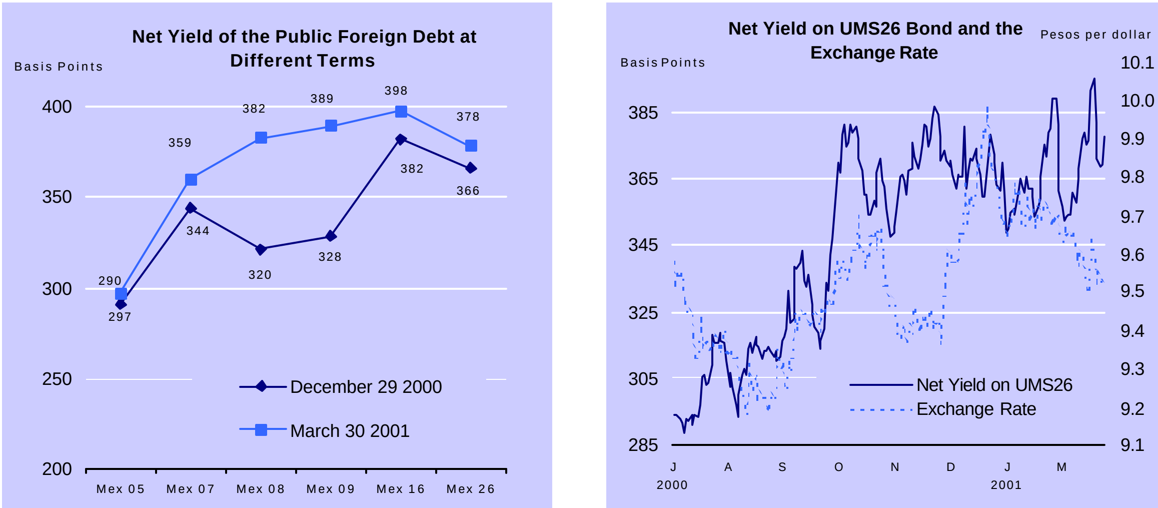
Finally, in Chile, lower export growth due to the situation in Asia has clouded prospects for economic growth this year.

II.2.1.4. Impact of the International Environment on the Domestic Economy

The deceleration of economic activity in the United States and the fall in the price of oil has caused a decline in the growth rate of Mexican exports. The effect of this on Mexico's external accounts has been mitigated by a significant deceleration of imports. Lower growth in the United States has been reflected in Mexico by an important weakening of economic activity and in a larger current account deficit. The latter was financed comfortably and without causing pressure on the exchange rate, due to the fact that in the January-March quarter foreign capital inflows —especially direct foreign investment— were substantially larger than those registered during comparable periods over the last six years. Furthermore, the greater availability of external resources meant that the events which had caused a deterioration in the country risk perception of emerging economies did not significantly affect the value of the peso. Thus, the exchange rate crisis in Turkey during the third week of February led to a rise of around 30 basis points in the yield on the UMS26 bond, while the peso exchange rate remained relatively stable in the same period. Similarly, towards the middle of March, the political crisis in Argentina caused a transitory increase in the aforementioned Mexican bond's yield as well as in the exchange rate (Chart 6).

The stable behavior of Mexican financial variables, in spite of a worsening external environment during the quarter, can be explained by three factors. Firstly, the favorable perception of financial markets regarding the Mexican government's commitment to macroeconomic stability, and the fact that investors see it as highly likely that the Fiscal Reform will be passed by Congress. They believe that, should this be the case, Standard & Poor's will grant investment grade to Mexican sovereign debt without much delay. Secondly, the positive spread that exists between the yields on assets denominated in pesos and those denominated in foreign currency. Finally, the greater than expected slowdown of domestic demand meant that the trade deficit grew only moderately during the period.

Chart 6 **Country Risk Indicators and the Exchange Rate**



SOURCE: Bloomberg and Banco de México.
Note: The net yield of the UMS26 bond is the spread over the yield of a U.S. government bond with a similar maturity.

At the close of March 2001, the peso nominal exchange rate was 9.47 pesos per dollar, which implied a 1.9 percent appreciation compared to its level at the start of the quarter. In January, the increasing uncertainty about the extent of the slowdown of the United State's economy caused a depreciation, which placed the exchange rate above the level that had been expected by private sector analysts towards the end of 2000. However, as result of greater external capital inflows and the recovery of oil prices, the exchange rate appreciated in February. In March it appreciated further, reaching a lower level than had been anticipated by analysts at the start of the quarter.

The comfortable financing of the current account deficit has meant that the economic deceleration in the United States has not induced the depreciation of the domestic currency that had been anticipated at the beginning of the year. Additional inflationary pressures have not, therefore, been generated in this area.

II.2.2. Compensations, Wages and Employment

Wages and employment are two of the main factors that influence the behavior of inflation. Below is a brief description of the path of these variables during the first quarter of 2001.

II.2.2.1. Compensations

In January 2001 nominal compensations per worker, in the sectors for which information is available, rose at annual rates between 8.8 and 15.8 percent. In two of theses sectors, the real annual variation in compensations observed in the aforementioned month was greater than or equal to 5.8 percent (Table 3).

Table 3 **Compensations per Worker**

Annual percentage change

	Nominal							Real						
	2000						2001	2000						2001
	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Jul	Aug	Sep	Oct	Nov	Dec	Jan
Manufacturing Industry	14.2	20.7	14.5	14.7	15.8	14.6	15.8	4.6	10.6	5.2	5.3	6.4	5.1	7.1
In-bond Industry	16.9	21.7	14.5	17.1	19.8	15.2	14.4	7.1	11.5	5.2	7.5	10.0	5.8	5.8
Construction Industry	5.6	12.5	16.5	10.5	11.3	n.d.	n.d.	-3.2	3.1	7.1	1.5	2.2	n.d.	n.d.
Commerce Sector	13.4	19.5	16.5	15.9	18.9	16.1	8.8	4.0	9.6	7.0	6.5	9.2	6.5	0.7

SOURCE: Prepared with information from INEGI.

During the fourth quarter of 2000, all sectors but the in-bond industry registered negative monthly variations in output per worker. Moreover, except in the commerce sector, in January growth of output per worker was lower than growth in real compensations.

The rise of real wages over productivity gains translates into higher unit labor costs. In the fourth quarter of 2000 and in January 2001, the annual growth rate of real remunerations remained at high levels in most sectors. In the commerce sector, the average growth of this variable was 10.1 percent in the November-December period. It decreased in January, however (Table 4).

Table 4 **Unit Labor Costs and Output per Worker**

Annual percentage change

	Output per Worker							Unit Labor Costs						
	2000						2001	2000						2001
	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Jul	Aug	Sep	Oct	Nov	Dec	Jan
Manufacturing Industry	4.8	7.1	5.3	7.8	5.3	-1.1	3.3	-0.2	3.3	-0.1	-2.3	1.0	6.3	3.7
In-Bond Industry	-0.6	6.0	-2.1	1.7	2.6	3.4	1.3	7.7	5.2	7.4	5.8	7.2	2.3	4.5
Construction Industry	-3.8	6.5	-0.1	-7.7	-5.2	n.d.	n.d.	0.6	-3.2	7.1	9.9	7.9	n.d	n.d.
Commerce Sector	3.3	6.8	4.1	4.1	0.1	-4.2	1.2	0.7	2.6	2.8	2.3	9.1	11.2	-0.5

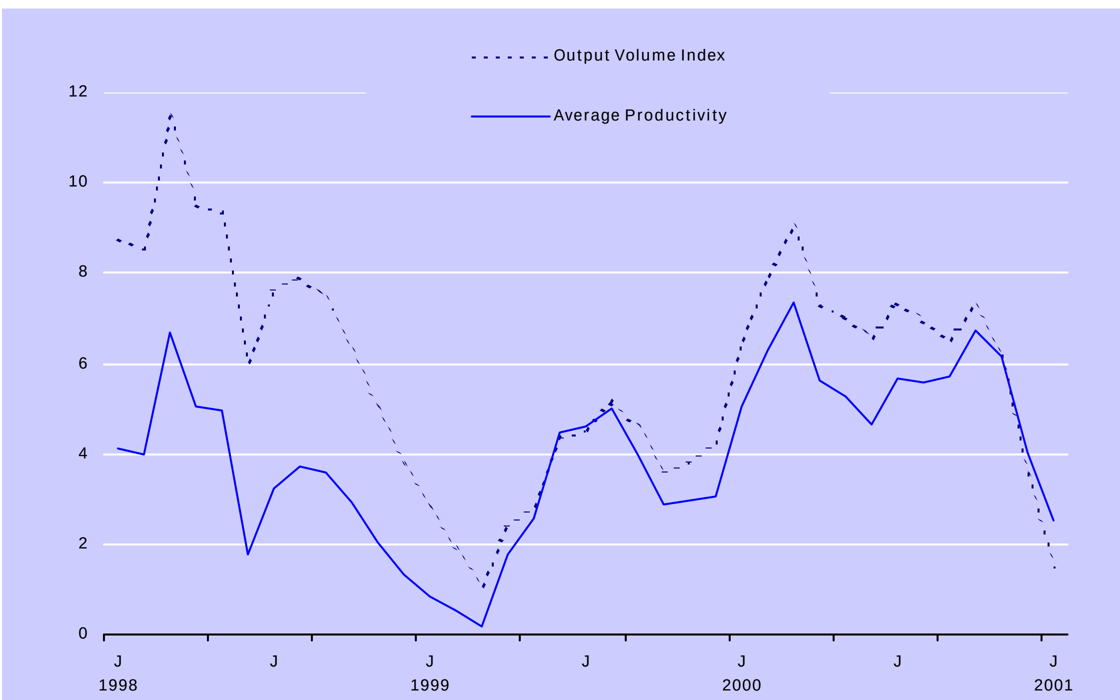
SOURCE: Prepared with information from INEGI.

In 1999 and part of 2000, real wage increases were offset by higher productivity, and as a result there was no significant rise in unit labor costs. In contrast, an important reduction in the growth of output per worker has been observed recently, and therefore gains in productivity have not been large enough to offset increases in real wages.

Labor productivity is highly correlated to the economic cycle. This is due to the fact that, when there is a deceleration of economic activity, companies do not usually make immediate adjustments in their payroll. Falls in output growth are generally larger than reductions in the number of employees and this translates into lower labor productivity. There is evidence that this is what is happening at present in Mexico. Recent data, for example, shows a fall in manufacturing industry activity, but employment in this sector has not been affected to the same extent. Thus, productivity has fallen considerably in that industry (Chart 7).

Chart 7 **Non-In-Bond Manufacturing Industry Output and Average Productivity**

Annual percentage change of the 3 month moving average



SOURCE: INEGI.

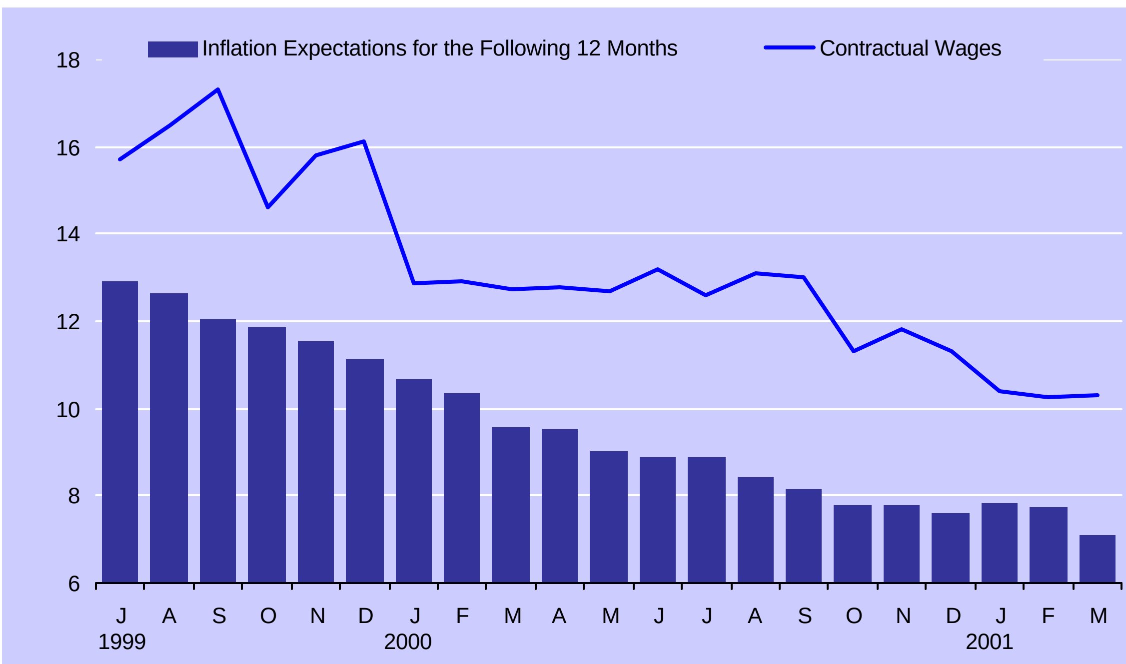
Should the reported trend in real wages continue, productivity gains would not be able to offset them and therefore unit labor costs would rise. In the context of an economic downturn, this could eventually mean greater inflationary pressures and slower growth in employment —or even a contraction in the latter variable.

II.2.2.2. Contractual Wages

Although the average nominal growth rate of contractual wages fell from 11.5 percent in the fourth quarter of 2000 to 10.3 percent in January-March 2001, the differential between contractual wages' nominal growth rate for the quarter and the inflation target for 2001 was still large. Furthermore, the gap between the rate of increase of contractual wages and analysts' inflation expectations for the following twelve months is still significant (Chart 8).

Chart 8 **Contractual Wages and Inflation Expectations for the Following 12 Months**

Annual percentage change



SOURCE: Survey of the Expectations of Private Sector Economic Specialists, Banco de México and Ministry of Labor and Social Security.

In the first quarter of 2000, the nominal growth rate of contractual wages in the manufacturing sector stabilized at around 11 percent. In other sectors the average increase in wages fell three percentage points, from 12.9 percent in December 2000 to 9.9 percent in March 2001 (Table 5).

The downward rigidity of nominal contractual wage growth during 2000, and to a lesser extent in the first quarter of 2001, deserves careful attention. Even in light of the recent moderation, the expected increase in real wages is likely to surpass sustainable gains in labor productivity throughout 2001. As a result, unit labor costs will probably continue to rise.

The negative effects on employment of real wage increases that are incompatible with medium term productivity gains are further reinforced by two additional factors: the deceleration of the United States' economy and less vigorous investment in Mexico. This is due to the fact that in the context of an economic downturn, producers find it more difficult to transfer higher costs to the price of their products. Thus, in the medium term, the adjustments for higher production costs would have to be made through reductions in employment and in firms' profits.

Table 5 **Contractual Wages by Sector**

Annual percentage change

	2000						2001		
	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar*
Manufacturing	12.5	13.9	13.1	12.7	13.3	10.8	11.1	10.7	10.8
Other Sectors	13.8	12.2	12.9	11.2	11.4	12.9	10.0	9.8	9.9

SOURCE: Prepared by Banco de México using information provided by the Ministry of Labor and Social Security.
*Preliminary Information.

II.2.2.3. Employment

At the end of the first quarter 2001, the number of workers (temporary and permanent urban employees) affiliated to the Mexican Social Security Institute (*Instituto Mexicano del Seguro Social*, IMSS) fell by approximately 97,000 people compared to the level reported in December of last year[8] (Chart 9a). Likewise, between November 2000 and March 2001 employment fell 2.5 percent. Although the latter fall was partly due to seasonal factors, it was the largest in the last five years. Since January 2001 the employment rate has remained practically stagnant. In particular, the growth in the number of individuals permanently affiliated to the IMSS between the end of January and the end of March was only 0.2 percent.

The open unemployment rate stood at 2.3 percent in March, 0.4 percentage points above the figure for December 2000. Its decrease from February to March was due to seasonal factors

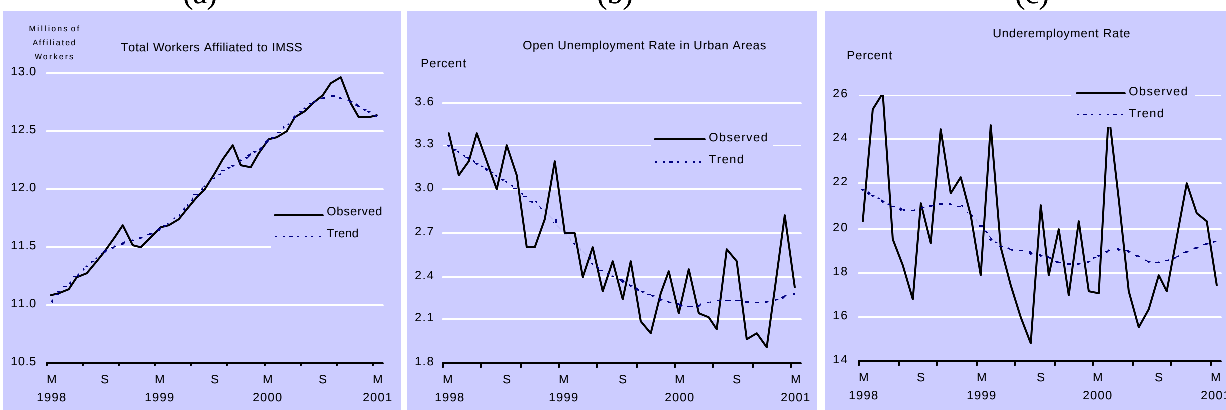
[8] Estimate based on preliminary information from the IMSS.

—seasonally adjusted figures show open unemployment has maintained an upward trend since January of this year (Chart 9b). Regarding the underemployment rate, it has registered a significant rebound since last September. It moved from 17.2 percent in June 2000 to an average above 19 percent in the first quarter of 2001 (Chart 9c). This upward movement has been reflected in its trend series, which has been increasing without interruption since last October.

Chart 9 **Employment and Unemployment Indicators**

Trend Series

(a) (b) (c)



SOURCE: IMSS and INEGI.

II.2.3. Aggregate Supply and Demand

The deceleration of domestic supply continued in the fourth quarter of 2000. There was also an unambiguous reduction in the growth of all the components of aggregate demand. The weakening of both aggregate supply and demand is shown even more clearly by their seasonally adjusted quarterly growth rates. The deceleration of aggregate demand in the fourth quarter is the first sign that the disparity between the expansion of aggregate supply and demand may have begun to narrow.

The behavior of aggregate demand in the fourth quarter of 2000 reflects the weakening of all its components. The lost momentum of public expenditure and investment are particularly noteworthy. This was partly due to the concentration of public spending in the first quarter of 2000. In turn, the annual growth rates of private consumption and investment fell almost three percentage points in response to the decline in the growth rate of GDP, which was in turn reflected by a less tight labor market and a fall in job creation during the latter months of 2000. The gap between GDP growth and private sector spending was significantly reduced in the fourth quarter.

The further decline in the growth rate of GDP during the fourth quarter of 2000 was less pronounced than the decline of domestic demand. As a result, the growth rate of imports dropped to a larger extent than that of exports.

Table 6 **Aggregate Supply and Demand in 2000**

Real annual percentage change

	I Q.	II Q.	III Q.	IV Q.	Annual
Aggregate Supply	11.7	11.2	11.4	8.0	10.5
GDP	7.7	7.6	7.3	5.1	6.9
Imports	24.9	22.3	23.2	16.1	21.4
Aggregate Demand	11.7	11.2	11.4	8.0	10.5
Total Consumption	8.9	9.4	10.0	6.6	8.7
Private	9.6	10.2	10.5	7.6	9.5
Public	3.9	4.6	6.1	0.6	3.5
Total Investment	10.9	10.5	11.1	7.6	10.0
Private	12.8	8.9	10.8	8.2	10.2
Public	-4.5	26.0	13.1	5.3	8.6
Exports.	17.3	15.8	16.9	14.1	16.0

SOURCE: INEGI.

In order to properly analyze the slowdown of the Mexican economy it is necessary to study the main seasonally adjusted components of aggregate supply and demand. From this analysis it becomes evident that the quarterly growth rates of private spending (consumption plus investment) have been lower in the last two quarters. It is worth underscoring that in the last quarter of 2000 the corresponding seasonally adjusted quarterly rates were almost zero and similar to that for GDP.

Preliminary information about the evolution of aggregate supply and demand in the first quarter of 2001 suggests that the trends observed during the latter months of 2000 have become more pronounced.

The conclusion that domestic demand has continued to weaken is based on the following information:

(a) The main indicators of private consumer spending show a lower rate of expansion. In February, sales reported by the National Association of Self Service and Department Stores (*Asociación Nacional de Tiendas de Autoservicio y Departamentales*, ANTAD) rose at a real annual rate of

6.1 percent, lower than that for January (8.2 percent) and December (11.4 percent). Seasonally adjusted figures for February show that sales fell 0.5 percent compared to the previous month. Likewise, in January the seasonally adjusted figures for commercial establishments, prepared by INEGI, show that wholesale sales have been declining for several months whereas retail sales have weakened. Finally, in February sales of some consumer durables — like stoves, washing machines, refrigerators and automobiles— lost momentum.

(b) The annual growth rate of imports of consumer goods fell from 33.8 percent in the last quarter of 2000 to 29.1 percent in the first quarter of 2001.

(c) The annual growth rate of imports of capital goods declined from 21.7 percent to 7.5 percent in the same period.

(d) In January, the annual growth rate of gross fixed investment was 0.4 percent, the lowest of the last 27 months.

Banco de México estimates that in the first quarter of 2001 private consumption and total investment rose 5 and 1.2 percent in annual terms. This would be compatible with an aggregate demand expansion of around 3 percent.

Available information also shows that GDP has continued to decelerate in 2001:

(a) The annual growth rate of the Global Indicator of Economic Activity (*Indicador Global de la Actividad Económica*, IGAE) decreased from 4.8 percent in the fourth quarter of 2000 to 3.2 percent in January. Seasonally adjusted IGAE figures for January show a slight positive change compared to its level in the previous month.

(b) Industrial output has suffered a considerable deceleration. Its annual growth rate moved from levels above 5.8 percent in May-October of 2000 to 4.6, -0.4, 1.9 and -3.7 in November, December, January and February, respectively.

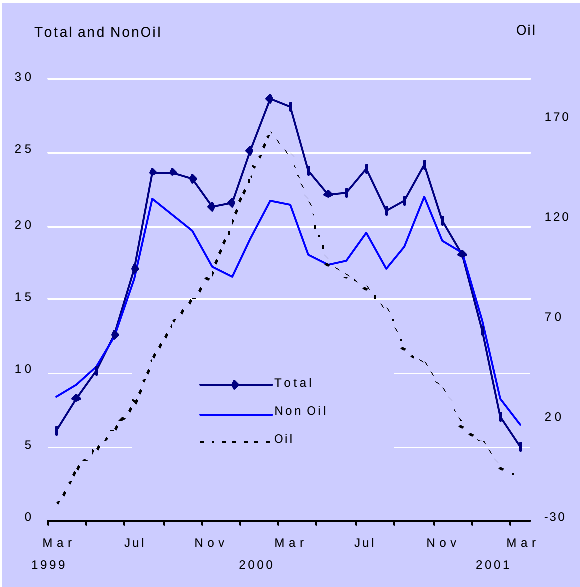
Taking the above into account, Banco de México estimates that the annual growth rate of real GDP could be

2 percent in the first quarter, and around 3 percent for the year as a whole.

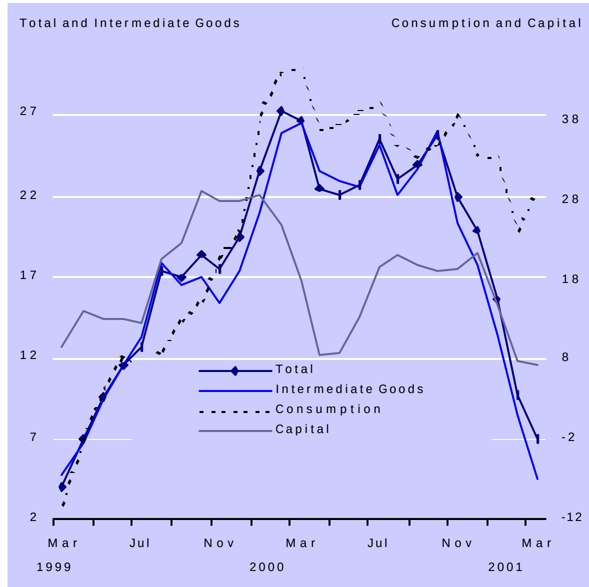
Chart 10 **Imports and Exports**

Annual percentage change of the 3 month moving average

Exports



Imports



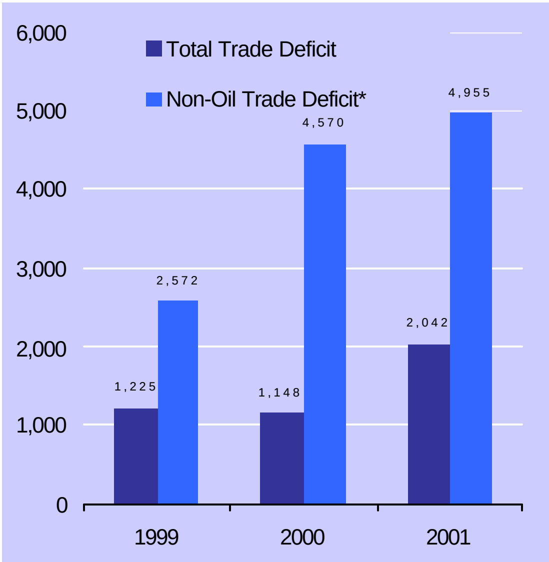
The rapid deceleration of domestic supply and demand is a clear sign of the significant impact weaker economic activity in the United States has had on the Mexican economy. The direct effect this has had on Mexican exports led to a swift fall in industrial production growth. As a result, the expansion of employment has declined considerably and consumption growth has weakened. In turn, this has had negative repercussions on the growth of private investment. The slowdown of both the United States' and Mexican economies has also induced significantly less vigorous growth in Mexican imports and exports since the last few months of 2000.

Although the trade deficit accumulated in the first quarter of 2001 was larger than that observed over the same period in the previous year, trend data point to an incipient reduction in the last few months.

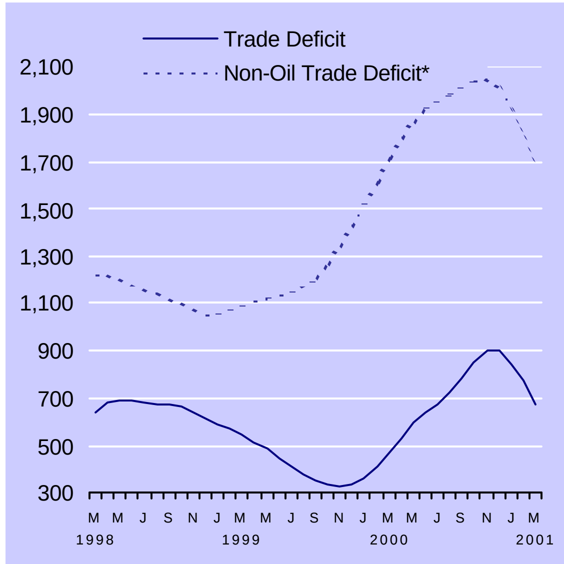
Chart 11 **Trade Deficit: Total and Excluding Oil**

Millions of dollars

January-March



Trend



* Excluding imports of gasoline, butane gas and propane gas.

The above seems to confirm that the disparity between the growth of domestic supply and demand is narrowing. It is therefore possible to anticipate a current account deficit equivalent to 3.6 percent of GDP in 2001, slightly higher than in the previous year.

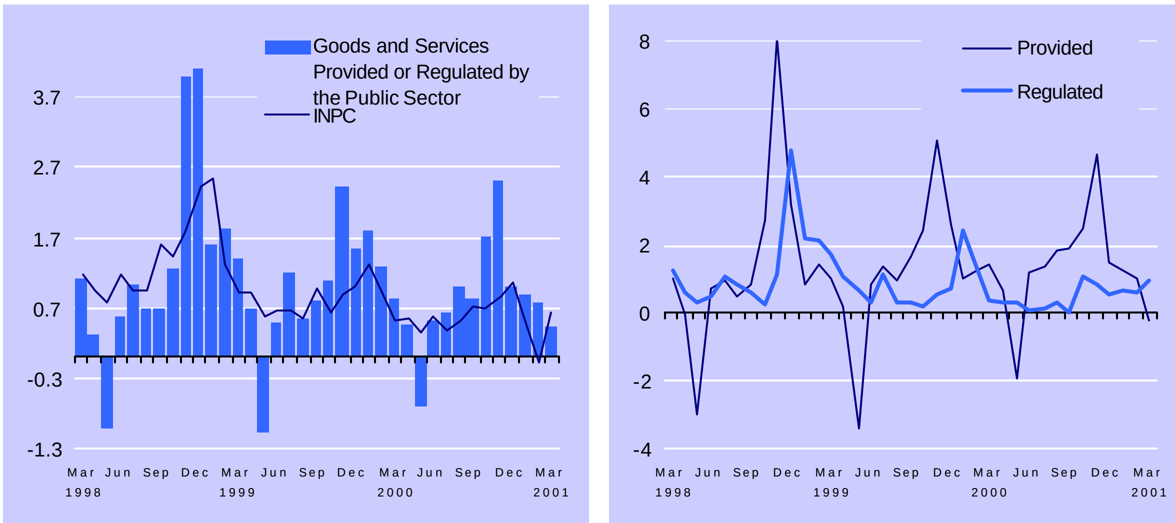
The widening of the trade deficit in the January-March quarter did not significantly influence the foreign exchange market. This was due to the abundant supply of foreign capital inflows during the period and to the fact that the increase in the deficit was lower than had been expected. The following estimates for the period are worth pointing out: foreign direct investment of more than 3.3 billion dollars, portfolio investment above 1.1 billion dollars, 1.650 billion dollars in additional public and private sector net external debt, and a 2.0 billion dollar decline in Mexican residents' assets held abroad.

II.2.4. Prices of Goods and Services Provided or Regulated by the Public Sector

In January, February and March 2001 the monthly increases in the sub-index of prices for goods and services provided or regulated by the public sector were 0.90, 0.80 y 0.43 percent, respectively. Meanwhile, the INPC growth rates for the same months were 0.55, -0.07 and 0.63 percent (Chart 12).

Chart 12 **Price Index for Goods and Services Provided or Regulated by the Public Sector and the INPC**

Monthly percentage change



In January, February and March the sub-index for prices of goods and services provided by the public sector posted monthly increases of 1.22, 1.01 and –0.21 percent, respectively. Over the same months the sub-index for prices regulated by the public sector rose 0.64, 0.61 and 0.98 percent[9]. The prices that rose the most during the first three months of 2001 were those for domestic gas, local telephone services and city bus fares, which posted increases of 2.93, 6.05 and 3.35 percent, respectively.

The evolution of the prices of goods and services provided or regulated by the public sector continue to be an important source of inflationary pressures. Over the first quarter this sub-index contributed 0.39 percentage points to the increase of the INPC. The annual growth rate of this sub-index is still a cause for concern as it remained above that of the INPC.

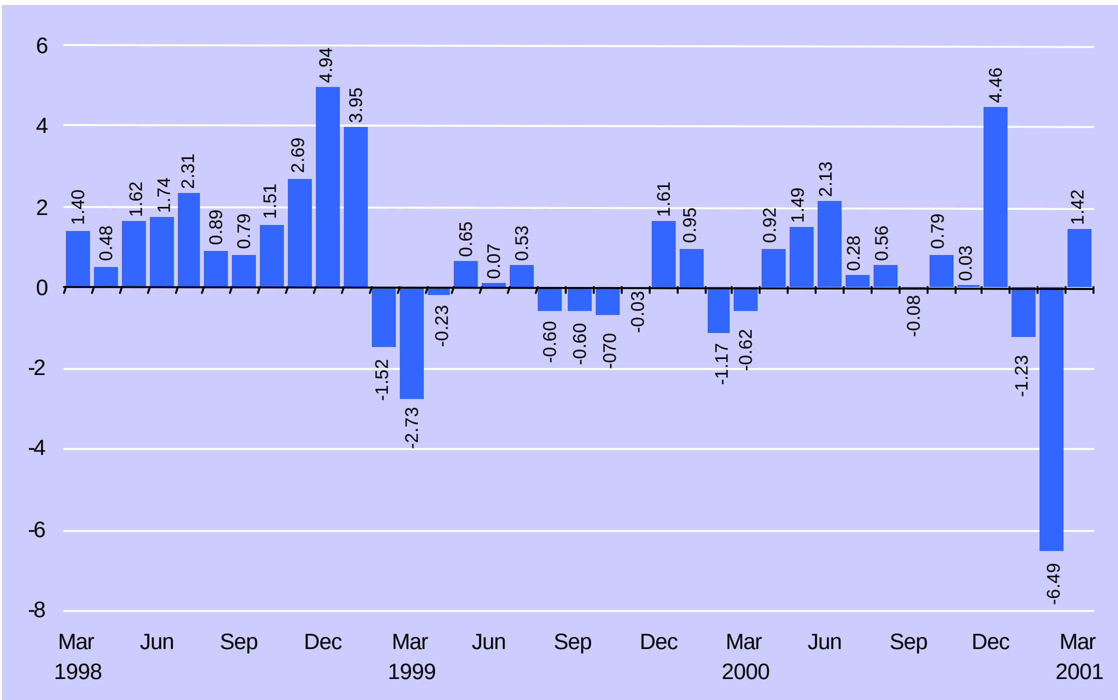
[9] The prices considered in the sub-index for goods and services provided by the public sector are: gasoline, domestic gas and electricity. The products whose prices are regulated by the public sector are: long distance international telephone calls, taxi fares, city bus fares, subway or electric transport fares, inter-city bus services, parking lots, automobile ownership taxes, local telephone services, highway tolls, domestic long distance telephone calls, telephone line installation and service fees, oil and lubricants, and duties and licences.

II.2.5. Transitory Factors that Affected Inflation

The annual inflation of agricultural and livestock products was 3.98 percent in March. This contrasts favorably with the 10.07 percent inflation rate registered by this sub-index in December of 2000. This evolution can be explained by the reduction in the prices of these products observed in January and especially in February (Chart 13).

Chart 13 **Price Index of Agricultural and Livestock Products**

Monthly percentage change



III. Monetary Policy During the First Quarter of 2001

In this section the reasons which led Banco de México to tighten its restrictive monetary policy stance on January 12th will be analyzed. A complementary evaluation of the impact the adopted measures had upon inflation expectations and on both nominal and real interest rates is also presented. Finally, the evolution of the monetary base and other monetary aggregates is reported.

III.1. Monetary Policy Actions

On January 12th Banco de México widened the "short", from 350 to 400 million pesos and maintained it at the latter level for the remainder of the quarter. This measure, just as the increases of the "short" implemented during the last quarter of 2000, was undertaken in order to ensure the attainment of less than 6.5 percent inflation in 2001.

Throughout the second half of 2000, overall inflation showed downward rigidity. Although this behavior was mainly due to transitory factors, the private sector's expectations regarding annual inflation for 2001 remained around 7.6 percent, a figure clearly incompatible with the inflation target.

In the last few weeks of 2000 and the early weeks of 2001 various risk factors about which Banco de México had repeatedly warned began to materialize. The data then available suggested that domestic spending continued to grow at rates higher than those for output. In the external front, the United States' economy slowed down considerably in the second quarter of 2000 and the majority of analysts anticipated that it would grow at a rate of less than 2 percent in 2001. Finally, the price of the Mexican crude oil export mix dropped considerably. These elements pointed to a significant widening of the current account deficit and a likely depreciation of the peso. If the latter were to occur it could give rise to inflationary pressures.

In response to the above situation, some analysts revised their inflation forecasts for 2001 upwards. Moreover, domestic interest rates fell in the first few days of January, which was incompatible with the appearance of the aforementioned risk factors. Thus, the attainment of the inflation target for the year required a more restrictive monetary policy stance.

As has already been stated in several sections of this Report, the data that was published later on confirmed the deterioration of economic conditions, particularly in the external front.

Although the most recent information available for aggregate demand indicates its growth rate is weakening, it is still above the corresponding rate for GDP. National account statistics show that the annual growth rate of private consumption moved from 10.5 percent in the third quarter of 2000 to 7.6 percent in the fourth quarter. Over the same interval, the expansion rate of private investment declined from 10.8 to 8.2 percent. In both cases, however, the rates were still higher than real GDP growth (5.1 percent in the fourth quarter).

Forecasts for the United States’ economy in 2001 have been repeatedly revised downward. In addition, although the price of Mexico's crude oil export mix has increased since December, its estimated average price for 2001 is still substantially below that observed during last year.

The aforementioned evidence suggests that the evaluation of future economic conditions and risk factors that had been made at the time the "short" was widened was appropriate. The monetary policy adjustment was therefore necessary in order to ensure that inflation and inflation expectations could resume their downward path. The widening of the trade deficit underscored the need for the coordinated and timely application of restrictive fiscal and monetary policies in order to reduce the vulnerability of Mexico’s external accounts.

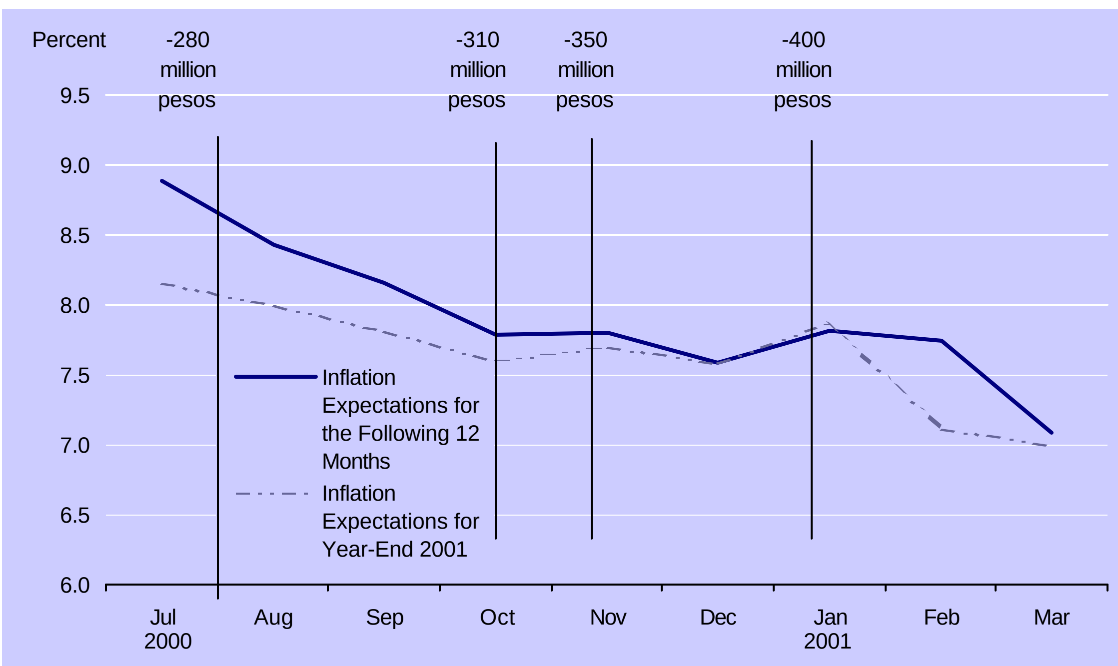
The path of inflation expectations is important for evaluating the results of monetary policy and for identifying inflationary pressures. Therefore, it is worth noting the significant improvement of inflation expectations for 2001 that took place in February (Chart 14)[10]. As in previous increases of the "short", after the rebound in inflation expectations that occurred in January due

[10] It is important to mention that the inflation expectations for 2001 recorded by the surveys conducted between January and March of the present year do not take into account the potential effects the Fiscal Reform may have on prices. However, expectations for the following twelve months, recorded in January and February, do incorporate this impact.

to the deterioration of the international environment, expected inflation resumed its downward trend. The impact of the "short" was undoubtedly strengthened by the significant decline in inflation observed in February. In all, inflation expectations for 2001 were 7 percent in the first quarter of the year, 0.58 percentage points below their level in December 2000.

At the end of March, inflation expectations for the following 12 months also improved when compared to their level in December 2000, having decreased 0.49 percentage points to 7.09 percent. Unlike data recorded in January and February, the latter figure did not take into account the possible effect of the Fiscal Reform. It is nevertheless paradoxical that this figure is higher than expected inflation for 2001, especially considering that inflation expectations for 2002 are also lower than the latter figure.

Chart 14 **Inflation Expectations and Accumulated Balances Objective ("Short")**



SOURCE: Survey of the Expectations of Private Sector Economic Specialists, Banco de México.

INPC, Core Price Index and Monetary Policy

Banco de México sets inflation targets using the National Consumer Price Index (INPC) as a reference. The reason for this is that the INPC is the best measurement for the cost of living in Mexican households. It is also the price index best known by the public.

Although objectives are determined according to the INPC, Banco de México also takes into consideration the core price index when formulating monetary policy. The calculations of this index exclude agricultural and livestock products, education services and goods and services provided or regulated by the public sector.

Fluctuations in the prices of agricultural and livestock products and of goods and services provided or regulated by the public sector —energy items in particular— greatly influence short term movements of the INPC.

Variations in the prices of agricultural and livestock products, particularly vegetables and fresh fruits, respond mainly to weather conditions in the country or abroad, which can suddenly affect the domestic supply of these goods and usually have a transitory impact on inflation.

The prices of goods and services provided or regulated by the public sector are not necessarily determined by market forces. In addition, energy prices included in this index are extremely sensitive to changes in the global supply and demand of these products.

Finally, the prices for education services have traditionally followed very marked seasonal patterns.

Core inflation is therefore a better indicator of inflation trends as it eliminates the aforementioned factors.

Inasmuch as the effects on inflation of variations in prices of agricultural and livestock products, education services and of goods and services provided or regulated by the public sector are temporary, the evolution of core and overall inflation ought to be similar over the medium term. Furthermore, because monetary policy affects prices with a lag, monetary policy actions must be directed towards ensuring that core inflation continually meets the targets set for overall inflation. In this way, the attained inflation rate will usually correspond to that measured by the INPC. Therefore, efforts to offset the transitory variations of the aforementioned subindices could be counterproductive and lead to greater volatility in interest rates and economic activity. Moreover, these repercussions could weaken price stability over the medium term.

Should persistent differences between the trends of INPC and core inflation indices be anticipated, Banco de México shall adopt the monetary policy actions it considers necessary to attain the established target for INPC inflation.

Thus, by using the evolution of the core price index as a guide in the formulation of monetary policy, Banco de México does not compensate for the direct effects of changes in the prices of the goods and services excluded from the measurement of core inflation. Nonetheless, Banco de México does actively seek to offset the secondary effects that may originate from a deterioration of inflation expectations due to the direct impact of the aforementioned factors.

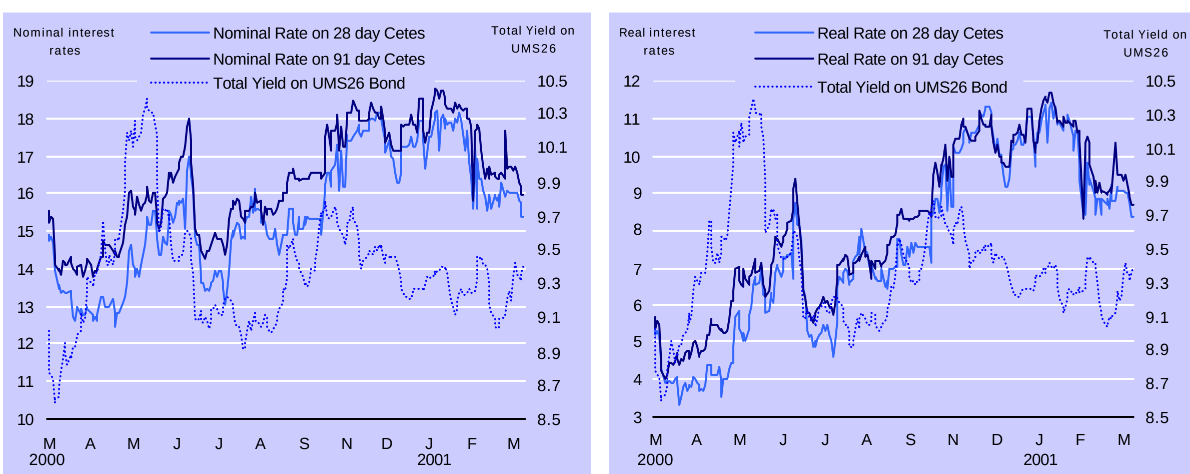
If the fiscal reform is eventually approved, it will be even more important to monitor the behavior of inflation expectations for the following twelve months. The corresponding forecasts shall include the immediate upward effect of the reform on prices. However, after a few months inflation expectations will probably fall significantly.

Nominal and real interest rates remained at high levels throughout the quarter covered by this Report (Chart 15). After the widening of the "short" on January 12th, between the close of the day preceding the implementation of this measure and the close of the following day nominal interest rates on 28 and 91-day Cetes rose by 29 and 82 basis points, respectively.

In mid-February there was an important reduction in nominal and real interest rates. This was probably related to the positive inflation results obtained in January and the first two weeks of February. Since then and for the remainder of the quarter, real interest rates on 28 and 91-day Cetes remained at around 9 percent. Although external interest rates fluctuated during the quarter, by the end of March they were at a level similar to that observed at the beginning of the year. Thus, the spread between domestic and external interest rates was slightly narrower than it had been in the fourth quarter of the previous year.

Chart 15 **Nominal Interest Rates, Real Interest Rates [1/] and Total Yield on UMS26 Bond**

Percent



1/ Equivalent to nominal interest rates adjusted by inflation expectations for the following 12 months.

In short, the tightening of monetary policy was undertaken to limit the eventual upward effect on prices of the risk factors that materialized at the end of 2000 and early 2001, and thus confirm the Central Bank's resolve to attain the inflation targets for this year and for the medium term. It is worth pointing out that, although expected inflation has decreased, it is still above the target and inflation expectations for the end of 2002 and 2003 are not in line with the stated objectives.

III.2. Monetary and Credit Aggregates

III.2.1. Monetary Base, Net Domestic Credit and Net International Assets

As inflation decreases the usefulness of narrow monetary aggregates for making inferences about prices in the short term is compromised by innumerable factors that affect economic agents' preference for liquidity. Consequently, for the last few years Banco de México has monitored the behavior of these aggregates only as an additional reference to the evaluation of the other variables that affect inflation in the short term. The expected daily path of the monetary base stock was thus included in the Monetary Program for 2001.

In the first quarter of 2001 the demand for monetary base declined by 32,833 million pesos (Table 7). This contraction was mainly due to the strong seasonal pattern shown in this period every year[11]. This outcome was very close to the forecast, having deviated -2.4 percent on average.

It is worth mentioning that, unlike other years, Banco de México's Monetary Program for 2001 did not establish a limit on the variation of net domestic credit[12]. During the period under analysis, the stock of this variable fell by 78,995 million pesos. This can be explained by the aforementioned decline in the demand for base money and by an important accumulation of international assets (4.716 billion dollars).

[11] The monetary base decreases in the first few months of the year and increases considerably towards the end. This pattern closely reflects the behavior of the public sector's expenditure.

[12] Variations in net domestic credit are computed by subtracting the accumulated variations of net international assets —valued in pesos at the current exchange rate applicable to each operation— from the accumulated monetary base flows.

Table 7 **Monetary Base, International Assets and Net Domestic Credit**

Millions

	Stocks		Effective flows accumulated during the year [1/]
	As of 30 Dec. 2000	As of 30 Mar. 2001	As of 30 Mar. 2001
Monetary Base (Pesos)	208,943	176,110	-32,833
Net International Assets (Pesos) [2/]	342,386	383,002	46,162
Net International Assets (Dollars)	35,629	40,344	4,716
Change in Net International Assets (Dollars)			4,716
Pemex			3,820
Federal Government			-238
Purchases through Options			735
Others [3/]			399
Net Domestic Credit (Pesos)	-133,443	-206,892	-78,995
Memorandum:			
International Reserves [4/] (Dollars)	33,555	38,036	4,481

1/ In the estimation of effective flows in pesos of net international assets, the exchange rate applied to the operation generating each flow is considered. The differential between net international asset stocks in pesos does not correspond to the concept of effective flows, due to the fact that the stocks of the former definition are valued at the exchange rate of the respective date. This also explains why the differential between net domestic credit stocks are not the same as the effective flows reported.
2/ Net international assets are defined as gross reserves, plus credit agreements with central banks with maturity of more than six months, minus total liabilities payable to the IMF, and minus credit agreements with central banks with maturity of less than six months.
3/ Mainly composed of dollar sales operations and interest earned on international assets.
4/ As defined in the Banco de México's Law.

III.2.2. Monetary Aggregates M1 and M4

The narrow monetary aggregate (M1) reflects the public's demand for liquidity which to a great extent responds to their need to carry out transactions. Thus, M1 is closely related to consumption (Chart 17). The real annual growth of this monetary aggregate declined from an average of 7.9 percent in the fourth quarter of 2000 to 6.8 percent in January-February of 2001 (Table 8).

The broad monetary aggregate (M4) increased at a real annual rate of 6.7 percent in the first two months of this year, a similar figure to that registered in the fourth quarter of 2000 (6.3 percent). Among the components of M4, the 29.8 percent nominal increase in the holdings of government securities by non-residents in the first two months of the year (5,510 million pesos) is noteworthy. In this period M4 also continued to reflect a contraction of bank deposits and a rise in holdings of public and private securities (Table 8). This was mainly due to the fact that commercial banks are not obtaining resources through their own instruments and have increased their intermediation through repurchase agreement operations involving government securities, which increased by 4.8 percent between December 2000 and February 2001.

Chart 16 **M1 Monetary Aggregate and ANTAD Sales**

Real annual percentage change of the trend series

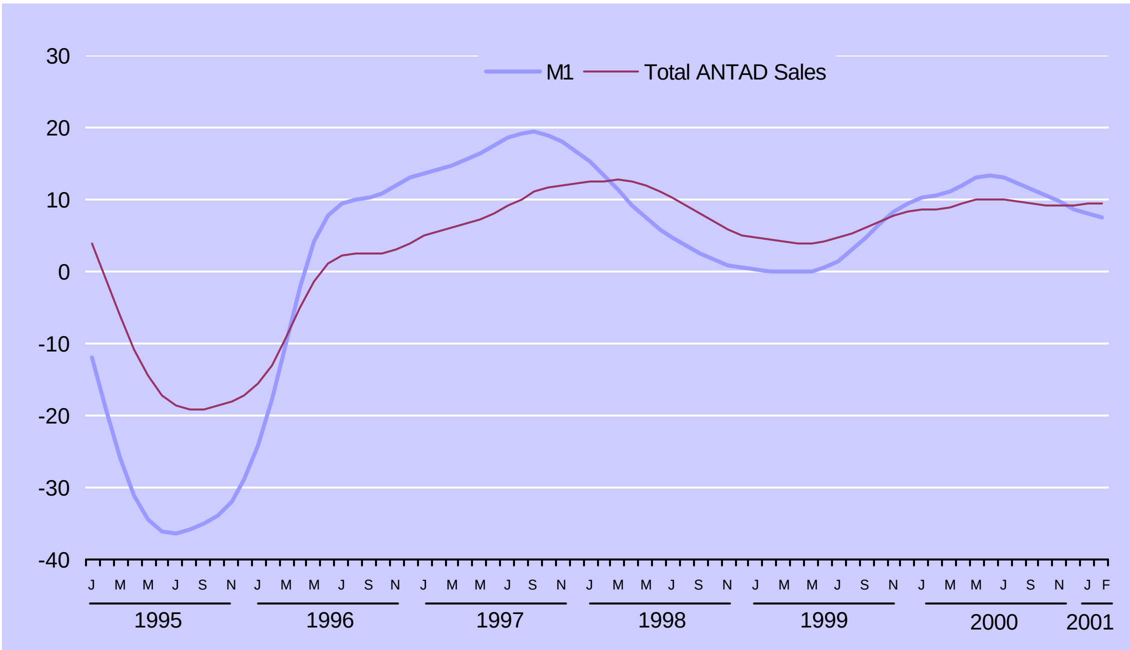


Table 8 **Monetary Aggregates**

Real annual percentage change

	2000 1/				2001	
	I	II	III	IV	Jan	Feb
M1	**11.2**	**13.5**	**12.3**	**7.9**	**6.3**	**7.4**
Bills and Coins held by the public	15.2	20.5	16.2	8.8	6.8	9.1
Checking Accounts 2/	9.4	10.7	10.6	7.6	6.1	6.6
M4	**7.9**	**8.1**	**6.9**	**6.3**	**5.9**	**7.6**
Bills and coins held by the public	15.2	20.5	16.2	8.8	6.8	9.1
Bank Deposits	-3.8	-4.2	-9.6	-11.4	-11.2	-10.1
Public Securities 3/ 4/	42.2	34.2	41.6	41.5	39.0	40.8
Private Securities 4/	0.0	17.0	33.0	31.5	12.2	21.7
Retirement funds excluding Siefores 5/	14.3	15.4	17.2	17.2	17.6	18.5

1/ Average quarterly stocks.
2/ Including current account deposits.
3/ Including securities issued by the Federal Government, BPAS and BREMS.
4/ Including securities held by Siefores (Specialized Retirement Funds).
5/ Including housing funds and Banco de México's retirement funds.

III.2.3. Financing to the Private Sector

The incipient recovery of bank credit that began at the end of the previous year continued in the first two months of 2001.

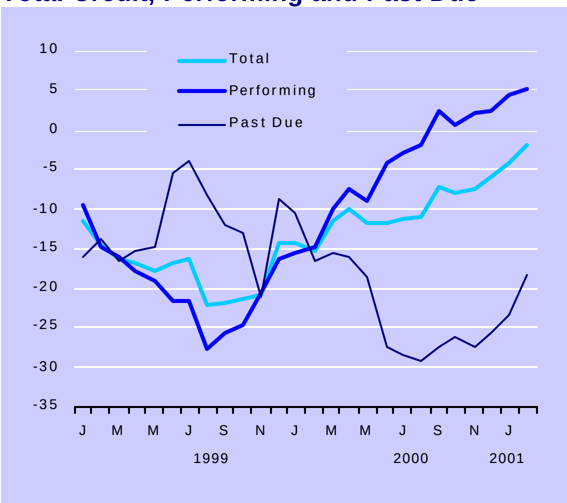
This can be seen in the evolution of the performing loan portfolio[13], which is growing at real positive annual rates (Chart 17). This is partly a reflection of the granting of new credit by commercial banks. Furthermore, when the performing loan portfolio is divided by type of credit, it can be seen that credit for consumption is expanding at high real rates while that granted to firms and individuals with a business activity is rebounding.

Chart 17 **Credit Granted by Commercial Banks to the Private Sector**

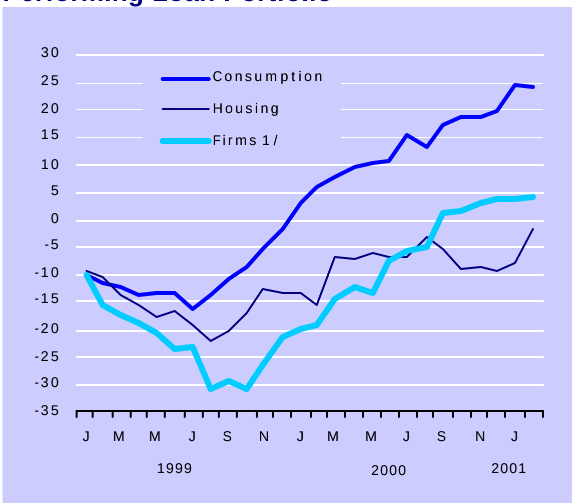
Bank's Own Portfolio

Real annual percentage change

Total Credit, Performing and Past Due



Performing Loan Portfolio



1/ Firms and individuals with a business activity. Does not include credit granted to non-bank financial intermediaries.

[13] Refers to the commercial banks' own portfolio, which excludes loans related to the IPAB-Fobaproa notes and Cetes-UDIS.

IV. Private Sector Outlook for 2001[14/]

IV.1. Forecasts for the Main Determinants of Inflation

Private sector expectations indicate that for the rest of this year the international environment will continue to be unfavorable for the Mexican economy. According to analysts' responses to Banco de México's survey conducted in March, the following forecasts deserve special mention:

(a) Mexican private sector analysts expect a 1.8 percent annual growth rate for the United States' economy in 2001.

(b) An estimated average price of 18.8 dollars per barrel for the Mexican crude oil export mix in 2001. Taking into account WTI oil futures prices of 28.25 dollars per barrel and the differential that prevailed in March 2001 vis-à-vis the Mexican crude oil mix, an average price of 19.23 dollars per barrel can be expected for Mexican oil (April 17th).

Expectations for the exchange rate significantly improved, while the analysts surveyed anticipate a slight reduction in the nominal growth rate of contractual wages.

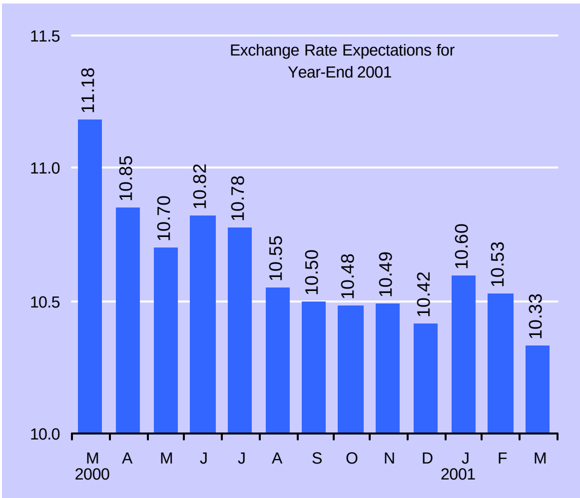
At the end of March, the private sector anticipated that at year-end 2001 the exchange rate would be 10.33 pesos per dollar. As a result, the peso futures prices have been falling significantly since mid-January of this year (Chart 18). Thus, in the fourth week of March, the December 2001 futures prices for the peso were 10.35 pesos per dollar.

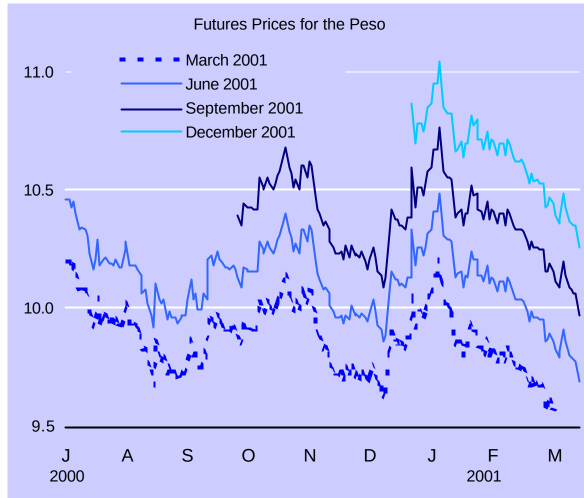
Analysts consulted in March forecasted that nominal wage increases would be 9.6, 9.6 and 9.3 percent in March, April and May of 2001, respectively. Therefore, they expect a moderate downward adjustment of this variable (Chart 19).

[14] Unless specified otherwise, the forecasts reported in this section are taken from the Survey of the Expectations of Private Sector Economic Specialists conducted each month by Banco de México.

Chart 18 **Futures Prices for the Peso and Exchange Rate Expectations for Year-end 2001**

Pesos per dollar

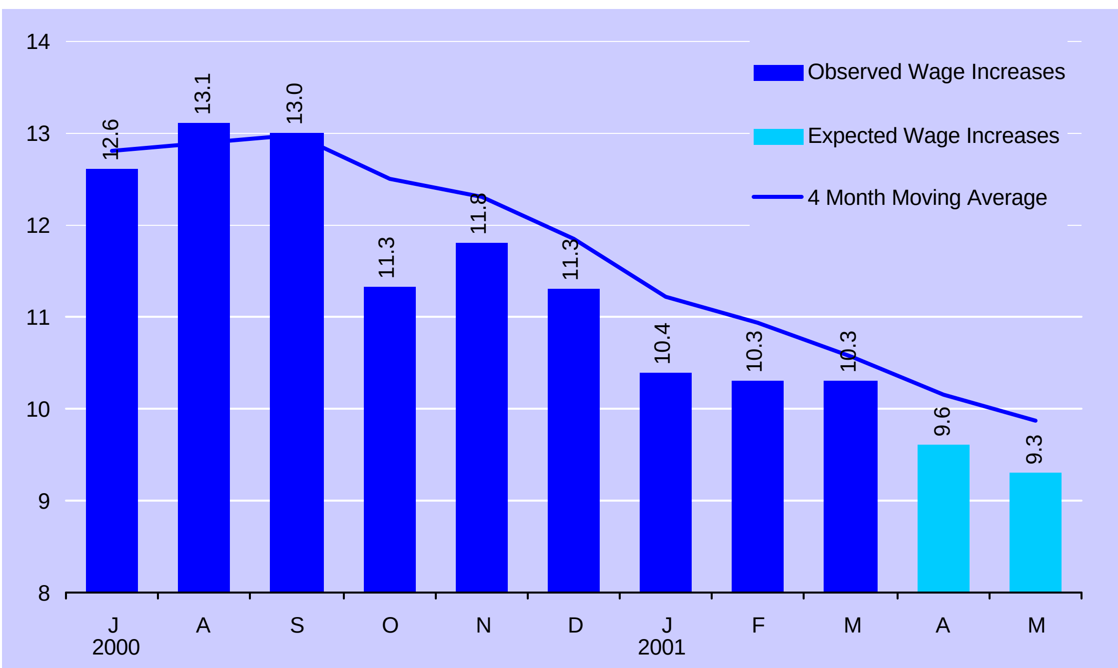




SOURCE: Bloomberg and Survey of the Expectations of Private Sector Economic Specialists, Banco de México.

Chart 19 **Contractual Wage Increases**

Percent



SOURCE: Ministry of Labor. For April and May of 2001, information was taken from the forecasts reported in Banco de México's Survey of the Expectations of Private Sector Economic Specialists.

Regarding the expected evolution of the prices of goods and services provided or regulated by the public sector, analysts anticipate that those prices will meet the levels established in this year's General Economic Policy Criteria (*Criterios Generales de Política Económica*)[15].

Analysts surveyed in March also expect Mexico's real GDP growth rate to be 3.3 percent in 2001, below January's estimate of 3.8 percent. In turn, they forecast trade and current account deficits below those reported in January's survey, decreasing from 12.455 to 12.013 billion dollars and from 22.708 to 21.956 billion dollars, respectively. In addition, they estimate an 8 percent increase in non-oil exports and a 15 percent decline in oil exports for 2001. Regarding imports, an expansion of 8 percent is anticipated over the same period. Finally, they foresee a foreign direct investment inflow of 13.274 million dollars.

In general, both the business climate and business confidence indicators show a clear deterioration vis-à-vis those registered at year-end 2000. Only 10 percent of the analysts who took part in the survey conducted in March considered that the business environment will be favorable, while 24 percent thought it will remain unchanged and the rest believed it will deteriorate.

According to the results of the survey, the main factors that could limit the Mexican economy's expansion over the following six months are as follows: the weakness of external markets and of the world economy (29 percent of all responses); the high cost of domestic financing (16 percent); the monetary policy being applied (15 percent); the availability of domestic financing (7 percent); and, finally, international financial instability (6 percent of responses).

IV.2. Private Sector Inflation Expectations

In the survey conducted in March, monthly inflation forecasts for April, May and June were 0.51, 0.69 and 0.63 percent, respectively.

Analysts who took part in the survey adjusted their inflation expectations for 2001 from 7.87 percent in January to 7 percent in March, and reduced their inflation expectations for the following 12 months to 7.09 percent. Taking into account the

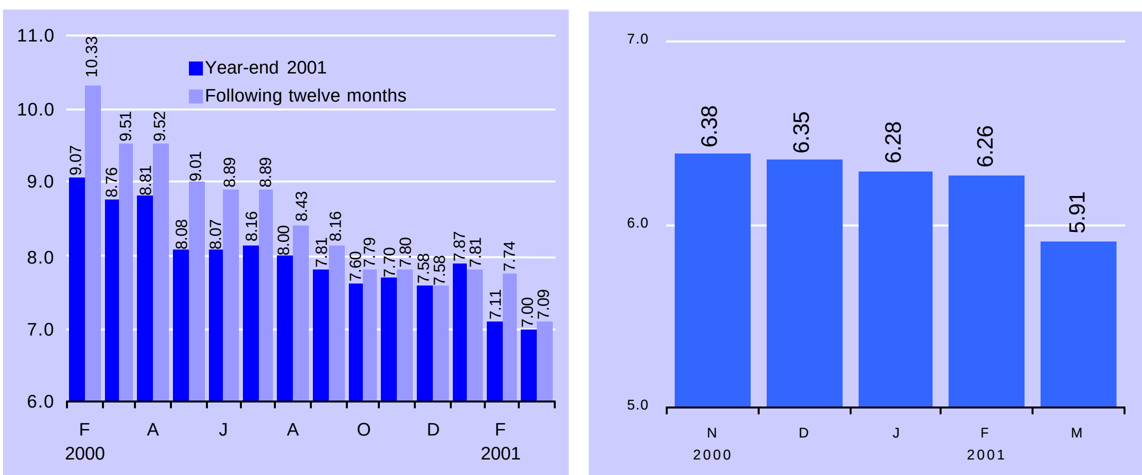
[15] One of the factors that has had an important impact on the evolution of prices for goods and services provided or regulated by the public sector in the last few months has been the increase in the price of domestic gas. Nevertheless, it is expected that in the following months this factor will become less relevant due to the fact that as of March 12th the Ministry for Economic Affairs (*Secretaría de Economía*) imposed a temporary price ceiling for end users (with an average 7 percent reduction), by means of the decree published in the Federal Official Gazette.

likely effects of an eventual approval of the Fiscal Reform, the consultants have estimated a 9.16 percent inflation rate for the following twelve months and 8.76 percent for the end of this year. Thus, according to analysts, the Fiscal Reform will have a greater impact on inflation for the following 12 months (2.06 percentage points) than on inflation for 2001 (1.76 percentage points). This may be due to the fact that, although analysts estimate a 70.6 percent probability that the Fiscal Reform will be approved in 2001, some of them believe it will happen when Congress resumes in September, and consequently part of the impact on inflation will materialize in 2002. Annual inflation for next year is forecasted at 5.91 percent, significantly lower than the 6.28 percent reported in January this year (Chart 20).

Chart 20 **Evolution of Inflation Expectations**

Annual percentage change

Year-end 2001 and the Following 12 months | Year-end 2002



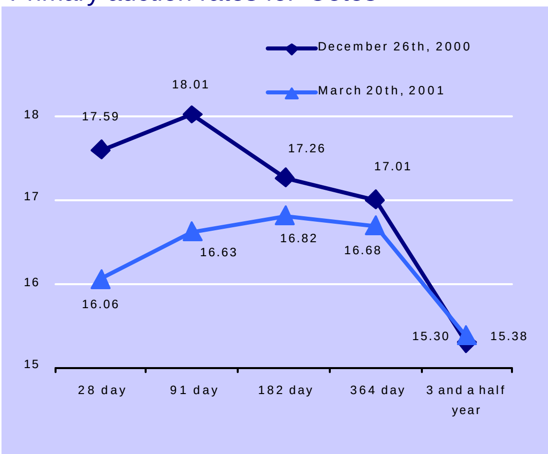
SOURCE: Survey of the Expectations of Private Sector Economic Specialists, conducted by Banco de México.

The nominal Cetes yield curve indicates that a downward adjustment of inflation expectations has taken place in the last few months. This is compatible with market forecasts of future lower short term interest rates, and is shown by the forward rates on 28-day Cetes (Chart 21).

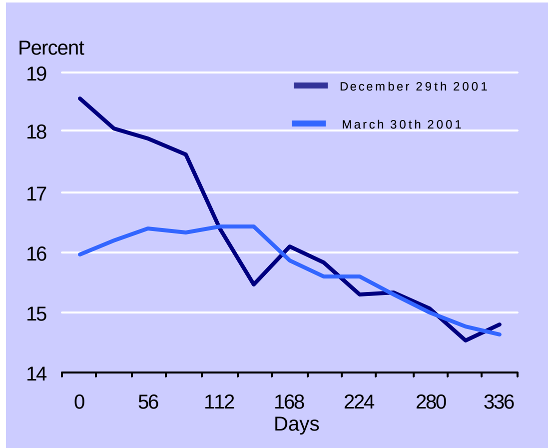
Chart 21 **Nominal Cetes Yield Curve and Forward Rates**

Percent

Primary auction rates for Cetes*



"Forward" rates



* The 3 and a half year instrument is a bond issued with fixed-rate coupons.

V. Balance of Risks and Conclusions

At the close of the first quarter of 2001, annual inflation had fallen 1.79 percentage points to 7.17 percent. Over the same period, core inflation continued to decline and by the end of March was less than 6.5 percent. This clearly shows that the reduction of inflation has not predominantly been due to the slower growth of some price sub-indexes, but rather is fundamentally a reflection of a correction of the medium term trend.

The above results were obtained in spite of a greater than expected deterioration in various aspects of the international environment. In this respect, it is worth pointing out the following: i) forecasts for the growth of the United State's economy in 2001 continued to be revised downwards; ii) international financial market participants do not foresee a clear solution to Argentina's present economic crisis; and iii) the behavior of oil prices was in line with what had been contemplated by the Federal Revenues Law.

Lower growth of the world economy affected the Mexican economy during the first few months of the year. It is estimated that domestic supply and demand have decelerated during the first quarter more than had been anticipated in the Monetary Program presented in January. Therefore, the current account deficit has also widened at a lower rate. In addition, market perceptions are that both the Federal Government and the Central Bank are firmly committed to macroeconomic stability. This is reinforced by the Fiscal and Financial Reform proposals that have been put before Congress, and by monetary policy actions undertaken over the last few years. In spite of difficult external circumstances, the aforementioned factors, together with expectations for the successful outcome to Fiscal Reform negotiations, has resulted in abundant inflows of foreign capital, and in particular of foreign direct investment. All the above has led to an appreciation of the nominal exchange rate.

The above mentioned elements helped core inflation to decline during the quarter. The appreciation of the exchange rate had a favorable effect on core inflation for goods, while the deceleration of output and domestic demand limited firms' capacity to pass on higher unit labor costs to the final prices of their products. Therefore, this contributed to a reduction in core inflation for services.

The evolution of the international environment and of the Mexican economy during the first quarter of 2001 led to a revision of Banco de México's base scenario for the remainder of this year. The assumptions about the external situation have changed as follows:

(a) The real annual growth rate forecast for the United States' economy has been revised downward, moving from an interval between 1.8 and 2.4 percent to one between 1.2 and 1.8 percent. Likewise, the recovery that had been expected for the third quarter will probably be delayed.

(b) Based on the difference between WTI futures prices and the price of the Mexican crude oil mix in March, the anticipated average price of Mexican oil in 2001 has been modified from 18.52 dollars per barrel in January to 19.23 dollars in April.

(c) The behavior of the various components of the capital account in the January-March period makes it possible to anticipate that the availability of external funds in 2001 —direct foreign investment in particular— will provide stable and sufficient resources to finance Mexico's current account deficit.

The reduction in the growth of the United State's economy has had a greater than expected impact on Mexican exports and imports, as well as on output and employment. It is thus highly possible that the growth of real GDP will be less than originally expected.

Weaker output and employment growth has been prompted by slower expansion of all the components of domestic demand. It is likely that the growth of domestic demand will slow down more than that of domestic supply. Thus, it is reasonable to expect a current account deficit equivalent to 3.6 percent of GDP in 2001, lower than the forecast contemplated in the General Economic Policy Criteria.

In the base scenario for the remainder of this year, some domestic factors that could hamper the disinflation process still remain. Among these are the following:

(a) private sector expectations are still higher than the inflation target; and

(b) contractual wage revisions continue to be incompatible with the inflation target and with foreseeable gains in productivity.

These factors could eventually cause upward pressure on the prices of non-tradable goods and foster a larger current account deficit. This could in turn induce an adjustment of the exchange rate, which could then affect the prices of tradable goods. Furthermore, nominal wage increases that are incompatible with the inflation target and expected gains in labor productivity raise the social cost of attaining price stability, because they severely affect job creation and the generation of corporate profits. The aforementioned becomes even more important in a situation where the growth of aggregate demand has declined considerably.

In the base scenario described above, the current restrictive monetary policy stance is considered appropriate in order to reach the short and medium term inflation targets.

The base scenario is undoubtedly subject to a great deal of uncertainty. An evaluation of the risks, both domestic and external in origin, that the Mexican economy will face in the near future is presented in the following pages. The actions that are considered appropriate to offset any disturbances that might materialize are also set out.

Regarding the future evolution of the international environment, the risk factors that could hinder the reduction of inflation and limit the expansion of the Mexican economy are:

(a) a more drastic slowdown or even a recession in the United States; and

(b) a international price of oil substantially lower than that anticipated at present.

As already stated in this document, although available data clearly points to a marked slowdown of the United States' economy, its depth and duration are still difficult to estimate. The possibility that this economy could suffer a recession —defined as negative growth rates over two consecutive quarters— depends primarily on the behavior of private consumption. Lately this variable has continued to grow at positive rates despite the setbacks in the stock markets, employment, economic activity and confidence indexes.

The eventual worsening of the slowdown of the United States' economy will weaken global economic growth and could lead to a further drop in oil prices. Furthermore, a contraction in the demand for fuel as a consequence of the global economy's slower growth could coincide with increased oil supply derived from the additional production capacity that will be available in the second half of 2001.

A recession in the United States would have multiple effects on the Mexican economy; therefore, its eventual repercussions on domestic inflation are not evident. Should a recession take place, it is likely to have an unfavorable impact on domestic output and job creation. This would be reflected in a further reduction of aggregate demand growth that would mitigate inflationary pressures in the non-tradable goods sector. Nevertheless, the easing of aggregate demand pressures might not be enough to prevent a widening of the trade deficit, which would deteriorate further should oil prices fall. In turn, a larger current account deficit could generate additional demand for foreign currency, which if not offset by greater supply, would lead to a depreciation of the peso's real exchange rate. This could then give rise to inflationary pressures. The total impact of a more severe deceleration of the United States' economy on Mexican inflation is therefore uncertain.

Under the above circumstances, Banco de México would respond in a timely manner to any indication of an upward revision of medium term inflation expectations and to the unfavorable evolution of non-tradable goods prices.

At the time of publication of this Report, the main domestic risk factor for the base scenario has to do with the Fiscal Reform that has been proposed to Congress by the President.

Recent crises in emerging economies have fundamentally been a consequence of fiscal problems stemming from the failure to achieve the social consensus necessary to guarantee public sector solvency. Therefore, the approval of a fiscal reform in Mexico — that would strengthen public finances and reduce their dependence on oil revenues— is a requisite in the process of consolidating macroeconomic stability.

In order to attain permanent price stability at the lowest possible social cost, the economic policies of the Federal Government and of the Central Bank must be compatible. In particular, when market perceptions are that public finances are not solid, the cost for society of abating inflation is higher. This type of scenario tends to generate pressures on aggregate demand, an increase in country-risk and higher real interest rates. The costs of abating inflation are minimized in the presence of strong public finances, as this reduces pressure on financial markets and allows the transition to lower inflation rates to be obtained with lower interest rates.

The approval of a fiscal reform that significantly increases public revenues and reduces the government's financial borrowing requirements would not only facilitate the success of the disinflation process over the medium term, but is also indispensable to attain it.

Nonetheless, the approval of the Fiscal Reform could have an upward impact on prices in the short run. It is difficult to estimate this impact in advance, for the following reasons:

(a) Uncertainty over the specific measure that will be approved by Congress.

(b) Producers' capacity to pass indirect tax increases on to their prices depends on several factors, among which the strength or weakness of aggregate demand is particularly important.

(c) The Fiscal Reform would contribute to a reduction in the growth of private spending and would therefore help the disinflation process.

(d) The improved economic outlook that would stem from the implementation of the Fiscal Reform, as well as the possibility of Standard & Poor's granting investment grade to the Mexican sovereign debt, could contribute to exchange rate stability, as well as to a lower country-risk perception and real interest rates.

Due to the difficulty of determining the joint effect these factors could have on inflation —since not all of them operate in the same direction— the total impact the Fiscal Reform will have on the general price level is highly uncertain.

Should the aforementioned Reform have an upward impact on prices, it would produce a transitory deviation from the inflation target in the short run. However, if the monetary authority's preventive actions manage to ward off the materialization of secondary effects, inflation would return to its originally planned path in the medium term. Therefore, the multi-annual inflation objectives and the timely actions of Banco de México shall be instrumental to the formation of inflation expectations in line with inflation targets for 2001 and 2003.

Moreover, after having contained the possible deterioration of inflation expectations, the disinflation process would be significantly reinforced by a more solid fiscal stance, and consequently the attainment of medium and long term inflation targets would be more likely.

In this respect, it is also relevant to emphasize that the need to finance high public sector financial requirements in domestic markets exerts an important pressure on real interest rates. Therefore, approval of the Fiscal Reform will be a contributing factor to the decline of real interest rates.

In this context, the main risk for both the economy and the disinflation process is if the Fiscal Reform is not approved or if it is modified in such a way as to reduce the potential increase in public revenue collection. Should this occur, macroeconomic stability would be jeopardized and —as recently seen in other emerging markets— the following undesirable consequences could ensue: higher interest rate, lower economic and employment growth, falls in real wages, and pressure on the exchange rate due to a deterioration of country-risk perceptions. In this scenario, the government, faced with financing restrictions, would have to cut public expenditure sooner rather than later.

Due to the aforementioned risks, the advisability of maintaining a restrictive monetary policy stance is buttressed by the need to consolidate public credibility in multi-annual inflation targets. Although the results that have been obtained in the transition towards an inflation targeting regime have been positive —with observed inflation rates below the targets set for 1999 and 2000— it should not be forgotten that the international environment was particularly favorable in those years.

In order to strengthen the credibility of monetary policy, it is important that the inflation target for 2001 be attained as well, notwithstanding the less auspicious environment. If the risk factors weaken in the course of the year and the evolution of observed and expected inflation becomes more compatible with the agreed multi-annual targets, pressures on monetary policy should tend to ease.