Inflation Report

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Summary

The results posted by the Mexican economy in the last six months surpassed both official and private sector expectations. Economic growth was stronger than anticipated on account of the robust external demand for Mexican exports and very vigorous domestic spending. Although in this year the decline in inflation has also been more pronounced than expected, prices continue to rise at a faster pace than in industrial countries. The current domestic inflation level and the still insufficient downward adjustment in inflation expectations for 2001 are the main reasons the Board of Governors of Banco de México has taken into account to maintain —and even tighten— the restrictive monetary policy stance.

The world economy has also performed well, exceeding the projections made a few months ago. The current rate of global economic expansion entails a latent risk of inflationary pressures. This is especially true in the case of the United States' economy, which has yet to provide conclusive evidence of slowing down. Moreover, due to the significant increase in international oil prices, consumer prices have risen in importing countries.

The above underscores the need to closely monitor the evolution of various risk factors, both external and domestic.

Recent Evolution of Inflation

Throughout the second quarter inflation continued to decline faster than anticipated at the beginning of the year, thus allowing for the attainment of an inflation rate below 10 percent several months ahead of schedule. Consequently, it is likely that by the end of the year, the annual target will have been achieved with some margin.

As anticipated in the Inflation Report for January-March 2000, the National Consumer Price Index (INPC) annual inflation rate declined markedly in the second quarter of the year. Likewise, accumulated inflation for the second quarter was below that posted in same period of 1999 and in the first quarter of 2000. In June of this year annual inflation closed at 9.41 percent.

Several indicators of the trend of inflation have shown a clear downturn. In particular, core annual inflation fell 1.87 percentage points in the quarter, to its current level of 9.29 percent, below the consumer inflation rate measured by the INPC.

Main Determinants of Inflation

The following factors have an impact on price growth: exchange rate variations, wage increases, changes in the prices of public goods and services, and aggregate demand pressures. In the short-term, inflation is also influenced by transitory phenomena such as fluctuations in the prices of agricultural and livestock products.

The external environment impinges upon the behavior of the exchange rate. In the second quarter of 2000, external conditions were less favorable to the Mexican economy than in the previous quarter. Although high oil prices continued to have a positive influence on Mexico's trade balance, more expensive fuel and the continued momentum of economic activity in the main developed economies gave rise to uncertainty regarding potential inflationary pressures and, therefore, to concern about the measures that the Federal Reserve and the European Central Bank could take. This situation affected international financial markets and, in turn, had repercussions on domestic markets as well.

Although the United States' economy has continued to post high growth rates, some indicators published in the latter half of the second quarter suggest that economic activity in that country has begun to tone down. Nonetheless, the evidence is still ambiguous.

Notwithstanding that future increases in the federal funds rate target cannot be completely dismissed, it seems less probable now that the United States' economic growth and financial markets could experience an abrupt adjustment.

The volatility of key variables in international markets, as well as the uncertainty surrounding the domestic elections, affected the evolution of the peso exchange rate. In the second quarter the peso depreciated more than had been anticipated. Yet, said depreciation had practically no repercussions on the growth rate of prices. Evidence of this is June's 0.22 percent monthly core inflation rate for merchandise —which includes the prices of those goods that would be most quickly affected by the depreciation of the domestic currency. This figure is the lowest posted by this indicator over the last 78 months.

With regards to the recent evolution of contractual wages, three issues deserve special attention: Firstly, the increases in nominal wages observed in April, May and June were above those expected by private sector analysts. Secondly, improvements in inflation expectations registered in the second quarter were not accompanied by a parallel moderation in wage growth. Thirdly, in the manufacturing sector as well as in other sectors of economic activity, the gap between the growth rate of nominal contractual wages and expected inflation seems to have been greater than the productivity gains in these same economic sectors over the medium-term.

Unit labor costs rise when real wages increase faster than productivity gains. In time, firms try to pass those higher costs on to the prices of their products. This could eventually generate an inflationary spiral that would result in higher interest rates, lower investment and a weaker demand for labor. The latter effect would in turn have an adverse impact on both real wages and job creation.

Inflationary pressures may also arise when the growth rate of aggregate demand exceeds the rate of expansion of aggregate supply over a prolonged period. This is so due to at least two reasons: First, an excess demand for tradable goods quickly translates into a larger trade deficit, which could in turn render the disinflation process more vulnerable to external and domestic shocks. Second, an excess demand for non-tradables would lead to higher prices for these goods.

Available information suggests that aggregate demand maintained its strength in the second quarter, particularly in the case of private consumption. Although aggregate demand expanded less rapidly than in the first quarter, the risk of strong aggregate spending eventually giving rise to higher prices for non-tradable goods and a larger trade deficit remains.

Although the total trade deficit has stayed at levels similar to those observed in the last two years, this has been due to the fact that the pressures imposed on imports by aggregate demand have been largely offset by higher oil export revenues and by the strong performance of non-oil exports. Said performance has been stimulated by the robust expansion of the United States' economy. Therefore, it must be emphasized that a larger non-oil trade deficit would increase the vulnerability of both the Mexican economy and the disinflation process vis-à-vis a possible fall in oil prices or a reduction in the United States' economic expansion rate.

The growth in the prices of goods and services provided by the public sector has been above the inflation target. In addition, the prices of agricultural and livestock products recovered in the second quarter.

Inflation expectations for year 2001 have been affected by the aforementioned phenomena and did not improve further in the last month. Their current level is still deemed high.

In sum, a number of aspects of the recent behavior of the main determinants of inflation deserve to be closely monitored: (a) the previously mentioned difference between nominal wage increases and inflation expectations and between real wages and the evolution of productivity gains and (b) the rebound in producer prices' annual inflation measured by the National Producer Price Index (INPP) excluding oil and services. These developments may represent the first symptoms of the effect the strong growth in aggregate demand may be having on the prices of inputs. Although during the second quarter the phenomena described above had no influence on inflation measured by the INPC, their effects could become evident in the future.

Monetary Policy

Banco de México tightened monetary policy twice in the second quarter: on May 16 and June 26. In the first instance, the "short" was widened from 180 to 200 million pesos, and to 230 million in June. Just as in the case of the "short" implemented last January, these measures were taken with two complementary aims. Firstly, to consolidate the conditions prevailing in financial, labor and goods and services markets, in order to attain an inflation rate under 10 percent in the year 2000. Secondly, to strengthen the declining trend of inflation so that by year 2003 this variable may converge towards the inflation levels prevailing in the economies of Mexico's main trading partners.

The widenings of the "short" were of a preventive nature, as some of the factors identified by the Board of Governors as precursors of future inflationary pressures intensified during the quarter.

These measures, as well as the response of market participants, helped to maintain real interest rates above the levels reported in the first quarter.

The upturn in domestic interest rates induced monetary conditions suited to attain the short and medium-term inflation objectives of Banco de México. Although these conditions have resulted in lower expected inflation rates for year 2001, these expectations are still at levels incompatible with the objective of converging with the inflation of Mexico's main trading partners by year 2003.

When comparing the evolution of the monetary base against the forecasted path published in the Monetary Program for 2000, it is clear that the monetary base stock for the end of April was significantly higher than the estimated figure. This gap became much narrower in May, although it widened again in June. The April deviation was mainly due to the underestimation of the seasonal effect of the Easter holiday on the demand for bills and coins. The fact that the observed monetary base remained generally above its anticipated path was partly the result of a stonger than expected economic expansion.

As the first semester concluded, the limit for the variation in net domestic credit was complied with as well as the commitment not to diminish the level of net international assets. The variation in net domestic credit accumulated in the first half of 2000 amounted to -43,739 million pesos, well below the ceiling that had been established at -30,647 million. In turn, net international assets rose by 2.224 billion dollars.

Private Sector Expectations

After having declined in April and May, inflation expectations for year 2000 were revised slightly upward in June. This adjustment was mainly explained by a higher than projected inflation rate for June. On the other hand, in the second quarter inflation expectations for the following twelve months and for the year 2001 continued along the downward trend they have been showing for some time. It should be underscored that this trend was not affected by the repercussions of international financial market volatility on domestic markets nor by the uncertainty that arose in the weeks previous to the July 2nd elections.

The consolidation of the downward trend in medium-term inflation expectations within a volatile environment is attributable to the following factors: the favorable perception regarding the Mexican economy's fundamentals, the generally positive evolution of the main external variables influencing the domestic economy, and the timely response of monetary policy.

The surveys conducted in April and May reported lower peso/dollar exchange rate forecasts for year-end 2000. However, the volatility experienced by the spot exchange rate in June prompted a slight upward adjustment in year-end exchange rate projections, bringing this variable to 10.06 pesos per dollar. Likewise, the volatility reported in June caused a significant surge in the futures price for the peso that was nevertheless reversed in the early days of July. Thus, at the time this Report went to press, the December 2000 futures price of the domestic currency was at 9.72 pesos per dollar.

The analysts surveyed by Banco de México estimate that the wage increases that will take effect in July and August will reach 11.70 and 11.48 percent respectively.

According to the survey conducted in late March, analysts anticipate that the fiscal targets set by the federal government shall be attained. Therefore, for the remainder of the year the prices of public goods and services are expected to report no deviations with regards to the program announced in early 2000.

Annual GDP growth forecasts have risen from 4.8 percent to 5.5 percent according to the March and June surveys, respectively. Although the indicators on business climate and confidence collected through Banco de México's survey suggest a favorable scenario, these indicators have deteriorated since March.

According to the aforementioned surveys, inflation expectations for 2000 and 2001 declined from 9.67 and 8.76 percent in March to 9.11 and 8.08 in May. Likewise, the forecasts on inflation for the following twelve months fell from 9.51 to 9.01 percent in the same period. In June, as the inflation rate came in above its projected level, inflation expectations were modified upward for July, August, September and for the year as a whole (9.21 percent). Projected inflation for the following twelve months and for year 2001 fell, however, from 9.01 and 8.08 percent in May to 8.89 and 8.07 percent in June.

The recent evolution of private sector's inflation expectations indicates, therefore, that the inflationary shock and the exchange rate volatility registered in June had an impact on the inflation expectations for the year 2000 only —in particular on the expectations for the months of July through September— while analysts continued to adjust their medium-term expectations downward. Nonetheless, the latter are still at high levels, incompatible with the path required to converge towards the inflation of Mexico's main trading partners by year 2003.

Assessment of Risks and Conclusions

The main external factors that could hinder future reductions in inflation are: (a) an abrupt deceleration in the United States' economy; (b) a greater than expected increase in international interest rates; (c) a stock market crash in the United States; and (d) a considerable deterioration in oil prices.

Concurring with the opinion of most private analysts, Banco de México estimates that the probability of the pessimistic scenario is low. Therefore, the Central Bank's base scenario for the second semester includes the following forecasts: (a) a gradual deceleration of the American economy and (b) oil prices slightly below the average level registered in the first semester.

A gradual and orderly deceleration of the United States' economy would indeed act in favor of stability in international and domestic financial markets. Nevertheless, if and when this adjustment takes place, the growth of Mexican exports could be weakened.

Regarding domestic risk factors, the following should be taken into consideration. Throughout the second quarter, there were signs that the growth in aggregate demand could be pushing unit labor costs up along with contractual wage revisions and the producer price index (INPP). Even though there is preliminary evidence that the growth of aggregate demand has diminished marginally, this has occurred together with a slight deceleration in domestic supply growth. Consequently, the trade balance has remained relatively stable. In sum, available information suggests that an excessively strong expansion of aggregate demand may be taking place — particularly private consumption spending.

This situation could become more complicated in the future in response to recent developments in financial markets. Projections for the Mexican economy were favorably reassessed in the early weeks of July, after the elections had taken place without disruption. Accordingly, the exchange rate appreciated, interest rates fell considerably and the Mexican stock market index soared. These events may indicate that the markets are expecting larger short-term capital flows coming into Mexico. If such inflows were to materialize, together with consumers' and firms' stronger confidence on the future course of the domestic economy, a scenario of greater optimism could ensue and this would further stimulate the expansion of aggregate demand. The outcome would be additional pressures on the prices of non-tradable goods.

The progress so far made to curb inflation has been very significant. However, private sector expectations suggest that a certain degree of skepticism remains with regards to the feasibility of a continued reduction in price growth, in order to reach the target established for year 2003. This is corroborated by the fact that analysts anticipate merely a 1.14 percentage point reduction in inflation for 2001. This relative pessimism stems from the inflationary pressures that have been recorded in the last few months. Furthermore, such expectations are also the result of the array of domestic and external risks which, should they materialize, could complicate the future abatement of inflation.

After having weighed all the aforementioned elements, Banco de México estimates that accumulated price growth in the third quarter will be below that posted in the same period of 1999, and annual inflation will thus maintain its downward trend. Although annual inflation rates will decline between June and September, it is likely that such reduction will be less significant than the one attained in the second quarter. Finally, accumulated inflation in the third quarter will surpass that reported for the second quarter, mainly as a result of seasonal factors.

The challenge faced by monetary policy is to create the necessary conditions to consolidate the progress so far made in reducing inflation. A moderation of aggregate demand growth is a key element of this undertaking, inasmuch as it should not exceed the limits imposed by installed capacity.

Restrictive macroeconomic policies are essential to contain the expansion of aggregate demand. Accordingly, Banco de México has tightened the monetary policy stance several times during the year. However, more stringent monetary conditions could induce, at least initially, a greater appreciation of the exchange rate, which would in turn stimulate spending on tradable goods and bring forth a larger trade deficit. The resulting increase in the external deficit would likely be financed by short-term capital inflows. The latter outcome would nonetheless magnify the vulnerability of the disinflation process and subsequently weaken monetary policy's effectiveness to contain inflationary pressures. Therefore, fiscal restraint would be the most effective means to temper aggregate spending. By increasing public saving, such a policy measure would have a direct effect on the domestic economy's total saving, and would thus inhibit the continued expansion of aggregate demand while reducing the need for external financing.

Looking forward, it is essential to implement a fiscal reform that could substantially boost the federal government's capability of collecting non-oil revenues. This, in order to maintain sound public finances even within a less favorable context and support both the sustainability of the economic growth process and the continued decline in inflation.

In short, the optimum policy response to contain the aggregate demand pressures currently affecting the Mexican economy would entail a coordinated implementation of monetary and fiscal policies. This would allow for the simultaneous deceleration of domestic spending while limiting the deterioration of the country's external accounts. A moderation of the expansion of aggregate demand becomes even more significant within the context of the expected slowdown in the United States' economy, which by itself would likely trigger a larger Mexican trade deficit. The latter would widen further should domestic spending keep on growing at its current pace.

The implementation of more restrictive monetary and fiscal policies would help maintain the Mexican economy's external financing requirements within the limits imposed by sustainable long-term capital inflows, and would forestall inflationary pressures incompatible with the stated targets even if the external environment conditions were to deteriorate.