Inflation Report

April - June 2004

Summary

The recovery of the world economy continued during the second quarter of 2004. U.S. industrial production has gained strength through a greater number of divisions and is expanding at a higher rate than that of GDP. Thus, the outlook for industrial production remains optimistic for the second half of 2004 and for 2005. On another front, the vigorous recovery in expenditure, together with the persistent increases in different commodity prices (energy goods, among others), have led to an upward revision in inflation expectations. These factors have brought an increase in international interest rates, while the Federal Reserve has began to revert the monetary accommodation prevailing over the last years.

Given Mexico's strong integration to international goods and capital markets, the economy cannot decouple from the new global financial conditions. As a result, domestic interest rates have risen significantly while the exchange rate has experienced certain pressures. Nonetheless, the influence on both interest rates and the exchange rate has been mitigated by the significant increase in oil revenues and in remittances from Mexicans abroad. Both of them have provided ample resources to the economy.

In light of these developments, the Mexican economy has continued to gain strength. This was also influenced by consumption's expansion and the recent recovery in investment. In addition, the increase in non-oil exports has also reactivated industrial and manufacturing production. Robust economic activity has translated into higher job creation.

In the inflation front, one of the main challenges stems from the persistent increases in different commodity prices, associated with both the cyclical recovery of the world economy and geopolitical uncertainty. The main commodities affected by such conditions have been food, metal products, and energy-related goods. Price increases in these commodities have directly affected production costs of different goods and services and, consequently, producer prices. Moreover, such supply shocks have also affected several items of the Consumer Price Index (CPI), especially the food component of the core merchandise subindex and goods with prices administered by the public sector of the non-core subindex.

Despite the recovery in the different components of aggregate demand, there are still no signs of significant inflation pressures from these sources. This is due, among other factors, to the extended period in which the Mexican economy grew below its potential. Nonetheless, if expenditure continues recovering at the same pace, inflation pressures from this source cannot be discarded in the future. The fact that the economy is undergoing its cyclical recovery facilitates the passthrough of external supply shocks to consumer prices and the contagion of inflation expectations.

Given the aforementioned environment, conditions surrounding inflation have become more unfavorable. As a result, inflation expectations for the next twelve months have been revised upward in the last weeks while those for the medium and long terms remain above the inflation target. Accordingly, the Board of Governors of Banco de México has taken actions in order to tighten its monetary stance.

Recent Developments in Inflation

At the end of the second quarter of 2004, annual CPI inflation was 4.37 percent compared with 4.23 percent at the end of the previous quarter. Such rise was mainly due to the persistent increase in different commodity prices, which affected the CPI's core and non-core components. In June, annual core inflation was 3.64 percent, 0.12 percentage points above that exhibited at the end of the previous quarter, while annual non-core inflation stood at 5.99 percent, 0.21 percentage points above that in March.

Prices of different commodities began to rise in 2003, escalating in some products in the first half of 2004. Such developments generated the following inflation pressures:

(a) The higher prices in several food commodities have affected both core and non-core inflation.

Regarding the former, inflation pressures intensified during the quarter, making the food component of the merchandise price subindex rise from an annual rate of 5.12 to 5.83 percent between March and June. This largely explains the increase in the total merchandise price subindex, from 2.78 to 3.26 percent during the same period.

As for the latter, the effect of said pressures on the livestock goods included in the non-core subindex were mitigated by the gradual reversion of the shocks that affected these products at the beginning of the year. The reduction of trade restrictions on meat imports and the increase in the stock of egg-producing poultry contributed to such process. As a result, the annual variation in livestock good prices dropped from 12.50 to 10.55 percent as compared with March. Nonetheless, it still remains at high levels.

It is important to underline that in Mexico CPI inflation is more affected by price increases in food, when compared with other economies, due to the high weight that this item has in the CPI.

(b) The rise in the housing subindex's annual variation (0.13 percentage points between March and June) stemmed from international price increases in different metal products for residential construction.

(c) International price increases in energy goods affected the items of the subindex of prices administered by the public sector (gas, electricity and gasoline), which exhibited an annual variation of 8.35 percent at the end of the quarter, 3.19 percentage points above its March level.[1] This factor largely accounted for the climb in annual non-core inflation during the period (0.21 percentage points).

The aforementioned inflation pressures were partially offset by the decline in prices of fruits and vegetables during the quarter. During the analyzed period, fruits and vegetables' contribution to annual inflation fell from -0.07 to -0.25 percentage points.

The downward path followed by annual core services inflation (excluding housing) suggests an absence of significant pressures from aggregate demand. Between March and June of 2004, the annual variation of such indicator fell from 4.79 to 3.98 percent. This reduction more than compensated the pressures on the housing subindex. Thus, during the mentioned period, total core services inflation dropped from 4.35 to 4.07 percent.

In order to evaluate the outlook for inflation in the coming months, the likely behavior of

[1] Gasoline prices at border cities are adjusted every week based on the prices observed at the towns/cities closest to the other side of the border. In the rest of the country, such prices are adjusted according to a price increase fixed at the beginning of the year.

commodity prices must be analyzed. One of the main factors explaining commodity price increases is the higher demand for this type of goods, due to the vigorous expansion of the world economy, particularly that of China. Therefore, if the Chinese economy grows at a rate more consistent with its long-term potential, international prices are likely to stabilize. This effect could also be reinforced by the higher supply of commodities originated by the increase in their prices.

It should be stressed that the increase in commodity prices is probably reflecting a change in relative prices worldwide. Thus, as this process completes, commodities' inflation would be expected to slow gradually and, in some cases, begin to revert. This scenario is consistent with the current path exhibited by some commodities' futures prices.

Main Determinants of Inflation

The recovery of the world economy continued to consolidate during the second quarter of 2004. Available information suggests that U.S. GDP continued growing above its potential, despite the fact that economic activity turned out to be slightly less robust than that expected at the beginning of the quarter. The Asian economies, especially China, continued being a significant boost for world economic growth. On another front, the increase in oil and other commodity prices, among other factors, led to higher inflation throughout the world.

The strength of the U.S. economy, together with an increase in price growth and an upward correction in inflation expectations, translated into higher interest rates.

The external environment has influenced significantly the performance of the Mexican economy. The cyclical recovery of the world economy, particularly that of the U.S., usually entails two opposite effects: through external demand (positive), and tightening the financing conditions for emerging economies (negative).

On the one hand, the Mexican economy has benefited from a significant increase in oil and non-oil exports, which in turn has positively affected industrial and manufacturing production and employment. On the other, the world financial conditions have translated into higher domestic interest rates throughout the entire yield curve and in exchange rate pressures, therefore restricting the financing conditions for the different components of expenditure.

The balance of the abovementioned developments has fostered the expansion of aggregate demand. This is partly due to the fact that the effects on interest rates and on the exchange rate in today's financial environment have been mitigated by the significant oil revenues and remittances from Mexicans abroad, which have provided the economy with substantial resources.

Domestic demand exhibited the following results: i) consumption expenditure remained vigorous; and ii) investment slightly recovered due to the growth in construction and in machinery and equipment, despite the latter's mixed results.

External demand increased significantly as compared with the first quarter of 2004, specially when considering non-oil exports.

Regarding production, in April-May 2004, the Global Indicator of Economic Activity (*Indicador Global de la Actividad Económica, IGAE*) grew at an annual rate of 3.5 percent with an increase in all of its components. During the same period, industrial and manufacturing production grew at an annual rate of 3.0 and 2.9 percent, respectively. Manufacturing production has exhibited less strength than manufacturing exports, therefore suggesting a modest recovery in manufacturing production for the domestic market.

Given the slack prevailing in the goods and labor markets, the growth in expenditure has not created significant inflation pressures.

Based on the above considerations, GDP is expected to have grown during the second quarter of 2004 at an annual rate close to 4 percent.

During the second quarter of 2004, the external sector was characterized by the following aspects: i) merchandise exports and imports increased significantly at annual rates; ii) Mexican exports to the U.S. recovered considerably (although below total U.S. imports); iii) a substantial inflow of resources from remittances from Mexicans abroad; iv) reduced deficits in both trade and current accounts; and v) a moderate surplus in the capital account, and a small accumulation of international reserves.

Monetary Policy Actions

During the first months of the year, different supply shocks affected the prices of some items of the non-core subindex. Thus, inflation expectations were revised upward, particularly those for the end of 2004. In light of these developments, the Board of Governors of Banco de México tightened monetary policy by increasing the *corto* (short position) on two occasions: on February 20th, from 25 to 29 million pesos, and on March 12th, from 29 to 33 million pesos.

The effects of the restrictive measures on the monetary stance led to a flattening in the average yield curve from January to March. In particular, the bank´s funding rate rose considerably, closing the first quarter of 2004 at around 140 basis points above the minimum level exhibited at the beginning of the year.

During the last months monetary policy has faced significant challenges, such as:

(a) Restraining the effects of price increases in commodities to inflation expectations.

(b) Containing any cyclical pressures on inflation that could originate from the current strength in aggregate demand.

(c) Fostering an orderly adjustment of the economy to global financial conditions characterized by higher interest rates.

Economic information released in early April confirming the soundness of the U.S. recovery began to raise expectations that the Federal Reserve would begin to reduce the accommodative stance of monetary policy more rapidly than previously anticipated. This changed financial conditions considerably, increasing U.S. and world interest rates.

The new environment has affected investors' attitude in international markets significantly, creating greater risk aversion and, consequently, a portfolio rebalancing. This has brought about increases in the levels and volatility of interest rate spreads in emerging economies, therefore deteriorating their financing conditions.

Given Mexico's strong integration to the world's goods and capital markets, the economy cannot decouple from the prevailing international monetary conditions that affect the different accounts of the balance of payments. During the second quarter, this process was reflected in both increases in interest rates throughout the entire yield curve and in certain depreciating pressures over the peso.

In light of these developments, one of the main challenges of monetary policy is to foster that the economy adjusts in an orderly manner to the prevailing higher interest rates. This gains relevance when considering that higher interest rates, particularly in longer term instruments, may stem from gains in the marginal product of capital, which is reflected in higher real interest rates (characteristic of the current cyclical phase of the world and domestic economies), in long-term inflation expectations, and/or in different risk premia. The assessment of the recent changes in the yield curve is further complicated by the fact that on previous episodes of increases in international interest rates, financial instruments had a lower average duration. Thus, it is possible that the increase in long-term interest rate securities is partly reflecting higher risk and liquidity premia.

As monetary policy achieves the convergence of inflation to its target, it is clear that any upward revisions in long-term inflation expectations and/or in risk premia will be mostly contained. In this case, the adjustment of domestic interest rates to the new international monetary conditions will be orderly and of a lesser magnitude, thus mirroring the increases in real interest rates that are inherent to any economy's cyclical recovery.

Under said environment, together with the different inflation pressures that have arisen, Banco de México has been gradually restricting its monetary stance. In its press release of April 23rd, the Central Bank announced that given the upward revision in inflation expectations and the increase in foreign interest rates, it was not desirable to loosen domestic monetary conditions. Nonetheless, after its publication, the bank's funding rate fell sharply. Consequently, on April 27th the Board of Governors of Banco de México decided to increase the *corto*, from 33 to 37 million pesos. Such measure reverted the downward correction in this rate.

Following this event, bank funding rates adjusted on two occasions: first, in response to the Federal Reserve's decision to increase U.S. short-term interest rates, and second, in the week prior to the release of the Inflation Report April-June 2004, in response to Banco de México's decision to tighten the monetary stance. Both adjustments have led to a new flattening in Mexico's yield curve, thus reflecting the current monetary policy's restrictive stance.

Private Sector Outlook for 2004

En general terms, during the second quarter of 2004, private sector economic analysts' forecasts were as follows: a) inflation for 2004 is expected to be 4.08 percent; and for the next twelve months, 2005, 2006, and for the average in 2005-2008, 4.02, 3.78, 3.75 and 3.69 percent, respectively; b) June's forecasts for GDP growth in 2004 were 3.93 percent, figure above that in March (3.23 percent); and, c) 376 thousand formal jobs are expected to be created in 2004, and 444 thousand for 2005.

Balance of Risks and Final Remarks

Banco de México's scenario for the remainder of 2004 is based on expectations that the U.S. recovery will continue throughout the second half of 2004 and in 2005. GDP and industrial production in the U.S. are expected to grow 4.5 and 5.3 percent in 2004, respectively. In addition, the restrictive monetary conditions that are anticipated in international financial markets have raised domestic interest rates throughout the entire yield curve. Nonetheless, the effects of such conditions on expenditure have been mitigated by higher oil revenues and remittances of Mexicans abroad.

Based on the above assumptions, and on most recent information available regarding the performance of the Mexican economy, Banco de México's baseline scenario for 2004 is as follows:

Economic Growth: Real GDP is expected to grow between 3.75 and 4.25 percent.

Employment: 450 thousand formal jobs are expected to be created.

Current Account: The current account deficit of the balance of payments is expected to be slightly above 1 percent of GDP.

Inflation: During 2004, inflation has been subject to numerous shocks; for the next months, three factors (two of which originate from the prevailing external conditions) are expected to affect it.

First, one of the main challenges currently affecting the disinflation process is the increase in different commodity prices, due partly to a probable change in relative prices throughout the world, which has positively affected this type of goods. Nonetheless, as already mentioned, different reasons allow to anticipate that such pressures will eventually ease.

Second, uncertainty about the magnitude and intensity of Federal Reserve's monetary policy actions prevails. Should inflation conditions in the U.S. worsen, volatility in international financial markets, and therefore in Mexico's markets, could increase. Under such setting, one of monetary policy's main challenges is to foster the appropriate conditions so that the economy can adjust in an orderly manner to the current financial environment characterized by higher interest rates.

Third, despite the fact that no significant inflation pressures inherent to the current cyclical phase of the Mexican economy have been detected, these cannot be ruled out if the strength of aggregate demand continues.

Based on the above considerations, the expected inertial scenario for 2004 for the different CPI subindexes is as follows:

(a) The trend for total core inflation is expected to stay nearly constant and then decline gradually. The relatively constant level of this indicator, which is anticipated to continue in the following months, has originated from two opposite trends.

(b) First, merchandise core inflation has followed an upward trend, largely determined by the behavior of food prices. This has been due mainly to the increase in different commodity prices. Despite the fact that futures markets anticipate that this influence will start to recede, food prices are expected to continue moving up for some time. In addition, pressures over merchandise prices (food and other merchandises) could intensify if the exchange rate passthrough increases, as a result of the cyclical phase undergone by the economy.

(c) The behavior of annual core services inflation (excluding housing) suggests that the economy continues its long-term trend towards inflation abatement. However, it is important to stress that real wage increases must reflect the expected gains in productivity.

(d) The outlook for the housing subindex exhibits two opposite trends of similar magnitude: on the one hand, the pressures generated by the international price increases in some materials for residential construction, such as metal products; and, on the other, the moderate increases in housing rents due to a greater supply of housing with a growing access to financing. Consequently, the variation of such subindex is expected to exhibit some downward resistance.

(e) As for non-core inflation, the volatility in the prices of its different subindexes, together with the unexpected shocks that might affect it, make the assessment of its outlook more difficult. However, there are some factors that deserve mention: i) the effects of the shocks to livestock goods' prices, originated from the trade restrictions on meat imports at the beginning of the year, will continue reverting, albeit slowly, in the next months; ii) futures markets suggest a slight reversion in the price increases of energy commodities; and iii) the prices of fruits and vegetables have accumulated six months with negative month-to-month variations. This unusual phenomenon could revert in the near future. In absence of additional supply shocks, non-core annual inflation is expected to decline towards the beginning of 2005.

The abovementioned scenario confirms that the conditions surrounding inflation have become more unfavorable. This has been clearly reflected in inflation expectations. In the last weeks, inflation expectations for the following twelve months have been revised upward, while those for the medium and long terms remain above the target.

Under such setting, the Board of Governors of Banco de México has adopted different measures to incorporate a restrictive stance in monetary policy. In this regard, the Central Bank has reiterated the need for domestic monetary conditions to tighten.

The expected macroeconomic scenario is subject to two risk factors, which are opposite by nature: those affecting growth and those affecting inflation.

Regarding the former, most recent information suggests that U.S. aggregate demand has slowed slightly. In this regard, a risk factor would be that the economy of Mexico's main trading partner should weaken significantly, as it would directly affect the demand for Mexican exports.

To assess the repercussions of said scenario, it should be noted that external factors have played an important role in the recent expansion of the Mexican economy. This reflects that, currently, the domestic sources of growth are still insufficient. Therefore, should the former risk factor materialize, forecasts for growth and employment would be affected.

It is important to underline that both economic growth and employment estimates considered in the baseline scenario are far from being the ones required to address poverty and other social problems efficiently. In order to materialize and consolidate the Mexican economy's growth potential, its competitiveness must be raised. The Mexican economy needs to be more flexible to adapt to the world's changing conditions and to growing competition in foreign trade. Therefore, Banco de México reiterates the need to reach the agreements to both implement the required structural reforms and strengthen the country's institutions. As structural changes continue to be postponed, Mexico will become more vulnerable, loosing both market share in international markets and inflows of foreign investment to other emerging economies, and, most of all, wasting the opportunity to take full advantage of the current expansion of the world economy in order to create more jobs and improve Mexicans' welfare.

On another front, several inflation risks could also materialize. The most important would be that inflation pressures in the U.S. escalate, prompting the Federal Reserve to withdraw the monetary stimulus more rapidly and aggressively than expected. This would raise uncertainty in international financial markets, thus bringing about higher volatility in domestic financial markets.

Given the above scenario and risks, Banco de México will remain attentive in order to take the necessary actions to foster the convergence of inflation to its 3 percent target. By maintaining price stability, the Central Bank fosters, according to its constitutional mandate, a suitable environment for the adequate performance of economic activity. Nonetheless, in order for these conditions to translate into sustained growth, they must be complemented with other economic policy and structural reform measures that require both the willingness and responsibility of all of the country's social actors.