Inflation Report

January - March 2004

Summary

During the first quarter of 2004, the world economy's cyclical recovery gained strength. This condition has been more evident in the United States, whose economy exhibits robust growth and reveals a promising outlook for 2004 and 2005.

The favorable external environment has added to the recovery, also cyclical, of the Mexican economy, as evidenced by the country's increased pace of industrial and manufacturing activity. This has been due mainly to the higher external demand for Mexico's non-oil exports. On the domestic expenditure side, consumption has remained strong and investment has begun to improve, after having grown negatively for three consecutive years. Formal sector employment has also recovered since September 2003 with seasonally adjusted data.

The main challenge for disinflation has been the different supply shocks to some goods and services within the non-core price subindex during the first months of the year (livestock goods and goods and services with prices administered by and concerted with the public sector).

Despite the fact that at the beginning of 2004 Banco de México had warned about the possible presence of supply shocks in certain months of the year, which could bring inflation temporarily above 4 percent, the observed shocks have been greater than expected in both magnitude and length. Under such conditions, CPI inflation is expected to converge to its target more slowly and gradually. Nonetheless, this will largely depend on how fast the shocks to livestock prices revert, and also that prices of goods administered by and concerted with the public sector do not exhibit additional increases above the inflation target.

Core inflation, which is a better reference for analyzing inflation pressures in the medium term, rose at an annual rate of 3.52 percent in March, following a slight downward trend throughout the quarter. Nevertheless, this measure of inflation has remained relatively stable for a long period, a condition that contrasts with the slack prevailing in the goods and labor markets. As the economic recovery gains strength, the convergence of core inflation with the CPI inflation target could become more challenging. Therefore, Banco de México will keep a strict surveillance to detect in time any inflation pressures that could arise from the greater dynamism of aggregate expenditure and, thus, act accordingly.

Recent Developments in Inflation

At the end of the first quarter of 2004 annual CPI inflation was 4.23 percent, figure higher than that of the previous quarter (3.98 percent), but lower than that registered during the same period of 2003 (5.64 percent). Prices rose in January and February at an annual rate of 4.20 and 4.53 percent, respectively, and then fell in March.

The main factor limiting the disinflation process has been the different supply shocks to the non-core subindex during the first months of the year. Thus, while annual non-core inflation rose 1.12 percentage points in the first quarter, core inflation dropped 0.14 points. In particular, price variations in livestock goods and in goods and services administered by and concerted with the public sector accounted for nearly 55 percent of the quarter's accumulated inflation, despite the fact that their weight in the CPI is only 22 percent.

In this regard, the following events deserve mention:

(a) Annual non-core inflation exhibited high volatility throughout the quarter by rising significantly in January and February and then falling in March. Such behavior was determined by fruits and vegetables' annual price variations and by the higher annual inflation rates of livestock goods and of goods and services administered by and concerted with the public sector.

(b) Prices of livestock goods rose as a result of the hike in their international references and the temporary ban on beef and poultry imports from the United States, due to the different diseases that struck this country (such measures have been partially lifted).

(c) Prices of goods and services administered by and concerted with the public sector increased in the following items: urban transportation (particularly in Mexico City and in Estado de México); water and property taxes in some municipalities; and gasoline in border cities. Gas prices have also risen above the inflation target.

(d) Annual core inflation dropped due to the reduced price variations in services.

(e) The housing price subindex decreased at a slower annual rate of growth than that of the other services of the core subindex. Such results responded to lower home rent increments (due to a greater supply of housing), which were offset by the higher costs for residential construction. The latter was partly due to the rise in the international references of different construction materials (rod, metal products, etc.).

(f) In January and February, annual core merchandise inflation remained on the slight upward trend observed since the last quarter of 2002. This reflects, on the one hand, that the increase in food commodities' international references has partially affected CPI's group of processed foods, beverages and tobacco. Nevertheless, such trend could ease, as evidenced by the fall in food and other merchandise prices in March as compared to that in February.

Main Determinants of Inflation

During the first quarter of 2004, global demand was spurred by a combination of expansive macroeconomic policies, stimulative financial conditions and improved confidence. World economic growth, driven by a solid expansion of the U.S. and Asian economies, fueled international trade and brought about sharp increases in commodity prices. The world economy continued to improve despite the surge in oil prices.

Such context provided a favorable external environment for the Mexican economy. On the one hand, the recovery of industrial production in the United States, despite having been delayed, has fostered an incipient rebound of Mexican exports. On the other, the rise in the Mexican crude oil export mix price and the fall in sovereign spreads, which were below 200 basis points during most of the quarter, contributed positively to the performance of the domestic economy.

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During the first quarter of 2004, economic activity in Mexico improved, following the same trend observed since the fourth quarter of 2003. This was reflected in indicators for both domestic and external demand, and for production.

Sales indicators reveal an increase in consumer spending. During the first two months of the year, retail sales rose at an annual rate of 3.6 percent, thus accumulating fourteen months with positive growth. Spending in private consumption continued to expand due to lower interest rates, a greater availability of credit from commercial banks and chain stores, continuing increases in real average earnings, and the significant amount of remittances from Mexican workers abroad.

Investment showed some improvement during the first quarter of the year. This was due to increases in its component of machinery and equipment, given that construction had already increased throughout 2003.

External demand continued to recover during 2004-I. This was reflected in the development of non-oil exports, which grew at an annual rate of 11.7 percent.

Regarding production, during the first two months of the year, the country's main indicator for economic activity *(Indicador Global de la Actividad Económica, IGAE)* grew at an annual rate of 2.7 percent. In the last five months, industrial and manufacturing production exhibited accumulated increases of 2 and 1.9 percent, respectively, with seasonally adjusted data. Nonetheless, in the last months, manufacturing's recovery has been less robust than that in the United States.

Improved economic activity by the end of 2003 and in the first quarter of 2004 led to higher employment in the formal sector (190,102 jobs were created from September 2003 to March 2004 with seasonally adjusted data).

In the first quarter of 2004, Mexico's external sector was influenced by the recovery of external demand. Such conditions translated into higher exports of manufactured goods. Imports also rose due to increased production for the domestic market. As a result, the trade deficit widened slightly in 2004-I compared with the same period of 2003, while the current account deficit narrowed slightly. The decrease in the current account deficit was due to the higher revenues from remittances from Mexican workers abroad and from a reduction in net interest paid abroad.

Monetary Policy during the First Quarter of 2004

During the first months of 2004 it had already been anticipated that supply shocks could take place in certain months of the year and affect annual inflation temporarily by raising it above 4 percent. Nonetheless, such shocks have been greater in magnitude and length than expected. Such events led to a significant upward revision in inflation expectations for the short term (end of 2004). Observed increases in certain relative prices during the first quarter of the year should affect inflation only temporarily. Under such setting, inflation expectations for the medium (following twelve months and end of 2005) and long terms (average 2005-2008) were revised upward moderately.

Although indicators for inflation expectations do not anticipate that the observed supply shocks will affect inflation significantly in the medium and long terms, the worsening of inflation expectations for 2004 could jeopardize the convergence of inflation to its 3 percent target. This could take place if the determination of other prices in the economy, especially wage negotiations, are affected (second round effects). It is important to mention that contractual wage revisions in the first quarter of the year were above those agreed in the last quarter of 2003.

In light of these developments, and in order to prevent supply shocks from affecting the process of price determination of the economy, Banco de México's Board of Governors tightened its monetary policy stance by increasing the *corto* (short position) on two occasions: on February 20^{th}, from 25 to 29 million pesos per day, and on March 12^{th}, from 29 to 33 million pesos. Such decision was aimed at inducing the proper monetary conditions to attain the 3 percent inflation target. As a result, short-term interest rates rose significantly while long-term ones did so but not as markedly.

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During the first two months of 2004, lending to households remained as vigorous as in 2003. In February 2004, commercial bank's direct performing credit for both consumption and housing exhibited real annual variations of 45.9 and 9 percent, respectively. Such results contrast with commercial bank's credit to firms, which posted a real annual variation of -4.4 percent in that same month. Despite the fact that economic activity began to recover since the last quarter of 2003, it has still not translated into an expansion of bank credit to firms.

Private Sector Outlook for 2004

During the first quarter of 2004, private sector economic analysts kept their forecasts for GDP growth in 2004 practically unchanged (3.23 percent in March 2004 compared with 3.22 in December 2003). CPI inflation expectations for 2004 were 4.23 percent, figure higher than that forecasted in December 2003 (3.86 percent). On the other hand, forecasts for this variable for the next twelve months, and for 2005, 2006, and average 2005-2008 were 3.82, 3.76, 3.67 and 3.64 percent, respectively. Inflation expectations for the longer term, despite being still high, have not been revised upward significantly compared to their levels at the beginning of the year. Such results indicate that analysts do not expect CPI inflation to worsen in the medium term and, therefore, that the recent supply shocks to the non-core price subindex should affect annual inflation only temporarily.

Balance of Risks and Concluding Remarks

Given the above conditions, Banco de México's forecast for the main macroeconomic variables in 2004 is as follows:

Economic Growth: Estimates for real GDP growth in 2004 are kept unchanged at between 3.0 and 3.5 percent (probably falling in the upper limit of such interval).

Employment: Nearly 400 thousand jobs are expected to be created in the formal sector during the year.

Current Account: The current account deficit of the balance of payments is expected to account for 2 percent of GDP.

Inflation: The main challenge for the current disinflation process is the magnitude and persistence of the changes in relative prices in the CPI's non-core component. At the beginning of the year, Banco de México warned about the probability of having supply shocks that could make annual inflation rise above 4 percent in certain months of the year. As already mentioned, such shocks have been greater than expected in both magnitude and length. As a result, CPI inflation is expected to converge more slowly and gradually to its target.

It is important to point out that price increases in livestock products would tend to revert as the supply of such goods normalizes. This implies that, in the future, such prices could drop and therefore contribute to the reduction of inflation. On the other hand, price increases in goods and services administered by and concerted with the public sector that do not have international references tend to have a permanent effect on inflation, therefore scaling annual inflation for twelve months.

Consequently, and based on the previous considerations:

(a) At the margin, annual core inflation is expected to contribute to the reduction of CPI inflation during the next months.

(b) Merchandise core inflation is anticipated to ease its upward trend observed since the last quarter of 2002. Nonetheless, for this to occur, agriculture commodities' international references must also exhibit generalized lower inflation rates.

(c) Core services inflation excluding housing is expected to continue contributing to the permanent reduction of inflation. Such subindex is the one that best captures domestic inflation conditions. It is evident that inflation abatement would consolidate as wage negotiations moderate. However, these do not seem to correspond to the slack prevailing in the labor market.

(d) As for the housing subindex, two effects are taking place simultaneously. On the one hand, there have been some recent upward pressures coming from higher residential construction costs due to price increases in metal products, filler wire, rod, cement and ready-mixed concrete. On the other hand, such subindex is expected to remain on a downward trend, following the moderate increases in housing rents over the last years due to a greater supply of housing (with a growing access to financing). The latter trend accurately illustrates how structural reforms can have beneficial effects on inflation. In this case, the positive effect comes from the combination of the different financial reforms implemented, which have raised the certainty and competitiveness of the housing sector, in addition to the perception that the economy operates under low and stable inflation equilibrium.

(e) As for non-core inflation, the volatility of its different subindexes, and the unexpected supply shocks that affect it, make the assessment of its outlook for the next months more difficult. Nonetheless, there are two opposite factors that could take place. On the one hand, the effects of shocks to livestock goods' prices have started to revert, due to the lifting of restrictions on different meat imports from the United States. On the other, given the present recovery of the world economy, pressures over international energy prices could be more lasting and therefore affect the domestic prices of energy goods. Despite the above, non-core annual inflation is expected to decline gradually in the following months.

When inflation is subject to shocks like those registered in the first months of the year, a more detailed assessment of its main components is required. In this regard, core inflation has remained relatively stable for a long period. Such behavior has stemmed from the opposite trends followed by its two main components. On the one hand, the food component of core merchandise inflation has recently been subject to pressures which mirror the increase in food commodities' international references. On the other, core services inflation keeps following a downward trend. The effect of both trends has led to stable core inflation. Should the international references of commodities begin to decrease in a generalized manner, the downward trend followed by core services inflation would probably extend to total core inflation.

Whenever the economy faces supply shocks such as those exhibited in 2002, when electricity prices rose sharply, core inflation becomes a more relevant indicator for analyzing medium-term inflation expectations. The purpose of measuring core inflation is to have an indicator that excludes extreme variations in relative prices, which should only affect the inflation rate temporarily and not its trend for the medium-term. Core inflation thus becomes a useful reference for analyzing the most representative trend of CPI inflation in relation to its objective.

At the end of the first quarter of 2004, core inflation was 3.52 percent, following a slight downward trend during the period. However, as has already been reiterated, core inflation is converging slowly to CPI inflation's 3 percent target.

Before analyzing some of the most important risks surrounding the described macroeconomic scenario, some observations should be made.

The macroeconomic scenario largely reflects that the economy of our main trading partner is recovering more vigorously, therefore increasing the demand for Mexican exports. However, it does not foresee a turnaround in the domestic sources of growth that could translate into a swift recovery of investment. In fact, forecasts for growth and employment are far from being the required ones to alleviate poverty and address other social problems efficiently.

It is evident that in order for the economy's growth potential to materialize, its competitiveness must be raised. Moreover, and as reiterated on several occasions, progress must be made in implementing the structural reforms required by the economy.

As already pointed out, the expected macroeconomic scenario is subject to several risks.

Regarding the external ones, those discussed in previous Inflation Reports concerning the probability of having a disorderly adjustment in the U.S. fiscal and current account deficits still prevail. However, given the recent developments in the U.S. economy, it is very unlikely that such scenario would materialize in the short term.

In contrast, the consolidation of the world economy's recovery, particularly that of the United States, is expected to tighten international monetary conditions by increasing international interest rates. This could lead to a significant contraction in the demand for emerging markets' debt instruments, thus raising their costs for both external and domestic financing.

As for the domestic risks, which are those related with the convergence of inflation to its target, the following deserve mention:

(a) The disinflation process could be halted by the presence of new supply shocks or by a greater contagion of those registered during the first months of the year on prices. This could also take place if increases in different commodities' international references do not moderate.

(b) As for medium and long-term risks, the inflation outlook remains vulnerable due to the likely revisions on prices of goods and services administered by and concerted with the public sector. As long as these continue to deviate from both their opportunity costs and the prevailing market conditions, risks surrounding the attainment of disinflation will prevail.

Banco de México will keep a strict surveillance of the potential inflation pressures that could arise from the supply shocks that affected the disinflation process during the first quarter of 2004 and, should it be the case, act accordingly to make inflation converge to its target. This would also apply to inflation pressures that could originate from the greater dynamism of aggregate demand.

The main challenges faced by disinflation, in particular those regarding price determination of goods and services administered by and concerted with the public sector, brings to the fore the need to advance in the agenda of structural reforms. For example, progress in the energy and fiscal reforms would make most prices of these goods and services fully reflect their opportunity costs so that their determination is not based on other considerations such as to increase government's revenues.

Moreover, by raising the profitability of investment projects, such reforms would significantly boost investment in strategic sectors. This would spark factor productivity, thus raising the economy's growth potential and, finally, strengthening the disinflation process. Such conditions would provide a greater margin to alleviate poverty and other social problems and create more job opportunities.

Summing up, the agreements to advance in the agenda of pending structural reforms are essential to obtain the complete benefits of the previous reforms. This would significantly increase firms' competitiveness as well as the profitability of investments. Additionally, it would enable the country to take full advantage of the current expansion of the world economy in order to improve Mexicans' welfare.

Therefore, as in other Reports, Banco de México reiterates the convenience of reaching the agreements to both implement the required structural reforms and strengthen Mexico's institutions.