Inflation Report

JANUARY - MARCH 2000

Summary

In order to provide the public with more and better information to evaluate the monetary authority's actions, the publication of a quarterly report on inflation was announced by the Board of Governors of Banco de México when the Monetary Program for 2000 was presented. Bearing in mind that the two main features of any inflation targeting regime are explicit inflation objectives and improved communication mechanisms vis-à-vis the general public, this new publication represents an additional step towards the implementation of monetary policy within such a regime.

Monetary policy actions affect the evolution of prices with a lag and, therefore, the monetary authority must act when the outlook on future inflation is incongruent with the stated inflation objective. It is thus important that the different scenarios that could materialize in the future be presented by said authority along with their possible implications for current and upcoming central bank decisions. This is precisely one of the main reasons to publish this Report.

Recent Evolution of Inflation

In the first quarter of 2000, inflation was lower than expected by market participants, and remained within a range consistent with the objective of an annual inflation rate not to exceed 10 percent.

A clear downward trend in inflation was observed throughout the first quarter. At the end of March, the INPC (national consumer price index) posted a 10.11 percent annual growth rate, which favorably compares with the 12.32 percent inflation rate reported for December 1999.

The "underlying inflation" indicator —commonly used by most central banks operating under inflation targeting regimes— also fell during the first quarter of 2000, although the decline was more modest than that observed in consumer inflation.

The key factors affecting the evolution of inflation are: 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 highly volatile relative prices.

The external environment for the Mexican economy was favorable during the first quarter 2000. Among its main positive characteristics were: a) the vigorous expansion of the United States' economy; b) the upturn in international oil prices; and c) the investment grade conferred to Mexico's public foreign debt by Moody's and the improved assessment of said instruments by Standard & Poor's.

The appreciation of the Mexican peso in the first quarter was the result of both the favorable international environment and the good performance of the domestic economy. Said appreciation supported the decline in inflation as well as improvements in inflation expectations.

The information available to date on the evolution of wages in the third quarter 2000 is limited to contractual wage negotiations. Wage increases became more moderate in the fourth quarter 1999 and remained so in January-February 2000. In the last quarter of 1999 contractual wages rose 14.8 percent on average, whereas the corresponding rate for January-February 2000 was 12.9 percent. Preliminary information points to increases of similar magnitude in March.

The evidence indicates that the gap between increases in nominal wages and the inflation target for year 2000 has been smaller than during the previous year.

The available data on the evolution of aggregate demand and supply of goods and services confirms that the economic expansion trends observed throughout 1999 strengthened in the fourth quarter. Preliminary figures suggest that economic expansion accelerated in the first quarter of this year. Should this trend continue, the annual GDP growth rate could surpass the 4.5 percent originally estimated for 2000.

In spite of the fact that between January and March 2000 the prices of goods and services supplied by the public sector rose more than consumer prices in general —as measured by the INPC— the former have risen by and large in line with the corresponding projections and with the official inflation target for 2000.

Public finances have performed according to program as well. The sound fiscal stance has therefore contributed to an environment propitious for the continued abatement of inflation.

Another element that played a role in curbing inflation in the first quarter 2000 was the evolution of agricultural prices, which accumulated a 5.89 percent decline in said period. On the other hand, inflation in the first quarter was fueled by increases in the prices of housing, household services, beer and corn tortilla.

Merchandise prices (tradables) remain as the main force behind lower inflation figures, with the stability of the exchange rate as an important contributing factor. In spite of the fact that the prices for services —which are fundamentally determined by inflation expectations and labor costs— continue to rise at faster rates than those of merchandises, the downward trend in the former was confirmed in the first quarter 2000.

No inflationary pressures have been detected so far as a result of the substantial expansion of aggregate demand. Nonetheless, should the strong growth of private consumption and investment continue, the Mexican economy could become vulnerable to any of the following potential events or a combination thereof: a sharp fall in the prices of oil, a deceleration in the United States' economy, or a disruption in external financing. Any of the above would probably affect the exchange rate of the peso and future inflation.

Monetary Policy

The conduction of monetary policy requires careful analysis of inflationary pressures in order for the Central Bank to adopt the stance appropriate to achieving the short and medium term inflation objectives.

Accordingly, on January 18, 2000, a more restrictive monetary policy stance was adopted by increasing the "short" from –160 to –180 million pesos, and stayed at the latter level for the remainder of the first quarter.

This action was taken as a pre-emptive measure in light of a series of events that occurred in the early weeks of the year and which could have implied inflationary pressures incompatible with the inflation target for the year.

Since the widening of the "short" was implemented, the public's inflation expectations for year 2000 have declined from 11.14 percent in December 1999 to 9.67 percent in March 2000.

Therefore, the more restrictive monetary policy stance adopted by Banco de México seems to have been an adequate response, which has contributed to lowering the inflation rate expected for the year and to strengthening inflation's downward trend.

When comparing the observed monetary base path against the one estimated and published in the Monetary Program for 2000, a 2.9 percent deviation can be observed at the closing of March. The deviation practically coincides with the upper limit of the confidence interval originally estimated for the monetary base path at year-end. This development may be attributed to the following phenomena: a stronger than expected expansion of the Mexican economy and interest rates below their anticipated levels.

The quarterly limit for the variations in net domestic credit was complied with in the January-March period, as well as the commitment not to diminish the level of net international assets. Specifically, net domestic credit fell 82,628 million pesos —well under the –40,157 million limit— and net international assets rose by 4.971 billion dollars.

Outlook

Information on the private sector's expectations regarding the evolution of variables affecting the future course of inflation is obtained from two sources: the surveys conducted by Banco de México and the data implicit in financial and wage contracts.

In this regard, most analysts anticipate the persistence of an external environment favorable to the Mexican economy. At the time this Report was written, the December 2000 futures peso contract was at 9.91 pesos per dollar. According to the March survey conducted by Banco de México among private sector consultants, the exchange rate expected by the private sector for year-end was 10.10 pesos per dollar.

In the wages front, the analysts consulted anticipate that the annual increases to be negotiated in April and May will reach 12.3 and 12 percent, respectively.

With regards to the fiscal stance, the most recent survey points to an annual deficit equivalent to 1.01 percent of GDP. In addition, the observed expansion of aggregate demand and the expectation of stronger growth in exports have prompted the specialists surveyed to revise their GDP growth estimations for the year, from 4.3 percent in January to 4.8 percent in March.

Whereas in January 1999 the expected annual inflation rate for 2000 was 13.7 percent, in January of this year the comparable figure dropped to 10.62 percent, and in March it declined further to 9.67 percent. Moreover, the aforementioned surveys point to a continuous downward trend in inflation expectations for the next 12 months.

The downturn in inflation expectations suggested by the surveys is corroborated by information implicit in several financial instruments.

Recent trends shown by the United States' economy also indicate that growth will continue at a similar pace for the remainder of the year. On the other hand, it is expected that international oil prices shall decline slightly and that capital flows to emerging markets will continue. Therefore, the base scenario for the remainder of 2000 assumes that the effect of the external environment on Mexican inflation will be positive and that the restrictive monetary policy stance will be conducive to attaining the stated inflation target.

The key external risk factors include a) a drastic deceleration in the United States' economy, b) a sharp decline in oil prices, and c) a greater than expected hike in United States' interest rates or a severe drop in that country's stock market.

In the domestic front, the main risk factor is the possibility that the strong growth of aggregate demand witnessed in the last two quarters could lead to a deterioration of Mexico's external accounts and to increases in the prices of non-tradable goods which may be incompatible with the inflation target.

In order to curtail possible inflationary pressures in the non-tradable goods sector and maintain the external accounts at reasonable levels, it may be necessary to curb the growth of domestic spending. This would imply more restrictive macroeconomic policies. The most effective means to address the problem of an excessive expansion of aggregate demand and a widening of the external deficit would be a coordinated execution of monetary and fiscal policies.

Taking all the aforementioned factors into consideration, Banco de México anticipates that accumulated inflation in the second quarter 2000 will be lower than that observed in similar period of 1999 and also below that posted in the first quarter 2000. A reduction in annual inflation figures is expected as well.

Conclusions

The economic expansion in Mexico has become more solid in the last few months. This outcome has taken place in the context of declining inflation, downward inflation expectations, an upturn in private spending, the sustained momentum of the United States' economy, and a more optimistic perception by local and international investors about the future of the Mexican economy.

Current trends suggest that by December 2000 annual inflation will not exceed 10 percent given the monetary policy stance in force. However, the monetary authority shall remain alert and act promptly if necessary, for several reasons. Firstly, the decline in domestic inflation has benefited from events that may not be recurrent. Secondly, should the favorable external trends be partially reversed and domestic demand continue to grow, excess demand could arise leading to the resurgence of inflationary pressures. Therefore, monetary policy must maintain its restrictive bias, while the "short" shall be opportunely increased should the aforementioned risks materialize.

The strategic orientation of monetary policy is clear. However, two fundamental issues must still be taken into consideration when evaluating the specific measures required by changes in the environment: the appropriate timing for implementing monetary policy measures and the magnitude of the necessary adjustment.