

Inflation Report

July - September 2001

Summary

Developments regarding the general level of inflation during the third quarter of the year were congruent with the aim of achieving an annual rate of inflation of under 6.5 percent by December 2001.

Although notable progress has been made in the disinflation process, the rate at which prices rise in Mexico still remains high. This is why the Board of Governors of Banco de México has ratified the commitment to achieve a rate of inflation below 4.5 percent by the end of next year and a goal of 3 percent for 2003.

Recent Developments in Inflation

Price behavior during the third quarter of 2001 proved to be congruent with the achievement of the year's goal, inclusively with a certain degree of comfort. The following are among the most outstanding results during the period under analysis:

- (a) although annual National Consumer Price Index (CPI) inflation underwent fluctuations throughout the quarter, by the end of the period it was situated at 6.14 percent, 0.43 percentage points below the level recorded in June;
- (b) annual core inflation fell constantly, closing at 5.93 percent;
- (c) the fall in annual core inflation for goods was more pronounced and ended the quarter at 4.85 percent;
- (d) the annual core inflation for services remained virtually unchanged at 7.52

percent, near the level recorded in the last quarter; and

- (e) the annual rate of inflation for goods and services excluded from the calculation of core inflation, recorded very volatile behavior.

Two important conclusions can be reached from these facts regarding the existing disinflation process:

- (a) In an environment of moderate inflation, the volatility of prices of goods and services excluded from the calculation of core inflation has a relatively greater influence on CPI inflation than during high inflation periods. Therefore, under current circumstances the behavior of the core price index is an even more precise indicator of inflationary trends. From the foregoing it can be deduced that during the third quarter medium-term inflationary pressures eased.
- (b) The stability demonstrated by annual core inflation for services during the period indicates that the recorded rises in unit labor costs have represented an obstacle for the overall disinflation process.

The progress made during 2001 with regards to the reduction of core inflation for goods is basically explained by exchange rate stability. On the other hand, the downward rigidity of core inflation for services is attributable to the fact that increases in real wages have exceeded gains in productivity.

The education prices' sub-index rose by 11.78 percent in the quarter. This was a reflection of the increase in tuition at the start of each school year. On the other hand, the agricultural and livestock products' price sub-index accumulated an increase of 4.99 percent – the highest recorded in the whole year. In contrast, the prices of goods and services provided or regulated by the public sector fell by 1.07 percent in the period.

As in the case of the CPI, annual National Producer Price Index (PPI) inflation also underwent fluctuations in the third quarter of 2001, closing with a slight rise. In September, the annual increase of the PPI excluding crude oil and services was 4.67 percent, whilst in June it had been 4.46 percent.

Main Determinants of Inflation

The slowdown of the US economy and the terrorist attacks on September 11 were the phenomenon that dominated the international economic environment.

During the second and third quarters of 2001, growth of the world economy was practically stagnant, with a high degree of synchronization of the global economic cycle. These two circumstances had not coincided for the last thirty years. In virtue of the rarity of this situation, at present prospective analysis of the world economy is very uncertain.

Despite the adverse shock suffered by the world economy in September, no major fluctuations were observed in Mexico's financial variables.

The downturn of economic activity in the United States had a negative impact on the Mexican industrial sector in terms of both production and employment levels. However, the rapid downward adjustment of the growth in aggregate demand faced with these factors allowed the reestablishment of a balance between the increases in aggregate demand and aggregate supply of goods and services. This helped to ease inflationary pressures in two

ways. Firstly, this phenomenon has resulted in a lower than expected trade deficit, which gave rise to a lower demand for foreign resources. The foregoing, added to an abundant influx of foreign capital, aided exchange rate stability and the fall in the annual rate of inflation for goods. Secondly, the slowdown in the growth of aggregate demand probably limited the capacity of service providers to pass through rises in unit labor costs to their prices, thus avoiding an upturn in the annual inflation of the core services sub-index.

Regarding the behavior of the sub-indexes of prices excluded from the calculation of core inflation, a significant rise was recorded in the annual inflation of agricultural and livestock goods and a fall in the rate of price increase of goods and services provided or regulated by the public sector. Furthermore, the annual inflation of the education prices' sub-index remained practically constant. These effects almost completely cancelled each other out, in virtue whereof the general annual rate of inflation fell by the same amount as core inflation.

Monetary Policy in the Third Quarter of 2001

On July 31 2001, Banco de México's Board of Governors decided to reduce the "short" from 350 to 300 million pesos, and maintained it at the latter level for the rest of the quarter. As in the case of the reduction in the "short" accorded in the previous quarter, this measure was taken in response to the favorable behavior of inflation and the mitigation of certain risk factors that had been identified as potential obstacles to the attainment of the inflation target for 2001.

Observed developments of the economy and of inflation during the third quarter suggest that the diagnosis made at the time of adjusting the monetary policy stance was correct. Particularly, core inflation continued its downward trend. Additionally, given that the prospects of growth for the US economy deteriorated further, this suggests less pressure

on prices in the near future. Lastly, the supply of foreign capital was maintained, although it was less abundant than in the first two quarters of the year.

However, nominal contractual wage rises have remained above the sum of the foreseeable gain in labor productivity and the inflation target. This has probably limited the fall in inflation, particularly that associated with the services core index. The main reasons that support the reductions in the “short” include the expectation that a substantial fall in the rate of employment would lead to a downward movement in contractual wage settlements. As such downward movement did not materialize, Banco de México’s Board of Governors decided not to relax the monetary policy stance any further, given that rising unit labor costs would increase the difficulty of attaining the year 2002 inflation target.

During the first two months of the quarter, inflation expectations for year-end 2001 clearly fell. This represents an additional piece of evidence validating the diagnosis made when the “short” was adjusted.

The reduction in the “short” as well as the expected developments that never materialized at the end of the day translated into lower domestic interest rates and a narrower spread between them and foreign interest rates. However, this fall in rates was partially reverted on later dates - an outcome attributable to the combination of the following influences: an upturn in annual inflation and of inflation expectations for the year, the implications of the foregoing on monetary policy management and greater international financial volatility associated with events in the United States. Although the aforementioned factors do not imply inflationary pressures that endanger the attainment of the inflation target this year, when combined with the persistently high contractual wage rises, they justified a prudent monetary policy stance.

In the third quarter of 2001 the stock of the monetary base increased on average at an annual nominal rate of 11.7 percent, lower than that recorded during the same period last year (27.3 percent). During the quarter the observed stock of base money continued below the forecasted level, with an average deviation of – 2.4 percent. The above is basically explained by a lower than expected economic growth.

Banco de México’s net foreign assets rose by 2.047 billion dollars in the third quarter. On the other hand, in the same period, net domestic credit fell by 18.092 billion pesos, reflecting the aforementioned accumulation of foreign assets.

Private sector financing by commercial banks underwent a slight recovery during the third quarter of the year. This can be seen in the evolution of the performing portfolio, whose balance has increased at positive real annual rates, particularly that of consumer credit.

*Private Sector Outlook for 2001**

The estimates of private sector financial analysts regarding the evolution of the international economy for the rest of the year underwent a significant downward revision.

Expectations related to the annual growth rate of the US economy for the year 2001 were cut from 1.6 percent in June to 0.8 percent in September. Notwithstanding the foregoing, the US economy growth rate is expected to recover to 1.8 percent in the year 2002.

The average price of the Mexican crude oil export mix forecast for 2001 is 19.69 dollars per barrel. By 2002, the average price is expected to be 17.16 dollars per barrel. At the end of September the private sector’s

* Unless otherwise stated, the reported forecasts are taken from the Survey of the Expectations of Private Sector Economic Specialists conducted by Banco de México.

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prediction was that the exchange rate in December 2001 would be 9.54 pesos per dollar. Analysts estimate that contractual wage rises for October and November will be 8.43 and 8.13 percent, respectively.

Consultants forecast that real annual GDP growth in 2001 will be 0.21 percent, considerably lower than the figure reported in June (2.07 percent). The prediction regarding real GDP growth for 2002 was also lowered from 4.46 percent in June to 2.85 percent in September.

Indicators related to the business climate and to confidence levels continued to show fragility.

The main factors capable of slowing down the economy over the next six months are: the weakness of foreign markets and of the world economy (28 percent of answers); international financial instability and international political uncertainty (12 percent each); uncertainty regarding the domestic economic situation and a possible contraction of the supply of foreign resources (8 percent each); and, lastly, the fall in the crude oil export price and the weakness of the domestic market (7 percent each).

Monthly inflation forecasts for October, November and December 2001 were 0.60, 0.68 and 0.87 percent, respectively. Such forecasts imply that annual inflation will fall from 6.14 percent in September to 5.64 percent in December.

Predictions regarding annual inflation for the next twelve months fell from 6.84 percent in June 2001 to 5.72 percent in September. Annual inflation at the end of 2002 will be 5.24 percent, lower than the 5.64 percent forecast in June. Finally, inflation is expected to reach 4 percent in 2003.

Balance of Risks and Final Remarks

The performance of the Mexican economy throughout 2001 has been affected by three major factors:

- (a) the drastic slowdown of the United States' economy;
- (b) the availability and terms of foreign financing; and
- (c) the increase in unit labor costs derived from excessive contractual wage rises.

It is worth mentioning that the behavior of the world economy, and specifically that of the United States, already pointed towards a period of more pronounced economic weakness even before the terrorist attacks on September 11. The attacks confirmed this insight and induced an increase in international capital markets' risk aversion. This impact will lead to an increment in the cost and fall in availability of financing for emerging economies. Furthermore, the deterioration of prospects for growth of the world economy has given rise to an important reduction in the price of oil. Thus, regrettably, the external risks that Banco de México warned of in its previous Report have materialized: a lower US growth rate, a lower oil price and stricter external financing terms.

The main elements that make up Banco de México's base scenario for the evolution of the international economic environment for the remainder of 2001 and for 2002 are:

- (a) Slow growth of the United States' economy in 2001 of around 1 percent and an upturn by the second semester of 2002;
- (b) An average price of Mexican crude oil export mix for year-end 2001 of 19 dollars per barrel and between 16 and 17 dollars for 2002;
- (c) An increase in the cost of financing for most international companies and for all emerging economies; and
- (d) Risks due to the fragile financial situation of the economies of certain countries in the region.

Based on the foregoing, a forecast was prepared of the principal economic variables for the rest of 2001 and for 2002. The most

relevant results of this prognosis are shown below:

- (a) The impact of the deterioration of US economic expectations, of the sectorial effects of the attacks and of the fall in oil prices suggests zero GDP growth in 2001. On the other hand, it is expected that the Mexican economy will expand in 2002 at a rate of approximately 1.5 percent.
- (b) The effect of changes in the international environment on domestic inflation is uncertain. On the one hand, lower growth of aggregate demand in Mexico may help reduce inflationary pressures. On the other, although aggregate demand and imports have demonstrated a considerable degree of flexibility in adapting to the fall in foreign demand, the adjustment required due to lower income from tourism, remittances and oil exports may not occur so automatically. This, added to a possible reduction in capital inflows, may lead to greater exchange rate volatility, which in turn would put pressure on tradable goods prices. Additionally, rises in unit labor costs and the observed downward rigidity of core inflation for services indicate that inflationary pressures will continue to arise in this sector that are incongruent with the 2002 inflation target.

Although recent inflationary developments indicate that the 2001 inflation target will very probably be attained, for the year 2002 pressures on prices can be discerned that make it unwise to actively pursue less restrictive monetary conditions, at least whilst wage rigidity persists.
- (c) The repercussions of the deterioration of the external environment on exports and tourism may lead to an increase in the current account deficit in 2002, to levels of around 3 percent of GDP.

It should be made clear that the materialization of the foregoing forecasts is subject to a very high degree of uncertainty.

At the time of publication of this document, the principal domestic risk factors that could lead to a change in the described base scenario are:

- (a) that an eventual rejection of the tax reform bill or the passing of a version with a lower tax collecting capacity than expected by the markets were to lead to a drastic deterioration of expectations; and
- (b) that the gap between contractual wage settlements and the sum of the inflation target and foreseeable increases in labor productivity were to widen.

The tax reform bill is called-on to act as an important aid in the successful culmination of the disinflation effort.

The adverse international environment implies that the rebound of growth in exports and of the Mexican economy as a whole will be gradual. Furthermore, when this occurs it will be difficult to expect the expansion to be as vigorous as that achieved over the last two years. This is due to the fact that the growth rates of the US economy are not expected to return to their high levels of the last five years in the near future.

Faced with the aforementioned outlook, factors of the domestic economy must be reinforced in order to allow Mexico to expand its growth potential:

- (a) macroeconomic stability; and
- (b) the advancement of pending reforms.

Regarding macroeconomic stability, the greatest contribution that can be made by fiscal and monetary policies, is to persevere with the prudence that has characterized them to date. For this reason, the Board of Governors of Banco de México has ratified the commitment

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to achieve a rate of inflation below 4.5 percent by the end of 2002 and an inflation of 3 percent in 2003.

In addition, the passing of a satisfactory tax reform bill that strengthens the solvency of the public sector is indispensable.

In terms of structural aspects, progress needs to be made in the following priority areas, among others:

- (a) reform of the energy sector;
- (b) deepening of the economic deregulation process;
- (c) promotion of the development of the capitals market and the achievement of higher domestic rates of saving; and
- (d) stimulus of investment in infrastructure, technology, education and health.

Progress in the aforementioned fields will permit an increase in domestic economy productivity. This will favor faster economic growth, more and better jobs and a more equitable distribution of income.

It is possible that concerns about national security as a result of the terrorist attacks will lead to the opening process being redefined in more regional terms in the future. In order to exploit this situation, Mexico is faced with the

opportunity of consolidating its economic integration with the United States and Canada. This would be achieved through greater convergence of macroeconomic, financial, labor, regulatory and legal policies, as has occurred among European countries over the last decade.

If this can be achieved, Mexico would become more attractive as a destination for investment and tourism, and at the same time it would facilitate both migratory flows and the transfer of technology.

The immediate future holds important challenges for Mexico's economy. Differing from the recent past, when the external environment was favorable, adverse global conditions today have to be compensated through an increase in the competitiveness of Mexican companies. This aspiration will only become a reality if decisive progress is made on the agenda of structural change defined by the current Administration, with the active participation of the Congress, in an atmosphere of democratic and plural debate. This is the road to a quicker recovery and the achievement of high and sustainable growth rates, in a context of low and stable inflation.