

# Inflation Report

*January - March 2006*

## *Summary*

The development and outlook for world economic activity continues to be positive. During the first quarter of the year, the U.S. economy grew significantly, after having slowed during the fourth quarter of 2005 due to several transitory factors. During 2006, it is expected to grow around 3.4 percent. For the same year, the European and Japanese economies are expected to grow at a higher rate, while the dynamism of economic expansion in China and the rest of the Asian countries is expected to prevail. This environment, together with restrictions to raise the supply of energy goods and the presence of adverse geopolitical factors, has contributed to maintain international energy prices high. The latter factors gained relevance in April, leading to new surges in oil prices.

Despite the aforementioned, world inflationary pressures still remain relatively contained. In particular, the main indicators of core inflation have continued to exhibit moderate levels, therefore contributing to curb inflation expectations. Under such environment, characterized by strongly anchored inflation expectations, risk premia for long-term fixed income securities have remained low compared with their historic levels. Among other factors, this has contributed to maintain long-term interest rates at low levels. As a result, international financial markets continue to exhibit relatively benign conditions.

Nonetheless, this trend has been subject to some adjustments, as most recent data suggests a higher than expected world economic expansion, in particular in the U.S. economy. Greater monetary stringency of the central banks of the main advanced economies is also expected. The latter has fostered an increase in long-term interest rates in international financial markets. Furthermore, expectations of increases in interest rates in some developed economies, particularly in Japan, have contributed to revert certain financial leveraged positions in the currencies of such countries in order to finance holdings of assets in other currencies. The convergence of these factors has affected the value of assets and currencies in emerging

economies, which experienced some depreciation of their currencies and exhibited higher volatility towards the end of the first quarter. Nonetheless, access to financing for these economies continues to be, overall, positive.

Economic activity in Mexico exhibited a favorable performance during the first quarter of the year. The growth of manufacturing exports, especially those related with the automotive industry, contributed significantly to this result. Together with the positive performance of exports, domestic expenditure has remained vigorous. In this regard, it is important to mention that both consumption and investment continue to benefit from revenues from workers' remittances and crude oil exports. Under this setting, GDP is expected to grow around 5.2 percent during the first quarter of the year. This figure will also be influenced by seasonal factors, because, unlike 2005, the Easter holiday took place in the second quarter of 2006. The rate of growth of economic activity during the first quarter and the outlook for the rest of the year allow for anticipating that GDP growth will be between 3.5 and 4 percent during 2006.

As expected in the previous Inflation Report, in January 2006, annual headline inflation rebounded due to the volatility of both fruits and vegetables' prices and their annual variations. This was due to the effect of the unusual reduction in the prices of these items in January 2005, contributing to raise their annual variations during the first months of this year. Nonetheless, in March, headline inflation returned to levels close to those recorded at the end of 2005. As for core inflation, which is a good indicator of the medium-term trend of headline inflation, it remained around 3 percent.

The improvement in inflation conditions has contributed to a downward adjustment in private sector analysts' inflation expectations for both headline and core inflation for all terms. In this regard, Banco de México expects headline inflation to be between 3 and 3.5 percent for the end of 2006, and core inflation to remain close to 3 percent for the remainder of the year.

## Summary

### **Recent Developments in Inflation**

As expected in the previous Inflation Report, during the first months of 2006, annual headline inflation rebounded. After reaching 3.33 percent in December 2005, it rose to 3.94, 3.75 and 3.41 percent in January, February and March 2006, respectively. This was due mainly to the behavior of the non-core price subindex. Core inflation exhibited more stability, recording during the referred months 2.98, 2.90 and 3.04 percent.

During the first quarter of the year, the annual variation of the non-core price subindex rose in January and decreased in the following months. As a result, this indicator moved from 3.76 percent in December 2005 to 5.93 percent in January, 5.52 percent in February and 4.20 percent in March 2006. This development mainly resulted from variations in the prices of fruits and vegetables, particularly tomato prices, which during the same period of the last year reached very low levels (on this occasion, this behavior did not repeat). Adjustments in the subindex of administered prices also contributed to the jump in non-core inflation at the beginning of the year. On another front, during the quarter, the annual variation of both livestock goods' prices and regulated prices fell.

At the end of the first quarter of 2006, annual core inflation was 3.04 percent, 0.08 percentage points below its level of December 2005. In March, the annual variation of the core merchandise and services subindexes was below that recorded at the end of the year (of both, merchandise prices fell the most). Regarding both groups that comprise the merchandise subindex (food and rest of merchandises), both recorded slight reductions in their annual variations. As for the services subindex, the annual variations of the two groups that comprise it moved in opposite directions. On the one hand, the annual growth rate of non-housing services decreased. On the other, price increases in certain construction materials such as rod, copper pipe and cement fostered an upturn in the annual growth rate of prices of housing-related services.

### **Main Determinants of Inflation**

#### *International Environment*

During the first quarter of 2006, world economic activity seems to have rebounded, after having slowed down in the last months of the previous year. Timely indicators suggest a significant strengthening of domestic demand in the U.S., which had been affected at the end of 2005 by the impact of the

hurricanes in the Gulf of Mexico, among other factors. Economic activity in the euro area is expected to have rebounded, while Japan continued its recovery process. On another front, inflation has remained low despite the surge in oil prices, the recent increase in the prices of other commodities and the increased use of productive capacity of several economies. Nonetheless, the monetary authorities of the main advanced economies have continued to express their concerns about inflationary risks. In this regard, the continued increases in U.S. interest rates, and a new increase in the euro area deserve mention. In Japan, the apparent end of deflation has motivated the end of the policy of quantitative objectives of monetary aggregates, creating expectations that the central bank of that country will abandon its policy of zero interest rates. Despite the aforementioned, global financial conditions continued to be favorable.

#### *Aggregate Demand and Supply*

During the first quarter of 2006, aggregate demand and GDP continued to recover just like in the second half of 2005, after having slowed down during the first half of that year. In the first three months of 2006, the behavior of both aggregate demand and production was influenced upward by the statistical effects associated with the Easter holiday. This resulted in an increase in the number of working days during the first quarter of 2006 as compared with the corresponding quarter of the previous year, leading to the opposite effect for the second quarter of this year. The aforementioned contributed to raise the annual rates of both aggregate demand and GDP during the first quarter, and will reduce those during the second quarter.

The main aspects characterizing the behavior of aggregate demand during the first quarter of 2006 were as follows: i) consumption expenditure grew at an annual rate close to that recorded during 2005; ii) investment grew at higher annual rates than in the fourth quarter of 2005 and for that year as a whole, mainly mirroring the growth exhibited by its components of imports of capital goods and construction; and, iii) the recovery of exports of goods and services during the second half of 2005 strengthened further during the first months of 2006.

The development of GDP and domestic expenditure during the first quarter of the year did not create significant pressures on production capacity, considering that: i) most of the growth of GDP stemmed from two sectors, agriculture and manufacturing. In the case of the former, its improved performance was basically due to the

positive changes in weather conditions. As for manufacturing, after having recorded modest results during the previous year, its expansion responded to the greater dynamism of external demand in several sectors, together with the strong recovery of automotive exports; ii) despite progress in manufacturing production, its level during the first quarter barely surpassed the previous maximum level observed in mid-2000; and, iii) gross capital formation, an indicator of the economy's production capacity, has grown for more than two years at a significant annual rate.

### *Costs and Prices*

During the first quarter of 2006, contractual wages negotiated by enterprises under federal jurisdiction recorded, on average, a 4.3 percent increase, 0.2 percentage points below that observed during the same period of the previous year.

During the first quarter of the year, administered prices exhibited less volatility than that observed in international markets. This is explained by the effect of the measures adopted by the federal government. In this regard, the decision to update propane prices at an annualized rate of 4 percent, together with low-consumption electricity tariffs and gasoline prices in non-border cities, deserve mention. The federal government also announced that starting April 25, 2006, gasoline prices at northern border cities will not exceed the level reached during the week of April 11-17, 2006, therefore reducing the effects associated with possible additional increases in the prices of this fuel in the foreign cities closest to the Mexican border.

The annual variation of the subindex of regulated prices continued to follow a downward trend during the first quarter of 2006. This decrease was mainly due to the significant reduction in the car ownership tax and the slower growth rate of prices of the following items: public transportation, intercity bus services, water usage fees, taxi, property taxes, and parking lots.

International prices of grains and meat directly affect the domestic prices of these products, and indirectly the production costs of different processed foodstuffs. During the first quarter of 2006, international prices of grains increased moderately. The behavior of their futures suggests that for the remainder of the year they could follow an upward trend. During the analyzed period, international prices of beef fell and future contracts reveal that these could decrease further during the second quarter. International prices of pork meat increased

slightly in March, and futures suggest that they could follow a downward path in the following months, and afterwards such trend would revert.

As for steel prices, during the first quarter of 2006, domestic prices of steel-related products rose significantly at an annual rate, due to some speculative activity in retail trade. The price of this metal and its by-products has remained stable in the U.S. market. Steel prices are particularly relevant in the CPI because of their incidence on the costs of construction materials and its effect on the determination of high consumption electricity tariffs. In addition to the above, copper prices have increased, mainly affecting the costs of certain construction materials.

### *Monetary and Credit Aggregates*

The broad monetary aggregates continue to grow vigorously. The greater supply of domestic financial resources has been coupled by an increase in the inflow of foreign resources.

The significant revenues from oil and lower financial costs, among other factors, have allowed the public sector to reduce its borrowing requirements. This has increased considerably the availability of additional resources for households and firms, which accounted for 2.8 percent of GDP during 2005. A few years ago, households and small and medium firms faced significant credit constraints, which have been decreasing gradually. Nonetheless, since households are still in the process of increasing their consumption patterns, they are probably less sensitive to credit costs. In this regard, it is important to mention that, in general terms, lending interest rates are still high, and have not fully reflected the fall in deposit interest rates originated by the reduction of inflation.

### *Monetary Policy Actions*

Domestic monetary conditions have been significantly affected by conditions prevailing in international markets. In this regard, although there is slack in global financial conditions, the stronger expansion of the U.S. economy has led to a rebound in long-term interest rates in international financial markets, which, at the margin, has also generated lower appetite for emerging economies' instruments. As a result, the value of assets and currencies in such economies tended to depreciate, and exhibited higher volatility towards the end of the first quarter.

Emerging economies' access conditions to financing continue to be, in general terms, favorable. This is

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mainly due to the fact that despite the trend towards greater monetary astringency by the main advanced economies' central banks, interest rates for longer terms are still low compared to historic levels. It is clear that emerging economies' financial conditions are highly dependant on the behavior of long-term yields in international financial markets. Under such context, as these rates are adjusted upwards, access to financing for these economies could deteriorate.

On another front, Mexico's inflationary environment continues to be favorable. In particular, core inflation remained around 3 percent during the first quarter of the year. Annual headline inflation rebounded during the first months of 2006 as expected due to the volatility of the fruits and vegetables' price subindex. Nonetheless, this effect disappeared rapidly as headline inflation in March returned to levels close to those recorded at the end of 2005. These results enabled inflation expectations for different terms to follow a downward trend. Thus, in March, private sector economic analysts' forecasts for headline inflation reported by Banco de México for the end of 2006, 2007 and 2008 were 3.47, 3.57, and 3.53 percent, respectively. In the same survey, expectations for core inflation for the end of 2006 were 3.11 percent, in contrast with 3.27 percent recorded in December 2005.

Summing up, the outlook for inflation has evolved favorably. Up to now, the different risks faced by the disinflation process have had limited effects on wage negotiations and, in general terms, on the price determination process. Consequently, inflation continues to converge to its target.

The concurrence of the above factors fostered conditions that enabled the Board of Governors of Banco de México to continue to reduce the monetary restriction during the first quarter of the year. In particular, the Board of Governors allowed for a loosening of domestic monetary conditions of no more than 50 basis points in January, and no more than 25 basis points each time in February and March. In its monetary policy press release of April, the Board of Governors allowed for a further loosening of monetary conditions of no more than 25 basis points, but stated that no space is available to ease further monetary conditions in the foreseeable future. As a result, the 1-day bank funding rate decreased to a level of 7.0 percent on April 21, 2006.

During the first quarter, the reduction in short-term interest rates together with the relative slack in international financial markets, led to a decline in the

yield curve for all terms, therefore prompting a reduction in interest rate spreads between Mexico and the U.S. Nonetheless, as already pointed out, this process has been subject to certain adjustments. In particular, the transition to an environment of tighter global monetary conditions and the higher volatility in international financial markets observed towards the end of the first quarter and beginning of the second, fostered an upward adjustment in long-term domestic interest rates. As a result, the yield curve steepened.

### **Balance of Risks and Final Remarks**

Based on the above mentioned macroeconomic environment and on most recent information regarding the development of the Mexican economy, Banco de México's baseline scenario for 2006 is as follows:

**GDP Growth:** GDP growth is expected to be between 3.5 and 4 percent.

**Employment:** Approximately 700 thousand jobs are expected to be created in the formal sector (number of workers insured by the IMSS).

**Current Account:** The current account deficit of the balance of payments is expected to be around 0.8 percent of GDP.

**Inflation:** Core inflation is expected to remain around 3 percent for the remainder of the year. Annual headline inflation is anticipated to be between 3 and 3.5 percent at the end of the year, exhibiting certain volatility from its non-core component.

In this regard, the following should be highlighted:

a) A slight rebound in core inflation is anticipated to take place in April, due to the effect of the Easter holiday (that took place on a different month in 2005 with respect to 2006) on the prices of tourism-related services. These effects are anticipated to disappear in the following months.

b) A small rebound in the annual variation of the housing-services price subindex is expected due to the unusual fall of this subindex in the same months of the previous year, associated with the reduction in the cost of several construction materials. Nonetheless, its impact on core inflation will be compensated by the expected reduction in the prices of the rest of services and merchandises.

c) Although the international prices of energy remain high, they are expected to affect headline inflation

only moderately, due partly to the policies adopted by the Federal Government to determine prices of goods and services administered by the public sector.

d) As for the rest of the components of CPI's non-core index, no significant inflationary pressures are expected.

The outlook for inflation has improved. Nonetheless, the following risks must be considered:

i) International prices of energy continue to be a source of possible inflationary pressures. In particular, growing geopolitical uncertainty has fostered a new rebound in these prices. The magnitude and duration of this adjustment represents a considerable risk for world inflation.

ii) Futures prices of certain grains have increased. This could represent an obstacle for the reduction of processed food prices annual variation and, therefore, affect livestock products' prices.

iii) Price increases of certain metals could affect the value of construction materials.

iv) The growth rate of services prices, particularly of non-housing-related services, remains high.

v) Considerable increases in the prices of certain fruits and vegetables should not be discarded.

vi) Inflation expectations for different horizons are above the 3 percent target.

Considering the base scenario for inflation and the balance of risks, the Board of Governors of Banco de México allowed in April for a loosening of monetary conditions, establishing that no space is available to ease further monetary conditions in the foreseeable future.

Further risks that could affect the outlook for growth established in the baseline scenario prevail.

First, demand-side inflationary pressures could arise in the U.S. In such case, U.S. monetary authorities could increase their reference rates more or for a longer period than currently expected by financial markets. This scenario could lead to increases in long-term interest rates in US dollars, which would, in turn, lead to a reduction in appetite for risk and to higher volatility in financial markets.

Another risk related to external factors is that the high current account deficit in the U.S. could

become unsustainable. Although this is a medium-term risk factor, if materialized it could have significant effects worldwide, particularly for the Mexican economy.

Moreover, as mentioned repeatedly by the Central Bank, the continued displacement of Mexican manufacturing production by China and other economies in international markets is a significant risk that has already affected the Mexican economy. Such risk has increased due to the lack of progress in making the economy more competitive, wasting the opportunities for growth created by a particularly favorable international environment. Other emerging economies have advanced decisively in implementing reforms and in modernizing their economies, allowing them to grow vigorously. Should this competitiveness slump in Mexico's economy continue, the opportunities for growth and the creation of more and better-paid jobs in the country could be affected significantly.

Finally, political uncertainty associated with Mexico's electoral process of 2006 could arise. Certain analysts have pointed out that this could lead to higher volatility in financial markets. In this regard, it is important to point out that the implementation of prudent macroeconomic policies has allowed Mexico to be, at present, in a much better position to face these risks.

An assessment of the above mentioned risks reveals the importance of the economy's macroeconomic anchorage, and the key role played by monetary policy. This highlights the need for an autonomous central bank, which, in the case of Mexico, has price stability as a constitutional mandate. Such a mandate looks forward to assure on a permanent basis –beyond particular circumstances- an environment of certainty that allows to face external and domestic risks and to take advantage of the country's growth potential.