Monetary Policy

Report on Monetary Policy January – June 2000

BANCO DE MEXICO

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I. Report on Monetary Policy

I.1. Introduction

In compliance with Article 51, section II of the Law of Banco de México, the Board of Governors of this Institution presents the following report on monetary policy for the period from January 1 to June 30, 2000, to the Federal Executive and the Congress of the Union.

According to the constitutional mandate set for Banco de México, the primary objective of monetary policy is to seek the stability of the general price level. This mandate is founded on the overwhelming empirical evidence, both in Mexico and abroad, which shows that high inflation rates undermine economic growth, the distribution of income and real wages. For this reason, the primary objective of monetary policy in most of the world's central banks is to curb inflation.

The experience of those economies that have attained a permanent reduction of their rates of inflation within a floating exchange rate regime proves that the costs of reducing inflation are lower if this process is implemented in a gradual manner. Because price growth continues to be high in Mexico, the Board of Governors of Banco de México has proposed a gradual and sustainable strategy. Therefore, the present scheme of monetary policy contains several fundamental aspects:

(a) the goal of achieving an annual inflation rate not to exceed 10 percent in year 2000;

(b) the objective of bringing domestic inflation down, in line with that of Mexico's main trading partners by 2003;

(c) the practice of constantly evaluating inflation's current situation and outlook, which should serve as the foundation for conducting monetary policy; and

(d) an emphasis on greater transparency in the operation of the Central Bank and more effective communication with the public.

Monetary policy has a delayed effect on the evolution of prices. Therefore, the monetary authority generally reacts when its

evaluation shows an inflation outlook that is not compatible with the proposed targets.

I.2. Economic Developments in the First Semester

The performance of the Mexican economy over the first six months surpassed both public and private sector's expectations. A stronger than anticipated growth resulted from a dynamic external demand and a quite vigorous domestic spending. Although the slowdown in inflation this year has been greater than expected, price growth is still significantly higher than in industrialized countries. The current inflation level and the still insufficient downward adjustment in inflation expectations for the year 2001 are the main reasons why the Board of Governors of Banco de México has maintained —and even tightened— the restrictive stance of monetary policy.

World economic growth was also stronger than forecasted in the first half of the year. Growth in emerging market and European economies accelerated, while the pace of economic expansion in the United States did not provide conclusive evidence of slowing down. On the other hand, Japan was still caught up in a delicate situation.

The pace of global economic expansion implies a potential risk of inflationary pressures. This is especially true for the United States' economy, in which the evidence of a slowdown is still tentative. Besides, owing to the sharp increase in international oil prices, consumer prices rose in most oil importing countries.

In Mexico, inflation performed favorably during the period. This assertion is based on the analysis of the various price indices, whose main results are as follows:

(a) annual inflation has been on a falling trend since February last year, having attained a rate below 10 percent several months ahead of schedule;

(b) the decline in overall annual inflation has toned down owing to a rebound in the rate of inflation of agricultural and livestock products and goods provided or regulated by the public sector;

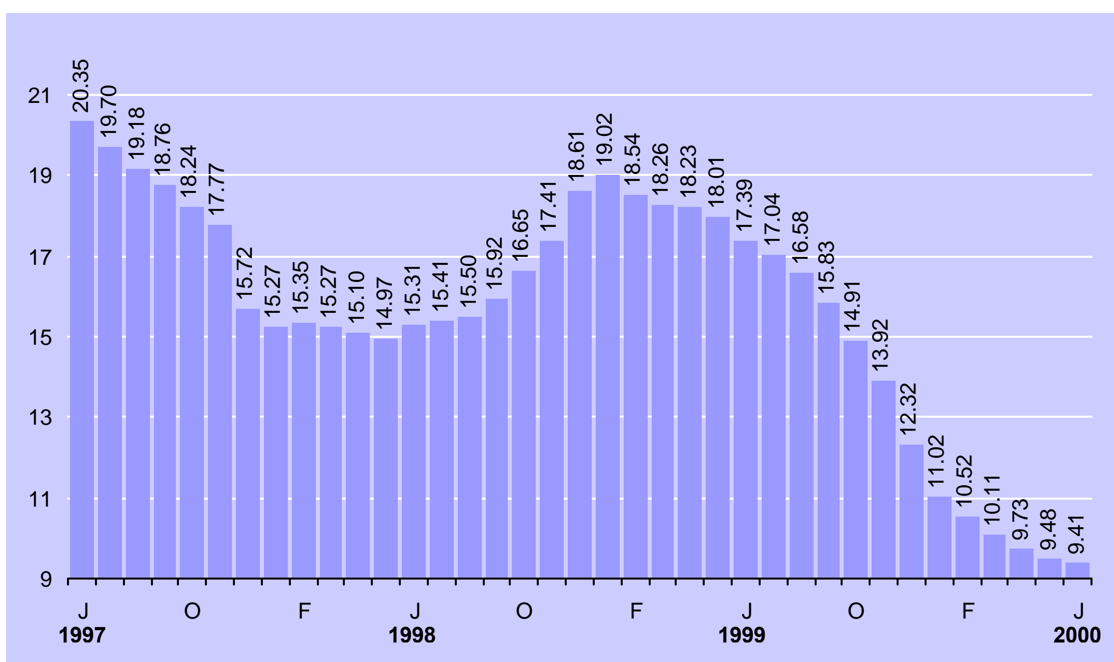
(c) the various measurements of medium-term inflation trends showed a downward path for the second quarter;

(d) annual core inflation declined at a rate similar to that observed over the last few months, and is now below the inflation rate of the National Consumer Price Index (INPC); and

(e) the annual core inflation rate for goods was the lowest over the last 78 months and considerably lower than core inflation for services. This performance suggests that exchange rate adjustments observed during the semester did not affect price growth.

Graph 1 **National Consumer Price Index (INPC)**

Annual change in percent



On the other hand, the annual growth rate of the National Producer Price Index (INPP) excluding crude oil and services rose during the second quarter.

I.3. Monetary Policy in the First Half of Year 2000

On January 18, the restrictive monetary policy stance was reinforced by increasing the “short” from 160 to 180 million pesos, the latter level having remained in effect through the remainder of the first quarter. The decision to further tighten monetary policy had a dual purpose: a) to create conditions in the financial, labor

and goods and services markets conducive to maintaining inflation under the 10 percent target for 2000; and b) to reinforce the downward trend in inflation, allowing for a definitive convergence with external inflation by 2003.

The decision to increase the "short" was based on pre-emptive criteria and responded to events in the first few weeks of the year that could have led to inflationary pressures incompatible with the goals. The main reasons behind this decision were:

(a) the sharp decline in inflation in 1999 and in the first few months of this year was not only due to the application of a monetary policy with a restrictive bias, but also to factors that may not be recurrent;

(b) although the public's inflation expectations for this year have been converging toward the official target since late 1999 and in early 2000, they remain above said target. Since a significant number of contractual wage negotiations is conducted in the first few months of the year, it was extremely important to reaffirm the monetary authority's commitment to price stability; and

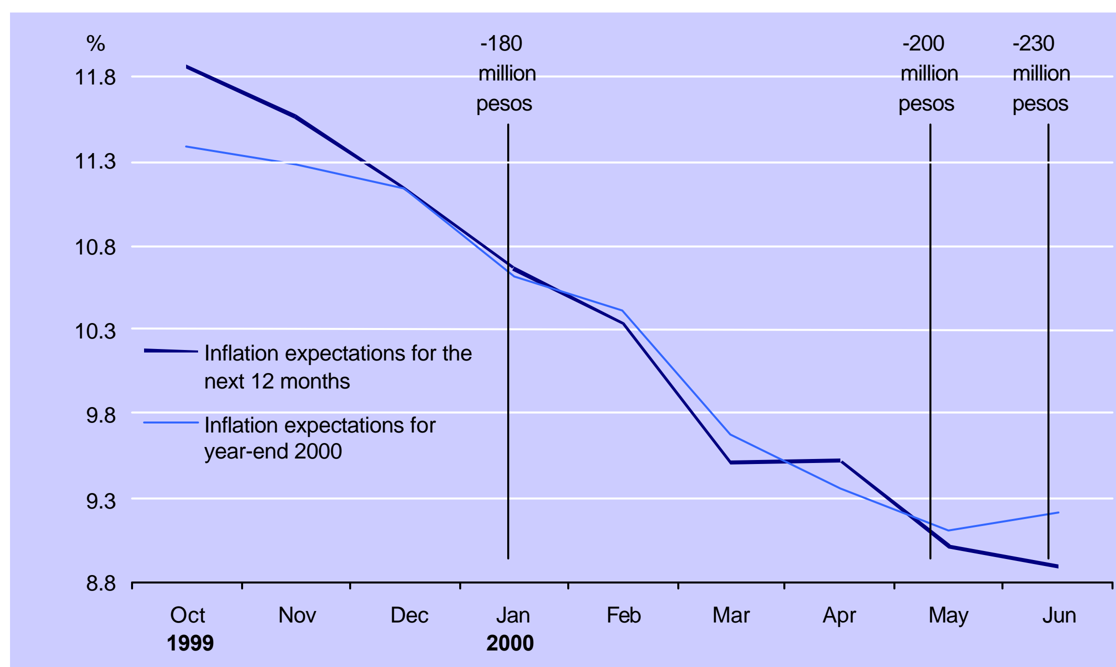
(c) in early January there were a number of price hikes involving changes in relative prices that were incompatible with the annual inflation target. Those adjustments could have influenced inflation expectations and therefore the evolution of other prices.

Since the "short" was increased, the public's inflation expectations for 2000 fell from 11.14 percent in December 1999 to 9.67 percent in March. Expected inflation for 2000 and for the following 12 months displayed a downward trend that became more acute in January after the "short" was widened. This suggests that monetary policy actions have, in effect, contributed to a major change in inflation expectations.

There was a sharp decline in domestic interest rates in tandem with an improvement in the perception of country-risk. In the January-March period, the average spread between the yields on UMS26 and United States' Treasury Bonds was 54 basis points lower than in the previous quarter. Similarly, average inflation expectations for the next 12 months fell 143 basis points while nominal rates on 28-day Cetes retreated 190 basis points. Had domestic interest rates fallen without there being a change in the perception of country risk and inflation expectations, Banco de México's restrictive policy stance would not have been as

effective. In that case, the decline in domestic interest rates would have induced a depreciation of the exchange rate, as the public would have replaced assets with a lower risk-adjusted return with others whose yields had remained constant. However, during the first quarter the exchange rate either appreciated or remained stable while domestic interest rates decreased.

Graph 2 **Inflation Expectations and Accumulated Balances Objective**



SOURCE: Banco de México's Survey of the Expectations of Private Sector Economic Specialists.

Given the evolution of the aforementioned variables, it may be concluded that the tightening of Banco de México's monetary policy stance during the first quarter was a suitable preventive reaction. The market's response was clearly reflected in a decline in expected annual inflation and supported the downward trend in inflation.

During the second quarter Banco de México tightened monetary policy twice: on May 16 and on June 26. On the first date, the "short" was widened from 180 to 200 million pesos and to 230 million pesos on the second date. Similarly to the reinforcement of the restrictive monetary policy stance implemented in January, the decision to widen the "short" during the second quarter was based on pre-emptive criteria, and responded to some factors that arose and had been identified by the Board of Governors as possible sources of future inflationary

pressures. The main considerations behind these actions were as follows:

(a) although inflation expectations during the second quarter for 2000 were already below 10 percent, analysts did not anticipate a significant decline in inflation for the year 2001. For example, in Banco de México's June Survey on the Expectations of Private Sector Economic Specialists, the inflation forecast for this year was 9.21 percent while the forecast for 2001 had been still at 8.07 percent;

(b) the strength of aggregate demand could result in price increases for non-tradable goods, wage pressures, and a larger trade deficit —this would complicate the future decline in inflation;

(c) the increases in the prices of some fruits and vegetables during the second quarter could hinder the disinflation process in the next few months and affect the evolution of inflation expectations;

(d) in June, inflation expectations for the July-September period and for the year 2000 rebounded slightly. This could contaminate the evolution of medium-term expectations and hamper the attainment of the objective of bringing domestic inflation in line with that of Mexico's main trading partners by the year 2003; and

(e) inflationary pressures in the main developed economies worsened owing to the vigorous economic growth observed in those countries, which resulted in higher international interest rates.

Based on the above diagnosis, the more restrictive monetary policy stance has several purposes:

(a) to limit the expansion of aggregate demand in order to diminish the risk of inflationary pressures caused by excessive growth in domestic spending;

(b) to reduce the likelihood that a more severe monetary restriction worldwide could create a disorderly adjustment in domestic financial markets, which could in turn deteriorate inflation expectations and affect the evolution of prices;

(c) to prevent increases in certain prices (agricultural and livestock products and domestic gas) from contaminating the inflation expectations formation process;

(d) to inhibit the influence of the June upward revision of short-term inflation forecasts on medium- and long-term expectations; and

(e) to reaffirm Banco de México's commitment to its medium-term inflation target, in order to strengthen the downward trend of expectations for the year 2001 and achieve the convergence with the inflation of Mexico's main trading partners by the year 2003 at the lowest possible cost.

An important element to identify inflationary pressures and, thereby, to determine suitable monetary policy measures is to analyze the evolution of inflation expectations. Inflation expectations for 2000 have fallen from 9.67 percent in March to 9.11 percent in May, and rose slightly to 9.21 percent in June. The responses gathered by the April survey aroused concern because the inflation expected for the following twelve months (April 2000–April 2001) turned out to be higher than the inflation expected for the year 2000. This implied that private sector analysts anticipated that the disinflation process would come to a halt at some point. Consequently, one of the reasons for having widened the "short" on May 16 was to restore the downward trend of medium-term inflation expectations.

Graph 3 **Evolution of Inflation Expectations**

Annual change in percent

SOURCE: Survey of the Expectations of Private Sector Economic Specialists, Banco de México.

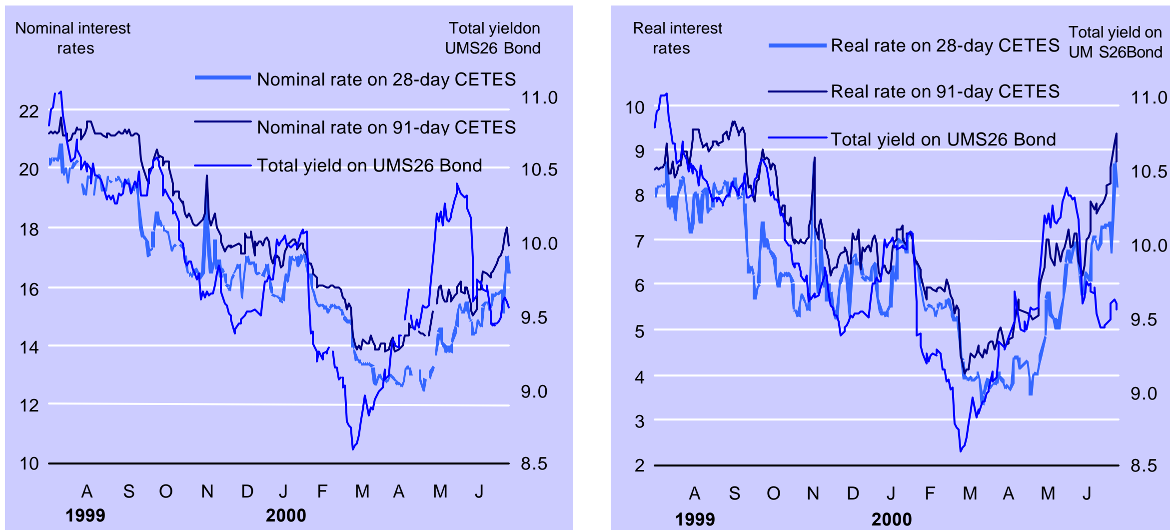
Responding to the measure taken, inflation expectations for the following twelve months significantly improved in May.

However, in June, after inflation for the first two weeks of the month had been made public —reporting a higher rate than expected by the market— inflation expectations for the year 2000 and for the third quarter were adjusted upward. Undoubtedly, this could have been the prelude to a deterioration of longer-term expectations. To avoid the materialization of such scenario and considering the other inflationary pressures mentioned, the "short" was widened again, this time to 230 million pesos. Subsequently, short- and medium-term inflation forecasts fell, suggesting that the aforementioned monetary policy actions reinforced the downward trend of medium-term inflation expectations, and that short-term expectations were affected by transitory phenomena such as price increases in agricultural and livestock products.

With regards to the effectiveness of the measures taken, interest rates have gone up clearly after each of the increases in the "short". For example, the day following the first widening of the "short" in the second quarter, the government's funding rate rose 84 basis points. Moreover, the June 26 increase in the "short" induced a one percentage point rise in said interest rate. Therefore, these measures and the response of market participants did contribute to maintaining higher real interest rates than those observed in the first three months of the year.

Graph 4 **Nominal Interest Rates, Real Interest Rates, and Country Risk**

Percent



During the second quarter, nominal and real interest rates in Mexico were also affected by external interest rates as well as by country-risk perception. As a result of NASDAQ's drop in April

and May, the perception of Mexico's country-risk significantly deteriorated and was reflected by a rise in the total yield on the bonds denominated in foreign currency issued by the Mexican government (UMS26). Domestic financial markets were affected as nominal and real rates on Cetes went up and reached levels similar to those observed at the beginning of the year. In late May and early June, nominal rates on Cetes showed a slight downward trend that was interrupted by the effect of the exchange rate depreciation observed in the second week of June and by the widening of the "short" on June 26. Although real interest rates closed the second quarter at levels much higher than those reported in late March, they posted significant reductions in the days following the elections.

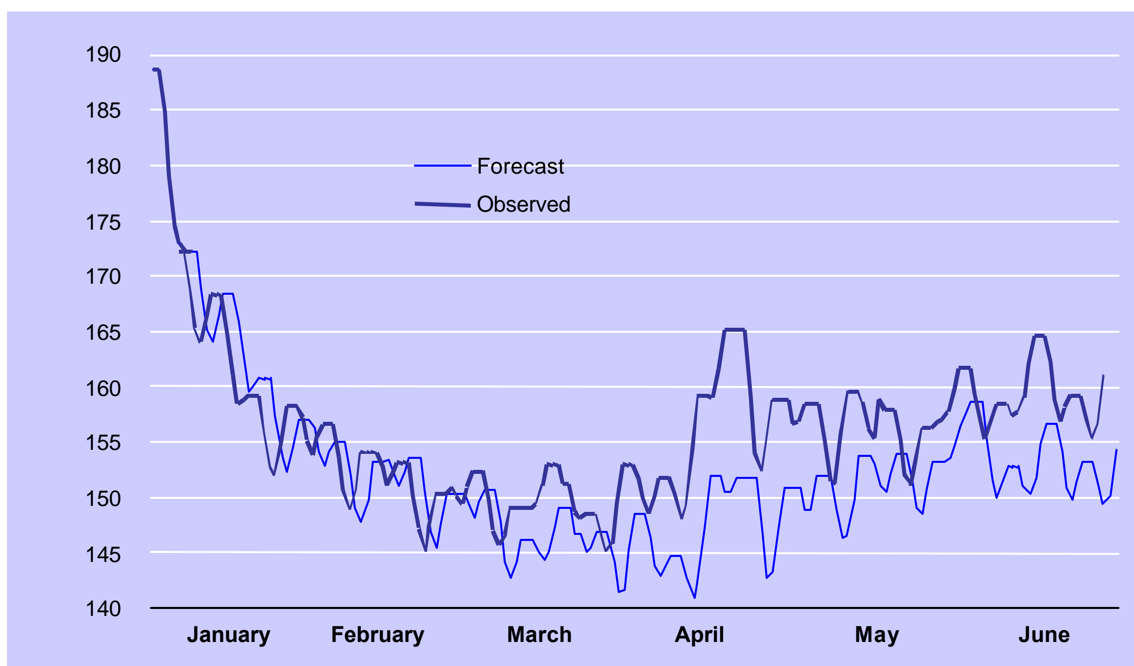
The rise in domestic interest rates —associated to increases in external rates, the volatility of international and domestic markets and a tighter monetary restriction— favored the necessary monetary conditions for Banco de México to remain capable of achieving its short- and medium-term inflation targets. Although the above has been reflected by a decline in the inflation expected for the year 2001, such expectation is still at levels inconsistent with the objective to bring domestic inflation into line with that of the Mexico's main trading partners by the year 2003.

I.4. Evolution of the Monetary Base and Compliance with the Quarterly Limits on Net Domestic Credit and International Asset Accumulation Objectives

When the evolution of the monetary base is compared against its forecast published in the Monetary Policy Program for 2000, it can be observed that there was a deviation of 2.9 percent by the end of March. This deviation practically coincided with the announced upper limit of the confidence interval for the monetary base forecast at the end of the year (+/- 3.07 percent). Therefore, the gap seen in March may be attributed to the error intrinsic to any econometric model. In April the monetary base stock was significantly higher than the estimate. However, the difference considerably diminished in May. The deviation occurred in April is mainly accounted for by the fact that the seasonal effect of Easter on the demand for bills and coins had been underestimated. In June, the gap widened anew to reach 4.7 percent at the end of the second quarter. The fact that the observed monetary base was generally above its anticipated path has in part been due to the economy's stronger than expected expansion.

Graph 5 **Evolution of the Monetary Base in the First Semester of 2000**

Thousands of millions of pesos



As the first semester concluded, the limit on the variation in net domestic credit was complied with as well as the commitment not to allow the level of net international assets to fall. Thus, in the first half of the year, the accumulated change in net domestic credit was -43,739 million pesos, below the –30,647 million pesos pre-established ceiling. In the aforementioned period net international assets rose by 2.224 billion dollars, out of which 445 million dollars stemmed from foreign exchange operations with the Federal Government and Pemex, and 872 million with credit institutions (922 million dollars in purchases through the options scheme and 50 million dollars sold by means of the established automatic mechanism).

II. Assessment of Risks and Conclusions

During the first semester of this year, the downward trend displayed by inflation since early 1999 strengthened, whether it is measured by the overall index (INPC) or by the core inflation index. The above outcome is accounted for essentially by the combination of the following factors:

(a) since January nominal increases in contractual wages have been lower than those negotiated in 1999;

(b) the external environment continued to be favorable in spite of occasional episodes of volatility;

(c) the domestic supply of goods and services has been very flexible, especially during the first quarter of the year; and

(d) monetary authorities' proactive approach to maintain inflation expectations in line with medium-term targets.

Since May, annual inflation reached a level below 10 percent, which had been anticipated to take place a few months later. If the prices of agricultural and livestock products and of the goods and services provided or regulated by the public sector had not grown as much as they did, a further decline in inflation would have been feasible.

In this regard, in the last weeks of June and early in July, the growth in the prices of agricultural and livestock products decelerated. On the contrary, the prices of goods and services provided or regulated by the public sector kept growing at high rates. This suggests that in the coming months the latter prices will continue to exert pressure on overall inflation.

In the period analyzed, there were additional signs that the vigorous growth in aggregate demand —mainly in private consumption— is already affecting the prices of production inputs. In this regard, the following issues are cause for concern:

(a) the growth in unit labor costs in various sectors of economic activity;

(b) the fact that contractual wage revisions have not fully incorporated the improvement in inflation expectations.

Consequently, ex-ante increases in real contractual wages are still inconsistent with gains in labor productivity foreseeable in the long-run;

(c) the shortage of skilled labor in some regions; and

(d) an upturn during the second quarter in the INPP annual growth rate excluding oil and services.

Although these events do not endanger the attainment of short-term inflation targets, they suffice to maintain the restrictive bias of monetary policy in order to achieve in 2001 an inflation rate consistent with the medium-term goal: to reach an inflation rate similar to that prevailing in the economies of Mexico's main trading partners by year-end 2003.

The base scenario for the remainder of the year 2000 is based on a careful consideration of risks implicit in the evolution of external and domestic environments.

The main external factors that could hamper the future decline in inflation are the following:

(a) an abrupt slowdown in the Unites States' economy;

(b) a much grater than expected increase in international interest rates;

(c) a collapse of the securities markets; in the United States; and

(d) a steep fall in international oil prices.

Signs of an economic slowdown in the United States during the second quarter sufficed for the Federal Reserve not to raise its interest rate target at its June 28 meeting. Nevertheless, the evidence that the growth of aggregate demand in that country is moving toward a sustainable rate is still tentative and preliminary. In any case, the probability of an abrupt slowdown in the United States' economy has diminished marginally since the first quarter.

The United States' economy is still growing at a vigorous pace and the slowdown observed in the second quarter may have been due to seasonal and climatic phenomena only. Therefore, a scenario where economic activity accelerates in the second half of the year along with inflation may not be discarded. Under such circumstances, an increase in interest rates far greater than expected may be required, which may induce an abrupt contraction

of economic activity in the United States and a sudden drop in that country's securities market. Finally, regarding the feasibility of a drop in international oil prices and in that country's securities market, some analysts believe that both stand at excessively high levels. Thus, it would not be prudent to reject the likelihood of the aforementioned events actually occurring.

As it was mentioned in the Inflation Reports of the first two quarters of this year, should any of the aforementioned possibilities materialize, the exchange rate would probably depreciate in response to a reduced supply of foreign exchange. Under this situation, the corresponding correction in the nominal exchange rate would lead to a higher real equilibrium exchange rate. Since exchange rate movements have caused higher inflation in the past, any correction in the exchange rate would lead to the deterioration of inflation expectations and would thereby affect all kinds of contract negotiations. This is why the monetary authority will react immediately should there be evidence that exchange rate adjustments could be causing a significant upward revision of medium-term inflation expectations and affecting the evolution of prices of non-tradable goods.

Monetary policy actions would not be geared to protecting a specific exchange rate level, however. One of the main advantages of a floating exchange rate regime is having the necessary flexibility for the real exchange rate to move towards another equilibrium level in response to external socks (such as changes in the terms of trade and in capital flows, etc.) or internal shocks (for example, changes in the level of public spending). Nevertheless, a higher real exchange rate may result from various combinations of nominal depreciation and inflation. In such a scenario, Banco de México's interventions would focus on achieving the adjustment required in the real exchange rate at the lowest possible cost in terms of inflation.

Concurring with the opinion of most private analysts, Banco de México estimates that the pessimistic scenario described above is not likely to occur. Therefore, the Central Bank's base scenario for the external environment during the second semester includes the following forecasts:

(a) a gradual deceleration of the American economy; and

(b) international oil prices slightly below the average level registered in the first semester.

A gradual and orderly slowdown of the United States' economy would indeed act in favor of stability in international and domestic financial markets. Nevertheless, if and when this adjustment takes place, the growth of Mexican exports —oil and non-oil exports alike— could be weakened.

The balance of the aforementioned events would be a reduction in the growth rate of aggregate demand and a widening of the trade deficit, which would very likely continue to be financed mainly by foreign direct investment.

Regarding domestic risk factors, the following should be taken into consideration. Throughout the first semester of the year, there were signs that the rapid growth in aggregate demand could be pushing unit labor costs up along with contractual wage revisions and the producer price index (INPP). Even though there is preliminary evidence that the growth of aggregate demand has diminished marginally, this has occurred together with a slight deceleration in domestic supply growth. Consequently, the trade balance has remained relatively stable. In sum, available information suggests that an excessively strong expansion of aggregate demand may be taking place —particularly in private consumption.

This situation could become more complicated in the future in response to recent developments in financial markets. Projections for the Mexican economy were favorably reassessed in the early weeks of July, after the elections had taken place without disruption. Accordingly, the exchange rate appreciated, interest rates fell considerably and the Mexican stock market index soared. These adjustments may indicate that the markets are expecting larger short-term capital flows coming into Mexico. If such inflows were to materialize, together with consumers' and firms' stronger confidence on the future course of the domestic economy, a scenario of greater optimism could ensue and this would further stimulate the expansion of aggregate demand. The outcome would be additional pressures on the prices of non-tradable goods.

The progress so far made to curb inflation has been very significant. However, private sector expectations suggest that a certain degree of skepticism remains with regards to the feasibility of a continued reduction in price growth in order to reach the target established for year 2003. This is corroborated by the fact that analysts anticipate merely a 1.14 percentage point reduction in inflation for 2001, which would represent a relative setback when compared to the results obtained in the last few years. This relative pessimism stems from the inflationary pressures that have been

recorded in the last few months and described throughout this Report. Furthermore, such expectations are also the result of the array of domestic and external risks which, should they materialize, could complicate the future abatement of inflation.

After having weighed all the aforementioned elements, Banco de México estimates that price growth in the third quarter will be below that posted in the same period of 1999, and annual inflation will thus maintain its downward trend. Although annual inflation rates will decline between June and September, it is likely that such reduction will be less significant than the one attained in the second quarter. Finally, inflation in the third quarter will surpass that reported for the second quarter, mainly as a result of seasonal factors. In this regard, it is worth mentioning that September is usually a month of relatively high inflation caused by rises in tuition and other school fees.

The actual challenge faced by monetary policy is to create the necessary conditions to consolidate the progress made so far in reducing inflation. A moderation of aggregate demand growth is a key element of this undertaking, inasmuch as it should not exceed the limits imposed by installed capacity.

Restrictive macroeconomic policies are essential to contain the expansion of aggregate demand. Accordingly, Banco de México has tightened the monetary policy stance several times during the year. However, more stringent monetary conditions could induce, at least initially, a greater appreciation of the exchange rate, which would in turn stimulate spending on tradable goods and bring forth a larger trade deficit. The resulting increase in the external deficit would likely be financed by short-term capital inflows. The latter outcome would nonetheless magnify the vulnerability of the disinflation process and subsequently weaken monetary policy's effectiveness to contain inflationary pressures. Therefore, fiscal restraint would be the most effective tool to temper aggregate spending. By increasing public saving, such a policy measure would have a direct effect on the domestic economy's total saving, and would thus inhibit the continued expansion of aggregate demand while reducing the need for external financing.

Looking forward, it is essential to implement a fiscal reform that could substantially boost the federal government's capability of collecting non-oil revenues. This, in order to maintain sound public finances even within a less favorable context and support both the sustainability of the economic growth process and the continued decline in inflation.

In short, the optimum economic policy response to contain the aggregate demand pressures currently affecting the Mexican economy would entail a coordinated implementation of monetary and fiscal policies. This would allow for the simultaneous deceleration of domestic spending while limiting the deterioration of the country's external accounts. A moderation of the expansion of aggregate demand becomes even more significant within the context of the expected slowdown in the United States' economy, which by itself would likely trigger a larger Mexican trade deficit. The latter would widen further should domestic spending keep on growing at its current pace.

The implementation of more restrictive monetary and fiscal policies would help maintain the Mexican economy's external financing requirements within the limits imposed by sustainable long-term capital inflows, and would forestall inflationary pressures incompatible with the stated targets even if the external environment conditions were to deteriorate.