Summary

Annual Report 2000

BANCO DE MEXICO

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I. Introduction

The performance of the Mexican economy in the year 2000 was substantially better than had been expected at the beginning of that year. Annual inflation fell from 12.32 percent in December 1999 to 8.96 percent in December 2000, and the annual inflation target of less than 10 percent was thus reached by a wide margin. The stabilization effort was most noticeably reflected by the 6.72 percentage point reduction in core inflation from last year. Furthermore, Gross Domestic Product (GDP) rose 6.9 percent in real terms, 3.2 percentage points higher than the growth rate registered in the previous year. All of the above helped to create 525 thousand formal jobs, thus allowing for a reduction in the open unemployment rate and a significant recovery in real wages.

The economic results in 2000 were made possible by the application of an appropriate economic policy in the context of a favorable environment. The latter was characterized by the strong expansion of the United States' economy and by the rise in international oil prices. The country also enjoyed improved access to international capital markets. The aforementioned, along with an orderly election process, meant that the year 2000 witnessed an end to the six-year crisis cycle that had troubled Mexico for more than two decades.

However, during the final months of 2000 some of the risks that Banco de México had warned against over the year began to materialize. In fact, it was confirmed that the United States' economy had entered a period of less vigorous growth, and the perception that the economic downturn in that country during 2001 would be greater than originally expected became more widespread. In addition, the price of the Mexican crude oil export mix fell sharply in December. Moreover, the deceleration of domestic output was made evident by the fact that GDP showed practically no growth in the fourth quarter —according to the seasonally adjusted figures— while domestic demand weakened less; therefore, the trade deficit widened significantly.

In short, 2000 was an exceptional year for the Mexican economy. Yet, the events of the last few months point towards a more complex scenario for the year 2001 that will require a combination of sound economic policies in order to consolidate the process of sustained economic growth compatible with the objective of reducing inflation.

II. International Environment

Although the uncertainty over the economic slowdown in the United States and a fall in oil prices prevailed throughout 2000, the influence of the international environment on Mexico's external accounts was generally positive. In particular, non-oil exports remained robust and the average price of the Mexican crude oil export mix was higher than that assumed in the formulation of the public sector budget. Net capital flows towards Mexico increased as a result of improved country-risk perceptions.

The development of the European, Asian and Latin American economies was also favorable during 2000, and even better than had been forecasted at the end of 1999.

III. Evolution of the Economy: General Overview

Economic Activity

Mexico's GDP measured at constant prices grew 6.9 percent in 2000, the highest growth rate in the last 19 years. It is also important to mention that at year-end GDP had registered annual increases over 20 consecutive quarters.

Throughout the year, aggregate demand showed vigorous growth (10.5 percent), significantly higher than the expansion of GDP. The domestic component of aggregate demand rose strongly in response to the considerable increases of 9.5 and 10.2 percent in private sector consumer spending and investment. In turn, public sector spending rose 4.6 percent in real terms, the highest growth rate for this variable in the last few years.

Exports of goods and services were again the component of aggregate demand that showed strongest growth —rising 16 percent at constant prices and higher than in 1999 (12.4 percent).

Employment, Wages and Productivity

The strength of the demand for labor in 2000 was shown in the total number of workers affiliated to the Mexican Social Security Institute (*Instituto Mexicano de Seguro Social*, IMSS). At the close of December this indicator had registered an annual increase of 4.3 percent. However, the deceleration of economic activity during the latter months of the year had an unfavorable effect on the number of individuals registered by the IMSS.

The open unemployment rate in urban areas fell continuously in response to the strong demand for labor. Thus, in December 2000 this rate had reached 1.9 percent of the economically active population (*Población Económicamente Activa*, PEA), the lowest level since 1985.

The average nominal increase in contractual wages was 12.4 percent in 2000, which represented an important decline with regard to that observed in 1999 (16.5 percent). Nevertheless, in the first nine months of the year contractual wage revisions were characterized by their downward rigidity. Therefore, *ex-ante* real wages remained high throughout the year.

Labor productivity rose during 2000 in the various sectors of the economy, except the construction industry. Yet, real wage rises were even higher, pushing unit labor costs up. This is a cause for concern due to the fact that persistent increases in these costs can have repercussions on future inflation.

External Sector

The trade deficit was 8.049 billion dollars in 2000, 44.2 percent higher than in 1999. The widening of this deficit was due to the fact that domestic demand grew at a much faster rate than GDP.

The growth of total exports in 2000 (22 percent, one of the highest rates in the world economy) was slightly less than that for imports (22.9 percent). The overriding factors in this result were: i) the expansion of the United States' economy, and ii) the high international oil prices that led to a 65 percent rise in the value of Mexican oil exports as compared to the figure posted in 1999. The aforementioned helped moderate the widening of the total trade deficit.

Mexico was the second most important trading partner of the United States in 2000, both in terms of destination of US exports and in terms of that country's total trade volume (sum of imports and exports). Mexico also maintained its position as the third most important exporter of merchandise to the United States, behind Canada and Japan.

The Mexican current account deficit closed the year 2000 at 17.690 billion dollars, equivalent to 3.1 percent of GDP; both figures were larger than those reported for 1999. The current account deficit was financed mainly by long term external resources. Inflows of foreign direct investment (FDI) rose to

13.162 billion dollars (2.3 percent of GDP), and thus covered three quarters of the deficit.

At year-end 2000, the stock of net international reserves was 33.555 billion dollars, while that for net international assets was 35.629 billion, both of which are historically high levels.

Public Finances

In the year 2000, total Public Sector Borrowing Requirements (PSBR) —including contingent programs and extraordinary revenues— amounted to 178,600 million pesos, equivalent to 3.29 percent of GDP. Excluding extraordinary revenues from privatizations, the PSBR reached 192,300 million pesos (3.54 percent of GDP).

The resources necessary to finance the PSBR (including extraordinary revenues) were obtained from both the domestic and external markets. Net indebtedness with the external sector rose by 22,500 million pesos, while the flow of net domestic financing totaled 156,000 million pesos. Of the latter sum, the placement of 166,600 million pesos of government securities and the accumulation of 81,400 million pesos worth of public sector deposits in Banco de México are noteworthy components.

Net Public Debt

The net broad economic debt, including contingent programs, was equivalent to 37.43 percent of GDP at year-end 2000, 2.11 percentage points less than the previous year's figure. This was due to reductions —as a percentage of GDP— in both the public sector debt and in that associated with the contingent programs.

Evolution of Monetary and Credit Aggregates and of the Securities Market.

During 2000 the narrow monetary aggregate (M1) posted an average increase of 11.1 percent in real terms, although its growth rate was lower in the fourth quarter. In turn, the broad monetary aggregate, M4, which measures financial saving, registered an average growth rate of 7.28 percent in real terms during the year. Even though the behavior of M1 and M4 was very similar over the year as a whole, the narrow monetary aggregate increased at higher rates than M4, thereby reflecting the public's preference for more liquid financial assets and the vigorous expansion of private sector consumer spending during the year.

Evolution of Credit Granted to the Private Sector

Bank financing began to show signs of recovery during the year 2000. Commercial banks' performing loan portfolio grew at positive rates in real terms, which was partly due to the granting of new direct credit. In fact, consumer credit has grown at an increasing rate, while that granted to firms and individuals with business activities has rebounded.

Notwithstanding the slight recovery in bank financing observed during 2000, alternative sources of financing continued to become more important.

Flow of Funds

In 2000 the private sector was a net saver in the domestic market (5.1 percent of GDP) and a net borrower of external resources (4.8 percent of GDP). In comparison, the public sector funded its large financing requirements mainly through the domestic market. Therefore, the savings generated in the domestic financial system were mainly channeled towards the public sector, leaving limited resources for the private sector.

If the public sector's economic balance were used as an indicator of this sector's financial position, it would lead to a qualitatively different conclusion: it would suggest a private sector's net indebtedness equivalent to 1.3 percent of GDP for the year. In other words, the analysis would underestimate the private sector's net domestic creditor position and overestimate the amount of financing it received from abroad. Therefore, the domestic economy's net indebtedness would be attributed to both the public and private sector deficits. On the other hand, using the PSBR including contingent programs as the appropriate indicator, it can be seen that the indebtedness incurred during the year 2000 was fundamentally due to the public sector.

Inflation

Evolution of Consumer Prices

In the year 2000 the National Consumer Price Index (*Indice Nacional de Precios al Consumidor,* INPC) rose 8.96 percent. The annual inflation target of less than 10 percent was thus attained by a wide margin. In turn, annual core inflation --which reflects price trends— was 7.52 percent, 6.72 percentage points less than the figure reported for 1999.

The difference between the behavior of INPC inflation and core inflation can be explained by the evolution of the price indices that the latter indicator excludes. The price subindices for education services and goods and services provided or regulated by the public sector continued to grow at annual rates above that of the INPC. Likewise, the annual growth rate of prices for agricultural and livestock products started to accelerate in April, and reached 10.7 percent in December.

The exchange rate is another factor that significantly influences the evolution of prices in Mexico. The stability of this variable observed during 2000 helped inflation expectations to be continuously revised downward throughout the year. Thus, annual inflation expectations were reduced from 11.14 percent in January 2000 to 8.85 percent in December of the same year.

National Producer Price Index

The annual growth rate of the National Producer Price Index (*Indice Nacional de Precios Productor*, INPP) excluding oil and services was 7.38 percent in 2000. This represents a 1.28 percentage point reduction from the annual figure registered for 1999. However, annual inflation as measured by the INPP excluding oil and services leveled off during the year. Regarding the INPP excluding oil and including services, its annual growth rate was 8.58 percent, 3.37 percentage points less than in 1999.

IV. Monetary Policy and Exchange Rate Policy

Monetary Policy

Elements of the Monetary Program

The Monetary Program for 2000 established an annual inflation target of less than 10 percent. This target was in line with the medium term objective of attaining an inflation rate similar to that observed in the economies of Mexico’s main trading partners by the end of 2003.

Based on the above, the Monetary Program for 2000 rests on three main elements: i) the basic operational rule of not generating either an excess or a shortage of liquidity in the money market; ii) Banco de México’s power to modify its monetary policy stance in the face of any event that could put the attainment of inflation objectives at risk; and iii) a greater effort to communicate with economic agents.

As in previous years, two additional elements were incorporated into the Monetary Program for 2000. The first of these refers to the publication of the estimated daily path of the demand for base money. The second consists of fixing quarterly limits for net domestic credit variations.

Monetary Program Implementation

During the first weeks of 2000, certain events took place that could have undermined the attainment of the inflation target for the year as well as that for the medium term. These events were as follows:

a) the inflation rate reduction observed towards the end of 1999 and in early 2000 was partly due to non-recurring factors, such as the appreciation of the exchange rate and the fall in the prices of fruits and vegetables;

b) expectations were above the inflation target, thereby increasing the likelihood that wage negotiations taking place at the beginning of the year could be incompatible with the inflation target; and

c) in the first few days of January some price increases were registered that were considered incompatible with the inflation target.

Faced with this situation, on January 18th the Board of Governors of Banco de México decided to tighten the restrictive monetary policy stance by widening the "short" from 160 to 180 million pesos. As soon as this measure was implemented, inflation expectations came down considerably, which in turn led to a gradual decline in interest rates.

During the second quarter of the year some of the factors that could generate inflationary pressures intensified. In response to this, on May 16th the Board of Governors of the Central Bank decided to reinforce its monetary policy stance, widening the "short" to 200 million pesos. The most important reasons behind this measure were as follows:

a) inflation expectations for 2001 were still higher than what was compatible with Banco de México's inflation target for the year 2003;

b) the vigorous expansion of aggregate demand;

c) increase in the prices of some fruits and vegetables; and

d) the rise in international interest rates in response to the inflationary pressures registered in industrialized nations as a result of robust economic growth and higher energy prices.

Nevertheless, due to higher-than-expected inflation in the first half of June, economic agents once again revised their inflation expectations for the year 2000 upwards. This, together with the fact that the previously mentioned factors remained unchanged, led the Board of Governors of Banco de México to widen the "short" for the third time on June 26th, to 230 million pesos.

During the third quarter, aggregate demand continued to grow faster than output. In response, on July 31st, the Board of Governors of Banco de México implemented, as a preemptive measure, an increase of the "short" to 280 million pesos.

The Board of Governors of Banco de México put into practice analogous measures on two more occasions during the last quarter of 2000. On October 17th the "short" went from 280 to 310 million pesos, while the final increase took place on November 10th, to 350 million pesos. These measures were deemed necessary in order to ensure the conditions needed to achieve the inflation target for 2001.

Evolution of the Monetary Base

The estimate of the demand for base money was based on the following assumptions: a real GDP annual growth rate of 4.5 percent, an annual inflation rate of no more than 10 percent, and a remonetization factor of 4.9 percent (which did not take into consideration the possible effects of the uncertainty caused by the Y2K problem).

Although the assumptions used in the preparation of the aforementioned forecast did not materialize precisely, the demand for monetary base was very similar to what had been anticipated. Real GDP grew at a higher rate —which led to an increase in the demand for liquidity— while inflation was lower —reducing the demand for nominal monetary stocks. These opposite effects almost offset each other completely. Thus, at year-end the monetary base stock stood at 208,900 million pesos, having deviated only 1.5 percent from the original estimate.

Net Domestic Credit and Net International Assets

The Monetary Program commitments were fulfilled in 2000, as net international assets did not decline and the limits established on the variation of net domestic credit were met. Thus, at year-end net domestic credit had contracted by 57,152 million pesos. This behavior was fundamentally due to the accumulation of 8.249 billion dollars of net international assets during the year.

Exchange Rate Policy

In the year 2000, the floating exchange rate regime allowed for the impact of various factors that generated short term uncertainty to be absorbed by temporary exchange rate fluctuations.

Banco de México participated in the foreign exchange market through two mechanisms: dollar purchases through put options, and the contingent dollar sales scheme. Each month Banco de México auctioned, among commercial banks, 250 million dollars worth of options to sell dollars to the Central Bank. The total auctioned over the year was 3 billion dollars, of which 1.844 billion were exercised. It was only on June 8th that Banco de México made a contingent dollar sale of 200 million dollars.

V. Final Remarks

In 2000, for the second consecutive year, the Mexican economy experienced higher than expected growth and below-target inflation. This was reflected by a substantial creation of jobs and the recovery of real wages. Thus, the year's results confirm that the abatement of inflation can be compatible with economic expansion and improvements in the standard of living of the population.

Nevertheless, at year-end 2000, one of the most widely anticipated economic risks in recent years finally did come about: the slowdown of the United State's economy. Partly as a consequence of this, international oil prices dropped suddenly in December. Likewise, in the first months of 2001 the price of Mexican crude oil has remained at levels considerably below the average for the previous year.

Some recent developments in the Mexican economy are also a cause for concern:

a) The weakening of output observed over the last few months has been sharper than that registered for domestic demand.

b) In the first quarter of 2001 the nominal increases in contractual wages (10.2 percent on average) have been higher than foreseeable gains in labor productivity and the inflation target.

c) Although inflation expectations for year-end 2001 have declined importantly in recent months, they still remain at levels incompatible with the inflation target for the year.

In order to attain the targets proposed for 2001, especially in the face of a difficult international environment, it is crucial to persevere with the implementation of disciplined monetary and fiscal policies. The challenge for Banco de México is to create the monetary conditions that will allow continued progress in the abatement of inflation. Undoubtedly, this task would be much easier if monetary policy measures go hand in hand with a sound fiscal stance. Unfortunately, at the moment public finances show a number of structural weaknesses that have to be dealt with. For that reason, a comprehensive fiscal reform to strengthen public finances is indispensable.

Needless to say that in order to promote vigorous and sustained economic development, it is crucial to implement structural changes that contribute to a more efficient economy. Among these are the revision of the regulatory framework governing the energy and telecommunication sectors, as well as the continuation of efforts to strengthen and modernize the financial system.

The Board of Governors of Banco de México reiterates its commitment to continue using all the instruments at its disposal in a firm and timely manner in order to attain the following objectives: an inflation rate not to exceed 6.5 percent by year-end 2001, and approximately 3 percent by 2003.