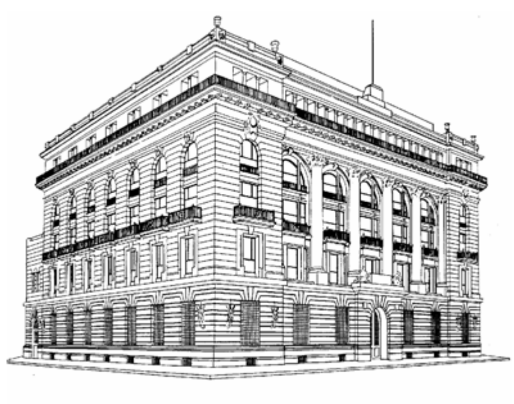
Annual Report Summary

2001



BANCO DE MEXICO

APRIL 2002

I. Introduction

Throughout 2001 Mexico suffered the effects of the global economic slowdown, especially that of the United States. GDP fell 0.3 percent.

Nonetheless, unlike previous recession periods, inflation in Mexico declined markedly surrounded by a stable financial environment. Annual inflation fell from 8.96 percent to 4.40 percent between December 2000 and the same month in 2001, therefore attaining the target for three consecutive years. Both nominal and real interest rates fell to levels unseen for many years and the exchange rate exhibited remarkable stability.

Several elements allowed the Mexican economy to undergo an orderly adjustment to the downward phase of the economic cycle: i) monetary policy compatible with the inflation target; ii) fiscal discipline; and iii) the structural reforms launched in previous years (most importantly, trade liberalization). These factors led to more long-term external capital inflows and also helped to curb the current account deficit. All of the aforementioned leads to believe that Mexico's economy will recover in line with the rest of the world.

II. International Environment

A synchronized slowdown of the economies of the United States, Japan and Europe was observed in 2001, which caused an unusually severe contraction of international trade flows. The deterioration of global economic growth throughout the year had a considerable impact on the Mexican economy's performance as it led to reduced levels of exports, economic activity and employment.

The uncertainty and disruption caused by the terrorist attacks on September 11 had an adverse impact on the world's most important financial centers' operations. In response to intensified risks in an economy that was already fragile, U.S. authorities agreed to loosen monetary policy and made plans for additional fiscal incentives. As a result, economic activity in the United States started to show signs of recovery by the end of 2001.

The synchronization of world economic slowdown responded to factors inherent to each region as well as to others of world impact. In this context, the global nature of the disturbance generated by contraction in the technology sectors and the consequent correction in the valuation of the shares of companies linked to these sectors deserve mention. In the euro area and Japan, several factors of domestic origin reduced the authorities' capacity to stave off the effects of external shocks.

For Latin American countries, the world economic slowdown translated into a contraction of private capital inflows, lower volume of merchandise exports, and a deterioration of the terms of trade.

As for Mexico, although contagion from the Argentine crisis did not materialize and the fall in oil prices was as expected, the export sector had to confront the sharp decline in demand from Mexico's main trading partner.

III. Developments in the Mexican Economy: General Overview

Economic Activity

The main aspects that characterized economic activity in 2001 were as follows:

a) After five years of continuous growth, real GDP fell 0.3 percent.

b) Aggregate demand shrank due to a modest increase in domestic spending and a significant fall in exports of merchandise and services.

c) Consumption continued to contribute positively to GDP growth, but its effect was offset by a substantial reduction in investment spending.

d) Private consumption, the main component of aggregate demand, was the only item that grew during the year mostly due to greater availability of credit and lower interest rates.

e) Private sector spending as a whole rose because lower levels of investment from this sector did not cancel out the expansion of consumer expenditure.

f) Public expenditure in consumption and investment declined considerably at constant prices, significantly contributing to the decline in domestic demand.

g) After having increased on a yearly basis since 1986, exports of goods and services fell due to weak external demand.

h) Business climate and confidence indicators remained pessimistic for most of 2001, posting a slight improvement in November-December.

i) The slowdown of economic activity affected all productive sectors, but most severely, the industrial sector.

j) Both the level of GDP and its annual percentage change were lower in real terms than estimates of potential GDP for 2001.

k) During the second half of the year, indicators for output, domestic expenditure and external demand behaved unfavorably. Despite such behavior, during November-December the number of positive indicators rose slightly.

l) Banco de México's leading indicator improved significantly during the second half of the year, thus suggesting that the economy could start to recover during the first months of 2002.

Employment, Wages and Productivity

Slower GDP growth, together with the behavior of earnings and wages, contributed to deteriorate employment conditions in 2001.

The following were the most outstanding aspects of Mexico's labor market in 2001:

(a) The significant fall of employment in most sectors of economic activity.

(b) Significant regional differences in the fall of formal employment, which was more evident in both northern frontier states and in higher industrialized states.

(c) The contraction of employment in Mexico's northern states due to the weakening of the maquiladora industry and other export-related activities.

(d) The upward trend of open unemployment in urban areas, although its increase was below expectations considering the fall in formal employment.

(e) Nominal wage increases above both observed inflation and expected inflation for the following twelve months.

(f) Several sectors experienced real wage increases per worker which did not correspond to labor productivity gains. The rise of real average wages also responded to the abatement of inflation.

(g) A significant decrease in real terms of the total wage bill in the maquiladora industry as well as in other activities. However, the total wage bill increased in the non-maquiladora manufacturing and trade sectors.

(h) Incipient gains in labor productivity in the manufacturing industry, and reductions in other sectors. This, coupled with the increase in real average wages, raised unit labor costs, therefore affecting employment negatively.

(i) A substantial loss of competitiveness in several sectors due to high unit labor costs.

(j) Fewer strike calls and lower worker involvement in these movements than in 2000, although a greater number of strikes occurred.

External Sector

Mexico's external sector was influenced by the following factors: the slowdown of the world economy (particularly of the U.S. economy); the fall in international oil prices; and large capital inflows to Mexico. Moreover, the synchronization of Mexico's business cycle with that of the United States led to a rapid adjustment in Mexican imports due to the weaker demand for

Mexican exports. This prevented the trade and current account deficits from widening significantly in 2001, ending the year below expected levels. In fact, the current account deficit was smaller than in 2000.

During 2001, the most outstanding features of Mexico's external sector were as follows:

(a) A sharp decline in the value of both exports and imports of goods compared to their levels of the previous year.

(b) Exports of both oil and non-oil goods fell.

(c) Plummeting manufacturing exports, especially those related to the maquiladora industry, during the second half of the year.

(d) Higher share of Mexican exports in U.S. imports. As a result, Mexican exports performed better in that market than the rest of the U.S. trading partners as a whole.

(e) A decline in merchandise imports originated by the weakness of output, domestic demand and the demand for exports.

(f) A wider trade balance deficit due to a decline in the value of oil exports. In fact, the non-oil trade deficit fell substantially compared to its level in 2000.

(g) A more moderate current account deficit than in the previous year (measured in both current US dollars and as a proportion of GDP) financed with long-term external resources.

(h) A large inflow of resources from workers' remittances.

(i) A capital account surplus (the highest for the last eight years).

(j) An unprecedented amount of foreign direct investment, considerably larger than the current account deficit.

(k) A reduction in public sector and commercial banks' external debt.

(l) A significant increase in international reserves, which reached record-high levels at year-end.

The trade deficit amounted to 9.95 billion US dollars, 24.4 percent higher than in the previous year (8 billion US dollars).

The average price of the Mexican oil export mix in 2001 was 18.57 US dollars per barrel, a significantly lower figure than in the previous year (24.62 US dollars).

At region level, Mexico's foreign trade was characterized by: i) an overall trade surplus with NAFTA trading partners; ii) a surplus with the rest of the countries in the American Continent; and iii) a deficit with Europe, Asia and the rest of the world. The widening of Mexico's total trade deficit resulted from a combination of a larger surplus with the NAFTA region, a lower surplus with the rest of the countries in the American Continent, and a higher deficit with the other regions. Thus, Mexico's widening deficits with Asia and Europe more than compensated the larger trade surplus with the NAFTA region.

The current account deficit ended the year at 17.681 billion US dollars (2.9 percent of GDP). This deficit was lower than that of 2000 measured both in current US dollars (17.737 billion) and as a proportion of GDP (3.1 percent).

The capital account recorded a surplus of 22.707 billion US dollars, its highest level in the last eight years. This resulted from a combination of a high inflow of long-term resources from the private sector via FDI and external financing.

The other items of Mexico's balance of payments were characterized by the following: a 2.299 billion US dollar positive flow in the errors and omissions line item; and an accumulation of Banco de México's international reserves amounting to 7.325 billion US dollars. In December 31, 2001, the stock of international reserves totaled 40.880 billion US dollars, its highest historical level at the end of the year.

Public Finances

Economic Balance

In 2001, the non-finance public sector deficit reached 42.1 thousand million pesos (0.73 percent of GDP). Both of these figures were below those of the previous year, albeit slightly higher than the target approved by Congress (by 2.1 thousand million pesos and 0.08 percentage points of GDP). The primary surplus (difference between revenues and expenditures excluding public sector's financial costs) was 150.4 thousand million pesos at year-end. This surplus was below the target (by 10.5 percent) and its level of the previous year (by 1.5 percent at constant prices). The primary surplus measured as a proportion of GDP remained at the same level as that observed in 2000 (2.61 percentage points).

Monetary and Credit Aggregates and Stock Market

Monetary Base, Net International Assets and Net Domestic Credit

The stock of the monetary base at the end of 2001 was 225.580 thousand million pesos, 11.806 million below estimates. The monetary base expanded at an average nominal rate of 12.8 percent during the year, below that forecasted in the Monetary Program (16 percent). This represented an average deviation of –2.9 percent, which can mainly be explained by the unforeseen slowdown of economic activity. However, as a proportion of GDP, the monetary base rose, therefore continuing the remonetization process that began in 1977.

At the end of 2001, remonetization was higher than that forecasted in the Monetary Program (3.7 vs. 2.6 percent), mainly as a result of two factors that fueled the demand for real monetary base stocks: i) the considerable decline of interest rates, and ii) the increase in real earnings.

In order to preserve the balance between the supply of monetary base and public's demand for it, Banco de México sterilized the monetary impact of accumulating international reserves by increasing central bank liabilities that are not included in the monetary base. This led to a 71,517 thousand million-peso contraction of net domestic credit.

Monetary Aggregates

The stock of the narrow monetary aggregate (M1) grew at a real annual average rate of 7.8 percent, below that registered in 2000 (11.1 percent).

The stock of the broad monetary aggregate M4 expanded at a real average annual rate of 9.9 percent in the last quarter of 2001. Most of the growth of this aggregate stems from the large quantity of financial savings channeled through the retirement savings system (including SIEFORES, INFONAVIT and other retirement funds).

Financing to the Private Sector

The stock of bank financing to the private sector deteriorated throughout the year. This behavior responded, among other factors, to the impact of prevailing international uncertainty on the credit market and its connection with domestic economic activity. Economic uncertainty gained relevance as a factor explaining the lower demand for credit. However, lower inflation has allowed for a reduction of lending rates and an extension in loans' maturities.

Flow of Funds

Public Sector Borrowing Requirements (3.9 percent of GDP) were financed through external (2.9 percent of GDP) and private sector (one percent of GDP) surpluses. The private sector was a net saver in the domestic market (5.3 percent of GDP) and a net borrower of external resources (4.2 percent of GDP). In contrast, the public sector funded its large financing requirements mainly through the domestic market. Therefore, savings generated in the domestic financial system were channeled to the public sector, leaving limited resources for the private sector.

Stock Market

Despite the economic contraction and uncertainty prevailing in 2001, the Mexican stock market exhibited a relatively favorable performance. At the end of the year, the Mexican Stock Exchange Index (*Indice de Precios y Cotizaciones de la Bolsa Mexicana de Valores, IPC*) accumulated a nominal increase of 12.7 percent over its level during the same period of 2000, thus implying an increase of 8 percent in real terms and 18 percent in US dollars.

The evolution of the Mexican Stock Market during 2001 is mainly explained by the following factors: i) a positive assessment of the prospects for Mexico's economy, unlike other emerging economies (particularly those of Latin America); ii) the behavior of the U.S. stock markets; and iii) the inflow of resources related to Citigroup's purchase of BANAMEX.

An additional factor that influenced investors' preference for Mexico was the Mexican Stock Market's yield measured in US dollars, which, in 2001, was above those obtained in the majority of the world's most important stock markets.

Inflation

The inflation target established in the monetary policy program for 2001 was attained for a third consecutive year. Prices grew at a real annual rate of 4.4 percent in December 2001, 2.1 percentage points below the target. As for annual core inflation, which is a more accurate indicator of medium-term inflationary pressures, it was 5.08 percent at the end of the year, 2.44 percentage points below 2000 figures.

Among the factors that contributed to the favorable behavior of prices during the year, the following deserve mention: i) a preventive monetary policy throughout 2000 and at the onset of 2001; ii) the decline in aggregate demand; iii) the strength of the exchange rate; and, iv) the supporting evolution of agricultural and livestock goods' prices and of prices administered and regulated by the public sector.

Consumer Prices

During the first half of the year, the annual growth rate of CPI prices was below that recorded during the same period of the previous year and, therefore, consistent with the set target. Hence, the target for the annual growth rate of prices was practically attained in June (6.57 percent).

Inflation is usually higher in the final months of the year as a result of seasonal factors. However, this did not occur in 2001 for the following reasons: i) there were no problems in the supply of agricultural goods as favorable weather conditions prevailed, therefore preventing sales abroad from affecting domestic prices; ii) prices of household-use gas fell sharply in July and August (13.16 and 7.28 percent, respectively) offsetting increases in the prices of other goods and services during that period; and iii) the appreciation of the exchange rate and falling domestic consumption (which prompted sale discounts in July) led to a significant decline in core merchandise inflation. As a result, inflation was 2.24 percent in the second half of the year, only 0.13 percentage points above that observed in the first six months.

Main Determinants of Inflation

At year-end 2001, annual headline inflation was below annual core inflation. In particular, the education subindex (school fees) continued to expand at rates above those of the CPI. In contrast, the annual growth rate of agriculture prices and administered and regulated prices decreased significantly.

In Mexico, the exchange rate affects the behavior of prices significantly. The appreciation of the exchange rate in 2001 and the eventual decline in the rate of growth of core merchandise inflation contributed to revise inflation expectations downwards gradually throughout the year. The positive results in abating inflation were another factor that contributed to the downward revision in inflation expectations.

During 2001, merchandise prices grew at slower growth rate than that of services prices. This behavior mainly responded to the appreciation of the exchange rate. The rate of growth of services prices decreased less due to the slower adjustment of nominal wage increases. Thus, while core merchandise inflation fell 2.83 percentage points in 2001, core services inflation did so by only 1.90 percentage points.

IV. Monetary and Exchange Rate Policy

Monetary Policy

During the last few years, Banco de México's monetary policy regime has been adjusted to changing circumstances in Mexico's economy. These developments have led to the formal adoption of an inflation-targeting scheme with the following main characteristics:

(a) Acknowledgement of price stability as the basic goal of monetary policy.

(b) Establishment and announcement of short and medium-term inflation targets.

(c) Consolidation of an autonomous monetary authority.

(d) Transparent implementation of monetary policy.

(e) Permanent assessment of potential sources of inflationary pressures.

(f) Use of alternative inflation indicators such as core inflation.

As in previous years, the instrument used by Banco de México to modify its monetary policy stance was the accumulated balance objective of commercial banks' current accounts held at the Central Bank, also known as the "short" or *corto*.

Monetary Program

In the Monetary Program for 2001, the following factors were considered necessary to attain short and medium-term inflation targets:

(a) A restrictive monetary policy stance.

(b) Adjustments in administered prices compatible with inflation targets.

(c) Wage increases consistent with both sustainable productivity gains and the inflation target.

(d) Absence of severe external shocks.

(e) A structurally sound fiscal stance.

It is important to mention that, unlike other years, Banco de México's Monetary Program for 2001 did not set limits to variations in net domestic credit.

Monetary Program Implementation

Banco de México modified its monetary policy stance on three occasions in 2001. The Central Bank increased the amount of the “short” in the first quarter, while in the second and third quarters it loosened its monetary policy by reducing it.

On January 12, 2001 Banco de México increased the “short” from 350 to 400 million pesos. This action was aimed at ensuring the attainment of annual inflation that would not exceed 6.5 percent. As in previous occasions when the “short” was widened, inflation expectations resumed their downward trend shown throughout 2000.

The positive impact of the increase in the “short” on inflation expectations contributed to reduce nominal and real interest rates significantly.

During the second quarter of 2001, inflation exhibited a favorable evolution and some elements of risk that had been identified at the beginning of the year as potential obstacles for accomplishing the target for 2001 were mitigated. In response, Banco de México announced on May 18, 2001 its decision to reduce the “short” to 350 million pesos, maintaining it at that level for the rest of the quarter.

Furthermore, in order to maintain its liquid creditor position vis-à-vis the banking system, on June 22, 2001 Banco de México called on Mexican credit institutions to make voluntary deposits at the Central Bank with three-year maturities. These deposits would pay interest every 28 days at rates equivalent to the arithmetic average of the 28-day Interbank Equilibrium Interest Rate (*Tasa de Interés Interbancaria de Equilibrio, TIIE*) during the corresponding period. The creation of these deposits meant monetary policy would preserve its effectiveness to influence the evolution of short-term interest rates.

Later, on July 31, 2001, the Board of Governors of Banco de México decided to further reduce the “short” to 300 million pesos, maintaining it at this level for the remainder of the year. This decision, like the reduction of the “short” in the previous quarter, was motivated by the favorable evolution of inflation and the mitigation of some risk factors that had threatened the attainment of the inflation target in 2001. Among those were: a) the significant downturn of economic activity in the United States, which reduced economic growth in Mexico considerably; b) during the first two quarters of the year there was an abundant supply of foreign capital, particularly from foreign direct investment. Thus, the evolution of the current and capital accounts contributed to exchange rate stability; and c) preliminary data concerning public finances during the January-May period implied that the fiscal stance would foster the proper conditions for stabilization.

Inflation ended the year below the 2002 target. Nevertheless, although there were some factors that could limit the surge of additional inflationary pressures, the possible reversion of transitory factors that had previously contributed to a sharper decline of inflation in 2001, along with other sources of inflationary pressures, led the Board of Governors of Banco de México to keep the “short” unchanged during the last quarter of the year.

Exchange Rate Policy

During 2001, Mexico’s exchange rate policy was conducted as per the guidelines established by the Foreign Exchange Commission. Since 1995, Mexico has operated under a floating exchange rate regime.

In May 2001, the Foreign Exchange Commission considered that the stock of net international assets accumulated at that date no longer justified the use of the above mechanism and therefore it was suspended until further notice after the June 29, 2001 auction. In order to preserve the symmetry of the floating exchange rate regime in force, the Foreign Exchange Commission also decided to stop contingent US dollar sales starting July 12, 2001.

In those months where the mechanism for auctioning call options by the Central Bank was in force, 1.5 billion US dollars were auctioned (250 million US dollars per month), of which 1.36 billion were exercised. The automatic currency-sale mechanism was not used during the period.

During 2001, the floating exchange rate regime allowed short-term uncertainty regarding the performance of the Mexican economy to be absorbed through temporary fluctuations in the exchange rate. The terrorist attacks of September 11 led to a slight depreciation that was largely reverted by the end of October.

The exchange rate followed an appreciation trend throughout 2001, reaching 4.6 percent at the end of the year. This behavior can mainly be explained by the large amount of capital inflows resulting from favorable medium-term expectations on the

Mexican economy, Mexico's sound external accounts, and the reduction of country and exchange rate risks.

V. Final Remarks

Despite being affected by an adverse international environment in 2001, the Mexican economy managed to enter the world business cycle in an orderly manner due to the country's sound economic fundamentals, among which the following are:

(a) The positive results regarding disinflation.

(b) The discipline of public finances.

(c) The floating exchange rate regime and market-determined interest rates.

(d) The comfortable foreign public debt amortization schedule in 2001 and 2002.

(e) The stability of foreign investment fostered by previous structural reforms.

(f) The moderate current account deficit.

Notwithstanding the expected recovery of world growth, it is unlikely that economic activity of Mexico's main trading partners will return to the levels seen before the current downturn. Besides, Mexico's output in recent years has been adversely affected by rising unit labor costs originated by real wage increases and falls in productivity. This loss of competitiveness could curb the country's capacity to expand at the moment when economic activity in the United States rebounds. This brings to fore the need to reinforce the domestic factors that will allow Mexico to reach high and sustainable growth rates under a less favorable international environment. Among these factors, the following should be mentioned:

(a) Maintaining macroeconomic stability.

(b) The energy sector reform.

(c) Improvements in the economic regulation framework.

(d) The promotion of capital market development and of higher domestic saving rates.

(e) Incentives for investing in infrastructure, technology, education and health.

(f) The labor market reform.

The above reforms are essential to achieve the needed productivity gains to foster job creation, improve real wages and allow economic growth in the medium term.

Perseverance in monetary and fiscal discipline will be crucial to return to the path of high and sustainable growth. In this regard, the results obtained in 2001 are very promising because they were achieved in a context of adverse international environment. The attainment of macroeconomic objectives in previous years strengthened the credibility of economic policy authorities. Thus, the results obtained in 2001 should have a considerably positive impact since they were attained under very severe economic disturbances.

For 2002, the Federal Government and Congress have confirmed their firm commitment to continue implementing prudent fiscal policy in the midst of an uncertain environment.

Regarding monetary policy, the Board of Governors of Banco de México reiterates its commitment to attain an inflation rate of less than 4.5 percent in 2002 and approximately 3 percent by 2003. The Central Bank will use the instruments at its disposal in a timely and effective manner to ensure an environment of low and stable inflation that, together with the recovery of economic growth, will lead to a sustainable improvement in Mexicans' welfare.