REPORT ON MONETARY POLICY

JANUARY 1, 1995 – DECEMBER 31, 1995

BANCO DE MEXICO

JANUARY, 1995

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FOREWORD [1]

In accordance with Article 51, Section I, of the Bank of Mexico's Law [Ley del Banco de México], the Board of Governors of this Institution hereby sends the Federal Executive and the Congress of the Union this exposition on monetary policy for the period of January 1 to December 31, 1995.

(1) The 1994 figures are preliminary and subject to revision.

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Introduction

In accordance with Article 28, sixth paragraph, of the Mexican Constitution, and its respective bylaw, the Bank of Mexico's primary objective is to secure the stability of the national currency's purchasing power.

In order to fulfill this mandate, the Bank has the power to autonomously manage its own credit. In economic literature, as well as in this exposition, this power is understood as being synonymous with the authority to determine monetary policy. However, in the strictest sense, monetary policy also involves exchange rate policy.

Even possessing the aforementioned authority, a central bank cannot directly control the evolution of the general price level. Its influence on such evolution is revealed through the effect of its actions upon aggregate demand. In addition, there is an ample range of factors foreign to any central bank that affect the evolution of prices. Therefore, the usefulness of the Agreement to Overcome the Economic Emergency and the Central Institute being a signatory of it. This Agreement and the "Pacts" that have preceded it have been valuable instruments in coordinating various economic policies —among which are the exchange rate, monetary, fiscal and wage policies— with the common purpose of reducing inflation.

It is important to analyze the context in which monetary policy is implemented, for the adoption of a monetary policy suitable to each situation is a necessary, although not sufficient, element in order to achieve price stability. The first section of this document deals with this issue, and hence provides a brief description of Mexico's economic situation during 1994. The second section analyzes the evolution of monetary and exchange rate policies in said year. The third section presents the monetary policy for 1995, in the context of the floating exchange rate regime now in effect.

In regards to the mandate to secure the stability of the peso's purchasing power, it is appropriate for the Bank of Mexico to establish quantitative targets for the reduction of inflation, both for the year to which this report corresponds and for the medium and long terms. This is the substance of the fourth section of this document.

I. ECONOMIC SITUATION IN 1994.

I.1. Production and Employment.

Economic activity in Mexico significantly recovered in 1994. According to the most recent estimates, Gross Domestic Product (GDP) increased by 3.1 percent[1] in that year, owing to the expansion of investment and consumption expenditures, as well as the faster growth of exports of goods and services. The improvement in economic activity during 1994 should be considered as satisfactory, particularly if one remembers that serious disturbances of domestic and external origin took place in that year.

1 All rates referred to in sub-section I.1 are rates in "real terms".

The recovery of economic activity was evident by the second quarter of 1994 (see Charts 1 and 2). In the first, second and third quarters, real GDP grew at annual rates of 0.5, 3.8 and 4.5 percent, respectively. All components of aggregate demand contributed to said recovery. The gross capital formation expanded at very high rates —more than 8 percent— in response to the ample investment opportunities that had arisen in recent years and that widened with NAFTA. Construction grew at a particularly high rate (7.7 percent), only surpassed by investment in machinery and equipment (8.5 percent). The latter showed increases in its imported goods component as well as in domestically produced goods.

The expansion of consumption was driven by higher real wages and by a certain degree of recovery in employment. In the first three quarters of 1994, total consumption increased 2.5 percent in relation to the same period of the previous year; its private and public components rose by 2.4 and 3.3 percent, respectively. Consumption expanded at a lower rate than GDP. This implies an increase in Mexico's domestic savings rate. In addition, the volume of goods and services exported remained high for all of 1994, posting an 8 percent growth rate for the first three quarters of the year, with respect to same period of the year before[1].

The improvement of production extended to many sectors of the economy. Industrial production grew at a rate of 4.2 percent for the first ten months of the year with respect to the same period of 1993, propelled by its

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1 This rate is significantly lower than that of goods and services exported as measured in dollars. This is mainly due to the fact that figures on the volume of exports, taken from National Accounts, are calculated using fixed weights of 1980. In this year the proportion of oil exports to total exports was much larger than that reported in recent years, for the former have since remained practically stable.

main three divisions —construction, manufacturing and electricity. These grew at annual rates of 8, 3.3 and 7.4 percent, respectively.

The recovery of economic growth in 1994 translated into an increase in employment. Employment in the private formal sector can be measured through the number of workers affiliated to the Mexican Social Security Institute (IMSS). From January to November, the total number of workers affiliated to IMSS increased by 453.3 thousand (see Table 2 and Chart 3)[1] . The increment was especially large in the manufacturing sector, particularly in the areas of textiles and apparel, base metals, and metal products and machinery. Employment behavior in the services, commerce and construction industry sectors was also favorable. The in-bond industry for export continued actively hiring personnel in 1994: in the first ten months of the year, employment in this industry rose at a 7.2 percent average annual rate.

Table 1
QUARTERLY GROSS DOMESTIC PRODUCT
Annual percentage changes
over same period of previous year

	1993			1994			
	III	IV	Year	I	II	III	I-III
TOTAL	-0.8	-0.1	0.4	0.5	3.8	4.5	2.9
PRIMARY SECTOR	10.5	-0.3	1.8	-3.7	11.2	-5.3	0.9
INDUSTRIAL SECTOR	-3.2	0.1	-0.2	-0.1	4.8	6.9	3.8
Mining	-0.6	4.7	1.1	3.8	1.1	1.9	2.3
Manufacturing Industry	-4.7	-1.6	-1.5	-1.9	4.5	6.6	3.0
Construction	-0.6	3.5	-3.1	3.9	8.0	10.8	7.5
Utilities	4.4	2.4	3.9	4.5	7.3	9.3	7.1
SERVICE SECTOR	-0.4	0.2	0.9	1.4	2.5	4.6	2.8
Commerce, restaurants and hotels	-4.1	-2.4	-1.2	-0.3	1.4	5.2	2.1
Transportation, warehousing and communications	1.6	1.5	2.4	4.1	8.8	9.1	7.3
Financial, insurance and leasing	5.4	4.7	4.9	4.2	4.3	4.9	4.5
Community, social and personal services	0.7	0.8	1.1	1.1	0.5	1.5	1.0

1 This figure results from an increase of 409.9 thousand permanent workers and of 43.4 thousand temporary workers. In order to compute these figures, the following items are subtracted from the total number of affiliated workers: insured doctors (collectively and individually), students, voluntary continued coverage, insured doctors' families, and not identified.

Source: *Sistema de Cuentas Nacionales de México, INEGI.*

Chart 1

REAL GDP AND MAIN COMPONENTS
OF AGGREGATE DEMAND
(Annual percentage changes)

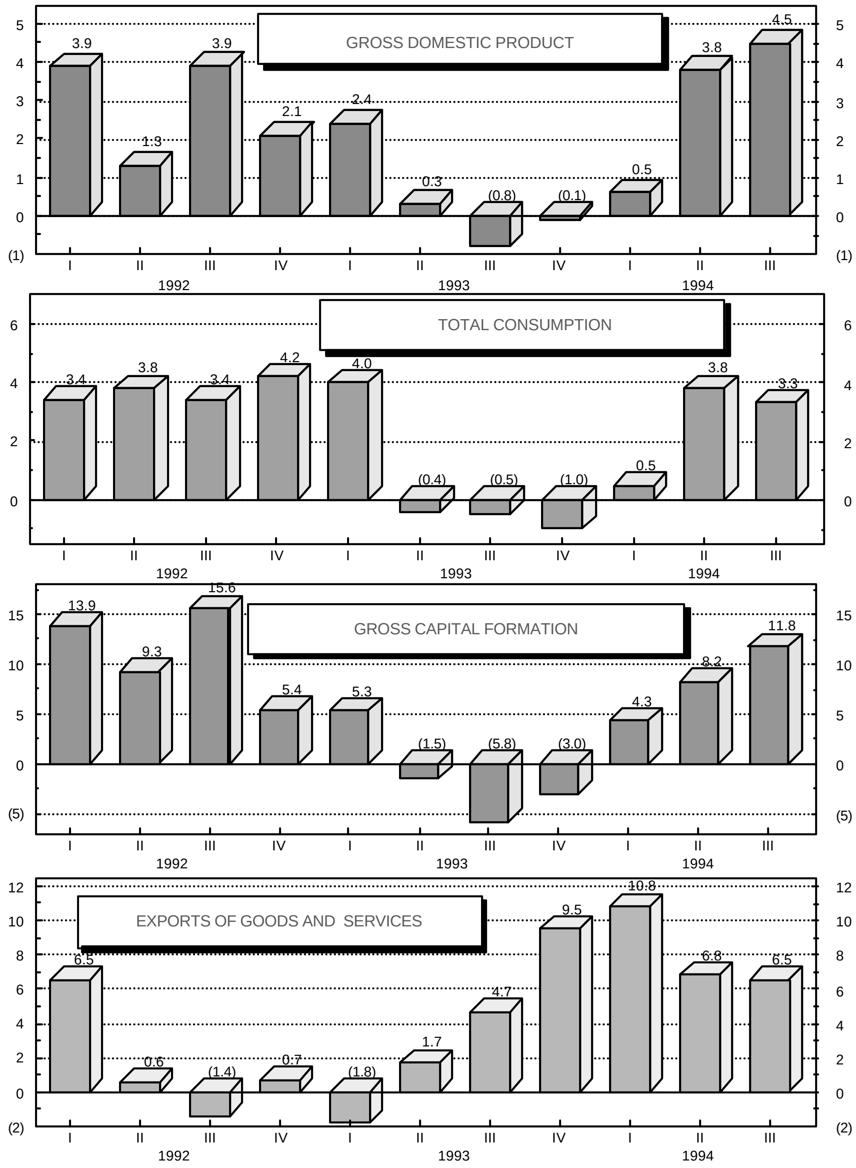
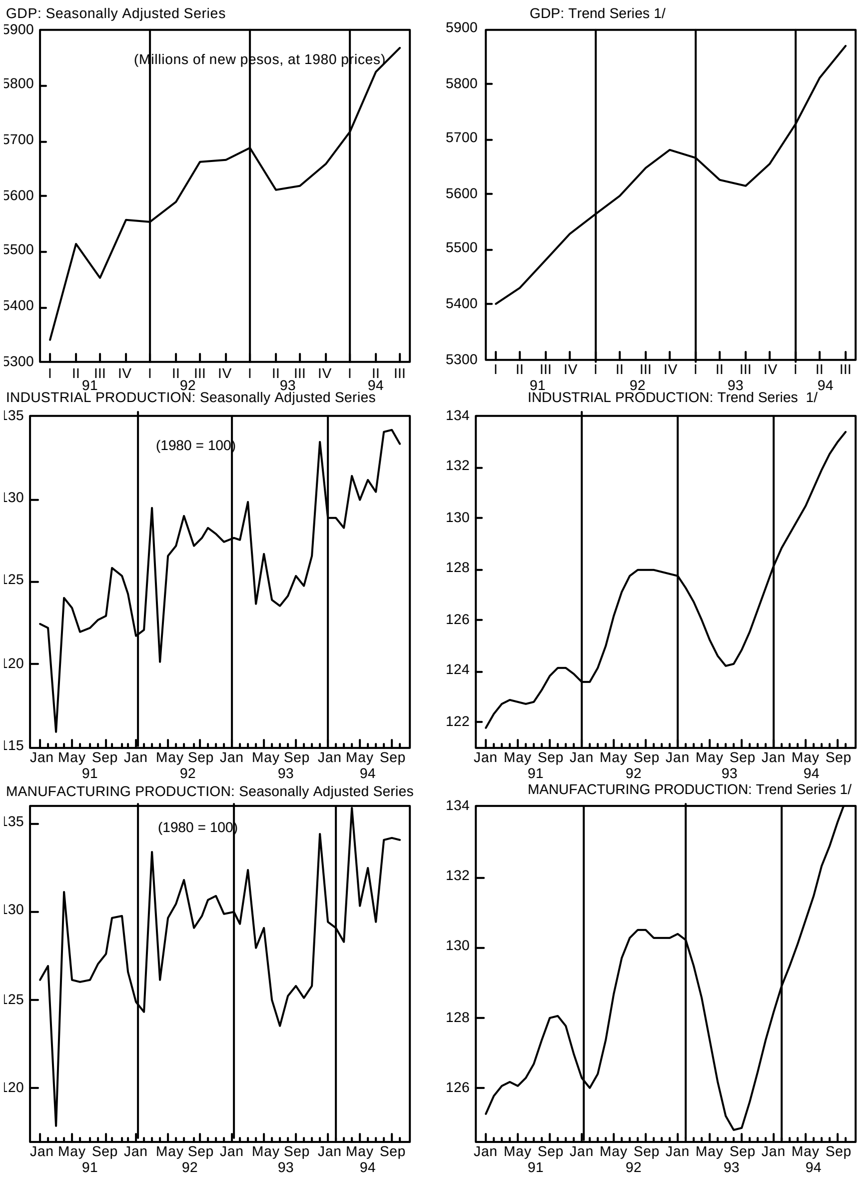


Chart 2

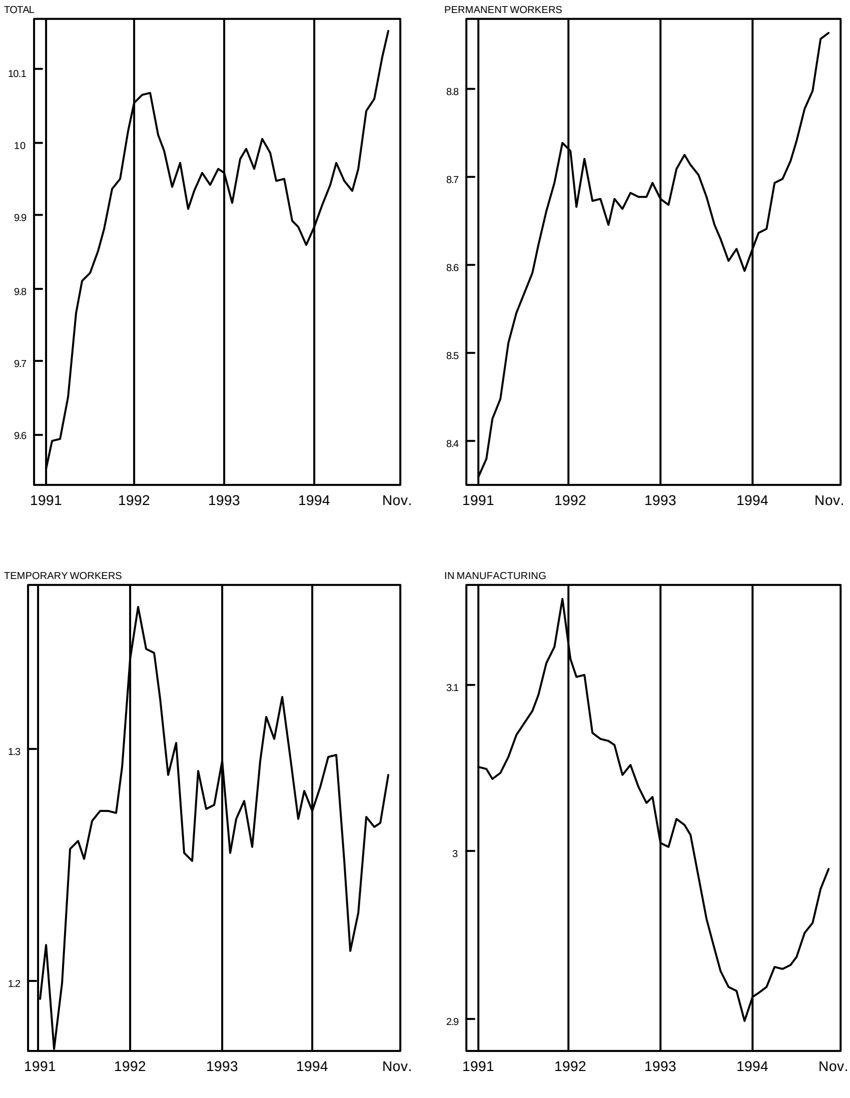
INDICATORS OF ECONOMIC ACTIVITY



1/ The so-called "trend series" is the result of eliminating seasonal variations and abrupt swings from a series of statistical data.

Chart 3

WORKERS AFFILIATED TO IMSS
SEASONALLY ADJUSTED SERIES
MILLIONS OF AFFILIATES



The remarkable upward trend of productivity in the manufacturing sector in the last few years was magnified in 1994 (see Chart 4). In the first ten months, average productivity per worker rose at a high rate (10.1 percent)[1] . This made it possible for the unit cost of labor in this sector to decline 5.8 percent —thus increasing the international competitiveness of Mexican manufactured products— notwithstanding a 3.7 percent rise in average real wages paid to workers.

Table 2

EMPLOYMENT

Annual percentage changes

	1992	1993	1993		1994			
	Annual	Annual	III	IV	I	II	III	Oct-Nov
Affiliates of IMSS								
Total	2.0	-0.4	0.2	-0.8	-0.3	-0.4	0.6	2.5
Permanent Workers	1.6	-0.3	-0.2	-0.9	-0.6	-0.1	1.4	2.9
Manufacturing	-0.5	-3.2	-3.6	-4.0	-3.1	-2.4	0.2	2.3
Agriculture & Livestock	-7.5	-4.7	-1.2	1.7	-0.5	-0.7	-2.2	-1.8
Mining	-10.3	-12.8	-13.8	-14.9	-11.0	-2.9	4.5	10.2
Construction	10.6	3.1	6.1	0.3	2.1	-0.3	-1.3	2.6
Personnel Employed by In-bond Industry	7.5	7.1	6.6	5.7	4.4	7.3	8.7	10.5(1)

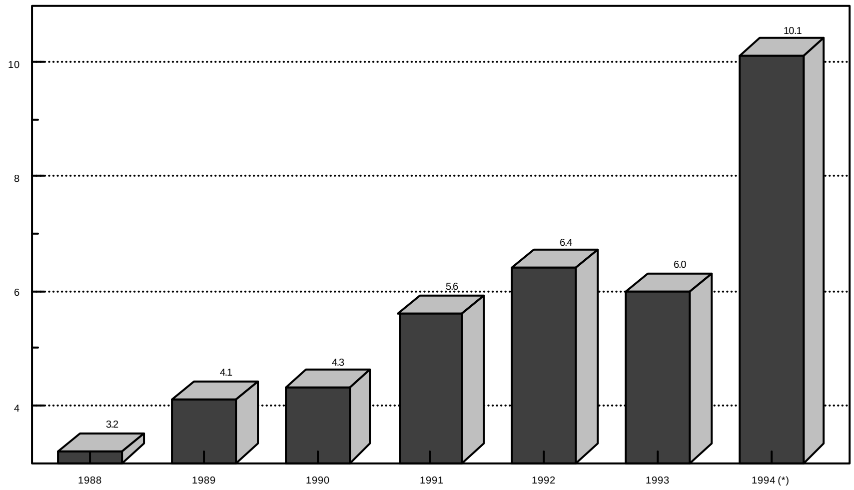
(1) Refers to October. The annual rate for the January-October period is 7.2 percent.

1 Increases in productivity per worker can stem from one or more sources, such as better technology, the use of more efficient equipment, or more dedicated employees.

Chart 4

AVERAGE PRODUCTIVITY PER WORKER IN MANUFACTURING

(Annual percentage changes)



(*) January - October

I.2. External Sector.

The evolution of the external sector throughout 1994 was characterized by the following: a) favorable growth in total merchandise exports —originating in non-oil sales, since oil exports remained practically unchanged—; b) acceleration in the growth of manufactured exports, by both in-bond and non in-bond industries; c) recovery in the growth of imports of all kinds of goods, mainly in response to the start of NAFTA and renewed economic growth; d) higher levels for the balance of payments' trade and current account deficits; e) reversal, during certain periods, of capital flows into Mexico, in the aftermath of political or criminal incidents with vast negative impacts. The exchange rate regime finally became unsustainable when these events coincided with the perception that the current account deficit could not be financed much longer.

Table 3

TRADE BALANCE

Millions of dollars

	1993	1993 January-November	1994 January-November	Absolute Change	Percentage Changes 1993	Percentage Changes 1994(1) Jan.-Nov.
	(1)	(2)	(3)	(3-2)		
Total Exports	51,886	47,207	55,526	8,319	12.3	17.6
Oil Exports	7,418	6,912	6,737	-175	-10.7	-2.5
Non-Oil	44,468	40,295	48,789	8,494	17.4	21.1
Agriculture & Livestock	2,504	2,279	2,358	79	18.6	3.4
Minerals	278	252	319	67	-21.9	26.5
Manufactures	41,685	37.763	46,112	8,348	17.7	22.1
In-bond Industries	21,853	19,840	24,072	4,233	17.0	21.3
Other	19,832	17,924	22,039	4,115	18.5	23.0
Total Imports	65,367	59,468	72,376	12,908	5.2	21.7
Consumption Goods	7,842	7,077	8,576	1,499	1.3	21.2
Intermediate Goods	46,468	42,373	51,717	9,345	8.5	22.1
In-bond industries	16,443	15,130	18,782	3,652	18.0	24.1
Other	30,025	27,243	32,936	5,693	3.9	20.9
Capital Goods	11,056	10,018	12,082	2,064	-4.3	20.6
Trade Balance	-13,481	-12,261	-16,850	-4,589	-15.4	37.4

(1) Over same period of previous year.

In the first eleven months of 1994, the trade deficit was 16.850 billion dollars, representing a 4.589 billion dollar increase over same period of 1993. For that same time interval in 1994, the current account deficit was 27.022 billion dollars.

It is important to note that in the first eleven months of 1994 total merchandise exports grew 17.6 percent over the level reached in the same period of the previous year. This rate was even larger than that for 1993 (12.3 percent). Manufactured exports grew 22.1 percent in the first eleven months of 1994, the highest rate since 1989. Thus, manufactured exports accounted for 83 percent of total merchandise exports. The dynamics of non-oil exports, and particularly manufactured exports, in 1994, reflected the greater international competitiveness achieved by the Mexican economy. This competitiveness is the result of structural changes and large private investments that have taken place in Mexico in the last few years. In fact, the significant expansion of non-oil exports has surpassed the performance of most nations of the world.

Between January and November 1994, the capital account of the balance of payments posted a 14.592 billion dollar surplus (this surplus was certainly less in December, for in that month important capital outflows took place), after having reached 23.778 billion dollars in the same period of the previous year (30.882 billion for 1993 as a whole). The inflow of portfolio foreign investment between January and November of last year reached 4.716 billion dollars. This amount is the combination of inflows to the stock market for 3.802 billion dollars, and to money markets for 914 million dollars. Thus, net portfolio foreign investment was 57 percent less than in 1993 (see Table 4). In 1994, capital inflows from private borrowing abroad also decreased from the year before.

Table 4
CAPITAL ACCOUNT OF THE BALANCE OF PAYMENTS
-Millions of Dollars-

	1993		1994	CHANGES	
	JAN-NOV	JAN-DEC	JAN-NOV	%	ABS.
	(1)		(2)	(2)/(1)	(2)-(1)
Foreign Direct Investment	4541.6	4900.6	7819.1	72.2	3277.5
Portfolio Foreign Investment	11056.6	17201.6	4716.1	-57.3	-6340.5
Stocks	7029.3	10716.6	3802.0	-45.9	-3227.3
Money Market	4027.3	6485.0	914.1	-77.3	-3113.2
Net Borrowing	12097.6	12859.4	7614.7	-37.1	-4482.9
Public	1572.4	1488.6	2491.4	58.4	919.0
Private	10525.2	11370.8	5123.3	-51.3	-5401.9
Other 1/	-3917.6	-4079.3	-5558.2	41.9	-1640.6
TOTAL	23778.2	30882.3	14591.7	-38.6	-9186.5

1/ Refers to assets abroad.

In contrast, foreign direct investment showed a very favorable evolution, having reached approximately 8 billion dollars. This amount is 70 percent larger than that for 1993. Said investment flowed continuously throughout the year, without being interrupted by the aforementioned negative events. This is indicative of foreign direct investment being determined by the favorable medium and long term profitability outlook of investment projects.

Chart 5

PORTFOLIO FOREIGN INVESTMENT

Flows in millions of dollars

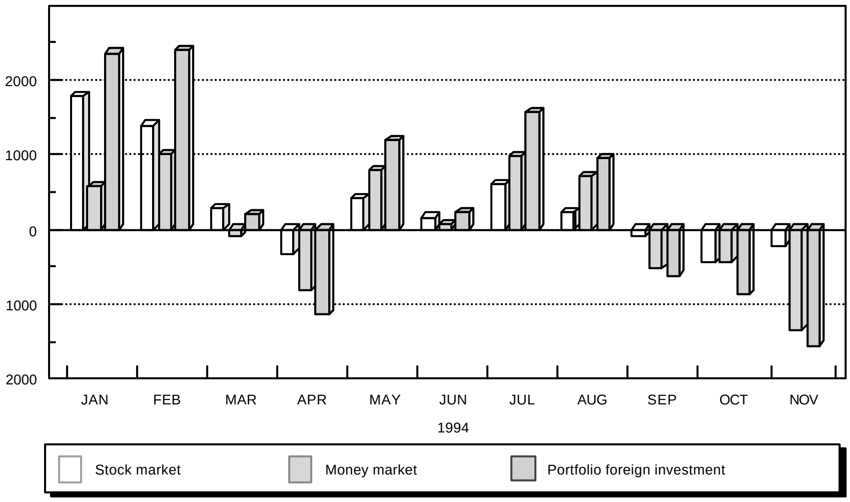
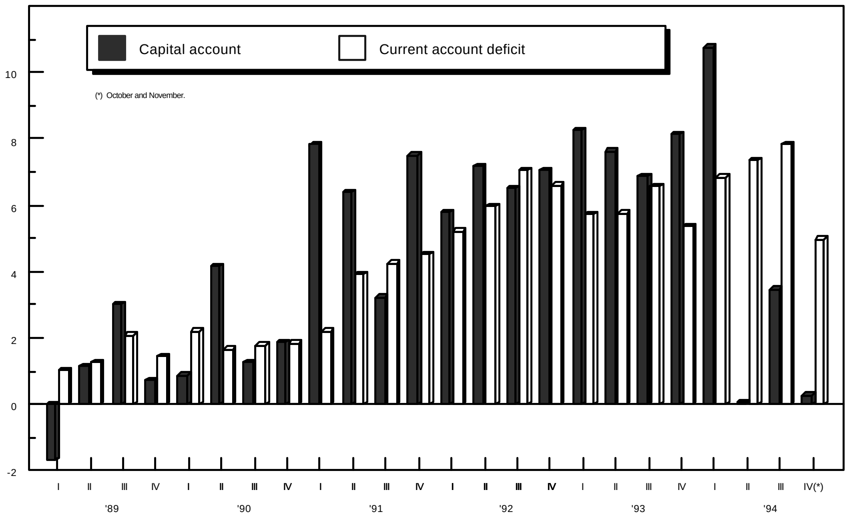


Chart 6

CURRENT ACCOUNT DEFICIT VS. CAPITAL ACCOUNT

Billions of dollars



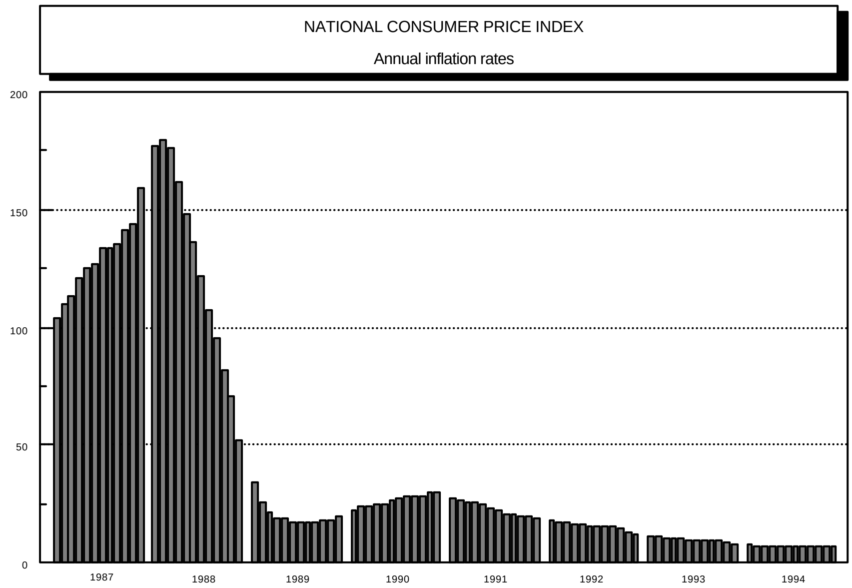
I.3. Inflation.

I.3.1. Consumer Prices.

Consumer inflation, as measured by the National Consumer Price Index (INPC), reached 7.05 percent between December 1993 and December 1994 --the lowest inflation in the last 22 years.

The moderate inflation of 1994 is attributable to several factors: (a) the Mexican economy's openness to competition from abroad, which allowed the expansion of domestic demand to be met by a supply of goods and services capable of responding swiftly; (b) the limited impact on prices of adjustments in the exchange rate, within the flotation band, between January and December 19 —which is attributable to a reduction in the marketing margins on imported goods or on those containing a substantial proportion of imported components— and; (c) a monetary policy geared to lowering inflation.

Chart 7



In order to analyze more precisely the structure of inflation, it is useful to classify, in the four traditional groups, those goods included in the basket of the National Consumer Price Index (INPC): goods and services included in the basic basket, merchandise not included in the basic basket, services not included in the basic basket, and fruits and vegetables. The following table shows the annual price changes in 1994 for the groups just mentioned.

Table 5

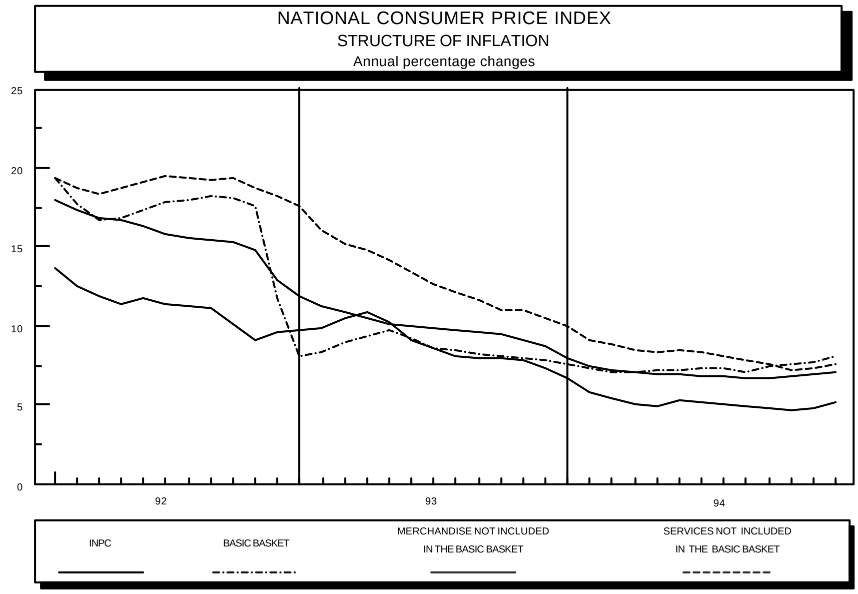
National Consumer Price Index

Percentage changes

	Dec. 92 / Dec. 91	Dec. 93 / Dec. 92	Dec. 94 / Dec. 93	Weights for the Index
GENERAL INDEX	11.9	8.0	7.1	100.00
Basic Basket (B.B.)	8.1	7.5	8.1	35.29
Publicly Produced Goods & Services	5.9	11.2	7.6	8.59
Privately Produced G. & S.	9.0	6.0	8.3	26.70
Merchandise not included in B.B.	9.7	6.6	5.1	31.54
Services not included in B.B.	17.6	10.0	7.6	28.29
Fruits and Vegetables	14.3	2.6	6.1	4.88

As the table shows, in 1994 the prices of services not included in the basic basket were those that posted the largest accumulated growth (7.6 percent); however, for the first time in several years, their increase was similar to that of the general average (see Table 5 and Chart 8). The group referred to is mainly composed of services not exposed to international competition, and whose prices largely depend on wages. In 1994 these prices rose 9.0 percent, while in 1993 they went up 15.4 percent. Therefore, moderation in wage increases was a very important factor in the decline of the inflation rate for non-basic services.

Chart 8



The above chart clearly shows the minor increment in the prices of merchandise not included in the basic basket (5.1 percent). This happened in spite of the significant rise of external inflation measured in pesos during said period (12.6 percent)[1] . The following reasons explain the aforementioned phenomenon:

a) The start of NAFTA brought about lower protection levels in trade. This exerted a downward influence on the prices of certain products (clothing, furniture, household appliances, dairy products, meat, spices, household linen, school supplies, auto-parts). The effect of lower tariffs on the INPC for 1994 is estimated at 0.6 percentage points.

1 Measured by the evolution of the dollar/peso exchange rate and the United States' consumer price index, without taking into consideration the abrupt movement in the exchange rate at the end of December, 1994. Given that the December devaluation did not start to show its effects until the end of that month, these effects did not significantly affect prices in the monthly average. Therefore, the effects of the December devaluation are not evidently depicted in the 5.1 percent annual inflation rate.

b) Producers established in Mexico who did not succeed in increasing the efficiency of their companies enough had to reduce their profit margins. They had to do this in order not to lose market share to imports. Traditional outlets were also pressured to reduce their margins in the face of an increasing number of supermarkets with advanced technology.

c) It is possible that, since before early 1994, many entrepreneurs had already reflected in their prices part of the peso's depreciation, which began in February. This as opposed to having used the ceiling of the flotation band as the standard for fixing their prices. This hypothesis seems valid because from December 1991 to December 1993 the increase in the prices of non-basic merchandise was 15.1 percent, whereas external inflation measured in pesos —on the basis of the market exchange rate— was only 6.9 percent. If measured on the basis of the flotation band's ceiling, external inflation would have been 13.7 percent.

d) The extent of the underground economy probably also had an impact on the price level of these types of goods.

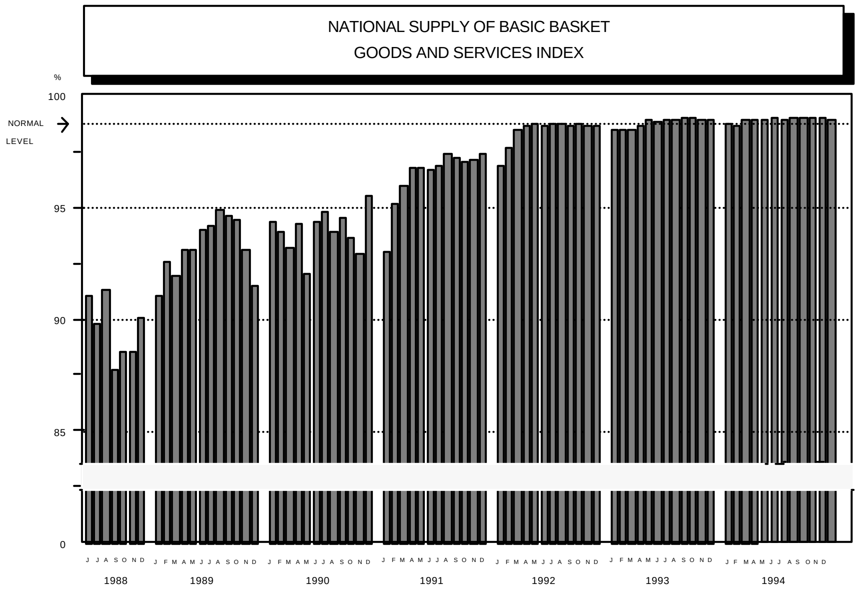
In relation to the prices of goods and services included in the basic basket, the corresponding index rose 8.1 percent in 1994. This rate is higher than the general inflation and the highest of the four traditional groups'. This fact is mainly explained by the very sharp rise in the prices of certain products, such as coffee (79.9 percent), pharmaceuticals (17.6 percent), soft drinks (15.9

percent), bread (17 percent) and vegetable oil (20.5 percent). The case of coffee mirrors the large increase in its international price. In the case of bread it is important to remember the marked boost in the international price of wheat. The rise in the prices of pharmaceuticals, soft drinks and vegetable oil is explained by the ongoing gradual liberation of their prices. The moderate advances in the prices of gasoline (5.7 percent), electricity (5 percent) and tortillas (3.3 percent) were instrumental in partially counteracting the effect of increases in the prices of the previously mentioned products.

I.3.2. Supply of basic goods

In 1994, the index for the supply of basic goods reached the highest level since 1980, when it was first calculated. According to the Bank of Mexico's surveys, in 1994 the level of supply of basic products, as well as of other merchandise, was practically optimal.

Chart 9



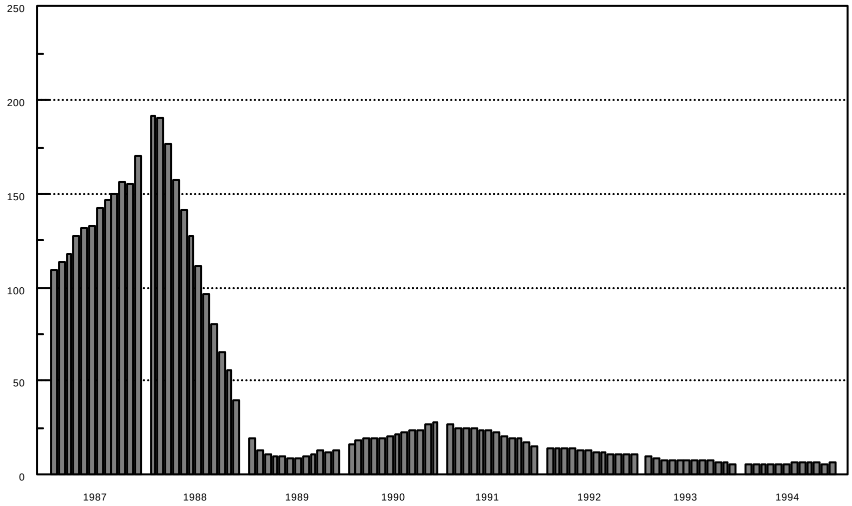
I.3.3. Producer Prices.

The National Producer Price Index, excluding crude oil for export, rose 7.1 percent in 1994. This rate was 1.2 percentage points larger than that for 1993.

Chart 10

NATIONAL PRODUCER PRICE INDEX EXCLUDING OIL

Annual percentage changes



The rise in producer prices during 1994 is mainly due to the 20.3 percent increase in export goods' prices (2.0 percent in 1993). In turn, the rise in the prices of final goods was 6.2 percent (6.1 in 1993). The increase in the sub-index corresponding to goods for export was a result of the evolution of the international prices of goods that Mexico sells abroad and the depreciation of the exchange rate. Of the 20.3 percent increase just mentioned, 12.7 percentage points correspond to the impact of external prices, and the remainder to the adjustment in the exchange rate.

Table 6

National Producer Price Index [1/]

Percentage changes

	Dec. 92 / Dec 91	Dec. 93 / Dec. 92	Dec. 94 / Dec. 93	Weights on the Index
GENERAL INDEX	10.4	5.9	7.1	100.00
Domestic Demand	10.4	6.1	6.2	92.40
Families' Consumption	10.9	5.8	6.6	63.84
Government's Consumption	7.6	5.6	6.8	1.15
Investment	8.9	7.2	5.1	27.41
Exports	10.4	2.0	20.3	7.60

1/ This indicator does not include the Service Sector.

I.4. Public Finances.

At the printing of this document, no final figures for 1994 were yet available. During the first three quarters of the year, the public sector's economic balance registered a surplus of 5,500 million new pesos, equivalent to 0.4 cent of GDP. The primary balance from January to September was a surplus of 31,800 million new pesos, 2.6 percent of GDP. These figures correspond to a cash-flow methodology, measured "above the line".

Among public sector policy actions that affect aggregate demand, the supply of credit granted by national development banks and trust funds is very important. The remarkable growth of this item in 1994 was a crucial factor in the expansion of aggregate demand. Estimates show a 55,000 million new peso increase in the stock of credit supplied by these institutions to the private and social sectors. This figure is equivalent to 4.4 per cent of GDP, 1.9 percentage points higher than in 1993.

II. EXCHANGE RATE AND MONETARY POLICIES IN 1994.

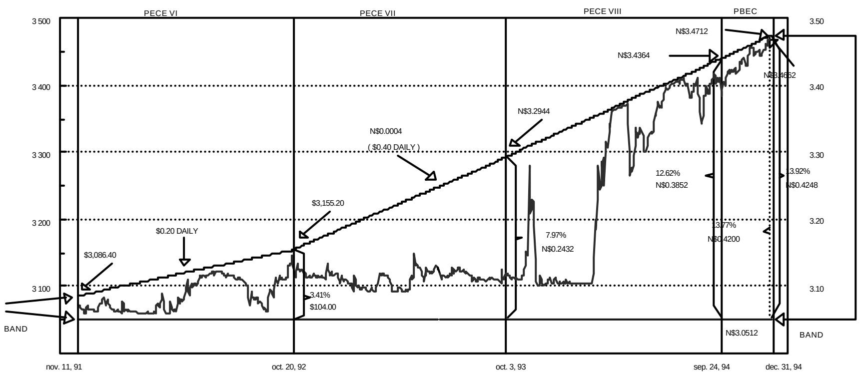
II.1 Exchange Rate Policy.

From 1985 and until March 31, 1994, exchange rate policy was determined by the Credit and Foreign Exchange Commission of the Bank of Mexico. As of April 1, 1994, and in compliance with Article 21 of the Central Bank's Law, the exchange rate policy is determined by the Foreign Exchange Commission. This Commission is formed by the Secretary of Finance and Public Credit, the Deputy Secretary of Finance, another Deputy Secretary of this Ministry, the Governor of the Central Bank and two other members of this Institution's Board of Governors. The Statutes of both Commissions state that the definition of the exchange rate policy ultimately lies within the jurisdiction of the Federal Executive, via the Finance and Public Credit Secretary.

During most of 1994, the exchange rate regime established in November 1991 was kept in effect. This regime allowed the exchange rate to fluctuate within a daily widening band. From October 20, 1992, the band's ceiling increased by 0.0004 new pesos per day, while its floor remained at 3.0512 new pesos per dollar during this whole period (see Chart 11). On December 20, the band's ceiling was raised by 15 per cent, maintaining the 0.0004 new pesos daily increase. As this proved unsustainable, the band regime was abandoned and a floating exchange rate regime was adopted on December 22.

Chart 11

EXCHANGE RATE REGIME
In effect from November 11, 1991, to December 19, 1994



NOTE: On January 1, 1993, a new monetary unit was introduced, the new peso (N$), at a rate of N$ 1 for each $ 1,000 "old" pesos.
PECE means Pact for Stability, Competitiveness and Employment, signed by the Federal Government, labor unions, campesino organizations and the entrepreneurial sector.
* Natural days
Last datum: December 19, 1994.

Beginning the second half of February, the foreign exchange market was recurrently subject to pressures. Since then, not only did interest rates in the United States start to rise, but also a series of political and criminal events in Mexico caused uneasiness regarding the country's political stability.

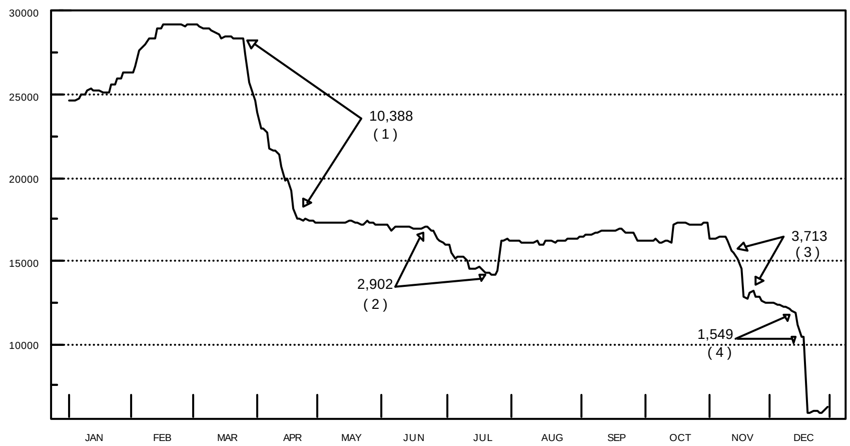
In March, accentuated increases in the exchange rate followed a series of dire criminal incidents: the kidnapping of a prominent banker and, above all, the tragic assassination of the presidential candidate of the Institutional Revolutionary Party. For the remainder of the year, the exchange rate stayed at a level close to the upper limit of the band, reaching this limit at certain intervals. When the latter occurred, the Bank of Mexico had to intervene in the market in order to prevent the exchange rate from surpassing the limits of its flotation band.

Certain political and criminal incidents coincided with the periods during which the exchange rate reached the band's ceiling. Consequently, international reserves decreased (see Charts 11 and 12). Chart 12 shows the loss of reserves associated with the murder of Mr. Colosio, the resignation of the Secretary of the Interior, the accusations and resignation of the Deputy General Attorney, and with the renewed hostility shown by the Zapatista Movement in Chiapas.

Chart 12

STOCK OF NET INTERNATIONAL RESERVES IN 1994

(Millions of dollars)



(1) Murder of the PRI's candidate for President.
(2) Resignation of the Secretary of the Interior.
(3) Deputy Attorney General's claims.
(4) Intensified hostility of the EZLN.

These capital outflows are not surprising, for political or criminal incidents as those taking place in 1994, tend to abruptly reduce the expected return of investment in a country, after adjusting for risk. This, in addition to the current greater mobility of capital, generates very sharp and significant adjustments in portfolios, which are virtually impossible to counteract with increases in interest rates.

As shown in Chart 12, from the end of April until mid-November 1994, the level of international reserves remained stable, except for some short periods. This fact is significant as it implies that during all this period the net flow of capital into Mexico was of similar proportions to those needed to finance the current account deficit. The global balance of payments remained in equilibrium.

Two reasons explain the above. First, as soon as the foreign exchange market started being under pressure, the exchange rate was allowed to rise within the band's limits; and second, because a restrictive monetary policy was adopted. This policy induced significant increases in interest rates. The reference interest rate (TIIP) —which reflects the interbank money market conditions— rose from 10.8 percent in mid-February to 22.1 percent in mid-April, and remained at high levels, both in nominal and real terms, for the rest of the year (Charts 13 and 14).

The Ministry of Finance and Public Credit and the Bank of Mexico encouraged the substitution of dollar-denominated government paper --Tesobonos, whose value is not affected by fluctuations in the exchange rate-- for peso-denominated government bonds (Cetes, Bondes and Ajustabonos). Thus, the financial authorities offered investors an option to cover their exchange risk exposure. At the same time, offering Tesobonos contributed to a more rigid monetary policy. As evidence of this, it is clear that investors' preferences for Tesobonos were reflecting that the expected yield on this instrument --adjusted for exchange rate risk-- was higher than that on peso-denominated papers. This necessarily implied higher interest rates on peso-denominated paper due to arbitrage possibilities among the different financial instruments available in the market. However, the observed hike in interest rates was less than that which would have been required to achieve equilibrium in financial markets and in the balance of payments had the supply of Tesobonos not been expanded.

Thus, the appropriateness of distributing the burden of the adjustment among more than one variable is apparent. Had the adjustment concentrated on a single variable, its fluctuations would have been higher, more acutely affecting sensitive sectors.

In 1994, the circulation of Tesobonos rose by 26.4 billion dollars. In this regard, it must be mentioned that this allowed a 77,860 million new peso reduction in the outstanding stock of peso-denominated government paper.

Chart 13

RETURN ON 28 DAYS CETES AND TIIP

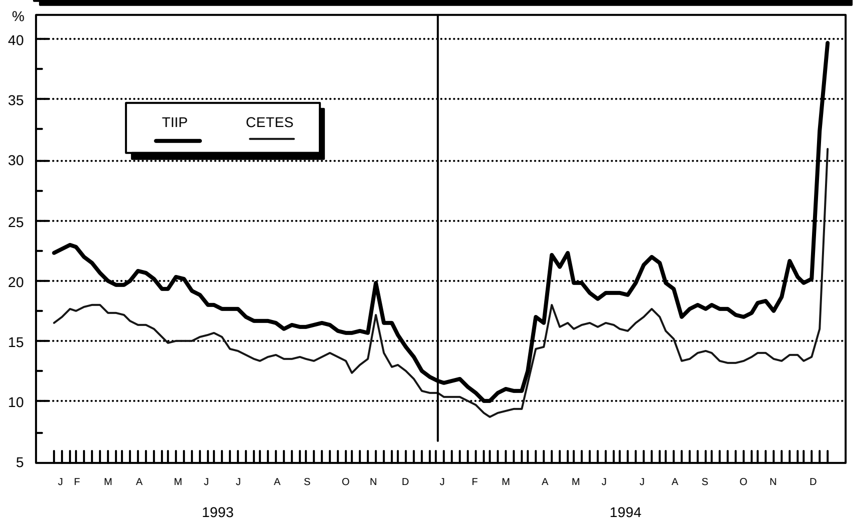
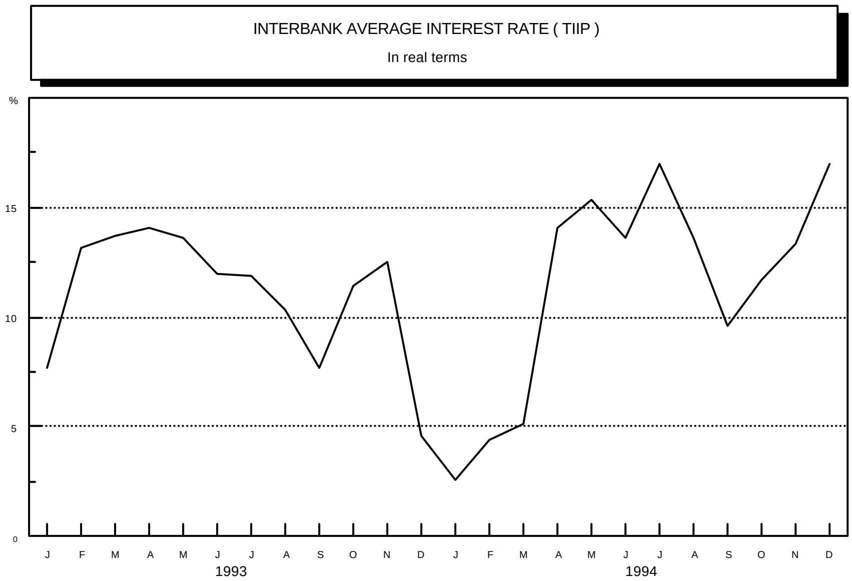


Chart 14



The success in stabilizing the domestic financial market from end-April to mid-November helped the recovery of economic growth with decreasing inflation. However, new unfavorable events occurring in mid-November and from the second week of December on, produced a situation that proved difficult to solve. This was due to: a) the margin for exchange rate adjustments within the band had eroded; b) the level of international reserves had fallen from 16.221 to 11.146 billion dollars from November 11 to December 16; c) real interest rates had reached high levels causing serious difficulties for financial intermediaries and for debtors in general. All these factors, together with a renewed volatility in international financial markets, with some agents' perception of the difficulty for financing the external current account deficit forecasted for 1995 under these circumstances, and with the intensified hostile attitude of the Zapatista Movement on December 19, caused an attack against the domestic currency, which could not be curtailed by previously effective means.

Therefore, on December 19, 1994, the Foreign Exchange Commission agreed to abandon the exchange rate regime, announcing —in the context of the “Pact”— their decision to adopt a floating exchange rate regime. However, some of the signatories of the Pact argued in favor of attempting to stabilize the foreign exchange market by raising the upper limit of the band, before allowing the rate to float. The latter was accepted by the Foreign Exchange Commission. As is widely known, this strategy proved to be unsuccessful. Therefore, it was agreed to establish a floating exchange rate system as of December 22, 1994.

II.2. Monetary Policy and Monetary Aggregates

During 1994, the Bank of Mexico conducted its monetary policy according to the general guidelines established by its Board of Governors, as explained in the document "Exposition on Monetary Policy" of last May. These were:

(1) Daily adjustments on the supply of base money, with the aim of satisfying its expected demand —given market interest rates— and constrained to the resulting variations on base money not jeopardizing the inflationary target. Once this last condition was met, the Bank of Mexico sought not to be contractionary.

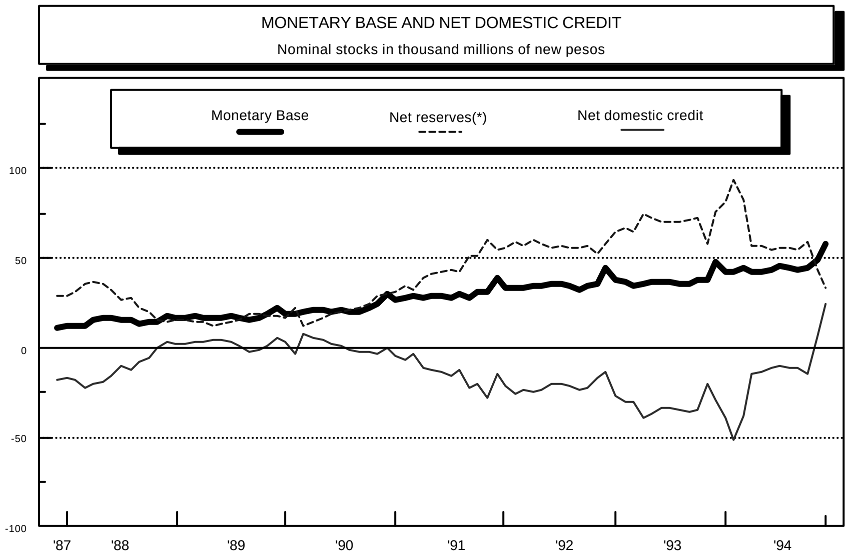
(2) If for any reason, including the emergence of exchange rate pressures, compliance with inflationary targets was jeopardized, the Bank would

continue meeting daily demands of base money —since otherwise the payments system would not clear— but at higher than market interest rates. It should be kept in mind that, other factors being equal, the demand for goods and services and for foreign exchange tends to decline with higher interest rates.

As was amply explained in the previous section, the exchange market was under recurrent pressures during 1994. These pressures created various effects, among which, losses of international reserves during the most critical episodes. Under these circumstances, the central bank adopted a restrictive monetary policy. This was not carried out by contracting the monetary base, but through the conditions by which base money is supplied.

The decline in international reserves was a cause, by itself, of the decrease in the monetary base. This decrease made it necessary to conduct compensatory operations in money markets. If liquidity had not been replenished through these operations, interest rates would have reached very high levels, seriously affecting debtors in general, including financial intermediaries. This could have constituted an additional factor promoting capital flight, which in turn would have required further expansions of primary credit.

Chart 15



* As defined by the Bank of Mexico Law.

The trend of the Bank of Mexico's net domestic credit in 1994 should be examined within the context of its evolution in previous years. As can be seen in Chart 15, net domestic credit decreased significantly between March 1990 and March 1994. This resulted from the large-scale sterilization policy conducted by the Bank of Mexico in order to diminish the inflationary impact of the large capital inflows received by Mexico during those years. In this period, and until as recently as mid-November 1994, international reserves amounted to well over a hundred percent of the monetary base.

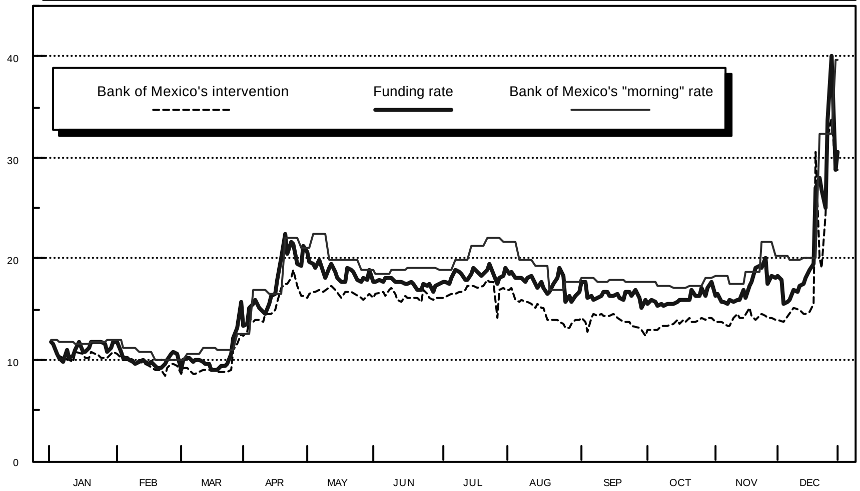
The above-mentioned factors indicate an appropriate, and by no means lax, monetary policy:

(a) During periods of international reserve losses, the Bank of Mexico replenished liquidity at sufficiently high interest rates to reestablish equilibrium in the exchange market. This can be seen in Charts 16 and 12. These charts show that during episodes of reserve losses, interest rates increased.

(b) The Bank of Mexico replenished liquidity through very short-term repo's and credit auctions. Given that the Bank of Mexico charges the maturing operations at the beginning of the day to the accounts that credit institutions hold with the central bank, these institutions are forced to obtain more deposits or to reduce their credit. If they do not succeed, they are forced to resort to the use of credit from the central bank, usually at much higher than market rates.

Chart 16

OVERNIGHT MARKET RATE, BANK OF MEXICO'S OVERNIGHT INTERVENTION RATE IN MONEY MARKETS AND IN THE "MORNING" MARKET
January - December 1994



In the case of Mexico, the demand for cash or currency (bills and coins) is virtually equal to the demand for base money since credit institutions are not forced to maintain deposit reserves with the Bank of Mexico. Given the exchange rate regime in effect up to the establishment of the floating exchange rate system, the demand for monetary base could be satisfied through net domestic credit of the Bank of Mexico and/or the monetization of international reserve increases. Given that international reserves were accumulated after February 1994, net domestic credit had to increase during that period in order to satisfy the excess demand for cash. It should be recalled that the growth of the supply of monetary base —when this growth is mirrored by an increase in its demand of the same amount— does not generate inflationary pressures.

Beginning in September 1993, and all through 1994, an acceleration in the growth rate (at annual rates) of bills and coins in circulation was observed.

Table 7
NOTES AND COINS IN CIRCULATION
Annual Growth Rates

	NOMINAL Circulation	REAL Circulation
DEC. 92	16.2	3.8
1993		
JAN.	14.9	3.3
FEB.	13.8	2.6
MAR.	14.6	3.7
APR.	10.2	0.1
MAY.	9.9	-0.1
JUN.	11.3	1.3
JUL.	11.0	1.2
AUG.	9.2	-0.4
SEP.	13.6	3.8
OCT.	15.3	5.6
NOV.	13.0	3.9
DEC.	12.3	4.0
1994		
JAN.	15.5	7.5
FEB.	17.1	9.2
MAR.	27.8	19.3
APR.	19.4	11.6
MAY.	18.0	10.3
JUN.	20.3	12.6
JUL.	22.4	14.5
AUG.	26.0	18.0
SEP.	24.7	16.9
OCT.	20.5	12.8
NOV. e/	28.6	20.2
DEC. e/	20.6	12.7

Various factors may explain this increase in the demand for cash. Among these factors one might highlight a stronger economic activity starting in the second quarter of 1994, coupled with lower inflation. These factors continued to sustain the remonetization process in the economy, which had been underway for several years. However, the evolution of economic activity and inflation do not fully explain the total increase in the public's demand for currency. The following factors could explain the extraordinary growth in the circulation of cash in 1994.

1. **Substitution of bills and coins for checks.** During 1994, checking account balances in domestic currency abruptly decreased, and at year-end were 8.1 percent below the level observed at the end of 1993. The hypothesis that a significant substitution of currency for checking account balances occurred can be confirmed in Table 8. Thus, the accelerated expansion in currency circulation partly compensated for the decrease in the total balance of checking accounts.

Table 8

MONETARY AGGREGATES AND MONETARY BASE

Nominal Annual Growth Rates

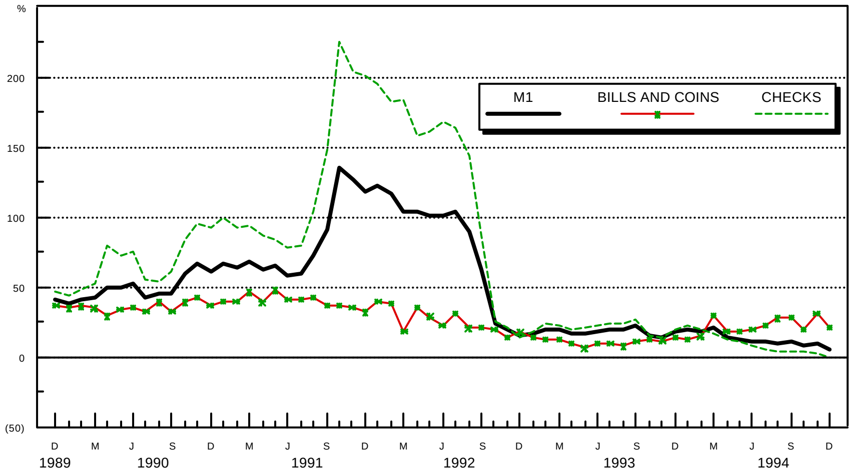
			CURRENCY (M1)				
	M4	M2	M1	CHECKS PESOS.	CHECKS FOR. CY.	BILLS AND COINS	MONETARY BASE
1993							
JAN.	23.5	23.0	17.2	17.8	37.6	13.8	11.4
FEB.	23.2	23.1	20.1	21.7	54.0	13.0	10.6
MAR.	24.8	21.0	19.2	21.9	24.1	12.0	4.9
APR.	26.0	23.2	16.9	20.0	22.7	9.2	1.8
MAY.	26.5	26.1	16.7	21.4	11.9	6.3	4.6
JUN.	28.5	25.3	18.3	22.1	15.4	9.5	2.9
JUL.	27 .5	27.3	20.1	24.5	22.1	9.7	3.3
AUG.	29.5	23.5	19.5	24.1	23.4	7.1	3.8
SEP.	29.8	22.7	21.8	26.5	16.5	10.9	10.1
OCT.	28.4	17.4	14.9	15.7	16.9	12.7	7.0
NOV.	26.1	18.8	13.5	13.3	33.2	11.7	7.6
DEC.	27.3	14.4	17.7	19.8	12.3	13.7	7.3
1994							
JAN.	24.7	12.5	19.5	22.5	13.7	12.8	12.7
FEB.	26.7	12.2	18.6	21.7	-7.8	14.6	15.8
MAR.	25.6	16.3	20.3	16.3	28.4	30.0	29.7
APR.	19.8	15.9	14.5	11.8	37.4	18.5	18.8
MAY.	19.8	13.9	12.4	9.1	37.2	18.0	18.1
JUN.	19.5	15.1	10.6	6.2	34.2	19.4	20.3
JUL.	20.2	17.5	10.2	3.9	45.2	22.2	22.3
AUG.	21.7	21.6	9.9	2.0	49.0	27.4	25.7
SEP.	20.2	19.6	10.2	1.4	66.4	28.2	24.7
OCT.	20.6	21.2	7.5	2.0	34.7	19.0	20.1
NOV.	20.8	18.0	9.5	1.6	11.6	30.5	28.3
DEC.	26.3	24.2	5.7	-8.1	165.7	21.5	21.3

When analyzing the performance of checking accounts, it is useful to consider the public's motives for holding these resources in such accounts. One is the transaction motive. Another, is the possibility of using such accounts as investment instruments.

Chart 17

M1

NOMINAL ANNUAL GROWTH RATE



Fees charged by banks on handling of accounts and on checks issued increased considerably in 1994. The number of checks account holders could issue free of charge decreased.

Table 9

CHARGES ACCORDING TO A SAMPLE OF BANKS (Averages)

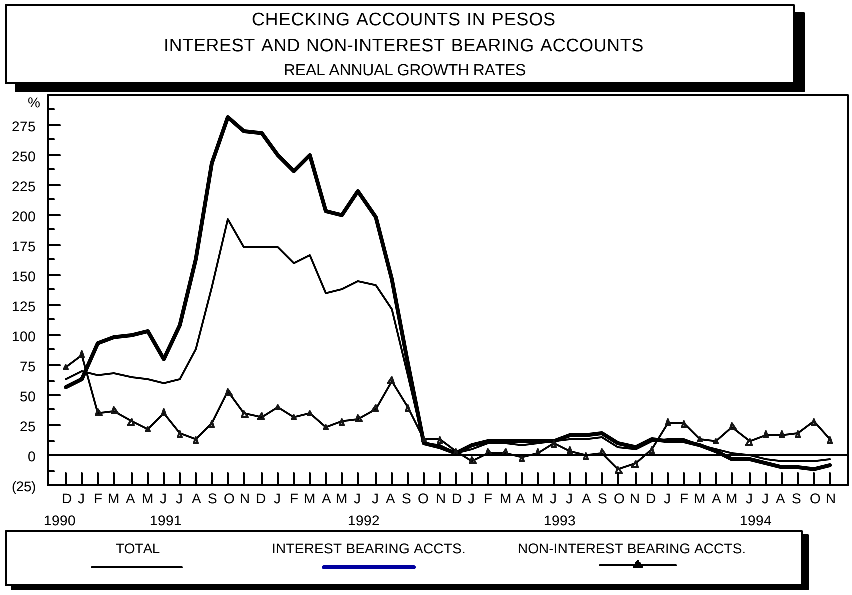
-New Pesos-

	1991	1992	1993	1994
ANNUAL FEE FOR ACCOUNT HANDLING	60.0	66.0	66.0	137.50
ON OVERDRAFTS		126.50	247.50	247.50
CHECKS ISSUED	0.50	0.82	0.82	1.38
CHECKS ON OTHER CITIES	---	---	---	11.00
COMMISSION ON SERVICES (payment of utilities, etc.)	---	---	---	3.30

Commercial banks increased their fees on checks issued and the penalties for balances below a required minimum, mainly to eliminate cross-subsidies among their clients. With the previous structure of fees for checking accounts, banks did not cover the costs of offering these services. The differential was covered by increasing intermediation margins. In any event, it is likely that commercial banks' policies on checking accounts induced many of their clients to prefer using cash.

Starting in April of 1994, commercial banks substantially reduced interest rates paid on checking account balances. This also induced a more intensive use of currency as the lower rates did not compensate clients for the transaction costs of using checks as a means of payment.

Chart 18



An additional factor that could explain the shift away from checking accounts is that commercial banks started charging fees on service payments (electricity, telephone, water, property taxes, etc.) The implementation of such fees induced the public's preference for making these payments in cash directly to the companies providing these services (CFE, TELMEX, etc.). Consequently, this resulted in an increased demand for cash.

2. **Reduction in the use of credit cards.** After the boom in credit card authorizations and the increase in overdue balances that followed, banks decided to adopt stricter norms in this regard. From December 1993 to August 1994, the number of credit card accounts declined by 1.7 percent. Also, the public's perception of greater risk involved in using credit cards —in view of the increasing frequency of fraudulent use and assaults— could have contributed to the reduction in credit card accounts. A decrease of 0.9 percent in real terms can be observed by comparing the outstanding credit card balances for December 1994 against those of a year before. As can be seen in Table 10, the reduction was more significant during the first three quarters. The subsequent recovery of balances resulted, in part, from the restructuring of overdue balances, which are now registered as performing.

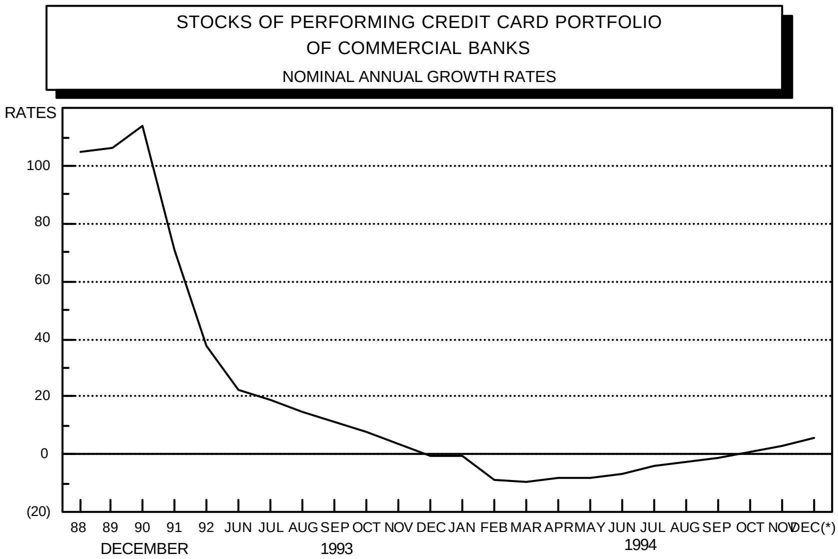
Table 10

STOCKS OF PERFORMING CREDIT CARD PORTFOLIO OF COMMERCIAL BANKS

(Stocks in millions of new pesos)

	TOTAL NOMINAL STOCKS	ANNUAL GROWTH RATES	
		NOMINAL	REAL
1987	1,198		
1988	2,454	104.8	35.1
1989	5,062	106.3	72.3
1990	10,818	113.7	64.5
1991	18,492	70.9	43.9
1992	25,504	37.9	23.2
1993			
JUL.	26,096	18.8	8.3
AUG.	26,344	14.9	4.8
SEP.	26,315	11.4	1.8
OCT.	25,944	7.8	-1.2
NOV.	25,900	3.6	-4.7
DEC.	25,449	-0.2	-7.6
1994			
JAN.	25,299	-0.8	-7.7
FEB.	23,599	-8.8	-14.9
MAR.	23,594	-9.5	-15.5
APR.	24,022	-8.0	-14.1
MAY.	24,220	-7.9	-13.9
JUN.	24,357	-6.8	-12.7
JUL.	24,985	-4.3	-10.4
AUG.	25,684	-2.5	-8.7
SEP.	26,059	-1.0	-7.2
OCT.	26,161	0.8	-5.6
NOV.	26,679	3.0	-3.7
DEC.	26,979	6.0	-0.9

Chart 19



(*) DEC 94 ESTIMATED

During the last months of the year, the volume of payments in the economy should have increased at least proportionally to inflation. Thus, if credit card use has contracted in real terms, other means of payments, such as cash, must presumably be used more.

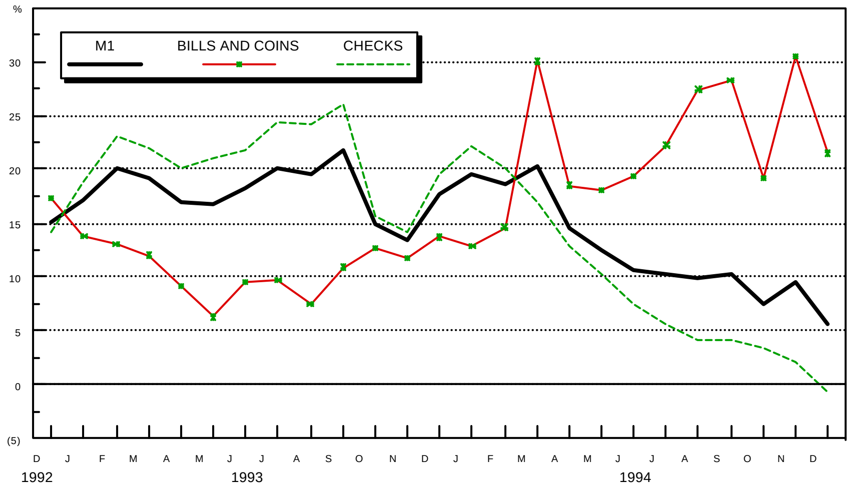
Sections 1 and 2 above provide sufficient elements to state that the unusual growth in currency in circulation —and therefore of base money— was due to an increase in its demand caused by exogenous factors. Under these conditions, the high rates of growth of base money, both in real and nominal terms, do not result from a lax monetary policy. This conclusion is reinforced by two additional points: M1 (see Chart 20) registered a low nominal growth (5.7 percent) compared to the increase in nominal GDP (10.4

percent) and a negative rate in real terms (-1.2 percent). The inflation rate — especially that corresponding to non-tradeable goods and services— continued to diminish until December's devaluation.

Chart 20

M1

NOMINAL ANNUAL GROWTH RATES



II.3 Additional comments.

The external current account deficit and the appreciation of the real exchange rate have been insisted upon as being the main causes of the devaluation of December 1994. In this regard, it is important to clarify that an external current account deficit is not always the result of an appreciation in the real exchange rate. To illustrate, in the recent years Japan has had a significant surplus in its current account while, at the same time, its currency has experienced an unprecedented appreciation in real terms.

The current account deficit results from an excess of investment over domestic savings. The widening of the gap between investment and domestic savings was primarily a reflection of the increase in the net accumulation of productive capital from 1989 to the end of 1994. Such an accumulation was boosted, to a considerable extent, by significant capital inflows from abroad. Foreign capital was attracted by advantageous investment opportunities existing in the country.

Higher levels of investment lead to increases in labor productivity and in real wages. Eventually, and in cases —such as Mexico's— where capital inflows are massive, the real exchange rate shows a tendency to appreciate. However, because it responds to increases in labor productivity, the appreciation should not be considered as a symptom of domestic products losing their external competitiveness. The evolution of Mexican exports in recent years confirms this argument. As has been already mentioned, manufactured exports grew at an annual rate in excess of 22 percent between January and November 1994, as compared to the same period of the preceding year —the highest rate in the last six years. This would not have occurred without the economy being increasingly competitive. Under these conditions, it is difficult to draw on developments of the current account and the real exchange rate to explain the recent devaluation of the domestic currency.

Only known or predictable elements can be taken into account while formulating economic policy. A policy cannot honestly be condemned for not having taken into consideration unforeseeable events. Specifically, regarding the implementation of monetary policy, it is clear that a forecast of the series of political disturbances in 1994 was not, and could not have, been made. Such a series of events included those of a kind not seen in Mexico for more than half a century.

As was mentioned in other segments of this document, the most negative political events caused reductions in the country's international reserves. However, until mid-November, these registered a level that amply exceeded the stock of base money. Once the psychological impact of the political events had faded, the balance of payments returned to equilibrium. It is difficult to believe that the restoration of such an equilibrium could have taken place in the context of a lax monetary policy.

In retrospect, it can be easy to find faults with the Bank of Mexico's monetary policy stance. However, at the time the decisions were being made, there was no set of reasons that, taken together, could justify a different policy course than that which was being implemented. Furthermore, it was reasonable to expect that the series of adverse political events would not continue once a convincing presidential election had taken place —such as the recent one.

Also in retrospect, it could be argued that a different fiscal-monetary policy mix could have averted the devaluation. However, there was no way the economic authorities could have foreseen the frequency and magnitude of the destabilizing factors that occurred in 1994.

III. CONSIDERATIONS TO DEFINE MONETARY POLICY.

At the present time Mexico has a floating exchange rate regime. This implies that the exchange rate may increase or decrease as necessary in order to balance the supply of and demand for foreign currency. According to this exchange regime, the central bank does not usually intervene in the market. However, in countries which have adopted such a system, central banks often intervene under extraordinary circumstances. This is what has recently occurred in Mexico when, in the past few weeks, foreign investments in government or bank paper have matured and have not been rolled-over. In such occasions, the Central Institute has sold foreign currency from its own reserves and from the Exchange Stabilization Fund, recently negotiated between Mexican financial authorities and foreign institutions, in order to avoid excessive fluctuations of the exchange rate.

The Bank of Mexico's net domestic credit program for 1995 has been formulated on the assumption that the floating exchange rate regime will continue. There are no grounds for any other assumption as the scarcity of reserves and various uncertainty factors prevent, for the time being, the adoption of a different exchange regime.

The current exchange rate regime is not a reason for the Bank of Mexico not to pursue the stabilization of the peso's purchasing power. The Central Institute should, principally, achieve said stability by appropriately handling its own credit and, thus, indirectly influencing the evolution of aggregate demand and, hence, prices.

Under normal circumstances, it is not necessary for a central bank operating within a floating exchange rate regime to set rigid limits on items such as the amount of its domestic credit (so called in order to distinguish it from external credit, i.e., international reserves) or on the monetary base. Within this context, the central bank may effectively combat inflation by tightening or loosening the amount of, or the terms under which it supplies, its primary credit (synonymous with domestic credit), according to its ongoing evaluation of indicators --even forward indicators-- of the evolution of prices. The amount or terms for granting primary credit indirectly influence the general price level because they have an impact on aggregate demand. If credit becomes more expensive, aggregate demand will tend to contract; if it becomes cheaper, the latter will tend to expand.

There are several indicators for the behavior of prices which central banks normally observe: the evolution of the exchange rate itself and that of wages; the international prices of raw materials; the public's inflationary expectations, the level of interest rates and the differentials between short and long term rates; the evolution of imports and exports of goods and services, and capital flows.

After carefully evaluating the effects of each of these indicators on the trend of the general price level, central banks, under normal circumstances, discretionally alter the amount of, or the terms for granting, their domestic credit.

Most central banks have stopped setting quantitative targets for the evolution of their own credit or of monetary aggregates, such as notes and coins in circulation, M1 and others. This has been in response to technological changes and adjustments in financial regulations that have come about in the last few decades, and which have negatively affected the more or less stable relationship that used to exist between some of these aggregates and nominal GDP in years past.

Nevertheless, the current crisis of confidence in the national currency calls for the adoption of an extremely strict primary credit policy. The Bank of Mexico can do this by imposing a limit to the growth of its own domestic credit for the year.

This procedure can efficiently encourage economic agents' inflationary expectations to meet price projections contained in the economic program adopted by the Federal Government --projections that correspond to the provisions of the Agreement to Overcome the Economic Emergency.

III.1 Limit to the Net Domestic Credit

The Federal Government's economic program and the commitments endorsed in the Agreement to Overcome the Economic Emergency set the framework for the Bank of Mexico to pursue its primary objective --procuring the stability of the national currency's purchasing power-- by limiting its domestic credit.

On January 4, the Bank of Mexico informed the public of its intention of setting a limit of 12,000 million new pesos for the growth of its net domestic credit in 1995. However, in light of more precise projections on the expected evolution of the national currency's velocity of circulation, the Board of Governors has decided to lower the limit to 10,000 million new pesos. This limit is consistent with the projected growth of real GDP (1.5 percent) and with an annual inflation rate that should not exceed 16 percent for the year's average -- 19 percent by end December 1995.

It is important to point out that the amount referred to is not a goal but rather a ceiling. Therefore, domestic credit could grow less if this helps stabilize the Mexican economy more swiftly, without creating serious complications.

In order to manage the primary credit within the stated limit, the Board of Governors will consider, among others, the following points:

- The discrepancy between the actual inflation and inflation rates as foreseen in the Agreement to Overcome the Economic Emergency. The Bank of Mexico will respond with contractionary measures should inflation appear to accelerate.

- The behavior of the exchange rate and that of differentials between interest rates for different terms. Monetary policy would be restrictive should the exchange rate begin a trend of depreciation. The same would happen if the differential between nominal long and short term interest rates widens, or if the differential between the real rates on Ajustabonos for a certain term and those corresponding to Cetes for the same term get larger. This is because the behavior of such differentials is thought to reflect the public's inflationary expectations.

- The results of surveys on both the public's and specialists' inflationary expectations.

- The effects of revisions to collective employment contracts. Monetary policy will be restrictive in as much as the results of wage increases are seen as incompatible with the profile of inflation projected in the Agreement to Overcome the Economic Emergency.

III.2 Definition of Net Domestic Credit

In regards to the established limit for the growth of the net domestic credit, the latter is defined as the difference between the monetary base and the Bank of Mexico's international reserves. The monetary base is defined as the sum of notes and coins in circulation plus the net stock of the current accounts that credit institutions have at the Bank of Mexico. The Bank of Mexico's international reserves are defined under the terms of Articles 19 and 20 of the Law governing the Institution.

III.3 Information on the Net Domestic Credit and on Financing Received for Exchange Regulation Purposes

The Bank of Mexico will report on the evolution of its primary credit on a monthly basis, as well as on the net flow of financing that the Institution might receive from abroad for exchange regulation purposes.

IV. Inflationary Targets

The Bank of Mexico shall exercise its constitutional mandate to pursue, as its primary objective, the stability of the peso's purchasing power.

To this effect, the Board of Governors has decided to establish targets for the stabilization of the general price level. There are two main reasons behind this. Firstly, so that economic agents can use these targets as a reference for their projections on future increases in the general price level, which will help them with the complex task of making long term decisions. Secondly, the Bank of Mexico itself depends on these targets to evaluate its actions on monetary policy.

Short Term Target

The Board of Governors considers that, as a result of the depreciation of the exchange rate, the first months of 1995 will bring high monthly inflation rates. In accordance with the Federal Government's economic program and the Agreement to Overcome the Economic Emergency, the Board of Governors expects these rates to decline considerably towards the end of the year, so that the inflation rate between December 1994 and December 1995 will remain below 19 percent. The Bank will act to support the success of said target.

Medium Term Targets

The Board of Governors believes that once the current economic situation has been overcome, it will be possible to move forward in the stabilization of prices. In this sense, a level of annual inflation under 10 percent by end-December 1996 is envisioned, and subsequently, the continued process of bringing domestic inflation rates in line with those registered by Mexico's main trading partners.

Long Term Targets

The constitutional mandate to which the Bank of Mexico is subject may not necessarily be fulfilled upon reaching the aforementioned medium term target. The long term target should be an inflation rate between 0 percent and 3 percent. According to international consensus, inflation rates within this range are compatible with a scenario of stability in the general price level. This is considered so because measures of inflation tend to overestimate price increases by not taking into full account improvements in the quality of products in addition to other technical problems, which are conducive to such overestimations.

The length of time necessary to attain the medium and long term targets will greatly depend on the consistency with which the different instruments of economic policy are implemented, including those entrusted to the central bank. This consistency will also be a key factor so that the abatement of inflation does not entail unnecessary burdens on economic growth and employment.