SUMMARY

REPORT ON MONETARY POLICY

FOR THE PERIOD JANUARY 1, 1997-JUNE 30,1997

This document is a report on the implementation of monetary policy for the first half of 1997 and the context in which it was put in practice. It also announces some adjustments to monetary policy for the remainder of 1997.

There has been a generally favorable development of Mexico's main economic variables during the first months of 1997. It should be noted that the remarkable recovery in economic activity has been achieved with a declining trend in inflation. This is not surprising, since both phenomena are not independent. The abatement of inflationary pressures has been a powerful ingredient for an accelerated and sustainable economic recovery.

An integral and key component of overall economic strategy is monetary policy, which has focused, in agreement with Banco de México's constitutional mandate, in achieving the abatement of inflation.

I. Monetary Policy

I.1 Brief Description of the Monetary Program for 1997

The 1997 monetary program establishes, as a general rule, that the central bank will adjust the supply of primary money on a daily basis such that this supply satisfies the demand for monetary base. This implies that in the absence of circumstances calling for a different stance, monetary policy is maintained neutral.

In order to facilitate the analysis on monetary policy, the central bank publishes daily, before conducting open market operations for that specific day, the objective for the accumulated balance of the commercial banks' current accounts with Banco de México.

With the same purpose, Banco de México decided to publish the monetary base's expected daily path for the year, compatible with a 15 percent rate of inflation and with the evolution of economic growth, interest rates and remonetization assumed when the program was designed.

In order to provide an additional assurance that no excess supply of primary money would be created, the central bank also made commitments in terms of the components of the monetary base, namely, domestic credit and net international assets.

The other fundamental element of the monetary program for 1997 concerns the conditions for supplying a certain portion of central bank credit. Eventually, Banco de México can leave the banking system "short" (According to the zero average reserve requirement in force since 1995, monetary conditions are tightened or relaxed by Banco de México through adjusting the objective of the cumulative balances of the current accounts that commercial banks hold at the central bank. Each day, the central bank formulates its market operations with the goal that the daily average of the net total balance of the current accounts of banks, accumulated during the reporting period, results in a predetermined amount. If that quantity is zero, monetary policy is neutral. If this amount is negative, it is said that Banco de México has left the market "short". When leaving the system in a "short" position, the central bank excersizes a certain influence on raising interest rates. If the quantity is positive, it is said that Banco de México has left the system in "long" , which promotes a decline in interest rates.), which means that the central bank operates with an objective of negative accumulated balances. In this case, the central bank could adopt this stance in order to combat disorderly conditions in the money and foreign exchange markets, or to propitiate that the evolution of the monetary base does not show undesirable deviations in relation to the path consistent with the assumed inflation rate.

Finally, it should be recalled that the 1997 monetary program does not contemplate utilizing "long" positions, a measure which, if adopted, would signal some monetary policy relaxation. The Board of Governors of the central bank has decided to temporarily dispense with this instrument, in order to strengthen confidence in the achievement of a declining inflation rate consistent with this year's established target. Additionally, as 1997 is an electoral year, it was important to give complete assurance that no measures would be taken that could be interpreted as a relaxation of monetary policy for political purposes. Such an interpretation could have had very adverse consequences on the financial markets.

I.2 Evaluation of the Monetary Program

The 1997 monetary program can be evaluated from the perspective of its compliance with the main objective: that monetary policy contribute to the abatement of inflation. In the first eight months of 1997, annual inflation declined 8.5 percentage points (from 27.7 percent in December of 1996 to 19.2 percent in August of 1997). On the basis of cumulative inflation for the period January-August 1997 and the evolution of contractual wage agreements and the exchange rate, the trend observed so far in annual inflation is expected to continue, such that in December of 1997 it will reach a rate close to the 15 percent target.

The consistency among the different aspects of economic policy has been effective in achieving a downward adjustment of inflationary expectations. As a result of the decline in inflation, reduced inflationary expectations and the relative stability of the exchange rate, interest rates have declined significantly in the elapsed months of 1997. While the 28 day interbank equilibrium interest rate (TIIE) reached 27.65 percent at the end of 1996, it has declined to 20.81 percent in September of the current year. On the other hand, while the average TIIE in real terms during the first eight months of 1996 was 9.8 percent, it decreased to 7.9 percent in the same period of 1997.

The observed declines in interest rates and their variability during the elapsed months of 1997 have been important factors contributing to the recovery of economic activity and employment. The increases of 9.9 percent in industrial production and of 9.1 percent in employment, the favorable evolution of exports and the recovery of consumption and real wages, confirm that when monetary policy concentrates on the fight against inflation, it makes its best contribution to economic development and growth.

I.3 Execution of the 1997 Monetary Program

The execution so far of the monetary policy program for 1997 can be evaluated on the basis of the evolution of the monetary base, net international assets, net domestic credit and the adoption of certain discretionary actions by Banco de México.

a) Monetary Base

As is known, last January Banco de México published a forecast of the daily path for the monetary base in 1997. During most of the time elapsed in 1997, and in particular since the end of April, this monetary aggregate has exceeded the band within which it was expected to fluctuate according to the forecast.

In order to determine if the described behavior of the monetary base has had (or could have) an inflationary impact, it is necessary to determine whether excess liquidity has been created.

If Banco de México were to expand the monetary base, and said expansion is not matched by a greater demand for bills and coins, the consolidated balance of banks' deposits at the central bank would be continuously positive, a situation which would indicate an excess supply of money. But this has not been the case.

In fact, what has happened during the year is that the demand for bills and coins has registered less of a contraction than was initially envisaged. Among the causes that have prompted a larger than expected demand for base money, are a more rapid economic expansion than expected, lower interest rates, a greater demand for cash by commercial banks in order to satisfy their cash-in-vault necessities, and other circumstantial factors.

In light of these circumstances and in view of the fact that inflation has remained close to its expected path, the central bank has not deemed it necessary to adopt a restrictive monetary policy which would procure the convergence (or at least the approach) of the observed monetary base to the forecasted path.

b) Net international assets

From December 31, 1996 to September 12, 1997, net international assets increased by 10,366 million dollars. This increase has been substantially larger than the minimum amount envisaged for the year as a whole in the 1997 monetary program (2,500 million dollars).

c) Net domestic credit

During the first eight and a half months of 1997, net international assets have increased significantly as mentioned in the previous paragraph, while the monetary base has decreased in relation to its end of 1996 balance due to seasonal factors, as was expected. This has determined a contraction of the central bank's net domestic credit. Otherwise, disequilibria in the domestic money market would have been generated. As variations in net domestic credit and in net international assets have combined to produce the desired amount of base money, it can be affirmed that the decline in net domestic credit has not implied any monetary tightening.

d) Discretional actions adopted by Banco de México

While in 1997 there have not been situations calling for the adoption of a "short" position, the central bank has had to make certain adjustments to its monetary policy. The reason is that during the first eight months of 1997, there have not always been simultaneous movements in interest rates and the exchange rate in directions that, in principle, would be natural. This is due to the following: 1) the rapid accumulation of net international assets; and 2) temporary circumstances which transitorily reduced the degree of competitiveness in the money market in the very short run.

In particular, in mid-April, the increase in short term interest rates started to be highly inconsistent with the evolution of prices and the exchange rate. Confronting this situation, Banco de México decided to act by establishing on April 17th a ceiling on rates for 24-hour open market operations. This limit was maintained for only one business day, since it was sufficient to reestablish orderly conditions in the money market.

Fixing a ceiling on interest rates together with other less important measures, produced the desired effect. The positive effect shown by these measures was due not so much to their quantitative importance, but to the fact that they were interpreted by the market as a signal by the central bank that, in its judgment, very short interest rates had reached excessive levels. However, it is not convenient to use ceilings of this kind frequently, since they block market forces in the determination of interest rates, which could risk compromising the role they should play in attracting and allocating financial resources.

I.4 Adjustment to Monetary Policy

One option for counteracting unnecessarily high levels of interest rates would be the use of the "long" position. Therefore, Banco de México has deemed it appropriate to modify its stance with respect to the utilization of such instrument. With the elections of July 6th concluded and with inflation demonstrating a very close path to the forecasted one, it is appropriate that the central bank regain the possibility for sending signals geared at declines of interest rates when such decreases are feasible and desirable.

Consequently, Banco de México would induce "long" positions, but only with caution and under the following conditions:

i) if the behavior of very short term interest rates were not consistent with the evolution of the exchange rate, in particular, in situations in which domestic currency were appreciating and there were no additional inflationary pressures;

ii) if the evolution of inflation were so favorable that there were high and well founded probabilities that the increase in prices would be clearly below the established target;

iii) if an unsustainable appreciation of the exchange rate resulted from sizable short term capital inflows to the money market;

iv) if there appeared increases in interest rates entirely due to disorderly condition in the money market.

Recall that in the past Banco de México has applied "short" positions as a response to disorderly conditions in the foreign exchange market, in particular when the exchange rate has suffered abrupt depreciations. By opening up the possibility of utilizing "long" positions, monetary policy can respond to an appreciating exchange rate using such measure. Hence, monetary policy acquires a symmetry which currently is absent.

It should be taken into account that on occasions there are movements in interest rates and in the exchange rate which appear to be inconsistent, but which are not. For instance, one of the reasons why interest rates have resisted a downward trend when the exchange rate is appreciating is the sizable and rapid accumulation of international reserves financed by Banco de México's money market operations. This downward resistance of interest rates cannot be resolved through the use of "long" positions, since it has a real underlying cause. The same analysis would apply in the appearance or increase in the fiscal deficit. In such cases, utilizing "long" positions is neither an answer, since the increase in interest rates would be caused by the greater demand for real resources by the public sector.

2. Exchange Rate Policy

There is no exchange rate regime without disadvantages. However, the overall results obtained in Mexico with the floating exchange rate regime can be considered positive.

Peso/dollar exchange rate volatility was considerably reduced during 1996 and in the months elapsed in 1997. This has, by no means, been a consequence of alleged measures oriented towards artificially maintaining the exchange rate at determined levels. It has been the result of a favorable international environment, a prudent fiscal policy, the continuous process of privatization and deregulation, a monetary policy consistent with the objective of abating inflation, and in general, significant progress in other areas of economic policy.

One concern with the floating regime was that investments in plant and equipment, particularly in the exporting sector, might suffer because of the difficulties in forecasting the real exchange rate. Nevertheless, investment in that sector has increased dynamically.

In light of the evolution of the exchange rate, of the prevailing liquidity situation in international financial markets and of the convenience of continuing to accumulate net international assets, the Exchange Commission decided on two occasions during 1997 to increase the amount of foreign exchange acquisitions that Banco de México can effect through the options mechanism.

The options mechanism has complied with its primary objective for which it was created. During the twelve and a half months of its operation to date, it has allowed Banco de México to acquire 4,036 million dollars.

In February of 1997, the Exchange Commission announced the adoption of a plan for contingent sales of foreign exchange by Banco de México. The purpose of this plan is merely to moderate exchange rate volatility, not to defend specific levels of the exchange rate. Up to the first half of September of 1997, circumstances have not appeared in which Banco de México would sell foreign exchange under this program.

Notwithstanding the generally satisfactory results which have been obtained with the float, the relative stability of the nominal exchange rate during 1996 and to date in 1997, has been a cause of concern for some sectors of society because it has resulted in a real exchange rate appreciation.

In this regard, the factors which have been generating the real appreciation of the currency should be identified in order to determine whether or not the authorities should adopt any measures in relation to this phenomenon.

The appreciation of the real exchange rate since the beginning of 1996 has mainly responded to the following considerations:

i) Inflation suffered by the Mexican economy since 1995 has its origin in the lagged adjustment of prices to previous devaluations. The natural convergence that tends to be observed between the percentage devaluation and the percentage increase in prices produced afterwards, had not been observed previously due to the substantial decline in domestic demand during 1995 and part of 1996.

ii) The other significant factor that has contributed to the real appreciation of the domestic currency has been the increase in foreign capital inflows, derived mainly from direct foreign investment and medium and long term credits.

In the case described in the previous paragraph ii), the authorities may take, with limitations, some measures to avoid or moderate appreciation of the domestic currency. The most direct way to achieve this result is through transforming the capital inflows into international reserves of the central bank, together with neutralizing the monetary expansion that results from the acquisition of foreign exchange by the central bank. This is precisely what has been done.

Nevertheless, it is questionable whether international assets should be accumulated indefinitely for the total or a great part of the capital inflows. To do so would have serious implications. Firstly, no advantage for the domestic economy's development would be derived from capturing foreign savings. Secondly, another complication not always evident is that the purchase of goods and services effected with the peso resources obtained from foreign investment, would crowd out other purchases by firms and households established in Mexico.

Thus other formulae have been considered for addressing pressures conducive to real appreciations of the currency which do not have solid fundamentals. In response to the latter, among other reasons, Banco de México has decided to open the possibility of leaving the system in a "long" position.

It should be noted that the use of the "long" could be ineffective for avoiding the appreciation of the real exchange rate, if the latter is caused by direct foreign investment, foreign investment in the stock market, or medium or long term indebtedness abroad. Such capital inflows respond to factors which are practically unaffected by monetary policy instruments. Monetary measures can only influence capital flows to the short term money market.

Another phenomenon which is cause for concern, and hence eventually undesirable situations in financial markets, is the appearance or widening of the current account deficit. Such widening tends to coincide with the appreciation of the real exchange rate, given that both phenomena are, generally, results of the same cause: net foreign capital inflows. Thus, the ability of monetary policy to affect the current account balance depends fundamentally on its effectiveness in modifying capital inflows. As noted in the previous paragraph, only when the current account deficit is the result of short term capital inflows channeled to the money market can monetary policy have some effect on the development of the current account deficit.

Fiscal policy can be more effective in controlling the current account deficit. Greater public sector savings reduces total expenditure in the economy, unless they are used to retire domestic debt. With the reduction of total expenditure, the current account deficit decreases.

Finally, it should be stressed that no exchange rate regime --whether fixed, floating, crawling peg, or managed within bands -- is capable of guaranteeing that the real exchange rate remains at a certain level for a considerable period. The real exchange rate responds to the evolution of the economy's fundamental elements and not to monetary manipulations. The same can be said about the current account.

Final Considerations

The reduction of inflationary pressures has induced, since March of 1995, a downward trend in interest rates, only interrupted by temporary upticks. The decline of both nominal and real interest rates has been one of the causes of the recovery of consumption and investment, mainly because it has facilitated the reduction in indebtedness of firms and households. In order to consolidate this process, it is of utmost importance that monetary policy persevere in the fight against inflation.

The National Development Financing Program 1997-2000 (PRONAFIDE), published by the Federal Executive last June, constitutes a significant contribution for the conduct of Mexico's economic policy for the medium term.

The PRONAFIDE presents a projection for the evolution of inflation during 1997-2000. This document indicates that, under appropriate circumstances, lower inflation targets could be established than the ones presented in said projections. Banco de México deems it feasible to achieve lower inflation rates than the estimates presented in the PRONAFIDE, which would anticipate the benefits of stabilization.

An economy in which there exist ample investment opportunities, as well as and with credibility and confidence in its policies and institutions, will receive flows of foreign resources which will, unless the central bank acquires the total, inevitably generate a deficit in the current account .

Over the years, an atavism has endured which originates in mercantilist ideas, which judges a surplus in the current account of the balance of payments as positive and a deficit as something "bad". Unfortunately, such atavism is harmful, since under certain circumstances, it may cause unjustified nervousness. This translates into unnecessarily high interest rates to the detriment of economic development. For this reason, it is prudent to ensure that the current account deficit does not reach a large percentage of GDP. Possibly the most effective measure for containing the increase in the current account deficit is the generation of a fiscal surplus. In this way, is possible for the central bank to acquire foreign exchange resulting from foreign investment without having to capture resources in pesos in the money market in order to sterilize the monetary impact of such purchases. In such a case, sterilization does not pressure interest rates, given that it is achieved through the deposit of the fiscal surplus at the central bank.

In spite of the benefits which generally result from capturing foreign savings, the misgivings are justified when foreign inflows are of a short term nature. This is because a sudden reversal in the flow may occur. Regarding this justified misgiving, it must be stressed that the best defense against such short term capital movements is a floating exchange rate regime. Such a regime increases the risk of short term foreign investments, given that any potential profit to be obtained by such investors due to differentials in domestic and foreign interest rates, may be easily eliminated by relatively small movements in the exchange rate.

This explains why foreign investment in debt instruments denominated in domestic currency has declined over 1995 and 1996, and although it has registered a moderate increase in 1997, the total amount is at present relatively modest.

In spite of the above, the possibility remains that even with a floating exchange rate regime short term capital inflows may induce considerable exchange rate fluctuations harmful to economic activity. Within the current monetary regime, the utilization of "long" positions is the ideal instrument for influencing, if needed, short term capital inflows and therefore avoid or moderate exchange rate appreciations resulting from such flows.

Finally, it should be reiterated that in addition to healthy public finances and a monetary policy geared towards price stability, long term economic growth requires greater degree of human capital in order to confront the new environment of global competition. At the same time, it is necessary to increase the savings rate. Economic development also depends on an effective justice system, an indispensable condition for the good functioning of a market economy. In conclusion, it is imperative to continue and to improve the task of modernization which has already begun.