

Annual Report Summary

2004



BANCO DE MEXICO

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I. Introduction

In 2004, Mexico benefited from the continued recovery of the world economy, which recorded its highest rate of growth since the mid-seventies. Mexican economic growth, which had begun towards the end of 2003, strengthened during 2004. Real GDP growth was 4.4 percent, figure above that anticipated by the main economic analysts at the beginning of the year.

In December 2004, annual headline inflation was 5.19 percent, above figures recorded in the same month of the previous year (3.84 percent). The path of headline CPI inflation in Mexico was significantly affected by the international environment. The contribution of several Asian economies, especially the Chinese, to world growth continued to increase during 2004 due to their intensive use of energy, metals and other raw materials, as well as the considerable growth of a wide range of their food imports. As a result, prices of such commodities were subject to significant pressures in international markets, therefore affecting headline inflation in Mexico. Given their nature, the aforementioned supply shocks mainly affected CPI's non-core component and the food items of the core merchandise subindex.

During the second half of the year, different weather-related factors changed the supply conditions of many agricultural products in Mexico and the U.S. The hurricanes that hit the East coast of the U.S. significantly reduced fruits and vegetables' crops. Tomato prices were particularly affected; in December, however, inflation pressures began to ease.

International financial markets exhibited low volatility, a high level of liquidity and a considerable search for yields during 2004. This resulted from a favorable growth scenario, reduced inflation pressures worldwide –except for price increases in several commodities, including the significant increase in crude oil prices– and the improvement in both U.S. corporate gains and in emerging markets' credit standings.

Under such conditions, Mexico's economic activity expanded. The strength of demand for Mexican exports and the availability of resources that have promoted domestic expenditure deserve particular mention. Regarding the latter, the most significant

have been oil revenues and workers' remittances, and the pace at which consumption and mortgage credit have been growing. This environment has sustained the proper conditions for the continued growth of consumption and the consolidation of the recovery of investment. Industrial and manufacturing production expanded, thereby contributing to job creation. Nonetheless, this did not lead to a fall in the unemployment rate in urban areas.

Throughout 2004, monetary policy faced the following challenges: a) containing the effects of price increases of several commodities in international markets on inflation expectations and wages; b) fostering an orderly adjustment of the economy to an environment of tighter global monetary conditions; and, c) limiting inflation pressures that could originate from changes in aggregate demand.

In light of the aforementioned, the Board of Governors of Banco de México tightened the monetary policy stance significantly in 2004. In this context, the combination of Banco de México's monetary policy actions and the relatively ample liquidity conditions prevailing in world financial markets have led to a significant "flattening" of the yield curve in pesos.

It is important to mention that despite the growth of several components of expenditure during 2004, no considerable inflation pressures from the demand side are envisaged. Furthermore, fluctuations in inflation during the year do not seem to have had any significant effect on wage negotiations.

Throughout the world, inflation abatement is a gradual process that must be carried through a long-term horizon. Therefore, although a series of exceptional shocks affected such process during 2004, the Central Bank reiterates its commitment to price stability, therefore safeguarding the basic conditions to produce and invest.

II. International Environment

In 2004, the Mexican economy was favored by the strengthening global recovery, which recorded its highest rate of growth since the mid-seventies (5.1 percent at an annual rate). Growth was driven mainly by the strength of economic activity in the U.S., China and most emerging economies, offsetting the weakness of the euro-area economies and Japan. Although growth

slowed in the second half of the year (partly as a result of surging oil prices), the U.S. and Chinese economies continued to grow at a fast pace. U.S. expansion was accompanied by a strengthening of industrial activity and of employment, which had been sluggish during 2003. Under such context, the Federal Reserve decided to raise interest rates gradually starting mid-year. Despite the latter, together with risk perceptions regarding the high U.S. current account deficit and its possible impact on exchange rates, international financial markets adjusted without major fluctuations, and emerging markets' country risk indicators fell to historically low levels.

The increasing importance of Asian economies in the global economy has significantly affected the demand for raw materials, particularly energy. As these economies are intensive users of such goods, their higher contribution to world growth has resulted in increased pressures on commodity prices in international markets, therefore contributing to an inflationary rebound in advanced economies throughout the year.

At the start of the present economic expansion, the U.S. recovery was mostly supported by consumer spending (which had also been the most important driving force of the economy during the previous downturn). The sources of growth were more balanced in 2004 as investment gained strength.

The federal government deficit for the fiscal year that ended in October 2004 was considerably below that forecasted at the start of that year (3.6 percent of GDP compared with 4.2 percent) and similar to the one observed in 2003. Nonetheless, the magnitude of the fiscal imbalance was a source of constant concern due to, among other things, its implications for the current account deficit.

The stance of U.S. monetary policy began to change gradually at the start of 2004. Thus, although the Federal Reserve was confident of a sustained rebound, the first interest rate hike did not take place until mid-year. In its press releases the Committee underlined its intention to withdraw the monetary stimulus at a measured pace. Consequently, in all of its meetings from June to December the target for the federal funds rate was raised 25 basis points, ending the year at 2.25 percent. Adjustments in the federal funds rate were anticipated by financial markets, and therefore, the latter adjusted smoothly to such changes.

External financing conditions were favorable for emerging nations during 2004. Abundant liquidity in international financial markets, investors search for higher yields and an improvement in emerging countries' fundamentals all contributed to such an environment. Under such setting, sovereign risk spreads for these countries fell to historic lows.

III. Developments in the Mexican Economy: General Overview

III.1. Economic Activity

Throughout 2004, the Mexican economy was influenced by the ample availability of external financial resources and the strength of both oil and non-oil exports. These factors fostered the expansion of private consumption and investment. Consumption made the highest contribution to real GDP growth, followed by gross capital formation and the net trade balance of goods and services. Consumption outpaced economic growth in 2004 and, measured at constant prices, accounted for 81.6 percent of GDP at the end of the year. The strengthening of investment through the year allowed for such indicator to be the most dynamic component of domestic expenditure. Its annual growth rate rose from 5.2 percent in the first semester to 9.7 percent in the second. After having fallen in 2001 and 2002, investment grew slightly in 2003 and expanded in 2004.

In 2004, the performance of the Mexican economy was mainly characterized by the following aspects:

- a) Real GDP grew 4.4 percent, the highest rate in the last four years.
- b) Both the external and domestic components of aggregate demand grew significantly at an annual rate.
- c) The expansion of consumption expenditure fostered GDP growth. In fact, consumption expenditure's annual contribution to GDP exceeded that of the previous three years. In particular, private consumption –aggregate demand's main component according to its share- was

avored by several factors such as a greater availability of financing and higher employment and real average earnings in various sectors.

- d) Investment was the most dynamic component of domestic demand as a result of increased private and public investment.
- e) Total public expenditure rose slightly due to a combination of higher government investment expenditure and reduced consumption expenditure.
- f) Exports of goods and services rose considerably.
- g) Domestic saving measured as a proportion of GDP at current prices, increased slightly compared with the previous year.
- h) During the last quarter of the year, Banco de México's Business Confidence and Consumer Confidence Indexes exhibited upward corrections.
- i) All three main sectors of output contributed to economic growth in 2004.

III.2. Employment, Wages and Productivity

In 2004, economic expansion was accompanied by an improvement in employment. The most relevant aspects of the labor market during the year were the following:

- a) Formal employment increased throughout the year, although at a slower annual rate during the fourth quarter.
- b) More permanent than temporary jobs were created. More jobs were created in larger companies.
- c) The expansion of formal employment practically included all states, but was more dynamic in the northern region.
- d) The number of workers insured by the IMSS rose in most sectors, including manufacturing.
- e) INEGI's monthly surveys of manufacturing employment reveal a significant recovery of employment in the

maquiladora industry. Nonetheless, its level exhibited a significant decline as compared with its maximum historic level in 2000.

- f) The open unemployment rate in urban areas rose slightly for the year as a whole as compared with the previous year, as a result of the trend exhibited by the open unemployment rate in Mexico City, which remained high throughout the year.
- g) Economic recovery in 2004 led to an increase in the demand for labor. At the end of 2004 the number of workers insured by the IMSS rose by 318,634 (2.6 percent) compared with December 2003.

Some of the most important aspects regarding earnings and productivity in 2004 were:

- a) In general terms, the main indicators for earnings grew at a slower rate than in 2003.
- b) Unit labor costs fell in both maquiladora and non-maquiladora manufacturing industries, as well as in the retail sector. Such results are explained by productivity gains and moderate increases in real average earnings in all three of the aforementioned sectors.

III.3. External Sector

During 2004, Mexico's external sector was characterized by the following: the strength of external demand, especially that from the U.S.; the significant rise in international crude oil prices; the loss of share of Mexican products in the U.S. market; the rapid expansion of merchandise imports, which responded to increased production and domestic expenditure in Mexico; significant inflow of workers' remittances; and, Federal Government's policies to reduce foreign debt and improve its conditions. The abovementioned factors narrowed the trade and current account deficits; in the case of the latter, as in previous years, it was mainly financed by long-term financial resources.

III.4. Public Finances

During 2004, the public sector's economic deficit amounted to 19.7 thousand million pesos, equal to 0.26 percent of GDP. Excluding outlays from the Voluntary Retirement Program for Public Employees (*Programa de Separación Voluntaria, PSV*), such deficit totaled 12.4 thousand million pesos (0.16 percent of GDP). The primary surplus, defined as revenues less expenditures other than financial costs, was 189.9 thousand million pesos (2.49 percent of GDP).

In 2004, budgetary revenues totaled 1,774.2 thousand million pesos (23.24 percent of GDP, figure similar to that registered in 2003), 166.2 thousand million above federal budget figures. Such surplus was mainly due to higher oil revenues (which equaled 1.79 percent of GDP and 82.2 percent of excess revenues). Budgetary expenditures totaled 1,797.5 thousand million pesos in 2004 (23.54 percent of GDP), an annual increase of 4.2 percent at constant prices.

III.5. Monetary and Credit Aggregates

During 2004, saving in domestic financial markets strengthened in response to Mexico's current economic conditions, specifically the economic recovery, and to structural factors. Regarding the latter, among the most important are the financial reforms adopted during the last years and the disinflation process which has allowed for a greater deepening of Mexico's financial system. The vigorous expansion of the broad monetary aggregates (M2, M3 and M4), which had begun towards the end of 2003, continued in 2004, exhibiting average annual growth rates of above 7 percent. In this regard, the Retirement Savings System (*Sistema de Ahorro para el Retiro, SAR*) has been an important source of domestic financial saving (25.7 percent of the flow of M4 in 2004), as do the recovery of bank deposits and the increase in non-resident savings in domestic financial instruments, mainly fixed rate long-term public securities.

Total financing to the non-financial private sector rebounded significantly in 2004, although it remains at relatively low levels. Domestic financing expanded throughout 2004, accumulating real annual growth of 9.5 percent by the end of the year. Such result represented a flow of 181 thousand million pesos

during 2004 (2.4 percent of GDP). This flow of domestic financing to the private sector came mainly from commercial banks and non-bank financial intermediaries (110 thousand million pesos and 44.6 thousand million pesos, respectively), and, to a lesser extent, from the issuance of debt instruments (16.4 thousand million pesos). Furthermore, the process to reduce foreign indebtedness continued (a reduction of 3.1 percent measured in foreign currency).

III.6. Inflation

Annual headline CPI inflation was 5.19 percent in December 31, 2004, while at the end of the previous year it had been 3.98 percent. The rise in headline inflation in 2004 mainly responded to external pressures, particularly to price increases of certain commodities. These price increases were mainly due to the higher share of economies, such as China -which are characterized by their intensive use of energy and metals and considerable food imports- in world growth. During 2004, inflation was also affected by the rise in the price of public transportation fares in some Mexican cities which are heavily weighted in the CPI, and by price increases in several fruits and vegetables during the second half of the year.

External inflation pressures affected CPI's non-core component and food items of the core merchandise price subindex. From December 2003 to the end of 2004 the former grew from 4.66 to 8.20 percent at annual rates (3.54 percentage points), while the latter did so from 4.70 to 7.04 percent (2.34 percentage points).

Goods and services with administered prices were mainly affected by the increase in international energy prices. The annual growth of the subindex of administered prices rose from 6.11 percent in December 2003 to 10.02 percent a year later, therefore implying an increase of 0.34 percentage points in their contribution to annual headline inflation.

Livestock goods prices grew at a faster rate during 2004 mainly as a result of three factors: i) higher production costs originated by the significant price increase in grain forage for cattle and poultry; ii) an increase in global demand for this type of goods; and, iii) sanitary problems that led to a reduction in world beef production, which was heightened in Mexico by authorities' restrictions on beef imports. Thus, the annual growth rate of livestock goods prices rose from 8.34 percent at the end of 2003 to

12.69 percent in December 2004, therefore contributing with 0.23 percentage points to annual headline inflation.

Price increases in several fruits and vegetables during the second half of 2004 constituted additional supply side pressures to those mentioned above. Such increases originated from the reduction in the supply of some of those products as a result of adverse weather in Mexico and the U.S. Between December 2003 and December 2004, the annual growth rate of the fruits and vegetables price subindex moved from -2.36 percent to 6.43 percent, producing an increment of 0.31 percentage points in the subindex's contribution to annual headline inflation during the reference period. In particular, the rise in tomato prices accounted for practically half of the increase in the fruits and vegetables price subindex's contribution to headline inflation.

Annual core inflation remained relatively stable despite considerable increases in processed foods' prices. Such result was the outcome of inflation pressure from foodstuffs being partially offset by the slower growth of services' prices. Thus, annual core inflation was 3.80 percent at the end of 2004 compared to 3.66 percent at the end of 2003.

IV. Monetary and Exchange Rate Policy

IV.1. Monetary Policy

In 2004, monetary policy faced the following challenges:

- a) Containing the effects of price increases of several commodities in international markets on inflation expectations and wage negotiations.
- b) Limiting inflation pressures that could originate from the economy's cyclical recovery.
- c) Fostering an orderly adjustment of the economy to an environment of tighter monetary conditions.

Although supply shocks usually have a temporary effect on inflation, the number and magnitude of these shocks during 2004 induced a considerable increase in inflation expectations for the medium term throughout the year. While annual inflation for 2004

increased by 121 basis points, expectations for annual inflation for the end of 2005 and for 2006 drawn from Banco de México's survey did so by 79 and 44 basis points, respectively.

Under these conditions, Banco de México tightened the monetary policy stance considerably in 2004. This was done mainly through two channels:

- a) By increasing the *corto* (short position) on nine occasions. The daily balance objective moved from 25 million pesos at the beginning of 2004 to 10 million in December.
- b) By stating in its press releases on monetary policy that starting July 25, 2004 until deemed convenient, domestic monetary conditions should mirror, at least, the greater monetary astringency prevailing in the U.S.

As a result of the abovementioned actions, short-term domestic rates rose significantly during 2004. In particular, the interbank interest rate rose from a minimum level of 4.73 percent on January 19 to 8.75 percent on December 31.

Even though the different items of expenditure evolved favorably during 2004, no significant inflation pressures from the demand side were perceived. At the same time, inflation pressures during the year apparently have not significantly affected wage negotiations.

IV.2. Exchange Rate Policy

In March 2003, the Foreign Exchange Commission announced the implementation of a mechanism to reduce Banco de México's rate of accumulation of international reserves. Although the abovementioned mechanism succeeded in slowing international reserve accumulation, the amount of US dollars auctioned daily fluctuated significantly between the end of 2003 and the beginning of 2004. Consequently, and in order to procure a more stable amount of quarterly US dollar sales throughout the year, the Foreign Exchange Commission decided to adequate the mechanism by modifying the schedule of US dollar sales, while keeping the total amount of US dollars to be auctioned unchanged. Therefore, starting in the quarter May-July 2004, the amount of US dollars to be

auctioned will continue to be 50 percent of the accumulated net reserves from the preceding quarter, after deducting total sales in that period. Such amount will be auctioned in equal parts during the following four quarters.

Favorable conditions prevailed in international markets during 2004, due to reduced worldwide geopolitical uncertainty and relatively loose monetary conditions throughout the year. This environment led to a significant search for higher returns, which, in turn, fostered capital flows to emerging markets including Mexico. As a result, the exchange rate against the US dollar remained relatively stable, and even appreciated slightly towards the end of the year.

The significant rise in international prices of several raw materials in 2004 contributed to a considerable appreciation of the currencies of many emerging economies which mostly export raw materials. Such was the case of Chile, Brazil, Argentina and Colombia. However, the Mexican peso remained more stable due to the fact that Mexico exports mainly manufactured goods (crude oil only accounted for around 12 percent of Mexico's total exports during 2004).

V. Final Remarks

Mexico's economic growth strengthened in 2004. In particular, the rebound in Mexican exports and the availability of resources that have promoted domestic expenditure (oil revenues, workers' remittances, consumption and mortgage loans) deserve mention. In 2004, for the first time in more than a decade, commercial banks granted more credit to both households and firms. Such environment fostered the continued growth of consumption and the recovery of investment. Industrial and manufacturing production expanded, therefore contributing to job creation, although this was not sufficient to provide all the necessary jobs for the new entrants to the labor market.

During 2004, inflation was subject to many supply shocks, mainly associated with the upward movement in the international references of several raw materials, as a result of the increasing contribution of several Asian economies, especially the Chinese, to world growth. These economies are characterized by their intensive use of energy, metals and other raw materials as well as by a

considerable increase in several food imports. Economic conditions were further complicated towards the end of the year by different weather-related factors that affected the production of several agricultural products. The number and intensity of supply shocks that took place in 2004 led to a significant upward revision in inflation expectations for the medium term. Under such environment, and in order to prevent wage negotiations and price formation from being contaminated, Banco de México tightened the monetary policy stance.