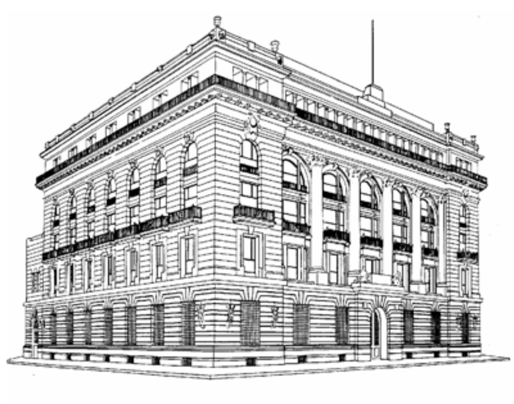
Annual Report Summary

2003



BANCO DE MEXICO

APRIL 2004

I. Introduction

Mexico exhibited limited growth in 2003. GDP grew 1.3 percent, figure below that anticipated at the beginning of the year by both government authorities and private sector economic analysts. Annual headline inflation was 3.98 percent at the end of the year, thus falling within the variability interval of plus/minus one percentage point around the 3 percent target determined for the end of 2003.

In the first half of 2003, the Mexican economy was affected by a particularly complex international environment. During that period, the world economy was driven by political uncertainty surrounding the war in Iraq. Lack of clarity regarding the length, costs and consequences of such war led to a loss of confidence among consumers and investors throughout the world. The latter was reflected in financial markets and translated into a fall in the main stock market indexes. Under this setting, the advanced economies faced unfavorable conditions for the recovery of demand. Consequently, during the first half of 2003, aggregate demand in Mexico remained weak, due partly to sluggish external demand. External conditions improved during the second half of the year, especially in the fourth quarter. Economic activity in the main economies of the world strengthened, especially in the United States. U.S. industrial production began to recover, a development of particular significance for the Mexican economy.

External conditions, together with other factors such as the fiscal and monetary discipline of the last years and the different financial reforms -which have allowed for a reduction in interest rates- the expansion of domestic financing, and the improvement in some components of domestic demand, fostered the recovery of the Mexican economy in the second half of the year. Thus, in 2003, private consumption grew more rapidly, while investment expenditure in construction rose. Nonetheless, the weakness of private sector investment in machinery and equipment in the last years is a cause of real concern. This is partly attributed to the lack of structural reforms and other measures to promote the economy’s efficiency and flexibility, which usually fosters the higher profitability of investment projects.

At the end of 2003, annual headline inflation was 3.98 percent, 1.72 percentage points below its level of December 2002. As for annual core inflation, which is an indicator that allows to identify medium-term inflationary pressures more accurately, it was 3.66 percent, 0.11 percentage points below its level of the previous year.

During the first months of 2003, the peso/US dollar parity depreciated due to the uncertainty related with the war in Iraq. This, together with supply shocks that affected non-core inflation at the beginning of the year, led to a continuous downward revision of inflation expectations, despite the restrictive monetary actions adopted at the end of 2002. Under such circumstances, and in order to revert such trend, Banco de México decided to increase the *corto* (short position) on January 10, February 7, and March 28, 2003.

As supply shocks at the end of 2002 and at the beginning of 2003 were absorbed, non-core inflation began to converge more rapidly to core inflation. The latter, together with an absence of significant inflation pressures from aggregate demand, allowed for anticipating medium-term headline inflation would continue its convergence to the target. Accordingly, Banco de México maintained the *corto* unchanged for the remainder of the year.

Banco de México’s main challenge in the long run is to consolidate price stability. Although the gradual convergence to an environment of low and stable inflation, together with different financial reforms, has raised the availability of credit, it is just a step in a long process. The attainment of price stability entails further benefits. First, in the absence of inflation pressures both firms and households welfare will not be jeopardized, thus creating more certainty so they can undertake long-term projects. This, in turn, would lead to an expansion in saving and investment. Second, by abating inflation, prices would truly reflect the relative shortage conditions in resource allocation and, thus, prevent the negative effect of inflation on Mexicans’ welfare.

II. International Environment

International economic conditions, albeit complex, improved throughout 2003. After a hesitant recovery due to the war in Iraq and a disease outbreak in Asia, the world economy began to grow more steadily. Nonetheless, U.S. industrial production, the most important variable for Mexico's economy due to its impact on exports, despite expanding in the last quarter of the year, recorded low annual growth in 2003. Given the low capacity utilization and favorable productivity results, inflation pressures in the U.S. were insignificant. Despite the fiscal and external imbalances, the low level of interest rates in the country created more favorable financing conditions for developing nations. In addition, an adequate management of economic policy in some of these countries fostered the recovery of capital flows and led to a reduction in country risk indicators. Finally, notwithstanding the fall in oil prices after the war in Iraq, these remained at levels relatively favorable for oil-producing countries.

The recovery of the U.S. economy, although being the strongest among advanced economies, was not uniform across sectors and did not become firmly established until mid-2003. The weak performance of the U.S. economy since autumn 2002 continued until the first quarter of 2003 due to the war in Iraq. Once geopolitical uncertainties were overcome, economic activity gained strength.

Despite the fact that U.S. GDP has grown robustly in the last two years, the Mexican economy exhibited a weak performance in 2003. The main reason is that Mexico's exports are strongly linked with U.S. industrial production. However, although U.S. industrial production expanded swiftly in the last quarter of 2003, the lag with which its effects are sometimes transmitted to the Mexican economy apparently explains why the latter did not exhibit a similar rebound.

The other advanced economies exhibited some improvement in 2003, due partly to the U.S. recovery but also to some positive domestic results. Economic conditions in emerging economies showed a positive trend. However, there were significant contrasts among regions. The East Asian economies grew the most, despite the effect of the SARS disease at the beginning of the year.

This outcome reflects China's robust growth, which contributed significantly to the world economy's expansion.

III. Developments in the Mexican Economy: General Overview

III.1. Economic Activity

In 2003, the Mexican economy grew only 1.3 percent, below government authorities and private sector economic analysts' forecasts at the beginning of the year.

Despite the external conditions, some domestic factors helped to strengthen Mexico's economic activity. Among those, the fiscal and monetary discipline of the last years, together with the financial reforms (which have allowed more domestic financing and a reduction in interest rates), fostered the recovery of some components of domestic demand. Such factors enabled the expansion of private consumption as well as higher investment in construction. Nonetheless, the weakness of firms' investment in machinery and equipment during 2001-2003 is a cause of concern.

In 2003, the performance of the Mexican economy was mainly characterized by the following aspects:

a) Despite exhibiting an important increase in the fourth quarter, real GDP grew by a mere 1.3 percent during the entire year.

b) Aggregate demand grew barely due to the significant expansion of consumption expenditure and the slight increase in exports of goods and services.

c) The expansion of consumption expenditure fostered GDP growth. In fact, consumption expenditure's annual contribution to GDP exceeded that of the previous two years. In particular, private consumption –aggregate demand's main component according to its share-contributed again to the expansion of economic activity. Consumption expenditure was favored by different factors such as the availability of financing, lower interest rates, and the increase in real average earnings in different sectors.

d) Investment fell at an annual rate for a third year in a row. Thus, its contribution to GDP was negative.

e) Total public expenditure increased due to the expansion of government consumption expenditure and higher investment expenditure.

f) Exports of goods and services exhibited modest growth during the year. Nonetheless, during the fourth quarter they increased due to the higher external demand.

g) Domestic saving measured as a proportion of GDP decreased compared with the previous year.

h) During the last months of the year, Banco de México's Manufacturing Business Climate Index exhibited an upward correction. As for the Private Sector Economic Analysts Confidence Index, also prepared by Banco de México, it increased from August to October and then decreased in the last two months of the year.

i) Agriculture and services contributed most to GDP growth, while industrial activity contracted.

III.2. Employment, Earnings and Productivity

Mexico's labor market was characterized by a weak demand for formal labor. Nonetheless, as economic activity recovered in the fourth quarter, such demand began to show signs of improvement.

The most relevant aspects of the labor market in 2003 were the following:

a) Formal employment fell due to low economic activity and, particularly, to the decline in manufacturing at an annual rate.

b) Formal employment fell more sharply in the country's northern and midland states. The fall of employment in northern states was mostly attributed to declines in the maquiladora industry and other export-related activities.

c) The open unemployment rate in urban areas followed an upward trend.

d) Lower increases in contractual wages.

e) Gains in labor productivity in the non-maquiladora industry. However, since such results were due to cyclical factors, they reflect a decline in employment rather than an increase in production.

f) Reduction in non-maquiladora unit labor costs throughout the year due to gains in labor productivity, which exceeded real average wage increases.

III.3. External Sector

During 2003, Mexico's external sector was affected by the following factors: the weakness of external demand in the first half of the year, particularly that from the United States; the country's loss of competitiveness due to the absence of structural change measures, which at the same time have limited foreign direct investment inflows; the rise in oil reference prices; slower growth in domestic production and demand, which, in turn, reduced the demand for imports and, thus, narrowed the trade and current account deficits; and country financial authorities' policies to reduce Mexico's foreign indebtedness. Under such setting, Mexico's external accounts did not exhibit significant imbalances in 2003.

In 2003, the external sector was characterized by the following aspects:

a) Reduced growth in both merchandise exports and imports.

b) Lack of strength of non-oil exports due to two factors: meager external demand during the first half of the year, particularly from the United States; and Mexico's loss of competitiveness due to the lack of structural change measures, which have already been implemented by other countries which are Mexico's competitors in international markets.

c) Significant increase in oil exports due to the higher volume and prices of crude oil.

d) Loss of share of Mexican exports in U.S. imports. In 2003, Mexico's non-oil exports to the U.S. grew at a significantly lower rate than U.S. total imports, thus confirming that exports of other countries to the U.S. increased during the reference period. Such is the case of China, who outranked Mexico as a second supplier to the United States.

e) Slight increase in merchandise imports due to both the lower growth in both domestic production and aggregate expenditure during the year, and the fall in manufactured exports that use imported inputs for their production.

f) Smaller total trade deficit due to the higher value of oil exports. Nonetheless, the trade deficit with China increased significantly, thus representing Mexico's highest bilateral deficit in 2003.

g) Significant inflow of resources from workers' remittances.

h) Reduction in the current account deficit of the balance of payments, measured both in U.S. dollars and as a proportion of GDP. As in previous years, such deficit was mainly financed with long-term financial resources.

i) Reduced FDI. Its level was the lowest in the last seven years.

j) Capital account surplus due mainly to inflows from the non-bank private sector, to FDI resources and to a reduction in Mexican assets abroad.

k) Significant decline in public and private foreign indebtedness. Regarding the former, the early redemption of the last outstanding series of Mexican Brady bonds issued after the debt restructuring program in 1990 deserves mention.

l) Significant increase in international reserves.

III.4. Public Finances

Fiscal results in 2003 were determined by higher than budgeted revenues, which were used to finance higher expenditures. The non-financial public sector deficit amounted to 41.7 thousand million pesos, equal to 0.62 percent of GDP. Excluding outlays from the Voluntary Retirement Program for Public Employees (*Programa de Separación Voluntaria, PSV*), the economic deficit totaled 25.5 thousand million pesos (0.38 percent of GDP).[1] The primary surplus, defined as revenues less expenditures other than financial costs, was 148.8 thousand million pesos (2.20 percent of GDP, 2.44 percent excluding the *PSV*).

III.5. Monetary and Credit Aggregates

At the end of 2003, the monetary base was 303.6 thousand million pesos, thus exhibiting an annual variation of 15 percent (16.4 percent considering average daily stocks during the year), and following a very similar pattern as that mentioned in the Monetary Program for 2003. The monetary base expands at a higher annual rate than nominal GDP; thus, its ratio to GDP continued to increase in 2003. Such process, known as remonetization, is due mainly to the significant reduction in the opportunity cost of holding money balances (interest rates). The reduction of interest rates is partly due to inflation abatement.

In 2003, Banco de México's net international assets rose by 8.337 billion US dollars. This, together with the increase in the monetary base, brought about a contraction in net domestic credit of 52,972 million pesos. International reserves increased by 9.451 billion US dollars during the year. The main source of international reserves was the purchasing of US dollars from PEMEX (15.380 billion). As for its uses, the federal government demanded 5.823 billion US dollars, while Banco de México sold 3.218 billion US dollars through the mechanism to slow the rate of international reserve accumulation established by the Foreign Exchange Commission.

The disinflation process undergone by Mexico in the last years has allowed for a greater deepening of the country's financial

[1] According to the Federal Budget, the PSV could be financed by increasing the indebtedness ceiling.

system. As a result, in 2003, the broad monetary aggregate M4 reached 49 percent of GDP, its highest level in the last thirty years.

In 2003, total financing to households gained strength while that to firms contracted. Such condition particularly involved bank financing, as consumption credit remained robust, while housing credit, for the first time in almost a decade, began to increase (7.1 percent at an annual rate, in December).[2] Nevertheless, after having grown by 7.1 percent in December 2002, financing to firms remained practically unchanged in 2003.

III.6. Inflation

Annual headline inflation was 3.98 percent in December 2003, 1.72 percentage points below its level in December 2002. Annual headline inflation thus remained within the variability interval of plus/minus one percentage point set around the 3 percent inflation target for the end of the year. Annual core inflation, which is an indicator that allows to identify medium-term inflation pressures more accurately, was 3.66 percent, 0.11 percentage points below 2002 figures.

The fall in annual headline inflation concentrated in the last three quarters of the year due mainly to the lower rate of growth of CPI's non-core prices in those months. In contrast, during the first quarter of the year, agricultural prices moved upward as a result of the inflation pressures that arose at the end of 2002.

CPI's non-core component contributed the most to the reduction in annual headline inflation by falling 5.39 percentage points, from an annual rate of 10.05 percent in December 2002 to 4.66 percent at the end of 2003. Such results confirm that the supply shocks that affected the disinflation process at the end of 2002 and in early 2003 had practically been assimilated by the end of 2003.

[2] Performing loans excluding portfolio related with debt-restructuring programs.

IV. Monetary and Exchange Rate Policy

IV.1. Monetary Policy

Banco de México adopted inflation targeting as its framework for monetary policy in 2001. Inflation targeting is mainly characterized by a) the announcement of multi-annual CPI inflation targets; b) the systematic approach for identifying the origin and characteristics of inflation pressures; c) a description of the Central Bank's monetary policy instruments to attain its inflation objectives; and d) a communication policy that fosters the accountability and credibility on Central Bank's monetary policy, which facilitates economic agents' decision-making.

During the first months of 2003, the peso-US dollar parity depreciated due to the uncertainty regarding the war in Iraq. This, together with the supply shocks that affected inflation's non-core component, kept inflation expectations upward despite the restrictive monetary policy stance adopted at the end of 2002. In light of such developments, Banco de México decided to raise the *corto* once more on January 10, February 7 and March 28, 2003; from 475 to 550, 625, and 700 million pesos, respectively.

The restrictive monetary conditions observed since the end of 2002, which intensified in the first months of 2003, raised interest rates, especially short-term ones. This, together with the initial reduction in non-core CPI inflation, led to a downward revision in inflation expectations for the end of 2003 and for longer time spans (following 12 months and end of 2004) since the second quarter of the year.

International interest rates remained at historically low levels in 2003. This, together with the less uncertainty that began to prevail in international financial markets by mid-year, led to a significant reduction in emerging markets' risk premia. Under such setting, and given the downward revision on inflation expectations, the entire yield curve (all terms) in pesos began to shift down significantly.

IV.2. Exchange Rate Policy

On March 2003, the Foreign Exchange Commission announced the implementation of a mechanism to slow Banco de México's international reserve accumulation,[3] given the significant amount of international reserves accumulated in the previous years. Although the accumulation of this type of asset entails significant benefits, such as improving the country's conditions for access to international financial markets, it also generates a carrying cost for the Central Bank. Such cost results from the difference between the yield on foreign currency reserves and the interest rate paid for the liabilities issued to finance the holding of such reserves. In fact, at the margin, the net benefits of continuing accumulating international reserves are smaller compared with their cost. Therefore, the mechanism to slow international reserve accumulation allows the Central Bank to channel half of the currency flows to the market so reserves do not build up. Furthermore, its operation is not determined by exchange rate's level or trend.

Different domestic and external events during 2003 created higher exchange rate volatility. At the beginning of the year, the peso depreciated rapidly at the same time volatility in exchange rate options increased. Such behavior was mainly due to geopolitical conditions surrounding the war in Iraq, which led to lower appetite for risk.

Once geopolitical uncertainty was overcome, risk premia began to diminish. This, together with lower foreign interest rates, enabled Mexican sovereign bond spreads to narrow as compared with U.S. Treasury bills, while allowing exchange rate pressures to decrease. Nonetheless, uncertainty associated with the likely weakening of Mexican and U.S. manufacturing made the peso depreciate once more against the US dollar by the end of the year and short-term domestic interest rates rise.

Since the exchange rate passthrough did not increase in 2003, inflation was not affected significantly by exchange rate fluctuations.

[3] See Foreign Exchange Commission's press releases of March 7 and March 20, 2003 and Banco de México's Telefax 18/2003. For a detailed description of the mechanism to slow international reserve accumulation see also Banco de México's Inflation Report January-March 2003, p.43-44.

V. Final Remarks

Significant progress in disinflation has been made in recent years. At the end of 2003, annual headline inflation was 3.98 percent. Nonetheless, efforts in attaining the 3 percent target must continue. Banco de México's main challenge in the coming years is to consolidate price stability around the target. Mexico's stronger macroeconomic fundamentals have brought about significant benefits that could be reinforced once price stability is attained. Further reduction in inflation would lead to lower interest rates. Lower and more stable interest rates diminish the risks associated with both lending and borrowing. As price stability consolidates, financial deepening increases, therefore guaranteeing sustained higher growth in the long term. Thus, an historical restriction once faced by the Mexican economy could significantly diminish in the future.

In the last three years, the Mexican economy has grown below its potential. As a result, measures to reduce poverty, to strengthen the country's infrastructure, to create jobs, to foster investment in basic capacities, and prepare new generations, have taken place less rapidly than expected.

Mexico's reduced growth should be analyzed in light of two phenomena that have been present in the last years. On the one hand, it is clear that the Mexican economy has been losing competitiveness in world markets, as confirmed by the reduced share of U.S. imports from Mexico. While other countries have inserted themselves in the global economy, Mexico has lagged in the modernization of its economy. On the other, manufacturing firms are continuously searching for more profitable locations throughout the world to base their production. Manufacturing processes that use labor more intensively have migrated from countries with higher labor costs and bottlenecks in the main sectors of the economy to countries with lower labor costs and more flexible and efficient economic frameworks. Thus, manufacturing production in different sectors (textiles and electronic equipment, among others) has migrated from industrial countries to emerging economies with higher competitiveness, especially in Asia.

Consequently, investment returns in Mexico have fallen compared with other countries. Mexico has become less attractive to domestic and foreign investors, as confirmed by the behavior of both gross fixed investment and foreign direct investment. Thus, it is unfortunate that given the current economic conditions in which, for the first time in the last decade, credit supply does not seem to be a limiting factor for the expansion of the economy, the country's lack of growth comes from lower levels of investment.

In order to materialize and consolidate Mexico's growth potential, the country must be more competitive on the global scale. The Mexican economy needs more flexibility to adapt to the world's changing conditions. Progress must be done in different areas. First of all, the government needs more resources to invest in infrastructure and human capital, and to extend the coverage of social welfare. In addition, the productivity and efficiency of the Mexican energy sector must be raised, providing it with the proper legal framework that meets the standards of a highly integrated world. At the same time, the country needs to strengthen its rule of law, consolidate economic stability, and have more efficient and active markets. Therefore, as in previous reports, Banco de México reiterates the importance of reaching the agreements to both implement structural reforms and strengthen Mexico's institutions.