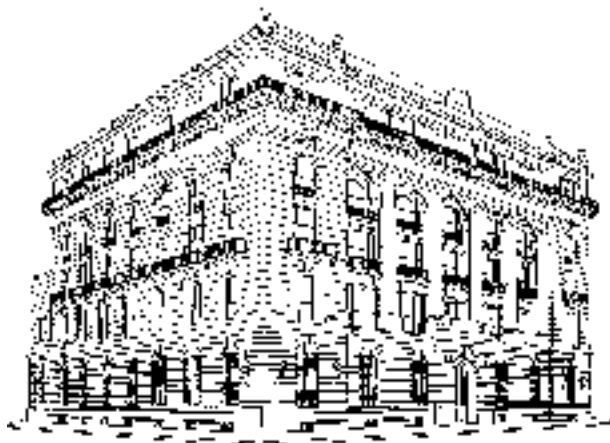


REPORT ON MONETARY POLICY FOR 1997



BANCO DE MEXICO

JANUARY, 1997

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In compliance with Article 51, Section I, of the Bank of Mexico's Law, the Board of Governors of this Institution hereby presents this exposition on the monetary policy for the period January 1st to December 31st, 1997, to the Federal Executive and the Congress of the Union.

This exposition updates and incorporates information already presented in the document "Main Elements of the Monetary Program for 1997", published last December.

CONTENS

[CHOICE YOUR PREFERENCE]

I. INTRODUCTION

II. MONETARY POLICY IN 1996

1. Objective of the Monetary Program

2. The Monetary Program

3. Execution of the 1996 Monetary Program

III. MONETARY PROGRAM FOR 1997

1. Objective of the Program

2. Preliminary Considerations

3. Elements of Monetary Policy for 1997

I. INTRODUCTION.

The Mexican Constitution establishes that the prime objective of monetary policy is to pursue the stability of the general price level. This criterion for the formulation of monetary policy is founded on the fact that inflation causes serious harm to the

welfare of the population, particularly as it affects income distribution, the efficient allocation of productive resources, the accumulation of savings and economic growth.

As explained in the following introductory paragraphs, the aim of reducing inflation, although it may not be apparent, signifies the high priority that has been given to economic growth, higher employment levels and the recovery of real wages.

In 1995, a severe decline, and even reversion, of net foreign capital flows into Mexico took place. Consequently, the exchange rate had to depreciate considerably. This depreciation of the national currency caused an immediate and substantial rebound in inflation and negative inflationary expectations. These pushed interest rates to very high levels, both in nominal and real terms. In turn, real wages were seriously affected by the acceleration of inflation and the decline in economic activity.

The significant increase in nominal and real interest rates, the deterioration of real wages and the contraction in economic activity made the debt burden of the private sector disproportionate to its income. In addition to generating a marked increase in the financial institutions' past-due loan portfolios, the private sector's large debt burden induced a severe contraction in both corporate investment and household consumption levels.

The difficult situation that banks have been experiencing during the two previous years, along with high interest rates and the over-indebtedness of both firms and individuals, contributed to a clear reduction in the amounts of financing available for purchases of durable goods and homes, personal expenditures and new investment projects. As investments declined, fewer jobs were created and the possibilities for paying better wages became meager.

All this illustrates how, by pushing interest rates up, inflation and negative inflationary expectations are powerful recessionary factors. These recessionary factors become more powerful with faster price increases, more unfavorable outlooks on future inflation and, consequently, higher interest rates.

The solution to this problem lies not in arbitrarily determining interest rates. Using administrative measures to fix interest rates at levels below those warranted by the market would produce adverse results. Firstly, deposits taken by the financial system would diminish. Therefore, funds available to finance economic activity would become more expensive and scarcer. Additionally, as bank deposits and other financial investments became less attractive, the public would increase their spending, thus fueling inflationary pressures. Alternatively, the public could purchase foreign currency, thus promoting the depreciation of the national currency and, consequently, inducing higher inflation.

The sole available means for a gradual but sustainable abatement of interest rates is to persevere in the application of a policy geared towards general price level stability.

In times of inflation, nominal interest rates tend to be higher than in times of stability, because, in the first place, savers demand compensation for the loss in the real value of their savings. Another reason why not only nominal but also real interest rates tend to be higher in times of inflation, is that there is more difficulty for accurately predicting the future course of inflation. This gives place for investors to require that interest rates, in addition to compensate them for the expected erosion of their principal's purchasing power, should incorporate a risk premium to cover for the possibility that inflation may turn out to be higher than expected during the period when their resources remain invested.

There are at least three reasons why at the present time lower real and nominal interest rates are desirable:

- to assist in the solution to the problem of over-indebted companies and households;
- to restore the dynamism of the Mexican credit market; and
- to reduce the fiscal cost of programs implemented in support of debtors and the restoration of banks' financial soundness. This would in turn allow reductions in the Federal Government's demand for financing, thus preventing future pressures on interest rates.

All of this would result in greater domestic consumption and investment, which would in turn induce faster economic growth, higher employment and greater opportunities for improvements in real wages.

In correspondence with the above, the main objective of the Bank of Mexico's monetary program for 1996 was to contribute towards a substantial reduction in inflation. In addition, the "Exposition on Monetary Policy for 1996" also stated that a monetary policy geared towards said objective, in combination with other policy measures contained in the Alliance for

Economic Recovery (Alianza para la Recuperación Económica, ARE), would make it possible to attain a real GDP growth rate above 3 percent.

Based on the results obtained, the strategy applied by the authorities has been adequate. Had it not been so, gross domestic product would not have risen around 4.5 percent in 1996, as available data would indicate. Furthermore, the open unemployment rate would have not fallen from 5.5 percent in December 1995 to 4.1 percent in the same month of 1996. Moreover, inflation would not have declined during the past year to a level that, although above what was originally projected, was almost one half of that observed in 1995.

A particularly encouraging aspect in 1996 was the performance of investment and consumption. Both components of aggregate demand, and investment in particular, contributed significantly to economic growth. Therefore, contrary to what sometimes is said, the recovery of economic activity has not been exclusively sustained by the momentum of the exporting sector. To a great extent, the rebound in investment has been possible as a result of the gradual decline in both nominal and real interest rates during 1996. As previously mentioned, said decline responded to significant improvements in inflationary expectations and the unwavering fiscal discipline.

In 1997, the Bank of Mexico, through the implementation of monetary policy, will continue to contribute towards lower inflation and, therefore, a steady, declining trend in interest rates. This is the best contribution the central bank can possibly make towards economic growth and a better distribution of income in Mexico. A strictly applied fiscal policy will also play a key role in obtaining the desired results.

In order to facilitate the presentation of the 1997 monetary program, it is pertinent to briefly review that for 1996.

II. MONETARY POLICY IN 1996.

1. *Objective of the Monetary Program.*

The objective of the 1996 monetary program was to **contribute** towards lowering inflation from almost 52 percent in 1995 to 20.5 percent in the following year.⁽¹⁾ These percentages reflect annual inflation as measured between December of one year and the same month of the previous year.)

The latter was the figure established in both the ARE and in the "General Economic Policy Criteria" (Criterios Generales de Política Económica), document which was sent by the Federal Executive to the Honorable Chamber of Representatives in November 1995.

2. *The Monetary Program.*

In order to design the monetary program for 1996, the Bank of Mexico forecasted, by means of econometric models, the probable path of the demand for base money for the year. Using these models implies adopting certain assumptions regarding the evolution of real GDP, inflation and interest rates. The assumptions adopted were compatible with the provisions on real GDP and inflation contained in the ARE and on interest rates contained in the "General Economic Policy Criteria". The estimation results showed that the monetary base increase consistent with these assumptions was 18,000 million pesos (m.p.), i.e., 27 percent of the stock of base money at year-end 1995.

As it will be shown ahead, the observed evolution of the monetary base during 1996 in fact complied with what had been established in the monetary program.

The following measures were applied by the Bank of Mexico so that the observed evolution of the monetary base would conform to the path projected for 1996:

1) Adjusting the supply of primary money (1 Primary money and monetary base are synonyms.)

on a daily basis so as to meet the demand for monetary base. In doing so, the Bank of Mexico a) supplied the daily demand for bills and coins; b) offset the monetary effects of movements in the Federal Treasury's current account in the central bank, as well as the effects of variations in net international assets; and c) completely compensated for the monetary effect of credit support granted to the Bank Fund for the Protection of Savings (Fondo Bancario de Protección al Ahorro, FOBAPROA) and to the Support Fund for the Securities Market (Fondo de Apoyo al Mercado de Valores, FAMEVAL).

2) Modifying, if needed, the conditions under which primary credit was supplied in order to ensure sound financial and foreign

exchange markets. This mechanism was used on certain occasions when it was deemed appropriate to prevent the occurrence of speculative spirals. Had these speculative attacks not been halted, they would have resulted in an accelerated depreciation of the domestic currency, generating additional inflationary pressures and larger interest rate hikes than those actually observed at the time.

In addition to establishing a growth objective of the monetary base, the central bank determined quarterly limits for the variations of its domestic credit. (3 In the 1996 monetary program, the item "variations in net domestic credit" was defined as variations in the monetary base minus variations in net international assets. In turn, the latter variations were to be the result of deducting the Bank of Mexico's liabilities vis-à-vis the International Monetary Fund (IMF) and the short-term (under 6 months) liabilities stemming from agreements with central banks, from the Bank of Mexico's gross international assets. The domestic currency equivalent of variations in net international assets is calculated using the exchange rate applied to each individual transaction. This definition of net domestic credit is the same generally used by analysts, and will continue to be used in the future).

To set these limits, the marked seasonality of the demand for monetary base was taken into account, as well as the expected minimum increase in net international assets.

3. Execution of the 1996 Monetary Program.

The execution of the 1996 monetary policy program can be evaluated with respect to the evolution of three variables: the monetary base, net international assets and net domestic credit.

a) Monetary base.

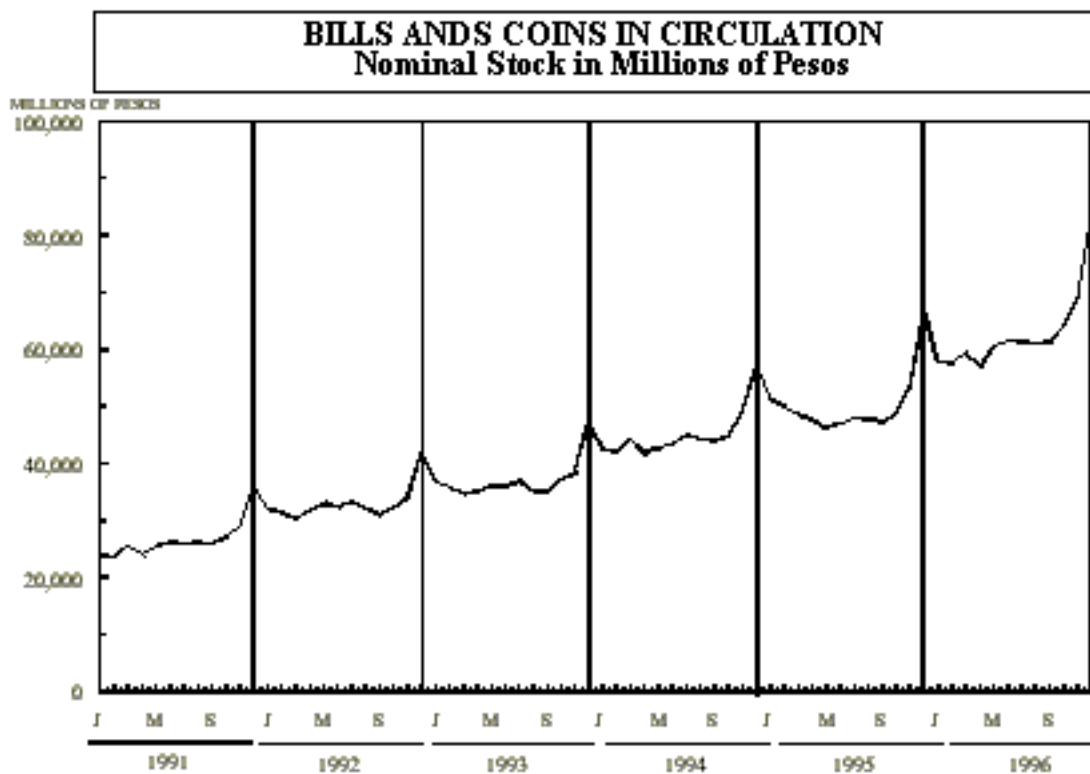
At year-end 1996, the stock of the monetary base was 83,991 m.p., which represented a 17,182 m.p. increase over the stock at year-end 1995. Therefore, the annual variation of the monetary base was slightly below the 18,000 m.p. anticipated in the Bank of Mexico's monetary program.

The variation in the stock of bills and coins in circulation was also 17,182 m.p. The correspondence between the latter figure and that for the monetary base is explained by the fact that, under the zero-average reserve requirement regime, banks do not need to maintain deposits in the central bank except to compensate for overdrafts they may incur. Thus, the behavior of the monetary base during 1996 depended fundamentally on the evolution of bills and coins in circulation.

It is well known that the demand for bills and coins is highly seasonal. The nominal stock of bills and coins in circulation tends to contract during the first few months of the year and remains relatively constant up to the end of October. During the last two months of the year, the demand for bills and coins expands significantly in response to both the payment of year-end and Christmas bonuses and the concentration of a large portion of households' and companies' annual expenses during this part of the year. The strong demand for said means of payment taking place during the last couple of months of every year reverts itself, to a large extent, shortly before the end of December. The demand for bills and coins also shows a seasonal pattern during weekly and fortnight periods.

The evolution of bills and coins in circulation during 1996 followed a very similar pattern to those of previous years (see Graph 1).

GRAPH 1



b) Net international assets.

Between December 31, 1995 and year-end 1996, net international assets increased 5,864 million dollars (4 This figure refers to the variation of net international assets during 1996 excluding the revalorization of gold stocks and liabilities with the International Monetary Fund. It is customary to reappraise the dollar value of gold stocks and liabilities with the IMF only at the end of every year, taking the international price of gold and the dollar/DEG exchange rate on December 31 as the bases for the corresponding calculations. If the aforementioned revalorizations were taken into consideration, net international assets would have risen by 6,348 m.d. for the year).

(m.d.). This expansion was substantially greater than the minimum anticipated in the monetary program for the year (1,400 m.d.). Several reasons account for this considerable accumulation of international assets: (i) the success obtained by the Federal Government in placing public debt abroad; (ii) extraordinary net revenues from operations with PEMEX, the outcome mainly of higher prices for Mexican export mix of crude oil; and (iii) the launching of an options mechanism by which banking institutions acquire the right to sell dollars to the Bank of Mexico if certain conditions are satisfied.

c) Net domestic credit.

In 1996, the Bank of Mexico's net domestic credit remained below the limits established in the monetary program for the year (see Table 1). Between January and December of 1996, net domestic credit posted a 28,260 m.p. reduction.

TABLE 1

EVOLUTION OF NET DOMESTIC CREDIT AND NET INTERNATIONAL ASSETS IN 1996

Accumulated Effective Flows in Millions

QUARTER	VARIATIONS IN NET INTERNATIONAL ASSETS				VARIATIONS IN NET DOMESTIC CREDIT	
	MINIMUM		OBSERVED		CEILINGS	OBSERVED
	(DOLLARS)	(PESOS)*	(DOLLARS)	(PESOS)**	(PESOS)	(PESOS)
I	0	0	1,775	13,832	-5,000	-21,141
II	500	3,850	1,631	12,630	-4,050	-17,846
III	1,000	7,770	3,295	25,335	-8,150	-30,504
IV	1,400	10,780	5,864	45,442	7,220	-28,260

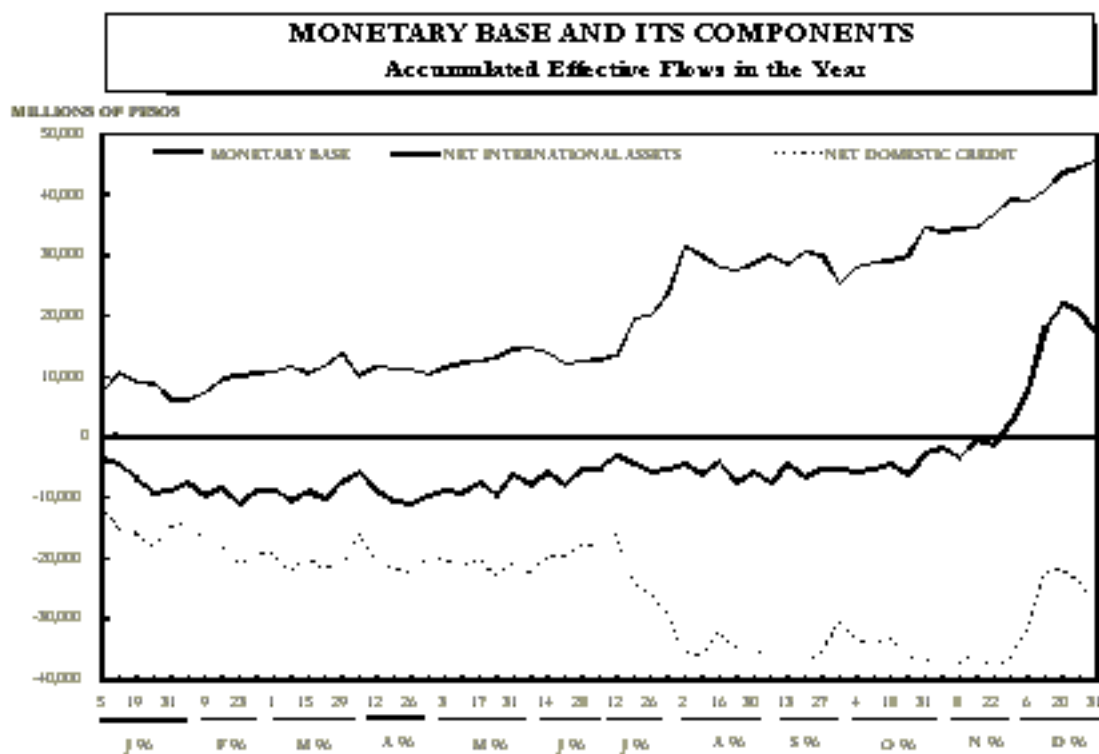
* To convert dollar figures into pesos, an annual average exchange rate of 7.70 pesos per dollar was used.

** The observed dollar variations in net international assets were converted into pesos at the exchange rate used in each individual transaction.

Net domestic credit is defined as the difference between the stock of monetary base and the stock of net international assets. Therefore, the evolution of net domestic credit during the year is explained by the behavior of both the monetary base and net international assets. In 1996, the domestic currency value of net international assets rose more than the monetary base, which meant that net domestic credit had to decline in order for the monetary base to maintain its desired path (see Graph 2).

Inasmuch as variations in net domestic credit and net international assets were combined so as to produce the desired stock of monetary base, it can be asserted that the decline in net domestic credit by no means implied any monetary restriction.

GRAPH 2



During 1996, there were some instances when the Bank of Mexico modified the conditions under which it granted its net domestic credit, with the main purpose of ensuring sound conditions in the money and foreign exchange markets.

As may be recalled, the Bank of Mexico has established accounting periods of 28 days during which banks seek to post a zero daily average balance in the current accounts they hold in the central bank. Banks strive to obtain said balance because, should the daily average balance be negative, the bank in question would have to pay an interest rate equivalent to twice the prevailing 28-day CETES rate on the respective balance. On the other hand, should the daily average balance be positive, the bank would lose the returns it could have obtained had it invested in the market the respective funds.

In order to meet the demand for bills and coins, the Bank of Mexico offered credit to banks via daily auctions, so as to offset maturing credits previously granted to banks, movements in the Federal Treasury's account, and the monetary impact of purchases of foreign currency by the central bank.

The central bank determines the sum of credit to be auctioned each day so that the overall net daily average balance of all current accounts held by banks at the Bank of Mexico -accumulated during the specific accounting period- may close the day at a predetermined amount. If said amount is negative, the Bank of Mexico would put the banking system in short and, if the

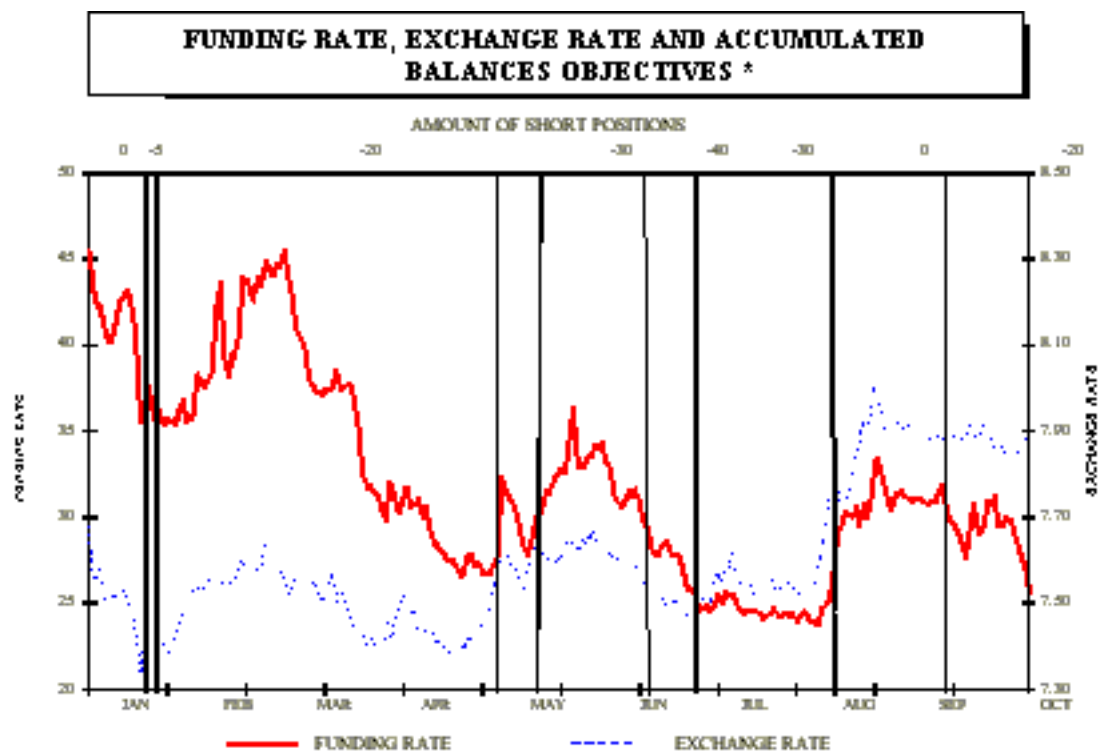
amount is positive, the system would be put in a long position. It follows that if the central bank puts the system in short, at least one credit institution will have to pay the penalty interest rate of twice the prevailing CETES rate.

It should be stressed that the Bank of Mexico always supplies the credit necessary to completely satisfy the demand for bills and coins, even when the banking system is put in short. Nevertheless, in this case, a portion of the credit is supplied at a higher interest rate, which is applied to the overdrafts in the current accounts of one or several banks.

When the system is put in short, the central bank exerts upward pressure on interest rates. Nonetheless, more than for any other reason, said pressure is the result of the signal given by Bank of Mexico. A point in case is that the maximum amount for which the system was short in 1996, 40 million pesos, represented only 0.0006% of the average monetary base for the year. In fact, it seems that adjustments in the short position have greater influence over interest rates than the actual existence of such a position.

In 1996, the central bank put the banking system in short a few times. These are depicted in Graph 3. The Bank of Mexico implemented these measures when a rise in interest rates, or the moderating of their decline, was deemed necessary, whether in order to prevent a devaluatory spiral or to offset other inflationary pressures which could have subsequently resulted in greater interest rate increases. It may seem paradoxical, but in order to attain permanent reductions in interest rates -which only declining inflation can ensure- it is sometimes necessary to promote temporary interest rate hikes.

GRAPH 3



* The objective for bank's current accounts accumulated balances is shown in the upper part of the Graph, in millions of pesos.

The monetary program for 1996 can also be evaluated vis-à-vis the attainment of its primary objective: to **contribute** towards the abatement of annual inflation from almost 52 percent in December 1995 to 20.5 percent in December 1996.

It must be borne in mind that, even when it has the ability of managing its own credit, a central bank cannot directly control the evolution of the general price level. Its influence over this variable is through the effect its actions can have on aggregate demand, the exchange rate and expectations. However, there are several factors outside the reach of any central bank's decisions that impinge upon the evolution of prices. Among these factors, the following must be emphasized: adjustments in the prices of public goods and services, increases in minimum wages, changes in indirect taxes, fluctuations in the international prices of raw materials, and external inflation. In the case of the Mexican economy, abrupt adjustments in minimum wages and in the prices of public goods and services are the factors that most affect the evolution of inflation. These factors are the result of administrative decisions and are, therefore, beyond the reach of monetary policy. Additionally, it must be considered that the effects of a central bank's monetary policy actions tend to lag behind the evolution of the general price level. Consequently, in

the short-term it is impossible to offset the effects of the aforementioned factors.

The 1996 accumulated variation in the National Consumer Price Index (Índice Nacional de Precios al Consumidor, INPC) was 27.7 percent, 7.2 percentage points over the inflation rate projected in the ARE and in the economic program for the year. The main elements that explain the deviation between the observed 1996 inflation and that set out in the ARE are: a) a substantially higher depreciation of the peso during the last few months of 1995 vis-à-vis the depreciation expected at the time the ARE was signed; b) the implementation till the end of December of price adjustments corresponding to the first phase of the ARE, which then mainly affected the 1996 inflation rate instead of that of 1995; c) the 12 percent increase in minimum wages effected in April, which was 2 percentage points higher than initially agreed upon; d) substantial increases in the prices of some agricultural products (both consumption goods and raw materials) in response to considerable elevations in the international prices of grains as well as the drought that affected a large portion of the country in the first few months of 1996; and e) the adjustments in minimum wages and the prices of public goods and services effected in December 1996 (not foreseen in the ARE) as part of the measures agreed upon within the Alliance for Economic Growth (Alianza para el Crecimiento, ACE). According to the best possible estimate, the factors listed above explain 5.8 percentage points of the 7.2 percentage point difference between the observed inflation rate and that established in the ARE. In other words, had these factors not impinged upon the actual evolution of prices, the inflation rate would have only been 21.9 percent. The individual contributions of each of these factors to observed inflation are listed in Table 2.

TABLE 2

ESTIMATION OF THE INFLATIONARY IMPACT OF THE DIFFERENT
FACTORS THAT EXPLAIN THE DEVIATION BETWEEN THE
1996 OBSERVED INFLATION RATE AND
THE 20.5 PERCENT ORIGINAL PROJECTION *

FACTORS	IMPACT ON 1996 INFLATION RATE (percentage points)
a) Higher than expected depreciation of the peso during the last few months of 1995	0.7
b) Implementation till the end December of price adjustments corresponding to the first phase of the ARE	0.4
c) 12% increase in minimum wages effected in April -2 percentage points above that initially agreed upon	0.8
d) Substantial increases in the prices of some agricultural and livestock products, resulting from the severe drought in the early months of 1996 and the elevation of international prices of grains	2.0
f) Adjustments in minimum wages and prices of public goods and services, effected in December 1996 as part of the measures agreed upon within the Alliance for Economic Growth	1.9
g) Other	1.4
Total	7.2

* Estimates of the impact of each of the aforementioned factors on the 1996 inflation rate

incorporate both their direct and indirect effects.

III. MONETARY PROGRAM FOR 1997.

1. *Objective of the Program.*

The primary objective of the 1997 monetary program is to **contribute** towards the abatement of the inflation rate to 15 percent. This percentage refers to the annual variation in the general price level between December 1997 and the same month in 1996. As a result of a monetary policy geared towards said objective, in addition to other measures contemplated in the Alliance for Economic Growth and in the document entitled "General Economic Policy Criteria", it is probable that real GDP will grow above 4 percent in 1997.

2. *Preliminary Considerations.*

The main characteristic that distinguishes a central bank from any other financial intermediary is its capacity to create unlimited amounts of money. The central bank issues money when it grants credit or when it buys foreign currency from banks. This is so because the countervalue of such operations is credited to the current accounts banks (5 Both commercial and development banks).

Hold in the central institute, against which banks may withdraw currency (6 The money issued by the central bank is taken out of circulation when operations inverse to the ones described take place, that is, when the central bank collects credits granted or sells foreign currency to banks. In these cases, the corresponding sums are debited from banks' current accounts or the central bank receives bills and coins in payment from banks.)

A central bank does not need to obtain deposits from the public in order to grant credit, nor does it need to have capital, as is the case with other credit institutions. For these reasons, the money issued by a central bank is known as primary money or monetary base.

The exclusive ability of issuing money must be used prudently. Otherwise, inflationary pressures or recessionary forces may originate to the detriment of the economy. In countries such as Mexico, which has a history of inflationary episodes, any excess in the supply of base money quickly develops into higher inflation via shifts in inflationary expectations. A strengthening of these expectations usually results in exchange rate depreciations, higher interest rates, higher nominal wages, and higher prices for goods and services.

Therefore, in designing its 1997 monetary program, the Bank of Mexico has taken special care to ensure economic agents that it will not create an excess supply of monetary base.

The Bank of Mexico has committed to conducting its operations so as to avoid the creation of positive overall accumulated balances in the current accounts banks hold in the central bank. It should be recalled that, under the zero average reserve requirement regime in force, banks do not need to, nor have incentives to maintain deposits in the central bank, except to compensate for overdrafts they may incur. Therefore, if on any particular day the Bank of Mexico's operations were to be conducted pursuing an overall positive accumulated balance in banks' current accounts, the central bank would be signaling its intention to produce an excess supply of money. To prevent this from happening, the Bank of Mexico will comply with the aforementioned commitment.

By attempting to equate the supply with demand for base money on a daily basis, the Bank of Mexico might inadvertently satisfy a demand for money that corresponds to a higher inflation path than desired. To ascertain whether this possibility is actually occurring, the central bank continuously compares the observed path of the monetary base against the expected path; the latter being compatible, in principle, with the assumption on inflation for the year. As it has been explained, the Bank of Mexico determines the monetary base's expected path on the basis of the assumptions on economic growth, interest rates and inflation for the year, as well as the marked seasonality of the demand for bills and coins.

In order to provide the public with additional information and means for analysis, the Bank of Mexico will publish the monetary base's expected daily path for 1997, which is compatible with a 15 percent inflation rate and with the assumed evolution of economic growth, interest rates and remonetization.

The mentioned path was estimated using econometric models. It has to be borne in mind that no econometric model will render an exact forecast, among other reasons, because the used assumptions will not necessarily materialize with precision. Therefore, it is to be expected that practically on a daily basis, deviations between the observed and estimated paths will be registered. According to the models utilized, the standard deviation of the regression's errors is 2.6 percent, which is equivalent to an approximate interval of plus/minus 2,700 m.p. in relation to the point estimate of end 1997.

It must be stressed that not every deviation between the monetary base's forecasted and observed paths will necessarily cause adjustments in the monetary policy stance. Should the observed path actually be over the estimated path in response to circumstances which imply additional inflationary pressures, the Bank of Mexico can be expected to adopt a restrictive monetary stance. Nevertheless, said deviation may also be the result of the inevitable errors inherent to all econometric estimations, or the result of any of the assumptions on economic growth, interest rates and remonetization not being attained. If, in the latter cases, the demand for base money is greater than expected, there will be no reason to induce a contraction by means of higher interest rates. Under these circumstances, a larger stock of monetary base would not be indicative of an excess supply of money that could lead to higher inflation.

The supply of primary money can be adjusted by the Bank of Mexico so as to satisfy the observed demand, be it through variations in the central bank's net domestic credit or in net international assets. However, the central bank has relatively better control over its domestic credit. For this precise reason, the inadequate management of net domestic credit potentially can be the easiest way to create an excess supply of base money. Therefore, in order to provide assurances that no inflationary pressures will be generated through this source, the Bank of Mexico has decided to once again incorporate quarterly limits on its net domestic credit into its monetary program.

Inasmuch as domestic credit is defined as the difference between the monetary base and net international assets, the quarterly limits on the variations of net domestic credit are the result of the expected evolution of these two variables. As previously mentioned, the monetary base's expected path depends mainly on the projected behavior of GDP, interest rates and inflation. In turn, the minimum increase in net international assets is estimated on the basis of the foreign exchange transactions the Bank of Mexico anticipates with the Federal Government and PEMEX, in addition to the foreign exchange purchases that will probably result from exercising the options that are auctioned amongst banks on a monthly basis.

If the demand for base money is greater than what is compatible with the limits established on domestic credit variations, the excess demand will only be accommodated via the accumulation of net international assets beyond the established minimum.

It must also be stressed that the limits established on the growth of the central bank's net domestic credit are ceilings rather than targets. Therefore, net domestic credit could grow less if the monetary expansion resulting from the accumulation of international assets is greater than the anticipated minimum.

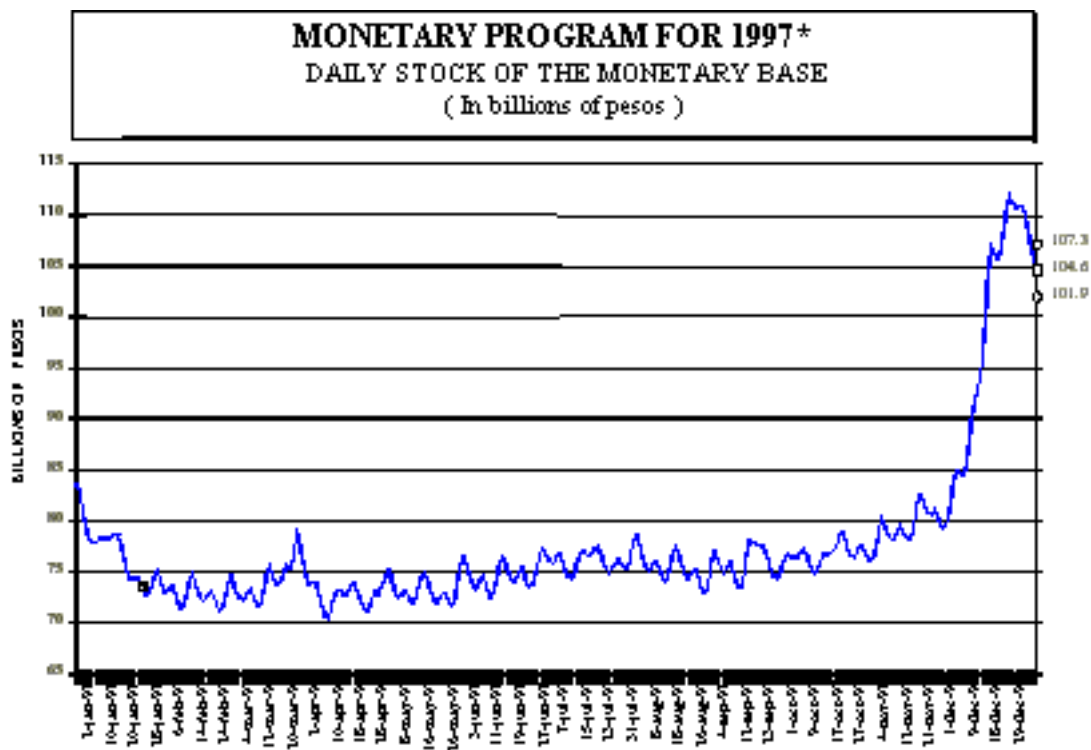
The Exchange Commission, made up of representatives from the Ministry of Finance and Public Credit and the Bank of Mexico, has considered that a greater availability of international assets would contribute towards improving the terms under which Mexico can obtain foreign financing. Therefore, an important part of the 1997 monetary program is a commitment to accumulating a minimum of international assets.

The last component of the 1997 monetary program is a previously used criterion for the implementation of monetary policy: the Bank of Mexico will continue to modify the conditions under which it supplies its net domestic credit by placing the financial system in short in order to ensure sound conditions in the money and foreign exchange markets. In addition, the central bank will put the system in short when necessary to ensure that the monetary base's path does not unwarrantedly deviate from the path compatible with the assumption on inflation for the year.

3. Elements of Monetary Policy for 1997.

(a) Expected path for the monetary base. Taking the projections on economic growth, interest rates and inflation for 1997 into account, as well as the seasonality of the demand for bills and coins in circulation, the Bank of Mexico has estimated a path for the monetary base. Said path is presented in Graph 4 and in the table in Annex I. (7 The comparison between the monetary base's estimated path for 1996 against the observed path is reported in Annex II.)

GRAPH 4



In accordance with the 1997 economic program, a substantial reduction in annual inflation and declining interest rates are expected. It is likely that these factors will stimulate the demand for base money as they reduce the public's opportunity cost of holding bills and coins. Therefore, the increase in the demand for base money will be greater than what could be expected on the basis of inflation and real GDP growth alone. In other words, some remonetization is anticipated for 1997. This remonetization will most probably take place during the year, as it did not happen during 1996. In this respect, it should be kept in mind that certain variables respond to their determining factors only after a certain period of time.

The Bank of Mexico estimates that the monetary base will expand 24.5 percent in 1997, as compared to the 1996 year-end stock. As a result of a remonetization of about 3.6 percent of the monetary base's 1996 year-end stock (83,991 m.p.), the expected increase for 1997 is greater than that resulting from combining the projections on real GDP growth (4.5 percent) (8 This figure refers to both the annual average GDP growth rate for 1997 and to the growth rate between the fourth quarter of 1996 and that of 1997).

and inflation (15 percent) for the year. By applying the monetary base's expected growth rate for 1997 (24.5 percent) to the monetary base stock as of December 1996, an annual flow of 20,580 m.p. will be obtained, which in turn will yield a stock of 104,570 m.p. on December 31, 1997. Like any other projection, this figure has an implicit margin of error. The confidence interval for the stock of monetary base at year-end 1997 is between 107,290 m.p. and 101,851 m.p., considering one standard deviation of the econometric model's residuals.

(b) Accumulation of net international assets. The Bank of Mexico intends to increase its net international assets by at least 2,500 million dollars in 1997. This accumulation will result from the foreign exchange transactions that the central bank normally carries out with the public sector and from the exercise of foreign exchange put options that the central institute auctions off among credit institutions on a monthly basis. This options mechanism encourages credit institutions to sell foreign currency to the central bank when there is excess supply in the foreign exchange market, and discourages said sales when there is excess demand. Moreover, this mechanism does not alter the nature of the floating exchange rate regime in force, as these options in no way predetermine the level of the exchange rate.

(c) Quarterly limits on the expansion of the central bank's domestic credit. The net domestic credit is defined as the monetary base minus net international assets. Therefore, the limit on the growth of net domestic credit for 1997 will equal the difference between the expected variation in the monetary base for the year and the aforementioned accumulation of net international assets valued in domestic currency. In order to facilitate the attainment of the intended minimum accumulation of net international assets, quarterly limits will be established on the growth of net domestic credit. The seasonality of the demand for base money and the expected minimum variations in net international assets during the year have been taken into consideration

to determine said limits, which are presented in Table 3.

TABLE 3

**QUARTERLY LIMITS ON THE VARIATIONS
OF NET DOMESTIC CREDIT IN 1997**

Accumulated Effective Flows in Millions

	MINIMUM INCREASES IN NET ASSETS		MONETARY BASE	NET DOMESTIC CREDIT**
	DOLLARS	PESOS *	PESOS	PESOS
	(1)	(2)	(3)	(3) - (2)
I	2,000	17,060	-6,500	-23,560
II	2,200	18,766	-6,800	-25,566
III	2,400	20,472	-7,600	-28,072
IV	2,500	21,325	20,580	-745

* An annual average exchange rate of 8.53 pesos per dollar is estimated for the year.

** These limits denote that net domestic credit will fall by at least the indicated amounts.

Inasmuch as domestic credit is the difference between base money and net international assets, the former will decline as net international assets increase, without being translated into contractions in the monetary base. Consequently, such a decline in domestic credit, if observed, would in no way imply a restriction on the economy, since the peso absorption would be offset by the injection of money resulting from the corresponding purchase of foreign currency by the central bank.

(d) Criteria for the implementation of monetary policy.

First: the Bank will try to keep the evolution of the monetary base from deviating undesirably from the monetary base's path shown in Graph 4.

Second: The Bank of Mexico will promote sound conditions in the foreign exchange and money markets. Therefore, if judged necessary, the central bank may modify the conditions under which it supplies its domestic credit, thus putting the banking system in short. Under such circumstances, a small portion of the total credit granted by the central bank to the system will be granted at an interest rate equivalent to twice the 28-day CETES rate. Once the conditions causing said monetary policy adjustments disappear, the Bank of Mexico will return to a neutral stance.

In order to satisfy the above-mentioned criteria, the central bank, as a general rule, will adjust on a daily basis the supply of primary money such that said supply will meet the demand for base money. Any estimation error of the demand for base money will be corrected through the next operations which the Bank will conduct in the money market.

From the above, it is concluded that the central bank will avoid an overall accumulated positive balance in the current accounts that commercial banks hold with the central bank, and it will only act to induce negative balances if this is convenient for meeting any of the above-mentioned criteria.

ANNEX I						
MONETARY PROGRAM FOR 1997						
Daily Forecast of the Stock of the Monetary Base						
(Billions of Pesos)						
1997						
Day	JAN*	FEB	MAR	APR	MAY	JUN
1	84.0	75.3	74.8	75.2	74.5	76.6
2	83.5	75.3	74.8	73.9	75.3	75.5
3	82.9	74.2	73.9	73.9	75.3	74.0

4	82.9	73.0	72.6	73.8	75.3	73.3
5	82.9	73.0	72.2	73.8	75.3	74.2
6	80.8	73.3	73.0	73.8	73.3	74.6
7	79.0	73.6	73.3	72.2	72.3	74.6
8	77.9	73.6	73.3	70.8	72.9	74.6
9	77.9	73.6	73.3	70.4	73.2	73.5
10	78.4	72.4	72.4	71.6	73.2	72.6
11	78.4	71.4	71.6	72.9	73.2	73.0
12	78.4	71.9	72.2	72.9	72.4	75.4
13	78.2	74.0	74.4	72.9	71.9	76.6
14	78.4	75.1	75.6	73.2	73.0	76.6
15	78.4	75.1	75.6	72.9	74.4	76.6
16	78.8	75.1	75.6	72.8	75.0	75.6
17	78.8	74.0	74.6	73.6	75.0	74.5
18	78.8	72.7	73.7	73.8	75.0	74.1
19	78.8	72.1	74.2	73.8	73.7	75.0
20	77.5	72.8	75.8	73.8	72.3	75.5
21	75.6	73.1	75.8	72.7	72.0	75.5
22	74.4	73.1	75.8	71.6	72.7	75.5
23	74.4	73.1	75.8	71.3	73.0	74.4
24	74.5	72.0	75.4	72.3	73.0	73.5
25	74.5	71.1	76.7	73.1	73.0	73.7
26	74.5	71.6	79.2	73.1	72.2	75.5
27	73.5	73.7	79.2	73.1	71.7	77.4
28	72.8	74.8	79.2	72.8	72.6	77.4
29	73.0		79.2	73.6	75.4	77.4
30	74.4		79.2	74.5	76.6	77.2
31	75.3		77.5		76.6	

* Observed data for the first 27 days of January.

ANEXO I

MONETARY PROGRAM FOR 1997

Daily Forecast of the Stock of the Monetary Base

(Billions of Pesos)

1997						
Day	JUL	AUG	SEP	OCT	NOV	DEC
1	76.2	78.5	77.0	76.4	80.3	84.9
2	75.8	78.5	75.7	77.1	80.3	84.5
3	76.4	78.5	75.0	77.4	79.5	85.6
4	76.8	77.2	75.5	77.4	78.4	89.4
5	76.8	75.7	75.9	77.4	78.1	91.9
6	76.8	75.2	75.9	76.3	79.1	91.9
7	75.6	75.8	75.9	75.2	79.6	91.9
8	74.4	76.1	74.6	74.9	79.6	92.8
9	74.3	76.1	73.5	75.9	79.6	95.8
10	75.4	76.1	73.5	76.8	78.8	102.6
11	76.7	74.9	75.8	76.8	78.1	107.1
12	76.7	74.0	78.2	76.8	78.9	107.1

13	76.7	74.4	78.2	76.5	81.3	107.1
14	77.0	76.5	78.2	76.9	82.6	107.1
15	76.6	77.6	77.9	77.4	82.6	106.5
16	76.6	77.6	77.9	78.5	82.6	105.8
17	77.3	77.6	77.6	78.9	81.8	106.6
18	77.6	76.4	77.5	78.9	80.9	110.1
19	77.6	75.0	77.1	78.9	80.7	112.0
20	77.6	74.4	77.1	77.7	80.7	112.0
21	76.4	75.0	77.1	76.6	81.3	112.0
22	75.2	75.2	75.9	76.3	81.3	111.0
23	74.9	75.2	74.6	77.2	81.3	110.7
24	75.7	75.2	74.4	77.6	80.0	111.0
25	76.3	74.0	75.4	77.6	79.2	111.0
26	76.3	73.0	76.6	77.6	79.9	110.1
27	76.3	73.4	76.6	76.8	83.0	110.1
28	75.6	75.7	76.6	76.0	85.0	110.1
29	75.3	77.0	76.9	76.7	85.0	107.5
30	76.4	77.0	76.4	79.0	85.0	105.6
31	78.1	77.0		80.3		104.6

ANNEX II

EVOLUTION OF THE MONETARY BASE IN 1996

