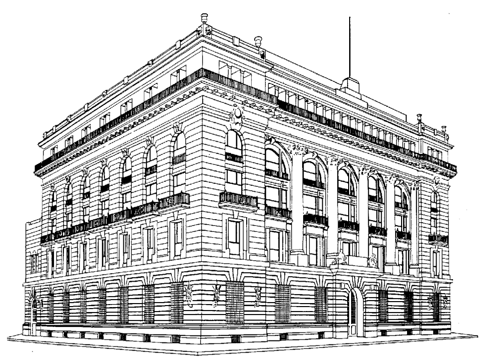
Report on Monetary Policy for 1999



BANCO DE MEXICO

JANUARY, 1999

BANCO DE MÉXICO

BOARD OF GOVERNORS

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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 1 to December 31, 1999, to the Federal Executive and the Congress of the Union.

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I. Introduction

The major purpose of Banco de México's monetary program for 1999 is to contribute to the reduction of inflation. Banco de México's persistent attitude in achieving such goal is not only explained by the obligation to comply with its constitutional mandate. It is also the reflection of an overwhelming amount of empirical evidence, derived both from its own experience as well as from other countries, pointing to the fact that a persistent and erratic increase in prices produces highly damaging consequences on economic performance and the material welfare of the population. Among the undesirable effects generated by inflation, stand out those related to economic growth, income distribution and the purchasing power of wages.

During 1998, the Mexican economy showed a generally favorable performance, even more so considering it faced quite an adverse external environment. The main external disruptions consisted of a sharp fall in oil prices; a marked deterioration in the country's terms of trade; lower global growth; and, a strong contraction of external capital flows. This last element was caused, to a great extent, by the substantial volatility observed in international financial markets, as a result of a global crisis qualified as the most severe in the last 50 years.

Economic policy during 1998 allowed the absorption of these external shocks without significantly affecting Mexico's productive activity and the economy's external standing. Nevertheless, as part of the adjustments of the economy to such shocks, the domestic currency depreciated substantially. Such depreciation generated a rise in 1998 inflation above the figure for 1997, as well as a deviation above six percentage points from the original target --although Banco de México repeatedly restricted its monetary policy during the year-- . Banco de México's Board of Governors finds this result highly unsatisfactory, which is why it considers that it is a matter of the utmost urgency to recover the downward behavior in price growth observed during 1996 and 1997. Consequently, the Board of Governors states its firm purpose of striving, through the orderly implementation of monetary policy, to achieve a prompt reversal in the trend of inflation, in order to attain the target established for 1999.

In designing the monetary program for this year, it has been necessary to take into account the inflationary inertia inherited from 1998 as well as the monetary policy measures implemented during that period, specially those still in effect. Therefore, before introducing the program, the following sections make a brief description of the events regarding inflationary matters during 1998 and the consequent monetary policy reactions within the context of the relevant external environment. In addition, there is a brief review of the Mexican economic performance during that year. Perspectives for the undoubtedly complicated external scenario for 1999 are discussed below. Moreover, said section also underlines the current soundness of the Mexican economy, which has been achieved in recent years partly as a result of the fiscal and monetary policy measures applied precisely in anticipation of difficult times. This section will serve as an introduction to a detailed description of the monetary program for 1999. The document ends with a series of concluding remarks stressing the need and feasibility of stabilization.

II. 1998: A Complicated Period for Inflation Abatement

II.1. External Environment: Extremely Unfavorable during 1998

The external context within which the Mexican economy developed during 1998, was extremely adverse as well as unexpected. Although, since late 1997, the Asian crisis was expected to have a negative impact on the Mexican economy, specially regarding the sharp fall in oil prices and the decrease in external capital flows, practically no one anticipated the intensity and sequels of such situation.

During the first quarter of 1998, the most relevant factor related to the aggravation of the difficulties in Asia. Even though the situation in the countries most affected by the turbulence started in 1997 tended to stabilize, it did not happen until after a relatively long period of financial uncertainty and volatility and an economic slowdown greater than anticipated. This effect primarily responded to the time needed to agree on the terms of financial aid and the political obstacles brought about by the implementation of corrective measures. These circumstances negatively affected other economies, both emerging and developed.

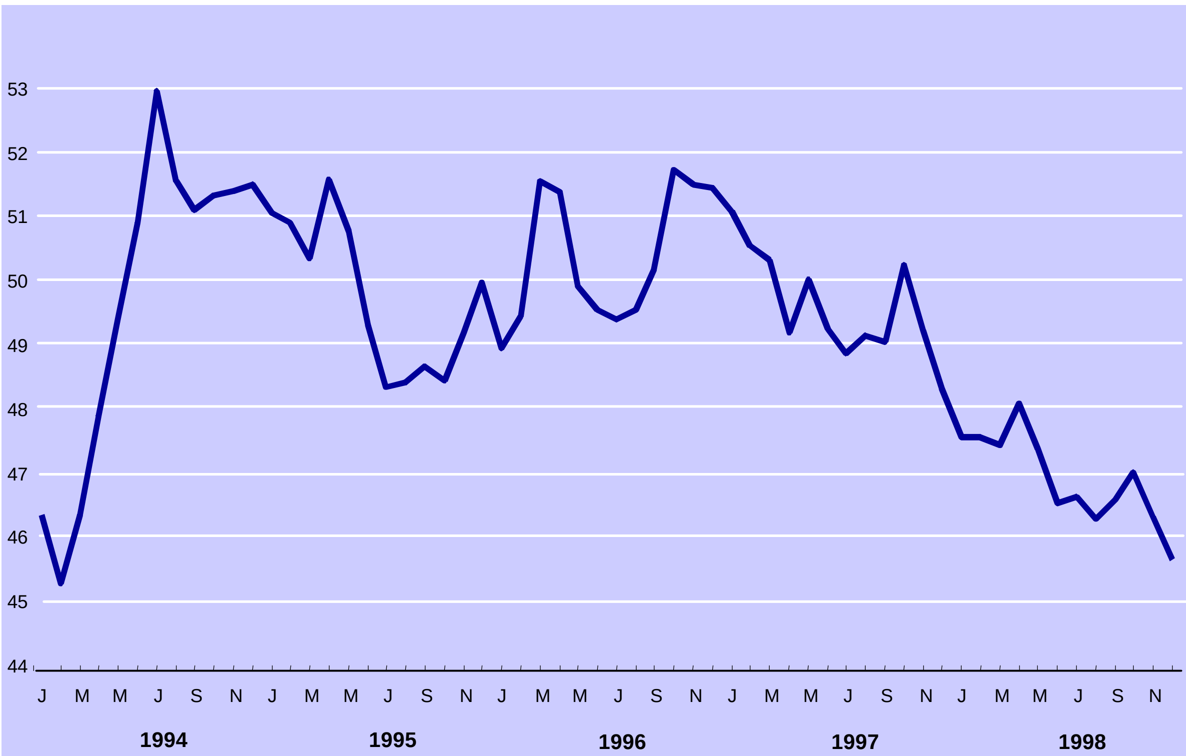
Japan was among the countries most impacted by the aforementioned financial developments. The Japanese economy is currently deep into a serious recession, greatly due to the banking sector crisis it is going through. The economic situation in Japan has considerably contracted its imports which, in turn, affected other countries' exports, particularly those from Asian nations. Moreover, the weakness showed by Japanese financial institutions brought about a considerable contraction of the resources channeled towards the rest of Asia and, consequently, exchange rate pressures on the region's currencies, specially those of China and Hong Kong. This situation continues to be a matter of concern.

One of the major effects of the reduction in the pace of growth of the Asian economies, has been the strengthening of the downtrend in oil prices, a trend that was seen developing since mid-1997. In fact, the price of the Mexican oil mix fell below seven dollars per barrel, the lowest price in more than twenty years, and one which exerted serious pressure on Mexican public finances.

Prices for other raw materials also fell and even international prices for manufactured products suffered sharp falls. In addition, an unfavorable performance of prices for an important part of exported Mexican goods was intensified during the second part of 1998 due to a slowdown in the pace of economic activity in Latin America and the United States. All these elements converged to deteriorate the Mexican terms of trade by 5.5 percent (see Chart 1).

Chart 1

Terms of Trade Index (Dollars)
1980 = 100



The lack of stability in international financial markets, which began in mid-1997, intensified in August 1998 with the Russian government's decision to devaluate its currency and default on its payments, both domestic and external. Russia's inability to honor its financial commitments, originated by persistent fiscal imbalances generated in the course of several years, was specially affected by the Asian crisis' contagion effect, which contributed to accelerate the pace of a deterioration in the Russian economy already in progress. As in other countries, once the Russian crisis exploded, there was also a long period of political instability, motivated by the difficulty to implement the required corrective reforms.

The Russian economy's collapse proved extremely harmful to the international financial markets. Its most serious consequence was that it led to a major qualitative change in the way in which participants in those markets assess sovereign risk. The absence of solid international support to Russia eliminated the false perception of security regarding investments in several countries, particularly in those intrinsically weak. This situation, along with the setting of capital controls in Malaysia, led international investors to show a marked aversion to emerging economies' markets.

As a logical consequence of the above, capital outflows from emerging countries were triggered (particularly during August and September of 1998), mainly from those with imbalanced public finances, weak financial systems and predetermined exchange rate regimes. This phenomenon primarily affected Latin American countries: Ecuador and Colombia were compelled to devaluate, while Brazilian and Venezuelan currencies were strongly pressured. The Mexican peso also suffered substantial depreciation in late August and September, particularly due to the fact that Mexican hedging markets appeared, to the eyes of numerous and important foreign investors, an appropriate tool to manage the risks of an eventual devaluation of the Brazilian real[1].

A clear proof of how international financial markets' expectations began to deteriorate since late August, with regard to the future of emerging economies may be observed in Chart 2. The substantial upward adjustment experienced by the net yield for discount Brady bonds of several economies is shown in that chart. As expected, there was a larger adjustment in countries (such as Brazil and Venezuela) where the greatest pressures existed derived from their macroeconomic imbalances and political uncertainty.

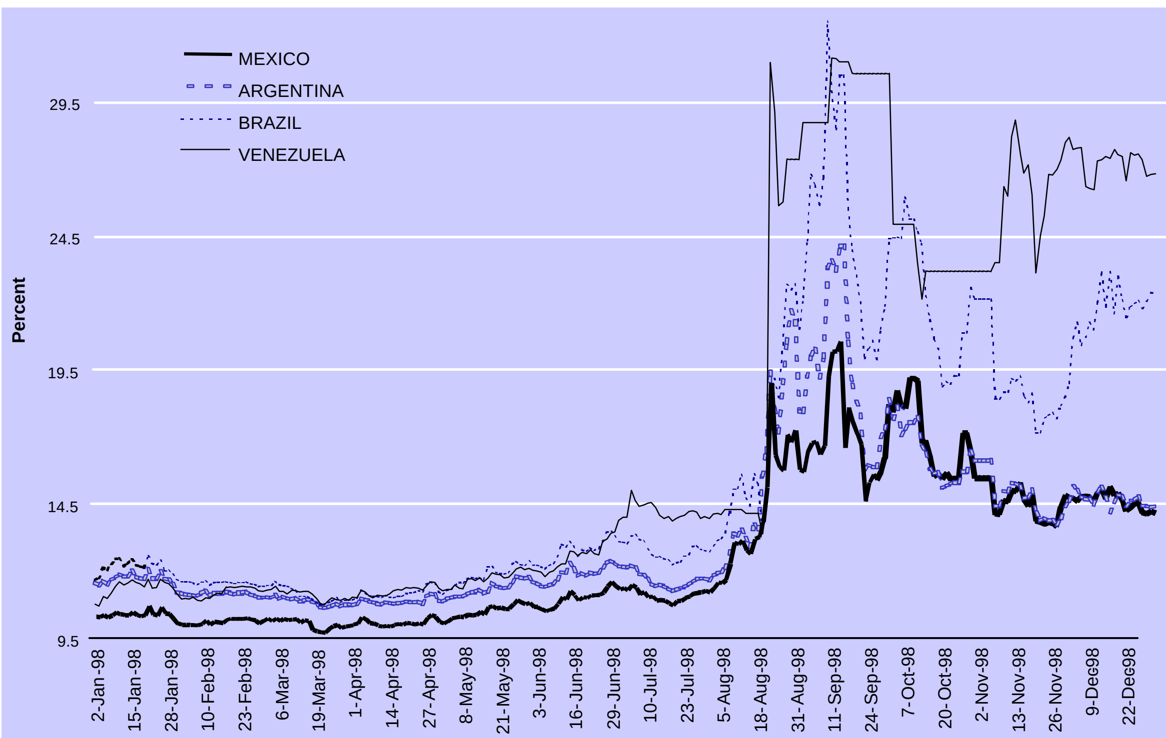
The crisis reached a climax during September, when the enormous losses suffered by investors as a consequence of the marked volatility in emerging markets, gave way to a substantial

[1] Some investors estimated that if the Brazilian real devaluated, the value of the peso would suffer from a "contagion" effect which would, in turn, generate a depreciation of the domestic currency (which did not come about entirely during January 1999 when the real actually began floating). Under such assumption, future or option-related peso sales would serve as good hedging against an eventual real depreciation. Spot peso exchange rates were affected with regard to the US dollar, because Mexican financial institutions who played the role of counterparty to such hedging transactions, balanced their positions, in turn, by buying dollars against pesos in the spot market.

contraction of liquidity. Resources were then channeled into assets considered "safe", a feature that seemed to be exclusive of debt instruments issued by developed countries. Such situation even caused some hedge funds in the United States to go bankrupt, motivating a questioning of the solidness of the banks exposed to emerging countries' risk. These institutions reacted by reducing their open credit lines to those nations, making their situation even more strenuous. The most severe case was that of Brazil, whose currency confronted a serious speculative attack. At those times, the international financial crisis was labeled as the most serious disruption in the last 50 years.

Chart 2

Brady Bonds' Net Yield for Selected Latin American Countries



Surce: Bloomberg . Last figure: December 31, 1998.

Pressures moderated in early October once the Federal Reserve decided to relax its monetary policy stance. In Brazil, President Cardoso, after his reelection, announced an adjustment package endorsed by the International Monetary Fund, several other financial institutions and the Bank for International Settlements. Likewise, multilateral organizations as well as G-7 countries, acted rapidly in order to relieve, at least partially, the substantial credit contraction that surged in international markets.

All of the above leads to conclude that the major channel transmitting the crisis was the one related to capital flows. The uncertainty brought about by the Asian crisis and other developments, generated a major contraction in resource flows into emerging markets. In Mexico, this situation reflected into a considerable depreciation of the exchange rate. This, in turn, resulted in higher than expected inflation; higher inflationary expectations; a rise in interest rates; and, a burgeoning deceleration in economic activity. In response to these developments, Banco de México adjusted its stance on monetary policy in several instances throughout the year.

II.2. Economic Activity during 1998: Encouragingly Robust

During 1998, the Mexican economy achieved important progress in several respects, including an elevated pace of growth in production which generated a significant increase in employment, along with improvements in workers' real wages.

External disruptions were the element affecting economic indicators the most, namely nominal variables such as the exchange rate, interest rates and, evidently, the rate of inflation. Economic policy, in particular, fiscal and monetary policy was aimed at the achievement of several objectives such as mitigating macroeconomic instability caused by these external disruptions; moderating inflationary pressures; and, maintaining the sustainability of external accounts. Conditions were thus created to allow a sustainable path of economic growth.

The major aspect of economic activity's performance during 1998 was the considerable growth in real Gross Domestic Product (GDP), albeit the difficulties already mentioned. For the first three quarters of 1998, GDP showed an accumulated annual growth of 5.3 percent. This figure implies the extension of an expansion initiated during late 1995, and must be considered as a very encouraging outcome, both given the aforementioned external situation and in comparison with the performance of other economies, developed or emerging. However, during the fourth quarter of 1998, economic activity slowed down in response to a reduction in the availability of resources required to finance domestic expenditure, as well as the weakness in external demand, which affected exports. Real GDP is estimated to have risen 4.8 percent in 1998.

In the course of 1998, private investment expenditure appeared as the most dynamic element in aggregate demand. During the first three quarters, this figure showed a 19.9 percent increase with regard to the same period the previous year. Every component of gross fixed investment rose, particularly that regarding real expenditure in machinery and equipment. Nevertheless, this element is expected to present a slowdown in the last quarter of 1998 as a reflection, to a great extent, of lower economic growth expectations for 1999, external resource restriction and higher interest rates. Forecasts signal towards an increase in private investment that amounted to a 17.2 percent rise during the year, which counts as the second highest annual rate registered during the last eighteen years.

Another element worth pointing out was the rise in private consumption, which reached 7.9 percent for the first three quarters of 1998. This behavior was responsible for a significant increase in per capita consumption, above that of GDP, leading to a fall in the domestic savings rate. Households' consumption expenditure in durable goods was more accelerated than that intended for services and non-durable goods.

Likewise, reductions in consumption and investment public expenditure in real terms, in response to the impact on fiscal income originated by collapsing oil exports values, are elements worth mentioning. During the first three quarters of 1998, this figure fell by 4.5 percent with regard to the same period of the previous year. The sharpest fall was shown by gross capital formation, which decreased 13.0 percent, compared to the decline in consumption which reached 1.9 percent.

However, it should be bore in mind that budgetary adjustments carried out in order to absorb the consequences of the oil disruption were timely and successful. If fiscal policy had not been modified in response to the fall in oil prices, the public sector would have had to rely upon domestic financing --given the lack of opportunities for external financing--, thereby displacing the private sector from the domestic credit market by means of high real interest rates resulting from such action. It is also possible that the exchange rate would have depreciated further, thereby causing higher inflation and, indirectly, the use of the inflationary tax.

Therefore, in trying to absorb the entire oil shock by means of restrictive fiscal measures, the public sector did not deem it necessary to resort to any additional financing, thus avoiding the use of the inflationary tax and, consequently, mitigating the shock's impact on economic growth. The major message this sends is that the cause of the economic disruptions was attributable to external upheavals and not to the economic policy responses to them. Economic policy is not capable of preventing or cancelling shocks; it can only strive for the economy to assimilate them at the lowest social cost possible.

In addition to fiscal adjustments, several other factors also contributed to prevent the oil shock from generating a balance of payments disruption. Among these elements were the wide diversification of Mexican exports (oil-related exports currently represent approximately 6 percent of the aggregate figure); the international asset figure; and the free determination of the exchange and interest rates.

A brief comparison of the economic outcome during 1998 against that of 1986 is in order, given that both were years when the Mexican economy was impacted by a sharp fall in international oil prices (even though the 1986 oil shock was greater in magnitude than that of 1998). A sample of the soundness on which the Mexican economy now relies as well as of the efectiveness of the economic policy adopted during 1998, is that in this period the outcome obtained was considerably better than in 1986. Namely, inflation during 1986 reached 105.7 percent, considerably higher than the 18.61 percent rate for 1998. Regarding economic activity, 1986 presented a significant contraction with the GDP falling by 3.1 percent, whereas economic growth estimated for 1998, 4.8 percent, is one of the highest figures attained by the world economy in such period. Other aspects worth taking into account are employment and real wages. In 1986, both variables fell, whereas in 1998 there was an increase in IMSS-enrolled workers, a significant reduction of the open unemployment rate and an improvement in most of the real wage indicators.

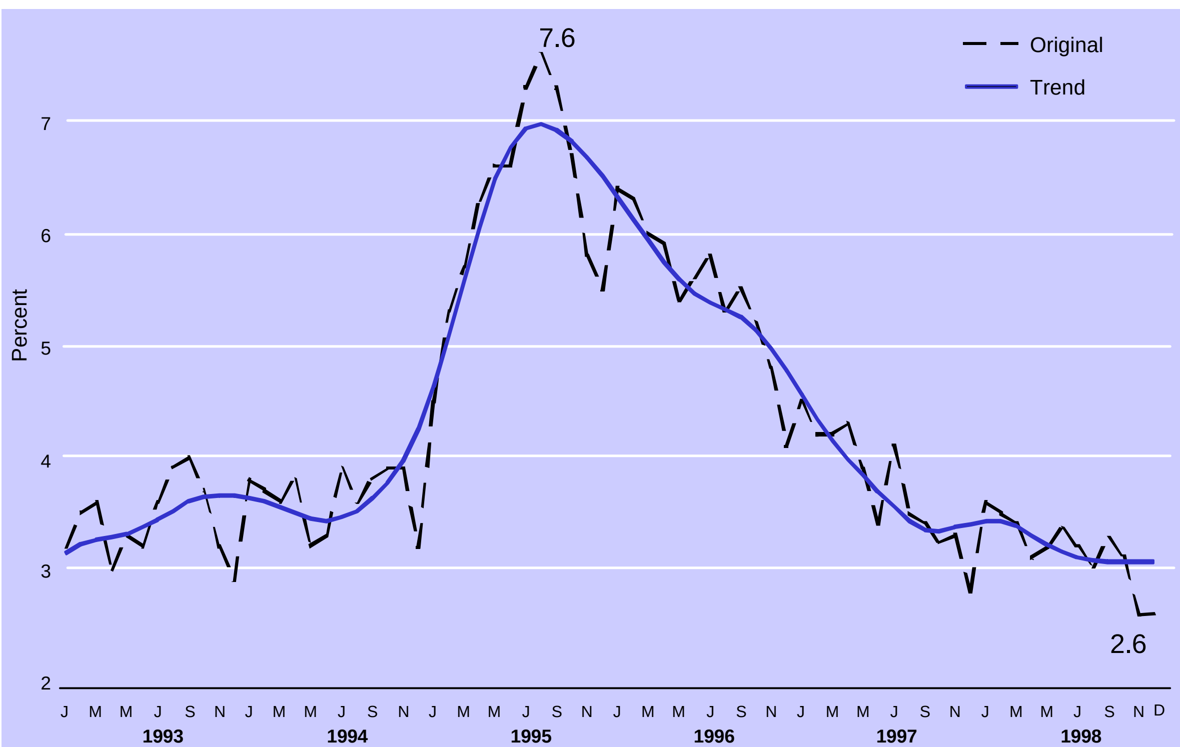
This proves that today's economy is better prepared to absorb external disruptions than in the past. The former is only a consequence of, on one hand, the flexibility of the current economic policy and, on the other, the structural change policies implemented in recent years.

It should be noted that production increased in almost every sector of economic activity, except agriculture, affected by adverse weather conditions. Therefore, during the first three quarters of 1998, industrial sector GDP grew at a 7.1 percent annual rate, while GDP for services increased 5.2 percent. In contrast, agricultural GDP contracted by 1.6 percent. In general terms, during most of the year there was little incidence from external difficulties on economic growth.

Concerning labor markets, it should be brought out that demand for labor recovered during 1998. Taking the figures regarding the number of permanent and part-time urban workers enrolled at the IMSS (the Mexican Institute of Social Security) as of December 15 1998, 942,000 posts were created, which implies a 9.0 percent rise. Significant abatement of urban unemployment allowed for the unemployment rate, during the November-December period, to fall to a 2.6 percent level, the lowest figure since late 1992 (see Chart 3)

Chart 3

Open Unemployment Rate in Urban Areas



It is also worth pointing out that overall wage raises in contract negotiations surpassed actual and expected inflation throughout the year.

Improving employment figures as well as wage raises, account for the significant rise in the total payroll for sectors such as manufacturing, commerce and construction.

During most of the year, labor productivity in the manufacturing sector grew above the corresponding pace for real earnings per worker. This outcome contributed to attain reductions in unit labor costs which, in turn helped strengthen international competitiveness of the sector's firms. In fact, the significant growth registered by non-oil exports is majorly a result of the dynamism manufacturing exports showed. During 1998, the value of non-oil exports increased at an 11.4 percent annual rate, while manufacturing exports grew slightly more (11.7 percent). Both export figures tended to decelerate towards the end of the year, as a result of a weakened external demand; increased competition from Asian products in foreign markets; and, a fall in international prices for a series of export products.

Furthermore, the fall in the value of oil exports resulted from the weakness in international crude oil demand and, consequently, a decrease in the price of the Mexican oil mix. Throughout 1998, the value of oil exports fell by 4,182 million dollars compared to the level registered during the same period the previous year. Such fact significantly affected trade balance as well as current account results. The collapse in global oil prices sharpened towards the end of the year, impacting even more negatively public finances and economic expectations.

Concerning imports, three reasons account for their rise: domestic productive activity expansion; domestic demand expansion; and, export growth. However, external purchases decelerated towards the second half of 1998.

Consequently, the trade balance showed a 7.7 billion dollar deficit during 1998 according to forecasted figures. Moreover, the current account deficit as a share of GDP is expected to result moderate (3.7 percent), albeit its rise owing to the fall in oil exports. For the first three quarters of 1998, such deficit amounted to 11.5 billion dollars. It should be pointed out that, when taking seasonally adjusted figures, the imbalance fell during the second and third quarters.

In contrast, the modest surplus showed by the capital account was primarily supported by long term external resource inflows. Even when the balance of direct foreign investment during 1998 resulted slightly lower than that for 1997, its amount and performance demonstrate that there are positive perceptions overseas regarding the investment opportunities Mexico has to offer. With regard to other forms of capital flows, the severe restriction felt during 1998 in terms of external credit availability, for public and private sector alike, led to very reduced movements in such figure during the year and in fact, a negative behavior for the third quarter. In any case, the capital account surplus sufficed to allow international asset accumulation.

Briefly, albeit the difficult external environment, the Mexican economy's performance may be deemed satisfactory.

II.3. Inflationary Shocks

Unstable international financial markets, collapsing oil prices and, in general, deteriorating terms of trade, generated larger than anticipated pressure on the exchange rate. The peso's depreciation impacted the prices of internationally tradeable goods which brought about upward adjustments in inflationary expectations. This, in turn, reflected on contractual wage revisions and higher prices in a wide variety of goods and services. In addition, unexpected rises for certain officially-controlled prices, the coming into effect of the minimum wage increase for 1999 (in December 1998), as well as an abnormal increase in the prices for certain fruits and vegetables (due to weather factors) contributed, to a lesser extent, in generating an inflation figure above the original target established by Banco de México. This deviation presented itself in spite of the fact that the central bank restricted its monetary policy stance on several occasions. It should be pointed out that this was so, because currency depreciations tend to affect prices rapidly, whereas restrictive monetary policy measures have a lagged effect on inflation's performance.

Table 1 presents a detailed description of how the CPI rate of variation performed in different periods.

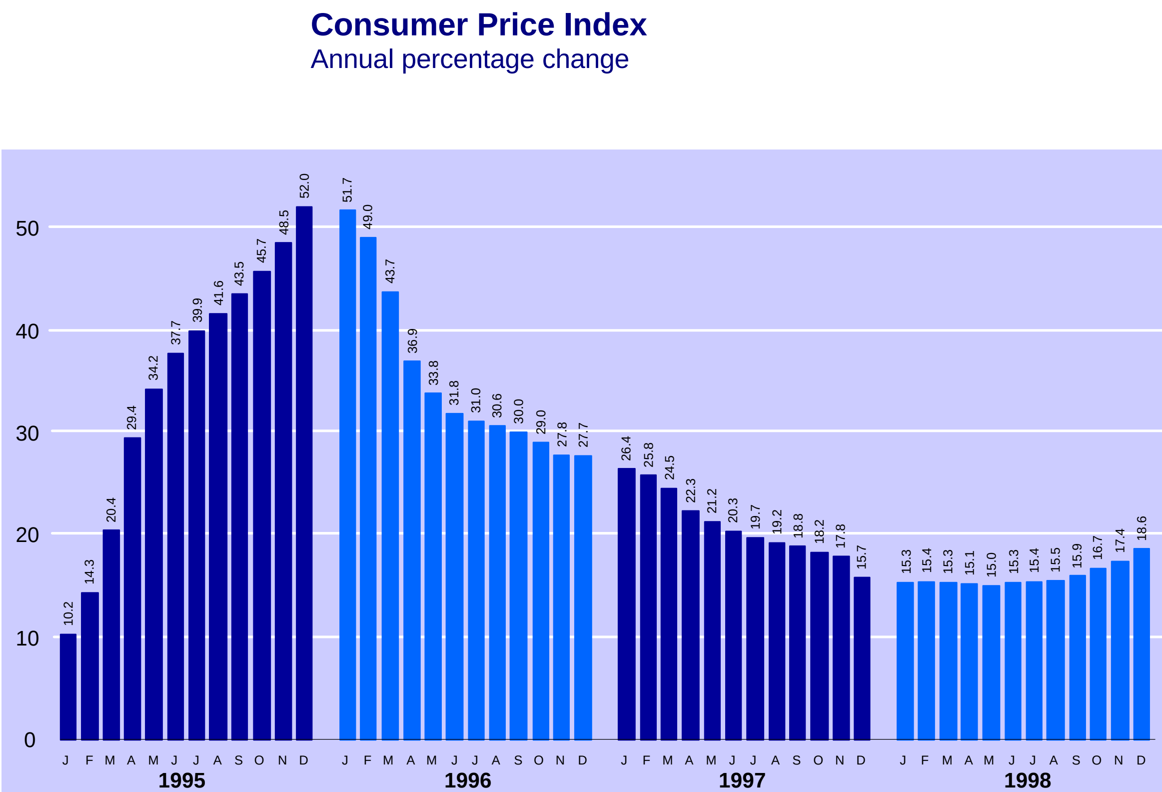
Table 1

Consumer Price Index
Percentage Changes

Month	Monthly		Annual		Accumulated with respect to previous December	
	1997	1998	1997	1998	1997	1998
January	2.57	2.18	26.44	15.27	2.57	2.18
February	1.68	1.75	25.64	15.35	4.30	3.96
March	1.24	1.17	24.46	15.27	5.59	5.18
April	1.08	0.94	22.33	15.10	6.73	6.17
May	0.91	0.80	21.23	14.97	7.71	7.01
June	0.89	1.18	20.35	15.31	8.66	8.28
July	0.87	0.96	19.70	15.41	9.61	9.32
August	0.89	0.96	19.18	15.50	10.58	10.37
September	1.25	1.62	18.76	15.92	11.96	12.16
October	0.80	1.43	18.24	16.65	12.86	13.77
November	1.12	1.77	17.77	17.41	14.12	15.78
December	1.40	2.44	15.72	18.61	15.72	18.61

Form the table above it is apparent that the annual inflation rate reached its lowest level last May (15.0 percent) and, from there on, it increased successively. In other words, the downward trend in actual annual inflation during 1996 and 1997 reverted in June 1998 (see Chart 4). The accumulated CPI rise during 1998 amounted to 18.6 percent, above that observed during the same period of 1997 (15.7 percent) and also substantially higher than the 12 percent target.

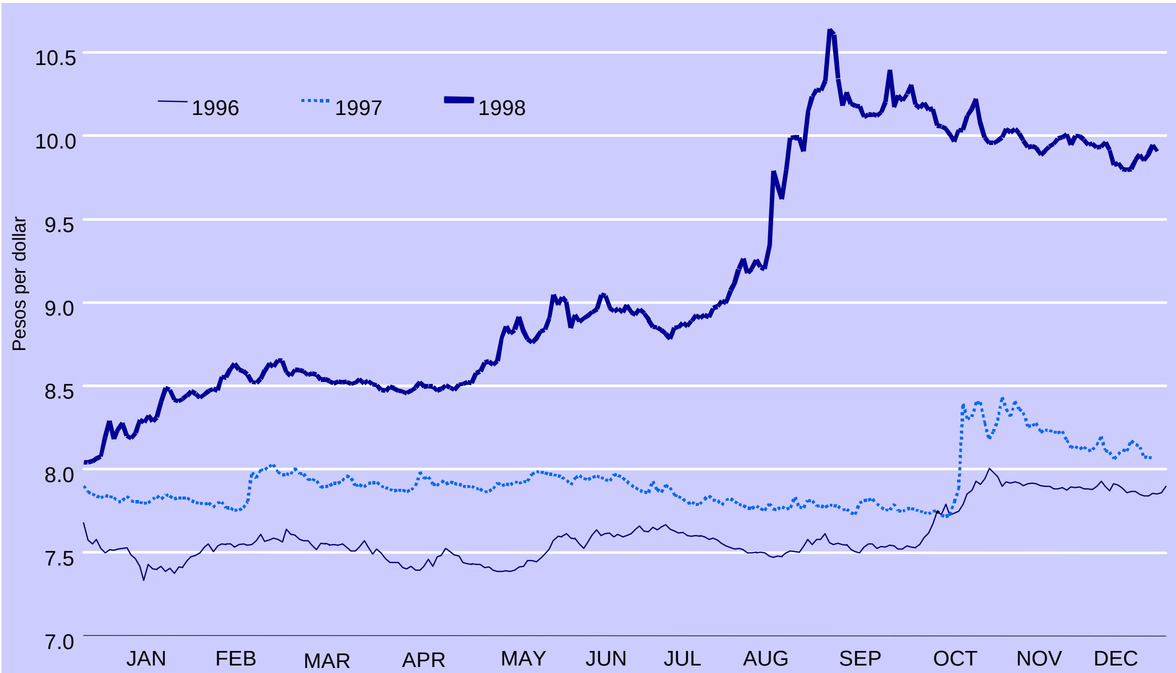
Chart 4



As it was previously stated, the factors explaining the path of inflation during 1998 were the following: a fastly depreciating currency (see Chart 5); its impact on inflationary expectations and their resulting effect on contractual wage negotiations; adjustments to officially-controlled prices; and, an unusual rise in fruit and vegetable prices. A detailed study of CPI's sub-categories may help clarify how the elements mentioned above impacted inflation.

Chart 5

Spot Exchange Rate*



* Last figure: December 31, 1998.

Exchange rate variations affect inflation twofold: (i) directly, through their impact on the price of tradeable goods and (ii) indirectly, by influencing inflationary expectations which, in turn, affect the wage determination process, therefore modifying other prices in the economy.

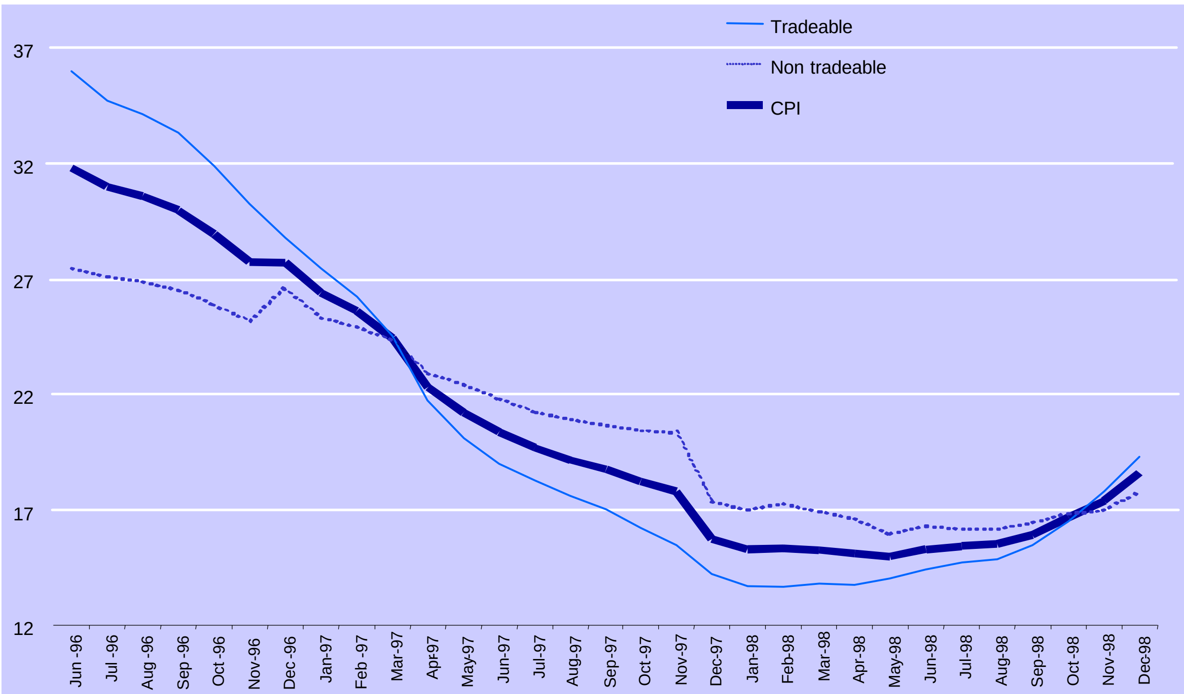
In order to determine the impact of both effects on inflation, Chart 6 presents CPI's annual variation as well as those related to tradeable and non-tradeable goods sub categories. From that chart, it may be concluded that, after having substantially contributed to lower the rate of inflation in 1996 and 1997, tradeable good price variations reached a turning point in January 1998, intensifying their uptrend from May, when the exchange rate depreciation began to accelerate. Therefore, this sub-category pressured in such manner that annual inflation began to show a burgeoning uptrend.

Exchange rate behavior also affects inflation indirectly through its effect on expectations, which, in turn, influence the determination of other prices in the economy, such as wages. The latter, in turn, impact non-tradeable goods' prices. According to

Chart 6, the annual growth rate of non-tradeable goods began to rise since August, which signals the presence of the aforementioned indirect effect.

Chart 6

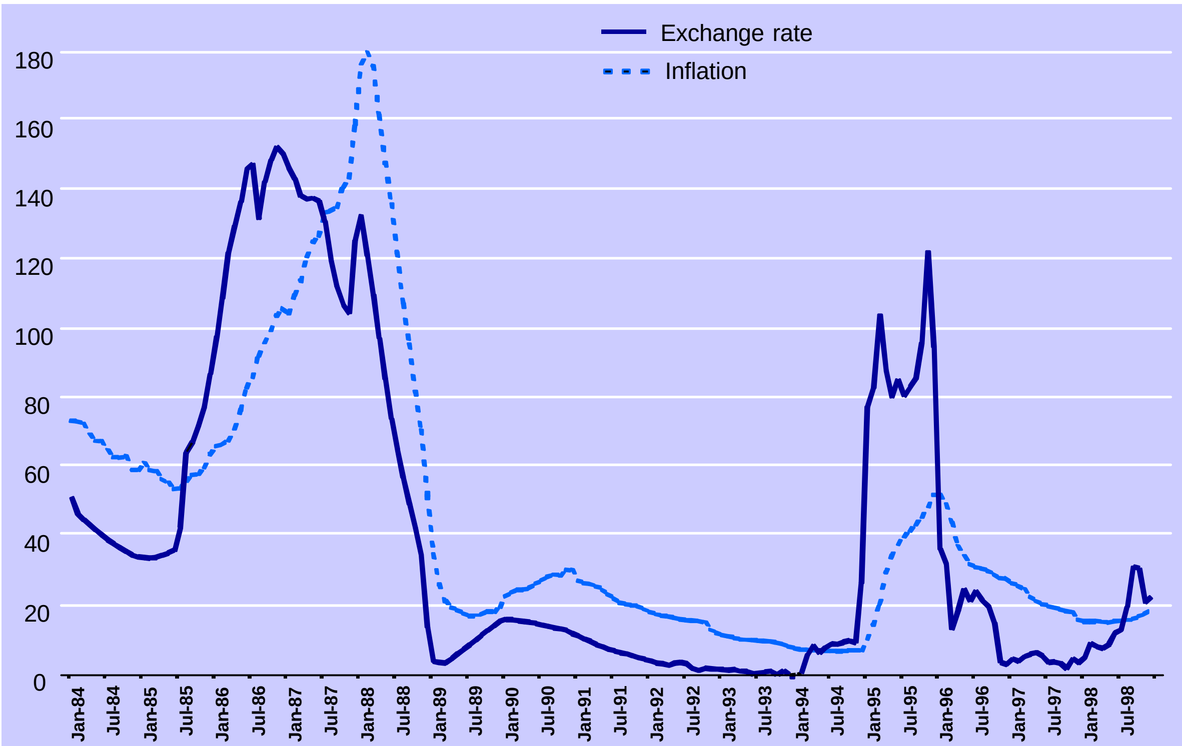
CPI, Tradeable and non Tradeable Goods Performance
Annual variations in percent



In Mexico, inflationary expectations are easily affected by exchange rate movements, due to the historically high correlation existing between these and the rate of growth in prices (see Chart 7). Not surprisingly then, economic agents' inflationary expectations responded, rapidly, to the sharp movements in the exchange rate observed during 1998 (see Chart 8).

Chart 7

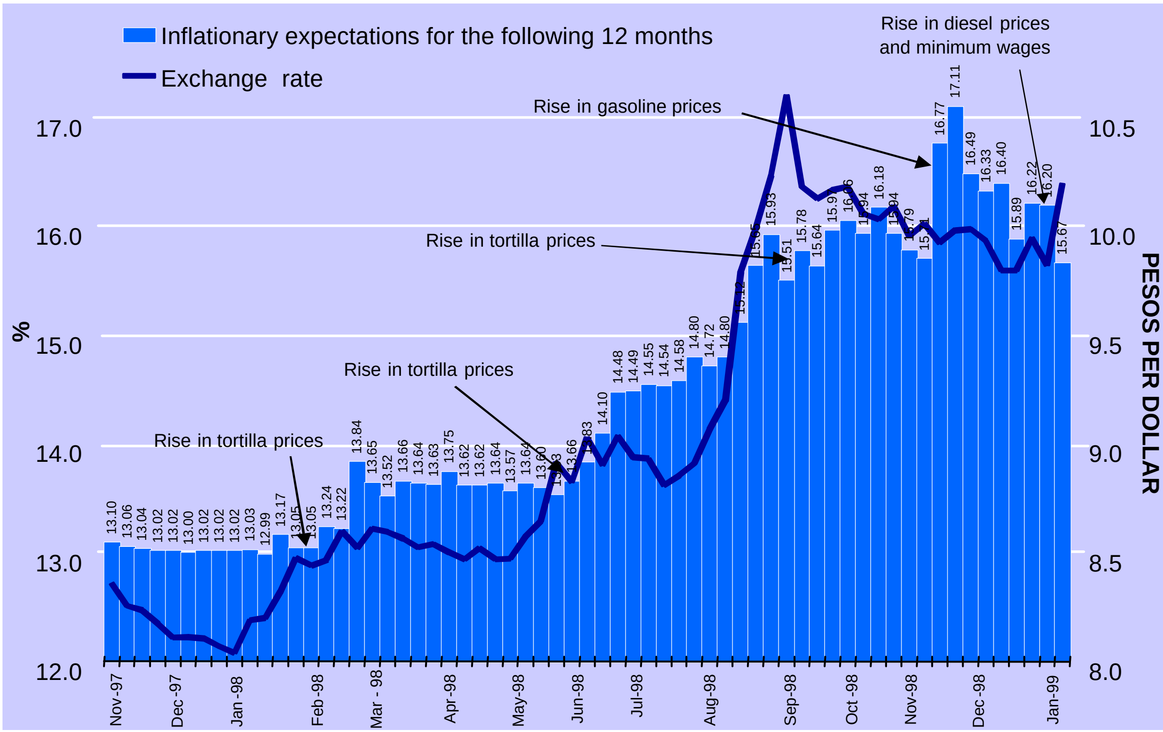
Inflation and Exchange Rate
Annual variations in percent



Changes in inflationary expectations are transmitted to prices primarily by means of the pressure they exert on wage revisions. In other words, if expected inflation rises, workers demand larger wage raises which firms will accept to the extent they presume such raises may be transferred in to their prices for goods and services. If this process extends into other sectors of the economy, inflation will rise, bringing along all the undesirable sequels on economic growth, income distribution and real wages.

Chart 8

Relationship Among Inflationary Expectations, Public Prices and Exchange Rate



Source: INFOSEL and Banco de México.
Last figure: January 15, 1999

Another factor causing a faster than expected rise in annual inflation during 1998, was officially-controlled price variation. Namely, three increases in tortilla prices were agreed (49.1 percent) and dough (39.9 percent), while in November the price of gasoline rose 15.9 percent. These variations undoubtedly affected the CPI directly. In addition, it has been observed that unexpected revisions to these prices tend to impact inflationary dynamics, since they influence expectations in the same fashion as described for exchange rate movements. Chart 8 clearly shows he rise in inflationary expectations after officially-controlled price increases were announced.

It should be pointed out that although public price variations reflected into higher inflation in the very short term, they are instrumental in advancing towards stabilization, since they contribute to keep public finances in order.

Lastly, fruit and vegetable prices increased by 45.3 percent during 1998, as a result of adverse weather factors present throughout the year.

Therefore, the 6.6 percentage point differential between actual inflation during 1998 and the target established at the end of the previous year, is practically explained in its entirety by the unexpected behavior of the exchange rate; of wages[2]; of fruit and vegetable prices; and, officially-controlled prices. Their contributions to said difference were, respectively, 2.19, 1.59, 1.47 and 1.33 percentage points.

II.4. Monetary Policy's Reaction to Inflationary Shocks

The 1998 monetary program was designed taking into account the possibility of it having to be applied in the midst of a difficult environment. For this reason, the program anticipated the use of specific rules in order to prevent the primary cause of inflation --excess money supply. In addition, and most relevant under the circumstances that prevailed, the program considered the possibility of adjusting the stance on monetary policy by means of discretionary actions in case of unexpected inflationary disruptions.

Consistent with the above, and in response to such inflationary surprise, Banco de México progressively restricted its stance on monetary policy during 1998. This was intended to strive for the direct variations on the CPI, consequence of the shocks, to remain as once and for all impacts, thus affecting both inflationary expectations and underlying inflation as little as possible. Therefore, throughout 1998 the central bank increased its "short" six times (see Chart 9). By "shorting" the banking system, the central bank exerts certain influence on interest rate rises. Such impulse is generated, primarily, by the signal sent to the markets through such action,

[2] It should be pointed out that variations in contractual wages are not necessarily independent from exchange rate behavior.

indicating that the central bank considers that interest rates should rise.

Faced with the sharpening of the adverse conditions in international financial markets, Banco de México took supplementary measures in August. These measures were intended to reinforce the restrictive effect of the "shorts". Among the most important:

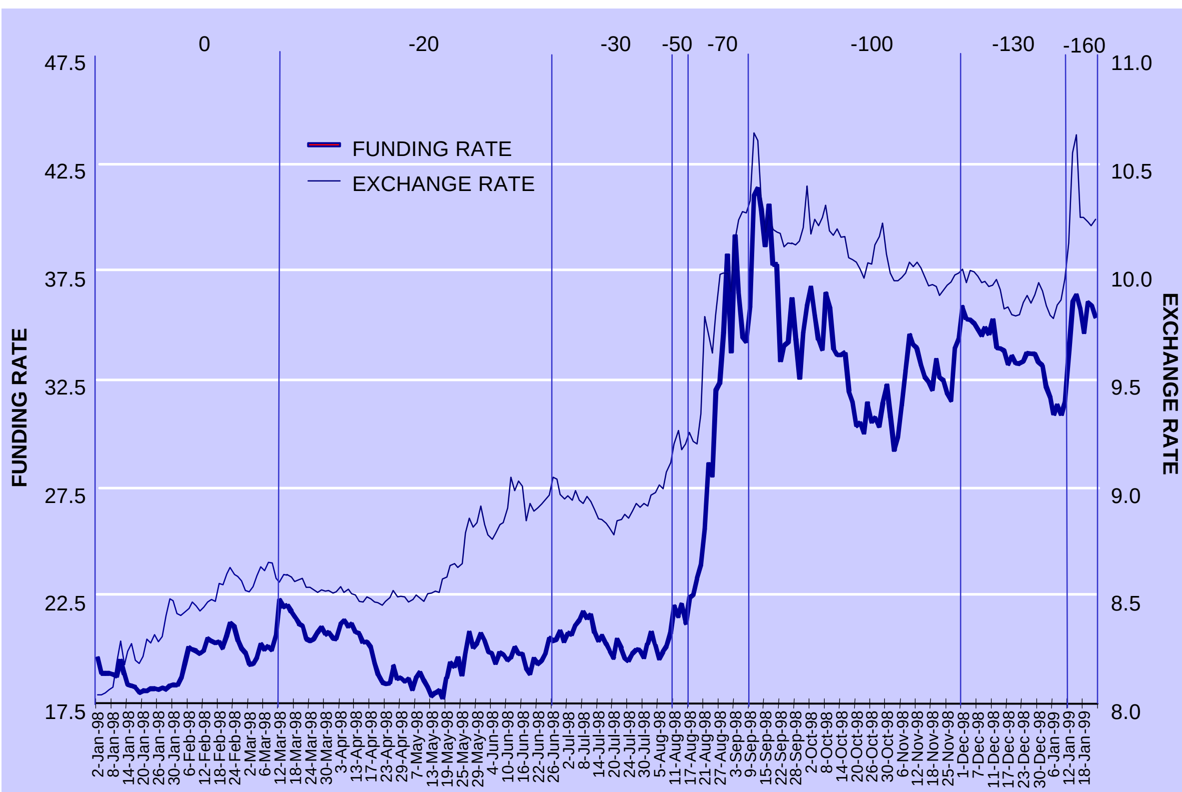
- A decrease in intraday financing granted by Banco de México through the payments system;

- Establishing, during certain days, a minimum rate for Banco de México's open-market operations; and,

- Establishing a compulsory deposit in the central bank from commercial banks.

Chart 9

Funding Rate, Spot Exchange Rate and Accumulated Balances Targets*

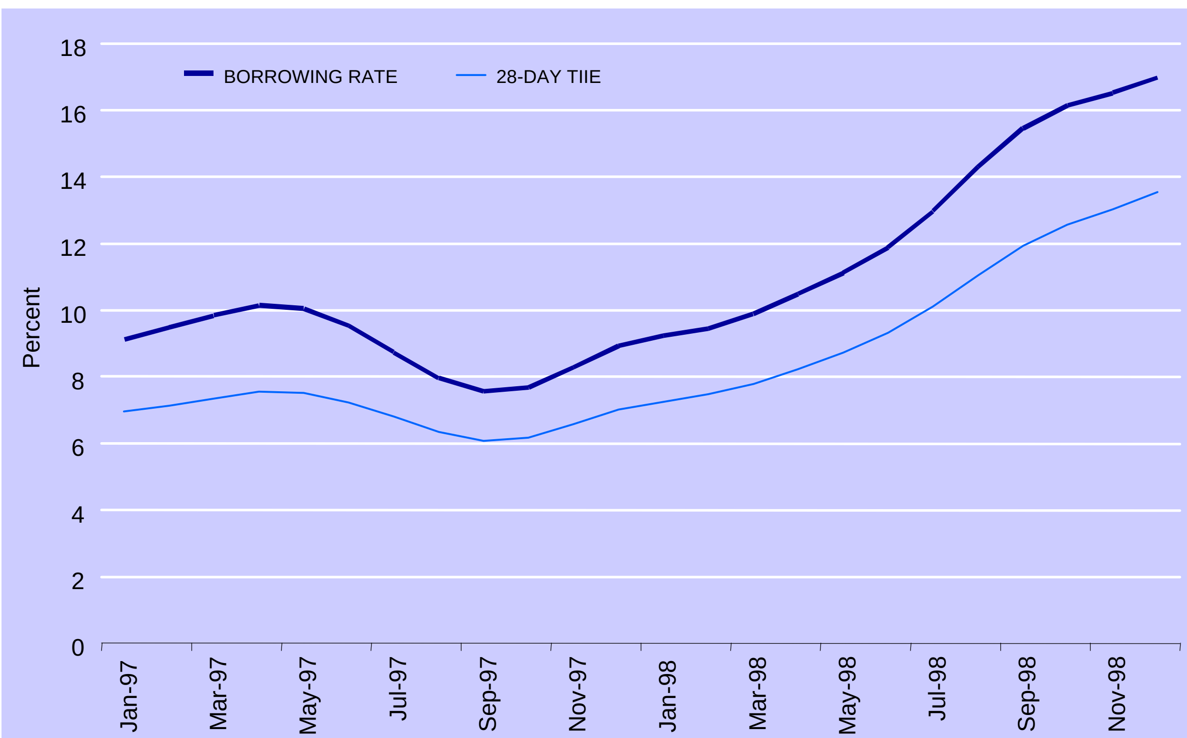


*Last figure: January 15, 1999.

As stated in Section II.3, the factor that contributed the most to increase inflationary pressures was domestic currency depreciation, which, as it can be observed in Chart 9, made itself present, essentially, during August and September. In addition, price adjustments to gasoline and diesel in November and minimum wages in December, also considerably affected the CPI during this two-month period. This explains why monetary restrictive actions were concentrated in the second half of the year. By the same token, the "shorts" were applied since late June, along with the majority of the supplementary measures implemented in August, remaining in effect for the rest of the year. Partly owing to this, nominal interest rates, after sharply rising in late August, kept from there on at levels which, although decreasing, were almost twice those of the first seven months of the year. Real interest rates also increased significantly, as it gathers from Chart 10. This is clear evidence of the restrictive nature characterizing the policy implemented by Banco de México during the second half of 1998.

Chart 10

Real Interest Rates*



* Ex-post real interest rate trend. Last figure: December 1998

Monetary policy measures implemented in August and September, limited domestic currency depreciation and even contributed to induce exchange rate appreciations from its highest levels. Undoubtedly this performance in the exchange rate during the last months of the year helped mitigate inflationary pressure.

The "short" agreed by the Board of Governors on November 30 was qualitatively different from its predecessors. The latter were intended to counter unexpected inflationary disruptions, whereas the former was implemented with the two following purposes in mind: to ease inflationary expectations' hikes for the following year, resulting from public price[3] adjustments announced then; and, in order to prevent disorderly price reactions and be able to reach the 13 percent inflationary target for 1999. This is why the Board of Governors decided to act in anticipation on the monetary front, in order to increase the probability of attaining the established objective, thus encouraging greater credibility in Banco de México's disinflationary commitment.

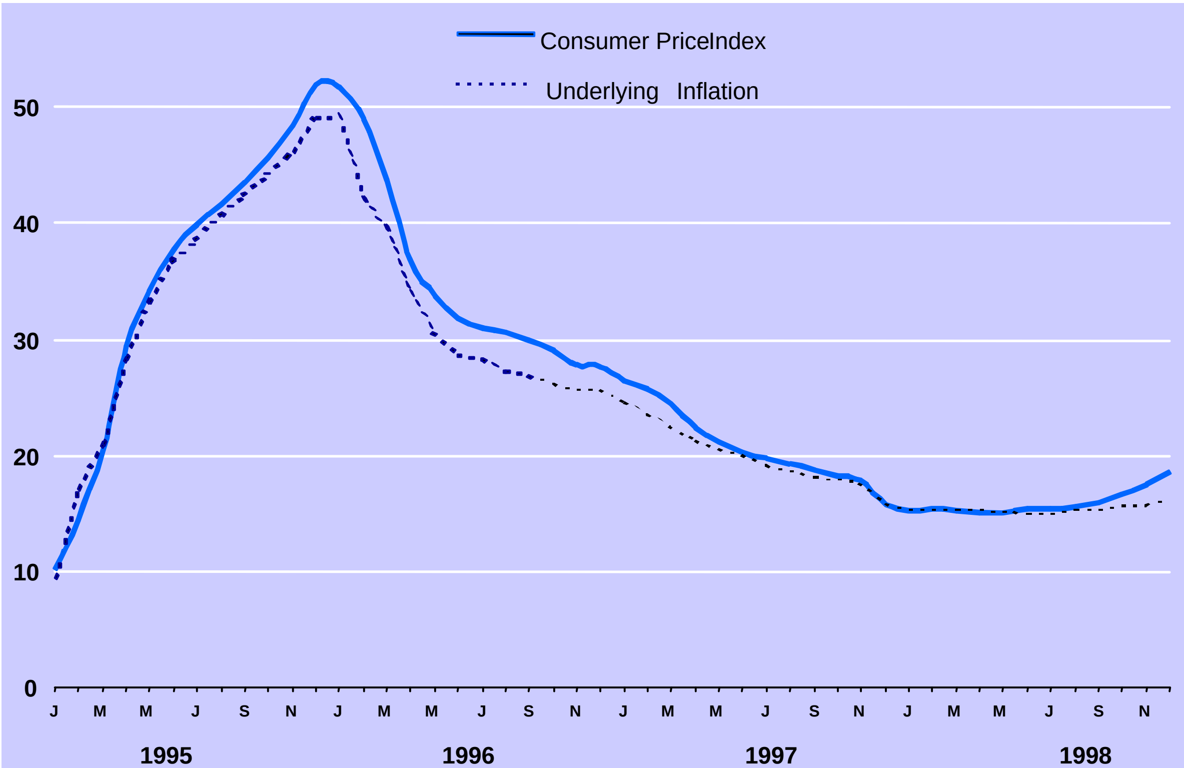
From Section II.3 it also gathers that, as stated before, towards late 1998 inflation was affected not only by the exchange rate, but also by the performance of fruit and vegetable prices as well as those prices whose behavior depends on authorities' decisions (gasoline, tortillas, electricity, etc.). Subtracting the items relative to fruits and vegetables as well as officially-controlled prices, one obtains a consumer price sub-index which primarily responds to variations in the exchange rate, in wages, and, in general, to monetary conditions. This sub-index is more useful as a tool in assessing monetary policy execution, since Banco de México is not capable of determining weather conditions or public prices. This sub-index could be called "underlying inflation".

Chart 11 presents the path of "underlying inflation". This chart shows that, between June and December 1998, its path resulted below that of inflation measured according to the CPI, maintaining relatively constant levels. This indicates that most of the inflationary pressures derived from exchange rate behavior were neutralized.

[3] In any case, in order to avoid the effects of public price adjustments on inflation it is not reasonable to completely ban such rises, because such decision would only generate fiscal or scarcity problems.

Chart 11

CPI and Underlying Inflation
Annual percentage change



Monetary restriction could have certainly been more intense, in an attempt to eliminate unexpected inflationary pressure. However, given the size of the disruptions, the shortness of the period within which they emerged and the size of the monetary contraction required to neutralize inflation's surprises entirely, Banco de México's Board of Governors did not deem advisable to proceed in such fashion. Clearly, the consequences on the real sector of the economy would have been damaging. To a great extent, the damages in question surge because economic agents do not immediately adjust their inflationary expectations downwards in concert with the actions taken by the authorities. Therefore, if the central bank attempted to cancel the direct impact on inflation of relative price adjustments entirely, monetary measures would have the effect of depressing economic activity, employment and investment, in addition to other negative effects on the financial system --which might even turn this anti-inflationary effort into something unsustainable--. Such conclusion is not exclusive of Mexico. It is precisely the high costs accompanying every attempt at brusquely containing (or rapidly reducing) inflation, that explain the inclination of central banks to adjust their measures' intensity, in order to attain in the end, price stability.

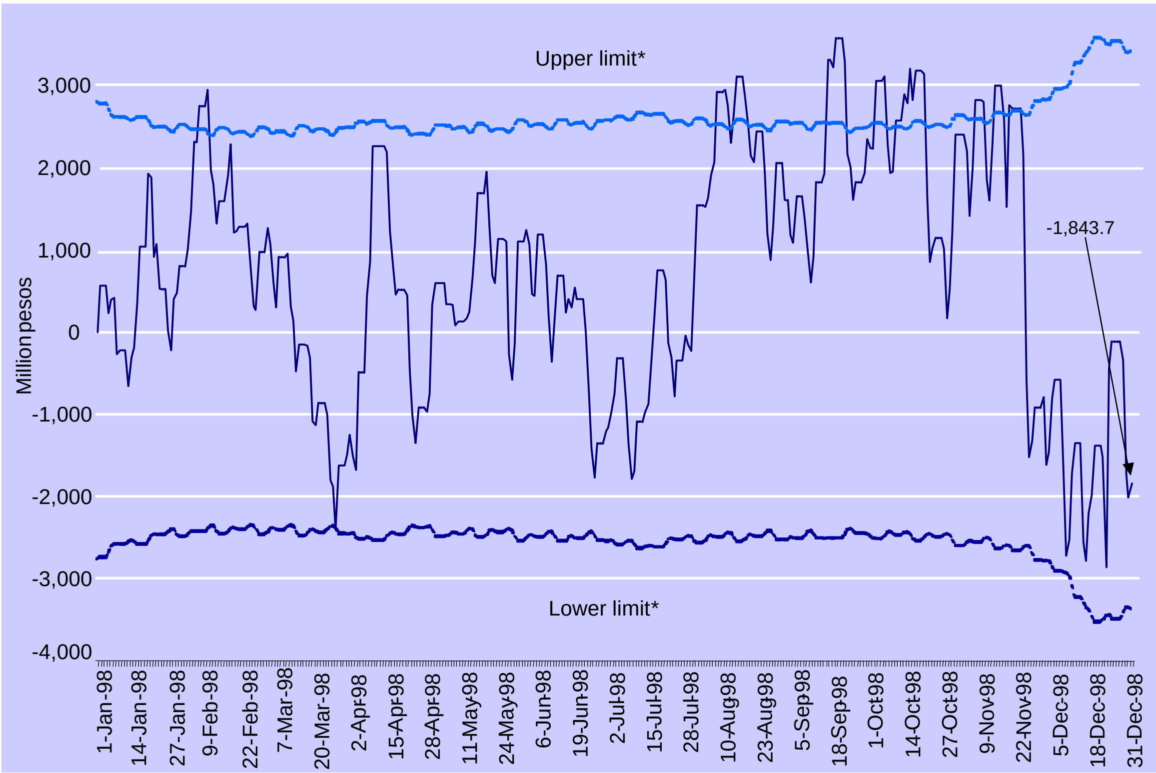
Other aspects of the 1998 monetary program may be assessed according to monetary base, net international assets and net domestic credit performance.

a) Monetary Base

As part of the 1998 monetary program, Banco de México announced a forecast for the daily path of the monetary base for that year. The fact of publicizing this forecast responds to the intention of letting the public have a reference regarding the performance of the demand for bills and coins in circulation, consistent with the macroeconomic framework foreseen early that year. Comparing the actual balance against the forecast, it gathers that monetary base practically kept within the confidence interval derived from such forecast during most of the period considered. This interval is calculated with one standard deviation from the model, and is considered in order to capture the impact of temporary disruptions on bill and coin demand (see Chart 12). Even though during certain periods monetary balances were demanded above the specified upper limit, it was a result of a holiday period approaching (a long weekend) whose effect is difficult to predict in an appropriate manner. However, once these periods passed, monetary base continued performing according to the forecast.

Chart 12

Monetary Base Divergence of the Actual Balance With Regard to the Forecast **



* Statistical interval calculated based on the standard deviation of the forecast

** Actual figure of December 31, 1998.

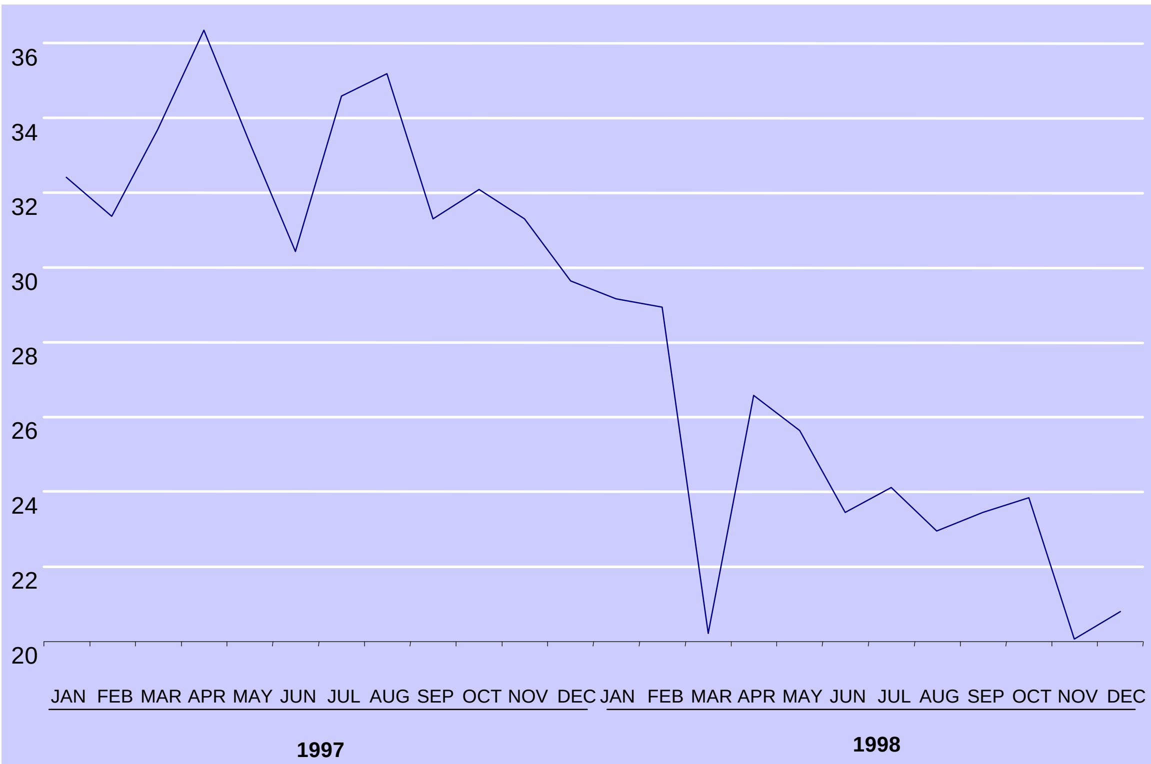
The fact that monetary base followed the path expected in early 1998 is worth explaining, given that actual inflation surpassed by more than 6 percentage points the year's target. The additional amount of monetary base demanded as a result of higher inflation was compensated by the depressive effect exerted by higher interest rates on demand for payment instruments[4]. In turn, interest rate levels were fundamentally a consequence of the reduced availability of external financial resources associated with the global crisis and the fact that Banco de México restricted its monetary policy stance. Therefore, the measures implemented by the central bank in response to greater inflationary pressure, contributed for monetary base to perform according to expectations.

[4] Economic growth resulted close to the figure originally contemplated

Consistent with the above, monetary expansion slowed down significantly, extending a trend established since 1997 as it gathers from the chart below.

Chart 13

Monetary Base
Annual Percentage Change



On the whole, it is worth underlining that monetary policy took the right steps when confronted with inflationary pressure. However, it should be bore in mind that the ultimate impact searched for, that is, on price dynamism, can only be attained with a lag: whoever expects an immediate reaction ignores the time required to operate transmission mechanisms as well as the restrictions imposed by the costs of disinflation.

b) Net International Assets

From December 31, 1997 until the close of 1998, net international assets[5] rose by 3,656 million dollars (md). This increase

[5] Net international assets are defined as gross reserves, plus credit agreements with central banks with maturities beyond six months, minus the liabilities with the IMF and central banks originated from credit agreements with less than six month maturities. Moreover, it considers the

resulted substantially above the minimum expected according to the 1998 monetary program (1,000 md). Nevertheless, these assets' behavior showed a certain variability, particularly during the second half of the year, as a consequence of the external shocks that affected the Mexican economy during that period. While, during the January-July period, net international assets increased by 1,378 md owing to having exercised the dollar put options issued by Banco de México (net from currency auctioned during the same period), from August until mid-October net international assets decreased. This is fundamentally explained by the fact that currency sales were made to the Federal Government in order for it to face the service of its external public debt (1,886 md) and transactions carried out in the exchange market, both by means of the automatic auction sales mechanism (610 md) and the discretionary intervention carried out on September 14 (278 md)[6].

Given the scarcity of fresh capital inflows towards emerging countries, as well as the difficult situation faced by the oil market, accomplishing the accumulation target for the fourth quarter would have been almost impossible. Nevertheless, this was attained owing to the following transactions:

i) The use, buy the Federal Government, in early October, of a contingent credit line granted by a group of foreign banks, amounting to 2,660 md;

ii) Financing received in mid-December by the Federal Government from multilateral institutions (the World Bank and IDB) for approximately 950 md; and

iii) PEMEX resources for 1,500 md, generated from the anticipated sale of payment rights on part of its crude oil exports for 1999.

c) Net Domestic Credit

Net domestic credit is defined as the difference between the amount of monetary base and the value of net international assets. Consequently, this concept's performance is explained by the development of the other two. Given that the path of the monetary base kept within the limits expected for the year, while at the same

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outcome from changes in US dollar value of currency purchase and sales transactions carried out to that date.

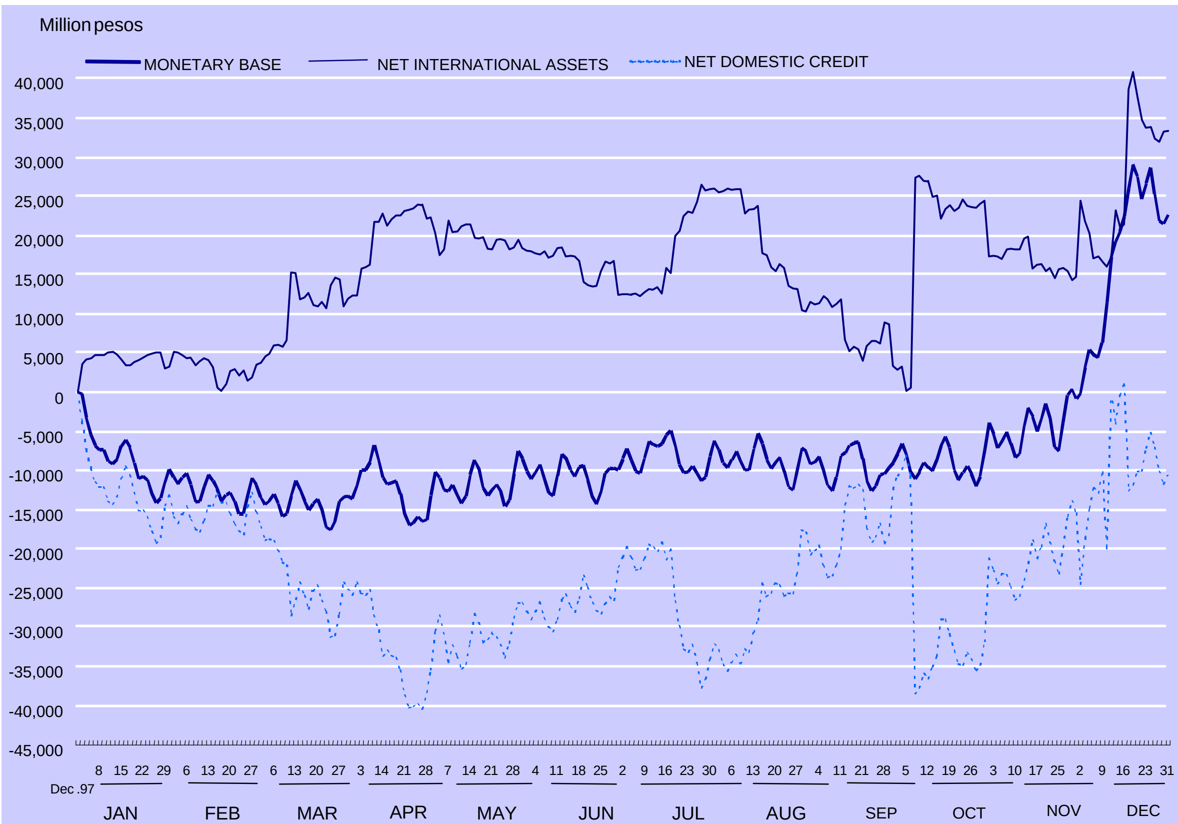
[6] See "*Informe sobre la Política Monetaria*", September, 1998

time accomplishing the target of international asset accumulation, net domestic credit respected the limits established for it.

To the extent that net domestic credit and net international asset variations combined to satisfy base demand, it is possible to conclude that the fall in net domestic credit did not imply in itself any monetary restriction (see Chart 14).

Chart 14

Monetary Base and its Components
Effective Flows Accumulated During the Year



* * *

Although 1998 inflation is primarily explained by the presence of enormous external shocks, it should be acknowledged that its performance has been unsatisfactory. Given that 1998 inflation was higher than that of 1997 and that it is still performing within an accelerated and unstable pattern, it is of the highest priority to reestablish its decreasing behavior. If such objective is not attained, Mexico-risk perception would deteriorate in the eyes of investors; external financing would be further reduced; debt's average maturity would shorten; and its cost would rise. Consequently, the economy's vulnerability would accentuate when confronted with external shocks and, sooner rather than later, inflation would increase, bringing along all the negative effects on economic growth, real wages and employment creation.

III. Perspectives for 1999

It is possible to expect that, during 1999, Mexico will continue facing a complicated external scenario. Nevertheless, it should be underlined that the Mexican economy closed 1998 in a relatively solid situation, enabling for continued growth and employment creation to go on during 1999. Combining these elements with uninterruptedly cautious policies -- particularly regarding the fiscal and monetary instances--, it should be reasonable to expect a growth in real GDP of 3.0 percent for 1999, reducing inflation at the same time.

The external scenario in which the Mexican economy will perform throughout 1999 is perceived adverse due to a series of reasons. First, given the expectation that demand in the international oil market will continue to be weak which, in turn, will keep oil prices low; in fact, these prices are expected to be lower than those for 1998. Therefore, in coordination with other countries, the Mexican export platform for crude oil has been moderated in order to avoid any further falls in its price. In addition to the above, world economic activity forecasts for 1999 signal towards a modest rate of growth, while the economy of Mexico's major trade partner will show a lower pace (see Table 2). Meager growth in global product will translate into a slight expansion of global trade as well as of industrialized country imports. Therefore, it is possible that such situation leads international prices of Mexican exports to continue registering low levels both those for raw materials as well as for manufactured goods. All these factors point towards lower economic growth throughout the year as well as a moderate expansion of Mexican exports.

Table 2

World Economy: Selected Indicators

	1997	1998	1999
Economic Growth (%)			
World	**4.2**	**2.2**	**2.2**
Main Industrialized Countries	**3.0**	**2.1**	**1.5**
United States	3.9	3.6	1.8
Japan	1.4	-2.8	-0.5
Germany	2.2	2.7	2.0
France	2.3	3.0	2.6
United Kingdom	3.5	2.6	0.9
Developing Countries	**5.7**	**2.8**	**3.5**
Asia	6.6	2.6	4.3
Middle East and Europe	4.5	3.3	2.9
Latin America and the Caribbean	5.1	2.5	1.5
Trade Growth (%)			
World	**10.4**	**3.3**	**4.3**
Industrialized Countries' Imports	**9.8**	**4.7**	**4.8**

Source: World Economic Outlook and International Capital Markets: Interim Assessment, IMF, December, 1998

Another factor likely to affect economic growth during 1999 is the anticipation that private capital net inflows will continue to be relatively low (see Table 3). This situation is due to three reasons: (i) international financial institutions will continue to show a cautious attitude towards risk-taking; (ii) owing to the disappearance of some hedge funds, the universe of potential investors in emerging markets has been reduced; and, (iii) some institutional investors are deceived of developing countries' financial markets, given the higher than expected volatility these markets have shown in recent years.

Table 3

Private Capital Net Flows [1/]
Billion dollars

	1996	1997	1998	1999
Private capital net flows [2/]				
Total	214.8	117.8	69.5	89.7
Developing countries	190.9	131.8	87.6	104.1
Africa	5.1	14.1	7.3	14.2
Asia	100.2	21.5	-18.3	-7.3
Middle East and Europe	3.9	7.9	24.9	21.9
Latin America	81.7	88.3	73.6	75.3
Countries in Transition	16.0	22.5	13.2	16.4
Recently Industrialized Economies [3/]	7.9	-36.6	-31.2	-30.8

[1/] Net capital inflow comprises net direct investment, net portfolio investment and other short and long term flows, including public and private loans.

[2/] Since these data are limited, other net investments could include certain public flows.

[3/] Hong Kong, South Korea, Singapore and Taiwan.

Source: World Economic Outlook and International Capital Markets: Interim Assessment, IMF, December, 1998.

Decreasing capital inflows will be one of the elements contributing to the future deceleration of economic growth in Mexico from 4.8 percent in 1998 to 3.0 percent in 1999. Furthermore, a moderation in domestic demand by the private sector, as well as continuing fiscal discipline will contribute to reduce the balance of payments' current account deficit for this year. Evidently, this is consistent with limited availability of external resources.

An additional aspect of such environment is the persistent frailty of the financial situation in certain economies. This also applies for financial market perspectives in some industrialized countries. An unfavorable performance of these two factors might introduce further volatility to domestic markets, thus complicating the battle against inflation. This is why, in the event of a volatile and difficult international environment, it is desirable that economic policies be flexible and coordinated.

A clear evidence of the risks referred to in the paragraph above, as well as their repercussions on the international financial system, may be gathered from January's developments in Brazil. Confronted with a serious speculative attack on its currency--intensified by the difficulties encountered to carry out their fiscal adjustment--, Brazilian monetary authorities attempted, first, on January 13, to shift the reference band for its currency upward. Such measure, without the support of a deeper fiscal and monetary restriction, proved unsustainable within a few days' time, leading the Brazilian real to flotation (January 15) which immediately generated a depreciation of more than 15 percent.

Fearing further contractions in external resource availability, the Mexican currency suffered a significant depreciation in response to the Brazilian crisis. Immediately after the shifting of the real's flotation band, the price of the Mexican currency against the US dollar rose, reaching levels of 11.4 pesos per US dollar. Under these circumstances, Banco de México decided to restrict its monetary policy stance, raising its "short" from 130 to 160 million pesos with the purpose of limiting the depreciation of the domestic currency, reestablishing order in the exchange market and preserving the possibilities of reaching the 13 percent inflationary target. The exchange rate reacted favorably to this measure, temporarily stabilizing around 10.50 pesos per dollar. Nevertheless, two days later, a sharp volatility made itself present again, once the flotation of the real was determined. During this second episode, domestic currency also lost value considerably once the news was announced (momentarily exceeding the 11 pesos per dollar level), only to correct itself later that day and ending with an appreciation with respect to the US dollar (at 10.25 pesos per dollar). This favorable reaction in the exchange rate (also registered in interest rates and the Mexican Stock Market) was surprising. Although Brazilian authorities have insisted that fiscal and monetary policies will be strengthened and the International Monetary Fund as well as the US government have expressed their support to the measures implemented, there is no doubt that circumstances in Brazil will continue to be, at least during the coming months, an element of uncertainty in the international financial environment.

In light of these perspectives for a difficult external environment during 1999, the Mexican government has laid the grounds in order to preserve a solid and consistent macroeconomic framework during the year. In this sense, the Executive Branch proposed a 1.25 percent of GDP economic deficit target for the year, below that of 1998. Such proposal was approved by the Mexican Congress. This measure will allow for orderly public finances, thus preventing upward pressure on interest rates by the government; it will not displace the private sector from credit markets; it will give support to domestic savings; and, it will prevent any imbalances from surging in the balance of payments.

Furthermore, the *Ley de Protección al Ahorro Bancario* (Savings' Protection Law) and the *Ley de Protección y Defensa al Usuario de Servicios Financieros* (Financial Services Users' Protection and Defense Law) recently approved by the Mexican Congress, will be a starting point in the path towards a more solid financial system, in order to facilitate the attainment of accelerated economic development in an environment of price stability. In this sense, it should be underlined that precautionary rules have also been established in order to allow banks to manage credit, market and liquidity risks adequately. As an example of this, the central bank recently reinforced a group of rules aimed at striving for commercial banks to count with the required liquidity in order to comply with their short term foreign currency liabilities.

A monetary policy commited to abating inflation -- such as the one set forth in this document -- is another ingredient required to guarantee a solid macroeconomic environment.

IV. The Monetary Program for 1999

Last November, the Executive Branch published its document *"Criterios Generales de Política Económica para 1999"* (General Economic Policy Guidelines for 1999). With Banco de México's participation, this document stated the inflationary target for the year. The following section details the main features of a monetary policy that, in principle, will make the attainment of such objective possible.

IV.1. Program's Objective

The central objective of the monetary program for 1999 is to contribute to reduce inflation down to 13 percent. This percentage refers to the change in the general price level in December 1999 with respect to the same month of the previous year.

It should be bore in mind that this target was established considering the following elements: inflation inherited from 1998; perspectives regarding the Mexican economy as well as the external environment; adjustments to minimum wages and public prices; and, the fiscal measures adopted in order to attain a 1.25 per cent of GDP deficit. Taking these elements into account, it is thought that by means of implementing an adequately restrictive monetary policy, the inflationary target stated above should be attained.

The above statement is supported on the acknowledgement that, although consistent monetary policy is an instrumental element in the fight against inflation, it is not often sufficient to reach the desired outcome. In order to accomplish the abatement of inflation demanded by society, monetary policy requires participation from the rest of the economic policies.

IV.2. Preliminary Remarks

For the design of a monetary program aimed at reducing inflation it is key to understand the process that generates such phenomenon. If the central bank supplies more primary money than the amounts demanded by economic agents, an imbalance is produced. This imbalance translates into inflation. However, Banco de México, like any other autonomous central bank in the world, has completely striked out such eventuality. This has been done by establishing a rule by which its daily transactions are aimed at matching monetary base's demand and supply. This is precisely one of the fundamental elements of the 1999 monetary program.

Once the above possibility is eliminated, inflationary pressures are then generated by, among others, the following instances: (a) external shocks producing sharp exchange depreciations; (b) unexpected variations in public prices; and, (c) contractual wage negotiations incompatible with the inflationary target and rises in productivity. Such disruptions, which materialized during 1998, generate immediate effects on the general price level, thus triggering inflation.

Price increases thus generated, increase demand for monetary base to be satisfied by Banco de México. This, in turn, produces the positive correlation normally present between inflation and monetary aggregates. If the central bank satisfies a higher demand for primary money at market interest rates (and the inflationary shock is not temporary), initial upward impulses will be validated. Nevertheless, if the central bank decides to satisfy a higher demand for base at interest rates above market levels, Banco de México counters, at least partially, the inflationary impact of the exogenous disruptions described above. This is what happens when Banco de México restricts its stance on monetary policy, normally by implementing or increasing the "short". Higher interest rates resulting from this measure may partially revert the impact of exogenous shocks (for example, by limiting exchange rate depreciation or even causing it to appreciate), thus moderating upward changes in inflationary expectations.

In the medium term, interest rate rises derived from the response of the monetary authorities to greater inflationary pressure, will decrease monetary base growth and, eventually, price rises. Such effect could be reinforced by the impact of a lower economic growth on the demand for money, related to a higher cost for loanable funds. In addition, demand for base will moderate in response to the decrease in inflation.

The ultimate objective in this case consists in sending a signal to entrepreneurs, workers and investors alike, to make them consider, when making their decision, the eventual reaction of Banco de México when faced with CPI disruptions, therefore minimizing the repercussions on inflationary expectations. Such reaction would prevent shocks from immediately translating into higher prices and, in addition, would prevent the economic agents from making resource allocations which would generate real costs for the economy in response to unmaterialized expectations. In so doing, the impact of such disruptions on the economy would decrease and the public's credibility in inflationary objectives would grow. This is the process through which the disinflationary target may become the nominal anchor of the economy.

The question here consists in the degree to which Banco de México is capable of countering the aforementioned inflationary shocks. There are two fundamental restrictions faced by the central bank regarding this subject:

- First, it is difficult to identify if such shocks are temporary or permanent: if they are temporary and the central bank restricts monetary policy, its action would generate unnecessary costs for the economy. On the other hand, if the shock is permanent and Banco de México does not take a restrictive stance, inflation would rise, making it more costly in the end to reach price stability; and,

- Second, restrictive measures implemented by the central bank tend to generate short term costs. If external disruptions were important, and the central bank attempted to immediately eliminate the inflationary impact resulting from such shock, monetary contraction would have to be severe, causing the economy disproportionate costs. This is obviously not advisable and, in fact, it could make monetary action counterproductive. In so doing, there is a high probability that monetary restriction would prove unsustainable and progress attained towards stabilization would not last. This is why, Banco de México may only partially counter inflationary disruptions in the short term, leading to the fact that **lasting inflation abatement may only be attained gradually.**

The above only proves that Banco de México is confronted with difficult questions when implementing monetary policy, which is why the incorporation of instruments enabling it to make timely adjustments to its monetary policy is instrumental. Monetary policy must be flexible and timely in order to face unexpected inflationary disruptions. It is by no means a coincidence that another fundamental element of the monetary program aims at granting Banco de México such instruments.

IV.3. Elements of the Monetary Program

As in previous occasions, the Board of Governors has determined as one of the fundamental features of its monetary program for 1999, a basic operating rule aimed at offering the maximum security that the central bank will not autonomously create any monetary base surpluses. **Banco de México, as a general rule, will make daily adjustments to primary money supply in order to match it to its demand. Any liquidity imbalances, resulting from errors in the daily estimation of base demand, will be immediately corrected by means of open- market operations carried out by Banco de México in the money market.**

In more technical terms, this is equivalent to pursuing a zero-balance target for the accumulated balances[7] of the accounts of commercial banks in Banco de México, when making decisions regarding its daily open market operations, or the amount of "short" to be applied. It also implies that Banco de México will sterilize the monetary impact resulting from, among other factors, variations in net international assets and any transactions carried out by the Mexican Treasury through the account this entity has in Banco de México.

The strict application of this rule would mean that Banco de México would passively accommodate any demand for monetary base. If so, certain problems would appear, namely, that the central bank could eventually be satisfying a demand for money consistent with a pattern of inflation above desirable levels.

In order to be able to detect such possibility, and act accordingly, Banco de México regularly compares the base's performance against a path considered to be consistent with the inflationary target. However, it is very difficult to succeed in determining such a path with precision. This is due to the following: (a) the relationship between inflation and base may change over time; (b) the basic assumptions required to forecast base demand for the year (regarding GDP growth and interest rate performance) might not materialize; and, (c) the relationship between base demand and the variables explaining its performance may also change over time. Therefore, Banco de México must continuously assess the differences that might appear between actual and expected figures, as well as analyze any other indicator giving information about

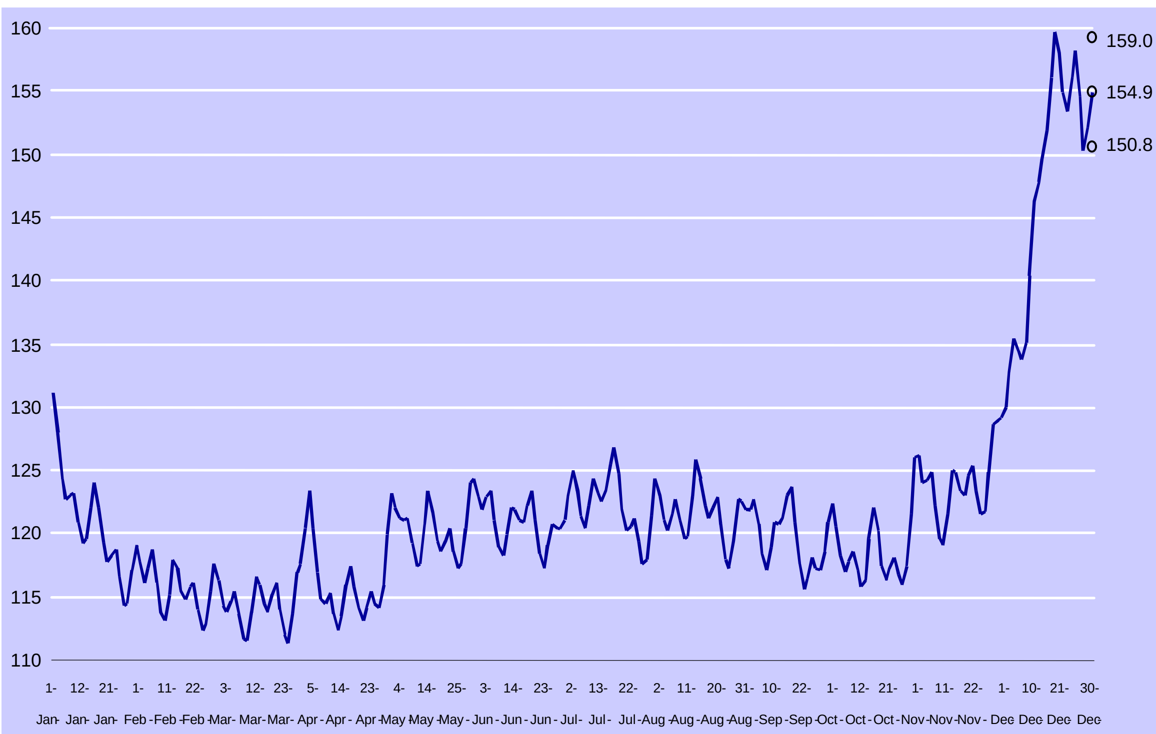
[7] For a detailed description of the accumulated balance mechanism, see Banco de México's "Informe Anual, 1996".

inflation's future performance, such as: exchange rate; available measurements for inflationary expectations; contractual wages; and, the degree of the economy's overheating (the relationship between potential and actual GDP).

In any case, since daily monetary base variations are a convenient and general reference for monetary policy monitoring, its path is once again published in this document as it has been done since 1997. **This path,** forecasted by taking the information available in January 1999, is consistent with the inflationary target for the year, provided the assumptions described further below materialize. **Therefore, this is another element in the monetary program.** The forecasted path may be observed in Chart 15, along with the sharp seasonality shown by the demand for bills and coins in Mexico.

Chart 15

Expected Monetary Base Path for 1999
Daily Balances
Billion pesos



Specifically, Banco de México expects an 18.1 percent[8] increase in monetary base throughout 1999 regarding the figure at the close of 1998 (131,109 mp)[9]. Therefore, expected growth for monetary base is higher than the combination of real GDP growth forecasts for 1999 (3.0 percent) and inflation (13.0 percent), which allows to anticipate a 1.5 percent remonetization of the monetary base at the close of 1998. It should be bore in mind that remonetization responds to interest rate and inflationary expectations' performance. Since these variables are expected to fall in the course of 1999, expectations point towards these changes to motivate a larger demand for primary money.

Monetary base's annual flow is estimated at 23,780 mp, which, in turn, generates a 154,889 mp balance at the close of 1999 (see appendix). The confidence interval for the monetary base balance figure, taking one standard deviation from the residuals estimated by the model, goes from 159,000 to 150,800 mp for the close of 1999.

Following the example of previous years, the 1999 monetary base path will serve as a reference in case any significant divergences exist between the forecast and the actual figures. Banco de México will assess such divergence and, only if they result from circumstances implying additional inflationary pressure, the central bank should be expected to restrict its stance on monetary policy.

Banco de México may match supply and demand for primary money either through variations in net domestic credit or in net international assets. The central bank has relatively more control over domestic credit than over international assets. Therefore, its management is, from a potential point of view, the easiest way to create excess monetary base. In response to the above, and in order

[8] Regarding the "Year 2000 issue", every central bank is confronted with a situation of great uncertainty, since the new millennium may generate an extraordinary, albeit temporary, rise in demand for bills and coins. Since 1997, Banco de México has been working in conjunction with other authorities and financial intermediaries, towards preventing the arrival of the year 2000 from affecting the domestic financial system's operation. In case the aforementioned increase in demand for payment instruments should materialize, Banco de México would satisfy it, since it would not generate any excess money supply impacting the inflationary process. The eventual effect of this phenomenon on monetary base performance during 1999 has not been incorporated into the forecast shown here, given the lack of solid elements to allow its assessment. However, if this factor should eventually generate any divergence from the path, it should not mean that Banco de México is deliberately expanding the monetary base.

[9] This figure refers to the balance at the close of 1998 of bills and coins in circulation. The corresponding figure for the monetary base was 419 mp higher than the previous due to an error in forecasting the primary money demand figure as of December 31, 1998. Given that this error was reverted the following day, the balance of bills and coins in circulation, at the close of the preceding year, was used to calculate the monetary base path for 1999.

to further guarantee that the central bank will not deliberately generate inflationary pressures, Banco de México has decided to once again incorporate quarterly limits to domestic credit variations. Such limits are a complement of the first fundamental element of its monetary program. Since domestic credit is defined as the difference between monetary base and net international assets, the aforementioned limits are the outcome of the expected behavior for both variables.

Expected variations in monetary base depicted in Chart 15, derive from GDP, interest rate and inflation anticipated paths. Furthermore, in view of the number of currency exchange transactions that Banco de México expects to carry out with the Federal Government and PEMEX, as well as foreign currency purchases likely to happen owing to the exercise of dollar put options from commercial banks to Banco de México, the Exchange Commission has decided to establish a commitment for 1999 to, at least, not reduce net international assets. This commitment is a reflection of two main factors: (a) the difficult external environment expected for 1999, where oil prices will keep depressed; the Federal Government will have limited access to international capital markets; and, there will be reduced private capital flows into emerging markets; and , (b) the Exchange Commission's perception that, although international reserves are not at their optimal level, they are sufficient to relaxedly confront Mexico's external liabilities within an adverse environment.

Table 4 shows the quarterly limits adopted for 1999 for domestic credit and net international asset variations.

Table 4

Quarterly Limits to Net Domestic Credit Variations 1999
Accumulated Effective Flows in Millions

	MINIMUM RISES IN NET INTERNATIONAL ASSETS		MONETARY BASE	LIMITS TO NET DOMESTIC CREDIT VARIATIONS 1/
QUARTER	DOLLARS (1)	PESOS (2)	PESOS (3)	PESOS (3) – (2)
I	0	0	-7,776	-7,776
II	0	0	-10,049	-10,049
III	0	0	-10,239	-10,239
IV	0	0	23,780	23,780

1/ If the limit is negative, domestic credit will fall by at least the indicated amount.

As stated before, since net domestic credit is the difference between monetary base and net international assets, the former may fall as international assets rise without it having to translate into a base decrease. Therefore, a decrease in net domestic credit should not imply a restriction on the economy, since the resulting peso absorption would compensate against monetary injection from currency purchases carried out by the central bank.

The first fundamental element of the monetary program and its supplementary measures are aimed at preventing Banco de México from creating any excess supply in monetary base. Unfortunately, this is not a full guarantee for attaining the desired abatement of inflation. As it has been explained elsewhere in this document, this is due to the fact that inflation may also surge from other sources. On one hand, external disruptions may cause an excessive depreciation of the domestic currency. On the other, contractual wage raises might result above the sum of the inflationary target plus productivity increases. By the same token, there could be unexpected adjustments to public prices with the purpose of keeping public finances under control.

Any of these events could cause interest rates to rise, tending to mitigate undesirable inflationary pressure. Nevertheless, the case may be that interest rates' automatic adjustment did not suffice to assure inflation's reasonable behavior. Under such circumstances, Banco de México would consider the possibility of restricting its monetary policy by means of the "short".

By increasing its "short", the central bank raises its negative target for accumulated balances[10]of the current accounts commercial banks maintain in Banco de México. Through this action the central bank exerts an upward influence on interest rates which, in general, results from the signal sent to the market through this instrument, as it was explained before.

Experience suggests that variations of the "short" influence interest rates more through the signal given by the "short" than by its own existence. The central bank might adopt a "short" not only as an instrument to fight against inflation, but also as a vehicle to eliminate disorderly situations in the exchange or money markets (in case the exchange rate rapidly depreciated in a very short time span or that interest rates are abnormally low).

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[10] It should be bore in mind that starting 1999 a 130 mp "short" was in effect. See Section II.4 of this document.

Symmetrically, and in case it should be required, Banco de México must also have the faculty of relaxing monetary policy. Such thing would be advisable in case inflation's behavior signaled that, every other element held constant, inflation was well below the target.

In such case, it would be advisable for Banco de México to adopt a more relaxed monetary policy stance. This would be mean either reducing the "short" or applying "longs", through which it would carry out its open market operations in order to accumulate positive balances in the aggregate of the current accounts that commercial banks keep in Banco de México.

The above paragraphs may be summarized as follows: Banco de México, under the current circumstances of financial market volatility, requires the faculty of being able to discretionarily adjust monetary policy, particularly restricting it if necessary. This introduces the last fundamental element of the 1999 monetary program:

Banco de México will adjust its stance on monetary policy in case unexpected circumstances make it advisable.

The central bank will use the "shorts", thereby adopting a more restrictive stance on monetary policy, under the following circumstances:

(a) In case it detects future inflationary pressures inconsistent with the attainment of the inflationary target. Namely, monetary policy will strive to neutralize exogenous shocks' **side-effects** on prices and will occasionally act in a precautionary fashion by **partially compensating the direct inflationary effects** of the key prices in the economy. The ultimate objective resides in making the necessary adjustments in order for relative prices to impact the CPI only moderately -by raising its level- without deteriorating inflationary expectations in order to prevent inflation's dynamics from turning perverse;

(b) When it is deemed necessary to restore order in exchange and money markets; and,

(c) When inflationary expectations are deemed extremely out of line with respect to the original target.

It is worth underlining that, in the past, Banco de México has made use of other instruments in order to strengthen its restrictive stance on monetary policy. Namely, vehicles such as compulsory deposits from commercial banks in the central bank and the employment of a temporary floor on the interbank interest rate[11]. However, more than alternatives to the "short", these tools are supplementary mechanisms intended to make it more efficient. This is why it should be expected from Banco de México to use the "short" as the vehicle for signaling variations in its monetary stance.

[11] See *Informe sobre la Política Monetaria,* September, 1998.

V. Concluding Remarks

During 1998, the Mexican economy performed favorably, particularly considering the adversity of external circumstances. The country is in a solid situation to continue growing and creating employments throughout 1999. If these factors are combined with sensible policies and if structural reform in the key sectors of the economy is furthered and expanded, Mexico will be capable of looking forward to a smooth transition into the next millennium.

However, Banco de México's Board of Governors considers that inflation's uptrend during 1998 is inconvenient and risky. Consequently, this institution reasserts its intention to attain the reversion of the referred trend in the near future. In order to attain such goal, the central bank will make use of all the tools referred to in this document. The 13 percent inflationary objective for 1999 is an ambitious target, given the circumstances that prevail. Nevertheless, it is instrumental that such objective be attained in order to pave the way for a gradual and sustainable disinflationary process.

Abating inflation should not be an objective in itself. Inflation brings inequality and inefficiency, reasons enough to make its abatement a social priority. Accelerated price rises damage the economy in three fronts: economic growth, real wages and income distribution. These conclusions are not the result of academic experiences, but of the eloquent empirical evidence in Mexico:

- Between 1957 and 1997, when there was one-digit inflation, GDP average annual growth rose 6.2 percent. Whenever annual inflation rose beyond one digit, average economic growth decreased to 3.7 percent.

- Between 1957 and 1997, when annual inflation rose above one digit, annual average real wage variation was negative (-2.8 percent), whereas when annual inflation reached one digit, annual average growth for real wages rose to 6.0 percent.

- Lastly, recent research shows that a 5 percentage point rise in inflation may, in the long term, decrease per capita income of the population's poorest quintile by 11.4 percent.

Confronted with these enormous social costs, there is but one possibility: disinflation. This is precisely the task to be headed by Banco de México. Once lasting stabilization is achieved, Mexico will be capable of enjoying the fruits of its success through higher, sustainable economic growth, rising real wages and improved income distribution.

Inflation damages the soundness of the macroeconomic framework by damaging public finances. This phenomenon stems from the increases in public debt service which, in turn, bring higher real and nominal-inflation generating interest rates. A sustainable 5 percentage point decrease in inflation might reduce the public sector's economic deficit by 0.8 percent of GDP, while the operational deficit might fall by 0.2 percent of GDP.

Monetary policy exerts its influence on inflation through several channels; however, these mechanisms are not immediate. Additionally, when a society has suffered inflation's consequences for a long time, it is only natural for economic agents to react slowly and skeptically when confronted with the authorities' decision to stabilize. Consequently, success requires two conditions to be fulfilled: persistence in implementing measures and patience in expecting the outcome.

Therefore, the appropriate path to follow when adopting a disinflationary program must go far beyond the immediate circumstances. Under this light, the Board of Governors deems reasonable to propose, as the stabilizing objective for the following five years, to gradually approach "external inflation".

Another lesson taught by time is that price stability may not be achieved, at a reasonable cost, only by means of monetary policy. In order to accomplish such objective, policies must be consistent among themselves. Throughout this year, the fiscal deficit objective of 1.25 percent of GDP is consistent with a significant reduction in inflation.

In a continuously changing environment, the central bank must maintain an attentive attitude with regard to inflation performance, in order to make a timely detection of unstabilizing disruptions and act accordingly, both individually and in conjunction with other public entities. In addition, in order to be capable of achieving stability, at a reasonable cost, the central bank must defend its stance publicly and convincingly.

The term "reasonable cost" has an instrumental theoretical and practical basis related to the role of expectations. If, for any historical reason, or a particular perception of current or future circumstances, the public assumes that a foreseeable price rise will be above that set forth by the government, and acts accordingly, a potentially undesirable situation for a stabilization program emerges. Under such circumstances, if authorities strictly stick to the official target, employing every instrument available to attain such target, the economic agents' projects will not materialize: price rises will be lower than expected. Given the rigid features of the Mexican economic system, frustrated expectations will translate into deceiving sales levels, stock accumulation, overproduction, decreasing profits and falls in employment among other consequences. Briefly, a recessive tendency of economic activity. Disinflation will have been achieved, but at a considerable cost. Logically, the larger the difference between the people's and the official estimates or, in other words, the lower the latter's credibility, the greater the sacrifice described above.

Upon the same line of reasoning, it may be understood then how important it is for a "social consensus" in favor of stability to exist. If decision-makers fundamentally adopt the idea of disinflation, attitudes and policies will be established accordingly. Therefore, divergence between planned and feasible will decrease, making the "cost" of adjustment more bearable.

Applying the above to immediate reality, it would be very convenient for future wage negotiations not to be based on inflationary expectations taking into account the inflationary bubble registered during last December and January. Such bubble should dissipate in February so that, not long afterwards, inflation would resume its downward behavior. Banco de México has oriented every action at attaining this goal. Therefore, if these factors are not incorporated into inflationary expectations when wage negotiations take place, firm costs will rise, employment will not grow as expected and workers' incomes will not increase as desired. Thus, to the extent that inflationary expectations adjust more rapidly in response to monetary policy, the disinflationary process will be less onerous.

Considering the above, it is evident that the relevance of the goals, instruments and outcomes should be completely clear for every participant involved in this process.

To this respect, it should be bore in mind that the 13 percent figure set forth by the Federal Government was established considering the situation prevailing during November 1998; that it was discussed and agreed with the central bank; and, finally, that it was explicitly contemplated when preparing the Expenditure Budget (*Presupuesto de Egresos*) as well as the Revenue Bill (*Ley de Ingresos*), approved by the People's representatives. Therefore, the objective has been firmly established, today as in the recent past, with the appropriate clarity.

Regarding the instruments employed to combat inflation, Banco de México has striven to explain their nature, the conceptual mechanics of their influence and the specific details of their operation.

Lately, Banco de México has intensified its communication efforts; in the near future, it has decided to increase such intensity since, in a democratic society, the only legitimate and effective venue in order to reach a common purpose -stabilization- is that of convincing the citizens of the objective's virtues and the instruments' pertinence.

This document complies with the legal mandate requiring the central bank to inform the Mexican Congress and the Executive Branch of its actions and projects. However, its intention is still more ambitious: to reassert the notion that inflation reduces --and, even eliminates--money's purpose as a measure of value, a medium of exchange and a means of payment. The strength of a currency depends on the confidence the public has on its ability to perform such tasks efficiently. The Board of Governors hereby states its conviction that regaining stability and strengthening the Mexican peso are one and the same thing.

VI. Annex

Daily Forecast of the Stock of the Monetary Base for 1999
(Billions of Pesos)

Days	JAN	FEB	MAR	APR	MAY	JUN
1	131.1	117.8	116.2	123.3	123.1	124.3
2	131.1	116.1	114.4	123.3	123.1	122.9
3	131.1	117.3	113.8	123.3	122.0	121.9
4	128.0	118.7	114.6	123.3	121.2	122.9
5	124.3	118.7	115.5	120.4	121.2	123.4
6	122.8	118.7	115.5	116.9	121.1	123.4
7	123.1	118.7	115.5	114.8	121.2	123.4
8	123.2	116.2	113.6	114.5	121.2	121.1
9	123.2	113.7	111.7	115.3	121.2	119.0
10	123.2	113.1	111.5	115.3	119.3	118.2
11	120.8	115.2	113.8	115.3	117.4	119.9
12	119.2	118.0	116.6	113.6	117.6	122.1
13	119.5	118.0	116.6	112.3	120.7	122.1
14	122.1	118.0	116.6	113.4	123.3	122.1
15	124.1	117.2	115.9	115.9	123.3	121.9
16	124.1	115.5	114.4	117.3	123.3	121.1
17	124.1	114.8	113.8	117.3	121.8	120.9
18	122.0	115.7	115.1	117.3	119.4	122.2
19	119.3	116.1	116.1	115.8	118.6	123.3
20	117.8	116.1	116.1	114.1	119.5	123.3
21	118.3	116.1	116.1	113.2	120.4	123.3
22	118.7	114.0	114.0	114.0	120.4	121.1
23	118.7	112.4	112.0	115.5	120.4	118.4
24	118.7	112.9	111.3	115.5	118.6	117.3
25	116.6	115.4	113.6	115.5	117.2	119.0
26	114.2	117.6	116.9	114.4	117.6	120.8
27	114.5	117.6	116.9	114.1	120.4	120.8
28	117.1	117.6	116.9	115.9	124.0	120.8
29	119.2		117.6	119.8	124.0	120.4
30	119.2		120.3	123.1	124.0	120.4
31	119.2		123.3		124.3	

Daily Forecast of the Stock of the Monetary Base for 1999
(Billions of Pesos)

Days	JUL	AUG	SEP	OCT	NOV	DEC
1	123.1	124.4	121.8	122.3	126.2	130.0
2	125.0	123.0	121.8	122.3	126.2	132.8
3	125.0	121.1	122.7	122.3	124.0	135.4
4	125.0	120.3	122.7	120.5	124.2	135.4
5	123.4	121.6	122.7	118.3	124.8	135.4
6	121.3	122.7	120.8	116.9	124.8	134.4
7	120.4	122.7	118.4	117.7	124.8	133.8
8	122.2	122.7	117.2	118.6	122.2	135.1
9	124.3	121.1	118.9	118.6	119.6	140.3
10	124.3	119.5	120.9	118.6	119.0	146.4
11	124.3	119.8	120.9	117.1	121.6	146.4
12	123.2	122.8	120.9	115.8	125.0	146.4
13	122.5	125.8	120.8	116.3	125.0	147.9
14	123.4	125.8	121.2	119.5	125.0	149.6
15	125.6	125.8	123.1	122.0	124.8	152.0
16	126.9	124.3	123.1	122.0	123.4	156.0
17	126.9	122.2	123.7	122.0	123.0	159.7
18	126.9	121.2	123.7	120.2	124.5	159.7
19	124.6	122.1	123.7	117.5	125.4	159.7
20	121.9	122.8	120.9	116.2	125.4	158.0
21	120.2	122.8	117.6	117.2	125.4	154.9
22	120.6	122.8	115.6	118.1	123.4	153.5
23	121.2	120.7	116.4	118.1	121.5	156.0
24	121.2	118.0	118.1	118.1	121.8	158.1
25	121.2	117.3	118.1	116.8	124.9	158.1
26	119.4	119.5	118.1	115.9	128.6	158.1
27	117.6	122.7	117.3	117.4	128.6	154.5
28	117.9	122.7	117.1	121.6	128.6	150.3
29	121.3	122.7	118.5	126.0	128.9	152.0
30	124.4	122.6	120.9	126.0	129.2	154.9
31	124.4	121.8		126.0		154.9