

Annual Report Summary

2006



BANCO DE MEXICO

APRIL 2007

I. Introduction

The global economic expansion remained robust during 2006 and became more balanced amongst regions than in previous years. Nonetheless, the pace of expansion of the U.S. economy slowed during the second half of the year. Inflationary pressures remained contained as previous oil price increases began to revert in the middle of 2006 and economic activity in several countries slowed.

The environment described contributed to the continuation of relatively easy conditions in international financial markets during 2006. In this context, sovereign spreads for some emerging economies remained close to their minimum levels. Nevertheless, towards the middle of the year international financial markets recorded an episode of turbulence in response to uncertainty regarding the course that the main central banks would set for their monetary policy stance. However, the turbulence was short-lived and did not have significant effects, allowing emerging bond and stock markets to recover during the second half of the year.

The Mexican economy grew 4.8 percent in 2006, figure above that recorded during 2005, higher than that anticipated by analysts at the start of the year, and the highest since 2000. Such result responded to the strength of consumption, vigorous investment and the favorable behavior of external demand. It is important to mention that, just as in previous years, among the factors contributing to domestic expenditure growth are the significant revenues from workers' remittances and oil exports, and a considerable increase in private sector's access to financing.

Although headline inflation declined during the first quarter of 2006, reaching levels close to 3 percent by the middle of the year, it rebounded in August and ended the year at 4.05 percent. Such behavior responded to the performance of its non-core component, particularly weather conditions affecting prices of some agricultural products. Core inflation also began to rise during the second half of the year, mainly as a result of higher sugar and corn-tortilla prices during the second half of the year. Notwithstanding the aforementioned, analysts' medium and long-term expectations for inflation remained relatively stable.

In light of the above, during the first quarter of 2006, the Board of Governors of Banco de México continued to revert its stance of monetary astringency adopted in previous years, leaving monetary conditions unchanged as of May. Nonetheless, given the supply shocks that affected inflation, in its monetary policy press releases from June to the end of the year, the Board signaled its intention to remain alert to the development of inflation expectations, specifically medium-term forecasts and their possible impact on wages.

II. International Environment

The world economy continued to exhibit vigorous growth during 2006, while the differences in growth rates between advanced economies narrowed. During the past five years, the global economic expansion has recorded its fastest pace since the seventies. Moreover, high growth has been accompanied by a significant convergence of GDP levels of emerging market economies, particularly those in Asia, with those of the advanced economies. Economic growth in the U.S. was only slightly higher than during the previous year, as the robust

expansion observed in the first quarter was offset by a significant slowdown during the remainder of the year in response to a deceleration of domestic demand. Economic growth in the Euro area reached a six year peak, driven mainly by stronger domestic demand, buoyed in turn by an improved business climate and a stronger labor market. In Japan, economic activity also expanded at a faster rate than during recent years as solid investment growth continued. Emerging market economies, led by China and India, expanded at a brisk pace.

Inflation remained well anchored at low levels during 2006, although robust economic growth coupled with high oil prices led to renewed concerns about greater inflationary pressures, while uncertainty surrounding the path of the policy stance of the main central banks resulted in a period of turbulence in international financial markets that lasted from May to June. Nonetheless, such turbulence was short-lived and did not lead to serious repercussions. International financial market conditions generally favored the expansion of demand due to the fact that long-term interest rates rose only slightly from already very low levels. Furthermore, emerging bond and stock markets recovered strongly after the volatility observed in May and June.

The U.S. economy grew 3.3 percent in 2006, although the pace of expansion fluctuated throughout the year. U.S. GDP rebounded during the first quarter as the effects of the hurricanes that struck the Gulf of Mexico in the autumn of 2005 began to dissipate. Nonetheless, in the following quarters the expansion of the U.S. economy slowed due to the weakening of several demand components. Adjustments stemming from the correction in the real estate sector, which saw a decline in the growth of property prices and a significant drop in home sales, were the most important factors limiting demand.

During 2006, annual CPI inflation was 3.2 percent, below that observed in 2005 (3.4 percent), as inflationary pressures declined during the second half of the year after having rebounded during the first semester. This behavior mainly reflected the behavior of oil prices throughout 2006. On the other hand, the rise in the cost of housing services put upward pressure on core inflation, which reached 2.5 percent during 2006, figure above the previous year's (2.2 percent). Core inflation measured by the consumption deflator (2.2 percent) was also slightly higher than in 2005 (2.1 percent).

Imbalances associated with low rates of saving, particularly the wide current account deficit, continued during 2006. The U.S. economy has experienced a significant decline in the savings rate over the past decade, mainly as a result of the increase in the fiscal deficit during the last recession and households' tendency to reduce their propensity to save. The latter began in the eighties and became more accentuated as household spending received an additional stimulus as a result of the rise in property prices and the greater availability of credit during the recent real estate boom.

Financial conditions continued to favor the expansion of demand in 2006. Short-term interest rates adjusted in line with the Federal Open Market Committee's decision to raise the target for the federal funds rate by 25 basis points in each of its meetings during the first half of 2006. In June, there was a pause in the process of tightening the monetary policy stance, which lasted until the end of the year. In its last four press releases of 2006, the Federal Reserve reiterated its concern about the level of inflation and the risk of additional pressures associated with the high level of resource utilization.

The global environment of vigorous growth and low inflation contributed to the maintenance of favorable conditions for emerging market economies in international financial markets. Furthermore, the decline in external financing requirements of these countries, together with prudent macroeconomic policies and higher appetite for risk among investors, brought about a reduction in sovereign risk spreads, which reached new historical lows.

III. Developments in the Mexican Economy: General Overview

III.1. Economic Activity

Economic growth was balanced among the economic sectors in 2006. The services and agricultural sectors expanded, while expansion in the industrial sector was particularly noteworthy in its manufacturing production and construction components. Nonetheless, economic activity weakened in the second semester, registering its most important deceleration during the fourth quarter of 2006.

The behavior of economic activity during 2006 was positive given that real GDP grew 4.8 percent, its highest rate in the last six years. Likewise, all the main components of aggregate demand exhibited significant growth. Nevertheless, the strength of GDP and demand declined slightly during the second quarter. Just like in 2004 and 2005, during 2006 the performance of domestic expenditure and economic activity benefited from the favorable performance of external demand and Mexico's oil trade balance surplus, as well as revenues from workers' remittances.

As for aggregate demand, private consumption continued to make the highest contribution to real GDP growth, followed by gross capital formation, while the net trade balance of goods and services made a negative contribution. It is important to mention that increases in consumption and investment during 2006 were higher than those recorded in the last five years.

In 2006, the performance of the Mexican economy was mainly characterized by the following:

- a) Aggregate demand and GDP grew at a higher rate than in 2005, although both items weakened during the second half of 2006.
- b) Both external and domestic demand rose considerably. The expansion of consumption expenditure being particularly noteworthy among the components of domestic demand.
- c) The strength of consumption expenditure was due to several factors, such as the greater availability of financing, job creation, the increase in real average earnings in some sectors, and further increases in the amount of external resources from workers' remittances.

- d) Investment outpaced economic growth for the third consecutive year. Such behavior resulted from increases in investment as well as both public and private expenditure. Imported capital goods registered the highest growth among the components of investment expenditure.
- e) Total public expenditure was higher in 2006 than during the previous year due to increases in both consumption and investment expenditure. Such behavior was favored by increased public revenues, partly derived from the high oil prices that prevailed during the year.
- f) Exports of goods and services rebounded compared to levels recorded in 2005. Such increase was achieved despite the deceleration of U.S. imports (Mexico's main export market) during the second half of 2006.
- g) At the end of the year, Banco de México's Consumer Confidence and Private Sector Analyst Confidence Indexes, as well as its Business Climate and Manufacturing Sector Confidence Indicators exhibited higher levels compared to December 2005.
- h) GDP growth responded to expansion in all three economic sectors: agricultural, industrial, and services.
- i) Similar to previous years, in 2006, economic growth was higher in the non-tradable goods sector than in the tradable goods sector, although the spread between their growth rates narrowed.

III.2. Employment, Earnings and Productivity

The significant expansion of economic activity in 2006 was reflected in a substantial increase in the demand for labor, which contributed to an important improvement of different employment indicators. Worth mentioning is the increase in formal employment in most sectors of economic activity. However, one labor market indicator which did not improve in 2006 was the national unemployment rate, which remained at a similar level to that observed in 2005. The aforementioned indicator was influenced upward by the greater participation of women in the economically active population.

The most relevant aspects of the labor market during the year were the following:

- a) A significant increase in the number of workers insured by the IMSS.
- b) Formal employment growth was more noticeable in temporary jobs in urban areas than in permanent jobs.
- c) Job creation included all states.
- d) The increase in the number of workers insured by the IMSS was highest in the services and construction sectors, although it was also significant in the manufacturing industry.
- e) The improvement of formal employment in 2006 did not translate into a shortage of skilled labor.

- f) During 2006, the average national unemployment rate remained at a very similar level to that observed in 2005, although it continued its upward trend during the second half of the year.
- g) The proportion of the population in informal employment remained high, despite the fact that it exhibited a slight downward trend throughout the year.

Some of the most important aspects regarding earnings and unit labor costs (ULC) during 2006 were:

- a) The main indicators for earnings exhibited mixed growth. The IMSS average reference wage for permanent employees and average contractual wages rose at a lower rate than in 2005. In contrast to the aforementioned, real average wages in the maquiladora and non-maquiladora industries rebounded.
- b) Average unit labor costs (ULC) in the maquiladora industry rose at a similar rate to that observed in the previous year. ULC in the non-maquiladora industry fell at a higher rate than during 2005.

III.3. External Sector

During 2006, Mexico's external sector performance was characterized by the following: vigorous external demand, although such strength declined during the second half of the year; high international oil prices; higher GDP and aggregate demand growth than that observed in 2005, reflected in a significant increase in the demand for imports; greater share of Mexican products in U.S. imports; and, an increased inflow of workers' remittances. The current account of the balance of payments recorded a modest deficit in 2006, measured both in US dollars and as a proportion of GDP. This result implied that the strength exhibited by aggregate demand and GDP during the year, did not translate into a widening of such deficit compared to its level in 2005. In this regard, the current account deficit was influenced downwards by the increase of both, the surplus in the oil trade balance and inflows from workers' remittances.

In 2006 the external sector was characterized by the following:

- a) Higher growth of non-oil exports than during 2005, although such expansion slowed during the second half of the year. The aforementioned partly responded to the behavior of automotive exports which increased significantly in 2006, but at a declining rate throughout the year. In 2006, positive results for non-oil exports were obtained despite the deceleration of external demand during the second half of the year.
- b) Significant increase in the value of oil exports in response to considerable higher crude oil prices in international markets. Nevertheless, such performance weakened in the last few months of 2006 partly due to a reduction in the volume of crude oil exports.
- c) Greater annual growth of merchandise imports with respect to that observed in 2005. This result responded to increased economic growth and stronger aggregate demand than during the previous year. All three

- components of imports (intermediate, capital, and consumption goods) grew, although capital goods imports did so outstandingly.
- d) A recovery in Mexican products' share of the U.S. market, after having lost share during the three previous years. Such improvement is maintained even when oil and automotive exports are excluded.
 - e) Significantly higher inflow of resources from workers' remittances.
 - f) A moderate current account deficit -which was lower than that registered in 2005- measured in both US dollars and in relation to GDP.
 - g) A moderate capital account surplus due to the net result of the following: inflows from foreign investment (both direct and portfolio), external financing channeled to the bank and non-bank private sector, and also to investment projects known as Pidiregas; outflows associated to reductions in public sector foreign debt; and, increases in Mexican residents' assets abroad. The public sector's reduction of its net external debt for 22.027 billion US dollars was particularly important.

III.4. Public Finances

During 2006, the non-financial public sector recorded an economic surplus of 9.8 thousand million pesos, equivalent to 0.11 percent of GDP. When excluding outlays from the Retirement Program for Public Employees (*Programa de Conclusión de la Relación Laboral*, CRL), such surplus totaled 21.6 thousand million pesos (0.24 percent of GDP). The primary surplus, defined as revenues less expenditures other than financial costs, was 261.2 thousand million pesos (2.85 percent of GDP).

Budgetary revenues totaled 2,263.1 thousand million pesos (24.72 percent of GDP), 309.6 thousand million (3.38 percent of GDP) above revenues forecasted in the Federal Revenues Law (*Ley de Ingresos de la Federación*, LIF). In real terms, budgetary revenues grew 12.1 percent in 2006. This result stemmed from increases in both oil (14.3 percent) and non-oil revenues (10.8 percent). Budgetary expenditures totaled 2,255.1 thousand million pesos. This result represented an annual increase of 11.1 percent at constant prices and accounted for 24.63 percentage points of GDP (23.40 percentage points in 2005).

Two important events occurred in the area of fiscal legislation during 2006. First, the new fiscal regime for PEMEX-Exploration and Production came into force. The main objective of this regime was to reduce the company's fiscal burden and, thereby, free up resources for further investment in oil exploration and exploitation. The second change in fiscal legislation concerned the introduction of the Federal Budget and Financial Responsibility Law (*Ley Federal de Presupuesto y Responsabilidad Hacendaria*). This new law established: a) the obligation to maintain a fiscal balance; b) the formula to determine the price of oil for budgetary purposes; c) rules for excess revenue sharing; d) adjustment mechanisms for when either oil and/or non-oil revenues fall below programmed levels; and, e) time limits for approving each year's fiscal package.

III.5. Monetary and Credit Aggregates

In economies where inflation declines significantly, and where such decline is perceived as permanent, remonetization processes (periods in which people gradually increase their holdings of monetary stocks) are commonly observed. This applies to the Mexican economy, where narrow monetary aggregates, among them the monetary base, have increased significantly in recent years. During the same year, the monetary base grew, on average, 16.2 percent at an annual rate, 4.1 percentage points above that observed in 2005 (12.1 percent).¹

International reserves decreased 989 million US dollars. During the third quarter of 2006, Banco de México's international reserves decreased by 11.44 billion US dollars. This reduction was the result of the Ministry of Finance's purchase of 12.451 billion US dollars destined to prepay foreign debt.² Resources for this purchase were obtained from the government's issuance of BONDES D for 135,051 million pesos. Simultaneously, Banco de México withdrew from circulation an equivalent amount of BREMs. As result of these operations, the stock of international reserves and BREMs decreased, reducing both, assets and liabilities from Banco de México's balance sheet. With these actions, BREMs will be substituted according to their maturity date by BONDES D.

In 2006, the monetary aggregate M1 recorded a nominal annual average variation of 15.6 percent, figure 4.4 percentage points below that observed in 2005. Such behavior was influenced by the decline in the opportunity cost of holding liquid financial assets due to a reduction in deposit interest rates and the expansion of economic activity. The monetary aggregate M2, which includes M1 plus residents' financial savings, grew at a real annual average rate of 10 percent, figure 0.8 percentage points above that registered in 2005.

The decline in public sector borrowing requirements and the slower pace of reserve accumulation by Banco de México continued during 2006. These factors have increased the availability of resources to finance the private sector. As for total financing to the private sector, financing from domestic sources stands out, in particular, commercial bank lending.

In 2006, credit to households grew 18.4 percent at a real annual rate and represented 14.1 percent of GDP, figure 1.6 percentage points higher than that recorded in 2005. Such growth resulted from stronger mortgage and consumption credit. Total financing to firms recovered significantly, registering a real annual variation of 10.2 percent and contrasting sharply with the real annual decrease of 0.4 percent observed during the previous year.

III.6. Inflation

Developments in headline inflation throughout 2006 mainly reflected the appearance and disappearance of certain supply shocks which affected a relatively reduced number of goods and services. During the first quarter of 2006

¹ Changes calculated based on the average of daily stocks.

² Banco de México's weekly balance sheet bulletin (*Boletín Semanal sobre el Estado de Cuenta del Banco de México*), Banco de México, August 22, 2006.

headline inflation remained at relatively low levels, while in the second it followed an upward trend, reaching 4.05 percent in December (3.33 percent at the end of 2005). Meanwhile, annual core inflation rose mainly during the second half of 2006, ending the year at 3.61 percent (3.12 percent in December 2005).

Annual headline inflation recorded relatively low levels during the first eight months of 2006 (3.38 percent on average), while in the last four months of the year it remained above 4 percent. Such behavior was mainly due to the non-core component of the CPI. In particular, the subindex of agricultural products fluctuated considerably throughout the year in response to changing weather conditions that affected the supply of certain crops. Annual non-core inflation was 4.96 percent at the end of 2006, figure 1.2 percentage points higher than that observed in December 2005.

The upward trajectory exhibited by annual core inflation resulted from price increases in several raw materials. During the first half of 2006, upward pressure was moderate and stemmed from the growth of the housing price subindex, which was driven by increases in prices of construction materials, particularly steel and copper. In the second half of the year, the processed foods price subindex affected the evolution of core inflation, due mainly to increases in sugar and corn-tortilla prices.

During 2006, corn-tortilla prices accumulated an increase of 13.82 percent. This upward movement was initially influenced by higher international corn prices driven by the greater global demand of this product for ethanol production. Such influence was exacerbated by various distortions characterizing the corn-tortilla chain of production.

In 2006, sugar prices recorded an annual variation of 31.93 percent. The price increase of sugar was not associated with increments in sugar international references. In response to the increase, a series of import quotas were authorized as of August 30, while the new sugar cane harvest cycle, which started in November, increased the product's availability. Nonetheless, the decline in sugar prices was limited: in December 2006 sugar prices in the domestic market were over 136 percent above their international references.

IV. Monetary and Exchange Rate Policy

IV.1. Monetary Policy

During the second half of the year upward pressure on both core and non-core inflation stemming from various supply shocks led to a rebound in headline inflation. In particular, non-core inflation was influenced by the adverse impact of weather conditions on the supply of tomato and onion, while core inflation was affected by sugar supply issues and the increase in corn-tortilla prices. It is important to mention that price increases concentrated in the latter two products and accounted for more than two thirds of the rebound of core inflation during 2006.

Under such conditions, the rebound in inflation is not expected to contaminate long-term inflation expectations. Thus, although inflation expectations for the end of 2006 were revised upward in response to the supply shocks that appeared during the last months of 2006, those corresponding to medium and long-term horizons remained stable.

In light of the developments in inflation as well as its outlook, during the first four months of 2006 Banco de México's Board of Governors continued the reduction of monetary restriction it had adopted previously. The Board allowed for a loosening in domestic monetary conditions of no more than 50 basis points in January and no more than 25 basis points in February, March, and April. Later, in its press release of April, the Board stated that in the foreseeable future, no space for a further loosening existed. This message was reassured in its press releases of May, June, and July, when the Board decided to leave the referred conditions unchanged. Likewise, in its press releases for the months from August to December, the Board also decided to leave monetary conditions unchanged. Nonetheless, in view of the supply shocks that occurred during that period, the Board will closely monitor inflation expectations to ensure the price formation process is not contaminated. As a result of the aforementioned actions, the overnight interbank rate remained at 7 percent from the end of April to December 2006.

During the first half of 2006, perceptions of a possible transition towards an environment of tighter global monetary conditions and increased volatility in international financial markets reduced investors' appetite for risk. Meanwhile, in Mexico, some uncertainty associated to the federal elections prevailed, which led to an upward adjustment in longer-term domestic interest rates. As a result of the aforementioned, the yield curve steepened during the second quarter of 2006, while the interest rate spread between Mexico and the U.S. also widened during the same quarter.

Subsequently, during the second half of the year, part of the adjustment in emerging economies' asset and currency prices reverted, while uncertainty in local markets associated to the election process dissipated. Thus, longer term domestic currency-denominated interest rates declined during the second half of 2006. Furthermore, given that medium and long-term interest rates decreased more in Mexico than in the U.S., sovereign spreads between the two countries narrowed, reaching historically low levels at the end of 2006.

IV.2. Exchange Rate Policy

As mentioned previously, during the second quarter of 2006, expectations of a possible transition to an environment of tighter global monetary restriction were accompanied by increased volatility in international financial markets and lower appetite for risk among investors. This situation led to a temporary rise in longer-term sovereign debt spreads in some emerging economies. In Mexico this adjustment was also affected by uncertainty surrounding federal elections and, as a result, domestic interest rates rose slightly more than in other emerging markets.

Increased volatility in international financial markets together with the resulting decline in international financial flows to emerging markets contributed to

a depreciation in the exchange rate of some economies, particularly during the second quarter of 2006.

It is important to point out that volatility in domestic financial markets was mainly of a short-term nature and gradually dissipated throughout the third quarter. Longer-term interest rates and the exchange rate recorded levels that had been seen before such volatility.

V. Final Remarks

The world economy continued to perform well in 2006. Global inflation remained well anchored in response to the decline in oil prices during the second quarter of the year and to expectations that economic activity would slow in some countries towards the end of the year.

Economic growth was positive in Mexico during 2006. GDP grew 4.8 percent at a real annual rate and the different economic sectors exhibited favorable results. The expansion of industrial activity was supported by both the performance of the domestic market and manufacturing exports, while positive results in construction stemmed from housing and public expenditure in infrastructure. The services sector also grew considerably, particularly in its communications and transport components. Such vigorous growth translated into significant job creation in the formal sector, increasing the number of workers affiliated to the IMSS by around 900 thousand.

Inflation was influenced by diverse supply shocks resulting from important increases in the prices of some agricultural products, particularly sugar and corn-tortilla, which contributed to the rebound in inflation during the second quarter of 2006. However, price increases in basic goods concentrated in only a few products and, given that they reflected changes in relative prices, did not significantly contaminate the economy's price and wage determination processes. It is worth mentioning that despite the rebound in headline and core inflation referred to, analysts long and medium-term inflation expectations remained relatively stable.

Under such context, during the first 4 months of 2006, Banco de México's Board of Governors continued to revert the monetary restriction it had previously adopted. Then, in its monetary announcement in May, the Board decided to leave monetary conditions unchanged, reiterating that in the foreseeable future, no space for any further loosening existed. Subsequently, in response to the supply shocks that affected inflation from August to December, the Board announced it would remain alert to changes in the public's inflation expectations and their possible impact on wages.