Inflation Report

April – June 2007

BANCO DE MEXICO

JULY 2007

BOARD OF GOVERNORS

Governor

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FOREWARNING

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Unless otherwise stated, this document has been prepared using data available as of July 27, 2007. Figures are preliminary and subject to change.

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1. Introduction

The outlook for the world economy continues to be positive. In particular, robust growth is anticipated for both this year and the following. After having slowed down at the beginning of the year, growth of the U.S. economy recovered during the second quarter, even though it remained below its potential. The U.S. economy is expected to continue to recover during the remainder of 2007 and during 2008. Economic growth in the Euro area, Japan, and emerging market economies remained relatively strong and the outlook is positive.

Inflation expectations over the medium and long term have remained stable in advanced economies. However, in some of them headline inflation has been affected by increases in commodity prices, mainly in those related to crude oil and food products, as well as by high rates of resource utilization. Against this backdrop, various central banks consider that the balance of risks for inflation has worsened and, have thereby continued to tighten their monetary policy stance in the last few months.

During the second quarter of the year, long-term interest rates in the U.S. followed an upward albeit oscillating trend. As a result, the slope of the yield curve increased. Unlike the rebound in long-term interest rates recorded in mid-2006 –which was associated with increased uncertainty about inflation- the recent increase reflected an upward adjustment in real interest rates, which appears to be the result of greater confidence in the outlook for growth in the U.S. International financial markets have adjusted in an orderly fashion to an environment of higher interest rates, characterized by a persisting appetite for risky assets. Hence, the prices of various assets and currencies of emerging market economies recorded positive results.

However, since mid-June, long-term interest rates started again to decline, while stock markets recorded losses and the spreads on sovereign debt instruments of emerging market economies increased. This occurred in a context of increasing concerns about losses on subprime mortgage loans in the U.S., and their potential impact on credit markets and economic activity in that country.

During the first half of 2007, economic activity in Mexico grew at a significantly lower rate than in 2006, due to a reduced dynamism of external demand, and a slower growth rate of domestic consumption and investment spending. Economic growth is expected to recover moderately during the rest of the year, in line with the gradual recovery expected for U.S. economic activity.

Since mid-2006, inflation has been affected by a series of supply shocks, which prompted a rebound in both annual headline and annual core inflation.

Given the number, magnitude, and persistence of these shocks, and considering that their direct effect on annual inflation calculations takes some time to disappear and that previsions for short-term inflation have been revised upward considerably, the balance of risks for inflation worsened during the first months of the year.

Under this context, in April, Banco de México's Board of Governors determined to tighten its monetary policy stance as a preemptive measure in order to prevent the price and wage determination processes from being contaminated by the aforementioned supply shocks and, therefore, have a better balance in terms of inflationary risks.

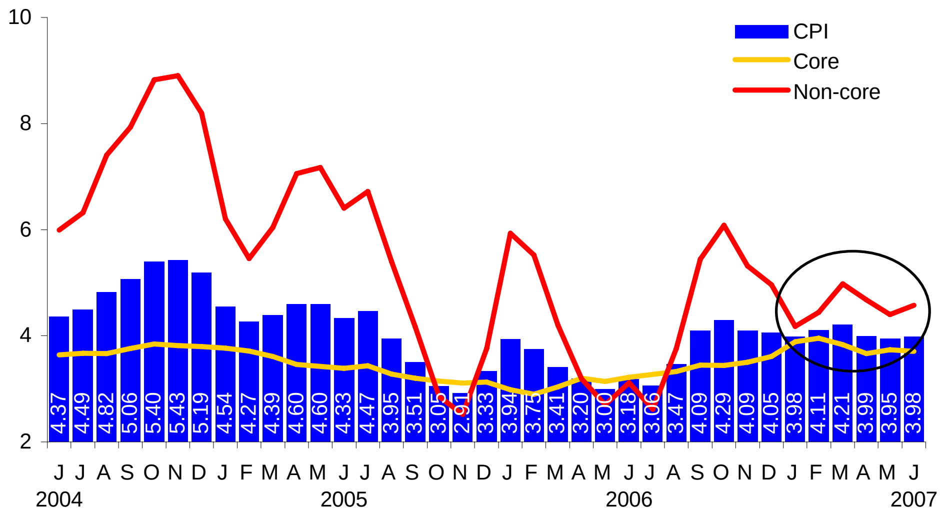
Since the effects of monetary policy actions on the economy take place with some lag, once the effects of the supply shocks on headline inflation's annual variations disappear, and in absence of further supply shocks, annual headline inflation is expected to converge gradually towards its 3 percent target, approaching it closely by the end of 2008.

Nonetheless, risks regarding the attainment of such prevision prevail. Consequently, Banco de México's Board of Governors has maintained a tightening bias in regards to its monetary policy stance.

2. Recent Developments in Inflation

During the second quarter of 2007, annual headline inflation remained slightly below 4 percent (3.98 percent at the end of June, Graph 1). Average annual inflation during this quarter was 3.97 percent, 0.13 percentage points below the first-quarter figure.[1] This was mainly due to the gradual fading of two supply shocks that affected prices since last year, and to the lower contribution of prices of travel packages on inflation. As for the referred shocks, worth mentioning are the declines in the annual price variation of the core group of housing-related services as well as fruits and vegetables. The fact that the sharp increases in the prices of construction materials manufactured from metals that took place between April and June 2006 did not repeat, contributed to the results of the Residential Construction Cost Index (*Índice del Costo de la Construcción Residencial*, ICCR), which affects housing items' quotes. In the case of fruits and vegetables, the result was mainly determined by the reduction in onion and lemon prices (due to supply normalization).

Graph 1
Consumer Price Index
Annual percentage change



The slight reduction of annual inflation during the second quarter of 2007 was partially offset by the greater pressure exerted by processed foods and livestock products prices. Food prices have not only increased in Mexico.[2] This has been the result of a greater global demand for animal originated foodstuffs and higher production costs. Higher production costs have also responded to the increase in the international prices of grains, due to a greater use of these commodities as inputs in biofuel production.

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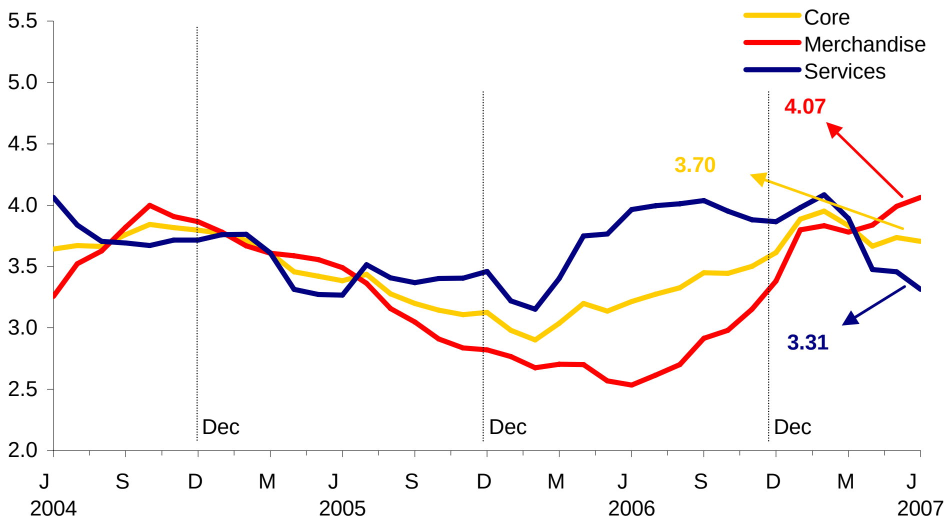
[1] Average annual inflation is estimated as the average of three CPI monthly indices divided by the previous year corresponding figure.

[2] It is important to notice the increase, in percentage points, in the annual percentage change (June 2006-June 2007) of several countries consumer price indices food items (processed and livestock products): Bolivia 5.40; Canada 1.17; Chile 3.15; Colombia 4.98; U.S. 1.79; Mexico 5.03; Nicaragua 5.26; United Kingdom 3.00; and, Uruguay 9.62.

During the analyzed quarter, within the core CPI index, the annual growth rates of the services and merchandise subindices followed opposite patterns (Graph 2). Regarding the former, its growth rate declined in greater magnitude compared to the latter. As a result, annual core inflation decreased to 3.70 percent at the end of the quarter. Annual quarterly inflation during the referred period was 3.70 percent, 0.19 percentage points below that of the previous quarter (Table 1).

Graph 2
Core Price Index
Annual percentage change



In June 2007, the services core price subindex recorded an annual variation of 3.31 percent, 0.58 percentage points below its figure at the end of the first quarter. This result was due to a reduction in the annual growth rates of prices of housing-related services and other services (Table 1).

The pattern followed by housing prices between April and June 2007 was mainly influenced by the reduction of inflation in the Residential Construction Cost Index, as a result of the fading of the shock that affected the prices of materials manufactured from copper and steel during the same period of last year (Graph 3a). Residential construction price inflation declined from 6.13 percent at the end of the first quarter to 0.60 percent at the end of the second quarter of the year.

The reduction in non-housing services price inflation was mainly determined by the decline in the annual growth rates of both travel-services and air-transportation fees (Table 1 and Graph 3b). This reduction was due to two factors: first, the Easter holiday took place on a different date than last year and, second, air transportation fees have been decreasing since 2004 as a result of greater competition in the aviation industry.

Table 1
Consumer Price Index and Components
Annual percentage change

	Annual Percentage Change							Annual Quarterly Change	
	Dec-2006	Jan-2007	Feb-2007	Mar-2007	Apr-2007	May-2007	Jun-2007	Quarter I	Quarter II
CPI	**4.05**	**3.98**	**4.11**	**4.21**	**3.99**	**3.95**	**3.98**	**4.10**	**3.97**
Core	**3.61**	**3.89**	**3.95**	**3.83**	**3.66**	**3.73**	**3.70**	**3.89**	**3.70**
Merchandise	**3.38**	**3.80**	**3.83**	**3.78**	**3.84**	**3.99**	**4.07**	**3.80**	**3.96**
Food	5.10	6.17	6.05	5.92	5.99	6.15	6.38	6.04	6.17
Dairy products	3.55	3.74	3.85	4.19	4.46	4.75	6.69	3.93	5.30
Rest of food	2.12	2.06	2.20	2.20	2.26	2.40	2.36	2.15	2.34
Services	**3.87**	**3.98**	**4.09**	**3.89**	**3.48**	**3.46**	**3.31**	**3.99**	**3.41**
Housing	3.73	3.78	3.81	3.59	3.43	3.22	2.95	3.73	3.20
Own-housing	3.45	3.45	3.38	3.17	2.98	2.68	2.34	3.33	2.66
Rest of services	4.02	4.21	4.41	4.25	3.53	3.74	3.74	4.29	3.67
Travel packages	3.70	4.81	5.89	7.10	-1.87	2.50	1.80	5.95	0.76
Air transportation	4.48	1.38	3.99	4.68	1.44	-2.46	-1.16	3.32	-0.76
Non-core	**4.96**	**4.17**	**4.44**	**4.98**	**4.67**	**4.40**	**4.58**	**4.53**	**4.55**
Agriculture	**8.30**	**5.55**	**5.83**	**8.67**	**9.96**	**6.15**	**6.68**	**6.66**	**7.60**
Fruits and Vegetables	**15.46**	**7.04**	**6.77**	**13.59**	**14.96**	**3.63**	**3.97**	**9.03**	**7.55**
Tomato	10.18	-26.77	-39.38	-37.02	-15.82	-12.98	-6.72	-33.95	-12.10
Onion	186.09	237.18	236.99	269.36	234.65	55.99	23.22	247.80	111.82
Lemon	-5.99	-12.16	23.73	74.96	103.37	13.54	-8.22	28.64	41.51
Livestock	**3.69**	**4.53**	**5.19**	**5.53**	**6.78**	**7.76**	**8.35**	**5.08**	**7.63**
Beef	-0.40	-0.08	1.05	1.37	2.46	4.32	5.63	0.78	4.12
Poultry	8.39	9.81	8.81	9.81	12.55	14.66	15.97	9.48	14.41
Administered and Regulated	**3.14**	**3.03**	**3.39**	**3.07**	**1.94**	**3.16**	**3.23**	**3.16**	**2.77**
Administered	**4.42**	**3.55**	**3.99**	**3.43**	**1.25**	**3.64**	**3.71**	**3.66**	**2.83**
Low-octane gasoline	5.59	4.21	3.83	4.46	2.39	3.48	3.66	4.17	3.18
High-octane gasoline	8.46	8.50	8.32	8.73	6.75	7.81	8.08	8.52	7.54
Electricity	5.07	4.52	3.99	3.87	-1.55	3.91	2.95	4.13	1.52
Residential-use gas	1.53	0.81	3.41	0.71	1.87	2.83	3.65	1.64	2.78
Regulated	**1.83**	**2.49**	**2.77**	**2.69**	**2.66**	**2.70**	**2.76**	**2.65**	**2.71**
Education	**5.71**	**5.64**	**5.61**	**5.60**	**5.59**	**5.55**	**5.63**	**5.62**	**5.59**

The merchandise subindex grew at an annual rate from 3.78 percent in March to 4.07 percent in June 2007, due to a faster growth rate of the prices of processed foods and the rest of merchandise (Table 1 and Graph 4a).

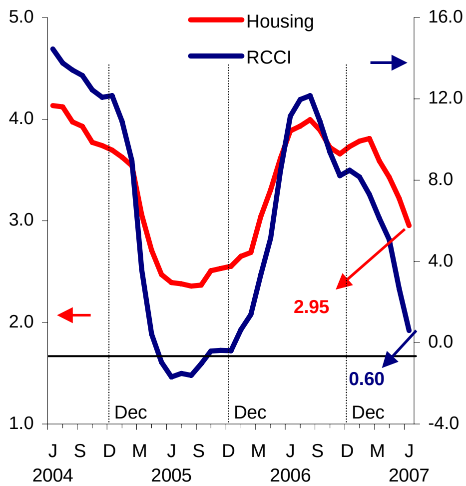
During the second quarter of 2007, the increase in annual core food inflation was primarily influenced by the price increase in several dairy products (Graph 4a).[3] These increases were due, among other factors, to the higher prices of grains -which have raised production costs in the milk and dairy industries- and to a greater world demand for animal originated foodstuffs (worth mentioning is the case of powdered milk, see Box 1).

The increase in core food price inflation during the analyzed period was compensated by the price behavior of corn-tortillas and sugar. The annual growth of corn-tortilla prices has decreased as a result of the stability exhibited by the tortilla market in the last five months (Graph 5a). This has taken place within the Agreement to Stabilize Corn-tortilla Prices, signed by the federal government and different sectors of the corn-tortilla industry.

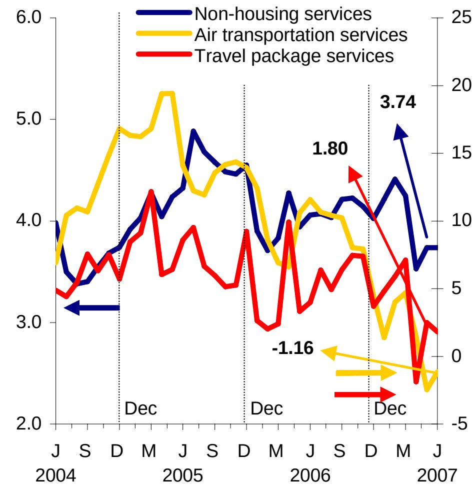
[3] The following dairy products are included in the CPI index: pasteurized mIlk and whole non-pasteurized/un-homogeneized milk; powdered milk; evaporated, sweetened and condensed milk and breastmilk substitutes; fresh unripened cheese; yogurt; stretched curd/string (*Oaxaca*) or broiler (*Asadero)* cheese; cream; unaged *Manchego* cheese and *Chihuahua* cheese; other types of cheeses; ice cream; and, American yellow cheese and butter.

Graph 3
Core Services Subindex

a) Housing Services
Annual percentage change

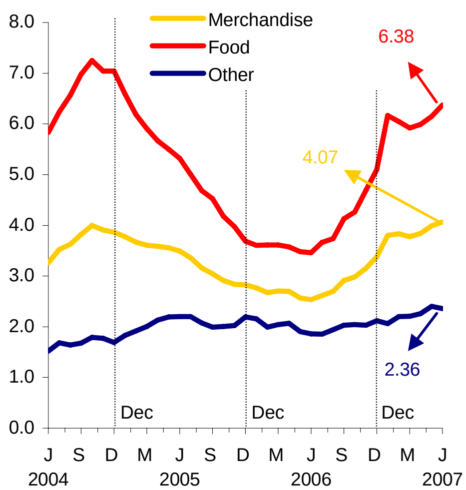


b) Non-housing Services
Annual percentage change

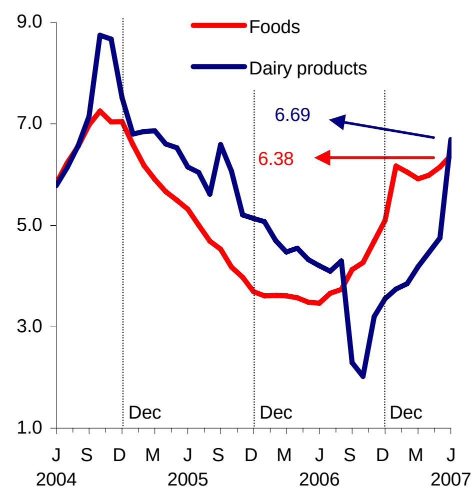


Graph 4
Core Merchandise Subindex

a) Merchandise
Annual percentage change



b) Merchandise: Food
Annual percentage change



Box 1
Recent Developments in Dairy Product Prices

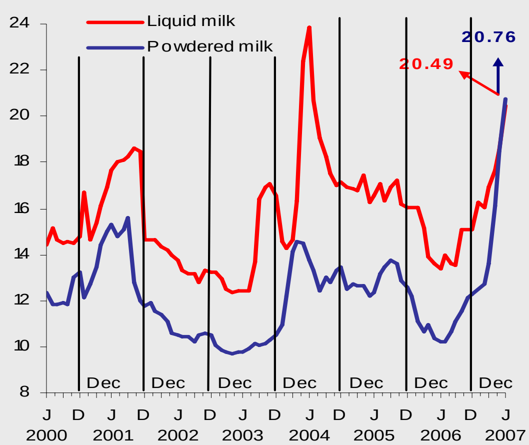
The annual growth rate of dairy product prices has been increasing since November 2006, reaching 6.69 percent in June 2007 (Table 1). Dairy product prices have a 3.00 percent weight in the CPI; therefore, their increase has affected headline inflation significantly. Within dairy products, prices of powdered milk have increased the most.

Table 1
CPI Dairy Products
Annual percentage change

Item	Weight	2006			2007					
		Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun
Dairy products	**3.00**	**2.02**	**3.20**	**3.55**	**3.74**	**3.85**	**4.19**	**4.46**	**4.75**	**6.69**
Pasteurized milk and whole										
non-pasteurized/un-homogeneized milk	1.86	2.92	4.51	4.85	4.89	4.68	5.01	4.99	5.01	7.06
Powdered milk	0.12	1.91	3.67	4.42	4.84	5.45	5.48	6.01	8.02	12.23
Evaporated, sweetened and condensed milk										
breastmilk substitute	0.05	4.95	5.18	5.08	5.16	5.19	5.47	6.20	6.42	6.30
Fresh unripened cheese	0.24	0.48	0.34	0.21	0.82	2.36	3.13	3.88	5.35	6.46
Yogurt	0.20	-2.25	-1.27	-1.56	-1.15	-1.52	-1.62	-0.12	-0.53	1.73
Stretched curd/string (*Oaxaca*) or broiler (*Asadero*) cheese	0.15	-0.51	-0.26	1.10	1.92	3.24	3.83	4.27	4.12	5.64
Cream	0.10	1.80	1.92	2.77	2.01	0.71	0.14	1.07	2.02	3.19
Unaged *Manchego* cheese and *Chihuahua* cheese	0.10	-0.05	0.20	-0.08	1.30	2.32	2.74	3.88	5.57	8.86
Other types of cheeses	0.07	-0.58	-0.58	0.42	1.36	3.47	4.42	5.76	7.05	7.60
Ice cream	0.05	0.70	1.62	2.47	2.91	3.17	3.60	3.69	3.38	3.05
American yellow cheese	0.03	1.51	1.83	1.58	1.42	1.52	2.30	2.10	2.28	5.21
Butter	0.02	3.84	4.97	6.67	6.13	5.69	5.98	5.43	5.10	6.29

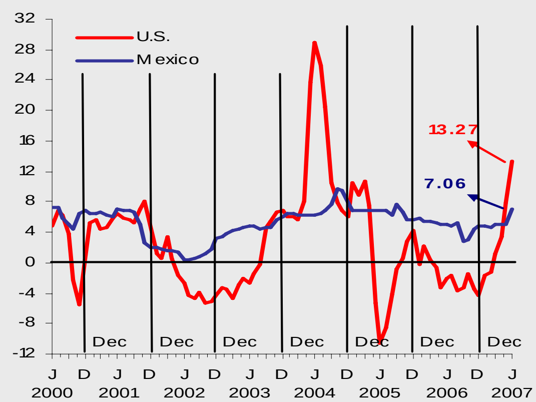
Domestic prices of dairy products have been affected by the increase in their international price reference. In June, international prices of powdered and liquid milk recorded annual variations of 103 and 53 percent, respectively (Graph 1). CPI inflation in some countries has been affected by these increases during the last quarter. For example, prices of pasteurized milk in the U.S. recorded an annual variation of 13.27 percent in June (1.36 percent in October 2006). During the last years, milk prices in the U.S. have recorded negative variations, while in Mexico inflation of milk prices has remained stable, exhibiting positive and less volatile variations (Graph 2).

Graph 1
International Wholesale Prices of Dairy Products
USD/100 lbs.



Source: Bloomberg.

Graph 2
Consumer Prices of Pasteurized Milk: Mexico and U.S.
Annual percentage change

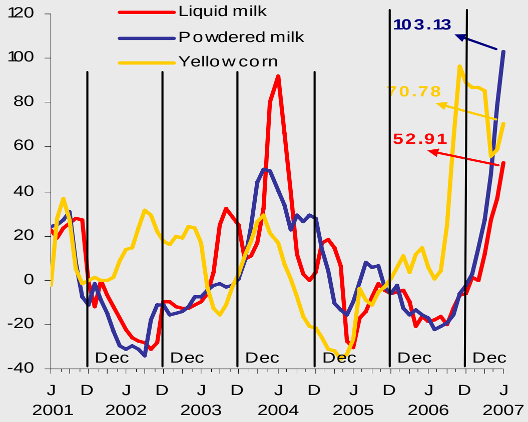


Source: Banco de México (Mexico) and Bureau of Labor Statistics (U.S.).

The recent developments in the prices of dairy products has been mainly the result of supply shocks -such as the higher prices of food commodities- along with the end of export subsidies in the European Union and adverse weather conditions in Australia. The aforementioned has taken place under an environment of increasing world demand for animal originated foodstuffs. Worth mentioning is the greater consumption of powdered milk from Asian countries, especially China.

1) Milk production costs have increased, thus affecting world supply of dairy products. These developments are associated with the significant growth in the international price of yellow corn since October 2006, as this grain is one of the main components of prepared livestock feed (Graph 3). Moreover, the increase in corn prices has responded to a greater use of this grain in biofuel production.

Graph 3
International Prices of Milk and Corn
Annual percentage change



Source: Bloomberg.

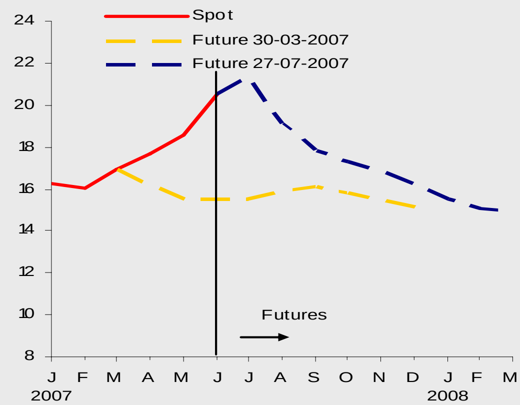
2) In the European Union, the Dairy Management Committee determined to cancel export subsidies for various products. Between June 15, 2006 and June 14, 2007, subsidies for powdered skimmed milk, powdered whole milk, condensed milk, butter, and cheese were canceled. With these measures, the European Dairy Association expects production and exports of powdered milk in Europe to decrease, while production of higher value-added goods, such as cheeses for local consumption, to increase.

3) In Australia, fourth exporter of dairy products in the world, dairy production decreased 4.8 percent in annual terms in May 2007,[1] as a result of the higher costs originated by the continuous drought that has hit that country since 2001.[2]

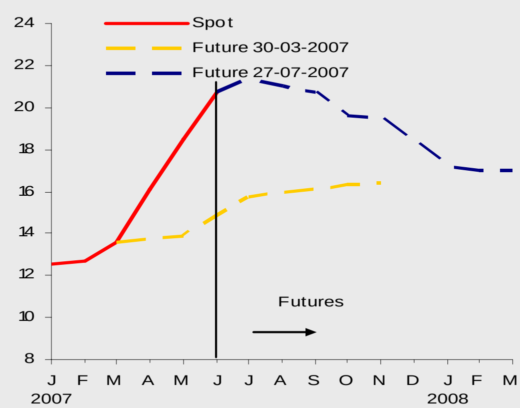
Finally, futures markets suggest that the recent increases in the international prices of dairy products will start to revert in the next months (Graph 4), mainly due to expectations of an increase in dairy production worldwide. As for prices of liquid milk, they are expected to start decreasing in August, ending the year at levels similar to those observed at the beginning of 2007. In contrast, prices of powdered milk are expected to decline at a slower rate, ending the year 47 percent above their levels in January, as a result of the strong world demand for this product.

Graph 4
International Prices and Futures Prices of Milk
USD/100 lbs.

a) Liquid milk



b) Powdered milk



Source: Bloomberg.

1/ According to the Food and Agriculture Organization (FAO).
2/ Dairy Australia.

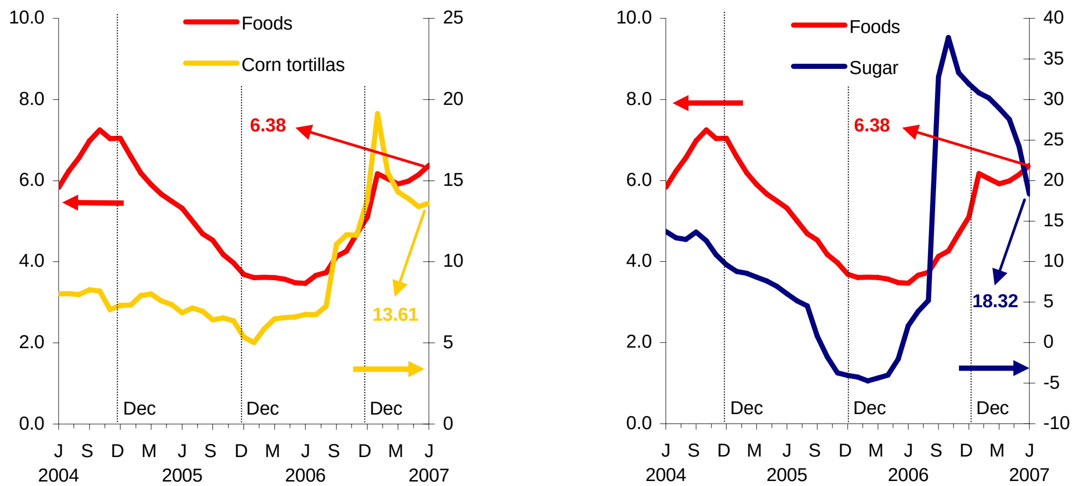
Sugar prices continued to decline during the first half of the year (Graph 5b) as a result of the fall in their international references and, recently, to the significant reduction of sugar import duties from the U.S. and Canada.[4] Domestic prices of sugar have been converging to their international references slowly (Graph 6).

[4] The federal government decreed a reduction in import duties for North American sugar as of May 9, 2007. The referred duty dropped from 288 to 35.31 US dollars per ton.

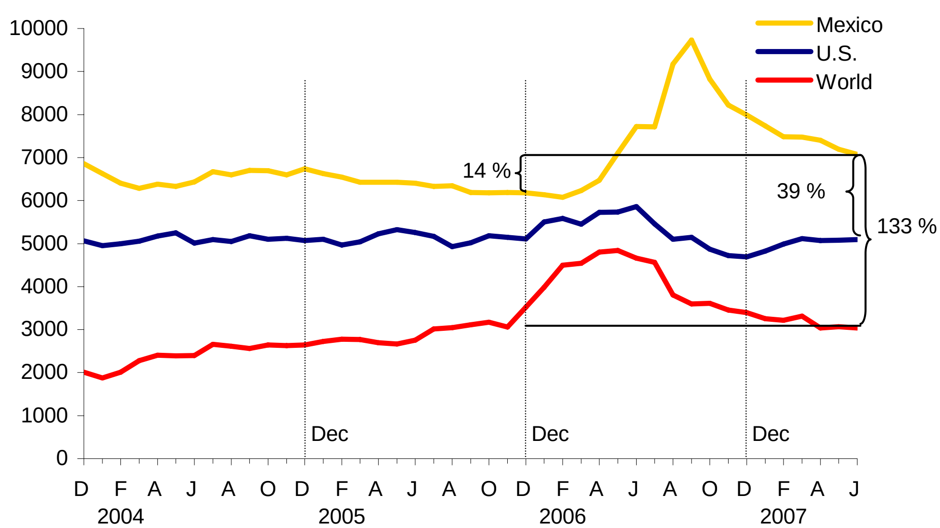
Graph 5
Core Merchandise Subindex: Food

a) Tortilla
Annual percentage change

b) Sugar
Annual percentage change



Graph 6
Domestic and International Prices of Sugar
Pesos per ton



Source: National System of Information and Integration of Markets (*Sistema Nacional de Información e Integración de Mercados*, SNIIM). U.S. Department of Agriculture (U.S. and World).

Annual non-core inflation reached 4.58 percent at the end of the second quarter of 2007, 0.40 percentage points below March's figure. The non-core price subindices recorded different rates of inflation. On the one hand, the corresponding rate for fruits and vegetables declined, while that for agricultural products and administered prices increased.

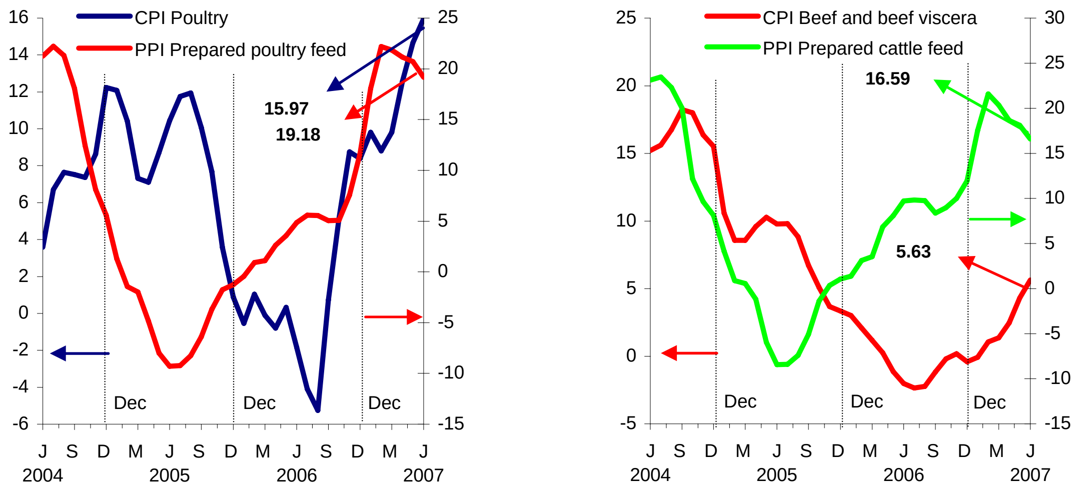
The fruits and vegetables subindex recorded a significantly lower annual variation between March and June 2007 (Table 1). This reduction was due to the fall in onion and lemon prices, as the supply of these goods increased throughout the quarter, as compared with the stock at the end of March 2007. However, the increase in tomato prices was a factor that partially limited this decline (Graph 8).

Livestock Inflation has increased gradually during the first half of the year (Table 1). The items that exhibited higher growth rates in their quotes were poultry and beef, as their production costs have been affected by the increase in grain prices and by the higher world demand for meat products (Graph 7 and Section 3.3.3). Nonetheless, during the analyzed quarter, the annual variation of prepared animal feed prices decreased.

Graph 7
Livestock Price Subindex: Poultry and Beef
Annual percentage change

a) Poultry
Annual percentage change

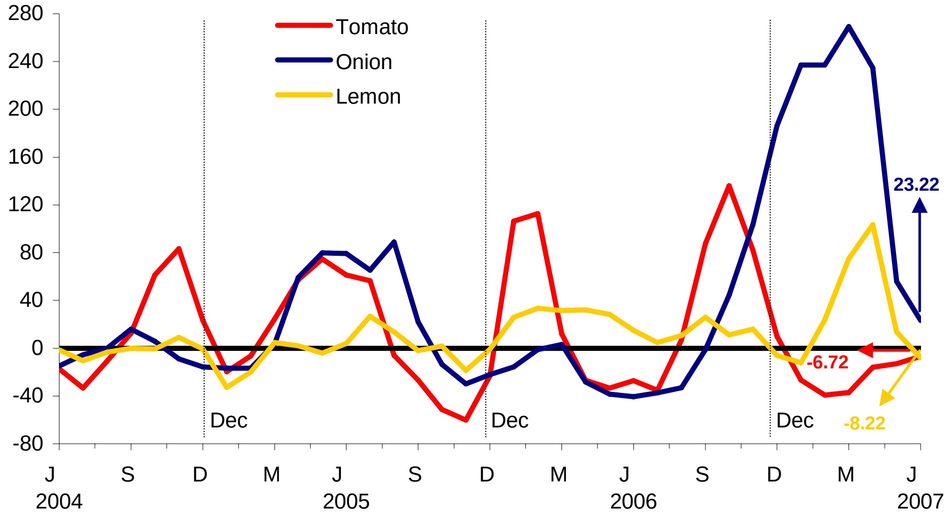
b) Beef
Annual percentage change



Inflation of administered prices rose during the analyzed quarter, mainly due to increases in natural gas prices (Table 1). This was partially offset by a slower growth rate of the other items that make up this subindex (electricity, and low and high-octane gasoline). The reduction in the annual variation of gasoline prices was due to a lack of price changes in border cities, as these were at the maximum level set on May 6, 2006. On another front, the fall in the annual growth rate of electricity tariffs was due to a lower contribution of high consumption electricity tariffs (*Tarifas Eléctricas de Alto Consumo*, DAC), which grew at a slower rate after metal prices did not increase as they had done so in the same period of the previous year (see Section 3.3.2).

The annual variations of the non-core subindices of regulated prices and private education prices did not change significantly between the first and second quarters of 2007 (Table 1).

Graph 8
Onion, Lemon and Tomato Price Index
Annual percentage change

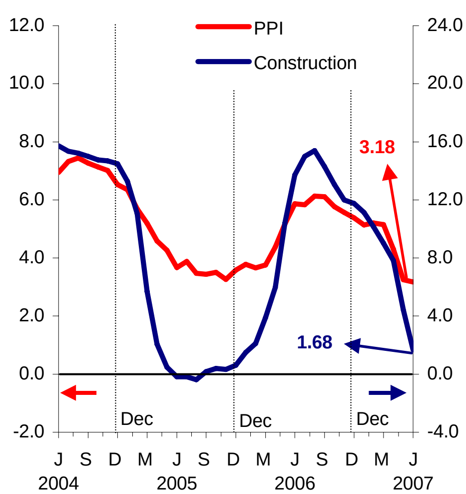


2.1. Producer Price Index

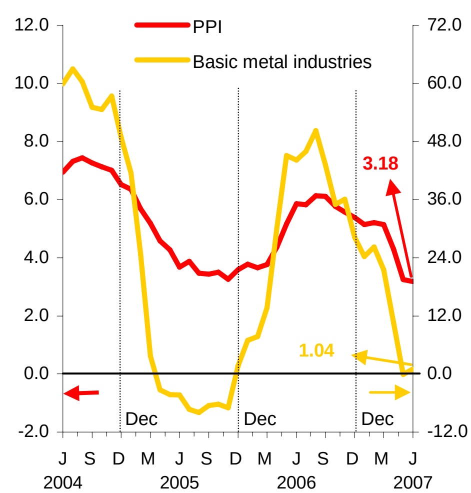
The annual growth rate of the Producer Price Index (PPI) continued to decline during the second quarter of 2007 (Graph 9). This indicator recorded an annual variation of 3.18 percent in June 2007. In contrast, at the end of the previous quarter, this figure was 5.14 percent. This reduction was due mainly to the lower growth rates recorded by the construction and basic metal industry price subindices, as a result of the effect of the supply shocks that last year affected the prices of different materials manufactured from steel and copper.

Graph 9
Producer Price Index excluding Oil: Merchandise and Finished Goods (PPI)

a) PPI and Construction
Annual percentage change



b) PPI and Basic Metal Industries
Annual percentage change



3. Main Determinants of Inflation

3.1. International Environment

Global economic activity exhibited robust growth during the second quarter of the year. In the U.S., economic activity strengthened, although GDP continued to expand at rates below that of potential output. At the same time, incoming information suggests dynamic growth in both the Euro area and Japan and a vigorous expansion in emerging market economies. In general, inflation remained under control. Nonetheless, concerns about the future path of inflation persist, mainly because of the intensive use of production resources in several economies and the increase in the level and volatility of commodity prices, particularly crude oil and food prices. In this context, several central banks continued to tighten their monetary policy stance. Despite the increase in short-term interest rates in various countries and the upward trend followed by long-term interest rates during the quarter, conditions of ample liquidity persisted in international financial markets.

3.1.1. Global Economic Activity

After having grown at an average annual rate of 3.2 percent during the period 2004-2006, the U.S. economy is in a process of adjusting to a slower pace of expansion. In this setting, the rate of growth has fluctuated significantly from one quarter to another. After reaching an annualized rate of 2.1 percent during the last quarter of 2006, GDP growth fell to 0.6 percent during the first quarter of 2007. Economic activity rebounded again during the April-June period, growing at an annualized quarterly rate of 3.4 percent. The reduction in the trade deficit, a significant expansion in government spending, and the end of the cycle of inventory correction contributed to the rebound in growth. Non-residential investment also expanded, mainly due to the greater dynamism of the non-residential construction component, as investment in equipment recovered only moderately. In contrast, residential investment continued to fall and there are no signs that residential construction has reached bottom. Furthermore, problems in the subprime sector of the mortgage market worsened during the quarter. In addition, household spending slowed down, perhaps in part reflecting the impact of higher gasoline prices and the vanishing impulse from capital gains on real estate assets.

The annual growth rate for US GDP growth has fluctuated less sharply recently. It declined from 2.6 percent during the fourth quarter of last year, to 1.5 percent during the January-March 2007 period and to 1.8 percent during the second quarter of this year. Despite the rebound on a quarterly basis observed during the April-June period, the economy continued growing at annual rates below those of potential output.[5] GDP is expected to gradually strengthen during the third and fourth quarters of 2007. The Federal Reserve expects the economy to expand at an annual rate in the rage of 2.25 to 2.5 percent during the fourth quarter of 2007, and of between 2.5 to 2.75 during the fourth quarter of 2008.

[5] The Federal Reserve Bank of Chicago estimates that nowadays the U.S. economy's potential growth rate is slightly below 3 percent.

In the Euro Area growth remained strong during the first quarter of 2007, as GDP expanded at an annual rate of 3.1 percent. Recent data point to a vigorous expansion during the second quarter, supported by favorable conditions both for domestic and external demand. The Japanese economy posted solid growth during the first quarter (annual rate of 2.6 percent), and is expected to have continued to grow during the second, stirred by a recovery of household spending, higher exports, and an expansion in firms' capital expenditure.

Overall, emerging market economies exhibited vigorous growth during the first months of 2007. The Chinese economy grew at a high clip during the second quarter (11.9 percent), despite measures adopted by the central bank to increase reserve requirements and interest rates, in a context of renewed concerns of Chinese authorities over the risk of overheating. Other Asian emerging economies, such as India, have also recorded solid growth. After having grown at an annual rate of 9.1 percent during the first quarter, Indian GDP continued to expand vigorously during the April-June period.

Latin America continued to grow at high rates during the first half of 2007, although below those observed in other emerging market regions. In Argentina, GDP grew above its potential rate, reaching an annual expansion of 8.5 percent in May, although with a tendency to slow down. The Brazilian economy continued to grow vigorously during the April-June period and for 2007 it is expected to grow above 2006 figures (3.7 percent). The Chilean economy grew at a strong rate during the first months of the year (annual rate of 5.8 percent), and available information suggests that growth continued during the second quarter.

3.1.2. General Trends of Inflation

In a context of greater volatility, the average price of crude oil increased significantly during the second quarter. The barrel of WTI reached an average price of 65 US dollars per barrel, i.e., 6.9 US dollars above the average for the prior quarter. Among the main factors that contributed to this rise were concerns about recurrent oil production stops in Nigeria, geopolitical risks in other oil producing regions, OPEC's continuous restrictions on oil production and low gasoline inventories. At the end of June, the price per barrel for the WTI crude was slightly above 70 US dollars, a level that had not been reached since August 2006.[6] As for non-oil commodities, the IMF's price index showed a deceleration as its annual rate of change decreased during the second quarter, although it remained at high levels.[7]

In the U.S., the rebound in the consumer price index (from an annual rate of 2.1 percent in January to 2.7 percent in June) was largely influenced by the increase in food and energy prices (Graph 10). However, no significant pressures on core inflation are observed, as it fell from an annual rate of 2.5 percent in March to 2.2 percent in June. Inflation as measured by the core personal consumption expenditure deflator fell from an annual rate of 2.4 percent during the first quarter to 2 percent during the second. Core inflation's favorable performance

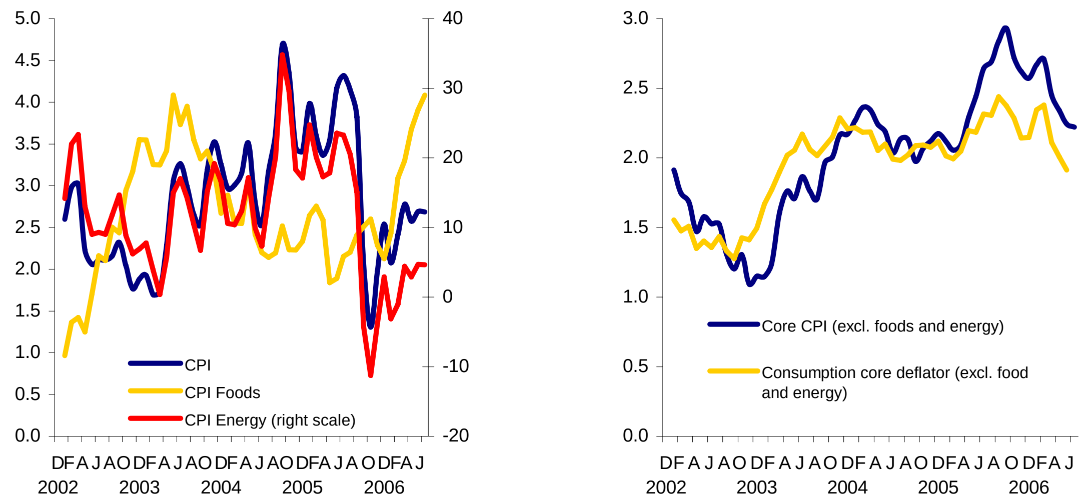
6 The price per barrel of the WTI crude oil reached 77 US dollars in July 27.

7 During the second quarter of 2007, the IMF non-fuel commodities price index increased at an annual rate of 19.7 percent, as compared with 24 percent during the first quarter. Food prices grew at a slower rate (annual rate of 7.6 percent during the second quarter vs.11.6 percent during the first). Metal prices increased 31.6 percent during the second quarter vs. 39 percent during the first. Agricultural commodity prices increased at an annual rate of 9.3 percent during the second quarter (13.5 percent during the January-March period).

mainly reflects the absence of significant wage pressures despite persistently low levels of the unemployment rate. This has contained the increase of unit labor costs despite slower productivity growth. The absence of significant wage pressures has also contributed to keep inflation expectations well anchored.

Graph 10
U.S.: Price Indices

a) Consumer Prices b) Core Price Indices



Source: BLS. Source: BLS and BEA.

In the Euro Area, annual headline inflation remained below the 2 percent reference value of the European Central Bank during the second quarter of 2007. However, some pressures partly related to sound economic activity were observed. The ECB expects average headline inflation to be between 1.8 and 2.2 percent in 2007. In Japan, the consumer price index once again recorded declines in annual terms in June (-0.2 percent).

Inflation in emerging economies has remained, in general, relatively low, although in some countries –such as China- both inflation and inflation expectations for 2007 have increased. Consumer price inflation in China followed an upward trend during the second quarter, from 3.3 percent in March to 4.4 percent in June. Except for some countries, moderate inflationary pressures were observed in most Latin American economies.

3.1.3. Financial Markets

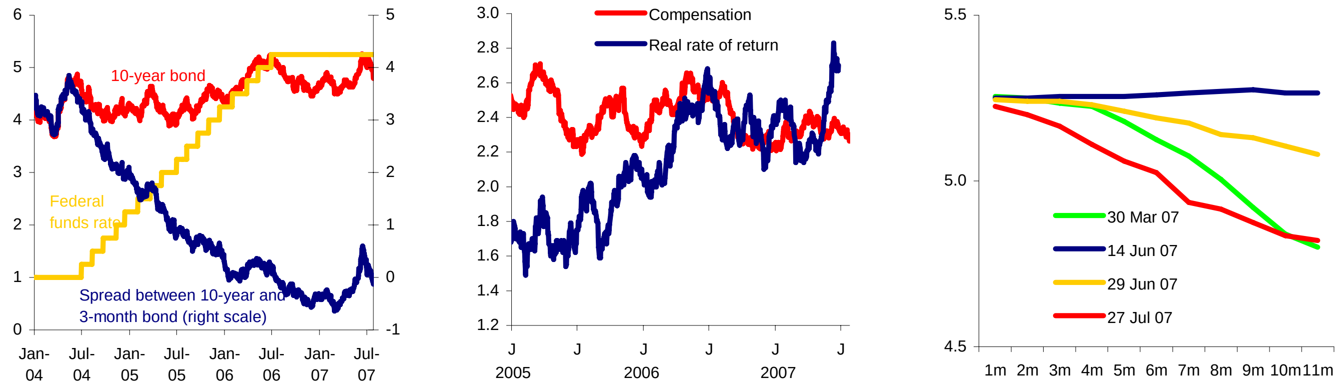
During the second quarter of the year, long-term interest rates in the U.S. followed an upward trend that was interrupted at the end of the quarter. Despite the increase in long-term interest rates and in reference rates of various central banks, ample liquidity conditions continued to prevail in international financial markets. On another front, stock markets of the main economies recorded new highs for the year, overcoming the weak results observed during the period of turbulence during the first quarter.

Graph 11
U.S.: Interest Rates
Annual percent

a) Yield on 10-year U.S. Treasury Bond, Federal Funds Rate, and 10-year and 3-year Bond Spread

b) Compensation for Inflation and Inflationary Risk, and Real Rate of Return on 10-year Bond

c) Federal Funds Rate Futures



Source: Federal Reserve. Source: Federal Reserve. Source: Bloomberg.

Unlike the rebound in long-term interest rates recorded in mid-2006 –which was associated with greater uncertainty about U.S. inflation- the recent adjustment was mainly due to higher real interest rates, which appear to reflect more confidence in U.S. economic growth (Graph 11). As a result, the slope of the yield curve increased. Contrary to what was observed in mid-2006, the perception of risks for emerging market economies was not affected by the increase in long-term interest rates in the U.S. and other industrialized nations. Sovereign risk spreads for emerging economies thus recorded new historical lows in early June. The increase in long-term interest rates and the reduction of sovereign risk spreads partially reverted since mid-June with a further deterioration of subprime mortgage loans in the U.S., which raised concerns about its negative effect on economic activity. The perception of greater risks for U.S. GDP growth led to a generalized decline in stock markets and to a rebound in the spreads on sovereign debt instruments of emerging market economies.

In its meetings of May 9 and June 28, the Federal Open Market Committee kept the policy rate unchanged at the 5.25 percent level that has prevailed for twelve months. In its press release of the end of June, the Committee mentioned that although readings on core inflation have improved modestly, it is not clear yet that the moderation of inflation pressures will be sustained. It also emphasized that the high level of resource utilization has the potential to sustain those pressures. The Committee thus reiterated that the future path of inflation was its main concern. In its monetary policy report submitted to the Congress on July 18, the Federal Reserve reported that it expects the increase in the price index for personal consumption expenditures excluding food and energy (core PCE inflation) to be between 2 and 2.5 percent in annual terms in the fourth quarter of 2007, and between 1.75 and 2 percent in the fourth quarter of 2008.

During the second quarter, the federal funds rate futures curve was affected, among other things, by expectations regarding the development of economic activity, shifting upwards in line with the rise of long-term interest rates and with perceptions of a better outlook for the U.S. economy. Nonetheless, when long-term interest rates decreased, the futures curve shifted downwards again, reaching, at the end of July, a level below that observed at the end of the second quarter (Graph 11).

In a context where the world economy continues to grow soundly, and pressures derived from the high degree of resource utilization and risks of new increases in commodity prices persist, several of the main world central banks continued to tighten their monetary policy stance. The ECB increased its reference rate once again in June, up to a level of 4 percent, and although it kept the rate unchanged in its meeting at the beginning of July, analysts expect the reference rate to resume an upward trend in the coming months. The Bank of England also increased its reference rate in May and July to 5.75 percent. Other central banks that have tightened their monetary policy stance in recent months include those of Canada, Colombia, South Korea, Chile, China, Norway, New Zealand, Peru, Poland, South Africa, and Sweden. In some countries, like New Zealand, the reference rate (8.25 percent) is far above the inflation rate (2 percent). In a context of uncertainty regarding the future path of inflation, the Bank of Japan left unchanged its policy interest rate during its meetings of April, May, June, and July.

The US dollar continued to depreciate during the second quarter of the year. Its pace of depreciation became more accentuated with the further deterioration of the market for subprime mortgages in the U.S. and the decline in long-term interest rates which started in mid-June. The yen also depreciated significantly against the main currencies during the second quarter, reaching its lowest levels observed against the US dollar since the end of 2002 and a record low against the euro in mid-July. In this context, and after having fallen 15.8 percent from the peak observed in February 2002 to the first quarter of 2007, the Federal Reserve's broad real effective exchange rate index for the dollar declined an additional 1.3 percent from March to June 2007.[8] The level registered in June is the lowest in the last decade. For the currencies of emerging market economies, the appreciation in real terms that has been observed in recent years continued during the April-June period (Table 2). Factors that vary from one economy to the other, such as the increase in commodity prices, the improvement in the economy's fundamentals, and higher short-term capital flows, have contributed to the aforementioned results in emerging market economies. However, the lower risk appetite that prevailed in international financial markets in July partially reverted the upward trend of short-term capital flows.

[8] The Federal Reserve's broad real effective exchange rate index is the dollar's average foreign-exchange value against the currencies of 26 countries, which are weighted according to the level of importance of the corresponding country's trade with the U.S.

Table 2
Real Exchange Rate in Some Emerging Market Economies
Annual percentage change 1/

	Dec-2004	Since Dec-2006 up to Jun-07	Mar-2007
Brazil	42.66	9.99	6.37
Russia	26.72	3.57	0.30
Indonesia	24.05	2.07	1.60
Thailand	20.29	4.08	2.35
South Korea	14.13	-0.31	0.81
India	12.07	8.90	6.93
Malaysia	10.53	1.98	0.52
China	6.92	0.74	0.00
Czech Republic	6.37	-1.30	-1.23
Chile	5.69	-0.85	1.62
Hungary	5.32	5.32	0.74
Poland	4.98	0.88	2.80
Argentina	3.31	-1.76	-1.07
Mexico	2.14	-2.29	0.28

Source: BIS.
1/ A negative sign indicates depreciation in relation to the US dollar.

3.1.4. Outlook

The world economy is expected to grow vigorously during the current and the following years. Global inflation is expected to decline slightly. Analysts project this scenario of gradual economic slowdown and lower inflation for both advanced and developing economies.

Although the current conditions are adequate for this favorable scenario to materialize, the possibility of a greater than expected slowdown in the U.S. or of a stronger global impact of the U.S. slowdown cannot be discarded. The adjustment in the U.S. residential sector has not concluded and there are no signs of stabilization yet. In this regard, it is worth reiterating the relevance of the problems that linger in the subprime sector of the U.S. mortgage market.

World inflation also faces various risks. Estimates on output gaps in most industrialized nations suggest that their economies are near or have reached the limits marked by potential output. Simultaneously, commodity prices, crude oil and food products in particular, have increased and remained highly volatile. In addition, the disinflationary effect of the greater participation of various emerging market economies in world markets seems to be coming to an end.

An additional risk is the possibility of a disorderly correction of global current account imbalances. Although the recent adjustments in the pace of expansion of various regions of the world economy have mitigated the dangers related to these imbalances, the risk of a sharp reversion of capital flows continues to prevail, which in turn could cause havoc in international financial markets and have potential implications for world economic activity.

3.2. Aggregate Demand and Supply in Mexico

During the second quarter of 2007, economic activity in Mexico is expected to have grown moderately in annual terms, slightly above first-quarter figures. The diminished dynamism of economic activity during the first half of

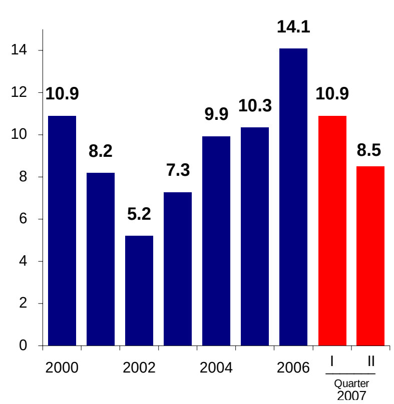
2007, as compared with 2006, included the different components of aggregate supply and demand and was affected negatively by external conditions.

During the second quarter of the year, aggregate demand was characterized by: i) both components of demand –domestic and external- grew moderately; ii) the slowdown of consumer spending that began during the fourth quarter of 2006 continued in the second quarter of 2007 (Graph 12a);[9] iii) investment expenditure grew at an annual rate above first-quarter figures, but significantly below that observed during 2006 (Graph 12b and c);[10] and, iv) exports of goods and services, particularly manufacture exports, grew moderately in annual terms, although slightly above first-quarter figures.

The following external factors affected both domestic expenditure and production negatively: i) the slowdown of demand for Mexican products from the U.S. (the main market for Mexican exports) continued; ii) automotive exports (which account for more than seven tenths of Mexican vehicle manufactures) recorded negative growth during the first half of the year; in contrast, during 2006, automotive exports rebounded significantly, contributing considerably to the growth of industrial production and total GDP; iii) revenues from workers' remittances fell in annual terms during the second quarter; in previous years remittances had exhibited a dynamic behavior that contributed to the expansion of private consumption; and, iv) the oil trade balance surplus decreased.

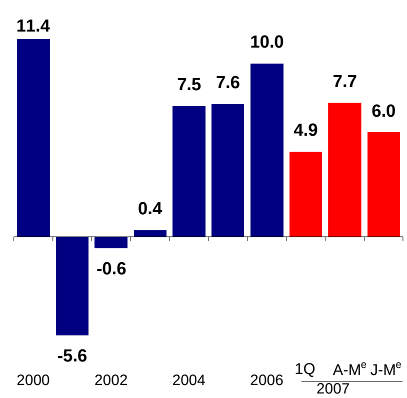
Graph 12
Domestic Demand Indicators

a) ANTAD and Wal-Mart Sales
Annual percentage change



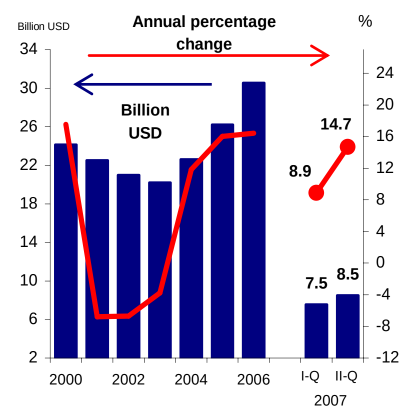
Source: ANTAD and Wal-Mart.

b) Gross Fixed Capital Formation
Annual percentage change



e/ Estimated.
Source: INEGI.

c) Capital Goods Imports



Source: Banco de México.

Some domestic factors also contributed to mitigate the annual growth of domestic expenditure during the second quarter. Worth mentioning is the slower

9 Private consumption indicators reveal that ANTAD and Wal-Mart overall sales during the second quarter of 2007 grew 8.5 percent in annual terms, while during the first quarter of 2007, 10.9 percent, and 14.1 percent during the entire 2006. An additional indicator of consumption spending is car retail domestic sales, which during the second quarter of the year decreased by 4.4 percent in annual terms, after having fallen 0.7 percent during the first quarter of the year. Last, consumer good imports (excluding gasoline and vehicles) grew at an annual rate of 11.6 percent during the second quarter of the year, while 11.4 percent during the first quarter.

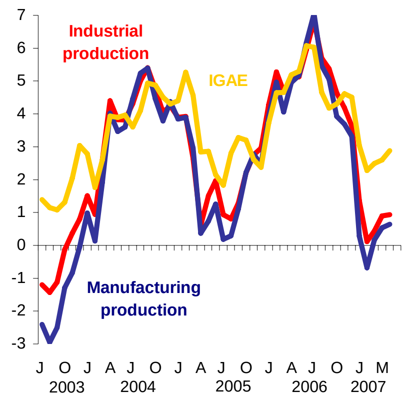
10 Investment spending is expected to have increased 7.7 percent in annual terms during the period April-May 2007, after having increased at an annual rate of 4.9 percent during the first quarter of 2007 and 10 percent during the entire 2006. Increased investment spending during the referred months benefited from the significant growth of capital good imports.

growth rate of the total payroll in real terms in the formal sector, as well as in the rest of the economy. This slowdown resulted from a decline in job creation and a moderate increase in real earnings. On another front, although financing to the private sector continues growing at high rates, the figures are slightly below those recorded in previous quarters.

The moderate growth of the different items of both aggregate demand and output during the second quarter of 2007 also mirrored the high growth rates recorded by these items during the same quarter of 2006. Indeed, during that quarter, many items recorded the highest annual rates observed in the last 5 or 6 years,[11] thus representing a very high statistical base for the annual comparison of the second quarter of 2007. In this context, during the second quarter of 2006 and, in general terms, during the first half of that year, a factor triggering the expansion of domestic expenditure and, consequently, of output were the outlays related to federal elections.

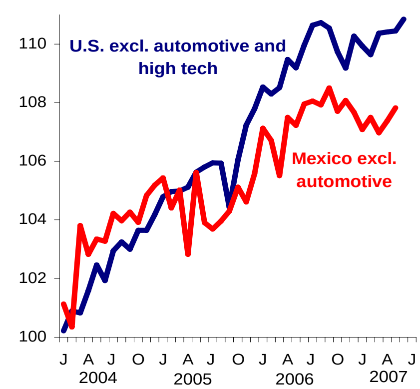
Graph 13
Production Indicators

a) IGAE and Industrial Production
Annual percentage change of seasonally adjusted data and 2-month moving average



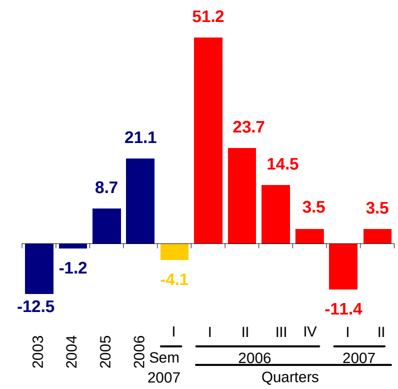
Source: INEGI.

b) Manufacturing Production in Mexico and the U.S.
Seasonally adjusted data 2003=100



Source: INEGI and Federal Reserve (for U.S. data). Seasonal adjustments of Mexico series (excluding automotive sector) are done by Banco de México

c) Automotive Production
Annual percentage change of number of units



Source: Prepared by Banco de México with data from AMIA and ANPACT.

The main aspect characterizing aggregate supply during the second quarter of 2007 was the moderate growth of both GDP and imports of goods and services.[12] Regarding the latter, growth was above that recorded during the first quarter, having capital goods imports a recovery (Graph 12c). The modest increase in industrial production, the positive results in the agricultural sector, and

[11] With seasonally adjusted data, during the second quarter of 2006, annual growth of aggregate supply and demand, GDP, domestic expenditure, and consumer spending, measured in constant pesos, was the highest since the fourth quarter of 2000, i.e., in 23 quarters. As for exports of goods and services, their annual growth during the referred quarter was the highest observed since the third quarter of 2004. Likewise, the annual growth of ANTAD sales during the second quarter of 2006 was the highest recorded since the release of this indicator (since 1997).

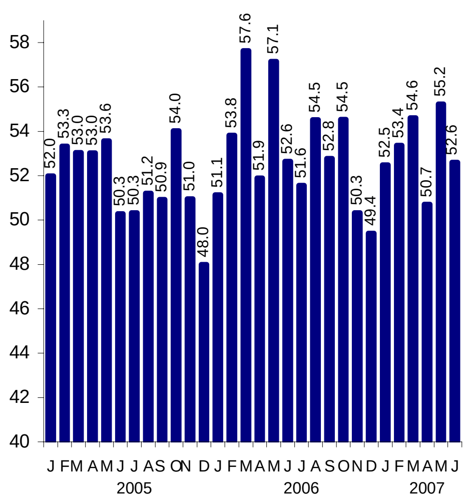
[12] Regarding GDP indicators, the Global Indicator of Economic Activity (*Indicador Global de la Actividad Económica*, IGAE) grew at an annual rate of 3.1 percent during the period April-May 2007. This result originated from increases in the three sectors that comprise this indicator: industrial (1.2 percent), services (3.9 percent), and agriculture (4 percent).

the higher growth rates recorded by the services sector contributed to GDP growth during the second quarter.

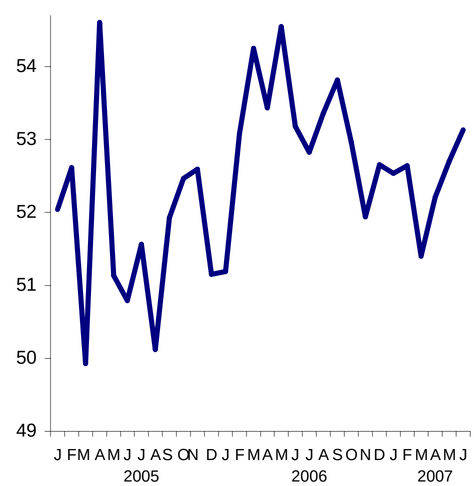
During the first half of 2007, industrial production slowed considerably in the four sectors that comprise it (mining, manufacturing, construction, and electricity), being the most affected manufacturing (Graph 13a).[13] The latter took place after production had recorded its highest growth (5 percent) in six years. The lesser dynamism of the manufacturing industry during the first half of the year clearly reflected the weak results of the automotive industry (Graph 13c) and the significant slowdown of the non-automotive manufacturing industry. These results are mainly attributed to external demand. In particular, and after having undergone a contraction during the first quarter, automotive production grew moderately during the second quarter. Nevertheless, automotive production (in both terminal and auto parts industries) is expected to have recorded negative growth in annual terms during the first half of the year, after automotive GDP had grown above 23 percent (38 percent the terminal automotive industry and 7 percent the auto parts industry) during the same period of 2006.

Graph 14
Manufacturing Business Conditions Index
Reference Indicator at 50 points

a) Original Data



b) Seasonally Adjusted Data



Source: Banco de México and INEGI.

Manufacturing production grew modestly in annual terms during the second quarter of 2007. Reduced growth was also observed in the new Indicator of Manufacturing Business Conditions, BCI (*Indicador de Pedidos Manufactureros*, IPM) prepared jointly by Banco de México and INEGI from the Monthly Survey on Business Conditions (*Encuesta Mensual de Opinión Empresarial*). The BCI includes the five variables and weights considered in the Purchasing Managers' Index (PMI) prepared by the Institute for Supply Management (ISM) in the United States. These variables cover the sequence of manufacturing production: expected volume of purchasing orders (weight 35%),

[13] Industrial production grew 1.2 percent during the April-May period, as compared with 0.5 percent during the first quarter of the year. The slight growth during the aforementioned period reflected the results of the manufacturing sector, which grew at an annual rate of 1 percent, after having fallen 0.2 percent during the first quarter. According to the national accounts, during the April-May period, automotive production grew at an annual rate of 3.7 percent, as compared with a contraction of 5.8 percent during the first quarter.

expected production (25%), expected level of employed personnel (20%), suppliers' delivery of raw materials (15%), and change in raw material inventories (10%). Under this context, the Manufacturing Business Conditions Index recorded in June a lower figure than in May; however, this decline reflects the indicator's seasonality. After seasonally adjusting this indicator, the BCI has increased on a monthly basis for three months.[14]

Based on the aforementioned considerations and on other indicators of economic activity, GDP is expected to have grown close to 3 percent during the second quarter of 2007. On a seasonally adjusted basis, during the quarter, GDP grew significantly on quarterly terms (above 1 percent), after having grown only 0.3 percent during the first quarter. This result suggests that the recent economic slowdown hit bottom during the first quarter of 2007.

The development of economic activity during the second quarter of 2007 and, in general, during the first half of the year, did not imply considerable pressures on available industrial capacity in view of the following: i) GDP and domestic spending grew at moderate annual rates during the quarter, therefore preventing the gap in their annual growth rates to widen; ii) GDP grew below the potential growth of the economy during the second quarter; and, iii) in recent years, industrial capacity in Mexico has increased considerably, due to the recovery of investment expenditure, which has allowed capital to expand and be channeled to more modern and productive projects. In a context of moderate growth during the first six months of 2007, investment grew above GDP.

3.2.1. Employment

The moderate growth of economic activity during the second quarter and, in general terms, during the first half of the year, led to slower job creation. This result was observed in both the total economy and the formal economy. The results of INEGI's Occupation and Employment Survey (*Encuesta Nacional de Ocupación y Empleo*) show that employed population in Mexico has grown at more moderate annual rates since the fourth quarter of 2006 (Graph 15a, b, and c), and formal employment has followed this trend as well. During the second quarter of 2007, the labor market was characterized by: i) employment continued to grow significantly in the formal sector (measured by the number of workers insured by the IMSS); however, the slowdown pattern that began during the last months of last year continued (Graph 16a).[15] These results were observed in most states; ii) job creation in the formal sector continued to show greater dynamism in temporary than in permanent jobs in urban areas;[16] and, iii) total employment grew at more moderate rates and included several sectors; however, this trend was more evident in the manufacturing sector (Graph 15b).

[14] Up to June, 42 monthly observations of the BCI and of its five components were obtained, which is a very short period for precise seasonal adjustment purposes. Seasonal adjustments however can be done especially if, in the last months, the BCI results have followed a one-direction trajectory.

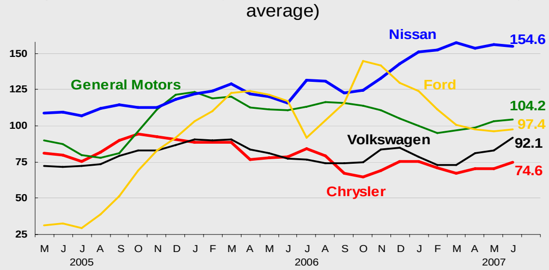
[15] As mentioned in previous Inflation Reports, the increase in the number of workers insured could be reflecting the greater fiscalization efforts on behalf of IMSS, considering that the annual growth of this indicator of formal employment has significantly exceeded annual GDP growth. Up to June, the level of formal employment on a seasonally adjusted basis exceeded by 1,831,753 jobs its maximum level recorded at the end of 2000.

[16] At the end of June 2007, the number of workers insured by the IMSS increased by 803,530 in annual terms and included 370,908 workers in permanent jobs (46 percent of the total variation) and 432,622 workers in temporary jobs in urban areas (54 percent of the total).

Box 2
Recent Developments in the Mexican Automotive Industry[1]

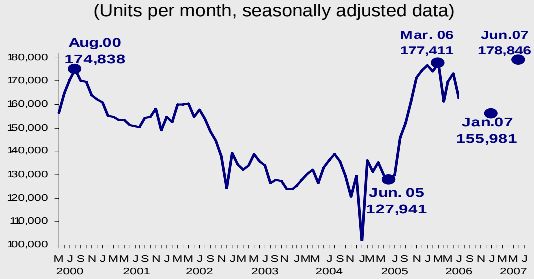
The automotive industry is a sector of economic activity of key importance for the Mexican economy, due to its production value, the jobs it creates, and its incidence in Mexican foreign trade. This activity stands out due to the value of automotive exports and imports, its significant trade surplus, and because it attracts foreign investment.

Graph 1
Vehicle Production
(2000=100, seasonally adjusted data and 3-month moving average)



The automotive industry in Mexico has been characterized recently by: a) a decline of Mexican vehicle production in annual terms during 2007, after having recovered considerably during the second half of 2005 and during the first quarters of 2006; b) a slower growth rate of car production, due mainly to weak external demand, mainly from the U.S., which is the main market destination for six of 10 car units made in Mexico; c) the contrasting results exhibited by different car automakers (Graph 1): in 2007, production fell significantly in some of them, while in others it increased; d) the slump in which domestic car sales have remained for the last two and a half years; and, e) the high volume of imported used vehicles and its negative effect on domestic car sales.

Graph 2
Vehicle Production
(Units per month, seasonally adjusted data)



i) **Reduced growth rate of vehicle production.** During the first half of 2007, vehicle production in Mexico declined 4.1 percent in annual terms, due to a sharp fall of -11.4 percent during the first quarter and a modest increase of 3.5 percent during the second quarter. Previously, during 2006, vehicle production had recorded high growth (21.1 percent). In June 2007, the number of Mexican-assembled vehicles on a seasonally adjusted basis was very close to that recorded in March 2006 (Graph 2), which, at the same time, was similar to that recorded in August 2000. During the first half of 2007, the contribution of the automotive sector (terminal and autopart industries) to GDP growth was slightly negative (-0.1 percentage points), while during the same period of 2006, it was considerably positive (0.6 percentage points).

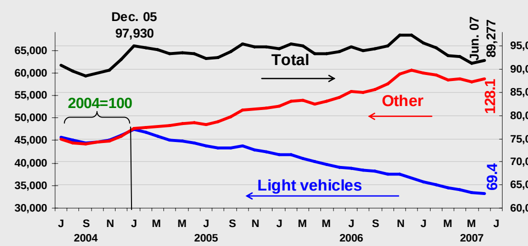
ii) **Weak external demand.** During the first half of 2007, the external market absorbed 76 percent of Mexican-assembled vehicles. This percentage has remained relatively stable in the last years. A little more than six out of 10 Mexican-assembled vehicles are destined for the U.S. market. Under such context, the decline in automotive production in Mexico during the mentioned period was mainly due to the weak results of domestic car sales in the U.S., which fell in annual terms during the first half of 2007 (Table 1). NAFTA-manufactured vehicles fell sharply and those assembled by American car automakers (Ford, Chrysler and General Motors), which have a strong presence in the automotive industry in Mexico, even more.

Table 1
United States: Light Commercial Vehicle (LCV) Sales

	2005	2006	2007 I Sem	2005	2006	2007 I Sem
	Annual percentage change*			Percentage structure		
Total sales	0.5	-2.6	-1.5	100.0	100.0	100.0
From U.S. car automakers	-2.6	-8.4	-7.3	55.7	52.4	50.5
Assembled-vehicle sales (NAFTA region)	0.4	-5.3	-4.4	79.9	77.6	76.3
Imported vehicle sales**	0.8	8.3	9.1	20.1	22.4	23.7

* Based on number of car units.
** Imported from non-NAFTA countries.

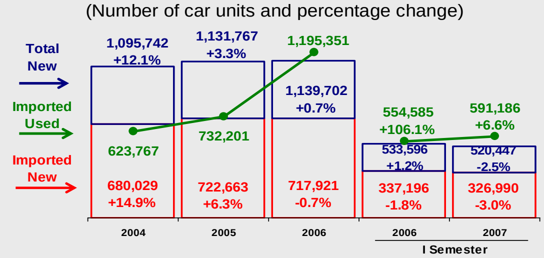
Graph 3
Vehicle Retail Unit Domestic Sales
(Number of units per month and 3-month moving average of seasonally adjusted data)



iii) **Domestic vehicle sales at a standstill.** During 2005 and 2006, car retail sales grew at annual rates of 3.3 and 0.7 percent, respectively, and, during the first half of 2007, they fell 2.5 percent. Nonetheless, after analyzing the monthly levels of these sales on a seasonally adjusted basis, these have remained practically in a slump for the last two and a half years. In fact, the level of seasonally adjusted retail sales in December 2005 (Graph 3) exceeded that recorded in June 2007. These results are mainly due to the long-period decline in light commercial vehicles (low-price vehicles) and to the fact that domestic sales of the rest of vehicles have also fallen during 2007.

iv) **High growth of imported used vehicles.** The slump faced by vehicle sales in Mexico could be associated with a significant increase in imported used vehicles of year makes 10 to 15 older. Imported used vehicles have rebounded considerably since the end of 2005 (Graph 4). In fact, the number of imported used vehicles in 2006 and during the first half of 2007 have exceeded domestic sales of new vehicles (both Mexican-assembled and imported). During the first half of this year, the average price of imported used car units was 1,575 US dollars.

Graph 4
Domestic Vehicle Sales
(Number of car units and percentage change)

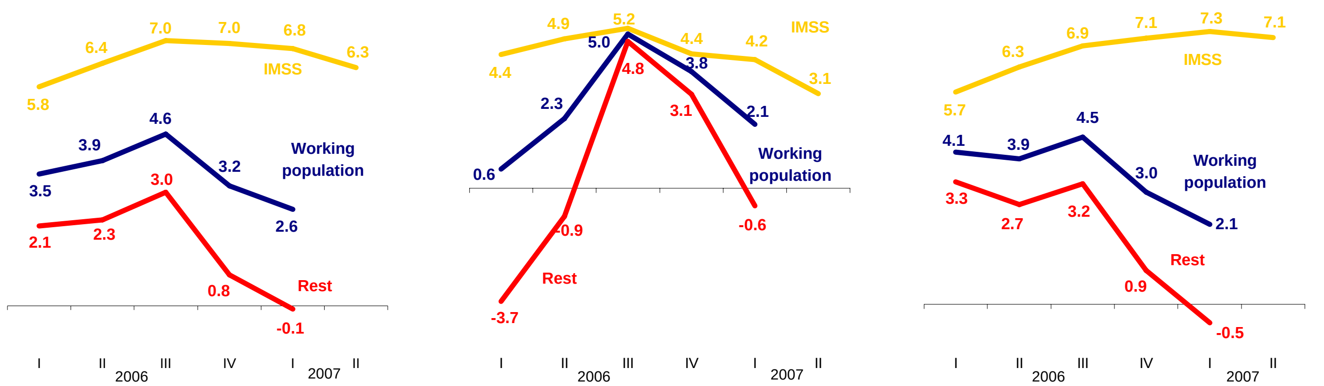


1/ Prepared by Banco de México with statistics from AMIA (*Asociación Mexicana de la Industria Automotriz, A.C.*), ANPACT (*Asociación Nacional de Productores de Autobuses, Camiones y Tractocamiones, A.C.*), and *Automotive News*.

During the second quarter, the number of workers insured by the IMSS continued to grow significantly in annual terms in various branches of the tertiary sector, such as commerce (172,150; annual growth of 6.5 percent); services for companies, individuals, and homes (290,980; annual growth of 9.5 percent); and, social and community services (65,666; annual growth of 4.3 percent). At the end of June, the number of manufacturing workers insured by the IMSS grew by 101,259 in annual terms, after having increased by 194,922 and 157,150 in September and December 2006, respectively.

Graph 15
Total Employed Population and Workers Insured by the IMSS
Annual percentage change

a) Total | b) Manufactures | c) Services



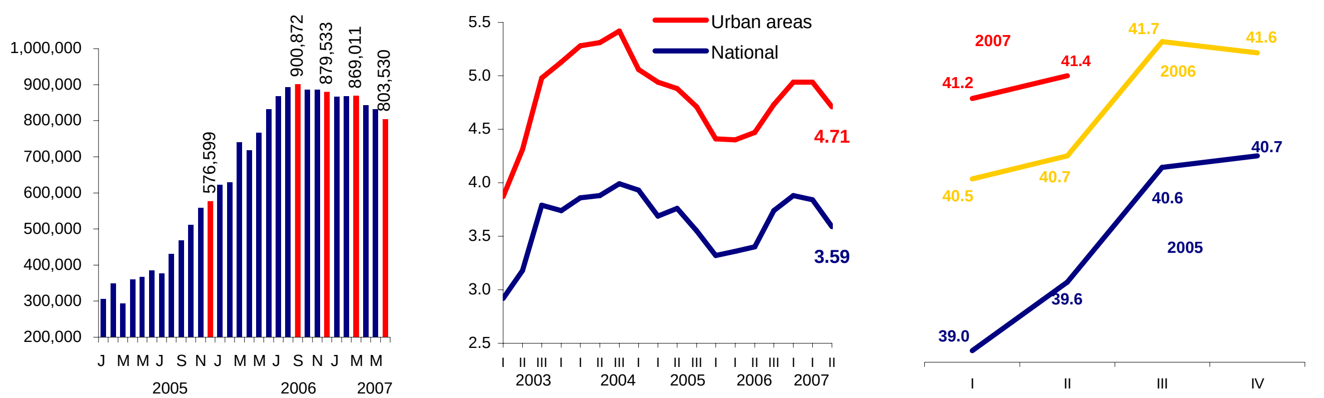
Source: INEGI and IMSS. Employed Population is obtained from INEGI's Occupation and Employment Survey (*Encuesta Nacional de Ocupación y Empleo*, ENOE) and includes secondary sectors and services. Government and international organizations are excluded from services. IMSS data include the same sectors. The segment Rest is obtained by deducting the number of workers insured by the IMSS from the employed population from the ENOE.

Graph 16
Labor Market Indicators

a) Number of Workers Insured by the IMSS
Annual change of original data

b) Unemployment Rate (National and in Urban Areas)
Percentage in relation to economically active population and seasonally adjusted data

c) Women Quarterly Participation Rate 1/



Source: IMSS.

Source: INEGI. Seasonal adjustments by Banco de México.

1/ The rate of participation is the percentage of the economically active population divided by the population 14 years and older.
Source: INEGI.

The upward trend followed by the unemployment rate (at both national and urban levels) since the second half of 2006 ended during the second quarter of 2007 (Graph 16b). More than being associated with a deterioration of job creation, this trend has been associated with significant increases in the “rate of participation” (the ratio of the economically active population to the population age 14 and older). These results are mainly attributed to the increased participation of women in the labor market and, consequently, in the Economically Active Population (*Población Económicamente Activa*, PEA) (Graph 16c). In contrast, men’s participation declined from 78.6 percent during the second quarter of 2006 to 78.2 percent during the same period of 2007.

3.2.2. External Sector

During the second quarter of 2007, the trade and current account balances recorded moderate deficit. In the case of the current account, the estimated deficit contrasts with the surplus recorded during the same quarter of 2006. This change is almost entirely attributed to the reduction in the surplus of the oil and automotive products trade balances.

During the second quarter of 2007, Mexico’s external sector was characterized by the following:

i) Non-oil exports grew at a higher annual rate than in the first quarter. However, this growth was significantly lower than the one observed in 2006.[17]

ii) The slight improvement in the growth rate of non-oil exports was mainly attributed to manufacturing exports: a modest increase in automotive exports (Graph 17b). These results contrast with the significant fall of automotive exports during the first quarter of the year.[18]

iii) The moderate growth of non-oil exports during the second quarter of the year and, in general, during the first half of 2007, was the result of a both a reduced growth of exports to the U.S. and a higher growth of exports to the rest of the world.

iv) During the analyzed period, the value of oil exports fell in annual terms (-3.8 percent), but more moderately than in the first quarter of the year (-14.9 percent). This reduction was due to the lower volume of crude oil exports (Graph 17a), in view that, in its annual comparison, the price of the Mexican crude oil export mix remained practically unchanged.

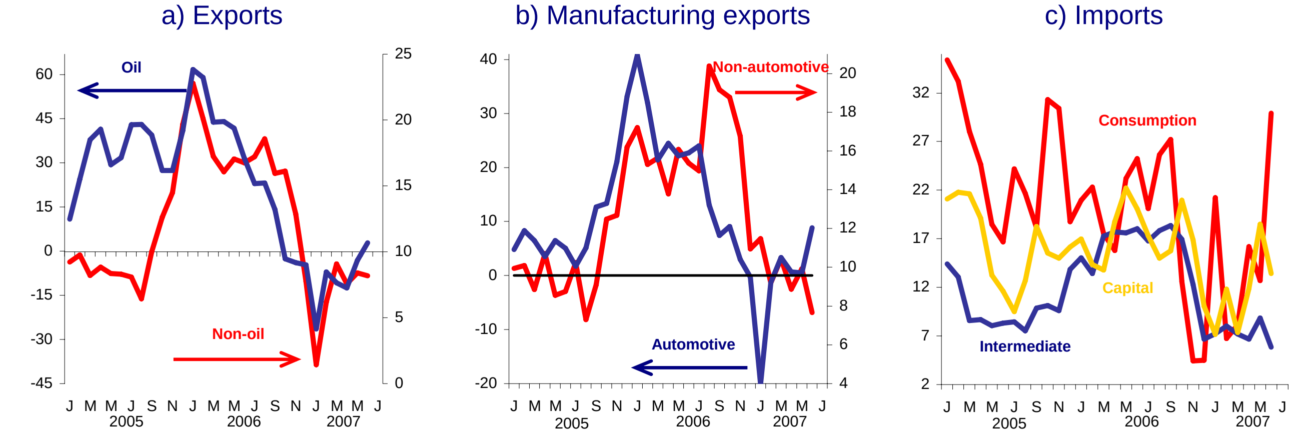
v) Merchandise imports recovered slightly as compared with the first quarter. This result was mainly attributed to the growth of imports of capital and consumer goods (Graph 17c).[19]

[17] During the second quarter of 2007, total exports grew 6.2 percent in annual terms as a result of both a 8.2 percent increase in non-oil exports (5.7 and 15.7 percent during the first quarter of 2007 and the entire 2006, respectively) and a 3.8 percent decline in oil exports (annual fall of 14.9 percent during the first quarter of 2007 and a 22.4 percent increase in the entire 2006). .

[18] During the second quarter of this year, automotive exports grew 3.4 percent in annual terms, after having fallen -5.8 percent during the first quarter.

[19] Merchandise imports grew at an annual rate of 9.7 percent (8 percent during the first quarter of the year and 15.5 percent during the entire 2006), as a result of 7.1, 19.6, and 14.7 percent growth of imports of intermediate, consumer, and capital goods, respectively.

Graph 17
Merchandise Exports and Imports
Annual percentage change of seasonally adjusted data and 2-month moving average, except in 2007



Source: Banco de México.

During the April-May period, and just like in the first quarter of the year, the share of Mexican exports in U.S. imports decreased (Table 3), contrasting with the significant increase recorded during 2006. This decline is completely attributed to the fall in oil exports. Excluding oil exports and automotive exports from total exports, the rest of Mexican exports grew moderately during the period, but above total exports of the rest of the U.S. trading partners. Excluding oil and automotive exports, the share of Mexican exports in U.S. imports increased from 8.5 percent during the April-May 2006 period, to 8.8 percent during the same period of 2007.

Table 3
U.S. Imports
Percent

	Share				Annual Percentage Change				
	January-May		April-May		April-May 2007				
	2006	2007	2006	2007	Total	Oil	Total excluding oil	Automotive	Total excluding oil and automotive
Total	**100.00**	**100.00**	**100.00**	**100.00**	**4.46**	**-0.62**	**5.155**	**-5.22**	**7.13**
Total excl. Mexico	**89.15**	**89.25**	**89.28**	**89.33**	**4.52**	**2.71**	**4.754**	**-7.22**	**6.78**
Total excl. Mexico and China	**75.14**	**73.55**	**74.98**	**73.83**	**2.86**	**2.86**	**2.863**	**-7.22**	**5.02**
1. Canada	17.24	16.61	16.76	16.57	3.28	-1.44	3.818	-7.14	7.69
2. China	14.01	15.70	14.30	15.50	13.21	-57.51	13.337	--	13.34
3. Mexico	**10.85**	**10.75**	**10.72**	**10.67**	**3.99**	**-19.51**	**8.713**	**3.43**	**10.93**
4. Japan	8.08	7.76	7.94	7.41	-2.45	--	-2.453	-10.60	3.00
5. Germany	4.96	4.92	4.95	4.93	3.98	--	3.984	-13.95	11.80
Total 5 countries	55.15	55.74	54.67	55.08	5.25	-10.99	6.374	-6.55	10.02

Source: Prepared by Banco de México with data from the Census Bureau (U.S. Department of Commerce).

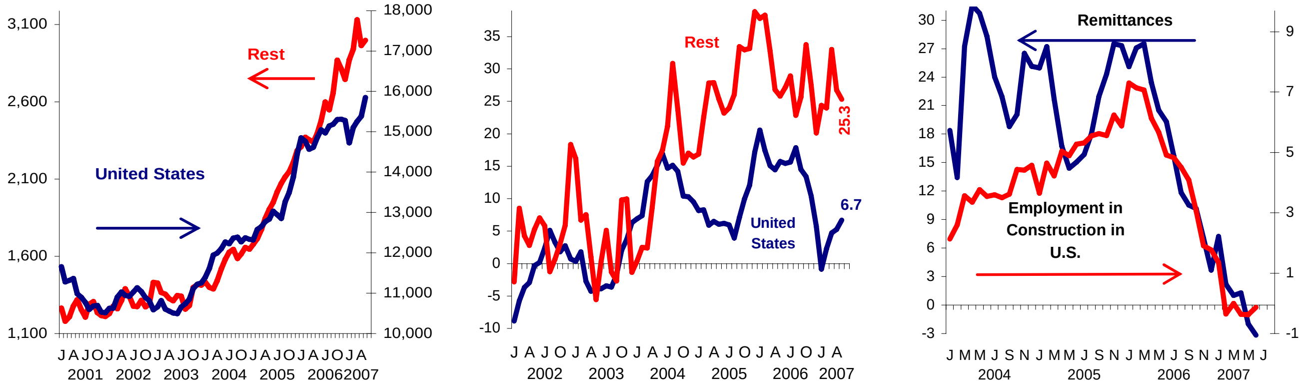
Graph 18
External Sector Indicators

Non-oil Exports to Different Markets
Seasonally adjusted data and 2-month moving average except in 2007

a) Million US dollars

b) Annual percentage change

c) Workers' Remittances in Mexico[1/] and Construction Employment in the U.S.
Annual percentage change of seasonally adjusted data



Source: Banco de México.

Source: Banco de México and U.S. Bureau of Labor Statistics (BLS).
1/ Two-month moving average except in 2007.

The annual growth of non-oil exports (7 percent) during the first half of 2007 was influenced downward by two factors: low growth of non-oil exports to the U.S. (3.65 percent), and a high concentration of these exports in that country, with a share of 83.34 percent. These results contrast with the significant increase of 27.39 percent in non-oil exports to the rest of the world (Graph 18a and b). During the first half of 2007, Mexican non-oil exports to the rest of the world recorded an annual absolute growth of 3,915 million US dollars, figure above the 3,211 million recorded by Mexican non-oil exports to the U.S. during the same period.

During the second quarter of the year, revenues from workers' remittances fell slightly (Graph 18c). Remittances totaled 6,138 million US dollars during the analyzed period,[20] thus representing an annual decline of 1.6 percent after having increased by 3.4 percent during the first quarter (15.1 percent during the entire 2006).

During the second quarter of 2007, the current account of the balance of payments recorded a deficit, as compared with a surplus during the first quarter. This result was mainly determined by the reduction in the surplus of both oil and automotive products trade balances. In the former case, the balance decreased from 5,415 million US dollars during the second quarter of 2006 to 3,946 million

[20] The significant slowdown in revenues from workers' remittances during the second half of 2006, which was more noticeable during the first half of 2007, is explained by various factors, such as: a) the improvement in Banco de México and remittance intermediaries' statistics coverage of remittance operations contributed to the higher remittance statistics in previous years; however, its effect has gradually disappeared; b) the increasing problems faced by Mexican migrants to the U.S., due to greater surveillance at the border from U.S. authorities; c) the greater difficulties faced by illegal Mexican migrants in the U.S. to find jobs, due to stricter government controls; and d) the economic slowdown in the U.S., which has affected negatively Mexican migrants in terms of finding jobs in that country. The slowdown has been more noticeable in the construction sector, which has been a source of employment for a significant number of Mexican workers.

during the same quarter of 2007. The automotive products trade balance surplus decreased from 6,415 million to 5,492 million US dollars.

The aforementioned, together with available information on other items of the external accounts, allow for estimating that during the second quarter of 2007, the current account of the balance of payments recorded a deficit of approximately 1.2 billion US dollars. During the first half of the year, the current account is estimated to have recorded an accumulated deficit of 4 billion US dollars (surplus of 1,566 million US dollars during the first half of 2006), accounting for 0.9 percentage points of GDP. During the second quarter of 2007, the capital account is expected to have recorded a surplus of around 1.9 billion US dollars (including errors and omissions). This balance would be the result of the following: revenues from resources from foreign investment (direct and portfolio); external financing for Pidiregas projects; and, outflows from public sector's payment of foreign debt. Finally, during the second quarter of 2007, Banco de México's net international reserves increased by 744 million US dollars. At the end of June, the stock of such reserves was 69,939 million US dollars.

3.3. Costs and Prices

3.3.1. Wages and Unit Labor Costs

During the second quarter of 2007, firms under federal jurisdiction negotiated with their workers the same average wage increase as in the second quarter of 2006 (Table 4). The average wage increase negotiated by private companies was above the corresponding figure for public companies, as has been observed since 1997. In the case of private companies, wage increases were above those recorded during the same period of 2006.

Table 4
Contractual Wage Average Increases and Number of Workers Benefited by Type of Company

	2006						2007		
	I	II	Jan-Jun	III	IV	Jan-Dec	I	II	Jan-Jun
	Contractual wage average increase (percent)[1/]								
Total	4.3	4.4	4.3	4.3	3.7	4.1	4.2	4.4	4.3
Public companies	4.0	4.0	4.0	4.1	3.6	3.8	3.9	4.2	4.1
Private companies	4.4	4.5	4.4	4.4	4.2	4.4	4.3	4.4	4.3
	Number of workers benefited (percentage share)								
Total	100	100	100	100	100	100	100	100	100
Public companies	19	27	22	48	77	44	19	27	22
Private companies	81	73	78	52	23	56	81	73	78

Source: Prepared by Banco de México with data from the Ministry of Labor.
1/ Average weighted by number of workers benefited during the period.

During the first four months of 2007, the annual growth of labor productivity in the manufacturing sector decreased (Table 5). This situation reflects the phase of the business cycle, in which the rate of growth of production usually slows down prior to that of employment.

Box 3

Survey of Foreign Direct Investment and Mexican Competitiveness

During May and June 2007, Banco de México and the Ministry of the Economy[1] conducted a survey among the main Foreign Direct Investment (FDI) companies in Mexico. The survey's purpose was for companies to evaluate various issues on the country's competitiveness and to identify their FDI values for 2007. The responses of 202 of the main FDI companies in Mexico allowed for estimating that their investment spending will amount to 15,716 million US dollars in 2007, which, considering their financing sources, represents FDI flows from the surveyed companies of 11,261 million US dollars. As for survey's responses on competitiveness issues, the following stand out:

a) **Factors affecting companies' competitiveness:** surveyed companies mentioned that the main factors affecting them negatively in Mexico vs. other countries where they can also invest are, basically, of a structural nature. According to foreign subsidiaries, these factors are as follows: the lag in implementing pending structural reforms (fiscal, labor, and energy reforms, among others); excessive regulation; bureaucracy inefficiency; and, the country's legal framework (Table 1). According to responses, environmental regulations, credit availability, the country's political situation, and the lack of available skilled labor have not affected significantly FDI companies as compared with other countries where they can also invest.

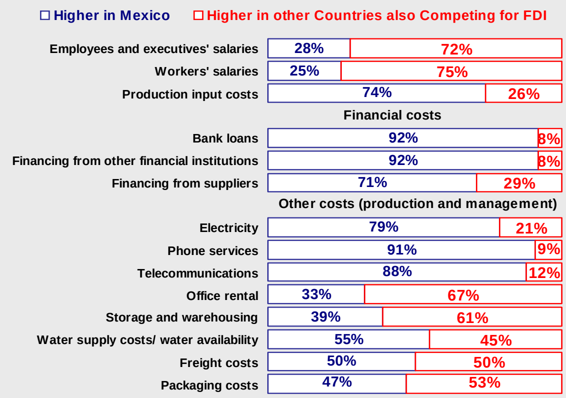
Table 1
Factors Affecting Negatively Companies' Competitiveness in Mexico and Other Countries
Percentage structure of responses

	Many	Few or Zero	Total
1. Pending structural reforms	73	27	100
2. Excessive regulations	53	47	100
3. Bureaucracy inefficiency	51	49	100
4. Legal framework	48	52	100
5. Corruption	47	53	100
6. Available infrastructure	43	57	100
7. Security for companies' premises, employees, and merchandise transportation	42	58	100
8. Non-custom restrictions to foreign trade	37	63	100
9. Requirements for setting up new businesses	33	67	100
10. Lack of domestic suppliers	32	68	100
11. Available skilled labor	29	71	100
12. Domestic political situation	25	75	100
13. Credit availability	14	86	100
14. Environmental regulations	13	87	100

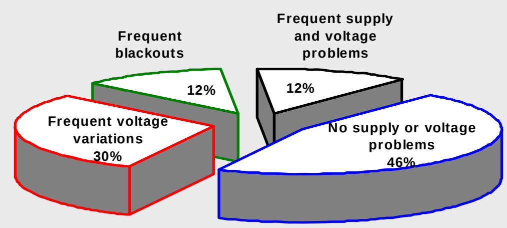
b) **Production costs in Mexico and other countries.** Companies stated that there are different costs that are higher in Mexico than in other countries also competing for FDI (Graph 1). Among these, the following stand out: financial costs, phone service and telecommunication costs, electricity costs, certain input costs, and costs related to water supply and its availability. According to responses, human resources costs (labor work, and employees and executives salaries) are cheaper in Mexico.

c) **Power supply quality.** 54% of companies mentioned that they frequently experience blackouts or voltage variations (Graph 2). 52% of surveyed companies mentioned that when they have upsized their production sites or opened new ones, they have faced electricity supply problems and/or excessive costs of connection to the public system (Graph 3). The latter was more frequent in the terminal automotive industry, and in the textile and apparel, and chemical industries.

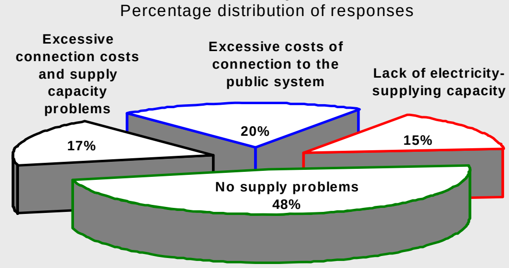
Graph 1
Production Costs in Mexico and Other Countries also Competing for FDI
Percentage structure



Graph 2
Quality of Power Supply to Companies
Percentage distribution of responses



Graph 3
Problems that have Arisen When Companies have Upsized their Production Sites or Opened New Ones
Percentage distribution of responses



Problems related to electrical power supply due to blackouts and voltage variations have implied the following costs for the affected companies: production continuity is severely affected, thus leading to production losses (Table 2); power plants and regulating equipments need to be bought; and, product delivery problems are present due to all of the aforementioned.

[1] Banco de México and the Ministry of the Economy joined efforts under the Coordination Agreement to Obtain Statistics on Foreign Investment in Mexico.

Table 2
Costs Faced by Companies due to Voltage Variations and Blackouts
Percentage distribution of responses

TOTAL	**100**
1. Production line failures	15
2. Purchase of power plants and voltage-regulation equipment	12
3. Production losses	12
4. Product delivery problems	10
5. Telecommunication systems affected	9
6. Fall in productivity due to production line failures	9
7. Loss of stored electronic data	8
8. Repair or replacement of damaged equipment	8
9. Material waste	7
10. Damage to industrial plant hardware	5
11. Lower quality of final goods	2
12. No cost	3

a) **Security costs.** Companies mentioned that spending on security measures affects significantly their costs. Nearly 85% of the companies stated that spending on security accounts for up to 2% of their sales revenues. 12% of companies mentioned that these costs can represent from 2 to 4% of their sales revenues. The results show that, on average, for all surveyed companies, spending on security represents approximately 1.5 % of their sales.

b) **Evaluating other issues on competitiveness.** In the survey, companies were asked to evaluate different factors that could affect their competitiveness. This allows for identifying different areas that need to be modernized. The issues considered are the existent infrastructure, the supply of human resources and hiring practices, and the tax system's degree of simplicity and transparency, among others. Companies gave a 1 to 4 value to each of the variables considered, according to:

1. meaning that the company **totally** agrees with the response to the left.
2. meaning that the company **to a certain extent** agrees with the response to the left.
3. meaning that the company **to a certain extent** agrees with the response to the right.
4. meaning that the company **totally** agrees with the response to the right.

Table 3
Various Issues on Mexican Competitiveness
Percentage distribution of responses

	Evaluation	1	2	3	4	Evaluation
		100%				
INFRASTRUCTURE AND PUBLIC SERVICES						
i) Mexican infrastructure overall	Covers the country's needs very adequately	3	31	51	15	Hardly developed and inefficient
ii) Mexican railway system	Covers the country's needs very adequately	3	9	29	59	Insufficient
iii) Mexican port infrastructure	Covers the country's needs very adequately	5	38	41	16	Inadequate
iv) Mexican air freight system, including Mexican airports' efficiency and current situation	Covers the country's needs very adequately	7	47	37	9	Inefficient and slow
TAX SYSTEM						
i) The Mexican tax system is:	Simple and transparent	1	8	49	42	Very complex and distorts companies' decisions
HUMAN RESOURCES						
i) Hiring and firing practices	They are flexible and adequate for companies' competitiveness in Mexico	8	32	40	20	Very limited due to current regulations
ii) Supply of skilled engineers, managers and technical professionals	Adequate availability	30	43	21	6	Very scarce
iii) Supply of low-skilled workers	Reliable/workers are punctual and are willing to learn and work in teams	15	50	31	4	Poor discipline at work and hardly any punctuality
OTHER ISSUES						
i) Starting a business in Mexico is:	Easy	2	18	56	24	Extremely difficult/long process
ii) Domestic suppliers are:	Many/they offer the required materials, equipment and services	5	50	36	9	Hardly any
iii) The quality of supplied products in Mexico is:	High/they are competitive worldwide and offer products and services adequately	7	56	33	4	Not very good/ most often are not technologically-adequate

Table 4
Rating of Various Issues Affecting Competitiveness

Issues	Rating
INFRASTRUCTURE	
Airports and air freight	6.3
Ports	5.8
Infrastructure overall	5.5
Railway system	3.9
HUMAN RESOURCES	
Supply of engineers, managers and technical professionals	7.4
Work discipline and low-skilled workers' willingness to work	6.9
Hiring and firing practices	5.7
TAXES	
Tax system	4.2
OTHER ISSUES	
Domestic suppliers' quality	6.7
Availability and variety of domestic suppliers	6.3
Uncomplicated formalities to set up businesses	4.9

The percentage distribution of responses is presented in Table 3. To facilitate its interpretation, values were given to each of the four response options (Table 4).[2] The issues of competitiveness that were given the lowest ratings were: the Mexican railway system (3.9 points); the complex tax system (4.2); the formalities to set up new businesses (4.9); the hiring and firing practices (5.7); and, infrastructure, in general (5.5). The issues that were best rated were the availability of skilled human resources (7.4 points), and the work discipline of low-skilled labor (6.9).

[2] The following scores were given to responses in Table 3: number 1=10 points; number 2=7.5 points; number 3=5 points; and, number 4=2.5 points. This score was weighted by the frequency of responses corresponding to each of the issues on competitiveness.

Table 5
Earnings, Labor Productivity and Unit Labor Costs in Manufacturing Industry
Annual percentage change

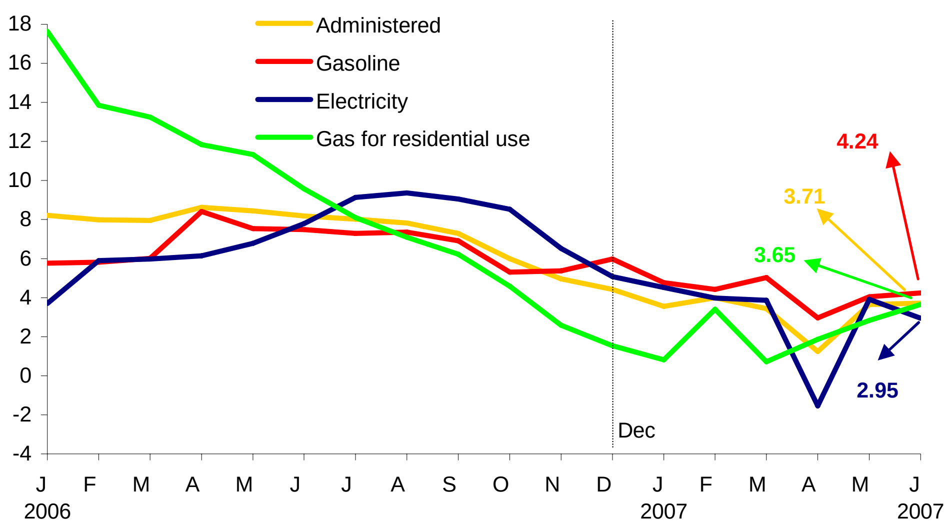
	2005	2006		2007				
	Jan-Dec	Jan-Apr	**Jan-Dec**	Jan	Feb	Mar	Apr	**Jan-Apr**
Labor productivity[1/]	**2.1**	4.4	**3.5**	-1.4	-1.0	-2.0	0.0	**-1.1**
Real average earnings	**-0.2**	0.9	**0.5**	0.2	0.2	-0.1	-0.1	**0.1**
ULC	**-2.2**	-3.2	**-2.8**	1.6	1.3	1.9	-0.1	**1.2**
Production	**1.3**	4.9	**4.9**	0.3	0.0	-0.8	1.3	**0.2**
Employment	**-0.8**	0.5	**1.3**	1.7	1.1	1.2	1.3	**1.3**

Source: Prepared by Banco de México with data from INEGI.
1/ Manufacturing labor productivity calculations of January 2007 are based on the Index of Manufacturing Production's Physical Volume (*Índice de Volumen Físico de la Producción Manufacturera*, IVFPM) because INEGI stopped releasing IVFPM transformation industry statistics.

3.3.2. Administered and Regulated Prices of Goods and Services [21]

The subindex of administered prices recorded an annual variation of 3.71 percent in June 2007, as compared with 3.43 percent at the end of the first quarter of 2007. This increase responded to the price behavior of gas for residential use, which grew at a faster rate from March to June 2007 (2.94 percentage point increase in the annual growth rate). This result was influenced by the increase in the international reference prices of natural gas, given that those of propane have remained unchanged at the 0.33 percent monthly rate of change set since last year.

Graph 19
Administered Prices Subindex
Annual percentage change

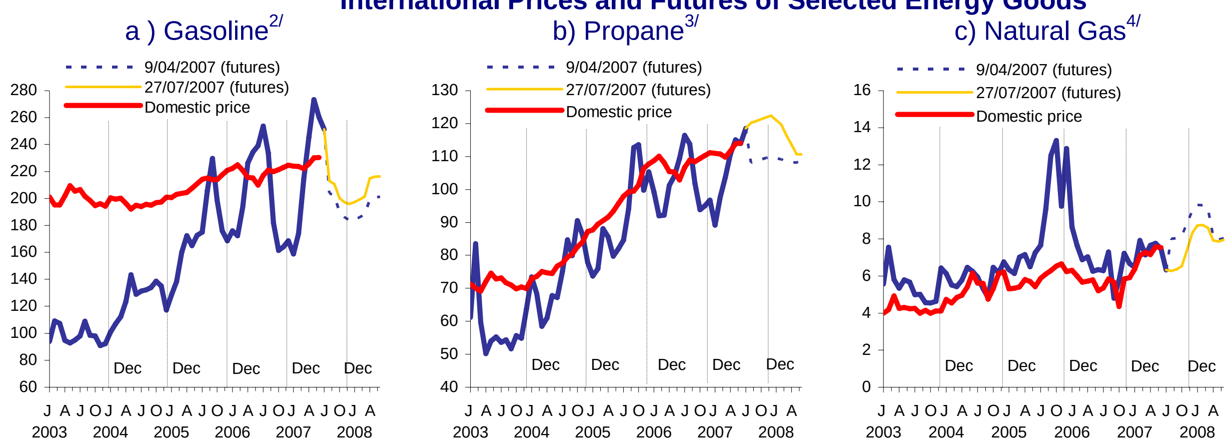


[21] The subindex of administered and regulated prices of goods and services includes items whose changes in prices, most of the time, do not affect inflation indefinitely. The basket of administered prices includes: electricity, gas for residential use, and high and low octane gasoline. The basket of regulated prices includes: oils and lubricants, inter-state transportation, city transportation, fixed-route/fare transportation, toll roads, license and other document fees, parking lots, water supply rights, property taxes, international long-distance phone services, domestic phone services, subway and electric transportation, taxi services, and automobile taxes.

In contrast, the annual variation of gasoline and electricity prices decreased between March and June 2007. In the case of low and high octane gasoline, their annual rates decreased by 0.80 and 0.65 percentage points, respectively. This result was due to the price behavior of these types of fuels at border cities, which remained at their maximum level set by the federal government since May 6, 2006. The annual change in electricity tariffs decreased by 0.92 percentage points, as a result of moderate increases in high consumption electricity tariffs (*Tarifas de Alto Consumo*, DAC).The fact that metal prices did not increase as in the same period of last year contributed to the moderate growth of high consumption electricity tariffs.[22]

During the second quarter of 2007, international prices of energy increased, surpassing those observed during the first quarter. Nonetheless, this increase only affected the natural gas domestic market, as both propane and gasoline prices for the domestic market are determined according to a pre-established rate of change. Recent futures prices of gasoline and propane were above those observed at the beginning of April. Futures prices of natural gas exhibited opposite results (Graph 20).

Graph 20
International Prices and Futures of Selected Energy Goods [1/]



1/ Futures prices correspond to the average of 10 days prior to the dates specified in the graphs. Data source: New York Mercantile Exchange.
2/ Texas. US cents per gallon.
3/ Mont Belvieu, Tx. US cents.
4/ Tetco, Tx. USD per MMBtu.

The subindex of regulated prices recorded an annual variation of 2.76 percent, as compared with 2.69 percent in March 2007. The rate of growth of this indicator has remained relatively stable as a result of no significant increases in public transportation fares in cities that carry a high weight in the CPI.

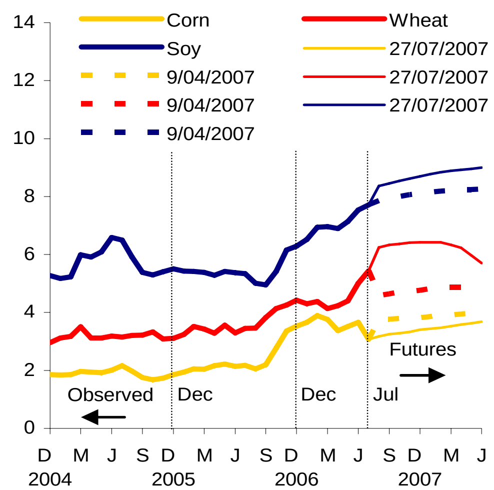
[22] High-consumption residential electricity tariffs are adjusted on a monthly basis according to the following formula: F = 0.8*TIP + 0.2*TCC. The first term in the equation (TIP), is comprised of three arithmetically averaged PPI subindices: Metal Products, Machinery and Equipment, Basic Metal Industries and Other Manufacturing Industries (since June 1, 2007, and according to the federal decree published in the Official Gazette, each index is included in the calculations based on the moving average of the four months previous to the reference date). The second term (TCC) represents price costs of the following fuels used for electricity generation: imported and domestic fuel-oil, natural gas, industrial diesel, and imported and domestic coal.

3.3.3. Metals and Food Commodities

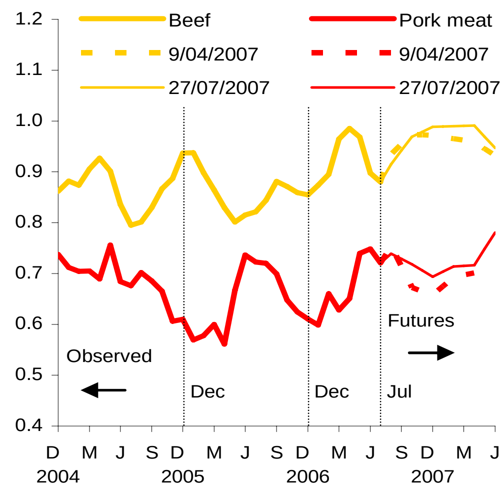
International grain prices continued to increase, following the same trend since September 2006. Most recent futures prices of soy and wheat were above those observed at the beginning of April. In contrast, futures prices of yellow corn reached slightly lower levels, due to a significant increase in corn's total sown area, as confirmed by the U.S. Department of Agriculture in late June (Graph 21a).

Graph 21
International Prices of Agricultural Commodities

a) Grains
US dollars per bushel



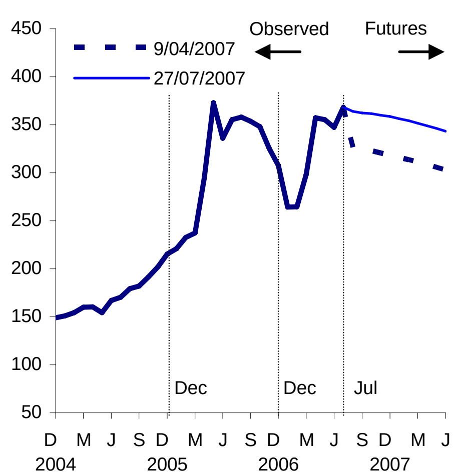
b) Meats
US dollars per pound



Source: U.S. Department of Agriculture (observed prices) and Chicago Mercantile Exchange (futures). Futures prices correspond to the average of 10 days prior to the dates specified in the graphs.

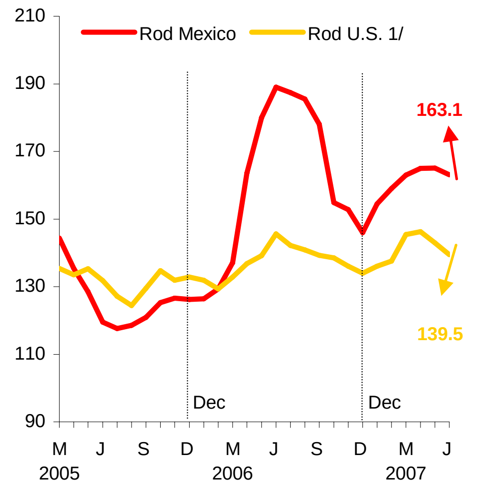
Graph 22
International Prices of Copper and Steel

a) Copper
US cents per pound



Source: Commodity Exchange Inc. and Metal Bulletin. Futures prices correspond to the average of 10 days prior to the dates specified in the graph.

b) Rod
Indices, base December 2003=100



Source: Banco de México and Bureau of Labor Statistics (U.S.).
1/ The U.S. Index includes all types of rod.

Between April and June 2007, international prices of beef and pork meat followed opposite patterns (the former decreased while the latter increased). Nonetheless, futures prices of these products suggest that this change in prices could revert during the second half of the year (Graph 21b).

International prices of copper rebounded between April and March 2007, and then began to decrease moderately. Futures curves for this metal suggest that in the next months their international reference prices could be at levels slightly below the current ones. International prices of steel stopped increasing as they had done so since the beginning of the year. In Mexico, steel prices grew at moderate rates (Graph 22).

3.4. Monetary and Credit Aggregates

3.4.1. Monetary Base, Net Domestic Credit and International Assets

The monetary base grew significantly during 2006, especially during the second half of that year. During the first semester of 2006 it grew at an annual rate of 14.6 percent, and during the second semester, 17.6 percent. As mentioned in previous Reports, the expansion observed in 2006 could be attributed to both the faster rate of growth of economic activity and the effect of temporary factors such as the greater use of money that usually takes place during federal elections. During the period January-June 2007, the monetary base grew 14.2 percent in annual terms. For this reason, although the remonetization process continues, it has been more moderate.[23]

Table 6
Monetary Base, International Assets and Net Domestic Credit
Millions

	Stocks		Annual % change	Flows in 2007		
				Quarter		
	At 31 Dec. 2006	At 30 Jun. 2007	At 30 Jun. 2007	I	II	Accumulated at 30 Jun. 2007
(A) Monetary base (pesos)	449,821	408,727	10.7	-40,007	-1,087	-41,094
(B) Net international assets (pesos) 1/ 2/	824,967	841,259	-12.2	-5,090	22,230	17,140
Net international assets (USD) 2/	76,304	77,933	-8.3	-421	2,051	1,629
(C) Net domestic credit (pesos) [(A)-(B)] 1/	-375,145	-432,532	-26.5	-34,918	-23,317	-58,234
(D) International reserves (USD) [(E)-(F)] 3/	67,680	69,939	-11.2	1,516	744	2,260
(E) Gross reserves (USD)	76,330	77,934	-8.3	-479	2,083	1,604
PEMEX				2,573	3,087	5,660
Federal government				-2,132	-412	-2,544
Sale of US dollars to banks 4/				-1,996	-1,407	-3,403
Other 5/				1,076	815	1,890
(F) Liabilities with less than six months to maturity (USD)	8,650	7,994	28.9	-1,995	1,339	-656

1/ Net international assets' cash flows in pesos are estimated based on the exchange rate applied to each transaction.
2/ Net international assets are defined as gross reserves plus credit agreements with foreign central banks with more than six months to maturity, minus total liabilities payable to the IMF and credit agreements with foreign central banks with less than six months to maturity.
3/ As defined by Banco de México's Law.
4/ Daily sales of US dollars according to the mechanism to reduce the pace of international reserve accumulation (see Foreign Exchange Commission's Press Release of March 20, 2003).
5/ Includes yields on net international assets and other transactions.

As shown in Table 6, during the period January-June 2007, net international assets rose by 1,629 million US dollars, reaching 77,933 million at the end of June.[24] The monetary base decreased by 41,094 million pesos during

[23] Figures calculated based on the average of daily stocks.
[24] For a definition of international assets and international reserves refer to the glossary of the weekly press release on Banco de México's balance sheet. Banco de México's broad credit position vs. the domestic market (net domestic credit) is obtained by subtracting international assets from the monetary base; i.e.,

the same period. As a result, Banco de México's net domestic credit fell by 58,234 million pesos during the period.

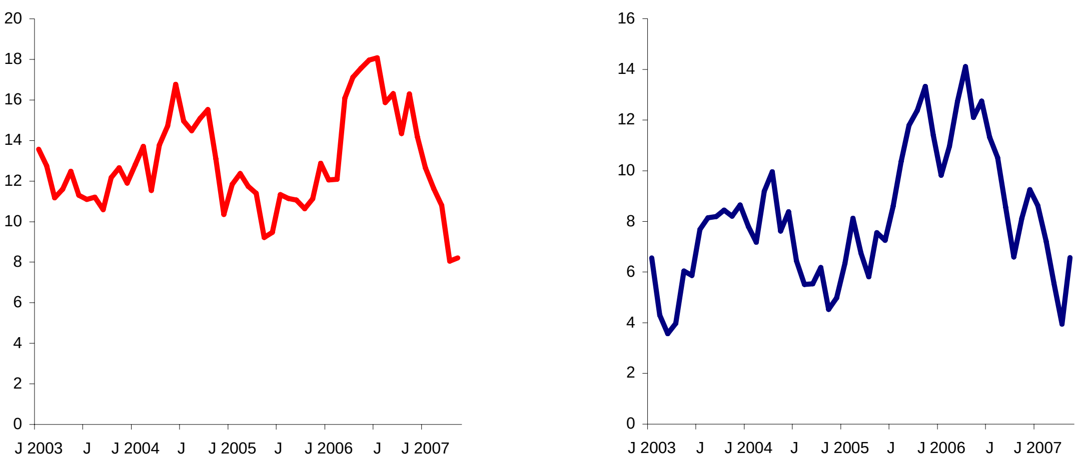
3.4.2. Monetary Aggregates and Financing

In a context where economic activity slowed down as compared with the previous year, during the period January-May 2007, the annual growth rates of the monetary aggregates followed a downward trend (Graph 23a and 23b). In the case of the monetary aggregate M1, all of its components slowed down. In May, this aggregate grew at a nominal annual rate of 8.2 percent. As for the slower growth of the monetary aggregate M2 (real annual rate of 6.6 percent in May), worth mentioning is the slower expansion of bank deposits and the fact that part of the resources from the retirement savings system (*Sistema de Ahorro para el Retiro*, SAR) were invested in financial instruments that are not included in the monetary aggregates.[25]

Graph 23
Monetary Aggregates

a) Monetary Aggregate M1
Annual nominal percentage change

b) Monetary Aggregate M2
Annual real percentage change



Up to the first quarter of 2007, the annual flow of financial resources accounted for 4.2 percent of GDP (Table 7). The public sector use of these resources accounted for only 0.5 percentage points of GDP.[26] As mentioned in previous Reports, the reduction in financing to the public sector has freed resources to finance the private sector. During the analyzed period, the flow of

financing granted or received domestically by the central bank. The international reserves definition excludes Banco de México's short-term (less than six months) foreign currency liabilities.

[25] In May 2007, the stock of SAR invested in domestic securities included in the monetary aggregate M2 grew at a real annual rate of 10.6 percent. The total stock of SAR, which, in addition, includes the resources invested in financial assets not included in M2 (equities, government securities issued abroad –UMS Bonds- and foreign debt securities), grew at a real annual rate of 14 percent.

[26] The public sector is defined as the sum of Public Sector Borrowing Requirements, States and Municipalities, and International Reserves.

financing to households accounted for 1.9 percentage points of GDP, while financing to firms, 2.7 percent.[27]

During the first five months of 2007, bank credit to the private sector continued to grow at high rates. In the case of credit to households, it grew at more moderate rates than in 2006 (Graph 24a and b).

Table 7
Total Financial Resources (Uses and Sources)
GDP percentage

	Stock at March 2007		Annual Flow		
	%GDP	% Structure	2005	2006	Mar 2006 - Mar 2007
Total sources	**72.9**	**100.0**	**7.8**	**5.5**	**4.2**
M4	55.1	75.6	7.5	7.0	5.2
Foreign financing	17.8	24.4	0.3	-1.5	-1.0
Total uses	**72.9**	**100.0**	**7.8**	**5.5**	**4.2**
International reserves 1/	8.1	11.1	0.9	-0.1	0.2
Public sector (HSPSBR) 2/	35.9	49.3	1.4	0.9	0.2
States and municipalities	1.5	2.0	0.1	0.0	0.1
Private sector	30.1	41.3	2.8	4.3	4.6
Households	13.7	18.8	2.0	2.3	1.9
Consumption	4.7	6.5	1.2	1.2	1.1
Housing 3/	9.0	12.3	0.7	1.2	0.8
Firms	16.4	22.5	0.8	2.0	2.7
Credit granted by financial intermediaries 4/	7.7	10.5	0.3	1.3	1.8
Issuance of debt instruments	1.7	2.4	0.0	0.1	0.0
External	7.0	9.6	0.6	0.6	0.9
Other concepts 5/	-2.7	-3.7	2.6	0.4	-0.9

Note: Figures may not add up due to rounding.
1/ As defined by Banco de México's Law.
2/ Historical Stock of Public Sector Borrowing Requirements (*Requerimientos Financieros del Sector Público*, SHRFSP), as reported by the Ministry of Finance (SHCP).
3/ Total portfolio of financial intermediaries and of the National Employees' Housing Fund (*Instituto del Fondo Nacional de la Vivienda para los Trabajadores*, INFONAVIT)..Includes debt-restructuring programs.
4/ Total portfolio of financial intermediaries and of the Includes debt-restructuring programs.
5/ Refers to non-sectorized assets, capital accounts and results, other assets and liabilities of both commercial and developments banks, Banco de México, non-bank financial intermediaries, and INFONAVIT, and non-monetary liabilities from IPAB, among others.

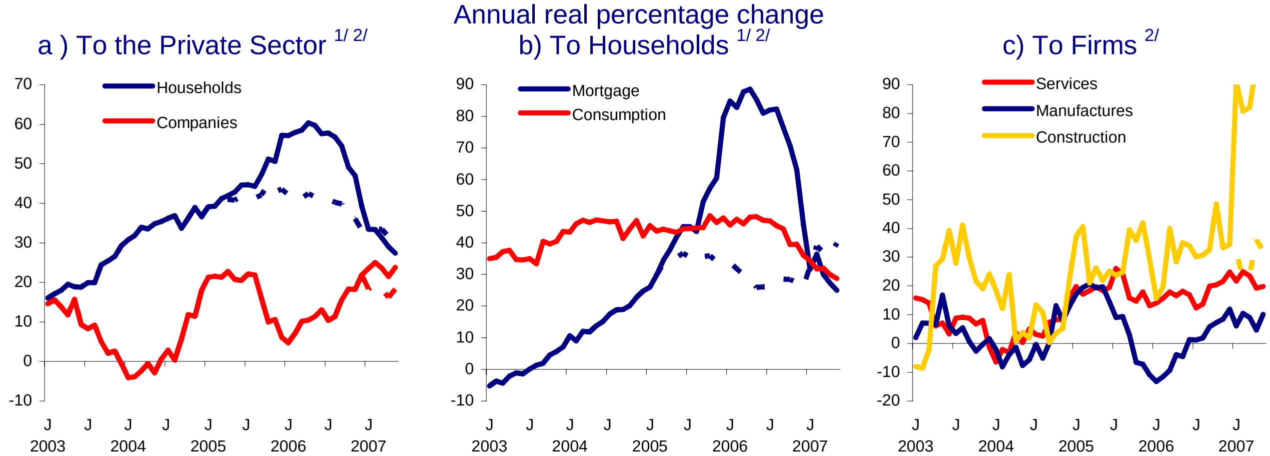
Commercial banks direct performing credit to households grew at a real annual rate of 27.4 percent in May of this year. The delinquency rate of commercial banks' credit to households was 4.08 percent in that month (4.87 percent for consumer credit and 2.59 percent for mortgage credit), 0.94 percentage points above May 2006 figure.[28] Regarding the components of commercial banks' credit for consumption, the delinquency rate of credit cards increased from 4.64 percent in May 2006, to 5.92 percent in the same month of 2007, and the delinquency rate of credit for durable goods and other consumer

[27] The annual flow of financing to households and firms up to March 2007 was affected by a change in CNBV accounting standards, which state that since January of this year, credit statistics of commercial bank and Sofoles should reclassify bridge financing for housing construction from mortgage loans (households) to credit to firms. This has implied a reduction in the stock of mortgage loans and an expansion in the stock of loans to firms since January 2007. Without this reclassification, resources to finance households and firms would have been 2.4 and 2.2 percent of GDP, respectively, during the analyzed period.
[28] The delinquency rate is defined as the ratio direct overdue portfolio to total direct portfolio.

credit increased from 2.48 to 3.28 percent during the same period.[29] The increase in consumer credit overdue portfolio is due, among other reasons, to the growth of credit to individuals with no previous credit history, and therefore, with higher credit risk.[30]

As for financing to firms, bank credit rather than financing through securities has accounted for most of the growth of domestic financing to firms. Banks' direct performing loans to firms increased by 23.8 percent in real annual terms.[31,32] Worth mentioning is the recent recovery of performing loans to the manufacturing sector (Graph 24c). The medium-term corporate debt market exhibited less dynamism, growing at a real annual rate of 5.3 percent in May.

Graph 24
Bank Performing Loans to the Non-financial Private Sector
Annual real percentage change



1/ Performing loans to households include banks' purchase of Sofoles mortgage portfolio.
2/ According to CNBV regulations, it includes reclassified bridge financing from mortgage loans to loans to firms since January 2007. In Graph 24a and b, and in the cases of household and mortgage loans, the dotted line excludes the purchasing of Sofoles performing loans portfolio and reclassified bridge financing for construction. In Graph 24 a and c, and in the cases of financing to firms and to construction, the dotted line excludes the effect of reclassified bridge financing for construction.

As mentioned in previous Reports, banks' interest rates for household credit are still high. In the first five months of the year, lending interest rates for household credit, both consumer and mortgage credit, did not change significantly. On another front, the growth of lending to smaller-size firms has led to higher credit risk and, therefore, at the margin, to higher lending interest rates for firms in the last months (Graph 25b).

The existence of basic and homogeneous banking services facilitates their comparison, fostering competition among banks and improving the population's access to the banking system. Considering the aforementioned, in June 2007, the Mexican Congress passed a new Law of Transparency and Financial Service Ordinance (*Ley para la Transparencia y Ordenamiento de los*

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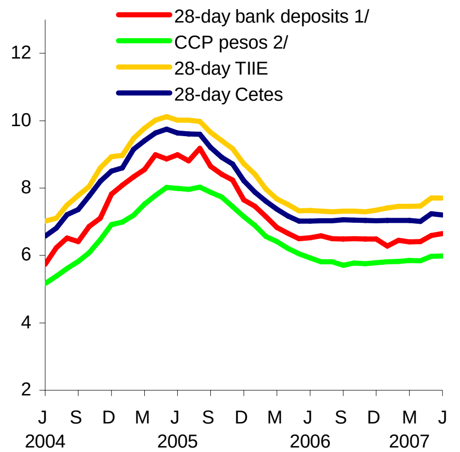
[29] Includes consumer credit for durable goods, personal loans, capitalized lease, and other types of credit.
[30] During 2006, commercial banks issued around 8.7 million credit cards, 40 percent of which were granted to people with no previous credit history (see *Informe sobre el Sistema Financiero 2006*, Banco de México, p. 64).
[31] Excluding the effect of the reclassification of bridge financing from mortgage loans to loans for firms, commercial banks' performing direct credit to firms grew at a real annual rate of 18.3 percent in May 2007.
[32] The delinquency rate of commercial banks' credit to firms was 1.05 percent in May 2007, while in the same month of the previous year it was 1.13 percent.

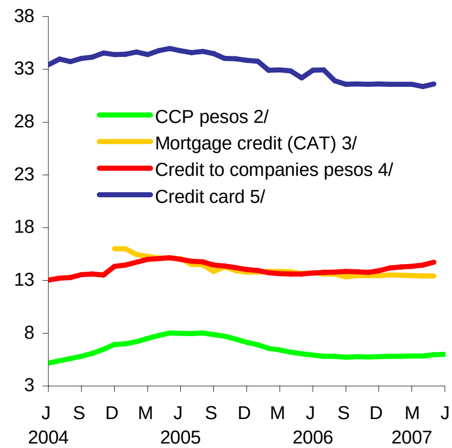
Servicios Financieros) and modified, among other laws, the Law of Credit Institutions (*Ley de Instituciones de Crédito*). Regarding the latter, it was determined that credit institutions that take deposits from individuals must offer two basic deposit accounts under the terms and conditions to be specified by Banco de México.[33]

Graph 25
Bank Deposit and Lending Interest Rates in Pesos
Annual percent

a) Deposit (Borrowing) Interest Rates



b) Lending Interest Rates



1/ Monthly average of payable rates (individuals and firms) settled in over-the-counter and trading floor operations.
2/ Includes term liabilities of banks in pesos, except liabilities from subordinate liabilities to be converted into capital, from the granting of guarantees, and from operations among credit institutions.
3/ Average of indicator that summarizes the Annual Percentage Rate of Charge or APRC (*Costo Annual Total, CAT*) and comprises costs due to interest rates, commissions, bonuses, obligatory insurance, and other financial services. Mortgage lending figures are obtained from the Simulator of Mortgage Credits available at Banco de México's web page (http://www.banxico.org.mx).
4/ Simple average of nominal interest rates on credits granted by commercial banks in pesos during the period. Information obtained from the regulatory report R04C of the National Banking and Securities Commission (*Comisión Nacional Bancaria y de Valores*, CNBV).
5/ Simple average of interest rates excluding VAT charged by banks including all credit card traditional products according to the report "Bancos: tasas de interés de tarjetas de crédito" by Infosel.

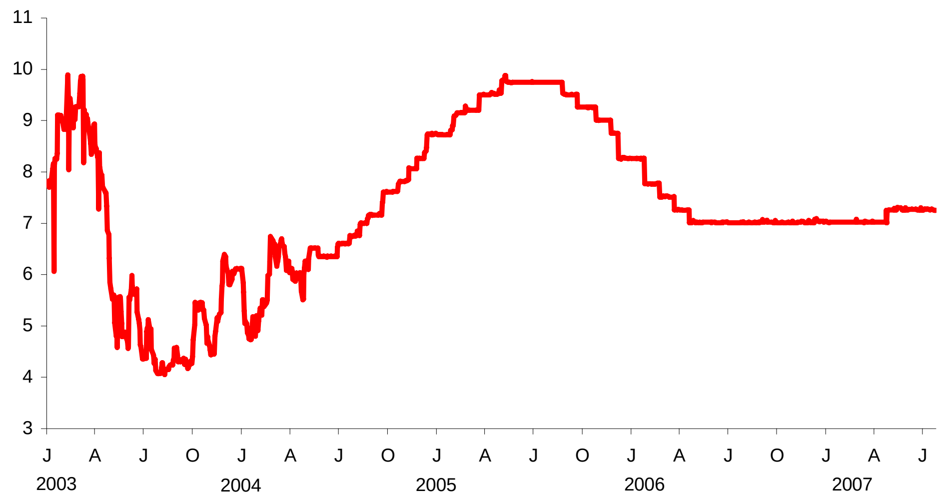
Under this setting of legal modifications, on July 17, Banco de México issued rules that state that credit institutions must offer these two products free of charges on opening an account, withdrawals, and balance enquiries. These products are the Basic Payroll Account (*Cuenta Básica de Nómina*) and the Basic Account for the Public (*Cuenta Básica para el Público en General*). The latter is a deposit account in which monthly deposits must not exceed the amount equivalent to 165 daily minimum wages fixed in Mexico City (Federal District).[34] Credit institutions have 180 days to comply with these regulations.

[33] See *Diario Oficial de la Federación* (Official Gazette), June 15, 2007.
[34] See Banco de México's press release of July 13, 2007 *Reglas a las que Deberán Sujetarse las Instituciones de Crédito Respecto de las Cuentas Básicas de Nomina y para el Público en General, a las que se Refiere el Artículo 48 BIS 2 de la Ley de Instituciones de Crédito* (Rules by which Credit Institutions Must Abide Regarding Basic Payroll Accounts and Accounts for the Public, as referred to in Article 48 BIS 2 of the Law of Credit Institutions).

4. Monetary Policy

After having kept the monetary conditions unchanged from May 2006 to March 2007, in the second quarter of 2007 Banco de México's Board of Governors tightened them by 25 basis points as a preemptive measure. With this action, since April 27, the overnight interbank rate increased to 7.25 percent (Graph 26). This measure was adopted in order to accomplish a better balance of risks for inflation, in particular, to prevent that the supply shocks that have taken place recently affect the price and wage determination processes.

Graph 26
Interest Rates
Overnight Interbank Interest Rate
Annual percent



Inflation in Mexico has been affected negatively since mid-2006 by several supply shocks that prompted it to increase in the last months of that year and in the first months of 2007. During the first quarter of 2007, annual headline inflation was, on average, above 4 percent.

Up to now, available information suggests that the referred shocks will affect inflation only temporarily. These shocks originated from price increases in a reduced number of products (sugar, corn-tortillas, cigarettes, and dairy products, see section 2.1) and, apparently, have not contaminated the price determination process.

However, by the end of the first quarter of the present year, the balance of risks for inflation worsened. Under this context, it is important to emphasize that Banco de México's Board of Governors evaluates a wide range of indicators to assess the balance of risks for inflation.

A set of indicators that are useful to evaluate the trend exhibited by inflation are the trimmed means. These exclude the effect of item prices that have undergone extreme variations (both the highest and the lowest), and, by construction, show a relatively stable path. Therefore, they are a good indicator of trend inflation. Graph 27a shows that, currently, the trimmed mean for annual headline inflation is slightly 40 basis points below annual headline inflation, albeit being close to 6 tenths above the 3 percent target.

The trimmed mean for annual core inflation has remained under annual core inflation since the end of 2003. In particular, although the trimmed mean is currently below 3.3 percent, more than 4 tenths below annual core inflation (Graph 27b), during practically all 2006 and the beginning of 2007 it followed an upward trend. The recent behavior of the trimmed mean for annual core inflation reveals that, in the last years, it has been affected negatively by a number of very persistent supply shocks. As mentioned, during the last months, these shocks have mainly affected food prices.

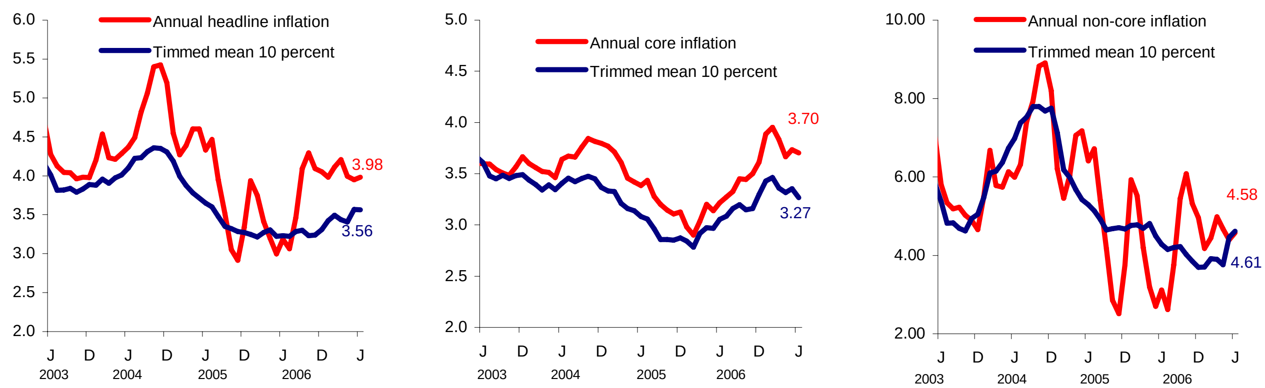
Finally, annual non-core inflation and its trimmed mean have been crossing in both directions for a long period of time (Graph 27c).

Graph 27
Headline Inflation and Inflation Indicators excluding the Contribution of Extreme Upper and Lower Trimmed Means at 10 Percent [/1]

a) Headline Inflation and Trimmed Mean
Annual percent

b) Core Inflation and Trimmed Mean
Annual percent

c) Non-core Inflation and Trimmed Mean
Annual percent



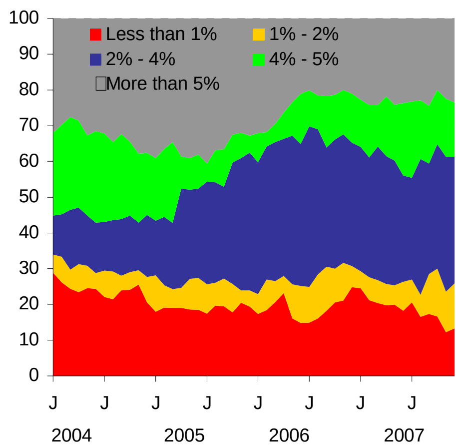
1/The trimmed mean excludes the contribution of extreme variations in certain items' prices from headline inflation. To strip these variations, the following calculations are done: i) monthly seasonally adjusted variations of CPI prices are arranged in descending order; ii) the items with the highest and lowest variation are excluded, considering up to 10 percent of the CPI basket, respectively, in each distribution tail; and, iii) with the remaining items, which, by construction, are located at the center of the distribution, the trimmed mean indicator is constructed.

Another set of indicators that offers information on the price determination process is constructed using the proportion of the CPI and core baskets corresponding to those price items exhibiting annual variations in a specific range. As mentioned in previous inflation reports, these indicators allow for analyzing if the increase in inflation responds to price increases of certain items or if it is an overall general upward price movement of goods and services. In the latter case, the proportion of the basket with annual price variations in the upper limits would be expected to increase considerably during a long period. Graph 28a and 28b presents this exercise for headline inflation and core inflation.

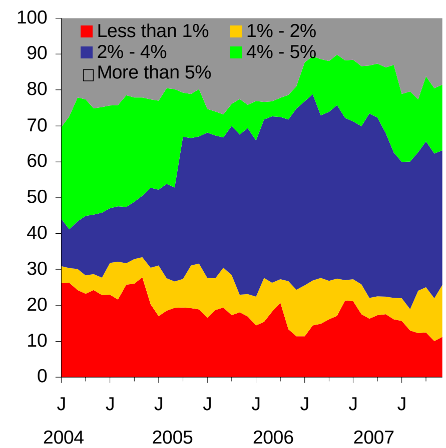
During the last months of 2006 and first months of 2007, the proportion of products included in the CPI basket that had been growing above 4 percent in annual terms increased, although it seems to have stabilized during the second quarter. Once more, food products were the most affected. Once again, this behavior originated from both the price increase in products that were directly affected by the supply shocks and the price increase in goods and services that use these products as raw materials.

Graph 28
Share of Items in the CPI and in the Core Price Subindex with Annual Price Variations within a Range [1]

a) CPI
Percent



b) Core Price Subindex
Percent



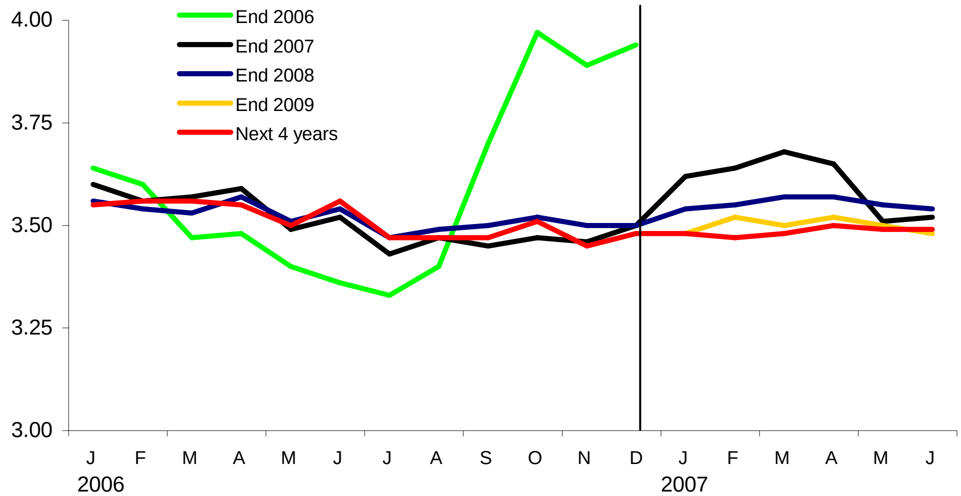
1/ The share of a price index's basket whose annual price variations fall within a range is calculated as follows: i) interest ranges are defined; ii) annual inflation of each of the items of the price index is calculated; iii) items are classified in the interest ranges according to their annual inflation; and, iv) the weights of the items in each range are added.

As for inflation expectations, although those corresponding to headline inflation for medium and long terms (end of 2008, 2009, and average for the next 4 years) remained relatively stable at around 3.5 percent during the first months of the year, expectations for shorter horizons (end of 2007) were revised upward considerably, as expected. Nonetheless, during May and June, these were revised downward slightly: in the case of headline inflation, from 3.65 percent in Banco de Mexico's survey of April, to 3.52 percent in June's survey, and, in the case of core inflation, from 3.52 to 3.48 percent (Graph 29).[35] Inflation expectations for the medium and long-terms remained stable, at around 3.5 percent during the referred months.

Another indicator containing information about long-term inflation expectations is the compensation for inflation (inflation expectations plus a risk premium) that investors demand for holding peso-denominated long-term bonds. This indicator is obtained by subtracting from the nominal yield on the 10-year bond, the real yield associated with indexed-debt instruments (Udibonos) with the same maturity. During the last twelve months, compensation for inflation has followed a relatively stable pattern (Graph 30).

[35] Inflation expectations from the Infosel survey for medium and longer horizons have remained at around 3.5 percent. Headline inflation expectations for the end of 2007 were revised downward, from 3.61 percent on April 27, to 3.58 percent on July 27. Expectations for core inflation for the end of 2007 were revised from 3.48 percent on April 27 to 3.62 percent on July 27.

Graph 29
Inflation Expectations: Banco de México Survey
Annual percent



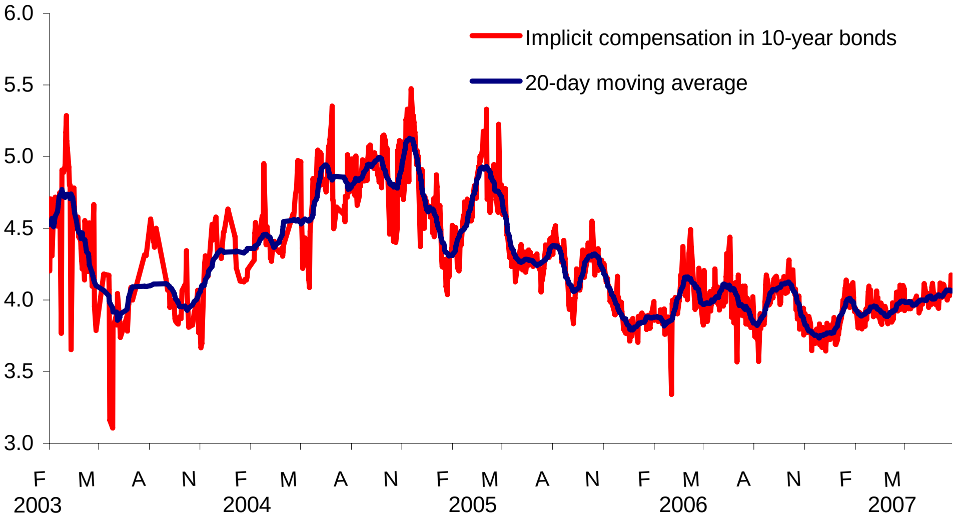
Summing up, considering the aforementioned, during the first months of the year, core inflation followed an upward trend, the proportion of items in the CPI basket growing at annual rates above 4 percent increased, and expectations for short-term inflation were revised upward considerably. The fact that headline inflation is above the upper limit of the inflation target variability interval increases the risk of contaminating the price determination process.

As mentioned in previous Inflation Reports, when inflation pressures originate from supply shocks, they reflect changes in relative prices, which should affect inflation only temporarily. In this case, the recommended policy response is that the central bank does not offset these pressures.

However, if the central bank considers that there is a risk that inflation expectations or the price determination process are likely to be contaminated, or that the balance of risks could worsen significantly, it must tighten its monetary policy stance to prevent such outcome. These circumstances led Banco de México's Board of Governors to tighten the monetary conditions as a preemptive measure in April.

The path followed by the yield curve in Mexico has been mainly determined by the conditions prevailing in international financial markets, as well as by the effects of the adopted monetary policy actions. In particular, despite the increase in long-term interest rates in the U.S. during the second quarter of 2007, medium and long-term interest rates in Mexico remained close to their historic minimum levels (Graph 31a). As a result, the spread between Mexico and U.S. interest rates for different terms narrowed considerably during the quarter, particularly for long-term interest rates (Graph 31b).

Graph 30
Compensation for Inflation and Inflationary Risk on Long-term Bonds
Annual percent

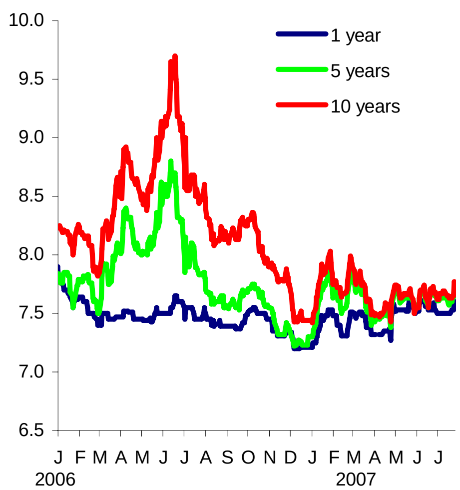


During the second quarter, the yield curve in Mexico "flattened" (Graph 32) while the yield curve in the U.S. "steepened" (Graph 11a). The tighter monetary restriction adopted in April and the effects of this measure on long-term inflation expectations in Mexico contributed to these results.

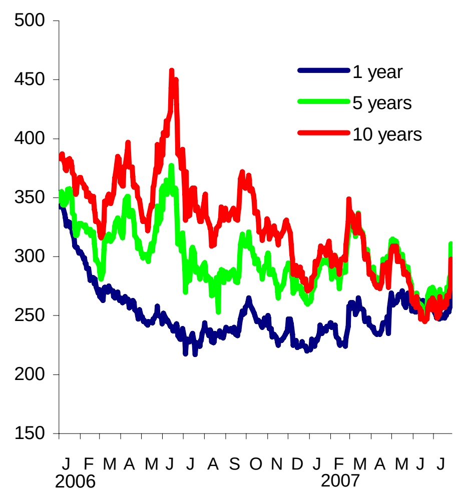
Nonetheless, since mid-June international financial markets have exhibited volatility due to problems in the U.S. mortgage market. This has led to a moderation in appetite for risk, which, in turn, has prompted an adjustment in securities markets and in the prices of assets and currencies of emerging market economies.

Graph 31
Interest Rates

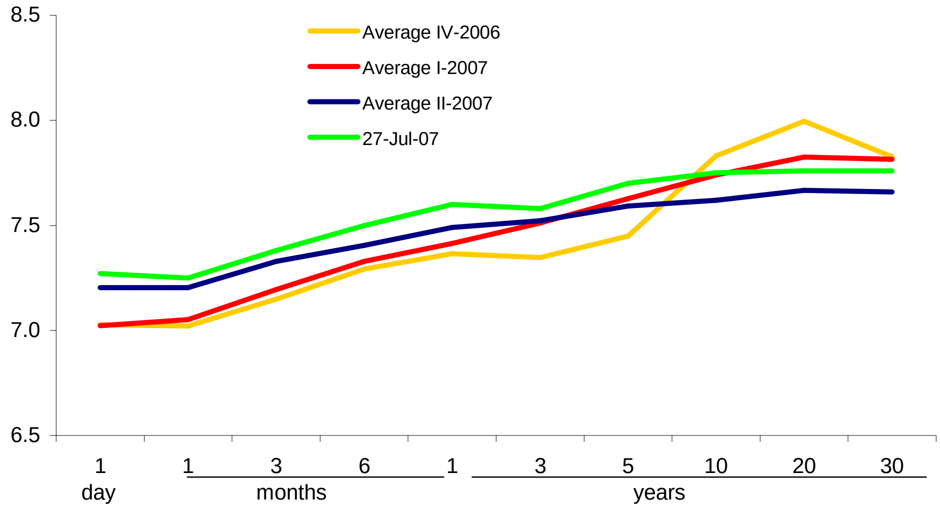
a) Interest Rates in Mexico
Percent



b) Spread between Mexico and U.S. Interest Rates
Basis points



Graph 32
Interest Rates
Yield Curve in Mexico
Percent



As for the outlook for inflation, once the effects of the shocks on annual headline inflation start to fade, and, in absence of further supply shocks, inflation is expected to resume its downward trend. Considering that the effects of monetary policy actions on the economy take place with a lag of between 18 and 24 months, headline inflation is anticipated to converge gradually to its 3 percent target, reaching it closely by the end of the fourth quarter of 2008. Given the aforementioned, the Board of Governors decided to leave monetary conditions unchanged in May, June, and July.

Recently, the risks surrounding the aforementioned prevision have increased somehow. On the one hand, the expected trajectory for the international prices of certain agricultural commodity prices remains high, while energy prices have fluctuated significantly and, once again, are high. On the other hand, expectations for medium and long-term inflation are half of a percentage point above the 3 percent inflation target.

Based on the various risks that inflation faces nowadays, the Board of Governors believes that the monetary policy stance must maintain a tightening bias. This means that, in the near future, the Board will most likely adopt measures to tighten rather than loosen monetary conditions. The Board will continuously evaluate the balance of risks and, should it perceive a deterioration that could hinder the attainment of the inflation target, it will act accordingly.

5. Balance of Risks and Final Remarks

Banco de México's expected economic scenario for 2007 is based on:

- The outlook for world economic growth is still positive. Regarding U.S. growth, the current average of forecasts of the main analysts is around 2.1 percent for GDP and 1.9 percent for industrial production. Both indicators are expected to recover gradually throughout the year.

- As for Mexico's external accounts, the oil trade balance surplus and revenues from workers' remittances are expected to remain at high levels this year. However, both items lost momentum. In fact, the former fell significantly during the first half of the year and the second also fell at an annual rate during the second quarter. In the first case, the results are attributed to lesser crude oil exports and to increasing imports of oil-related products. In the second case, results are due to a combination of several factors, among which the most relevant is the correction in the U.S. real estate market.[36]

- Favorable conditions for access to financing in international markets are expected to prevail. Nonetheless, to the extent that greater inflationary pressures worldwide or a further deterioration of the U.S. real estate market prevail, volatility in those markets could increase.

Based on the aforementioned macroeconomic conditions, and on information analyzed in this Report, Banco de México's baseline scenario for 2007 is as follows:

GDP Growth: Between 3 and 3.5 percent.

Employment: Creation of around 660 thousand jobs in the formal sector (number of workers insured by the IMSS).

Current Account: Current account deficit of around 1.2 percent of GDP.

Inflation: Considering that the effects of monetary policy actions on the economy take place with a lag of between 18 and 24 months, the Board of Governors believes that the current monetary policy stance, in absence of further supply shocks, will help headline inflation to converge to its 3 percent target, reaching it closely by the end of 2008.

As for the short run dynamics of inflation, annual headline inflation is expected to be between 3.75 and 4.25 percent during the third quarter of the year, and between 3.25 and 3.75 percent during the fourth quarter. As for core inflation, it is anticipated to show a slightly decreasing trend during the second half of 2007, ending the year at around 3.5 percent. In this regard, the following deserves mention:

- The merchandise subindex has been affected by price increases in corn-tortillas, sugar, cigarettes, and, recently, dairy products. In absence

[36] See footnote no. 20, p.28.

of further shocks, the effects of these price increases on annual inflation calculations are expected to start to fade starting September. This result is contingent to the behavior of corn-tortilla prices, which have stabilized due to the Agreement to Stabilize Corn-tortilla Prices, which was extended to August 15, 2007.

- Non-food merchandise prices have grown at a relatively stable annual rate since 2002, currently fluctuating slightly above 2 percent. Similar results are expected in the future.

- In 2006, the price subindex of housing services was affected by the price increase in construction materials, mainly those manufactured from copper and steel. The effect of these shocks has mostly disappeared in the last months and no further pressures are expected.

- Prices of non-housing services are expected to continue to grow at annual rates slightly below 4 percent.

- The non-core price index will continue to be mainly determined by the trajectory of fruits and vegetables prices. In absence of further shocks, fruits and vegetables prices are expected to reduce their contribution to annual headline inflation between August and October, due to the high prices attained by these products during the same period of 2006.

- Prices of livestock products could grow at higher annual rates, given that they continue facing pressures originated by the increase in grain prices and by the higher world demand for meat products.

- Administered prices are not expected to affect inflation significantly in the short term. Nonetheless, gasoline prices could be affected negatively if an additional tax on this product is authorized next year. On another front, the regulated prices subindex could grow at a faster rate, due to the updating of public transportation fees in some cities.

Among the risks for inflation in the short term, the following stand out:

i) High uncertainty about certain food prices prevails. On the one hand, the international prices of grains have been subject to pressures and have become more volatile. On the other, the increase in world demand for high-protein food products has become a continuous factor of pressure on the prices of these products (meat, dairy products, among others).

ii) Expectations that headline inflation will remain high in the short run increase the risk of greater side effects on other prices.

iii) Energy prices have remained high and have fluctuated significantly. In addition, the prices of other commodities, such as metals, remain volatile.

iv) If changes to the tax system that include additional taxes on certain goods like gasoline and cigarettes are approved, or if there is a significant increase in the fiscal burden on some sectors as a result of new taxes, headline inflation could be subject to temporary pressures.

Efforts to make inflation reach its 3 percent target face the following risks:

i) Services prices continue to grow at high rates.

ii) Inflation expectations are still above the 3 percent target.

The Board of Governors considers that the current monetary policy stance is consistent with the convergence of inflation to its target, in a time horizon compatible with the operation of the different channels of monetary policy transmission. Nonetheless, several risks prevail, especially regarding the increases in the international prices of food products. Although the significant increase in food prices has affected other economies as well, the high weight of food prices in the CPI, and various distortions in domestic food markets, make inflation in Mexico more vulnerable to this process. One of the most severe distortions is the lack of competition in some stages of the production chain of some food products, which aggravates the impact of the increase in the international prices of some food products on their domestic prices. Since the aforementioned entails higher risks on inflation, Banco de México's Board of Governors decided to keep a tightening bias in regards to its monetary policy stance.

There are other risk factors that could affect mainly the base scenario for GDP growth.

One of the main risks for the Mexican economy is the possibility that U.S. growth slows down more than expected. The possibility of a further deterioration of the U.S. real estate market deserves mention because it could affect financial markets and emerging market economies' access to financing. If the weakness of the real estate market continues or aggravates, consumption, which has remained vigorous up to now, would be negatively affected. Consequently, U.S. demand for foreign products, including those from Mexico, would decrease.

Finally, the revision and redesign of public finances should contribute to align the incentives framework for the Mexican economy, with the aim of increasing productivity and competitiveness. Banco de México considers necessary to advance in the actions to solve the structural problems of public finances, in order to reduce the country's dependence on oil revenues and foster the increase of productive public spending and public savings. This should take place under a framework that favors investment spending in projects with high social returns and promotes accountability of all levels of government and of public entities in charge of spending.

The approval of the fiscal reform would strengthen the government capacities and generate positive expectations. However, to consolidate long-term growth, structural changes must be undertaken regarding the fostering of competition, modernizing regulations, strengthening the security system, and, in general, improving the country's institutional framework. Only through these measures will competitiveness increase and potential growth be unlocked so that the Mexican economy can grow to its full potential and be able to create more opportunities and benefits for all Mexicans.