Inflation Report

April – June 2006

BANCO DE MEXICO

JULY 2006

BOARD OF GOVERNORS

Governor

GUILLERMO ORTIZ MARTÍNEZ

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Unless otherwise stated, this document has been prepared using data available as of July 28, 2006. Figures are preliminary and subject to change.

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Inflation Report April-June 2006

1. Introduction

The recent development and prospects for the world economy continue to be positive. However, risks have increased. Most recent information indicates that the composition of world growth might be changing. In particular, several indicators suggest that U.S. economic activity is gradually slowing, mainly originated by a deceleration in the housing sector and lower growth in private consumption. On the other hand, economic activity in Europe and Japan continues to recover, while in China and other Asian countries, it remains strong.

The vigorous growth of the world economy, particularly of certain Asian economies that use several energy goods intensively, has exerted pressure on the international prices of oil, therefore increasing their volatility. Several restrictions to raise the supply of these products, as well as geopolitical turmoil in some regions of the world, have also contributed to the aforementioned. As a result, international oil prices have reached record highs recently.

The higher prices of energy and other raw materials in international markets, together with an increase in capacity utilization, have led to greater inflationary pressures worldwide. The worsening inflationary environment has increased uncertainty on the main central banks' corresponding reaction and on the level of interest rates.

The abovementioned outlook has led to the following. On the one hand, the perception of higher interest rates in industrialized nations has increased the risks of a fall in world growth. On the other hand, investors' risk aversion has increased, therefore leading to higher volatility in international financial markets and to adjustments in the prices of several assets and currencies, mainly in emerging economies. Asset prices have also been affected by the reversion of positions, which are financed in markets where short-term interest rates are increasing. It is important to point out that the assets and currencies that have been mostly affected were those of emerging countries with high foreign borrowing requirements and, in general, with a less sounder economic position, according to markets' perception. Nonetheless, changes in the prices of assets and currencies have partly reverted in recent weeks.

Once several risk premia reached historically low levels, international financial markets adjusted. In addition, several indicators on firms' profitability show that they maintain a strong financial position, while long-term interest rates in developed markets are still low according to historical standards. Under such context, the recent events in world financial markets seem to be part of a correction of the phase of the cycle they are currently undergoing.

Financial markets in Mexico have been affected by both the lower appetite for risk worldwide and by certain uncertainty associated with the country's elections this year. Despite these circumstances, economic stability attained in recent years together with the deepening of financial markets have led to an orderly adjustment, with reduced costs in terms of inflation and growth. In fact, fluctuations in the exchange rate and in the prices of other assets have reverted during the last weeks.

Economic activity in Mexico continued to grow significantly during the second quarter of the year. This result was based on the expansion of the different components of aggregate demand, both domestic and external. The growth of domestic demand responded to the persistent dynamism of consumption expenditure and to the higher growth of investment. As for external demand, manufacturing exports, especially of the automotive industry, increased significantly. It is important to point out that the performance of domestic expenditure continued to be favored by revenues from both workers' remittances and crude oil exports.

The inflationary outlook in Mexico continued to be favorable. At the end of the second quarter, annual headline inflation was 3.18 percent, while annual core inflation was 3.22 percent. The latter has exhibited a slight increase associated with, among other factors, increased prices of different housing construction materials.

The abovementioned results have helped maintain inflation expectations at low levels. Thus, in Banco de Mexico's survey of inflation expectations carried out in June, expectations for annual headline inflation for the end of 2006, 2007 and 2008 were 3.36, 3.52 and 3.54 percent, respectively. Meanwhile, in the same survey, core inflation expectations for the end of 2006 were 3.28 percent.

Under such context, in its April press release on monetary policy, Banco de México's Board of Governors announced a reduction in domestic monetary restriction, stating that there is no space for an additional loosening of monetary conditions in the near future. As a result, in its press releases of May, June, and July, the Board decided to maintain monetary conditions unchanged while underlining the absence of a margin for any further slackening.

Despite the significant improvements in disinflation and the continuing favorable outlook for inflation, risks (described in the last section of this Report) prevail. Under such context, monetary policy will continue to be oriented towards fostering and consolidating the convergence of inflation to its target.

2. Recent Developments in Inflation

2.1. Inflation

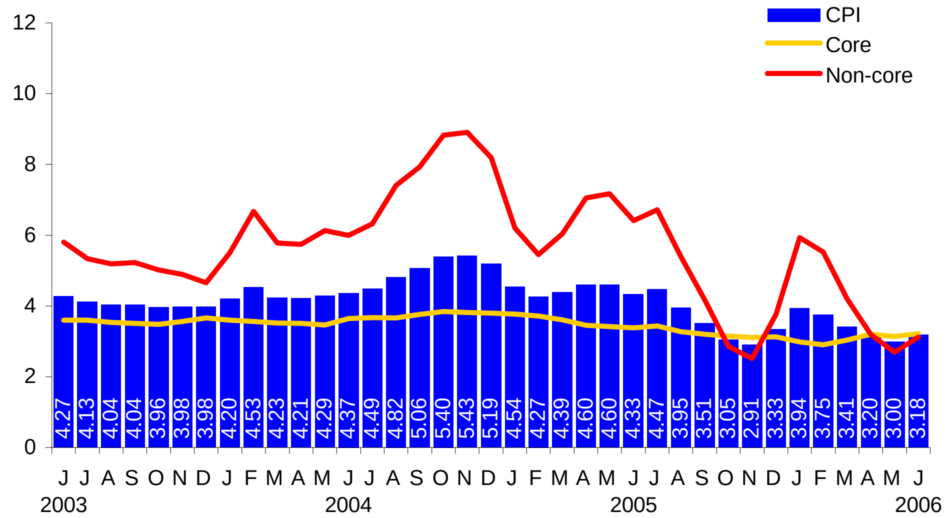
In June, annual headline inflation reached 3.18 percent and annual core inflation, 3.22 percent. These results implied a decline in the first case and an upward movement in the second, as compared with March results (3.41 and 3.04 percent, respectively). The jump in core inflation was due to the observed increase in the price subindex of services, especially in its housing component (Table 1).

Table 1
CPI Components
Annual percentage change

	Dec-2005 (a)	Mar-2006 (b)	Apr-2006 (c)	May-2006 (d)	Jun-2006 (e)
CPI	**3.33**	**3.41**	**3.20**	**3.00**	**3.18**
Core	**3.12**	**3.04**	**3.20**	**3.14**	**3.22**
Merchandise	**2.82**	**2.70**	**2.70**	**2.57**	**2.53**
Food	3.69	3.61	3.57	3.48	3.46
Other	2.19	2.04	2.07	1.91	1.86
Services	**3.46**	**3.40**	**3.75**	**3.76**	**3.96**
Housing	2.55	3.04	3.31	3.61	3.88
Other	4.55	3.83	4.28	3.94	4.06
Non-core	**3.76**	**4.20**	**3.19**	**2.70**	**3.12**
Agriculture	**-0.18**	**1.47**	**-2.63**	**-3.69**	**-2.04**
Fruits and Vegetables	**-1.86**	**5.29**	**-5.24**	**-8.58**	**-3.95**
Tomato	-23.18	12.02	-26.86	-33.46	-27.23
Other	4.12	4.26	-0.17	-1.25	1.02
Livestock	**0.93**	**-0.83**	**-0.90**	**-0.26**	**-0.83**
Administered and Regulated	**4.76**	**4.76**	**4.97**	**4.70**	**4.54**
Administered	**7.13**	**7.95**	**8.64**	**8.45**	**8.18**
Low-octane gasoline	4.47	6.24	8.69	7.80	7.74
High-octane gasoline	4.39	4.54	6.68	5.81	5.74
Electricity	4.27	5.97	6.14	6.78	7.79
Residential-use gas	14.79	13.26	11.84	11.33	9.58
Regulated	**2.43**	**1.62**	**1.43**	**1.31**	**1.22**
Education	**6.63**	**6.47**	**6.52**	**6.57**	**6.51**

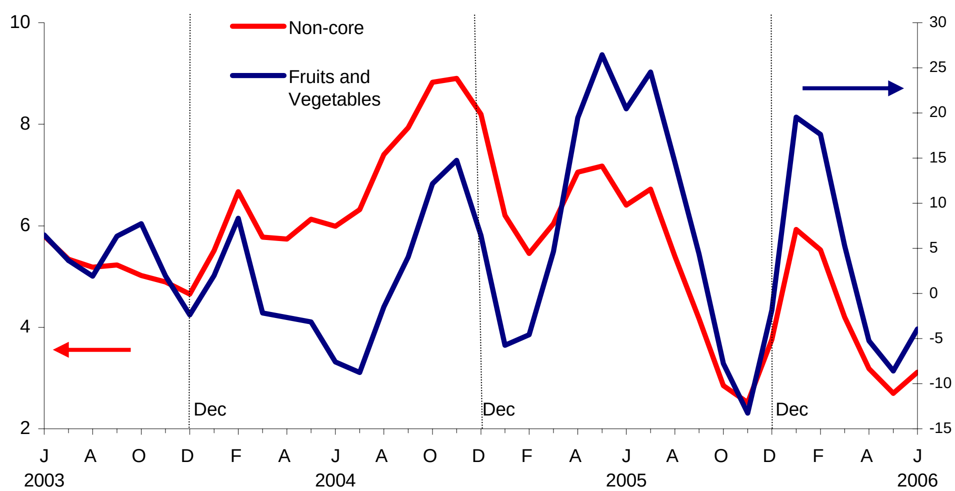
During the second quarter of 2006, headline inflation remained within the variability interval of plus/minus one percentage point around the 3 percent target. The Consumer Price Index (CPI) grew at an annual rate of 3.20, 3.00 and 3.18 percent in April, May, and June, respectively. Fluctuations exhibited by this indicator were mainly determined by the behavior of its non-core component (Table 1 and Graph 1).

Graph 1
Consumer Price Index
Annual percentage change



Annual non-core inflation was 3.12 percent at the end of the second quarter of 2006, 1.08 percentage points below the figure recorded at the end of the previous quarter (4.20 percent). This indicator exhibited some volatility during the analyzed period, mainly reflecting the fluctuations in fruits and vegetables' prices (Graph 2).

Graph 2
Non-core Price Index and Fruits and Vegetables Price Subindex
Annual percentage change

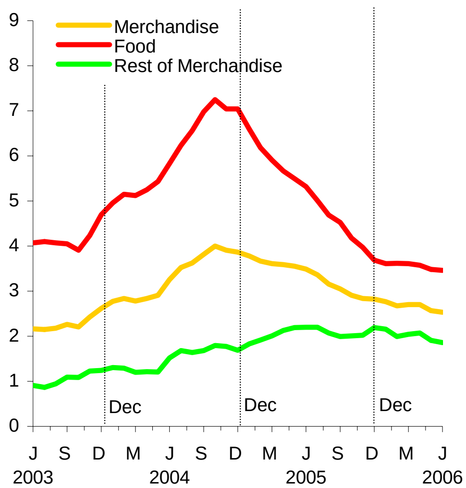


Fluctuations in annual non-core inflation between April and June 2006 were also influenced by the development of the prices of goods and services administered by the public sector, mainly by the increase observed at the beginning of the quarter in gasoline prices at border cities. Such an increase reverted partially afterwards, after the guidelines used by the government to determine these prices were modified (for a detailed description of the behavior of the administered price subindex, refer to section 3.3.2 of this Report).

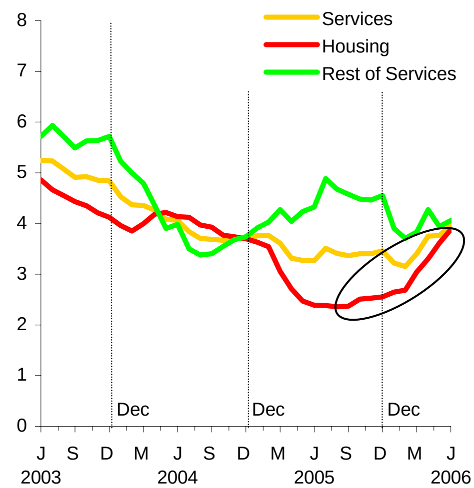
During the analyzed quarter, annual core inflation rose 0.18 percentage points, as a result of the higher annual variation of the subindex of services, which was partially offset by a decline in that corresponding to the merchandise subindex (Graph 3). Within the merchandise subindex, the annual variations of processed foods and of the rest of merchandise decreased (Table 1).

Graph 3
Core Merchandise and Services Subindexes

a) Merchandise
Annual percentage change

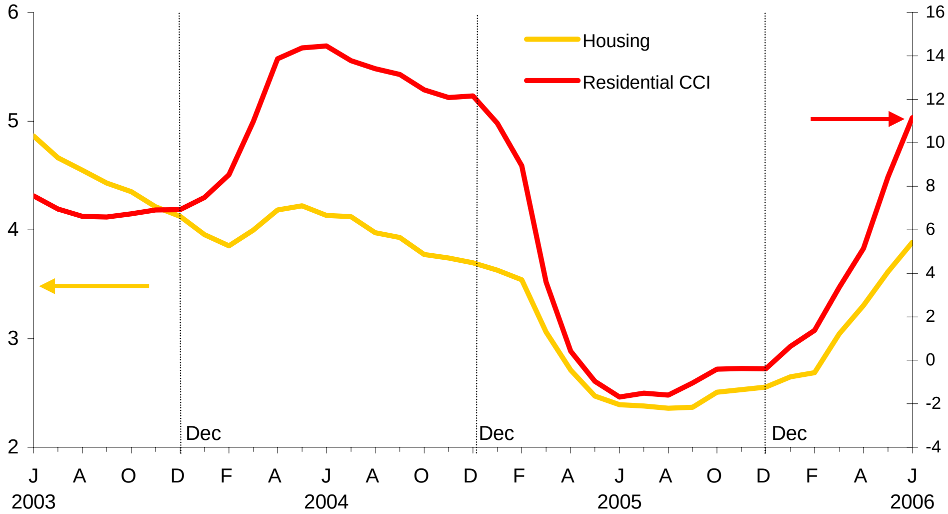


b) Services
Annual percentage change



The development of core services inflation during the second quarter of 2006 was mainly influenced by the faster growth rate of the housing services price subindex, which responded to increased costs of some construction materials related to steel, copper, and cement. In addition, the path of services inflation (excluding housing) contributed to the rise exhibited by core inflation (Graph 3). The jump in core inflation responded to the behavior of prices of several raw materials, energy and grains, among others, which affected the price determination process of air transportation, tourism, and food services.

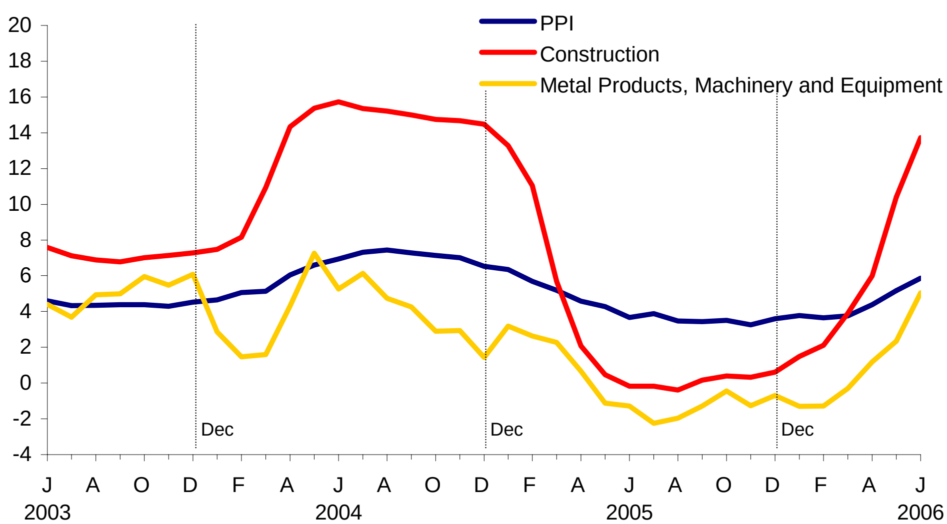
Graph 4
Housing Services Core Subindex and Residential Construction Cost Index
Annual percentage change



2.2. Producer Price Index

At the end of the second quarter of 2006, the Producer Price Index (PPI) excluding oil grew at an annual rate of 5.86 percent, figure 2.10 percentage points higher than that observed in March. Such increase was mainly due to upward movements in prices of steel and copper, which affected the prices of different construction materials such as metal products, machinery and equipment (Graph 5).

Graph 5
Producer Price Index Excluding Oil
Finished Goods and Services
Annual percentage change



3. Main Determinants of Inflation

3.1. International Environment

Available information suggests that global economic activity continued to expand at a high rate during the second quarter of 2006, accompanied by changes in the composition of world growth. The continuing world economic expansion led to greater resource utilization and, together with other factors, to further increases in commodity prices. Some analysts consider that the past increases in international oil prices may have been reflected in the pressures observed on core inflation, mainly in the U.S. and Europe. This contributed to create a perception of greater inflationary risks among the monetary authorities. In light of a greater likelihood of a further tightening in the stance of monetary policy, international financial markets began to exhibit higher volatility since the second week of May. In the emerging economies, this led to an increase in the perception of risk regarding these economies' debt instruments —especially debt denominated in domestic currency. There was a generalized decline in the prices of assets; however, the scope of the adjustment was differentiated across countries. Although volatility diminished at the end of the quarter, greater geopolitical turmoil in July prompted new increases in energy prices, and led to episodes of some uncertainty in financial markets.

3.1.1. Global Economic Activity

Timely information suggests that the global economy continued to exhibit solid growth during the second quarter of 2006. The U.S. economy recorded a significant expansion, although at a slower pace than during the first quarter, while the recovery in the Euro area continued. The Japanese economy continued to exhibit robust growth and economic activity in China remained strong. Such results contributed to high rates of economic expansion in emerging markets.

In the U.S., quarterly growth rates for GDP exhibited considerable fluctuations during the first half of 2006, following a transitory slowdown during the fourth quarter of 2005. Thus, once the factors that had depressed domestic demand during the last quarter of 2005 disappeared, GDP growth rebounded significantly, recording an annualized quarterly rate of 5.6 percent in the first quarter of 2006. Economic activity slowed again during the second quarter of the year, growing 2.5 percent on an annualized quarterly basis.

The volatility of U.S. economic activity suggested by the abovementioned annualized quarterly figures can be explained by the effect of the hurricanes, which hit the Gulf of Mexico towards the end of 2005. Annual growth rates for GDP, a more reliable indicator of the pace of economic expansion under these circumstances, suggest a gradual slowdown. Thus, the annual growth of GDP decreased from 3.7 percent during the first quarter to 3.5 percent in the second. Such results are mainly due to the lower growth rate of private consumption, which seems to reflect the effects of higher energy prices and a cooling housing market. Residential investment has been adjusting in response to the slowdown in the demand for new houses, and registered its first negative annual variation in five years during the second quarter. Although conditions remain favorable for growth in non-residential investment, this component also showed a lower rate of growth during the second quarter. Meanwhile, industrial activity continued to grow at high rates driven by the dynamism of exports. After increasing at an annual rate of 3.3 percent (5.1 percent on an annualized quarterly basis) during the first quarter, industrial production rose at an annual rate of 4.6 percent during the April-June period (6.6 percent on an annualized quarterly basis).

In the Euro area, economic activity rebounded during the first quarter of 2006, expanding by 2.5 percent on an annualized quarterly basis (2.0 percent at an annual rate), after having slowed down unexpectedly during the last quarter of 2005 (1.1 percent on an annualized quarterly basis and 1.7 percent at an annual rate). The recovery was mainly due to a strengthening of both consumption and exports. The European authorities expect a similar performance during the second quarter of the year.

In Japan, economic activity has continued to expand, now driven not only by the external sector but also increasingly by domestic demand. During the first quarter of 2006, GDP grew 3.1 percent at an annualized quarterly rate (3.5 percent at an annual rate). In the second quarter, economic growth remained robust in response to increased employment (and the consequent strengthening of household expenditure) and to the strength of private investment. Thus, by the second quarter of 2006, the duration of the current economic expansion will have equaled that recorded from 1986 to 1991 (18 quarters), which is the second longest since 1951.

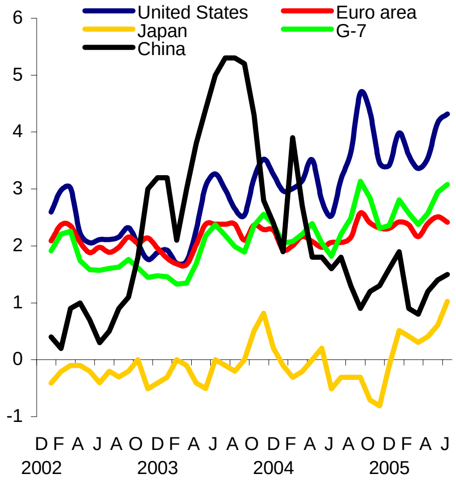
Emerging market economies have continued to exhibit solid growth. In China, GDP rose 11.3 percent at an annual rate during the second quarter of 2006. In recent months, the fast pace of expansion of demand has led to renewed concerns among analysts regarding the risk of economic overheating despite the fact that inflation remains low. As for the rest of emerging Asia, economic activity has remained robust. Meanwhile, in Latin America, GDP registered solid growth during the first quarter, above that observed during the October-December 2005 period.

3.1.2. General Trends of Inflation

Inflation followed an upward trend in the world's main economies during the second quarter of 2006. Such behavior reflected, among other factors, surging energy prices and increases in non-oil commodity prices (Graph 6).

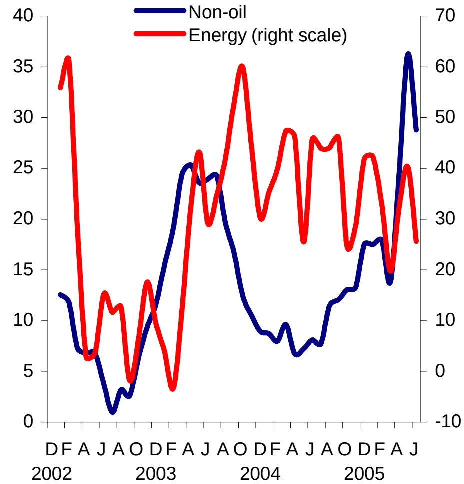
Graph 6
Consumer Price Indexes 1/
Annual percentage change

a) Consumer Price Indexes



Source: Bureau of Labor Statistics, Eurostat, Statistics Bureau, Statistics Canada and National Statistics.

b) Commodity Price Indexes



Note: The non-oil price index includes prices of foods, beverages, agricultural raw materials, and metals.
Source: International Monetary Fund.

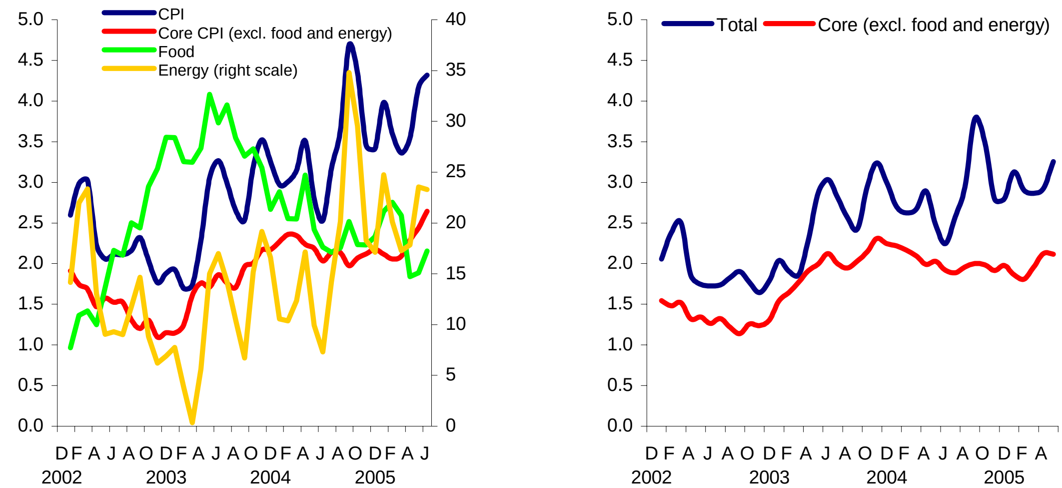
Oil prices rose considerably in April as it became apparent that global demand for oil would experience robust growth, while world production capacity would record a moderate increase. After a brief decline at the beginning of May, oil prices remained at high levels for the rest of the quarter, influenced by new geopolitical tensions associated with Iran. The price of WTI oil averaged 70.6 dollars per barrel during the second quarter (a little over seven dollars above the average observed during the previous quarter), reaching record levels in mid-July due to the emergence of conflicts in the Middle East.

The upward trend in the prices of non-oil commodities gained strength during the second quarter (Graph 6). According to the International Monetary Fund's index, during the first quarter the prices of these commodities rose 48.8 percent at an annualized quarterly rate (16.4 percent at an annual rate), while in the April-June period they recorded an increase of 61.1 percent at an annualized quarterly rate (29.8 percent at an annual rate). The most significant increases were observed in metal prices (130.1 percent at an annualized quarterly rate and 62.8 percent at an annual rate). Prices of food and agricultural raw materials also rose, but more moderately.

Headline inflation in the U.S. rebounded during the second quarter of 2006, while increased pressures on core inflation began to be observed (Graph 7). Consumer prices grew at an annual rate of 3.4 percent at the end of the first quarter but rose to 4.3 percent in June, surpassing previous expectations. CPI core inflation increased from 2 percent throughout the first quarter to 2.6 percent in June. The rise in the headline index was mainly due to the surges in energy prices observed during the last few months. The rebound in core inflation has been generalized, although higher in services and, particularly, in shelter related items.[1] Furthermore, some analysts believe that there could now be a greater pass-through from oil price increases to the core inflation indexes. It is important to mention that inflation is expected to decrease during the second quarter, and that long-term inflation expectations remain anchored at moderate levels.

Graph 7
U.S.: Price Indexes
Annual percentage change

a) Consumer Prices b) Personal Consumption Deflator



Source: BLS. Source: BEA.

Annual inflation in the Euro area rose from 2.2 percent in March to 2.5 percent in June, mainly as a sequel to rising oil prices. Although increases in labor costs have been moderate, the European authorities believe that inflation will remain at high levels for the remainder of 2006 and during 2007, partly as a result of the indirect effects of past increases in energy prices. In Japan, the recent behavior of inflation points to the end of deflation in that country. By June 2006, the core inflation index had recorded eight consecutive months of positive annual growth.

As for East Asia, inflation in the region has remained relatively contained, although higher inflationary pressures have been observed in several countries due to the strength of economic activity and the impact of energy price increases. Inflation in Latin America has exhibited a downward trend. Nonetheless, in some countries, such as Argentina, annual CPI inflation continues at double digits.

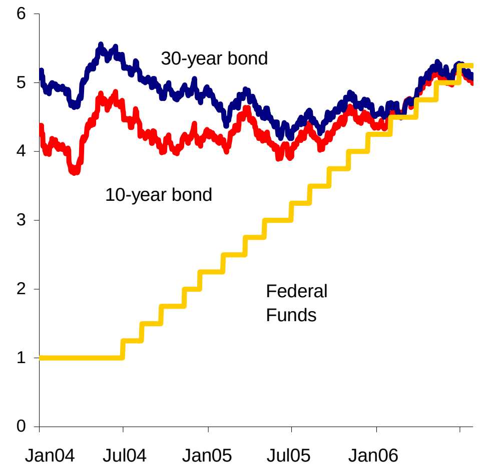
[1] The CPI includes several items related to shelter. The most important of these are rents and owner equivalent rent for owner-occupied houses, with a weight of some 29 percentage points in the CPI. Both indexes are calculated using data on the price of house rents. Several analysts have pointed out that past house price increases have begun to be reflected in higher rents after a period when expectations of a rapid rise in housing values fostered housing purchases as a better option than rented accommodation. Nonetheless, the recent cooling of the property market and the perception of higher interest rates in the future have made rented accommodation more attractive and, thereby, accelerated the convergence of rents with past house price increases.

3.1.3. Financial Markets

Conditions of relative ease continued to prevail in international financial markets despite the gradual rise in U.S. long-term interest rates with respect to their level at the start of the year. The yield for the 10-year U.S. Treasury bond was 5.14 percent at the end of the second quarter, after having been 4.85 percent at the end of the first quarter and 4.39 percent in December 2005 (Graph 8). Nonetheless, long-term interest rates remain at comparatively low levels. The moderate rise of long-term interest rates in a context where inflation expectations remain apparently stable is indicative of the difficulties to evaluate the future risks for inflation and economic growth.

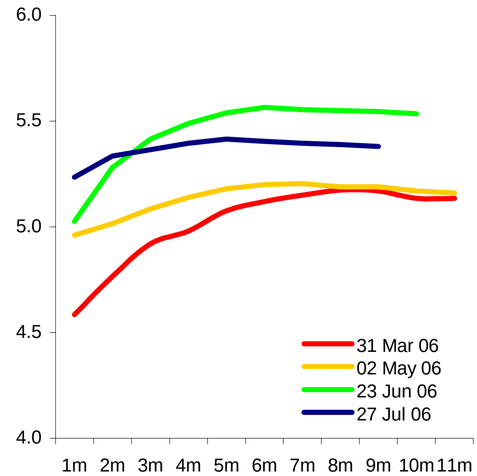
Graph 8
U.S. Interest Rates
Annual percent

a) Yield on U.S. Treasuries and Federal Funds Rate



Source: The Federal Reserve.

b) Federal Funds Futures



Source: Bloomberg.

During the second quarter of 2006, the Federal Reserve continued its policy of increasing its target rate by ¼ of a percentage point at each Federal Open Market Committee meeting. In response to increased inflationary pressures, forecasts for the federal funds rate were revised upward in mid-May, leading to a period of volatility in international financial markets. Nonetheless, this turbulence diminished after the FOMC meeting in June, when the target for the federal funds rate reached 5.25 percent. On that occasion, the Committee announced that although the moderation of economic growth should help to limit inflationary pressures, some inflation risks remained, and reiterated that future policy decisions would depend on the evolution of the outlook for both inflation and economic growth. Under such context, the futures curve for the federal funds rate moved downwards.

In the Euro area, the European Central Bank decided to raise its policy rates for the second time in the year at the start of June (the third increase since the beginning of the present tightening cycle in December 2005). Thus, the main reference interest rate increased 25 basis points to 2.75 percent. In its July meeting, the European monetary authority left its policy rates unchanged, while underlining that it would remain alert due to the fact that inflationary risks are increasing and monetary policy continues to be accommodative. Meanwhile, continued economic expansion in Japan has helped to narrow the output gap. As a result, expectations that the Bank of Japan would end its zero interest rate policy in the near future gained strength. Short-term interest rates in that country rose slightly at the end of the second quarter, ahead of the Japanese central bank's first adjustment to its reference interest rate, which took place on July 14.

Expectations of a more restrictive global monetary policy led to considerable volatility in international financial markets from the second week of May onwards. The latter was also influenced by the fact that leveraged positions, undertaken to take advantage of the availability of financing in currencies with low interest rates, began to be reverted. Such volatility was evident in emerging economies' foreign exchange and stock markets. The adjustment in stock markets during May and June led to their largest decline since 1998. Nonetheless, the upswing during the first few months of the year and the recovery since mid-June has meant that, despite this period of turbulence, many of these markets are still above the levels observed at the end of 2005.

In the foreign exchange markets, the US dollar weakened significantly between mid-April and mid-May. After the second week of May, such depreciation began to be reverted and the currencies of several emerging economies depreciated against the US dollar. Such was the case of the Turkish lira, which fell 20 percent vis-à-vis the US dollar in the last two months of the quarter. In Latin America, the Brazilian real and the Chilean peso depreciated by 4.1 and 4.7 percent against the US dollar, respectively, in the same period. During the second quarter, the US dollar effective nominal exchange rate, measured by the Federal Reserve Board's broad index, depreciated by 1.6 percent in relation to the average of the previous quarter.[2]

The widening of sovereign debt spreads was not as marked during this period of volatility. Sovereign spreads in emerging markets (EMBI Global) increased 39 basis points during the May-June period,[3] without any discernable differences between regions. Nonetheless, the bonds most affected by financial market volatility were those of countries with high external financing requirements and, in general, those with higher risk perceptions, such as Turkey.

The recent period of volatility has been seen by some market analysts as a process of correction in investors' risk perceptions (stemming from greater uncertainty surrounding inflation and the likely monetary policy response), and not as a shift in expectations concerning the global macroeconomic outlook. By the end of the second quarter, international financial markets exhibited greater stability and markets had staged a partial recovery, without the period of turbulence having unduly affected growth and inflation prospects in most emerging economies. Nonetheless, renewed geopolitical tensions led to volatility in some markets during July.

[2] The broad index is a weighted average of the US dollar's exchange rate vis-à-vis the currencies of this country's main trading partners (26 countries, including emerging market economies).

[3] EMBI Global sovereign spreads decreased 24 basis points between the end of June and July 27.

3.1.4. Outlook

The outlook for the world economy for the remainder of 2006 and 2007 is favorable. The current phase of global economic expansion is expected to continue. In the U.S., a gradual downshift in the pace of economic growth is expected in response to, among other factors, a slower expansion of consumption and a cooling of the housing market. Meanwhile, forecasts are for economic recovery in Japan to continue, economic growth in the Euro area to accelerate, and emerging market economies to exhibit positive results, in general. Despite the gradual reduction of output gaps in the main advanced economies, no signs of increased wage pressures have been observed. Nevertheless, greater resource utilization coupled with increases in commodity prices (particularly oil) has led to greater risks to the outlook for inflation.

Increased risks for inflation in the U.S. and other countries have modified the outlook for the path of monetary policy in the main advanced economies. Although, up to now, the adjustment of international financial markets to such changes has been relatively orderly, a further deterioration in the international financial environment cannot be ruled out in view of the persistence of significant risk factors. On the one hand, oil prices remain high and there is a risk that geopolitical or other factors could push these prices even higher. In a context in which some analysts believe that an increased pass-through from energy prices to core inflation could be taking place in several countries, this might lead to higher than expected increases in interest rates. Furthermore, although housing prices have declined in some countries, such prices are still at historically high levels in some of them, and a strong adjustment in property values, however unlikely, could weaken the current economic expansion. Finally, in the longer term, it is important to underline the persistence of risks derived from global disequilibria in current accounts (particularly in the U.S. and China), with the resulting potential of an adjustment in foreign exchange markets.

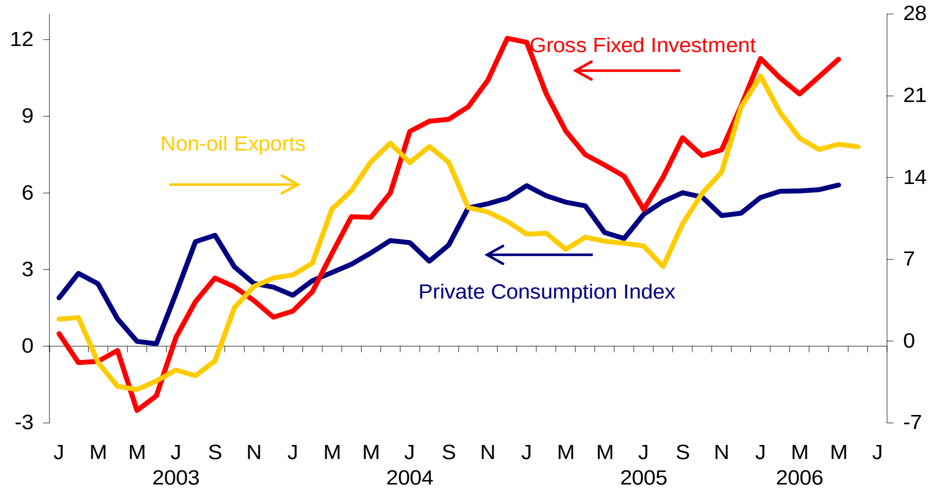
3.2. Aggregate Demand and Supply in Mexico

3.2.1. Indicators of Aggregate Demand and Supply

During the first half of 2006, aggregate demand and GDP grew above 2005 figures in annual terms. In general terms, during the first half of the year, aggregate demand was characterized by the following aspects: i) a higher annual growth of both domestic and external demand; ii) a persistent dynamism of consumption expenditure (Graph 9); iii) a higher expansion of investment expenditure in annual terms, being the most important that of imports of capital goods; and, iv) a consolidation of the improvement of exports of goods and services recorded during the second half of previous year. This last development was observed during both, the first and second quarters of the year.[4]

[4] The behavior of private consumption indicators during the second quarter of 2006 reveals that during the April-May period seasonally adjusted retail sales grew at an annual rate of 2.7 percent (1.3 percent at an annual rate with original figures). In addition, during the second quarter ANTAD sales grew 16.5 percent at an annual rate. According to investment indicators, investment is expected to have risen at an annual rate of 8.7 percent during the April-May 2006 period (11.2 percent according to seasonally adjusted figures). During the second quarter, imports of capital goods measured in current US dollars grew 18 percent. As for investment expenditure, during the January-May period it grew at an annual rate of 11.1 percent, a higher rate than the figure reported in the last five years.

Graph 9
Domestic and External Demand Indicators
Annual percentage change of seasonally adjusted data (2-month moving average)

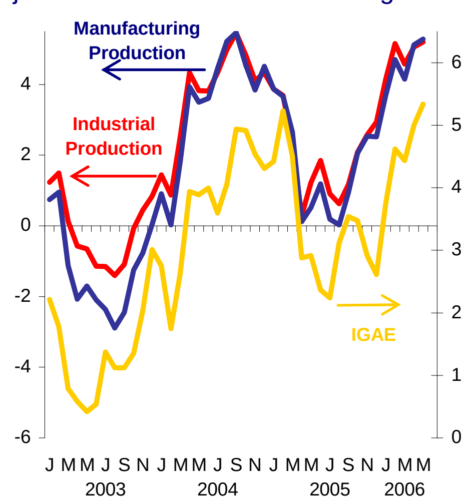


Source: INEGI for Gross Fixed Investment and Banco de México for the Monthly Index of Private Consumption and for Non-oil Exports. Non-oil exports measured in current US dollars. Seasonal adjustments by Banco de México

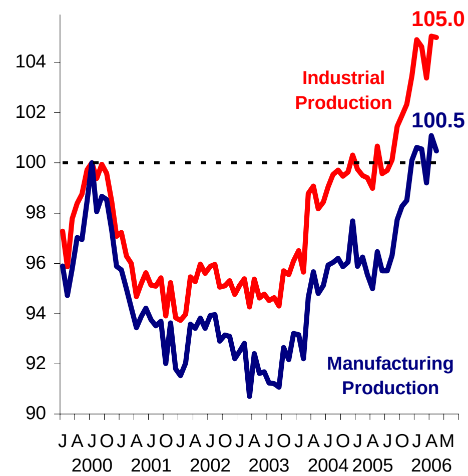
The rebound in economic activity during the first two quarters of 2006 benefited from several external factors. First, external demand exhibited a positive behavior, therefore contributing to the greater dynamism of non-oil exports. Second, the completion of important automotive industry investment projects led to significant growth in automotive production and exports. Such investment enabled the modernization of production lines for new models and also increased automobile manufacturers' offerings. Third, during the first six months of 2006, and just as in the previous two years, the strength of domestic expenditure and production was boosted by new increases in the oil trade surplus and by higher revenues from workers' remittances.

Graph 10
Production Indicators

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



b) Seasonally Adjusted Series
July 2000=100

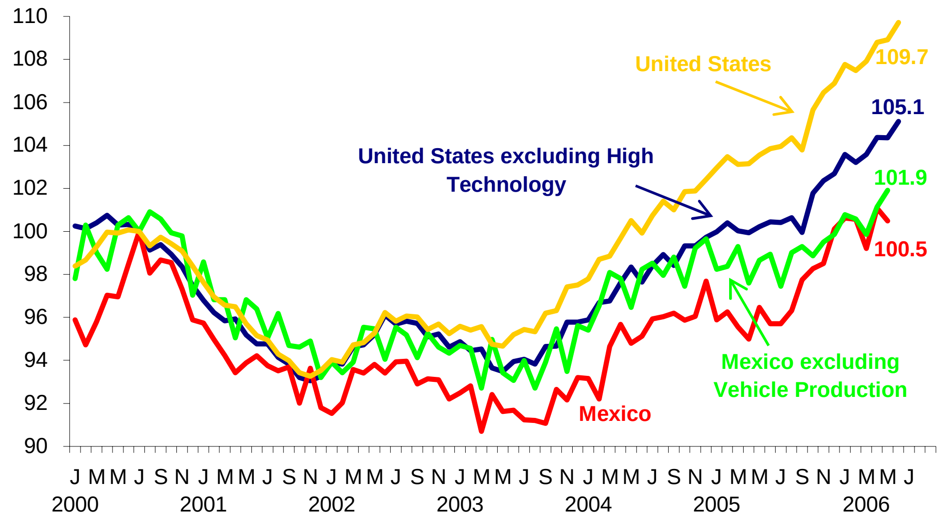


Source: INEGI. Seasonal adjustments by Banco de México.

During the first six months of 2006, aggregate supply was characterized by higher annual growth of both GDP and imports of good and services, than that recorded during 2005.[5] Furthermore, expansion was balanced among the sectors, as all three economic activities (agricultural, industrial and services) grew significantly in annual terms.[6]

One important aspect in the behavior of GDP during the first six months of 2006 was the significant improvement of industrial production (Graph 10). This rebound was due to increased activity in all four of its sectors (mining, manufacturing, construction, and electricity), the recovery in manufacturing being the most significant (Graph 11).[7] The improvement in manufacturing began at the end of 2005 mainly as a result of higher growth of export-related production, while production for the domestic market has also recovered slightly during recent months. The strength of export-related production has been reflected in the growth of manufacturing exports, especially vehicles.

Graph 11
Manufacturing Production in Mexico and the United States
Seasonally adjusted data, July 2000=100



Source: INEGI. Federal Reserve Board for U.S. data. Seasonal adjustments for the series "Mexico excluding Vehicle Production" by Banco de México.

The automotive industry is of significant relevance for the Mexican economy due to its production value, the employment it creates, and its effect on Mexico's foreign trade. Regarding the latter, it is important to mention the industry's significant trade surplus. Vehicle production of most automotive companies in Mexico rose considerably during 2005 and in the first half of 2006, mainly in response to the production of new models for export to the U.S. Thus, in

5 During the April-May period, the Global Economic Activity Indicator (*Indicador Global de la Actividad Económica*, IGAE) grew at an annual rate of 3.9 percent (5.3 percent with seasonally adjusted data).

6 Growth in the agricultural sector during the second quarter of 2006 benefited from higher precipitation levels, which allowed a significant increase in crop planting during the period. Such results contrast with the delayed rains and even drought seen in some regions of the country during the same quarter of 2005.

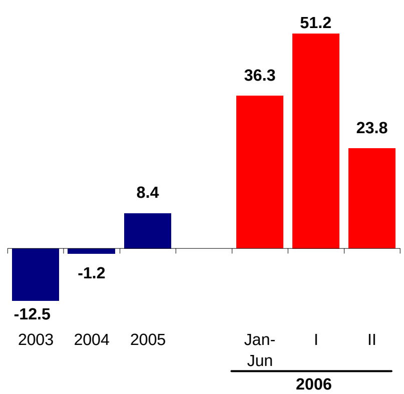
7 During the period April-May 2006, industrial and manufacturing production grew at an annual rate of 2.4 and 2.1 percent, respectively, while on the basis of seasonally adjusted figures they did so by 5.2 and 5.3 percent. Vehicle production (Branch 56) grew at an annual rate of 17.6 percent and 24.5 percent on a seasonally adjusted basis.

the second quarter, vehicle production and exports grew at annual rates of 23.8 and 35.4 percent, respectively (29.8 and 39.2 percent with seasonally adjusted figures). Such results have led to a significant increase in the share of Mexican manufactured models in U.S. car sales (Graph 12).

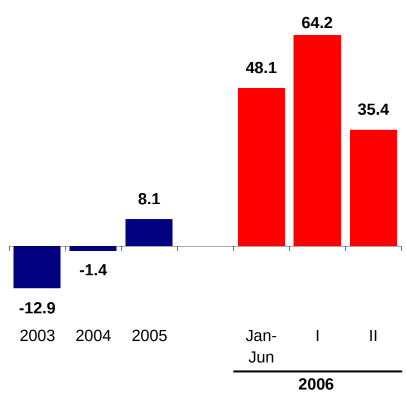
Based on the aforementioned, as well as on the performance of other indicators of economic activity, annual GDP growth is expected to have been over 4 percent during the second quarter of 2006, after having expanded 5.5 percent during the first quarter. During the second and first quarters of the year, GDP (and several components of aggregate demand) was influenced by the statistical effect of the Easter holiday.[8] Measured with seasonally adjusted figures in order to correct for the aforementioned statistical effect, annual GDP growth during the second quarter of 2006 is expected to have been higher than that observed during the first quarter of the same year.

Graph 12
Automotive Industry Indicators

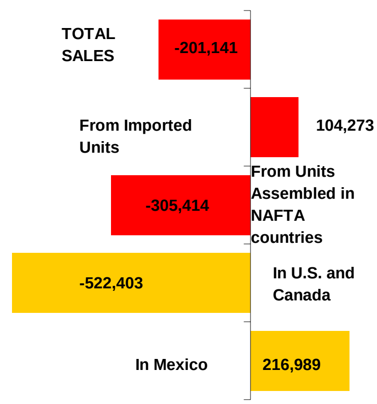
a) Total Production
Annual percentage change of number of vehicle units



b) Total Exports
Annual percentage change of number of vehicle units



c) United States: Annual Variation of Vehicle Sales; January-June 2006
Number of units



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

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

A significant aspect of the development of Mexican economic activity during 2006 is that the higher growth of both GDP and domestic demand has not implied pressures on the economy's production capacity, considering that: i) GDP growth was balanced among all three sectors. The improved performance of the agricultural sector is basically due to benign weather conditions, while the services sector has expanded similarly as in the previous two years. As for the increased rate of growth of the industrial sector, it has reflected, at the margin, higher manufacturing production, after having grown modestly during the previous year. This improvement is mainly due to the greater dynamism of external demand in various sectors and to the rebound in vehicle exports; ii) despite the progress of manufacturing production, its level during the second quarter of 2006 barely

[8] The statistical effect of the Easter holiday resulted in less working days during the second quarter of the year than in the same quarter of 2005, while it had the opposite effect in the first quarter of 2006. This had a downward influence on annual GDP growth during the second quarter and an upward influence in the first.

exceeded its maximum previous levels reached in mid-2000;[9] iii) the branch of manufacturing that has exhibited greater dynamism in 2006 has been the automotive-production industry, due to the production of new models, after the vehicle assembly companies did significant investments to modernize and expand their production capacity; and, iv) since 2004, production capacity has strengthened gradually, considering that investment has recovered significantly after having remained weak for three years. One indicator of the strength of the investment process and of the modernization of capital stock and its potential impact on the country's production capacity is the increase in the value of capital goods imports. Such purchases rose 48.7 percent measured in current US dollars between the first half of 2003 and the same period of 2006.

3.2.2. Employment

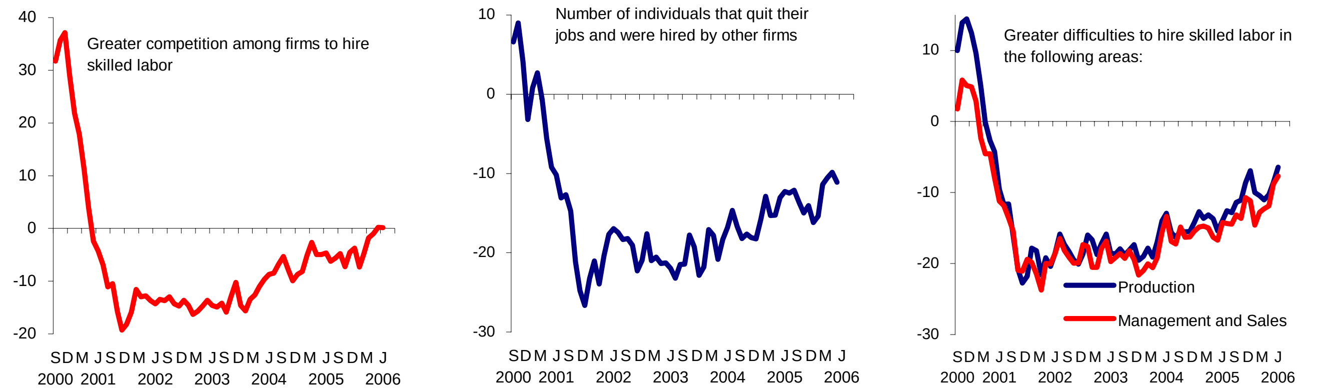
Economic expansion during the first half of 2006 was reflected in an increase in the demand for labor which led to an improvement in several employment indicators. Thus, the recovery of job creation in most sectors of the economy recorded during the first quarter of the year strengthened during the second quarter. Furthermore, the national and urban unemployment rates dropped slightly during the second quarter. Available information suggests the improvement in the labor market was not reflected in a greater shortage of skilled labor. Manufacturing sector employment indicators prepared by Banco de México show that during the second quarter of the year, firms did not face difficulties to recruit and hire skilled labor for their production, sales and management areas (Graph 13). Furthermore, there was no increase in the competition between firms to hire skilled labor. Thus, results from Banco de México's monthly survey of private sector analysts' forecasts hardly mention a shortage of skilled labor or labor costs as factors that could hinder economic activity in Mexico during the following six months.[10]

During the second quarter of 2006, the labor market was characterized by the following: i) improvement in formal employment, measured by the number of workers insured by the IMSS; ii) formal employment growth concentrated more in temporary jobs in urban areas, although creation of permanent jobs exhibited greater strength during the period April-June; iii) the number of workers insured by the IMSS rose in most sectors, the highest increases being in services and construction, although the increase was also significant in manufacturing; iv) the national open unemployment rate fell slightly; and, v) the number of workers employed considered as underemployed or working in informal-related activities remained high.

[9] This result mainly reflects the performance of the maquiladora industry, whose output level is currently measured through the number of man-hours worked. This indicator underestimates production levels compared to that which would be seen if indicators of actual production volumes or maquiladora industry's exports were considered.

[10] During the second quarter of 2006, only 1.43 percent of responses mentioned "increased wage costs" or "a shortage of skilled labor" as factors which could hamper economic activity over the following six months. See results of the Survey of Private Sector Analysts Forecasts June 2006.

Graph 13
Labor Market Indicators
Manufacturing Sector: Labor Shortage Indicators
2-month moving average of balance of responses



Source: Results from Banco de México's Monthly Survey of Economic Conditions in the Manufacturing Sector. Balance of responses refers to the weighted average of enterprises mentioning to have faced greater competition from other firms to hire skilled labor (or enterprises mentioning that the number of workers that resigned to be hired in other firms increased) less those mentioning to have faced less competition from other firms to hire workers. In the case of the right-hand graph, the balance of responses refer to the percentage (weighted) of firms that mentioned to have faced greater difficulty to hire labor less those mentioning to have faced less difficulty.

At the end of the second quarter of 2006, the number of workers insured by the IMSS increased by 832,580 in annual terms (6.5 percent growth) (Graph 14b). Such increase was the highest recorded by this indicator in the last 72 months (since July 2000)[11] and comprised 350,456 permanent jobs (3.2 percent growth) and 482,124 temporary jobs (25.8 percent growth). Therefore, temporary jobs in urban areas accounted for almost 58 percent of the increase. However, during the last few months, permanent jobs increased more than temporary positions. Thus, 51 percent of the 279,539 new formal jobs recorded from the end of the first quarter to the end of the second quarter were permanent positions.

Seasonally adjusted figures for formal employment show that in June 2006 this indicator surpassed its historic maximum reached at the end of 2000 by 1,032,522 workers (Graph 14a).

The increase in formal employment during the second quarter of the year comprised all sectors of economic activity and was particularly high in construction (141,452 workers and 14.2 percent), trade activities (153,471 workers and 6.2 percent) and in other services (302,064 workers and 7.1 percent).[12] Manufacturing employment also improved significantly (173,389 workers and 4.6 percent). Thus, the recovery of manufacturing employment that began in 2004 continued during the first half of 2006. Nonetheless, on a seasonally adjusted basis, and up to the end of June 2006, the total number of manufacturing workers insured by the IMSS fell by 518 thousand (11.5 percent) as compared to its level in October 2000 (Graph 15a).[13] In fact, the accumulated growth of manufacturing employment has only included temporary positions in

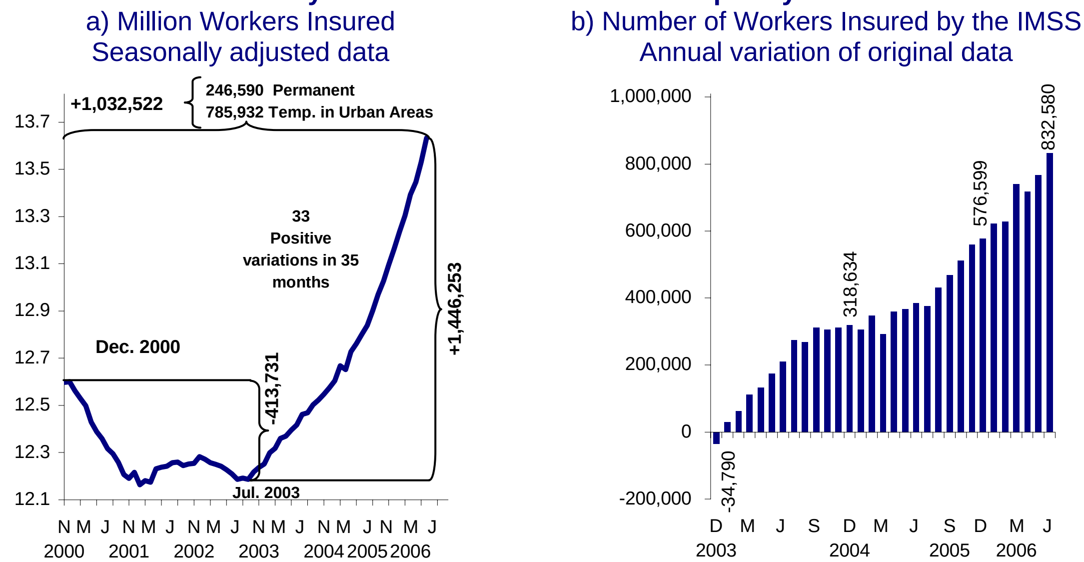
[11] As mentioned in previous Inflation Reports, the increase in the number of workers insured could also be reflecting the results of greater fiscalization efforts by the IMSS.

[12] The sector Other Services includes services for enterprises and individuals, as well as social and community services.

[13] The weakness of manufacturing sector employment has been a feature of several economies during the last few years. See Box 1: Manufacturing Employment in the U.S. and Mexico, in the Inflation Report April-June 2005 (pages 21 and 22).

urban areas due to the fact that during the aforementioned period of over five years, the number of permanent workers in this sector declined significantly.

Graph 14
Workers Insured by the IMSS: Permanent and Temporary in Urban Areas



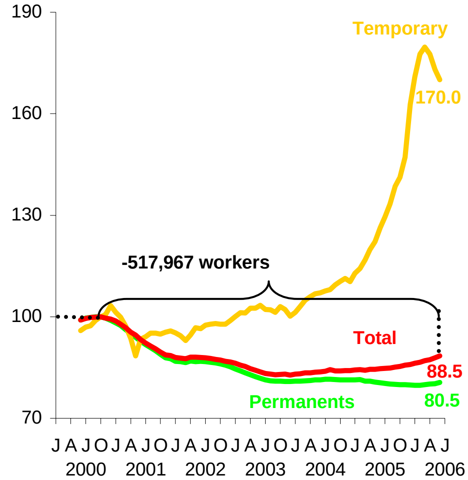
Source: IMSS. Seasonal adjustments by Banco de México.

According to the Occupation and Employment Survey (Encuesta Nacional de Ocupación y Empleo, ENOE) conducted by INEGI, during the second quarter of 2006, the national and urban unemployment rates declined slightly. On a seasonally adjusted basis, the former fell from 3.41 percent during the first quarter to 3.37 percent in the second (Graph 15b), while unemployment in urban areas decreased from 4.4 percent to 4.36 percent during the same period. Finally, in June of this year, the percentage of working population which considered themselves as underemployed was 5.72 percent, while the working population in informal-related activities was 27.8 percent during the first quarter of 2006.[14]

[14] According to the Occupation and Employment Survey (ENOE) conducted by INEGI, the underemployed population is made up of individuals that need to work and are available for working more hours than the number of hours they are currently working. As for the working population in the informal sector, it includes individuals participating in economic market activities operating with their own household resources, but not established as enterprises with a status independent from households. In such production units there are no accounting practices and no distinction is made between households and enterprise wealth.

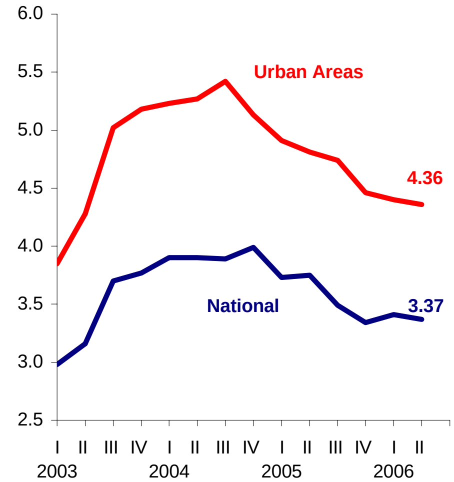
Graph 15
Labor Market Indicators

a) Manufacturing Workers Insured by the IMSS
Seasonally adjusted data, Workers Indexes: October 2000=100



Source: IMSS and seasonal adjustments by Banco de México.

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



Source: INEGI and seasonal adjustments by Banco de México.

3.2.3. External Sector

During the second quarter of 2006, and just as in the previous quarter, the current account of the balance of payments recorded a surplus. Such result was obtained despite the higher annual growth of aggregate demand as compared with that shown in 2005 and the fact that domestic expenditure growth outpaced GDP with the consequent increase in goods imports.

During the second quarter of 2006, the external sector was characterized by the following aspects:

a) As in the first quarter, non-oil exports registered higher growth than that observed during the entire 2005.[15] It is important to note that figures for external trade during the second quarter (just like other indicators of economic activity) were influenced downward by the statistical effect of the Easter holiday. Thus, the annual growth of non-oil exports during the second quarter was lower than that observed during the first quarter of the year. However, measured on a seasonally adjusted basis, annual growth was similar in both quarters.

b) Terminal automotive industry manufacturing exports continued to exhibit robust annual growth (Graph 16).[16]

[15] During the second quarter of 2006, merchandise exports rose 18.1 percent in annual terms (14 percent in the entire 2005), in response to an increase in oil (36.4 percent) and non-oil (15 percent) exports. Within non-oil exports, manufacturing exports (both maquiladora and non-maquiladora) grew 15.3 percent.

[16] During the second quarter, manufacturing exports from the automotive sector grew 20 percent in annual terms (23.5 percent based on seasonally adjusted figures), as a result of a 32.6 percent increase in

c) A significant annual growth of oil exports driven by further increases of international crude oil prices. In fact, the value of oil exports as well as the average price of the Mexican crude oil export mix reached unprecedented historically high levels during the quarter.

d) A higher annual growth of merchandise imports with respect to that observed in the entire 2005. Such increase included all three of its components (intermediate, capital and consumption goods), with the expansion of capital goods imports being the most noteworthy.[17] On the basis of seasonally adjusted figures, the annual increase of imports was higher than that recorded during the first quarter of the year.

e) A moderate rise in the non-oil trade deficit, partly in response to the higher dynamism of domestic expenditure with respect to GDP growth. However, such deficit continued to be influenced downward by the favorable behavior of automotive exports.

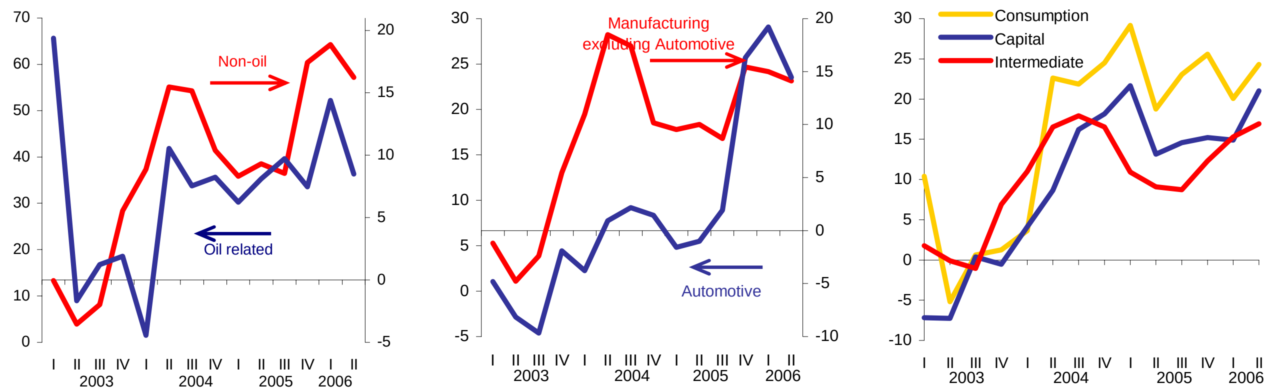
During the April-May 2006 period Mexican exports to the U.S. grew 14.25 percent in annual terms, figure higher than the expansion registered by that country's total imports (12.34 percent). This implied that Mexican exports gained share in U.S. imports, from 10.56 percent during the period April-May 2005 to 10.74 percent during the same period of 2006. Such improvement mainly reflected the favorable behavior of oil and automotive exports. If such products are excluded from total Mexican exports to the U.S., the share of Mexican products in U.S. imports decreases slightly from 8.58 to 8.52 percent. However, it is important to point out that, even after oil and automotive exports are excluded, the share of Mexican exports in U.S. imports improved during the first five months of 2006.

vehicle exports and a 9.7 percent rise in exports of the remaining automotive sector products (maquiladora and non-maquiladora).

[17] Merchandise imports grew 16.9 percent in annual terms (18.4 percent based on seasonally adjusted figures) during the second quarter, while in the first quarter of the year they expanded 19.2 percent in annual terms (15.9 percent based on seasonally adjusted figures). Such rates were higher than the one registered during the entire 2005 (12.7 percent). The aforementioned behavior during the second quarter of 2006 stemmed from increases in imports of intermediate and capital goods (16 and 18 percent, respectively) as well as those of consumer goods (20.6 percent). The growth of consumer goods imports was influenced upward by a considerable increase in the value of gasoline imports (108.2 percent). In fact, if the latter are deducted from total imports of consumer goods, remaining imports grew at an annual rate of 8.1 percent during the second quarter.

Graph 16
Merchandise Exports and Imports
Annual percentage change of seasonally adjusted data

a) Exports b) Manufacturing exports c) Imports



Source: Banco de México.

During the second quarter of 2006, and just as in the first quarter, the surplus in the current account mainly resulted from three factors: a higher surplus in both automotive and oil trade balances, and, increased resources from workers' remittances. In particular, the oil trade surplus rose from 4.247 billion US dollars during the second quarter of 2005 to 5.41 billion during the same quarter of 2006, while the automotive trade balance increased from 4.73 billion to 6.075 billion during the same period. Resources from workers' remittances amounted to 6.241 billion US dollars during the second quarter of 2006, 1.027 billion (19.7 percent) more than in the same period of 2005.

Table 2
U.S. Imports
Percent

	Share				Annual Percentage Change: 2006					
	January - May		April - May		April-May					Jan-May
	2005	2006	2005	2006	Total	Oil	Total excluding Oil	Automotive	Total excluding Oil and Automotive	Total excluding Oil and Automotive
Total	**100.00**	**100.00**	**100.00**	**100.00**	**12.34**	**32.11**	**10.08**	**9.01**	**10.29**	**11.59**
Total excluding Mexico	**89.65**	**89.16**	**89.44**	**89.26**	**12.11**	**30.39**	**10.11**	**8.66**	**10.36**	**11.51**
Total excluding Mexico and China	**76.13**	**75.18**	**75.74**	**74.96**	**11.17**	**30.46**	**8.65**	**8.66**	**8.64**	**10.12**
1. Canada	17.53	17.46	17.30	16.93	9.94	57.54	6.29	6.60	6.18	10.61
2. China	13.52	13.98	13.69	14.30	17.28	7.29	17.30	--	17.30	17.26
3. Mexico	**10.35**	**10.84**	**10.56**	**10.74**	**14.25**	**42.84**	**9.83**	**10.53**	**9.53**	**12.39**
4. Japan	8.66	8.06	8.30	7.93	7.28	--	7.28	12.52	4.03	2.08
5. Germany	5.22	4.97	5.27	4.98	6.05	--	6.05	1.19	8.31	10.30
Total 5 countries	55.28	55.31	55.13	54.87	11.82	49.27	9.91	8.34	10.36	11.93

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

Based on the aforementioned, as well as on the performance of other components of the external accounts, the current account of the balance of payments is estimated to have recorded a surplus of approximately 1.3 billion US dollars during the second quarter of 2006. Such results imply that the accumulated current account surplus during the first half of 2006 might have been 2.1 billion US dollars (a deficit of 2.444 billion US dollars was recorded in the first half of 2005). Meanwhile, the capital account (including errors and omissions) is expected to have recorded a surplus of around 10 billion US dollars during the second quarter of 2006. Such result was mainly due to net inflows of resources from foreign investment, both direct and portfolio, and public sector's net outflows originated by a reduction of foreign debt. During the second quarter, Banco de México's net international reserves increased by 11.256 billion US dollars. Thus, at the end of June, the stock of international reserves recorded 78.743 billion US dollars.

3.3. Costs and Prices

3.3.1. Wages and Unit Labor Costs

Wage increases negotiated by firms under federal jurisdiction during the second quarter of 2006 were, on average, the same as those granted during the same period of 2005. Thus, during this period, this type of contracts (which have 12-month validity), rose by 4.4 percent. The annual variation of wages in public enterprises was, on average, 4.0 percent, while the average growth of wages in private enterprises was 4.5 percent (Table 3).

Table 3
Contractual Wage Average Increases and Number of Workers Benefited by Type of Enterprise

	2005					2006					
	I	II	III	IV	Jan-Dec	I	II	Apr	May	Jun	Jan-Jun
Contractual Wage Increase (Percent)[1/]											
Total	4.5	4.4	4.4	4.2	4.4	4.3	4.4	4.4	4.2	4.6	4.3
Public Enterprises	3.6	4.0	4.1	4.0	4.0	4.0	4.0	3.5	4.0	4.1	4.0
Private Enterprises	4.7	4.6	4.7	4.7	4.6	4.3	4.5	4.4	4.4	4.7	4.4
Number of Workers Benefited (Percentage Share)											
Total	100	100	100	100	100	100	100	100	100	100	100
Public Enterprises	19	22	46	72	41	19	27	1	53	8	22
Private Enterprises	81	78	54	28	59	81	73	99	47	92	78

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

Table 4
Earnings, Labor Productivity and Unit Labor Costs by Sectors
Annual percentage change

	2004	2005		2006				
	Jan-Dec	Jan-Apr	**Jan-Dec**	Jan	Feb	Mar	Apr	**Jan-Apr**
Non-maquiladora Manufacturing Industry								
Labor Productivity	**7.1**	2.3	**2.0**	6.4	4.9	10.6	-1.7	**5.0**
Real Average Earnings	**0.3**	-0.5	**-0.1**	0.3	1.0	0.2	0.9	**0.6**
ULC	**-6.3**	-2.5	**-2.0**	-5.7	-3.7	-9.4	2.7	**-4.0**
Maquiladora Industry[1/]								
Labor Productivity	**2.5**	-2.1	**-1.1**	1.6	-0.2	1.8	-2.3	**0.2**
Real Average Earnings	**-0.2**	-1.9	**0.4**	1.2	1.6	3.2	2.5	**2.1**
ULC	**-2.6**	0.2	**1.6**	-0.4	1.8	1.3	4.9	**1.9**

1/ Manufacturing production estimates are based on total hours worked. Thus, average labor productivity per worker reflects labor intensity in the productive process.
Source: Prepared by Banco de México with data from INEGI.

During the period January-April 2006, average unit labor costs in the non-maquiladora manufacturing industry fell. Such reduction was higher than that observed in 2005, as a result of increased labor productivity (Table 4). On the contrary, ULC in the maquiladora industry grew, as compared to their level during the same period of 2005, due to an increase in real average wages.

3.3.2. Administered and Regulated Prices of Goods and Services

The administered prices subindex posted an annual variation rate of 8.18 percent in June 2006, 0.23 percentage points above its level in March. Such result was due to the increase in both gasoline prices at the border and high consumption electricity tariffs. In the case of gasoline prices, such increase responded, first, to the upward movement in the international references of this fuel; however, after the maximum price for border cities was determined, this trend was interrupted.[18] As for high consumption electricity tariffs, the increase was due to the upward movement in metal prices, which affect the formula for calculating this service.[19] In contrast, the annual growth rate of residential-use gas prices decreased (Graph 17).

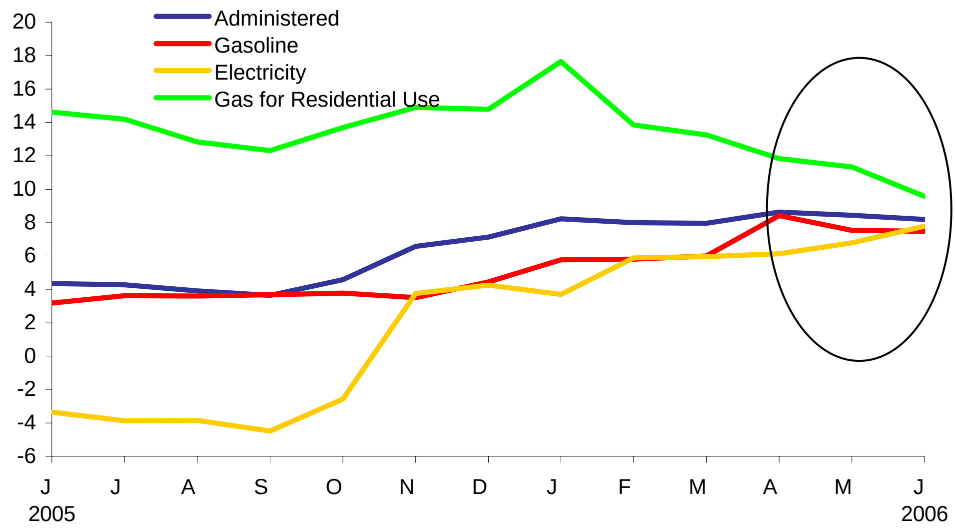
As a result of several government measures, domestic prices of gasoline, propane and natural gas exhibited less volatility than their international references (Graph 18). Thus, price increases observed recently in international markets for both gasoline and propane have not led to significant inflationary pressures as compared with other countries.20 During the analyzed period, external gasoline prices were higher than domestic prices, the opposite of the behavior observed in previous years. Nonetheless, the behavior of gasoline futures suggests that domestic prices could again become higher than external prices towards the end of the year. Furthermore, the increase of international liquid gas prices did not pass through to domestic prices due to the federal government's decision that prices of this fuel would be adjusted according to an annual rate of 4 percent. External prices of natural gas have followed a downward trend, which according to future contracts, could revert in the next quarter. Although domestic prices of this fuel are influenced by movements in international prices, their behavior has been more stable due to different measures established by the federal government to reduce their volatility (Graph 18c).

[18] The federal government issued two press releases regarding gasoline prices at border cities. The first, that starting April 25, 2006, these prices could not surpass the level reached during April 11-17, 2006. The second, that starting May 6, the maximum price for gasoline at border cities will be that corresponding to the minimum price observed in a particular city during the same reference date (in this case, Ciudad Juárez).

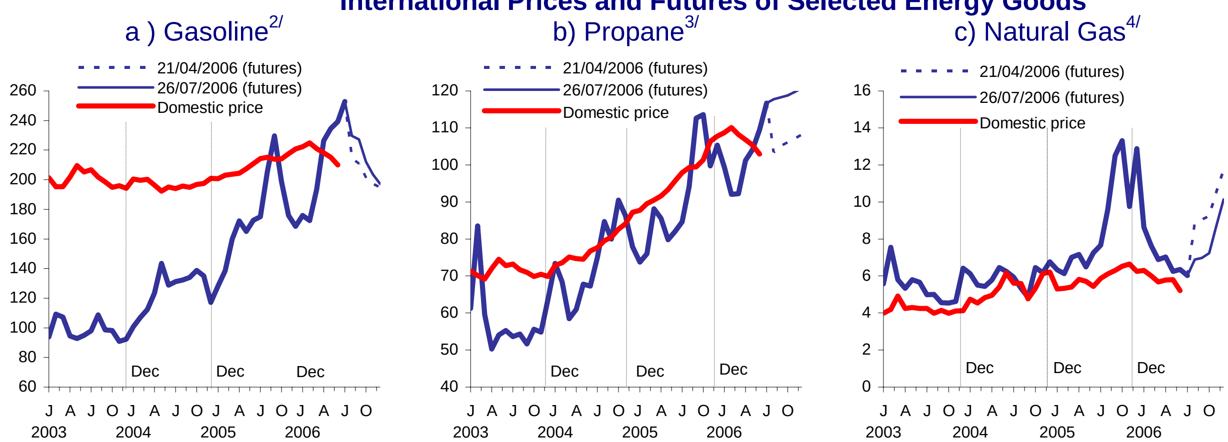
[19] High-consumption residential electricity tariffs are adjusted on a monthly basis according to the following formula: F = 0.8*TIP + 0.2*TCC. The first term in the equation (TIP), is comprised of three arithmetically averaged PPI subindexes: Metal Products, Machinery and Equipment, Basic Metal Industries and Other Manufacturing Industries. The second term (TCC) represents price costs of the following fuels used for electricity generating: imported and domestic diesel; natural gas; industrial diesel; and, imported and domestic coal.

[20] In addition to the measures implemented during the second quarter of 2006 to limit the pass-through movement from international gasoline prices to domestic prices in border cities, the federal government had previously established measures to influence domestic prices of the following fuels: gasoline, low-consumption electricity, liquid and natural gas (See Inflation Report January-March 2006, p.39).

Graph 17
Administered Prices Subindex
Annual percentage change



Graph 18
International Prices and Futures of Selected Energy Goods [1/]



1/ Futures prices of April 21 and July 26, 2006 (New York Mercantile Exchange).
2/ Texas. US cents per gallon.
3/ Mont Belvieu, Tx. US cents.
4/ Tetco, Tx. US dollars per MMBtu.

At the end of the second quarter of 2006, the subindex of goods and services regulated by the federal government recorded an annual variation of 1.22 percent, 0.40 percentage points below that observed in March. This reduction has been mainly due to the lesser number of cities that recorded increases in public transportation rates or highway tolls during this period.

3.3.3. Metals and Food Raw Materials

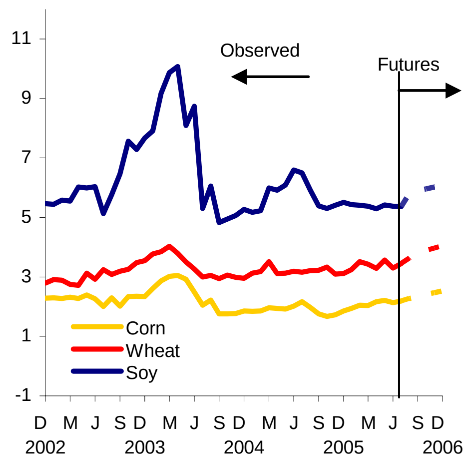
During the second quarter of 2006, international prices of grains increased moderately. The behavior of their futures suggests that for the remainder of the year they could follow an upward trend. These increases may affect the production costs of several processed foods, such as bread and cereals, as well as the costs of some fish products.

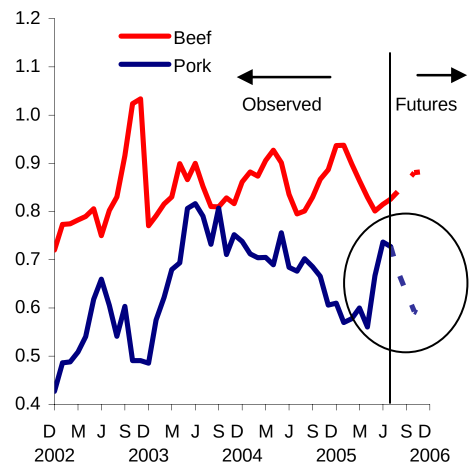
International prices of pork meat rose approximately 30 percent during the second quarter. However, in this case, futures suggest that this increase could revert in the following months (Graph 19). As a result, the impact of international prices on domestic pork meat prices and its derivatives is uncertain. International prices of beef have behaved similarly. During the second quarter, these prices fell slightly as compared to their level at the end of the first quarter, while future contracts reveal they could rise during the following months.

Graph 19
International Prices of Agricultural Raw Materials [1/]

a) Grains
US dollars per bushel

b) Meat
US dollars per pound

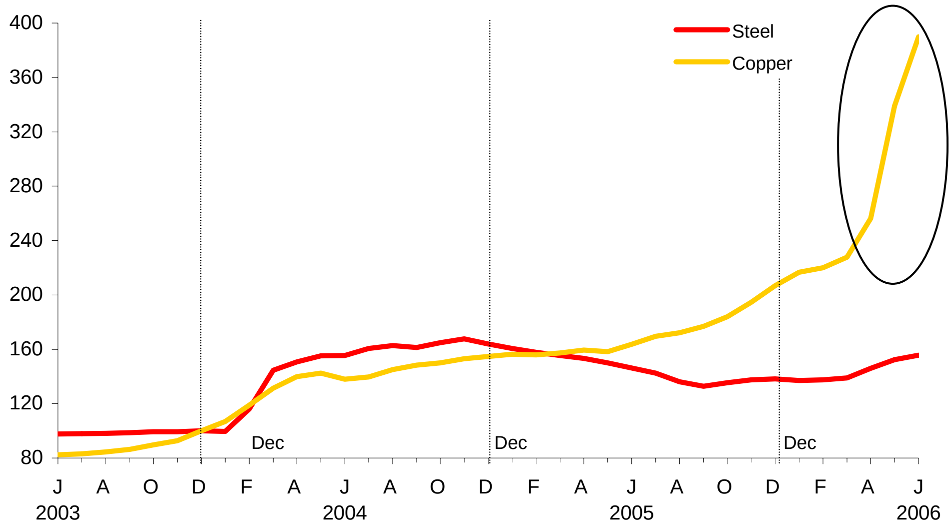




1/ Futures prices correspond to July 26, 2006. In the case of grains, values correspond to the Chicago Board of Trade, while in the case of meat, to the Chicago Mercantile Exchange.
Source: U.S. Department of Agriculture.

Steel and copper prices rose significantly during the second quarter of 2006 as compared to their levels observed during the previous quarter. Between March and June, steel and copper recorded price increases of 12.1 and 71.2 percent, respectively (Graph 20). In both cases, such an increase responded to both the developments in international markets and the effect of labor conflicts that have been affecting production.

Graph 20
Domestic Price of Steel and Copper
Indexes Base December 2003=100



Price increases in metals mainly affected both the prices of construction materials and high consumption electricity tariffs (see Section 3.3.2). Price increases in both metals and electricity have affected the costs faced by several merchandise manufacturers, and could eventually imply pressures on consumer prices.

3.4. Monetary and Credit Aggregates

3.4.1. Monetary Base, Net Domestic Credit and International Assets

During the second quarter of 2006, the monetary base grew at an average annual rate of 14.6 percent, figure higher than that observed during the same period of the previous year (13.2 percent).[21] The expansion of the monetary base has increased recently, partly as a result of greater cash use during Mexico's electoral process. The growth of this aggregate is expected to slow during the second half of 2006.

During the second quarter of 2006, international assets rose by 8.934 billion US dollars. Thus, the stock of international assets accumulated by June 30 was 84.980 billion US dollars.[22] The monetary base increased by 16,029 million pesos. As a result, Banco de México's net domestic credit declined by 84,248 million pesos during the quarter (Table 5).

[21] Variation calculated based on the average of daily stocks.

[22] 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 after deducting international assets from the monetary base; i.e., financing granted or received domestically by the Central Bank. The international reserves definition excludes Banco de México's short-term foreign currency liabilities (less than six months).

Table 5
Monetary Base, International Assets and Net Domestic Credit
Millions

	Stocks		Annual % Change	Flows in 2006		
				Quarter		
	At Dec. 31, 2005	At June 30, 2006	At June 30, 2006	I	II	Accumulated at June 30, 2006
(A) Monetary Base (Pesos)	380,034	369,072	17.5	-26,990	16,029	-10,961
(B) Net International Assets (Pesos) 1/ 2/	788,167	957,918	35.4	21,062	100,276	121,338
Net International Assets (US dollars) 2/	74,115	84,980	29.5	1,931	8,934	10,865
(C) Net Domestic Credit (Pesos) [(A)-(B)] 1/	-408,133	-588,846	49.8	-48,051	-84,248	-132,299
(D) International Reserves (US dollars) [(E)-(F)] 3/	68,669	78,743	27.5	-1,182	11,256	10,074
(E) Gross Reserves (US dollars)	74,110	84,945	29.5	1,914	8,922	10,835
PEMEX				6,420	10,555	16,976
Federal Government				-3,556	-932	-4,488
Sale of US dollars to banks 4/				-1,407	-1,550	-2,957
Other 5/				456	848	1,305
(F) Liabilities with less than six months to maturity (US dollars)	5,441	6,203	62.0	3,096	-2,334	762

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 part of the strategy to improve the composition of public sector's debt, external debt has been substituted for domestic debt. In June 2006, the Ministry of Finance and Banco de México announced the advanced payment of approximately 7 billion US dollars of loans granted by the World Bank and the Inter-American Development Bank. In order to carry out this operation, the Federal Government will purchase US dollars from Banco de México's international reserves using resources it will obtain from bond placements (Bondes D) in the domestic debt market, a similar instrument to Banco de México's Monetary Regulation Bonds (*Bonos de Regulación Monetaria del Banco de México*, BREMs). The resources denominated in local currency that Banco de México obtains from this operation will be used for the advanced payment of BREMs. As a result, the balance of international reserves and BREMs will decrease, reducing Banco de Mexico's liabilities as well as assets and, therefore, the cost of financing such reserves. Once this operation has taken place, Banco de México will cease to issue BREMs, and monetary regulation operations (e.g. sterilization) previously carried out with these instruments will be carried out with Bondes D.

3.4.2. Monetary Aggregates and Financing

The reduction in the opportunity cost of holding liquid assets observed since mid-2005 combined with increased economic activity has strengthened the expansion of the narrow monetary aggregates. In particular, the annual growth of the monetary aggregate M1 increased from 9.2 percent in May 2005 to 17.6 percent in the same month of 2006 (Graph 21a and 21b). This increase also responded to the greater use of cash associated with the election process.

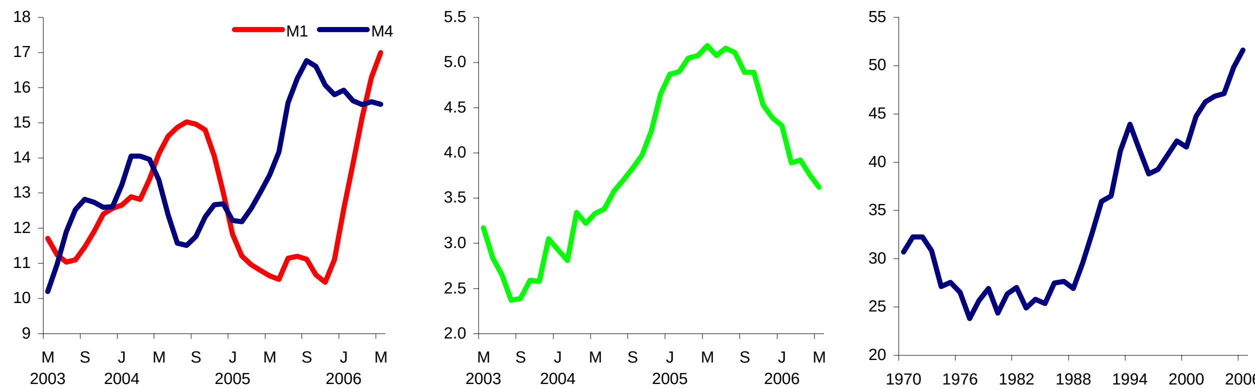
The broad monetary aggregate M4 grew at an annual rate of 15.4 percent during the first five months of 2006. In this regard, the Mexican economy's continuing process of financial deepening deserves mention. In May 2006, financial saving accounted for 52 percent of GDP (Graph 21c). These results have been fostered by a stable macroeconomic environment, an inflow of resources from the Retirement Savings System, and, recently, by an increased economic activity.

Graph 21
Monetary Aggregates M1 and M4 and Interest Rates

a) Monetary Aggregates M1 and M4
Annual percentage change of trend series

b) Spread between Interest Rates on Term Deposits and Liquid Instruments
Annual percent

c) Monetary Aggregate M4 [1/]
Percent of GDP



1/ Last observation: May 2006. Average stocks of the last 12 months.

The greater supply of domestic financial resources coupled with a reduction in public sector's demand for such credit has fostered an increase in financing to the non-financial private sector.[23] Such trend is even more evident when analyzing performing loans granted by commercial banks to households. In particular, financing granted to consumption (real annual growth of 48.3 percent in May 2006) has expanded significantly during the last few years. Such results have started to be reflected in increased non-performing and performing loans with some arrears, particularly of credit cards.[24] However, it is important to mention that despite this moderate increase, the overdue loan portfolio of credit cards is still at low levels.[25]

[23] High oil revenues and reduced financial costs, among other factors, have allowed the public sector to reduce its financial requirements over the last few years.

[24] Performing loan portfolios with interest payment arrears are not considered as overdue loans in accounting procedures.

[25] The credit card default ratio rose from 3.18 percent in December 2004 to 4.64 percent in May 2006. In contrast, arrears in bank financing to both social and residential housing continued to decline, reaching 2.1 percent in May 2006.

Table 6
Total Financial Resources of the Economy (Uses and Sources)
GDP percentage

	Annual flow: 1st quarter		Stock in first quarter of 2006		
	2005	2006	Real Annual Var.	% GDP	% Structure
Total sources	**6.0**	**7.2**	**4.4**	**71.2**	**100.0**
M4	5.5	7.1	11.3	52.5	73.7
Held by residents	5.1	6.5	10.5	50.5	70.9
SAR	1.6	1.3	8.9	11.5	16.2
SIEFORES	0.9	0.8	9.9	6.3	8.9
Other funds	0.7	0.5	7.6	5.2	7.3
Rest	3.5	5.2	11.0	39.0	54.7
Held by non-residents	0.4	0.6	38.2	2.0	2.8
Financing abroad	0.5	0.1	-11.2	18.7	26.3
Public sector 1/	0.3	0.3	-12.7	12.0	16.8
Commercial banks 2/	0.1	-0.3	-51.0	0.3	0.4
Private sector 3/	0.1	0.1	-4.7	6.5	9.1
Total uses	**6.0**	**7.2**	**4.4**	**71.2**	**100.0**
International reserves 4/	0.4	0.7	3.0	8.4	11.7
Public sector (SHRFSP) 5/	2.1	1.2	0.0	37.4	52.5
Domestic	1.8	0.9	7.4	25.4	35.7
External	0.3	0.3	-12.7	12.0	16.8
States and municipalities	0.2	0.1	3.2	1.5	2.1
Credit granted by financial intermediaries 6/	0.1	0.1	6.1	1.3	1.9
Debt instruments issued	0.0	0.0	-14.3	0.2	0.2
Private sector	2.4	2.6	5.8	27.3	38.3
Households 7/	2.0	2.2	16.3	12.6	17.7
Consumption	1.0	1.2	41.2	3.8	5.4
Housing	1.0	0.9	8.0	8.8	12.3
Enterprises	0.4	0.4	-1.9	14.6	20.5
Credit granted by financial intermediaries 6/	0.3	0.3	0.6	6.3	8.9
Debt instruments issued	0.0	0.1	-0.4	1.8	2.6
External	0.1	0.1	-4.7	6.5	9.1
Otros concepts	0.9	2.6	-26.9	-3.3	-4.6

1/ Includes net external indebtedness from the federal government, public enterprises and institutions, and PIDIREGAS placed abroad, as reported by the Ministry of Finance.
2/ Commercial banks' net external liabilities. Excludes non-residents' bank deposits.
3/ Includes loans and securities issued abroad by the private sector.
4/ As defined by Banco de México's Law.
5/ Historical stock of Public Sector Borrowing Requirements (SHPSBR) and flow of Public Sector Borrowing Requirements (PSBR), as reported by the Ministry of Finance. In 2004, it excludes the effect of the redemption of FOBAPROA promissory notes.
6/ Total portfolio of financial intermediaries. Includes debt-restructuring programs.
7/ Total portfolio of financial intermediaries and of the National Employees' Housing Fund (*Instituto del Fondo Nacional de la Vivienda para los Trabajadores,* INFONAVIT).

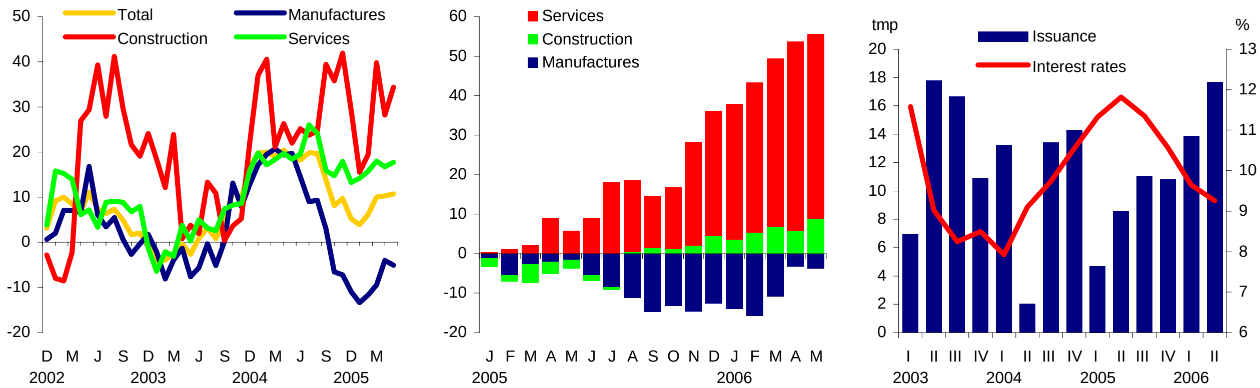
Commercial banks' direct performing credit to firms has continued to increase slightly, registering real annual growth of 11.4 percent in May 2006. The recovery of financing to firms has mainly occurred in the services and construction sectors (Graph 22). Over the last year, total direct performing credit rose by 54.9 thousand million pesos, while credit granted to the services and construction sectors rose by 52 thousand million pesos. These results also reflect the fact that industrial activities, particularly manufacturing, usually have access to alternative, mainly external, sources of financing. Finally, the medium and long-term corporate debt market has also exhibited a recovery, which amounted to around 18 thousand million pesos during the second quarter of 2006, at an average interest rate of 9.26 percent.

Graph 22
Commercial Banks Performing Direct Credit to Enterprises and Medium-term Private Securities

a) Commercial Banks Performing Direct Credit to Enterprises
Annual percentage change

b) Commercial Banks Performing Direct Credit to Enterprises
Flows accumulated in tmp

c) Medium-term Private Securities
Issuance and annual yield



As mentioned on several occasions, in general terms, lending interest rates are still high and have not fully reflected the fall in deposit interest rates originated by the reduction of inflation.[26] In this regard, Banco de México has determined that more and improved information should be available to users of financial services so they can choose the credit and services which are most appropriate for them. In line with this idea, Banco de México announced the introduction, starting September 2006, of regulations for banks and SOFOLES establishing guidelines for transparency when granting credit as well as other creditor protection measures.[27] One of the most important of these measures is the Total Annual Cost (Costo Anual Total, CAT) (an indicator which includes, among other costs, interest rates, commissions and obligatory insurance), which provides standardized information about the different credit offerings, making it easier to choose the lowest cost option.

[26] There is still a wide spread between deposit interest rates paid by commercial banks and the interest rates they charge (lending interest rates). In April 2006, the cost of taking term deposits in local currency was 6.2 percent in annual terms, while the interest rate charged on traditional credit cards was 32.9 percent, the total annual cost of mortgage credit was 13.8 percent and 13.6 percent for credit granted to firms.

[27] For further information, see Telefax Bulletin 8/2006 and the presentation on transparency regulations for granting credit, both of which are available on Banco de México's web page (http://www.banxico.org.mx).

4. Monetary Policy

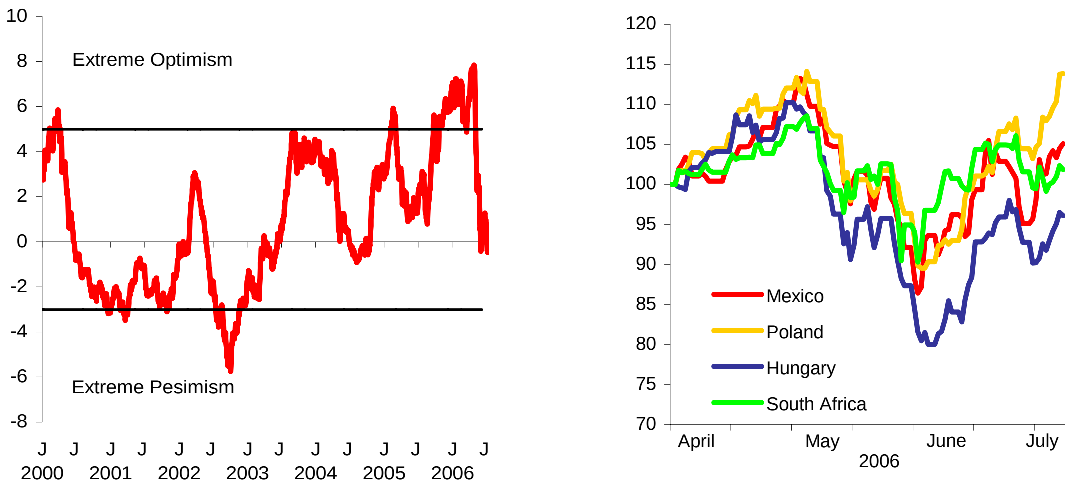
During the second quarter of the year, the higher prices of energy and other raw materials, combined with the increase in capacity utilization, implied greater pressures on inflation. This has created uncertainty regarding the main central banks corresponding reaction and, therefore, on the expected level of interest rates in international financial markets, particularly in the U.S.

The perception of a less accommodative global monetary environment has contributed to reduce investors' appetite for risk. This has also led to an adjustment in the prices of several assets and currencies, mainly in emerging economies (Graph 23). In these economies, the corresponding yields for long and medium-term debt instruments in domestic currency have increased, as compared with those recorded during the first quarter of the year (Graph 24). Nonetheless, such increases have reverted in the last weeks.

It is important to mention that long-term interest rates in developed economies are still at low levels as compared with their historic behavior. Thus, although global financial conditions have become less benign, a relative slackness prevails.

Graph 23
Global Risk Appetite Index and Stock Indexes

a) 1990-2006[1/] b) April-June 2006 (April 2006=100)[2/]



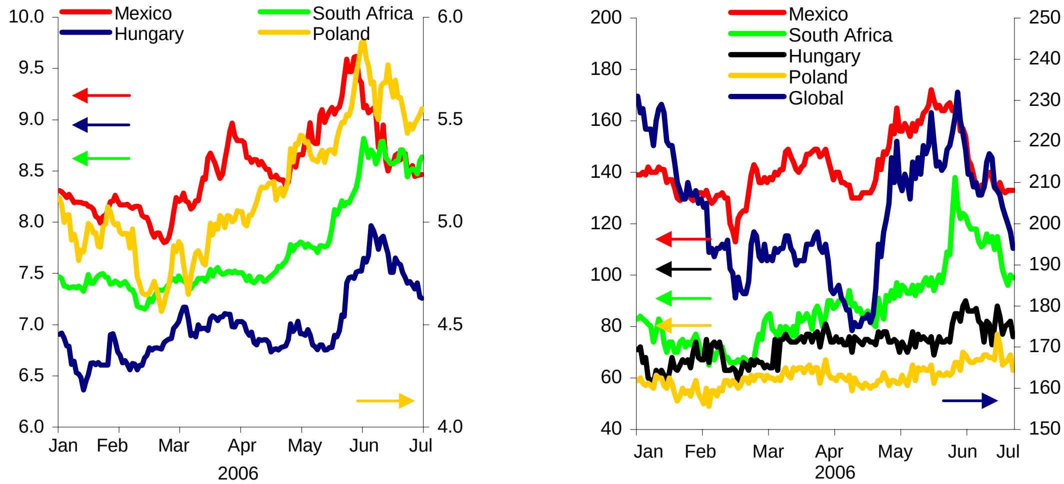
1/ Source: Credit Suisse. The index compares risk-adjusted returns on 64 assets. For each asset, both a 6-month excess return over cash and 12-month volatility are calculated. Then, a cross-sectional linear regression is run, where volatility is the independent variable and return is the dependent variable. The slope of the regression line is the value of the risk appetite index at that point in time. During periods of high investor risk appetite, risky assets such as developed equities and emerging markets typically have very high returns, while government bonds of advanced economies (G3+ government bonds) tend to have low or negative returns. The opposite is true during periods of low investor risk appetite.

2/ These countries are ranked similarly or slightly above Mexico in their credit ratings.

Graph 24
Long-term Interest Rates and Interest Rate Spreads (Several Countries vs. U.S.)

a) 10-year Interest Rates in Domestic Currency
Annual percent

b) EMBI 2005-2006 [1/]
Basis points



1/ EMBI global: sovereign spread.
Source: Bloomberg.

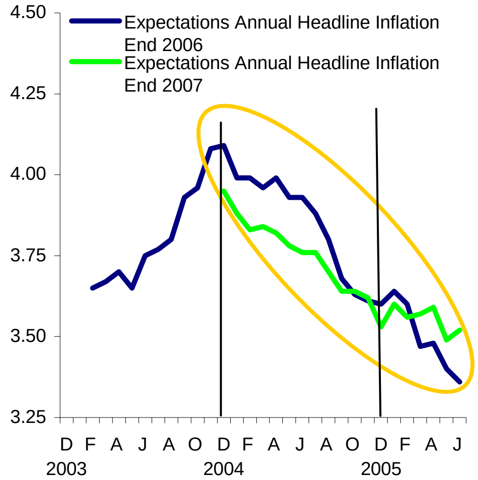
On another front, the inflation environment in Mexico continues to be favorable. During the first half of the year, core inflation remained close to 3 percent. As for headline inflation, and just as expected, during the second quarter it followed a downward trend, after having rebounded at the beginning of the year. It is important to mention that core inflation has remained for several months close to 3 percent, while headline inflation volatility has mainly reflected the volatility characterizing the fruits and vegetables price subindex, and, to a lesser extent, the administered prices subindex. Consequently, the pass-through of supply shocks to the inflation trend apparently has decreased significantly.

These results have contributed to maintain inflation expectations for different terms at low levels (Graph 25). Thus, inflation expectations obtained by Banco de México in June, regarding headline inflation for the end of 2006, 2007 and 2008 were 3.36, 3.52, and 3.54 percent. On another front, inflation expectations for core inflation for 2006 and 2007 were 3.28 and 3.22 percent, respectively. Analysts have still maintained their expectations for headline inflation for different horizons above target, although they still consider that core inflation will continue to remain at levels close to 3 percent.

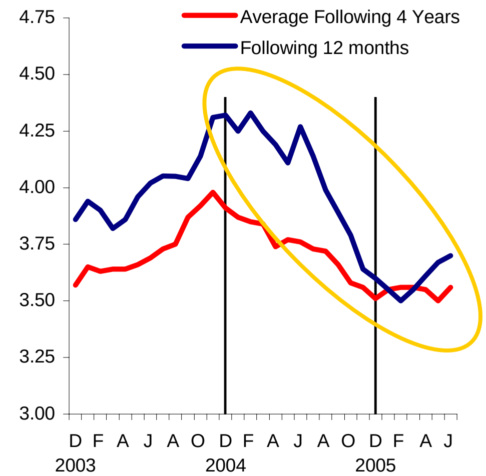
Considering that inflation, as well as its outlook, had behaved as expected by Banco de México, the Board of Governors allowed in April for a reduction in monetary conditions of no more than 25 basis points, stating that in the foreseeable future, no space for a further loosening existed. Thus, in its press releases of May, June, and July, the Board decided to maintain the referred conditions unchanged, having reiterated in those dates the absence of margin for a further loosening. These actions prompted bank funding rates to decline to 7 percent on April 21. Up to now, such rates have remained at that level (Graph 26).

Graph 25
Inflation Expectations: Banco de México Survey

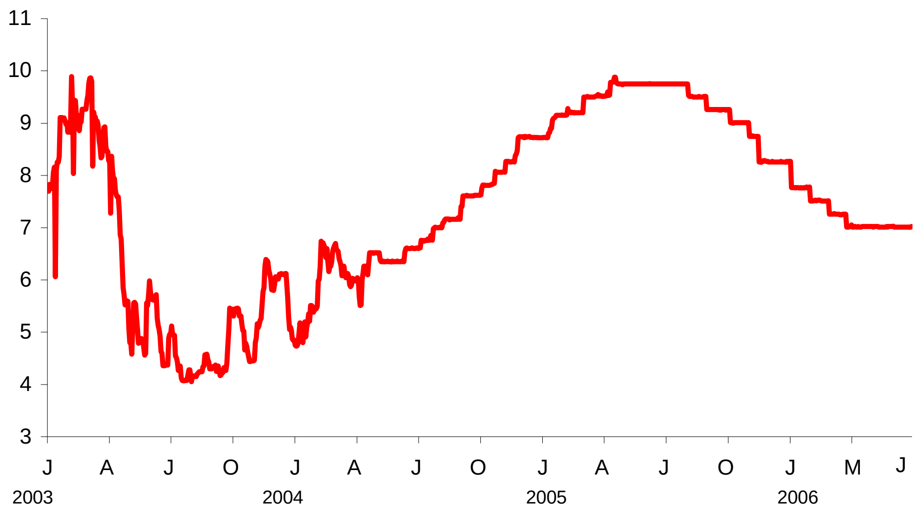
a) End of 2006 and 2007
Annual percent



b) Following 12 months and 4 Years (average)
Annual percent



Graph 26
Bank Funding Interest Rates
Annual percent

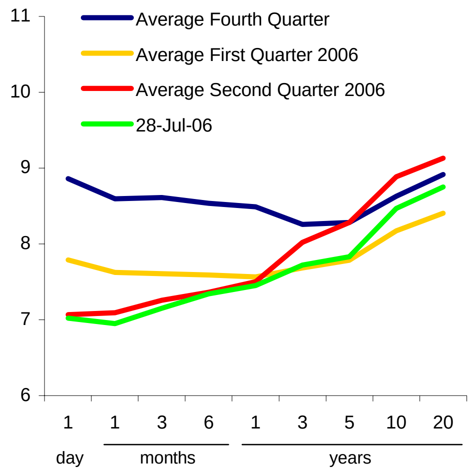


In the last months, domestic financial markets have been affected by greater global risk aversion and by uncertainty associated with this year's elections. As a result, the yield curve steepened during the second quarter (Graph 27a). Consequently, the spread between the 20-year government bond interest rate and the one–day bank funding rate moved from an average of 61 basis points during the first quarter of the year to 206 basis points during the second.

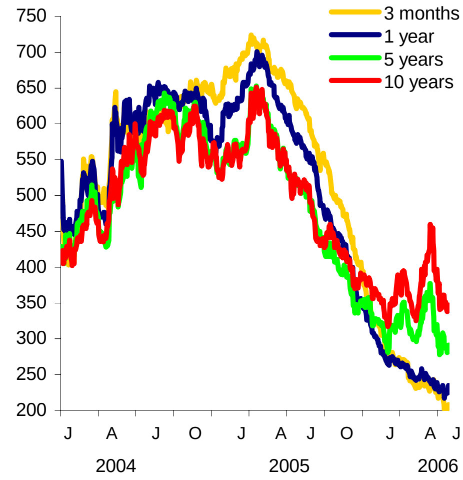
Notwithstanding the above, it is important to note that Mexican financial markets have adjusted to an environment where global monetary conditions are normalizing, with reduced costs in terms of inflation and growth. Part of the adjustment in the prices of several assets and currencies in emerging markets has also reverted recently. In addition, the uncertainty that usually precedes elections has started to diminish. In the last weeks, these factors have contributed to gradually revert both the increase in peso long-term interest rates and the adjustment of the exchange rate and other assets (Graph 27 and Graph 28).

Graph 27
Yield Curve in Mexico and Interest Rate Spread between Mexico and the U.S.

a) Yield Curve in Mexico
Annual percent

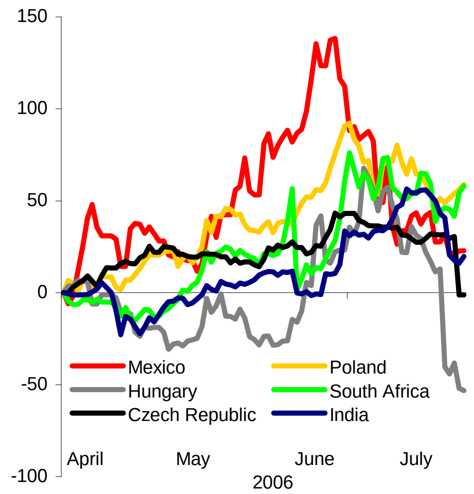


b) Spread Mexico – United States
Basis points

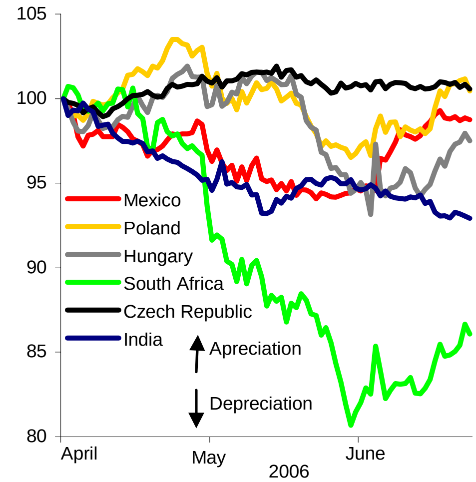


Graph 28
Yield Curve and Effective Exchange Rate in Emerging Economies

a) Change in the Slope of the Yield Curve
Basis points



b) Exchange Rate
April 2006=100



5. Balance of Risks and Final Remarks

Banco de México's expected scenario for 2006 is based on the following considerations:

a) A generally favorable outlook for world economic growth prevails, although some risks have increased. The main analysts anticipate the U.S. economy to grow, on average, around 3.5 percent. Industrial growth is expected to surpass GDP growth.

b) Mexico's external accounts are expected to continue to have high revenues from oil exports and from workers' remittances.

c) Although global monetary conditions are expected to tighten, leading to a reduction in investors' appetite for risk, a relative slack is anticipated to prevail in international financial markets. In particular, longer-term interest rates in emerging economies are expected to continue at historically low levels.

Based on the abovementioned conditions and on information already analyzed in this report, Banco de México's baseline scenario for 2006 is as follows:

GDP Growth: GDP growth is expected to be between 4.0 and 4.5 percent (in the previous inflation report these figures were between 3.5 and 4.0 percent).

Employment: Approximately 900 thousand jobs are expected to be created in the formal sector (number of workers insured by the IMSS).

Current Account: The current account deficit of the balance of payments is expected to be around 0.2 percent of GDP.

Inflation: Headline and core inflation are expected to be both between 3 and 3.5 percent at the end of the year. Headline inflation is expected to observe some volatility from its non-core component.

In this regard, the following should be highlighted:

a) Although core inflation has remained close to 3 percent throughout the year, the greater pressures it has faced have mainly originated from price increases in several materials for housing construction. These pressures could diminish as steel and copper production reestablish, as it has been affected by labor conflicts in some of this sector's enterprises. On another front, price increases of several raw materials have affected the prices of non-housing services, keeping inflation of the rest of services price subindex relatively high. Finally, merchandise inflation is expected to follow a lateral trajectory for the rest of the year.

b) Between August and November 2006, the annual variation of the non-core component could influence headline inflation upward, given that annual agriculture inflation is expected to rebound. This responds to the fact that during the same period of the previous year, the prices of these products exhibited atypical reductions.

c) Although international energy prices have reached new historically high levels, they are expected to affect headline inflation moderately, due to the different policies adopted by the federal government to mitigate the effect of international prices' volatility of these goods. [28]

For 2007, core inflation is expected to remain around 3 percent while headline inflation is anticipated to stand within the variability interval of plus/minus one percentage point around the 3 percent target. By the end of 2007, headline inflation is expected to be below 3.5 percent.

The outlook for inflation has improved. Nonetheless, the following risks must be considered:

i) International prices of different raw materials (eg, energy goods and metals) continue to be a source of inflationary pressures.

ii) Futures prices of certain grains point to an increase in their prices.

iii) The international financial environment has become less favorable.

iv) Services prices continue to grow at a high rate.

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

Further risks that could affect economic activity as established in the baseline scenario prevail.

First, if inflation continues to escalate in the U.S., monetary authorities could raise their reference rates more than as currently expected by financial markets, therefore increasing the risks of a slowdown in world growth.

As mentioned repeatedly, another risk factor that has affected negatively productive activity growth, and therefore, job creation, is the Mexican economy's loss of competitiveness. This mostly reflects the lack of advance in making Mexico's productive structure more flexible, which would allow the timely flow of different strategic inputs at competitive prices to those sectors with growth opportunities. The fact that other countries are moving in this direction reduces Mexico's competitive advantage, therefore increasing the difficulty of solving endemic problems, such as poverty reduction and the sharp inequality of income distribution.

On another front, the risk associated with global disequilibria still prevails. In fact, the current account deficit in the U.S. remains very high. However, many analysts continue to believe that there is a small probability of an abrupt correction of this imbalance.

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[28] For more information on federal government price and tariff policies see the Inflation Report January-March 2006 (p. 39).

Finally, during the last months, domestic financial markets were partly affected by the uncertainty associated with this year's elections. Other risk factors related with elections could arise, leading to new episodes of volatility. Nonetheless, as already mentioned, progress in stability and financial market deepening have contributed to increase the resilience of the Mexican economy, in order to face these episodes and foster an environment of certainty for investment and productive activity.