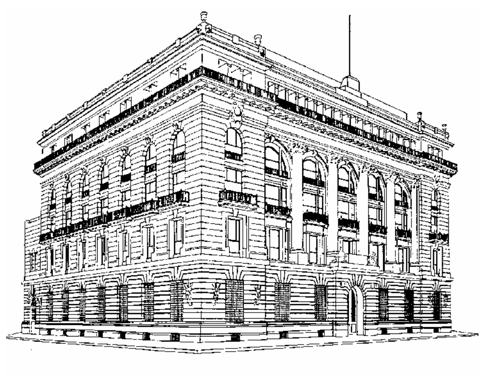
Inflation Report

July – September 2005



BANCO DE MEXICO

OCTOBER 2005

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FOREWARNING

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Unless otherwise stated, this document has been prepared using data available as of October 28, 2005. Figures are preliminary and subject to change.

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Inflation Report July-September 2005

I. Introduction

World economic activity has shown a favorable performance throughout the year. Although the economy has grown at a slower pace than in the previous year, the outlook remains positive (provided that risks mentioned below do not materialize). Regarding the U.S. economy, growth is expected to be more in line with its potential rate during 2005 and 2006. Economic analysts anticipate that the negative effects of the hurricanes that recently struck the U.S. South Coast will fade rapidly.

Nonetheless, the impact of these shocks, together with both the growing demand for crude oil and distilled products and restrictions to production capacity, boosted energy prices to new record highs during the third quarter of 2005. This has increased headline inflation and its expectations in different countries, particularly in the U.S.; however, the outlook is for core inflation to remain at moderate levels.

U.S. industrial production has slowed down at a faster pace than GDP since mid-2004. During the third quarter, industrial production was further affected by the hurricanes in the Gulf of Mexico. As mentioned in previous inflation reports, the industrial sector has also been affected by the reallocation of manufacturing production at a global level. Nonetheless, in general terms, industrial production continues to exhibit some dynamism and capacity utilization margins remain close to their historical average.

International financial conditions continued to be favorable. Interest rate spreads for emerging economies' sovereign issuers fell, reaching in some cases record lows at the end of September and the beginning of October. Nevertheless, there is a perception that the balance of risks for U.S. inflation deteriorated recently, contributing to an increase in U.S. interest rates. Should this trend prevail, the decline in appetite for risk that was observed during the last weeks could continue, therefore restricting at the margin the conditions for emerging economies' access to financing.

Mexico's economic activity during the year has been characterized by a slowdown of production and aggregate demand. Consumption and investment, as well as external demand, have lost strength. Manufacturing exports have been particularly affected by both the lesser dynamism of U.S. industrial activity and Mexico's loss of competitiveness. The loss of share of Mexican products in the U.S. market clearly evidences this condition.

The hurricanes that affected Mexico's south east region in October had a negative effect on regional economic activity. As a result, a reduction of around 25 basis points in GDP growth is expected during the fourth quarter of 2005. Nonetheless, these effects are anticipated to be partially offset by the reconstruction efforts.

As for inflation, throughout the year, and especially during the third quarter, the effects of the multiple supply shocks that affected the economy in 2004 have continued to diminish as a result of both the reversion of such shocks and monetary policy actions adopted. Thus, as expected, inflation has resumed its downward trend. In particular, headline inflation, which had reached 5.43 percent in November 2004, fell significantly, recording 3.51 percent in September of this year (4.33 percent in June). Core inflation has also declined considerably, reaching an annual variation of 3.20 percent in September. As a result, inflation expectations for all terms have been revised downward. Under such context, the inflationary rebound observed in 2004 had a limited effect on wage negotiations.

The inflationary outlook in Mexico has improved. As a result, Banco de México has begun to revert part of the monetary restriction adopted during 2004 and the first half of 2005. Nonetheless, the balance of risks is as follows:

a) World energy prices will probably remain high and volatile.

b) Certain agricultural products could be subject to volatility due to the weather-related shocks in the south east region or health problems regarding poultry production.

c) Although food inflation has declined, non-housing services inflation remains high.

d) Inflation is expected to be above 3 percent.

The reduction in Banco de México's monetary restriction is congruent with the decline in inflation and its expectations, as well as with the gradual convergence of inflation to its target. Nonetheless, considering such balance, and in order to reach and consolidate the inflation target, monetary policy will remain restrictive.

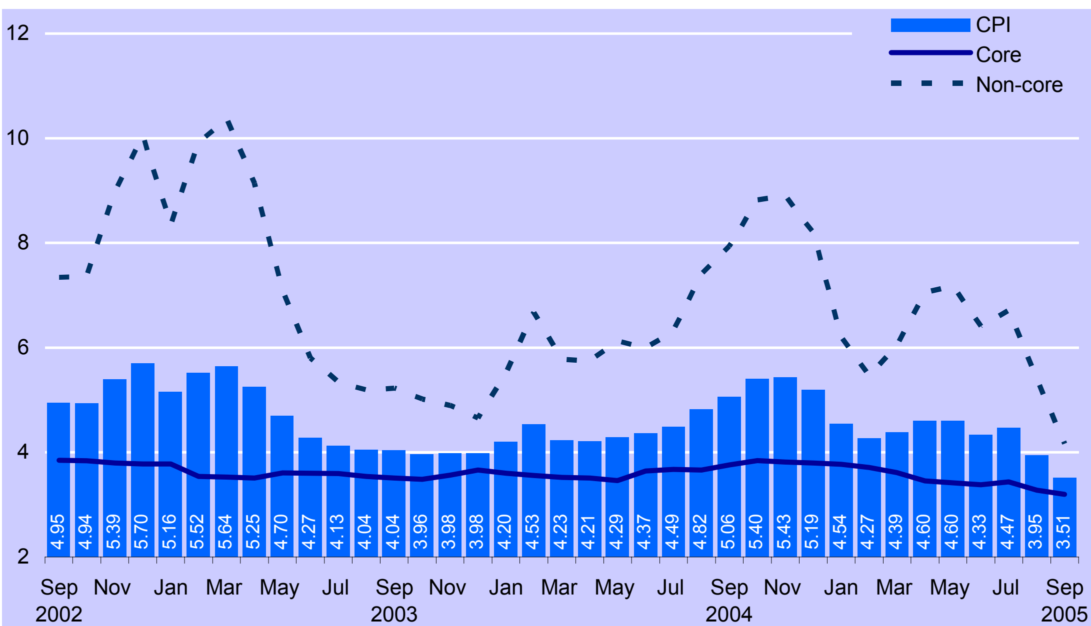
II. Recent Developments and Main Determinants of Inflation July – September 2005

II.1. Recent Developments in Inflation

In September 2005, annual headline inflation was 3.51 percent, 0.82 percentage points below that recorded in June (Graph 1). This decline is the result of the slower growth rate of the core and non-core components (an annual reduction of 0.18 and 2.24 percentage points, respectively, during the referred period). In general terms, the effects of the multiple supply shocks that affected inflation during 2004 continued to dissipate.

Graph 1 **Consumer Price Index (CPI)**

Annual percentage change



II.1.1. Non-core Inflation

The non-core index was the component that mostly contributed to the decline in headline inflation. In September 2005, this indicator was 4.17 percent, while at the end of the previous quarter it recorded 6.41 percent (Table 1). This was the result of a significant reduction in the annual growth rate of the agricultural products subindex and to a decline in the rate of both the subindex of administered and regulated prices and the education subindex.

Table 1 **CPI Components**

Annual percentage change

	Dec-2004 (a)	Jun-2005 (b)	Jul-2005 (c)	Aug-2005 (d)	Sep-2005 (e)	Difference (e-b)
CPI	**5.19**	**4.33**	**4.47**	**3.95**	**3.51**	**-0.82**
Core	**3.80**	**3.38**	**3.44**	**3.28**	**3.20**	**-0.18**
Merchandise	**3.87**	**3.49**	**3.36**	**3.16**	**3.05**	**-0.44**
Food	7.04	5.32	5.01	4.69	4.53	-0.79
Other	1.69	2.20	2.20	2.07	1.99	-0.21
Services	**3.72**	**3.27**	**3.51**	**3.41**	**3.37**	**0.10**
Housing	3.70	2.39	2.38	2.36	2.37	-0.02
Other	3.74	4.32	4.89	4.68	4.58	0.26
Non-core	**8.20**	**6.41**	**6.72**	**5.40**	**4.17**	**-2.24**
Agriculture	**10.11**	**11.95**	**13.53**	**8.76**	**4.53**	**-7.42**
Fruits and Vegetables	**6.43**	**20.47**	**24.53**	**14.55**	**4.35**	**-16.12**
Tomato	23.24	61.22	56.31	-5.98	-26.65	-87.87
Other	2.51	14.29	19.47	18.54	11.75	-2.54
Livestock	**12.69**	**7.16**	**7.30**	**5.36**	**4.65**	**-2.51**
Administered and Regulated	**7.51**	**3.52**	**3.40**	**3.23**	**3.14**	**-0.38**
Administered	**10.02**	**4.35**	**4.28**	**3.92**	**3.65**	**-0.70**
Low-octane gasoline	5.42	3.20	3.66	3.62	3.73	0.53
High-octane gasoline	8.47	3.04	3.37	3.45	3.40	0.36
Electricity	9.15	-3.35	-3.88	-3.86	-4.48	-1.13
Residential-use gas	18.27	14.60	14.20	12.83	12.31	-2.29
Regulated	**5.13**	**2.78**	**2.61**	**2.60**	**2.68**	**-0.10**
Education	**7.50**	**7.43**	**7.25**	**7.12**	**6.65**	**-0.78**

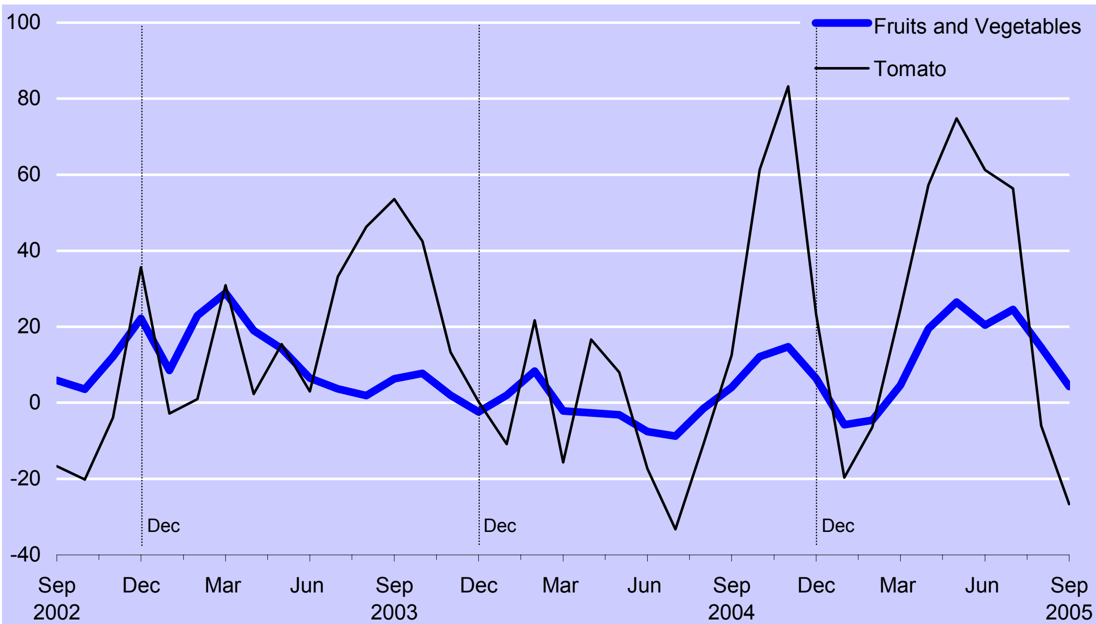
II.1.1.1. Agricultural Products Price Subindex

The annual growth of the agricultural products price subindex was 4.53 percent in September 2005, 7.42 percentage points below June figures. Fruits and vegetables prices mostly affected the behavior of this indicator during the analyzed period by exhibiting an annual growth rate of 4.35 percent in September, 16.12 percentage points below the figure at the end of the previous quarter (20.47 percent). This decline was largely determined by the evolution of tomato prices. During the same period of the previous year, tomato prices rose significantly due to the severe contraction in its supply, while during the current period prices remained at a relatively low level due to normal supply conditions (Graph 2).

Livestock prices also contributed to the favorable evolution of the agricultural products price subindex. In September 2005, livestock prices recorded an annual variation of 4.65 percent, 2.51 percentage points below June figures. This result was due to a moderate quarterly increase in the prices of beef and pork, which, during the same period of the previous year, increased considerably.[1]

Graph 2 **Fruits and Vegetables Subindex**

Annual percentage change

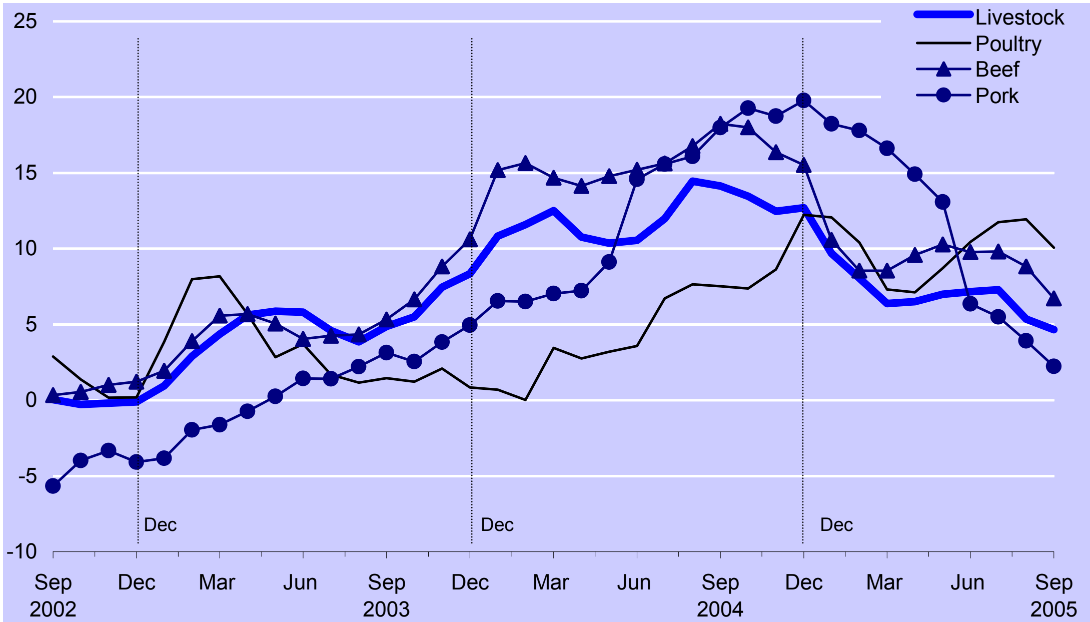


In contrast, the annual variation of poultry prices continued to follow an upward trend during July and August (11.76 and 11.94 percent, respectively). Nonetheless, the annual growth rate of poultry prices began to ease in September, attaining 10.07 percent (Graph 3).

[1] Price increases in beef observed during the previous year were due to a decline in beef world production, associated with new sanitary measures adopted in the main international markets. As for pork meat prices, their increase was related to a substitution effect as a result of the reduced supply of beef.

Graph 3 **Livestock Price Subindex**

Annual percentage change



II.1.1.2. Subindex of Administered and Regulated Prices

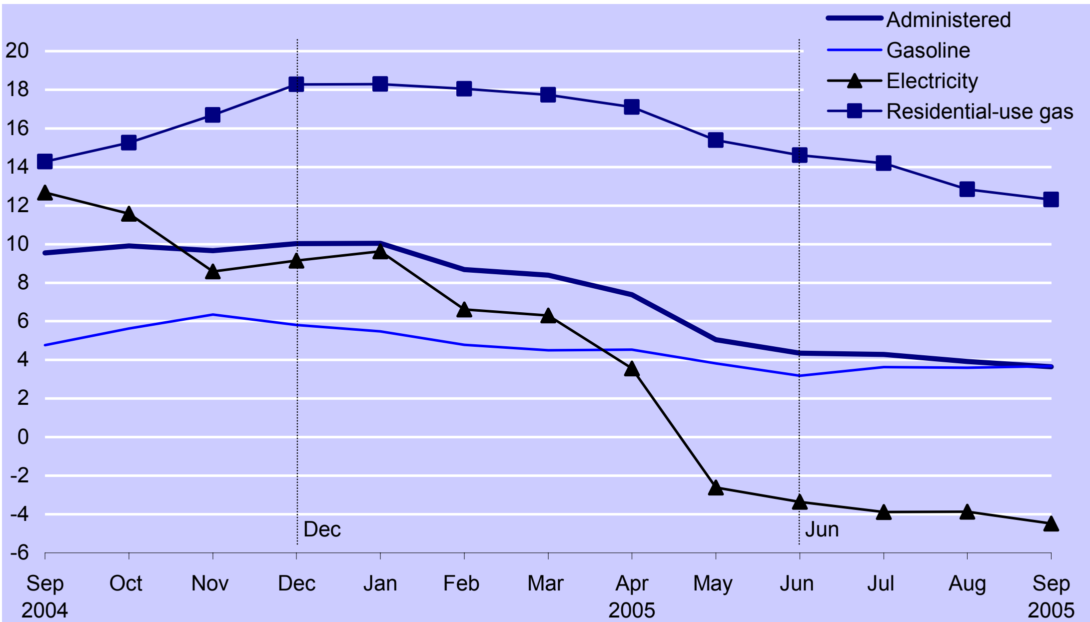
The subindex of administered and regulated prices rose at an annual rate of 3.14 percent in September 2005, 0.38 percentage points below June figures. During the analyzed period, the annual variation of administered prices decreased more than that of regulated prices (0.70 vs. 010 percentage points).

Inflation reduction in administered prices between July and September 2005 resulted from lower increases in gas and electricity prices (Graph 4). An additional factor contributing to the favorable behavior of this subindex was that gasoline prices at the border were already at the highest level allowed by their price updating rule; hence, border gasoline prices increased at the same rate as in the rest of the country, isolated from the increase in gasoline international references (Graph 5). Regarding prices of gas for residential use, increases in its international references had a limited passthrough on domestic prices, due mainly to two factors: i) the adoption at the beginning of the year of a monthly variation interval for propane prices from 0.75 to 1.75 percent;

and, ii) the announcement on May 16, 2005 of a maximum price set for low-consumption natural gas for residential use.[2]

Graph 4 **Subindex of Administered Prices**

Annual percentage change



As for electricity, the jump in energy international references only affected high consumption residential electricity tariffs (*Tarifas Domésticas de Alto Consumo, DAC*), given that regular tariffs are fixed according to a predetermined rate of change (0.469 percent per month). In addition, the increase in energy prices has a lagged effect on electricity tariffs because both fuel oil and natural gas prices are included in the formula to calculate DAC tariffs as a moving average of three and four months, respectively. The upward effect of energy costs was also mitigated by the decline in steel prices and the elimination of the highest bracket for DAC tariffs, officially announced on January 22, 2005.[3]

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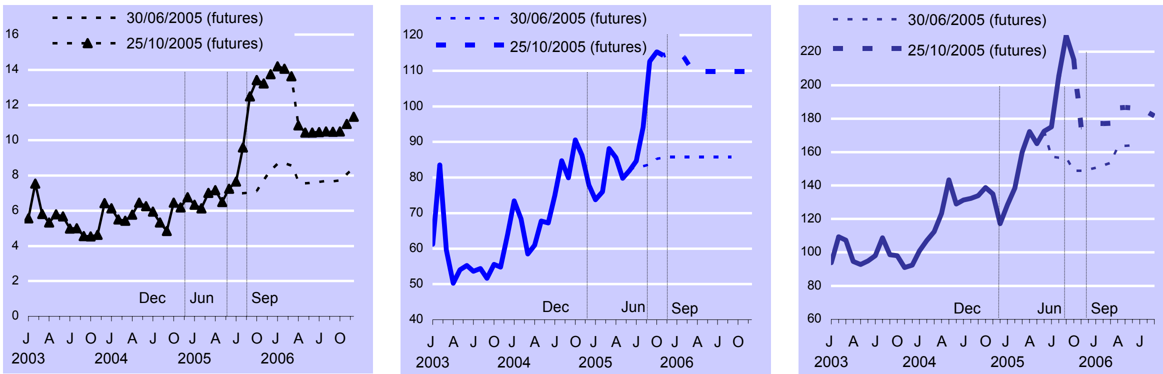
[2] This decree establishes a maximum price for concessionaries of low-consumption gas for residential use. A reduction of 28 percent was established on the price of natural gas with monthly consumptions of up to 47m^3. This discount is established with a downward rate of change criterion and does not apply to consumptions above 60m^3. This measure expires September 30, 2006.

[3] For further reference on the formula used by CFE to update DAC electricity tariffs see footnote 1, pag.5 of the Inflation Report April-June 2005.

Graph 5 **International Energy Prices and Futures** 1/

a) Natural gas 2/ b) Propane 3/ c) Gasoline 4/



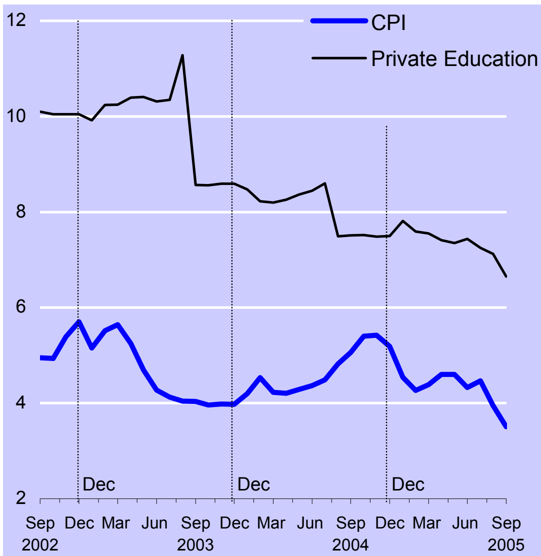
1/ Future prices correspond to June 30, 2005 and October 25, 2005.
2/ TETCO. TX. US dollars per MMBtu.
3/ Mont Belvieu, Tex. US cents.
4/ Texas, US cents per gallon.

II.1.1.3. Private Education Subindex

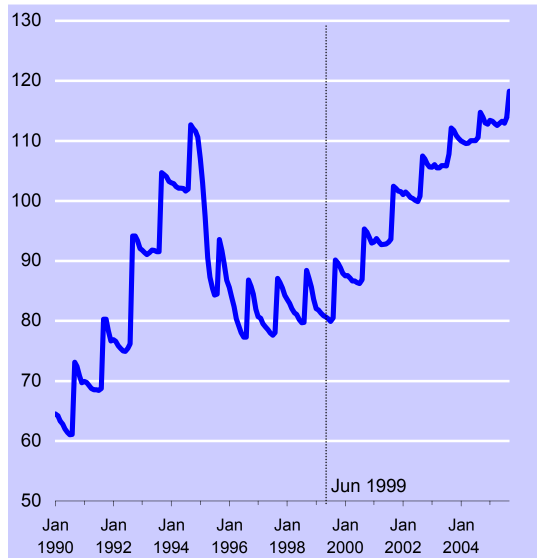
The private education subindex recorded an annual variation of 6.65 percent in September, 0.78 percentage points below June's level. Despite the downward trend exhibited by this subindex, its convergence towards headline inflation has been at a relatively slow pace. As a matter of fact, since June 1999, the private education subindex has been growing at a higher annual rate than that of the CPI, more than offsetting the relative fall exhibited by school fees in 1995 (Graph 6).

Graph 6 **Private Education Subindex**

a) Annual percentage change



b) Relative prices (private education/CPI)

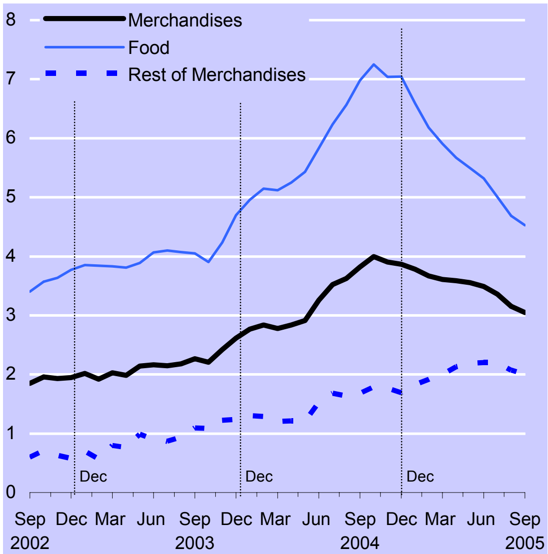


II.1.2. Core Inflation

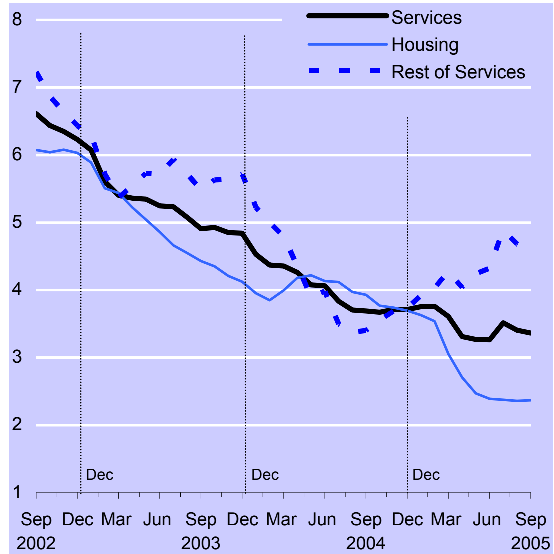
Annual core inflation was 3.20 percent in September 2005, while in June it was 3.38 percent. The reduction was due to the lower contribution of the merchandise price subindex. Its annual growth rate decreased 0.44 percentage points during the quarter, reaching 3.05 percent in September. As for the services subindex, it exhibited opposite results: its annual growth rate rose 0.10 percentage points, reaching 3.37 percent during the same month (Graph 7).

Graph 7 Core Merchandise and Services Subindex

a) Merchandise
Annual percentage change



b) Services
Annual percentage change



II.1.2.1. Core Merchandise Subindex

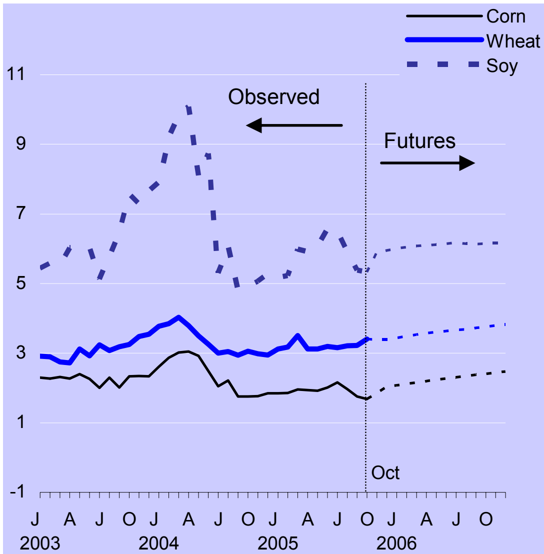
The merchandise price subindex evolution was the outcome of the behavior of both processed foods and the rest of merchandises. The annual growth rate of prices of processed foods moved from 5.32 percent in June to 4.53 percent in September. The lower increases in the prices of these products have mirrored their trajectory in external markets. This could be partly the result of more stable production costs, given that the temporary increase in food commodities' price inflation has gradually reverted (Graph 8 and Graph 9). The annual growth rates of the rest of merchandises decreased from 2.20 to 1.99 percent during the same period. This was mainly due to two factors: i) the appreciation of the exchange rate during the year; and, ii) lower car price increments as a result of changes in the new car tax (*Impuesto sobre Automóviles Nuevos, ISAN*), that went into effect on August 22, 2005.[4]

[4] The referred decree establishes that purchased vehicles up to 150,000 pesos are ISAN-exempt. Purchased vehicles valued between 150,001 and 190,000 pesos must pay half the ISAN rate.

Graph 8 **International and Futures Prices of Food Commodities** 1/

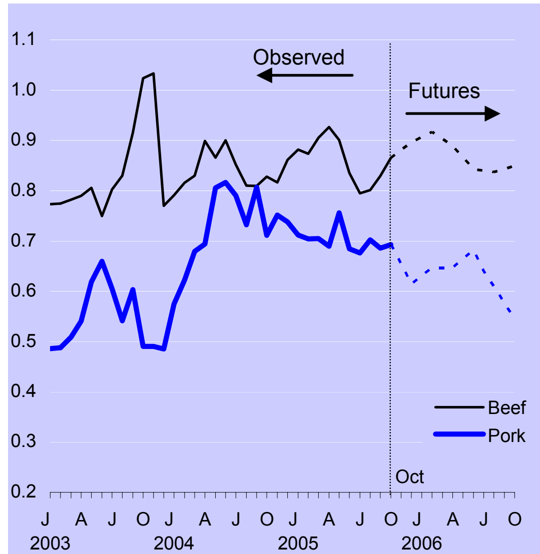
a) Grains

US dollars per bushel

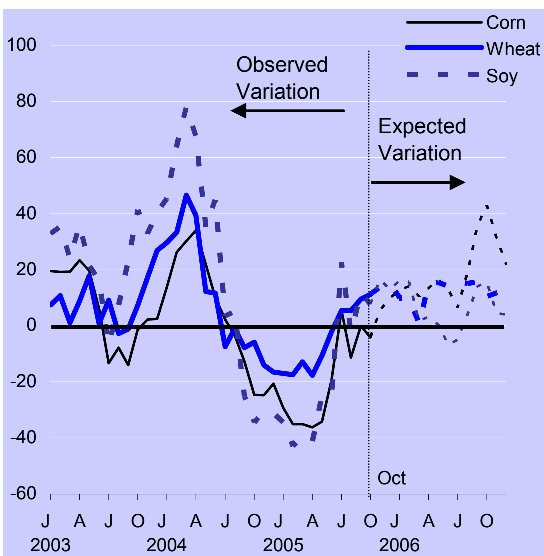


b) Meat

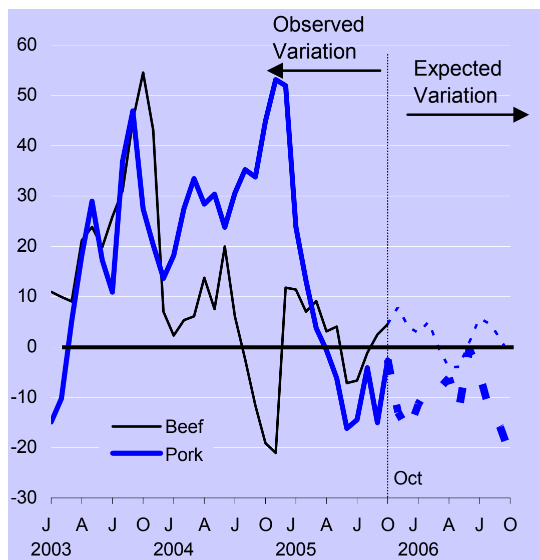
US dollars per pound



Annual percentage change



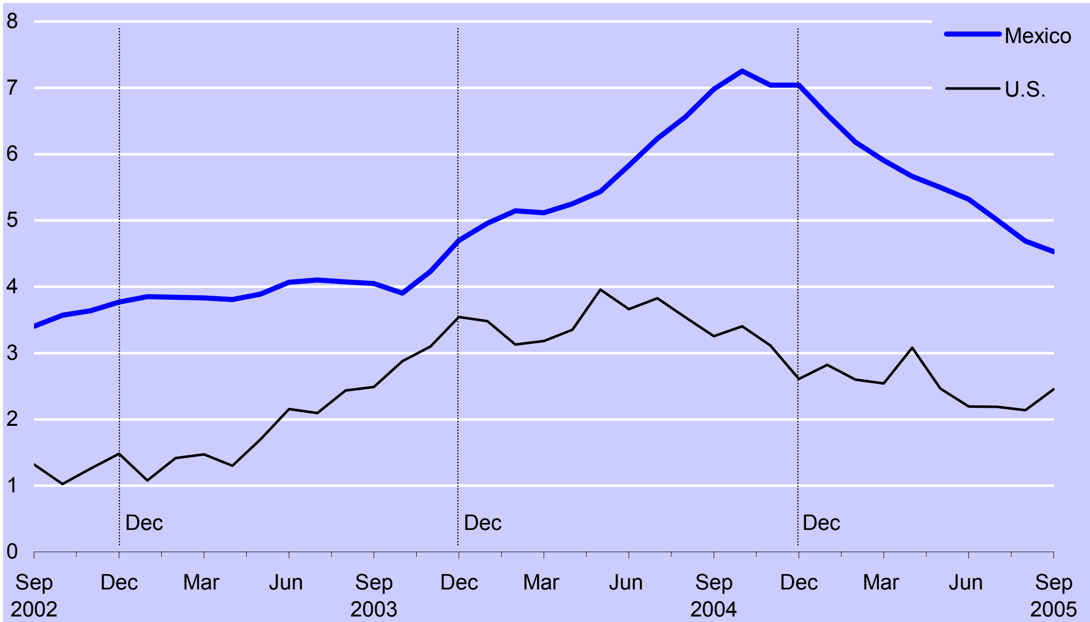
Annual percentage change



1/ Futures prices correspond to October 25, 2005.
Source: U.S. Department of Agriculture.

Graph 9 **Food Prices in Mexico and the U.S.**[1/]

Annual percentage change



1/ Mexico's food price information corresponds to the core food subindex published by Banco de México, while for the U.S. it corresponds to the series of foods and beverages from the consumer price index published by the Bureau of Labor Statistics.

II.1.2.2. Core Services Subindex

The increment in core services inflation was mainly related to the higher non-housing services' growth rate. Annual price inflation of non-housing services rose from 4.32 to 4.58 percent from June to September 2005. Within that group, food services contributed the most to such increase, accounting for practically half the annual variation exhibited. Insurance prices fell during 2004 and in 2005 their growth rate was close to zero, thus implying an increase in annual terms in insurance price inflation. Housing services inflation remained low and practically unchanged: from an annual growth rate of 2.39 percent in June to 2.37 percent in September 2005.

II.1.3. Monthly Inflation

Monthly inflation was 0.39, 0.12 and 0.40 percent during July, August and September 2005, respectively. In the last two months of the quarter, observed increases were below those forecasted at the beginning of July in Banco de México's Survey of Private Sector Economic Analysts Expectations. The non-core index exhibited reduced growth during both months, as compared with the previous year. In contrast, inflation in July was above forecasts, which coincided with higher core and non-core inflation figures than those recorded during the same month of 2004 (Table 2).

Table 2 **Observed and Expected Monthly CPI Inflation**

Percent

	2004				2005			
	Observed			Expected 1/	Observed			Expected 1/
Month	Non-core	Core	CPI	CPI	Non-core	Core	CPI	CPI
July	0.46	0.17	0.26	0.18	0.76	0.22	0.39	0.25
August	1.48	0.22	0.62	0.29	0.22	0.07	0.12	0.44
September	2.06	0.26	0.83	0.53	0.87	0.18	0.40	0.63

1/ Headline CPI inflation expected at the end of the previous quarter obtained from Banco de México's Survey of Private Sector Economic Analysts' Inflation Expectations.

II.1.4. Producer Price Index

In September 2005, the Producer Price Index (PPI) excluding oil recorded an annual variation of 3.44 percent. As shown in Graph 10, this indicator has fallen significantly during the last year (in August 2004 it reached 7.44 percent, the highest level since January 2001). The construction price subindex accounted for most of the decline of the PPI (the subindex's annual growth rate fell from 15.21 percent in August 2004 to 0.16 percent in September 2005). During the third quarter of 2005, the PPI exhibited a reduction of 0.23 percentage points as a result of the lower price inflation of its agriculture, forestry and fishing components (Table 3).

Graph 10 **Producer Price Index Excluding Oil**

Merchandise and final services, annual percentage change

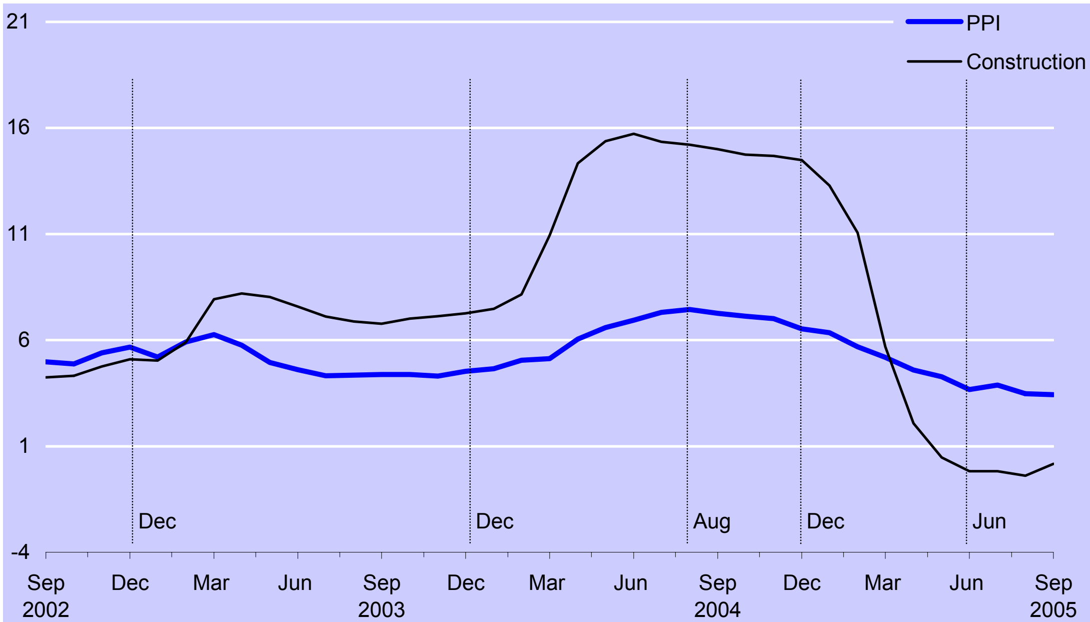


Table 3 **Producer Price Index Excluding Oil**

Merchandise and final services, annual percentage change

Item	Annual variation Dec-2004	Annual variation Jun-2005	Annual variation Sep-2005	Annual Incidence [1/] Dec-2004 (a)	Annual Incidence Jun-2005 (b)	Annual Incidence Sep-2005 (c)	Difference (c)-(a)	Difference (c)-(b)
PPI	**6.52**	**3.67**	**3.44**	**6.52**	**3.67**	**3.44**	**-3.0863**	**-0.2364**
Primary Sector	**8.58**	**12.75**	**5.49**	**0.31**	**0.44**	**0.21**	**-0.0991**	**-0.2366**
Agriculture, forestry and fishing	8.08	13.68	6.07	0.26	0.43	0.21	-0.0529	-0.2196
Mining	13.12	4.86	0.22	0.05	0.02	0.00	-0.0462	-0.0170
Secondary Sector	**7.78**	**1.82**	**1.76**	**3.23**	**0.77**	**0.74**	**-2.4906**	**-0.0294**
Manufacturing	5.10	2.71	2.46	1.51	0.80	0.72	-0.7904	-0.0732
Food, beverages and tobacco	7.27	5.30	4.62	0.69	0.50	0.44	-0.2532	-0.0650
Textiles, apparel, and leather industry	2.88	1.59	2.36	0.08	0.04	0.06	-0.0156	0.0193
Timber and by-products	8.68	5.80	3.53	0.03	0.02	0.01	-0.0192	-0.0085
Paper and by-products, printing and editorial	2.96	3.95	3.60	0.04	0.05	0.04	0.0070	-0.0043
Chemical, oil, rubber and plastic industries	8.98	7.73	7.83	0.37	0.32	0.32	-0.0446	0.0072
Non-metal minerals	1.59	0.59	-0.21	0.02	0.01	0.00	-0.0180	-0.0078
Basic metal industries	48.87	-4.32	-6.50	0.14	-0.02	-0.03	-0.1617	-0.0084
Metal products, machinery and equipment	1.43	-1.28	-1.28	0.14	-0.13	-0.13	-0.2686	0.0008
Other manufacturing industries	2.68	0.58	-0.82	0.01	0.00	0.00	-0.0165	-0.0065
Construction	14.49	-0.18	0.16	1.72	-0.02	0.02	-1.7002	0.0437
Tertiary Sector	**5.44**	**4.54**	**4.60**	**2.98**	**2.46**	**2.49**	**-0.4966**	**0.0296**
Electricity and Gas	11.32	-0.54	1.24	0.19	-0.01	0.02	-0.1686	0.0267
Restaurants and hotels	5.22	4.56	4.25	0.34	0.30	0.27	-0.0687	-0.0205
Transport and communications	8.23	6.00	5.90	1.21	0.89	0.87	-0.3346	-0.0122
Real estate rental	3.63	2.63	2.67	0.40	0.29	0.29	-0.1127	0.0027
Personal, social and community services	4.03	4.87	5.04	0.84	1.00	1.03	0.1880	0.0329

1/ In some cases, component's figures may not add up due to rounding up.

II.2. Main Determinants of Inflation

II.2.1. International Environment

The world economy continued to show a significant expansion during the third quarter of 2005. US GDP grew vigorously during the period, despite the impact of the hurricanes that struck the coast of the Gulf of Mexico. Although the latter are expected to affect economic activity also during the fourth quarter, analysts consider that their effects will be of small magnitude and short-lived. Thus, in 2005 and 2006, U.S. economic growth is expected to decelerate gradually as compared with 2004, to growth rates that are closer to potential. World economic growth during the July-September period was also fueled by the dynamism of the economies of China and other Asian emerging countries and, to a lesser extent, by the expansion of GDP in Japan. Lackluster growth continues to prevail in the euro area economy and although most recent data suggests an improvement in domestic demand and exports during the third quarter, the increase in oil prices is a risk factor for growth.

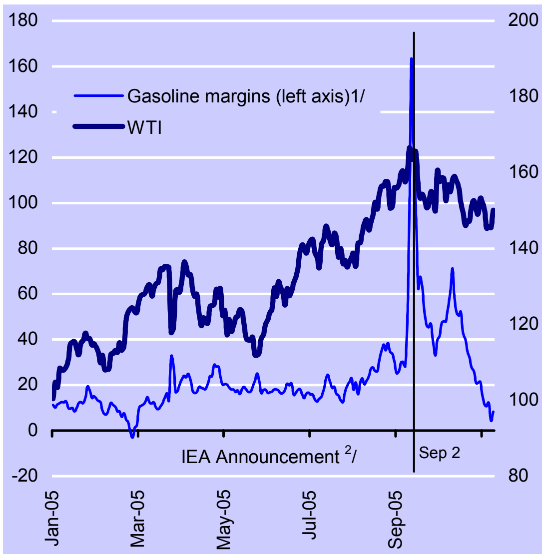
Despite the aforementioned good performance and an overall positive outlook, risks for the world economy have increased mainly as a result of a new surge in oil prices. This scenario has translated into higher inflationary pressures in several countries and could affect world economic growth. On the other hand, interest rate spreads for emerging markets' sovereign issuers have rebounded recently, in line with an increase in inflationary pressures and the likelihood of higher interest rates in the U.S. Nonetheless, spreads remain close to the record low levels reached at the end of September and the beginning of October.

II.2.1.1. Oil Prices

During the third quarter, international prices of crude oil continued to follow the upward trend observed during the first half of 2005. After a slight reduction in mid-July, prices continued to increase, as a result of both the higher global demand for oil and different problems related to oil production and refining. Hurricanes Rita and Katrina severely affected a significant part of U.S. oil infrastructure in the Gulf of Mexico, putting more pressure on oil supply capacity worldwide. As a result, the price of WTI oil reached a record high of nearly 70 US dollars per barrel on August 30 (Graph 11).

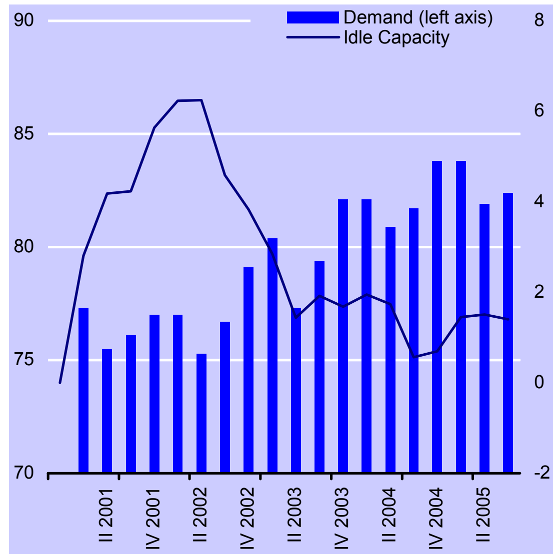
Graph 11 Oil Prices and Oil Demand

a) WTI Prices and Gasoline Margins
US cents per gallon



Source: U.S. Department of Energy and Bloomberg.
1/ Spread between the price per gallon of wholesale regular conventional gasoline in New York and of a gallon of WTI.
2/ On September 2005, the IEA announced that, in coordination with the U.S. government, it would sell 60 million barrels of crude oil and oil-related products from its emergency reserves.

b) Oil World Demand and OPEP Idle Production Capacity
Million Barrels per Day



Source: International Energy Agency.

Nonetheless, the announcement by the International Energy Agency (IEA) that its member countries would increase supply by 60 million barrels of oil-related products (including 30 million from the U.S. Strategic Petroleum Reserve), together with more flexible legal and environmental restrictions adopted by U.S. authorities regulating oil supply in the Gulf of Mexico, allowed oil prices to return to levels close to those observed prior to the hurricanes. The margin between the prices of gasoline and WTI oil, which had increased as a result of the hurricanes, also fell after the IEA announcement, although with a certain lag due to problems related to the production and distribution of oil-refined products. The price of the WTI oil averaged 63.35 US dollars per barrel during the quarter, 10.25 dollars above the average recorded during the April-June period. The Mexican crude oil export mix averaged 49.47 US dollars per barrel, i.e. 8.28 dollars above the price observed during the previous period.[5]

[5] On October 28, the price per barrel of the WTI oil was 60.68 US dollars, while that of the Mexican crude oil export mix was 47.59 US dollars.

II.2.1.2. Developments in the U.S. Economy

According to preliminary data, during the period July-September 2005, US GDP grew at an annualized quarterly rate of 3.8 percent (3.6 percent at an annual rate), above the 3.3 percent figure observed during the previous quarter (3.6 percent at an annual rate). Economic growth during the third quarter was mainly fueled by personal consumption expenditure and, to a lesser extent, by government expenditure. Personal consumption grew at an annualized rate of 3.9 percent (3.4 percent during the previous quarter), supported by employment growth and the continuous boom in real estate prices. Investment, both residential and non-residential, continued to expand, although at a lower rate than that observed during the April-June period. Net exports had a positive contribution to GDP growth, although considerably below that of the second quarter. Inventory adjustment was the main factor limiting U.S. economic growth during the third quarter.

Hurricanes Katrina and Rita left a significant human and material toll. In addition to the direct losses, the surge in gasoline prices has adversely affected the performance of the economy. Analysts surveyed by Blue Chip revised downward their forecasts for GDP growth for October-December, from 3.3 percent in August to 2.9 percent in October. Nonetheless, overall, analysts expect the effects of the hurricanes on the U.S. economy to be relatively moderate and short-lived.

During the third quarter, industrial production grew at an annual rate of 2.7 percent, below that recorded during the previous quarter (3 percent) and that observed in 2004 (4.1 percent). The slowdown observed since May 2004 was heightened by the damage of the hurricanes to oil infrastructure in the Gulf of Mexico, which affected industrial production in September. It is important to note that excluding the effects of the hurricanes and other temporary factors, the monthly growth of industrial production in September was higher than that observed on average throughout the year. Capacity utilization reached 78.6 percent at the end of the quarter, slightly below its historical average. Despite the impact of the hurricanes, analysts expect industrial production to grow 3.2 percent in 2005 (Table 4).

Table 4 **Expected U.S. GDP and Industrial Production Growth in 2005**

Annual and annualized quarterly percentage change

	GDP					
	Expected at the end of the second quarter			Most recent data		Observed
	III-2005 1/	2005 2/	2006 2/	2005 2/	2006 2/	III-2005 1/
Consensus Forecasts	3.2	3.5	3.3	3.5	3.3	3.8
Blue Chip Economic Indicators	3.3	3.5	3.3	3.5	3.3	
	Industrial Production					
Blue Chip Economic Indicators	3.5	3.5	3.5	3.2	3.4	1.3

1/ Annualized quarterly change (seasonally adjusted series).
2/ Annual percentage change.
Source: *Consensus Forecasts* (June 13, 2004 and October 10, 2005), Blue Chip Indicators (June 10 and October 10, 2005) and BEA-NIPA.

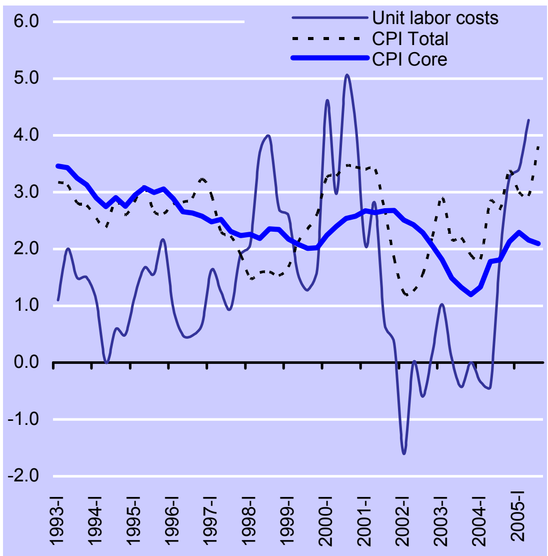
The labor market continued to strengthen during the first two months of the third quarter; however, September figures were affected significantly by the effects of the hurricanes. Employment creation averaged more than 200 thousand jobs in July and August and then fell to 35 thousand in September. It is important to point out that this reduction was considerably below analysts' expectations, partly due to the difficulty in collecting data in the hurricane-affected areas. Manufacturing employment contracted by 15 thousand jobs during the period July-August and by 27 thousand additional jobs in September. Once the situation in the hurricane-affected areas normalizes, employment is expected to strengthen again.

Headline inflation indicators followed an upward trend throughout the quarter. The annual rate of growth of the Consumer Price Index rose from 2.9 percent during the second quarter to 3.8 percent during the third, while that of the personal consumption deflator increased from 2.5 to 3.1 percent during the same period. Such increase was mainly caused by the surge in energy prices. In fact, measures of core inflation, for both the CPI and the personal consumption deflator, remained relatively stable during the quarter. During the third quarter, the former grew at an annual rate of 2.1 percent, slightly above that recorded during the second (1.9 percent). Although core inflation is at moderate levels and long-term inflation expectations have remained stable (Graph 12), risks of a rebound in inflation have increased. In particular, concerns over the possible second-round effects of surging oil prices (i.e. for the possibility that the latter leads to increases in the prices of other goods and services) have heightened. Other indicators of inflationary pressures also point to higher risks. In particular, the rate of growth of unit labor costs has been increasing consistently since mid-2004. Furthermore, the unemployment rate is at low levels (5.1 percent in September) and, according to some analysts, the output gap could turn positive during 2005.[6]

Graph 12 **United States: Inflation and Unit Labor Costs**

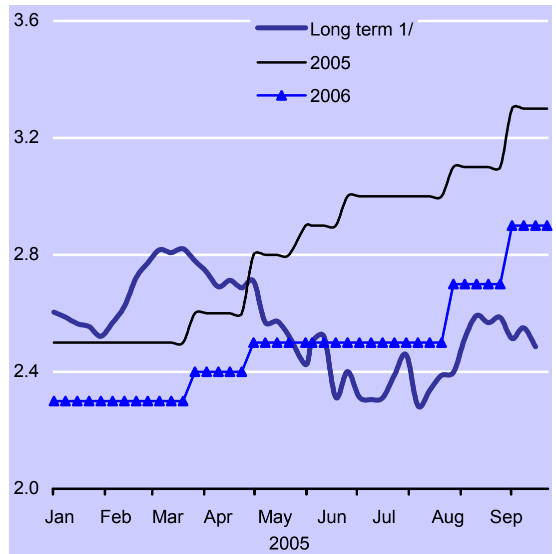
Annual percentage change

a) Labor Costs and Inflation



Source: Bureau of Labor Statistics.

b) Inflation Expectations



Source: Federal Reserve Bank of Saint Louis and Blue Chip.
1/ Refers to the yield of the 10-year U.S. Treasury nominal bond less the 10-year indexed bond.

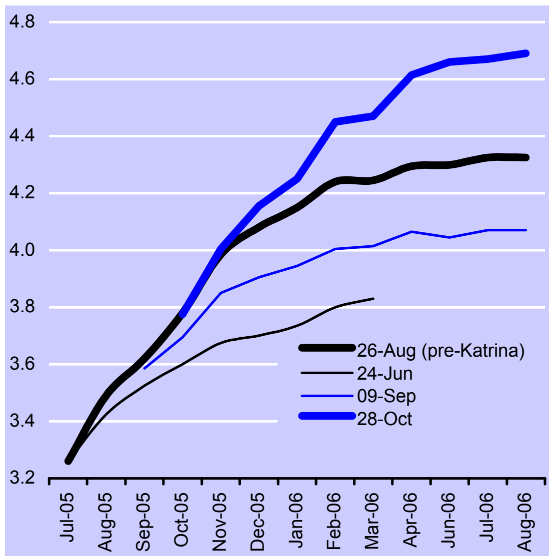
The Federal Reserve continued its policy of gradually withdrawing the monetary stimulus during the third quarter. In the two meetings held during the quarter, the Federal Open Market Committee (FOMC) raised the target for the federal funds rate by 25 basis points. As a result, the federal funds rate reached 3.75 percent at the end of September, 2.75 percentage points above the minimum level observed in June 2004. Considering that the balance of risks regarding both inflation and growth are balanced and that hurricane-related disruptions in economic activity do not pose a persistent threat, the Federal Reserve reiterated its intention to continue its policy of gradually increasing its reference interest rate. The hurricane episode prompted the curve of the federal funds rate futures to move downward for some days, under the belief that the Federal Reserve could make a pause in one of the remaining FOMC meetings of this year. Nonetheless, as the perception of higher inflationary risks increased, the futures curve rose again, reaching at the end of October levels above those observed prior to the hurricanes (Graph 13).

[6] Output gap forecasts for 2005 published by the OECD are still negative, while those of the IMF result in positive figures for 2005 and subsequent years (see OECD, *Economic Outlook*, No. 77, May 2005 and IMF, *World Economic Outlook*, September 2005).

Graph 13 **United States: Federal Funds Rate Futures and Interest Rates**

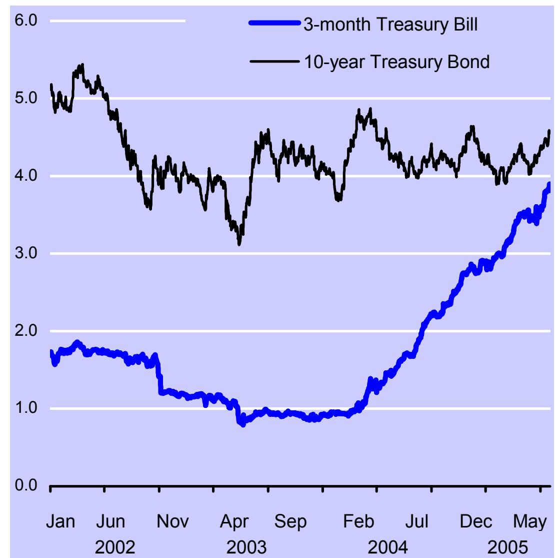
Percent

a) Federal Funds Rate Futures



Source: Federal Reserve Board and CBOT.

b) Interest Rates



Source: Federal Reserve Board.

Interest rates on 10-year Treasury bonds remained between 4 and 4.25 percent throughout the quarter and did not increase despite changes in short-term interest rates. At the end of the third quarter, the spread between the 10-year interest rate and the federal funds rate was slightly above half a percentage point, level below its historical average (91 basis points since 1954) and the lowest since April 2001. Nonetheless, in October, and as a result of the rebound in inflation and the strength of economic activity, the 10-year interest rate increased by 65 basis points with respect to its minimum level of the year, reaching 4.56 percent on October 28.

During the third quarter, the US dollar depreciated by 1 percent against major currencies and by 0.7 percent against a broad currency basket, therefore partially reverting the gains recorded during the April-June period.[7] The slight appreciation of the US dollar against the euro partly reflected the uncertainty regarding the outlook for growth for the European economy. The US dollar depreciated 5.1 percent against the Canadian dollar

[7] The Federal Reserve Board's index of the effective exchange rate of the dollar vis-à-vis the major currencies is an average of the foreign exchange values of the US dollar against the euro, yen, Canadian dollar, pound sterling, Swiss franc, Australian dollar and Swedish crown, weighted by the trade share of the country of each currency. The broad index is a weighted average of the foreign exchange values of the US dollar against the currencies of 26 countries. From the end of the third quarter to October 28, the US dollar appreciated by 0.7 percent against the major currencies and by 0.5 percent against the broad currency basket.

(probably as a result of the fact that Canada is a net exporter of energy goods). On the contrary, it appreciated 2.1 and 1.5 percent against the yen and the pound sterling, respectively.

Forecasts for U.S. growth for 2005 and 2006 have exhibited few changes, despite the effects of the hurricanes. In general terms, analysts expect economic growth not to be significantly affected by these events, given the sound performance of the economy prior to the hurricanes, the stimuli from expenditure in reconstruction efforts together with other public supports destined for the hurricane-affected areas, and the measures introduced to contain increases in oil and gasoline prices, among other factors. Thus, it is expected that the impact on consumption and GDP growth will be more noticeable during the last quarter of this year, and that the economy will recover rapidly from the impact of the hurricanes throughout 2006. Analysts surveyed by Blue Chip expect US GDP to grow 3.5 and 3.3 percent in 2005 and 2006, respectively, closer to what is perceived as the potential rate. On the other hand, forecasts for inflation for 2005 and 2006 have been revised upward to 3.3 and 2.9 percent, respectively, as a result of the higher prices of energy. Nonetheless, long-term inflation expectations remain anchored around 2.5 percent.

Although the overall outlook for the U.S. economy for the medium term is one of stable growth and contained inflation, several risks prevail. The large current account deficit is one of them. Although the external deficit narrowed during the second quarter, additional pressures could arise from a widening of the fiscal imbalance due to the reconstruction efforts in the hurricane-affected areas. In fact, some analysts consider that the trend to reduce the public deficit could revert as a result of those efforts and that the fiscal deficit could become a more immediate cause of concern. Another risk relates to the evolution of the oil market. Up to now, the surge in oil prices has had a moderate effect on economic activity and core inflation has remained relatively stable. Nonetheless, effects of higher magnitude in the future cannot be discarded. Furthermore, a rapid increase in interest rates could affect both the real estate market and consumption significantly.

II.2.1.3. Economic Developments in the Rest of the World

Euro area GDP grew at an annualized quarterly rate of 1.2 percent during the April-June period (1.5 percent in January-March). This slowdown is explained mostly by a lower contribution of the external sector to GDP growth. Consumption and investment spending continued to be affected by the low levels of confidence of consumers and firms, due to the volatility in oil prices, among other factors. Nevertheless, the depreciation of the euro throughout the year, the prevailing accommodative monetary conditions, and the strength of the world economy apparently have allowed for a slight strengthening of economic activity during the third quarter. However, if the upward trend in oil prices were to continue economic activity in the region could be affected negatively in the short term. Furthermore, oil price increases have begun to affect CPI inflation, which rose from 2.1 percent at an annual rate in June to 2.6 percent in September. In this context, the European Central Bank announced that it would monitor closely the behavior of inflation.

Economic activity in the United Kingdom remained weak during the third quarter: GDP grew at an annualized quarterly rate of 1.6 percent. The monetary authorities reduced the reference interest rate in August for the first time since July 2003, due to increasing concerns over the persistent weakness in consumption and private investment. CPI inflation has risen in recent months due mainly to the surge in energy prices.

During the first half of 2005, the Japanese economy grew as a result of the strength of household consumption and the rebound in non-residential investment. Household consumption strengthened as a result of a continuous improvement in labor market conditions, while investment was boosted by the greater confidence of the business sector and the expansion of corporate profits. In addition, the external sector contributed to economic growth during the second quarter. The economy is expected to have slowed its rate of growth during the July-September period. Despite the unfavorable conditions in the oil market, firms have revised upward their projections for capital expenditure in 2005. Furthermore, progress in structural reform is another factor supporting confidence. In this context, forecasts for GDP growth for 2005 have been revised upward, from 1.3 percent in June, to 2.1 percent in October.

Table 5 **Forecasts for GDP Growth in Other Advanced Economies**

Annual and annualized quarterly percentage change

	Forecasts at the end of the second quarter			Most recent data Estimate		Forecast
	III-2005 1/	2005 2/	2006 2/	III-2005 1/	2005 2/	2006 2/
Canada	2.8	2.6	2.9	2.8	2.8	3.0
Euro area	1.6	1.3	1.8	1.6	1.3	1.6
Japan	0.8	1.3	1.5	2.4	2.1	1.7
United Kingdom	2.0	2.4	2.3	1.6 3/	1.8	2.2

1/ Annualized quarterly change (seasonally adjusted series).
2/ Annual percentage change.
3/ Observed figure.
Source: Consensus Forecasts June 13 and October 10, 2005. Annualized quarterly rates are obtained from reported quarterly percentage change forecasts.

In China, GDP grew 9.5 percent and 9.4 percent at an annual rate during the second and third quarters, respectively, after having grown 9.4 percent during the first quarter. Such result is explained by the strength of both domestic demand and exports. The expansion of economic activity has encouraged analysts to revise gradually upward their forecasts for growth for 2005, from 8.6 percent in April, to 9.2 percent in October (Asia Pacific Consensus Forecasts). In July, the Chinese authorities decided to revaluate the renminbi against the US dollar by 2 percent and move towards a more flexible exchange rate regime, partly in response to the large surplus in the current account balance.[8] The renminbi has hardly fluctuated after this adjustment: since that date up to October 28, it has only appreciated an additional 0.3 percent.

After having rebounded sharply during 2004, economic growth in Latin America decelerated to a more sustainable rate during the first half of 2005. Higher revenues from exports of primary goods, mainly as a result of an improvement in the terms of trade of many countries in the region, continued to boost economic activity. In contrast, the rate of growth of manufacturing exports weakened somewhat. Since the second quarter, forecasts for regional growth for 2005 were revised slightly downward, although the regional average masks a divergence among countries' prospects. For example, for Argentina, Chile and Peru the outlook for the year improved, while for Mexico and Brazil it has deteriorated slightly. In general terms, after the rebound observed in the second half of 2004, inflation in Latin America has stabilized throughout 2005, although it is still volatile and

[8] Since then, the central bank uses a currency basket to manage the exchange rate, which includes mainly the US dollar, the euro, the yen and the won. Although weights of the currencies in the basket have not been published, authorities have indicated that they are in line with the trade share of China with the countries of each currency. On September 25, the authorities announced an increase in the range of fluctuation of the renminbi against currencies other than the US dollar, from +/- 1.5 percent to +/- 3 percent.

differences prevail among countries. In particular, inflation in Argentina has increased, from an annual rate of 6 percent at the end of 2004 to 10.3 percent in September, due to a combination of both growing wage pressures and price adjustments in some goods that were lagging, as well as some relaxation of monetary policy.

Emerging economies' access to external financing remained favorable during the third quarter, as a result of ample liquidity worldwide, investors' consequent search for higher yields, and reduced external financing requirements of many emerging economies. By the end of the third quarter, most emerging economies had covered their external borrowing requirements for 2005 and many of them were already beginning to pre-finance their external borrowing requirements for 2006. In this context, interest rate spreads for emerging economies' sovereign issuers fell, reaching in some cases record lows at the end of September and the beginning of October.[9]

The rebound in inflation and inflation expectations in the U.S. and the euro area has reinforced the perception that the Federal Reserve and the European Central Bank may accelerate the pace of monetary tightening. This could increase investors' risk aversion and bring about a deterioration of emerging economies' access to international financial markets. In fact, in recent weeks some recomposition of capital flows appears to have taken place, affecting several emerging economies.

II.2.2. Wages, Productivity and Employment

II.2.2.1. Contractual Wages

During the third quarter of 2005, contractual wages in enterprises under federal jurisdiction recorded a slightly higher increase than that observed during the same quarter of the previous year (4.4 vs. 4.3 percent).[10] The average increase of this wage indicator during the period January-September 2005 matched that observed during the first nine months of the previous year (4.4 percent). Hence, wage negotiations during 2005 were not affected by the rebound in headline inflation observed during the second half of 2004 (Graph 14a).

[9] At the end of the quarter, the EMBI Global indicator was 235 basis points and on October 3 it reached a historical minimum of 231 basis points. On October 27, the EMBI Global reached 252 basis points.

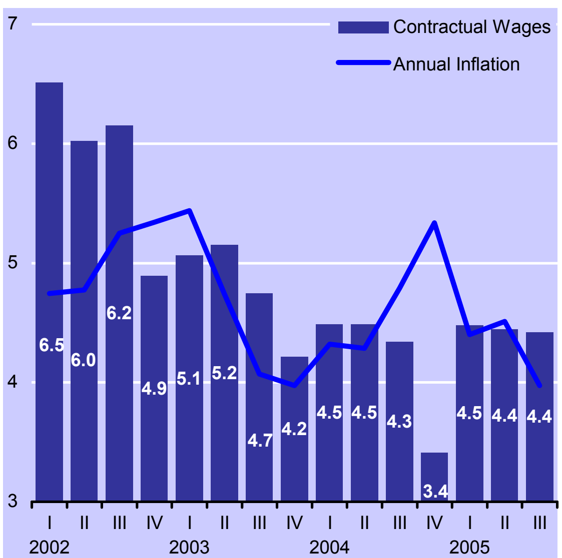
[10] Average of the period weighted by number of benefited workers.

During the third quarter of 2005, wage increases in public enterprises were 0.1 percentage points above those recorded during the same period of the previous year (Graph 14b and Table 6). However, this difference could increase during the next quarter, given that the Social Security Institute (*Instituto Mexicano del Seguro Social, IMSS*) granted its workers a higher wage increase (above one percentage point) than that negotiated in the previous year's wage revision. During the third quarter, the gap between wage increases granted by private and public enterprises was 0.6 percentage points, as compared with 0.7 points during the same period of 2004.

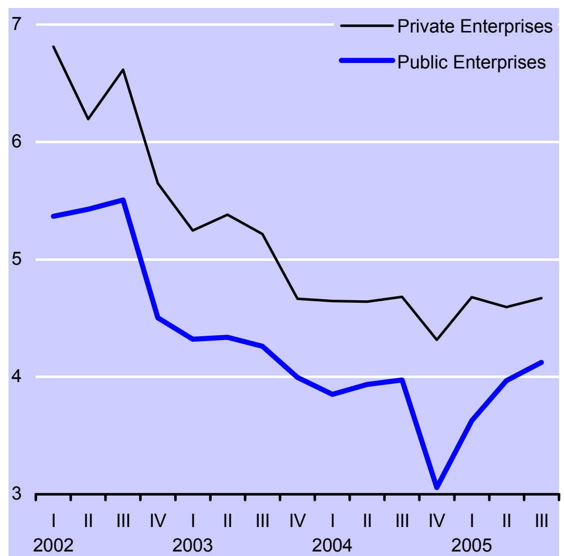
Graph 14 Contractual Wage Increases and Inflation

Percent

a) Contractual Wages and Inflation



b) Contractual Wages by Enterprise Type



Source: Prepared by Banco de México with data from the Ministry of Labor.

Table 6 **Contractual Wage Increases [1/] and Number of Workers Benefited by Enterprise Type**

Percent

	2004						2005						
	I	II	III	Jan-Sep	IV	Jan-Dec	I	II	III	Jul	Aug	Sep	Jan-Sep
Contractual Wage Increase (percent)[1/]													
Total	4.5	4.5	4.3	4.4	3.4	4.1	4.5	4.4	4.4	5.0	4.2	4.6	4.4
Public Enterprises	3.9	3.9	4.0	3.9	3.1	3.5	3.6	4.0	4.1	4.7	4.1	4.4	3.9
Private Enterprises	4.6	4.6	4.7	4.7	4.3	4.6	4.7	4.6	4.7	5.0	4.5	4.6	4.6
Number of Workers Insured (percentage share)													
Total	100	100	100	100	100	100	100	100	100	100	100	100	100
Public Enterprises	20	21	48	28	72	42	19	22	46	7	73	5	28
Private Enterprises	80	79	52	72	28	58	81	78	54	93	27	95	72

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

II.2.2.2. Earnings and Productivity

Between January and July 2005, real average earnings and labor productivity in maquiladora and non-maquiladora manufacturing industries, as well as in the retail sector, grew at an annual rate below that observed during the same period of the previous year. The former indicator grew at a slower rate, therefore contributing to an increase in the annual growth rate of unit labor costs (Table 7).

Table 7 **Earnings, Labor Productivity, and Unit Labor Costs (ULC) by Sectors**

Annual percentage change

	Non-maquiladora Manufacturing Industry			Maquiladora Industry			Retail		
	Labor Productivity	Real Average Earnings	ULC	Labor Productivity	Real Average Earnings	ULC	Labor Productivity	Real Average Earnings	ULC
2004									
(A) Jan-Jul	**6.7**	**0.7**	**-5.6**	**2.6**	**0.7**	**-1.8**	**8.0**	**2.9**	**-4.7**
Jan-Dec	6.3	0.1	-5.8	2.1	-0.2	-2.2	7.0	2.7	-4.0
2005									
Jan	3.4	-0.5	-3.8	-1.6	-2.2	-0.6	6.1	-3.1	-8.7
Feb	3.7	-0.2	-3.7	-0.9	-2.0	-1.1	2.7	4.1	1.3
Mar	-4.2	0.2	4.6	0.3	0.0	-0.2	3.3	2.5	-0.7
Apr	7.2	-2.2	-8.8	-2.8	-3.4	-0.7	7.5	3.4	-3.8
May	4.1	0.0	-4.0	-4.2	1.0	5.4	2.4	-4.8	-7.0
Jun	0.7	1.4	0.7	1.0	1.2	0.2	5.5	1.7	-3.7
Jul	-1.2	-1.3	-0.2	-1.6	0.2	1.8	2.5	-1.7	-4.0
(B) Jan-Jul	**2.0**	**-0.4**	**-2.2**	**-1.4**	**-0.7**	**0.7**	**4.3**	**0.3**	**-3.8**
Difference (B)-(A)	**-4.7**	**-1.1**	**3.4**	**-4.0**	**-1.4**	**2.5**	**-3.7**	**-2.6**	**0.9**

Source: Prepared by Banco de México with data from INEGI.

During the first seven months of 2005, labor productivity in the non-maquiladora manufacturing industry grew at an annual average rate of 2.0 percent. Nonetheless, this indicator continued to follow the downward trend observed since the second half of 2004, basically as a result of the slowdown in non-maquiladora manufacturing production. The decline in labor productivity in the divisions of timber industry, textiles, and metal products, machinery and equipment deserves mention (Table 8). On another front, during the January-July 2005 period, real average earnings recorded an annual growth of -0.4 percent. As a result, unit labor costs (ULC) also recorded negative annual growth, reaching an average of -2.2 percent during the referred period. Notwithstanding the above, it is important to point out that the fall in ULC during the first seven months of the year was below that recorded during the same period of the previous year (Table 7, Graph 15a and Graph 16a).

Table 8 **Labor Productivity in the Non-maquiladora Manufacturing Industry**

Annual percentage change

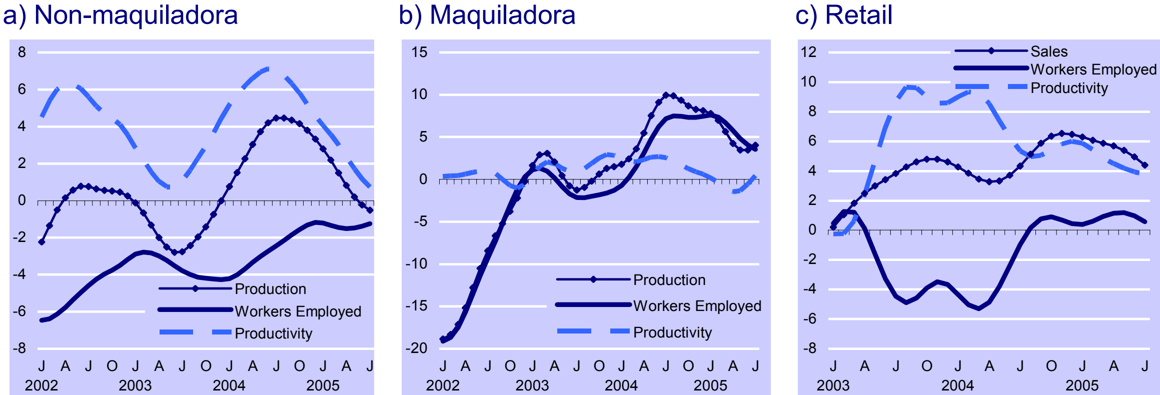
Period	Total	Economic Activities [1/]								
		I	II	III	IV	V	VI	VII	VIII	IX
2004										
(A) Jan-Jul	**6.7**	**2.9**	**11.5**	**9.1**	**4.1**	**7.6**	**5.2**	**5.2**	**8.9**	**13.5**
Jan-Dec	6.3	3.3	10.4	5.4	3.6	7.1	5.4	5.3	8.2	6.0
2005										
Jan-Dec	3.4	5.0	4.6	-8.9	2.8	3.5	5.2	0.8	-1.9	40.3
Feb	3.7	7.8	5.7	-6.2	-1.7	2.8	-1.3	-6.8	3.6	-0.8
Mar	-4.2	1.5	-10.8	-6.2	-5.2	-4.9	-4.4	-2.4	-10.8	-1.2
Apr	7.2	8.1	8.4	0.2	5.2	7.9	8.9	1.8	8.0	-3.6
May	4.1	6.2	0.5	-4.3	2.7	4.8	3.2	1.3	2.4	14.6
Jun	0.7	5.7	-1.4	-7.3	3.3	0.4	2.9	-1.7	-5.0	6.9
Jul	-1.2	3.4	-4.1	-11.9	1.9	-1.1	3.0	-3.8	-6.1	-5.4
(B) Jan-Jul	**2.0**	**5.4**	**0.4**	**-6.4**	**1.3**	**1.9**	**2.5**	**-1.5**	**-1.4**	**7.3**
Difference (B)-(A)	**-4.7**	**2.5**	**-11.1**	**-15.5**	**-2.8**	**-5.7**	**-2.7**	**-6.7**	**-10.3**	**-6.2**

1/ Economic activities are as follows: I, Foods, beverages and tobacco; II, Textiles; III, Timber industry; IV, Paper industry ;V, Chemicals and oil by-products; VI, Non-metal minerals; VII, Basic metal industries; VIII, Metal products, machinery and equipment; and IX, Other manufacturing industries.
Source: Prepared by Banco de México with data from INEGI.

Graph 15 **Production, Workers Employed and Labor Productivity**

Trend, annual percentage change

a) Non-maquiladora b) Maquiladora c) Retail



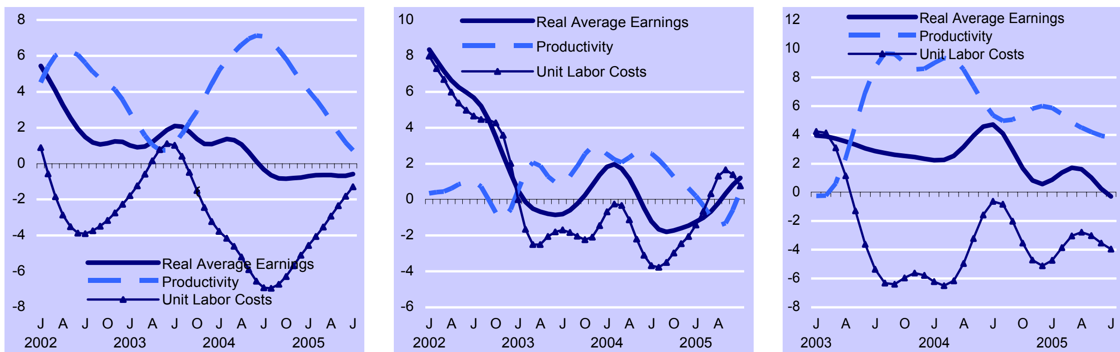
Source: Prepared by Banco de México with data from INEGI.

Productivity in the retail sector grew at an annual average rate of 4.3 percent during the period January-July 2005.[11] In tandem, real average earnings also rose 0.3 percent. As a result, ULC fell at an annual rate of 3.8 percent, 0.9 percentage points above the figure observed in the same period of 2004 (Table 7, Graph 15c and Graph 16c).

Graph 16 **Earnings, Labor Productivity and ULC**

Trend, annual percentage change

a) Non-maquiladora b) Maquiladora c) Retail



Source: Prepared by Banco de México with data from INEGI.

II.2.2.3. Employment

Employment indicators exhibited mixed results during the third quarter of 2005. On the one hand, formal employment continued to grow, despite the slowdown at an annual rate that affected economic activity. On the other, labor market indicators exhibited weakness, particularly because job creation concentrated in temporary posts and due to the sectorial composition of new jobs created.

In general terms, the most important aspects of the labor market during the third quarter of the year were as follows: a) formal employment improved, as reflected by the increasing annual variations observed during the quarter; b) job expansion concentrated mainly in temporary positions, and was more evident in larger enterprises; c) formal employment rose at an annual rate in all states; d) the increase in the number of workers insured by the IMSS included most sectors of economic activity; however, it was more evident in the services sector (in the manufacturing industry it was modest and concentrated in temporary positions);

[11] Productivity in the trade sector is calculated based on total sales and number of workers employed. Therefore, the resulting indicator cannot be compared strictly with that of the manufacturing industry, which is based on production and number of workers employed.

e) maquiladora employment continued to recover, although at a slower annual rate. In contrast, a new fall in annual terms in non-maquiladora manufacturing employment was recorded; and f) the open unemployment rate on a seasonally adjusted basis decreased slightly as compared with its average level observed during the second quarter of the year.

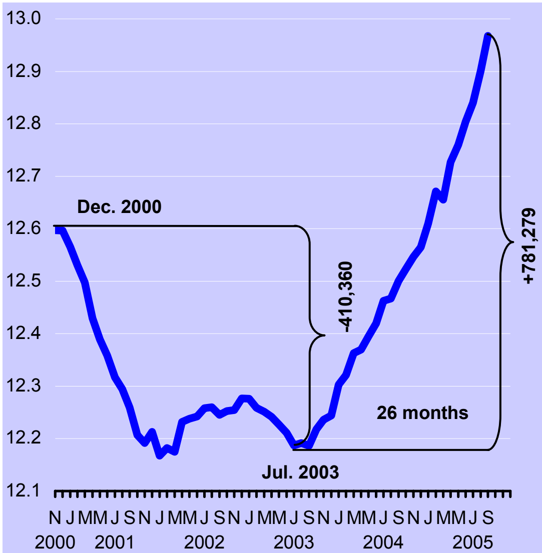
At the end of September 2005, 13,020,745 workers were insured by the IMSS, 220,962 more than the figure observed at the end of June. The number of workers insured with seasonally adjusted data rose throughout the third quarter. This indicator has increased at a monthly rate in twenty four of the last twenty six months. During such period, it accumulated an increase of 781,279 workers on a seasonally adjusted basis. As a result, formal employment figures at the end of September were 370,919 above the maximum level reached at the end of 2000 (Graph 17).

The number of workers insured by the IMSS rose by 468,723 in annual terms at the end of September of this year (annual growth of 3.73 percent). Such increase was the highest recorded in 58 months: 163,455 permanent jobs (1.5 percent increase) and 305,268 temporary jobs in urban areas (18 percent increase). Thus, temporary employment in urban areas accounted for nearly two thirds of annual job creation.

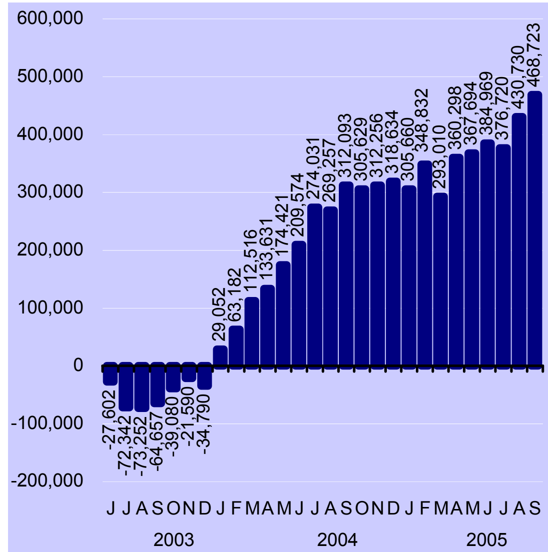
During the third quarter of 2005, formal job creation included most sectors of economic activity. Nevertheless, the most significant annual increases were observed in the services sector, particularly in trade (107,444 jobs) and other services (196,102 jobs), while in the industrial sector it was modest, especially in the manufacturing industry (61,748 jobs in both maquiladora and non-maquiladora industries). It is important to point out that the increase in the number of manufacturing workers insured by the IMSS was due to a combination of an annual decrease in permanent positions (60,196), which was offset by the growth in temporary positions (121,944) in urban areas. The dynamism of job creation in the services sector and its reduced expansion in the industrial sector could affect Mexico's potential growth rate, given the level of productivity spread between both sectors.

Graph 17 **Workers Insured by the IMSS: Permanent and Temporary in Urban Areas**

a) Million Workers Insured
Seasonally Adjusted Data



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



Source: IMSS. Seasonal adjustments by Banco de México.

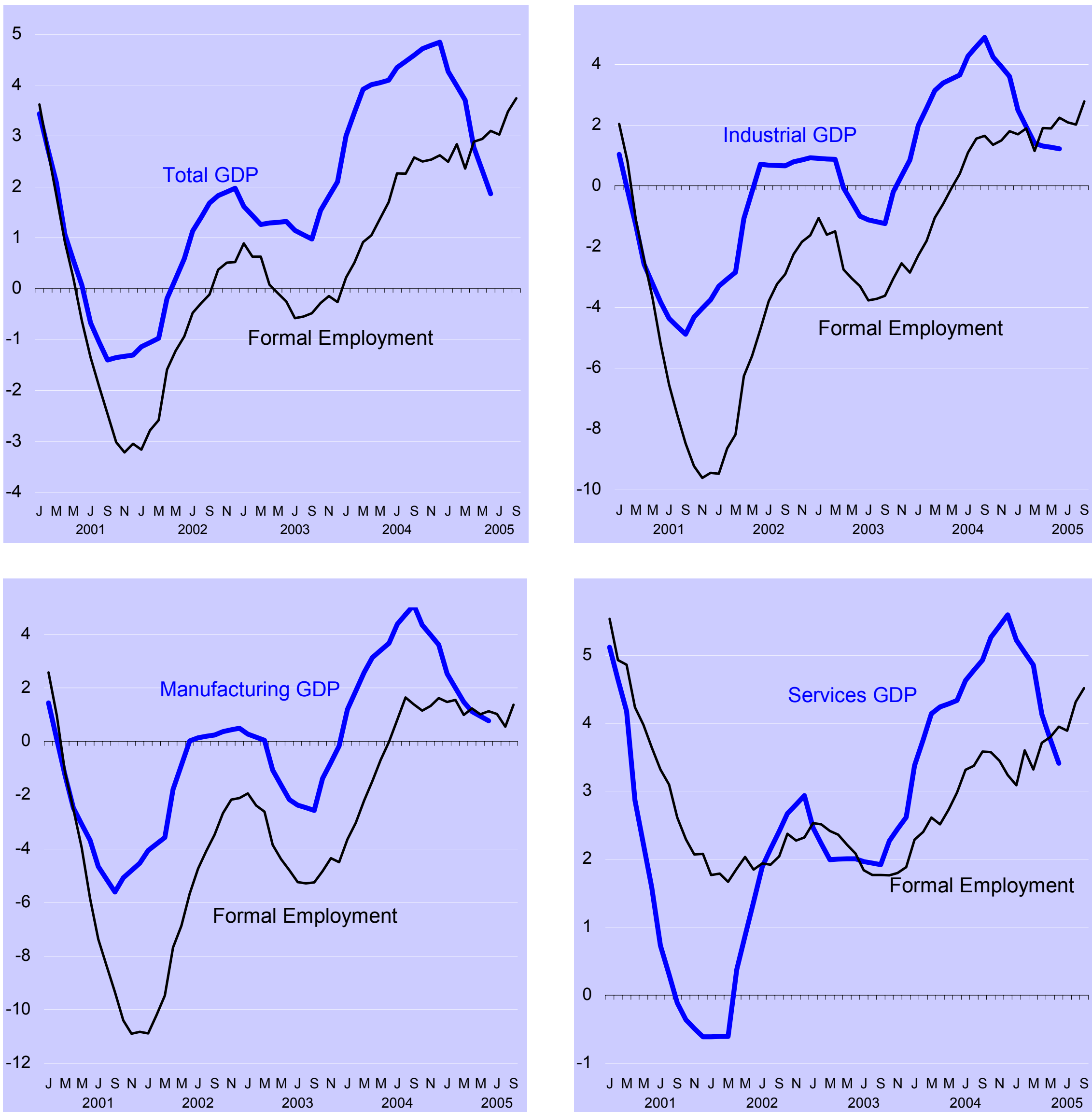
In general terms, the correlation between GDP and formal employment had exhibited a stable development for a long period. Such development was more evident in the industrial sector than in the services sector, and practically inexistent in the agriculture sector. Nonetheless, this correlation has changed (even in the industrial sector) during 2005, considering that GDP has grown at a slower rate and the number of workers insured by the IMSS has grown at a higher rate. It is possible that the contrast in the evolution of these two variables could be reflecting the results of the greater fiscal efforts done by the IMSS.[12]

During the third quarter of the year, the number of jobs in the formal sector rose in practically all states. The most significant annual increases were observed in Mexico City (98,586 jobs), Nuevo León (38,596 jobs), Jalisco (28,175 jobs), Chihuahua (30,353 jobs), Tamaulipas (28,220 jobs), and Quintana Roo (25,992 jobs). At the end of the third quarter, these six states accounted for 53 percent of annual formal job creation.

[12] It should be noted that previous exercises prepared by Banco de México suggest that nearly a third of the annual increase in the number of workers insured by the IMSS in 2005 cannot be explained statistically by the correlation that has prevailed for many years between GDP and employment. Part of this annual increment could be the result of greater fiscal efforts by the IMSS.

Graph 18 **Formal Employment and GDP**

Annual percentage change of seasonally adjusted data



Source: INEGI and IMSS; interpolation and seasonal adjustments by Banco de México.

Finally, according to the Occupation and Employment Survey (*Encuesta Nacional de Ocupación y Empleo, ENOE*) conducted by INEGI since this year, the national unemployment rate on a seasonally adjusted basis was 3.5 percent on average during the third quarter of 2005. This indicator had previously recorded 3.73 and 3.75 percent during the first and second quarters, respectively.

II.2.3. Aggregate Supply and Demand

Economic activity in 2005 has slowed as compared with GDP recorded in 2004 and, especially, with that observed in the second half of this year. This deceleration has included the three sectors of production (industrial, services and agriculture) and aggregate demand components (both external and domestic). Thus, during the present year, the slowdown of the domestic components of expenditure added to the reduced dynamism of external demand, already present since the second half of 2004.

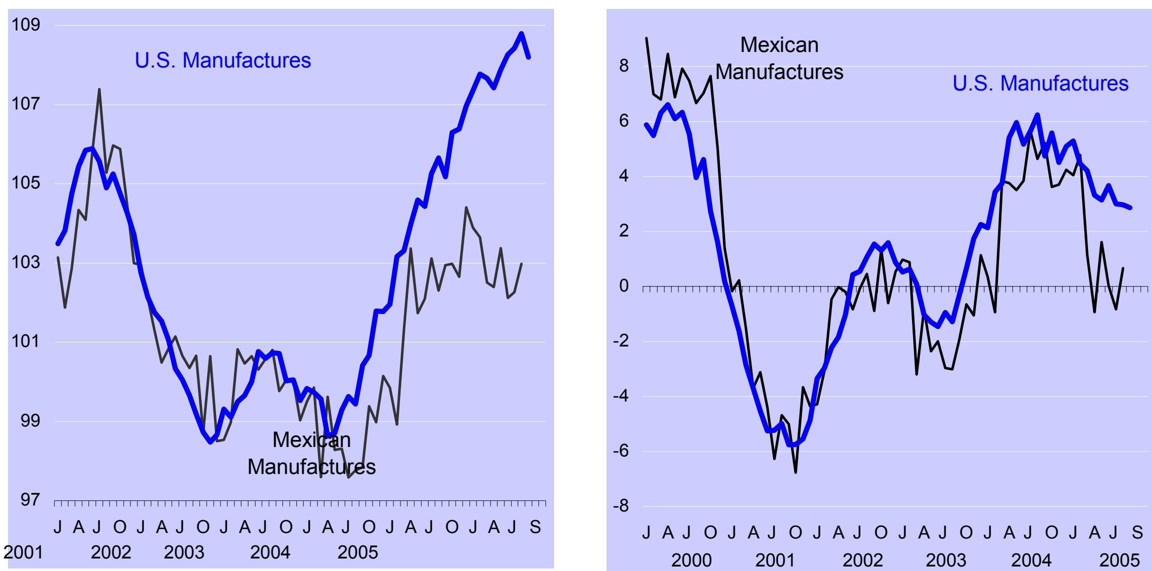
The reduced dynamism of economic activity throughout 2005 clearly reflects the current economic conditions, such as the lesser strength of external demand, which has also resulted from the reduced growth of the U.S. economy as compared with 2004. The latter has translated into a slower growth of exports, therefore affecting export production –as well as the production of other sectors- and domestic demand.

On another front, the slower growth of domestic production throughout the year clearly evidences that the lack of progress in implementing pending structural reforms continues to affect negatively the country's competitiveness and, in turn, economic activity. In contrast, in many countries which are Mexico's competitors in both external markets and in its own domestic market, actions to modernize their economies have been implemented more rapidly, therefore placing them one step ahead of our country. Should the structural reforms be implemented, Mexico would strengthen its aggregate supply -through gains in productivity- thus reverting the deterioration of its competitiveness and creating new opportunities of investment expenditure. All of the aforementioned would allow the economy to have more solid fundamentals to achieve its potential growth rate. Under such context, it is important to remember that the lack of advance in structural changes has been mentioned repeatedly in many of Banco de México's surveys conducted periodically on the manufacturing sector (among manufacturing firms, foreign investment firms and economic analysts) as the main obstacle to reach higher levels of investment in order to strengthen both productivity and competitiveness of the different sectors of the economy.

The export sector, basically manufacturing exports, has been particularly affected by the lack of advance in the aforementioned structural measures. On the one hand, in recent years, especially since 2003, the link between manufacturing production in Mexico and the U.S. has weakened, therefore implying a slower response of Mexican production and manufacturing exports to external demand (Graph 19). On the other hand, this trend also reveals that the Mexican economy has lost competitiveness in external markets, reflected in the declining share of Mexican exports in U.S. total imports. This loss of share –detailed further in the Balance of Payments and Capital Flows section- is very significant. Many exercises suggest that in 2005 such loss could be of approximately 15 percent the value of the non-oil exports, considering that Mexican products reached their highest share in the U.S. market during 2001.

Graph 19 **Manufacturing Production in Mexico and the U.S.**

a) Seasonally adjusted figures, 2002=100 b) Annual percentage change



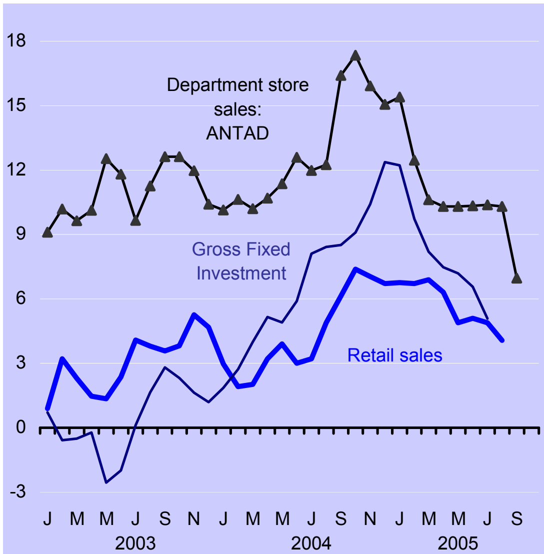
Source: Federal Reserve Board and INEGI; seasonal adjustments by Banco de México.

During the third quarter of 2005, the Mexican economy continued to slow down at the same annual rate observed in the first half of the year as compared with that observed in 2004. In particular, GDP is expected to have grown during such period very closely to the rate observed during the first half of the year. Three issues need to be mentioned regarding such results. First, the slowdown of economic activity continued to reflect the slower growth of the main components of aggregate demand. Second, within domestic demand, consumption and investment expenditure continued to exhibit moderate annual variations (Graph 20) as compared with those observed in 2004. Third, during the third quarter of the year, exports of goods and services grew at an annual rate slightly above that of the first half of the year, but below that of 2004.

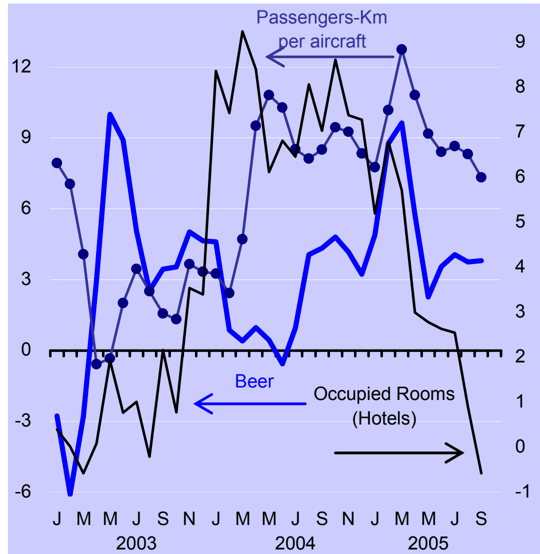
Graph 20 **Domestic Demand Indicators**

Annual percentage change of seasonally adjusted data

a) Domestic demand [1/]



b) Consumption Expenditure and Services Sector Indicators [2/]



Source: ANTAD, INEGI; seasonal adjustments by Banco de México.
1/ Two-month moving average.
2/ Three-month moving average.

Summing up, during the third quarter of 2005, economic activity was characterized by:

a) Regarding GDP indicators, the Global Indicator of Economic Activity (*Indicador Global de la Actividad Económica, IGAE*) recorded an annual increase of 3.2 percent during the July-August period, influenced by the sharp increase exhibited by its agriculture component (13 percent). Seasonally adjusted figures for the IGAE were 2 percent in August, above those recorded in December 2004.

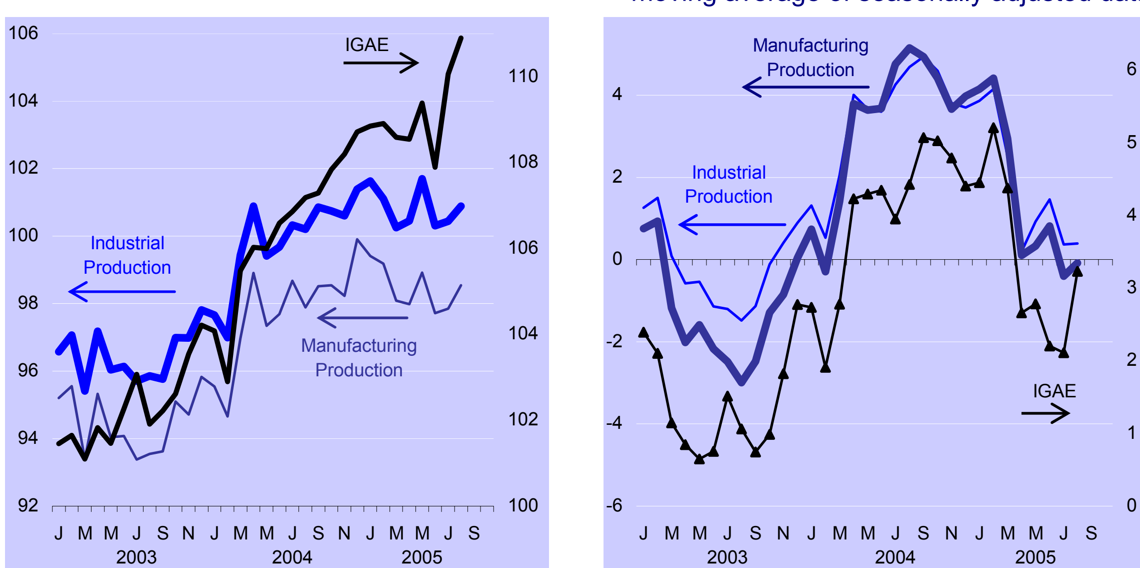
b) Private consumption indicators reveal that, during the third quarter, these continued to grow at the same moderate annual rate as in the first half of the year. In this regard, the following deserves mention: i) during the July-August period, retail sales grew at an annual rate of 4.4 percent, while in the first half of the year they had grown 5.5 percent (6.3 percent during the second half of 2004); ii) ANTAD sales grew significantly at an annual rate of 9.4 percent during the third quarter and 9.1 percent during the first three quarters of the year, both rates slightly below those observed in 2004 and, particularly, in the second half of that year (9.6 and 10.4 percent, respectively) (Graph 20). Nonetheless, department stores, have exhibited a slowdown in their sales during 2005; ii) during the third quarter, retail car sales in the domestic market grew at an annual rate of 7.3 percent and in the first nine months of the year, 4.7 percent, both rates below that observed in 2004 (12.1 percent); and, iv) other indicators of private consumption and services such as hotel occupation, beverage production, gasoline domestic sales, cellular minutes, and passengers flying through domestic airlines, among others, also grew at a moderate annual rate during the third quarter.

c) Investment grew at a moderate annual rate during the third quarter as compared with the first half of the year. Investment, which had begun to recover in 2004 –after three consecutive years of contraction/stagnation- has slowed its rate of growth through 2005. In July it grew at an annual rate of 2.9 percent. In that same month, investment on a seasonally adjusted basis and in real terms exceeded by only 3.8 percent its maximum level reached in November 2000 (Graph 20). During the third quarter, investment is expected to have grown at an annual rate close to 6.3 percent, unfavorable figure as compared with that observed in the second half of 2004 and in the first half of 2005 (9.7 and 7.5 percent, respectively).

Graph 21 Production Indicators

a) Seasonally adjusted data, 2000=100

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



Source: INEGI; seasonal adjustments by Banco de México.

d) Industrial production has been the component of GDP that has grown at a more moderate annual rate throughout 2005. Its most important sector, the manufacturing industry, has mainly contributed to such results. Manufacturing production for both the external and domestic markets grew at a slower rate during the first three quarters of the year. Thus, during the July-August period, industrial production grew at an annual rate of 0.4 percent, while that of manufacturing production remained unchanged. Consequently, during the first eight months of the year, industrial and manufacturing production grew at an annual rate of 1.1 and 0.9 percent, respectively, as compared with that recorded by both activities in 2004 (3.8 percent) (Graph 21). In August 2005, seasonally adjusted figures of industrial and manufacturing production were below those recorded in December 2004.

e) After a long period of nearly five years of gradually losing strength, the automotive industry began to improve during the second and third quarters of 2005. Thus, during the third quarter 2005, vehicle production in Mexico grew at an annual rate of 1.6 percent. During the third quarter, seasonally adjusted figures of vehicle production were 6.6 percent above those recorded during the second quarter. Vehicle production is expected to continue to gain strength during the rest of the year and in 2006, as a result of significant investments in the manufacturing of new vehicle models, for both external and domestic markets.

The behavior of a wide range of indicators allows for estimating that annual GDP growth during the third quarter was close to that observed during the first half of the year. This means that during the first three quarters of 2005, GDP growth is expected to have been approximately 2.9 percent, while in 2004 it was 4.4 percent. Nonetheless, it should be noted that the moderate annual growth rate exhibited by GDP during the third quarter of the year implies, on a seasonally adjusted basis, a positive and significant variation in GDP as compared with its level recorded during the second quarter.

On another front, the hurricanes that affected Mexico’s South East region in October have affected economic activity in that region adversely. As a result, GDP’s annual rate of growth is expected to fall by 25 basis points during the fourth quarter of the year. Nonetheless, these effects are anticipated to be partially offset by the reconstruction efforts.

II.2.4. Balance of Payments and Capital Flows

During the third quarter of 2005, Mexico's external sector followed the same general trends exhibited during the first half of the year, which were characterized by the following: a) non-oil exports grew at a slightly higher annual rate than in the first half of the year; however, this rate was significantly lower than the one observed in 2004. This result in the first nine months of the year was due to both the lesser strength of external demand and the loss of competitiveness of Mexican products in international markets; b) the value of oil exports continued to rise significantly at an annual rate (in fact, it peaked during the quarter); c) merchandise imports grew at a very similar rate to that exhibited during the first half of the year, although below that observed in 2004. This result is attributed to the lower dynamism of domestic demand in 2005 and to the slowdown of manufacturing exports that use imported inputs in their production; d) Mexican products continued to lose share in external markets; e) a small trade deficit, even though the non-oil deficit rose; f) a moderate current account deficit; g) significant revenues from workers' remittances; h) a capital account surplus; and, i) an accumulation of international reserves.

During the third quarter of 2005, the trade balance recorded a deficit of 1.489 billion US dollars, figure below that recorded during the same period of the previous year (1.948 billion). Nonetheless, the non-oil trade balance deficit rose from 5.377 billion US dollars during the third quarter of 2004 to 6.352 billion during the same quarter of this year.

Merchandise exports grew at an annual rate of 13.5 percent during the July-September period, as a result of increases in both oil and non-oil exports (40.1 and 9.5 percent, respectively). Within non-oil exports, exports of manufactured goods rose 9.3 percent. The surge in international oil prices continued. Such conditions contributed to raise the value of Mexican oil exports to 8.768 billion US dollars, the highest level recorded in a quarter. During the reference period, the Mexican crude oil export mix reached record highs (49.47 US dollars per barrel).

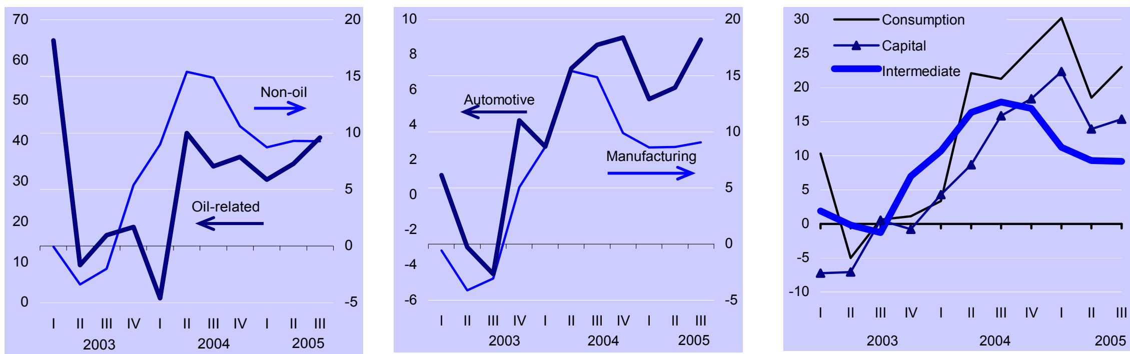
Just like in the first half of the year, during the third quarter of 2005, exports and imports of oil-related goods grew significantly at annual rates of 40.1 and 38.1 percent, respectively.

As a result, during the first nine months of the year the value of oil exports (including petrochemical exports) rose by 5.962 billion US dollars as compared with the same period of the previous year, while oil imports did so by 3.447 billion (gasoline imports accounted for 1.605 billion of the increase). Thus, during the period January-September 2005, Mexico's oil trade surplus was 12.058 billion US dollars, 2.515 billion above the figure recorded during the same period of 2004.

Graph 22 **Exports and Imports (Merchandise)**

Annual percentage change of seasonally adjusted data

a) Exports b) Manufacturing Exports c) Imports



Source: Banco de México.

During the reference period, merchandise imports rose at an annual rate of 12.1 percent, as a result of increases in its three components: intermediate goods (9.9 percent); consumption goods (21.7 percent), and capital goods (15.9 percent).

Foreign trade seasonally adjusted data show that during the third quarter of 2005 the rate of growth of non-oil exports continued to be below that recorded during 2004 (Graph 22). Regarding non-oil exports' components, automotive exports recovered during the third quarter, as partly mirrored by the higher value of car exports. Seasonally adjusted figures of merchandise imports grew significantly at an annual rate, close to that recorded during the first two quarters of the year. Nonetheless, imports have grown at a slower rate than in 2004, as a result of both the slowdown of production and domestic demand and the weaker expansion of external demand. The reduced growth of total imports can mainly be attributed to the behavior of intermediate goods imports.

Table 9 **U.S. Imports**

Percent

	Share				Annual percentage changes: January-August 2005				
	2003	2004	Jan-Aug 2004	Jan-Aug 2005	Total	Oil	Total Excluding Oil	Automotive	Total Excluding Oil and Automotive
Total	**100.00**	**100.00**	**100.00**	**100.00**	**13.5**	**35.0**	**11.5**	**3.6**	**13.1**
Total excluding Mexico	**89.02**	**89.39**	**89.29**	**89.78**	**14.1**	**35.3**	**12.2**	**4.4**	**13.6**
Total excluding Mexico and China	**76.89**	**76.01**	**76.47**	**75.56**	**12.2**	**35.2**	**9.7**	**4.4**	**10.9**
1. Canada	17.63	17.44	17.79	17.07	8.9	20.6	8.0	1.5	10.5
2. China	12.13	13.38	12.82	14.21	25.8	112.0	25.7	--	25.7
3. Mexico	**10.98**	**10.61**	**10.71**	**10.22**	**8.4**	**33.3**	**5.3**	**-0.1**	**7.6**
4. Japan	9.39	8.83	8.97	8.50	7.5	--	7.5	7.4	7.5
5. Germany	5.42	5.26	5.31	5.19	10.9	--	10.9	1.0	16.2
6. United Kingdom	3.40	3.15	3.18	3.02	7.8	89.0	3.3	15.7	1.3
7. Korea	2.96	3.14	3.12	2.70	-1.8	--	-1.8	4.2	-3.8
8. Taiwan	2.51	2.36	2.38	2.13	1.4	--	1.4	13.6	0.8
9. France	2.32	2.15	2.09	2.06	12.0	--	12.0	--	12.0
10. Malaysia	2.02	1.92	1.90	1.99	19.1	1.3	19.2	--	19.2
Total 10 countries	68.77	68.24	68.28	67.09	11.5	30.9	10.8	3.2	12.8

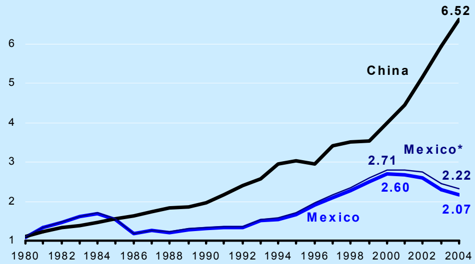
Source: Prepared by Banco de México with data from the U.S. Department of Commerce.

During the period January-August 2005, the performance of Mexican exports in U.S. imports was unfavorable. Although Mexican exports to that country grew at an annual rate of 8.4 percent during that period, it was clearly below that exhibited by exports of the rest of the U.S. trading partners (14.1 percent) (Table 9). The latter translated into a loss of share of Mexican exports in U.S. imports: from 10.71 percent in the first eight months of 2004 to 10.22 percent during the same period of 2005. The relatively unfavorable performance of Mexican exports deteriorates further when oil exports to the U.S. are excluded and prevails even after deducting Chinese exports to the U.S. (see Box 1).

Box 1
Loss of Share of Mexican Products in International Markets

During the last two decades Mexico's export sector grew significantly. Given its increasing share in both GDP and job creation, and its link with the rest of economic activity, its role in the economy gained more relevance. This process was favored by many structural changes done in the country, such as trade liberalization and the coming into effect of the North American Free-trade Agreement (NAFTA) on January 1, 1994. These events transformed Mexico into an important world exporter (Graph 1).

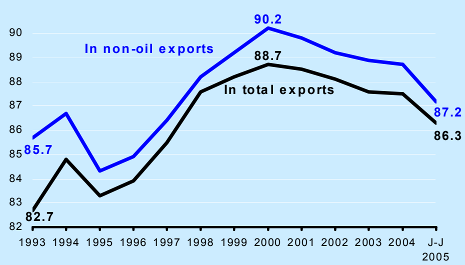
Graph 1
Share of Mexican and Chinese Exports in Total World Exports
Percent



* Excluding share of Chinese exports in total world exports.

NAFTA deepened Mexico's liberalization, made different sectors of the economy subject to increasing competition, and, by exploiting the country's comparative advantages, opened new opportunities for investments (both domestic and foreign), favoring the access of domestic products in U.S. and Canadian markets. As shown in Graph 2, since the coming into effect of NAFTA, the share of Mexican exports to the U.S. in total exports increased gradually, reaching around 90 percent in 2000.

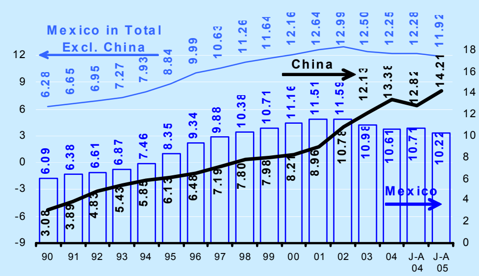
Graph 2
Mexico: Share of Exports to the U.S. in Total Exports
Percent



As a result, Mexico became the second supplier to the U.S., just after Canada. However, since August 2002, it has been outranked by China (Graph 3). Although Chinese exports had been increasing significantly in the last two decades, they gained more strength once the country entered the World Trade Organization (WTO) at the end of 2001 (Graphs 1, 2 and 3), which guaranteed the access of Chinese products in the main world markets.

Consequently, since 2002, the share of Mexican exports in U.S. imports began to fall (Graph 3 and 4). The magnitude of this loss of share, and of its likely consequences for the economy, can be illustrated by comparing the performance of Mexican exports to the U.S. during the period 2002-2005 vs. 2001, year in which Mexican exports reached their highest share in the U.S. imports.[1] From this comparison, the following aspects need to be highlighted: a) the share of Mexican exports in U.S. imports has fallen gradually, reaching substantial amounts; b) this loss has been the net result of the loss of share of a high number of Mexican products in the U.S. market, despite the market share gains obtained by other products; c) the loss of share of Mexican exports in U.S. imports seems to be partially explained by the increasing presence of Chinese products, given that such loss prevails even after excluding China from U.S. suppliers; d) Mexican exports in the U.S. market are being outranked by those of many countries; and, e) the weakening of Mexico's export sector apparently does not respond to an unfavorable structure of Mexico's export basket, given that the demand for products included in such basket has grown at a higher annual rate than that observed by total U.S. imports.

Graph 3
Share of Mexican and Chinese Exports in U.S. Imports
Percent

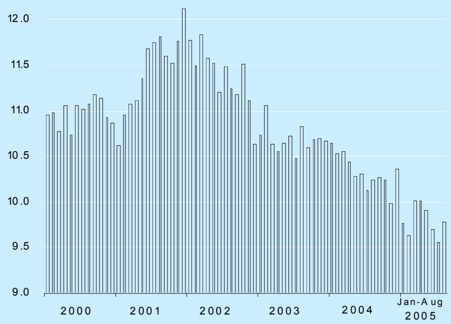


When comparing exports to the U.S. during the first half of 2005 with what would have been exported if Mexico had maintained the same market share as in 2001, the estimated net loss of share of Mexico's exports in U.S. imports amounts to 12.453 billion US dollars. This figure is the result of a number of products with loss of share (17.235 billion US dollars) and others exhibiting market share gains (4.782 billion). For the entire 2005, the corresponding net loss of market share is expected to be above 27 thousand million US dollars, equal to 15 percent of the value of non-oil exports forecasted for the year.

1 Results from exercises are illustrative and should not necessarily be considered as accurate estimates. Nonetheless, similar results are obtained with exercises based on different criteria.

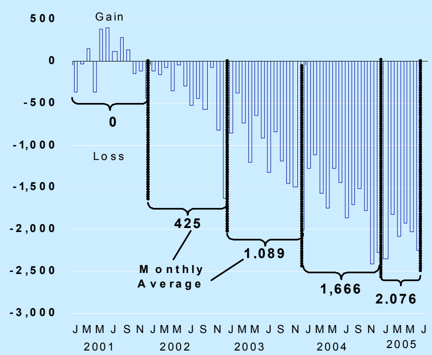
Graph 4

U.S.: Share of Mexico in Imports Excluding Oil
Seasonally adjusted data and percent



Graph 5

Net Loss of Market Share of Mexican Exports in U.S. Non-oil Imports
Million US dollars per month as compared with 2001



The most noteworthy export products exhibiting loss of share in U.S. imports are: automobiles and trucks; automobile seats; video cameras; TV sets; computers and their parts; men and women's suits and apparel; bathroom fittings; radio communication devices; stoves; and electric transformers (Table 1). Products gaining market share are: agriculture machinery; bovine cattle; intermediate and laminated iron and steel products; jewelry; vehicle motors and their parts; and fruits, legumes and vegetables (Table 2).

Table 2
Selected Mexican Export Products Gaining Share in the U.S. Market as Compared with 2001
Million US dollar gains during the first half of 2005

Product	Million US dollars
1. Tractors and Harvesting and Threshing Machinery	378
2. Gasoline and Diesel Motors and their Parts	288
3. Iron and Steel Intermediate and Laminated Products	229
4. Live bovines	200
5. Other Machines and Electronic Devices	118 (25.3%)*
6. Air and Vacuum Pumps	112
7. Jewelry	106
8. Beer	102
9. Other Fruits and Vegetables (Fresh or Refrigerated)	91
10. Medical Instruments and Equipment	84 (35.7%)*
11. Medicines	75
12. Fresh and Refrigerated Tomatoes	68
13. Pinneaples, Avocados, Guavas, Mangos, etc.	61
14. CD's and Recorded Tapes	55
15. Toilet Paper	38
16. Bakery Products	33 (42.6%)*
Subtotal	**2,037 (42.6%)***
Rest	**2,745 (57.4%)***
Total	**4,782 (100.0%)***

*/ Accumulated percentage of total market share gains.

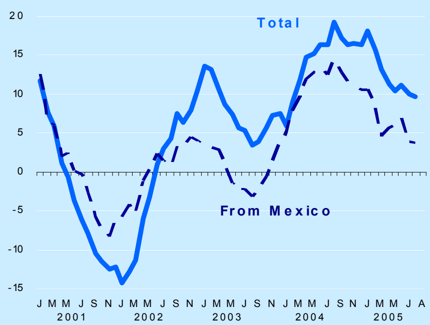
When analyzing the performance of other U.S. trading partners in the 15 products in which Mexico has lost market share, China has gained market share in all of them, except in the automotive industry (vehicles), which exhibits a very small gain (Table 1). India also improved its export performance in several of these products. An export sector which has recorded a significant loss of market share is the Mexican automotive industry (vehicles). During the fourth quarter of 2005 and in 2006 automotive exports are expected to recover significantly; however, the net loss of market share accumulated by this industry (vehicle production) will be difficult to revert.

Table 1
Main Non-oil Mexican Exports to the U.S. with Loss of Share
Million US dollars during the first half of 2005 as compared with 2001

Mexican Products which Have Lost Share	Mexico	Canada	Japan	Germany	United Kingdom	China	Korea	Singapore	Taiwan	Malaysia	India	Rest
1. Automobiles	-2,759	604	-933	774	1,099	62	1,496	0	6	0	0	-349
2. Video cameras	-2,213	-108	-588	10	-56	3,797	-391	110	-176	-334	5	-56
3. Computers	-2,085	-61	-2,319	-54	-180	9,519	-1,326	-1,322	-2,473	1,408	1	-1,107
4. T.V. sets	-1,294	-2	-383	-8	3	1,537	182	1	613	-482	12	-178
5. Computer parts	-648	-773	114	-1	-301	2,349	251	-303	-371	-122	7	-202
6. Women's Suits, Dresses, except Knitwear	-559	-75	-5	-9	-2	1,308	-153	-7	-65	-21	175	-587
7. Trucks	-413	-53	164	50	151	1	-1	0	-1	0	0	102
8. Knit t-shirts	-352	-34	0	0	-1	153	8	9	2	2	28	185
9. Bathroom fittings	-311	-63	29	118	-46	343	-10	-6	-72	3	28	-13
10. T.V., video camera and other electronical devices' parts	-300	-152	181	17	-48	316	133	-46	6	39	12	-159
11. Automobile seats	-281	-165	4	-10	-14	940	0	0	-76	-24	1	-374
12. Men's Suits, Dresses, except Knitwear	-226	-13	0	0	-1	497	-15	-13	-34	-30	52	-217
13. Radio communication and radar devices	-191	-64	116	10	19	59	-2	-11	43	-13	0	35
14. Stoves	-190	-67	-19	2	-3	393	-47	0	-19	-1	5	-53
15. Electric transformers	-166	-55	-19	0	-15	365	-3	-9	-39	-7	39	-90
Total of 15 products that have lost share	**-11,990**	**-1,080**	**-3,659**	**898**	**605**	**21,639**	**122**	**-1,597**	**-2,657**	**417**	**365**	**-3,062**
Rest of products that have lost share (591)	**-5,245**	**-5,802**	**-3,238**	**652**	**-1,379**	**17,091**	**-264**	**47**	**-915**	**-388**	**764**	**-1,321**
Total (606)	**-17,235**	**-6,882**	**-6,897**	**1,550**	**-775**	**38,729**	**-142**	**-1,550**	**-3,572**	**29**	**1,129**	**-4,383**

As previously mentioned, the loss of share of Mexican products in the U.S. market seems to be explained, only partially, by the greater presence of Chinese products. As shown in Table 3, during the period January-August 2005, exports of 101 countries to the U.S. had a better performance on an annual rate basis than Mexico, accounting for almost 75 percent of U.S. imports excluding oil. In addition, 84 of these economies gained share in the U.S. market.

Graph 6
U.S.: Imports Excluding Oil
Annual percentage change of a 3-month moving average



The consequences of the aforementioned for the Mexican economy, in terms of their impact on GDP growth and on aggregate demand, are considerable. Once more, and for illustrative purposes, an econometric model of the Mexican economy prepared by Banco de México was used to estimate the possible effects of the net loss of share of Mexican exports in U.S. imports accumulated between 2002 and 2005 on GDP, domestic expenditure and formal employment growth (Table 4). Results from this exercise reveal that GDP growth would have increased by almost one percentage point during 2005 if Mexican exports had not lost share in the US market. The negative effects on consumption growth and on the expansion of private sector investment seem to be significant as well. The exercise suggests that the loss of market share might have led to a decline in formal job creation, which, otherwise, would had been attained (271 thousand additional jobs in the formal sector).

Table 3
U.S. Imports According to Performance of Offering Countries

	Number of Countries	Imports Value Jan-Aug 2005	Annual Percentage Change	Share in U.S. Imports
Countries: **IMPORTS EXCLUDING OIL**				
Performing Better than Mexico	101	712,582	15.71	73.46
Gaining Share in the U.S. Market	84	368,820	23.48	38.02
Mexico	1	95,146	5.29	9.81
Performing Worse than Mexico	57	162,196	-0.92	16.72
Rest [1]	60	118	-43.01	0.01
Total:	**219**	**970,042**	**11.48**	**100.00**
IMPORTS EXCLUDING OIL AND AUTOMOTIVE SECTOR				
Performing Better than Mexico	95	552,375	19.32	66.80
Gaining Share in the U.S. Market	78	344,794	24.98	41.70
Mexico	1	68,060	7.62	8.23
Performing Worse than Mexico	63	206,381	0.76	24.96
Rest [1]	60	118	-43.01	0.01
Total:	**219**	**826,934**	**13.09**	**100.00**

1/ Includes countries exporting under 7 million US dollars during the period January-August, regardless of their performance in the U.S. market.

Graph 7
U.S.: Imports from Mexico, China and the Rest of the World Excluding Oil
Trend series leveled at October 2000(=100) peak

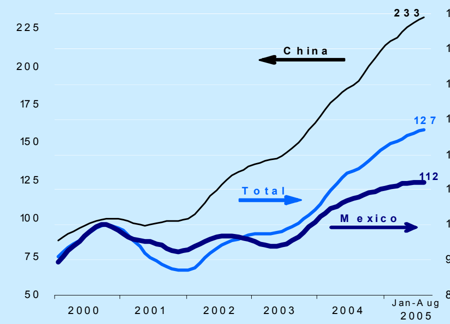


Table 4
Impact of Loss of Share of Mexican Exports in U.S. Imports in Mexico's Economic Activity
Percent and thousand workers

Year	Impact in Annual Growth of: GDP	Private Consumption	Private Investment	Formal Employment
2001	**0.00**	**0.00**	**0.00**	**0.0**
2002	**-0.32**	**-0.26**	**-0.40**	**-26.0**
2003	**-0.54**	**-0.51**	**-0.66**	**-50.7**
2004	**-0.78**	**-0.79**	**-1.16**	**-80.5**
2005	**-0.96**	**-0.92**	**-1.62**	**-115.3**
Accumulated Impact:				
2002-2005	**-2.55**	**-2.40**	**-3.73**	**-272.5**

The declining share of Mexican exports in international markets seems to be associated with the gradual loss of competitiveness of the Mexican economy. This conclusion coincides with the results of a number of studies on world competitiveness prepared recently, in which Mexico has been gradually outranked.[2] This fall in competitiveness gains more relevance in a context in which many countries are increasing their share in world trade. These economies have comparative advantages in many manufactured products similar to those exported by Mexico. Many of these economies have rapidly implemented structural reforms, the same ones that have been postponed in Mexico for several years. These reforms include, among other aspects, the tax reform, with its consequent provisions for infrastructure, education and basic social requirements; basic production inputs available at competitive prices (electricity, transport and communications); a more flexible labor market; and, strengthening the institutional framework. The latter includes transparency, the fight to eradicate corruption, the observance of property rights, including copyrights, strengthening the rule of law, and providing public security.[3]

2 Mexico's position in the World Economic Forum's Competitiveness Index and in AT Kearney's Confidence Index conducted among the main FDI recipient countries has deteriorated. For a second consecutive measurement, Mexico was ranked 31 out of 45 countries in IMCO's (Mexican Institute for Global Competitiveness) Global Competitiveness Index.

3 All of the aforementioned were continuously mentioned as factors limiting investments in a survey conducted recently by Banco de México and the Ministry of the Economy among FDI firms in Mexico.

Mexico’s inflows via workers’ remittances totaled 5.440 billion US dollars during the third quarter (annual growth rate of 20.5 percent as compared with that of last year). During the first nine months of 2005, revenues from remittances totaled 14.719 billion US dollars, an annual growth rate of 18.8 percent and below that recorded in 2004 (24 percent). Such amount originated from 43.3 million transactions for an average value of 340 US dollars/each, equal to almost 72 percent of revenues from crude oil exports recorded during that period.

The above mentioned information as well as partial data available from other external accounts’ items allow for estimating the following results for the end of the third quarter of 2005: a moderate current account deficit of around 0.6 billion US dollars, below that observed during the same quarter of 2004 (1.0 billion). Just like in previous quarters, the significant increase in oil exports and a higher inflow from workers’ remittances continued to contribute to such decrease. Considering the above, the current account deficit during the first nine months of 2005 is expected to be approximately 3.1 billion US dollars.

Finally, the capital account of the balance of payments including errors and omissions is expected to have been approximately 1.7 billion US dollars during the third quarter of 2005. This surplus was the net result of private sector inflows and of a reduction in public sector’s foreign indebtedness. International reserves rose by 1.062 billion US dollars during the reference period.

III. Monetary Policy

III.1. Monetary Policy Actions

During 2004, the Mexican economy was affected by many supply shocks to different CPI subindexes. In this regard, energy and agriculture goods, and metal products exhibited the most relevant and persistent price increases in international markets. These shocks made inflation jump from 3.98 percent at the end of 2003 to 5.43 percent in November 2004, therefore deteriorating inflation expectations significantly. Given the magnitude of the supply shocks and concerns that these could contaminate the process of price determination, the monetary stance tightened considerably. As a result, short-term interest rates moved from a minimum level of 4.73 percent on January 19, 2004, to 9.75 percent during the second quarter of 2005.

The inflationary effects of the supply shocks that affected the economy in 2004 have been diminishing throughout the year as a result of both the reversion of such shocks and the monetary policy actions adopted. This has been clearly evidenced by the downward trend followed by inflation: from 5.43 percent in November 2004 to 3.51 percent in September 2005. Non-core and core inflation have also declined considerably as mentioned in section II.1 of this report (4.17 and 3.20 percent, respectively, in September 2005). In this context, the inflation episode of 2004 apparently had a limited effect on wage negotiations.

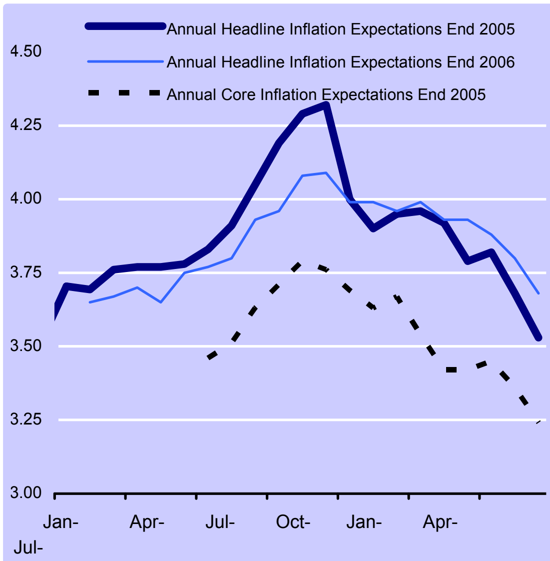
Under such conditions it is clear that the outlook for inflation has improved, as reflected by the sharp downward inflection exhibited by inflation expectations for all terms. In this regard, in Banco in Mexico's survey of September, forecasts for headline inflation at the end of 2005 were 3.53 percent (from a maximum level of 4.32 percent in December 2004). Expectations for core inflation for the end of the year were revised downward, reaching 3.24 percent in September (Graph 23). Expectations for longer terms have also been revised downward.

CPI is expected to end the year with an annual variation of around 3.5 percent and continue to converge towards its target in 2006. However, this prevision does not consider episodes of extreme volatility, mainly regarding the non-core component of fruits and vegetables prices.

Graph 23 **Inflation Expectations: Banco de México's Survey**

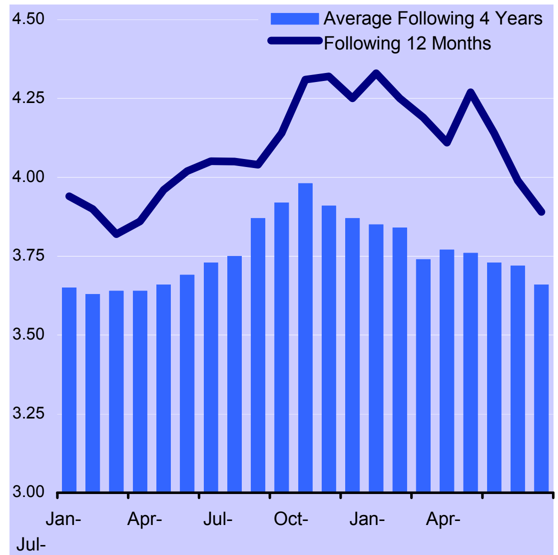
a) End of 2005 and 2006

Annual percentage



b) Following 12 months and Average for the Following 4 Years

Annual percentage



Since the second quarter of 2004, Banco de México's monetary policy stance has been implemented through two channels: i) by changes in the *corto* (short position); and, ii) by establishing minimum levels (floors) to domestic monetary conditions announced in the monetary policy press releases.

Regarding the first channel, the *corto* has remained at 79 million pesos per day since March 23 of this year. As for the second channel, the announcement that domestic monetary conditions should reflect, at least, the greater astringency in the U.S., continued up to May. As a result, the bank funding rate reached its highest level of the year. Later on, in its press releases of June and July, the Board of Governors announced that, as deemed convenient, domestic monetary conditions should not loosen.

As stated in its press releases of August, September and October, Banco de México allowed a loosening of monetary conditions of no more than 25 basis points on each occasion, keeping the *corto* unchanged. As a result, the one-day bank funding rate fell from 9.75 percent at the end of the second quarter of 2005, to 9.00 percent at the end of October (Graph 24).

Banco de México has two main instruments to induce changes in its monetary policy stance: minimum levels for monetary conditions and the *corto.* Given the magnitude and persistence of the supply shocks that affected inflation and its expectations during 2004, the Board of Governors began to signal the Central Bank's monetary policy stance more directly to market participants, through the referred minimum levels. Nonetheless, it still keeps the *corto* as an available monetary policy instrument to be used as deemed necessary.

Summing up, it is clear that the outlook for inflation has improved in recent months. Nonetheless, the following risks still prevail:

a) International energy prices are expected to remain high and volatile.

b) Several agricultural prices could be subject to volatility due to the effects of the hurricanes that struck Mexico or to possible health problems related to poultry production.

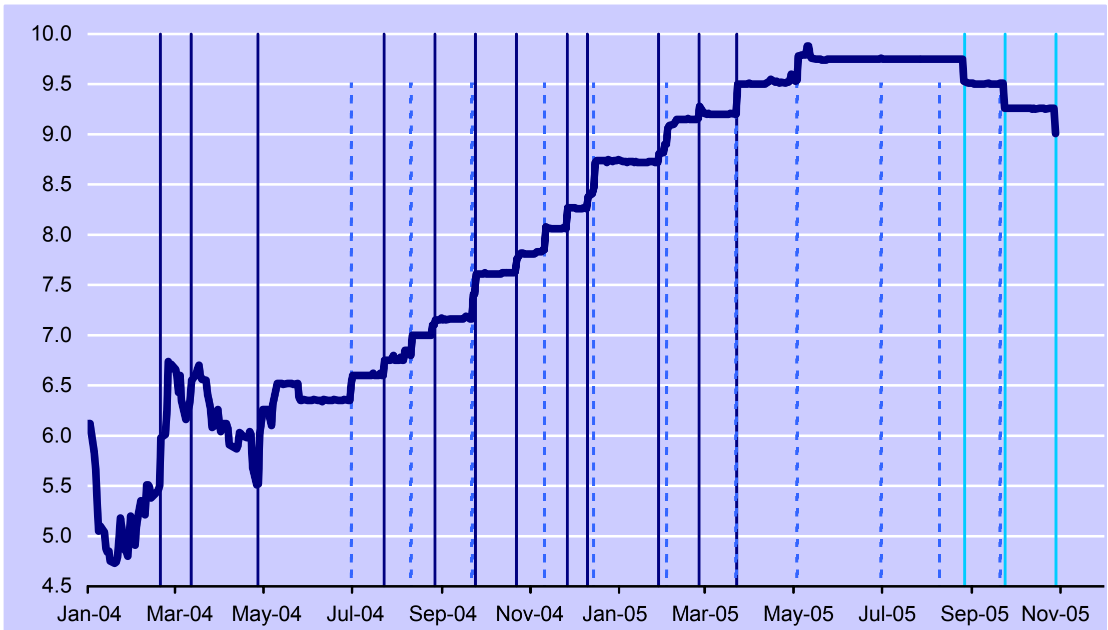
c) Although food inflation has fallen, non-housing services inflation remains high.

d) Inflation expectations remain above the 3 percent target.

Banco de México's actions to revert part of the monetary restriction are consistent with an improved inflationary outlook, as well as with the gradual convergence of inflation to its target. Nonetheless, given the aforementioned risks, monetary policy will remain tight.

Graph 24 **Banks' Funding Rates, Change in the *Corto*, and Change in the U.S. Federal Funds Rate** [1/]

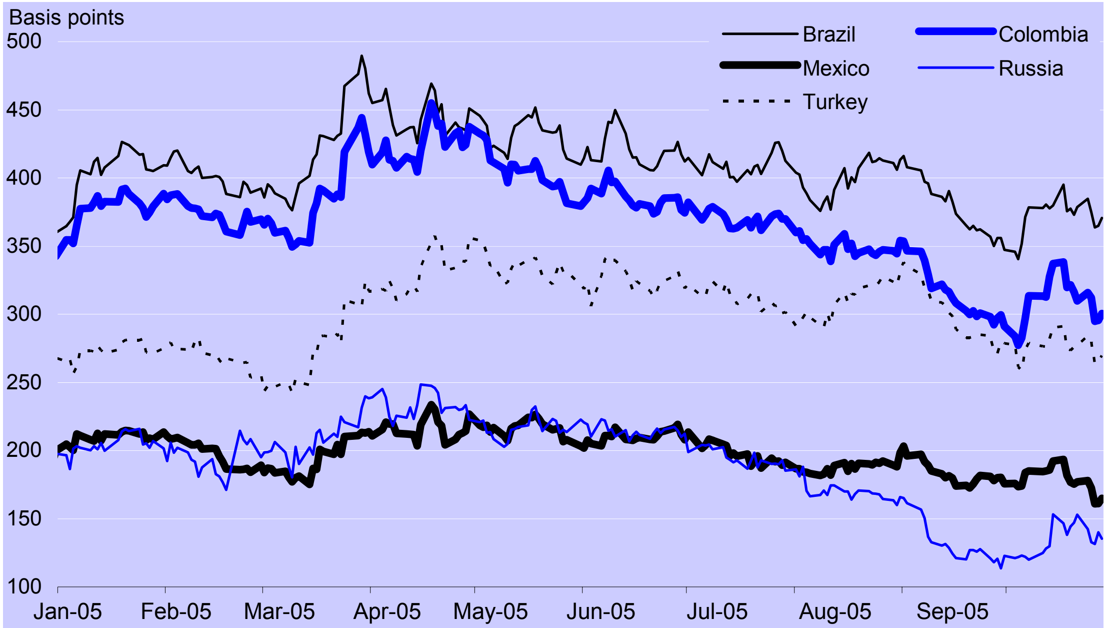
Annual percentage



1/ Continuous vertical lines indicate changes in the *corto*. Dotted lines indicate changes in the U.S. federal funds rate.

The external environment must be considered when evaluating domestic financial conditions. In particular, global liquidity conditions -and the consequent search for higher yields- have prevailed during the last months. As a result, interest rate spreads of several emerging economies' sovereign debt issuers fell to historically low levels at the end of September and beginning of October (Graph 25), notwithstanding the Federal Reserve's current cycle of increasing interest rates.

Graph 25 **Spread on 20-year Sovereign Bonds in US dollars and 20-year U.S. Treasury Bond** 1/



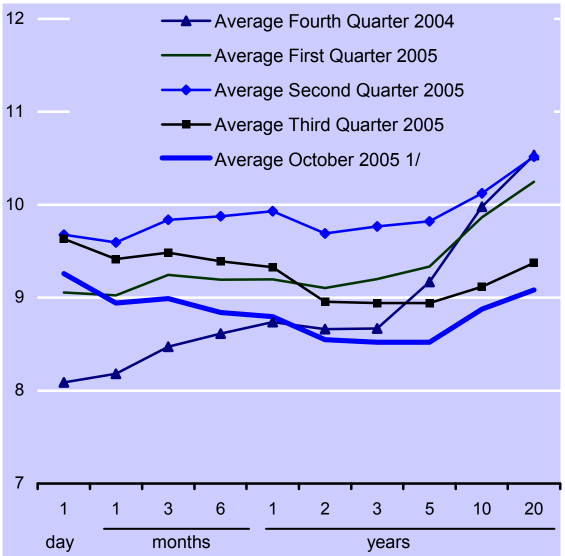
1/ Source: Bloomberg.

The slackness that prevailed during the third quarter in international financial markets passed on to domestic markets. Foreign investors have increased their positions in many emerging markets as alternatives to raise their portfolio yields. In particular, in Mexico, there was a significant inflow of resources to purchase debt instruments in local currency. This setting also reflects that Banco de México's monetary policy actions have contributed to reduce inflation expectations, and therefore, risk premia that is usually discounted from fixed-yield securities. As a result, the slope of the yield curve increased its inverted position during the third quarter of 2005 (Graph 26a).

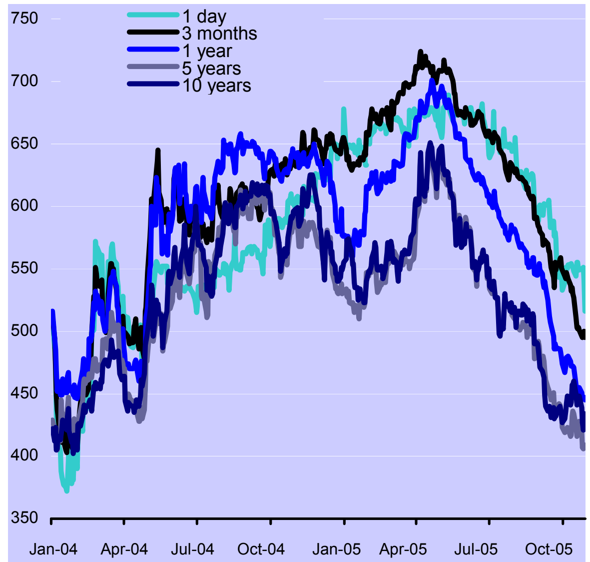
The convergence of these factors led to a considerable reduction in interest rate spreads in relation to the yields for similar terms in the U.S., especially regarding longer term instruments (Graph 26b).

Graph 26 Yield Curve in Mexico and Spread Mexico-U.S.

a) Yield Curve in Mexico
Annual percentage



b) Spread Mexico – U.S.
Basis points



1/ Latest data: October 28, 2005.

Nonetheless, it is important to point out that towards the end of the third quarter, further risks regarding inflation in both the U.S. and worldwide have been perceived. This result has been significantly influenced by the persistent surge in energy prices, heightened by the hurricanes that affected Gulf of Mexico's coasts. These conditions, together with the apparent strength exhibited by U.S. economic activity, have made interest rates increase. The aforementioned, as well as the perception that many economies could begin cycles of greater monetary astringency, could lead to higher risk aversion and, therefore, to a restructuring of capital flows worldwide. Under such context, emerging economies' conditions for external financing could deteriorate.

III.2. Monetary and Credit Aggregates

III.2.1. Monetary Base, Net Domestic Credit, and Net International Assets

The average stock of the monetary base was 309.6 thousand million pesos during the period July-September of 2005, recording an annual variation of 11 percent, below that observed in the last quarter of 2004 (14.5 percent).[13] The average growth of the monetary base during the year has followed a downward trend,

[13] Variations calculated according to the average of daily stocks.

which has intensified during the third quarter. Such result confirms the loss of strength of the monetary base's remonetization process, mentioned in previous inflation reports.[14]

During the reference period, the monetary base fell by 1.7 thousand million pesos. International assets rose by 46.9 thousand million pesos.[15] As a result, Banco de México's net domestic credit decreased by 48.6 thousand million pesos (Table 10).

Table 10 **Monetary Base, Net International Assets and Net Domestic Credit**

Millions

	Stocks		Flows in 2005			
	At Dec.31 2004	At Sep.30 2005	Quarter I	Quarter II	Quarter III	Acummulated at Sep.30 2005
(A) Monetary Base (Pesos)	340,178	312,475	-28,322	2,293	-1,674	-27,703
(B) Net International Assets (Pesos) 1/ 2/	716,170	755,491	-720	15,368	46,921	61,569
Net International Assets (US dollars) 2/	64,233	70,013	-88	1,491	4,377	5,780
(C) Net Domestic Credit (Pesos) [(A)-(B)] 1/	-375,992	-443,017	-27,602	-13,075	-48,596	-89,272
(D) Internatiomal Reserves (US dollars) [(E)-(F)] 3/	61,496	62,836	242	35	1,062	1,340
(E) Gross Reserves (US dollars)	64,198	69,981	-87	1,492	4,378	5,783
PEMEX			2,497	3,931	7,117	13,545
Federal Government			-1,087	-1,754	-2,159	-5,000
Sale of US dollars to Banks 4/			-1,380	-1,159	-849	-3,388
Other 5/			-117	474	269	626
(F) Liabilities with less than six months to maturity (US dollars)	2,701	7,145	-330	1,457	3,316	4,443

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 Exchange Commission's Press Release of March 20, 2003).
5/ Includes yields on net international assets and other transactions.

International reserves rose by 1.062 billion US dollars during the third quarter of 2005. Such result came from a 4.378 billion US dollar increase in gross reserves, which was partially compensated by an increase in Banco de México's liabilities with less than six months to maturity of 3.316 billion US dollars. Such result reflects the federal government's purchase of 2.878 billion US dollars to complete currency requirements to pay the total securities placed in external markets with maturity in 2006 and 2007.[16] The increase in gross reserves was mainly due to the following: the net effect of PEMEX's sale of US dollars to Banco de México of 7.117 billion US dollars; Banco de México's sale of

[14] Historical evidence confirms that in low inflation economies: i) shocks on income and interest rates are reflected more slowly on the demand for money; and ii) such demand tends to become more sensitive to changes in interest rates. See Inflation Report April-June 2003.

[15] For a definition of international assets and international reserves refer to the glossary of the press release on Banco de México's balance sheet (weekly release).

[16] See Ministry of Finance's press release of July 14, 2005 (Press release 053/2005).

US dollars through the mechanism to reduce international reserve accumulation (849 million); and, federal government's purchasing of 2.159 billion US dollars to service its foreign liabilities.

III.2.2. Monetary Aggregates and Financing

The monetary aggregate M1 has been growing at a slower rate, recording an annual average growth rate of 11.2 percent during the third quarter of 2005, below that observed in the last quarter of 2004 (12.9 percent). Such result is attributed to the decreased dynamism of its main components (bills and coins in circulation and checking accounts), which is partly explained by a higher opportunity cost of holding liquid assets. For example, the average yield on commercial bank term deposits rose from 6.9 percent in December 2004 to 7.9 percent in September 2005.[17]

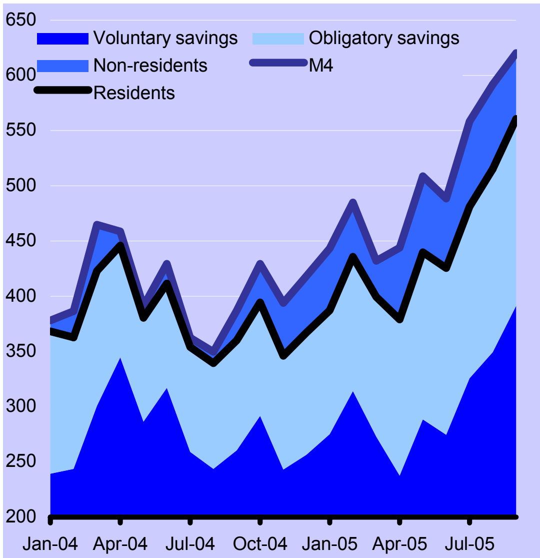
Financial savings in domestic instruments (broad monetary aggregate M4) has grown at a high rate (annual average rate of 16.2 percent during July-September). This result is partly explained by the vigor of obligatory savings generated through the Retirement Savings System (*Sistema de Ahorro para el Retiro, SAR*), which grew at an annual rate of 20 percent during the third quarter of 2005 and accounts for almost one third of financial saving's growth. The strength of financial savings also reflects progress towards low and stable inflation, which reduces uncertainty regarding domestic financial investment instruments. This has also led to a significant increase in the holding of public securities by non-residents (54.1 thousand million pesos from September 2004 to September 2005), especially in long-term securities. Thus, the flow of non-residents savings accounts for nearly 10 percent of the annual growth of M4.

[17] The spread between the time-deposit and demand-deposit interest rate rose from an average of 421 basis points in 2004 to an average of 601 basis points during the period January-August 2005.

Graph 27 Monetary Aggregate M4 and Commercial Banks' Performing Credit

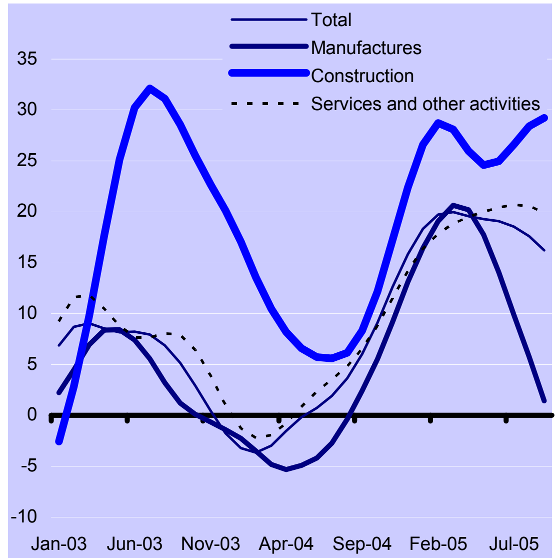
a) Monetary Aggregate M4

12-month flows in thousand million pesos



b) Commercial Banks' Performing Credit to Firms

Annual percentage change of trend series



The increased supply of domestic financial resources, together with the slackness prevailing in international financial markets, has been reflected, at the margin, in a greater availability of financial resources for the private sector. Nonetheless, the public sector and Banco de México still absorb an important share of the domestic financial savings available in the economy (67.8 percent in June 2005). Regarding the latter, it is clear that a decrease in the use of resources by the public sector and a lower accumulation of international reserves by Banco de México would increase the availability of resources for the private sector.

As for total financing to the private sector, household credit rose at an annual real rate of 14.1 percent in June 2005 (Table 11). As a result, its share in total financing accounted for 43 percent (37 percent in December 2003).[18] The following issues must be considered when analyzing the expansion of household credit: i) macroeconomic stability together with different financial reforms have allowed for a greater availability of resources, in better terms and conditions for all market participants; ii) household credit still has a relatively small level, accounting for only 12 percent of GDP; and, iii) the expansion of consumption

[18] Including commercial banks' credit granted for consumption and housing, development banks, Special Purpose Financial Companies (*Sociedades Financieras de Objeto Limitado, SOFOLES*), Savings and Loans Companies (*Sociedades de Ahorro y Préstamo, SAPS*), and mortgage portfolio from the National Housing Fund (*Fondo Nacional de Vivienda para los Trabajadores, INFONAVIT*).

credit from June 2004 to June 2005 only accounts for 1 percent of GDP.

Total financing to firms remains stagnated. Such result has been influenced by the weakness of foreign financing and the loss of strength of domestic debt issuance. Although commercial bank lending is expanding at a faster pace than in 2004, it has started to moderate its rate of growth. Within its components, construction lending has remained strong while manufacturing lending has slowed considerably (Graph 27b).

Table 11 **Total Financing to the Private Sector**

	Stocks in tmp				Flows in tmp		Annual real growth %	
	Mar.04	Jun.04	Mar.05	Jun.05	Jun.04-Jun.05	Mar.05-Jun.05	Mar.04-Mar.05	Jun.04-Jun.05
Total financing	**2,011.3**	**2,043.2**	**2,174.4**	**2,194.7**	**151.4**	**20.2**	**3.6**	**3.0**
Foreign	**576.9**	**566.1**	**559.8**	**550.3**	**-15.9**	**-9.5**	**-7.0**	**-6.8**
Direct foreign financing [1/]	351.8	351.7	351.6	343.0	-8.8	-8.7	-4.2	-6.5
Debt issuance placed abroad [2/]	225.1	214.4	208.1	207.3	-7.1	-0.8	-11.4	-7.3
Domestic	**1,434.4**	**1,477.1**	**1,614.7**	**1,644.4**	**167.3**	**29.7**	**7.8**	**6.7**
From commercial banks [3/]	632.8	649.0	744.5	776.5	127.5	31.9	12.7	14.7
From other intermediaries [4/]	265.6	279.8	287.2	294.2	14.4	6.9	3.6	0.8
Debt issuance	158.1	157.5	156.1	153.3	-4.2	-2.7	-5.4	-6.7
From INFONAVIT [5/]	377.9	390.8	426.9	420.4	29.6	-6.4	8.2	3.1
Memo:								
Households	**767.9**	**799.2**	**925.5**	**951.5**	**152.4**	**26.1**	**15.5**	**14.1**
Consumption	156.4	172.2	233.3	255.1	82.9	21.9	42.9	42.0
Housing	611.5	626.9	692.2	696.4	69.5	4.2	8.4	6.5
Firms [6/]	**1,243.4**	**1,244.1**	**1,249.0**	**1,243.1**	**-1.0**	**-5.8**	**-3.8**	**-4.2**
Foreign financing	576.9	566.1	559.8	550.3	-15.9	-9.5	-7.0	-6.8
Domestic financing [7/]	666.5	677.9	689.2	692.8	14.9	3.6	-0.9	-2.0
Foreign financing (US dollars) [8/]	51.6	49.1	50.1	51.1	1.9	1.0	-3.0	4.0

1/ Includes firms' foreign suppliers, credit granted by foreign banks and other creditors, commercial paper, bonds and emissions placed abroad. Source: Balance of Payments, excluding PIDIREGAS-PEMEX.
2/ Includes commercial paper, bonds and investments abroad. Source: Balance of Payments, excluding PIDIREGAS from PEMEX.
3/ Includes total credit portfolio and accrued interests and portfolio related with debt-restructuring programs (UDIs and IPAB-FOBAPROA).
4/ Includes credit granted by development banks, factoring firms, financial leasing companies, credit unions, SAPS and SOFOLES.
5/ Corresponds to performing and non-performing mortgage portfolio from the National Housing Fund (*Fondo Nacional de Vivienda para los Trabajadores, INFONAVIT*). Source: Quarterly Financial Statements, INFONAVIT.
6/ Includes Individuals with Business Activity.
7/ Domestic financing to firms includes total financing granted by factoring firms, financial leasing companies and credit unions. Financing granted by SAPS is not channeled to firms given that it is mainly destined to households.
8/ Billion US dollars. Nominal growth rate. Does not include PIDIREGAS from PEMEX.

IV. Private Sector Outlook for 2005-2006[19]

IV.1. Forecasts for Economic Activity and for Different Determinants of Inflation

During the third quarter of 2005, private sector economic analysts' forecasts regarding the main macroeconomic variables exhibited significant changes. The most noteworthy aspects were: a) inflation for different horizons is expected to follow a clear downward trend; b) interest rate expectations for Mexico at the end of 2005 and 2006 were revised downward as compared with those reported in the June survey; c) the expected level of the peso exchange rate for the end of 2005 was also adjusted downward (pesos per dollar); d) expectations for economic growth for 2005 were revised downward; and, e) business confidence and business climate indicators exhibited less strength. In the survey conducted in September, private sector economic analysts' forecasts were as follows: i) GDP is expected to grow 3.01 percent in 2005 (in the survey conducted in June 2005 such figure was 3.57 percent) (Table 12), and 3.42 percent for 2006; ii) in 2005 and 2006, 445 and 436 thousand jobs, respectively, are expected to be created in the formal sector; and iii) moderate trade and current account deficits are expected in 2005.

Throughout the third quarter of 2005, analysts surveyed by Banco de México continued to mention the lack of advance in structural change measures and domestic political uncertainty as the two main factors that could limit economic growth during the next months. They also reiterated that the advance in structural change measures would contribute to induce higher investment levels in the country and, consequently, to attain higher growth.

[19] Unless otherwise stated, forecasts reported in this section are drawn from Banco de México's monthly Survey of Private Sector Economic Analysts' Forecasts.

Table 12 **Private Sector Expectations: June and September 2005[1/]**

	June 2005	September 2005		June 2005	September 2005
Real GDP Growth in Mexico			**Exchange Rate (Pesos/US dollar, year-end)**		
2005	3.57%	3.01%	2005 (Banxico Survey)	11.40	11.06
2006	3.50%	3.42%	Futures [2/]	11.07	10.89
Trade Deficit (Million US dollars)			2006 (Banxico Survey)	11.79	11.53
2005	10,451	8,810	**Mexican Crude Oil Mix (Average US dollars per barrel)**		
Current Account Deficit (Million US dollars)			2005 (Banxico Survey)	38.08	42.76
2005	12,070	9,113	**Wage Increases**		
2006	15,405	12,781	For October 2005	n.a.	4.31%
Foreign Direct Investment (Million US dollars)			For November 2005	n.a.	4.35%
2005	14,270	14,048	**Business Climate Index**		
2006	13,548	13,664	1998=100 [3/]	119.9	116.3

1/ Unless otherwise stated, data are obtained from Banco de México's monthly Survey of Private Sector Economic Analysts' Forecasts.
2/ Exchange rate futures of June 30 and September 30, 2005 (INFOSEL).
3/ Average level of second and third quarters.
n.a./ Not available.

IV.2. Inflation Expectations

Inflation expectations for different horizons were revised downward. Headline inflation for 2005 is expected to be 3.53 percent in September 2005, figure lower than that reported in the June survey (3.79 percent). Core inflation for the end of 2005 was revised downward from 3.42 percent in June to 3.24 percent in September. Inflation expectations were also adjusted downward during the same period: for 2006, from 3.93 to 3.68 percent; for 2007, from 3.76 to 3.64 percent; and for the annual average for the period 2006-2009, from 3.76 to 3.66 percent.

V. Balance of Risks and Final Remarks

Banco de México's baseline scenario for the rest of 2005 and for 2005 is based on the following assumptions:

a) The world economy is expected to continue to expand, although at a slightly slower rate than that recorded during the previous year. The U.S. economy is expected to continue to slow down its rate of growth –as compared with the previous year- more towards its potential rate. Expectations for U.S. industrial growth have been revised downward for the rest of 2005, partly mirroring the effects of the hurricanes that affected the Gulf of Mexico's coast. It is important to note that excluding the referred impact and other temporary weather-related factors, industrial production remained strong at the end of the third quarter, in line with the economic deceleration observed since mid-2004. Under such context, industrial production is expected to grow 3.4 percent in 2006, as compared with forecasts for 2005 (3.2 percent) and the increase observed in 2004 (4.1 percent).

b) Although the balance of risks regarding world inflation has started to deteriorate –which could reflect in a faster than expected increase in international interest rates- in general terms, conditions for external financing are expected to remain favorable for emerging economies' sovereign and private issuers.

Based on the above macroeconomic environment and on most recent information, Banco de México's expected scenario for 2005 and 2006 is as follows:

GDP Growth: GDP growth is expected to be between 2.75 and 3.25 percent in 2005 and between 3 and 3.5 percent in 2006.

Employment: Between 500 and 600 thousand jobs are expected to be created in the formal sector (number of workers insured by the IMSS) in both 2005 and 2006.

Current Account: A moderate current account deficit of the balance of payments of approximately 1 and 1.2 percent of GDP is expected in 2005 and 2006, respectively.

Inflation: Headline inflation has resumed its downward trend. Thus, annual inflation is expected to be around 3.5 percent at the end of 2005 and continue to converge towards its target in 2006. The latter, provided that episodes of extreme volatility do not arise, especially in the non-core price component (particularly, fruits and vegetables). In this regard, the following deserves mention:

a) Prices of fruits and vegetables have been very volatile during the year, recording negative annual variations in January and February, and annual increases above 20 percent in May, June and July. In September, these prices rose at an annual rate of 4.35 percent. In particular, prices of certain agricultural products could be affected during the fourth quarter of 2005 due to the extreme weather conditions that recently affected Mexico.

b) Pressures experienced in 2004 on international prices of certain food commodities and beef products have eased throughout the year. The recent behavior of futures prices of some of these products suggests that the annual variation of livestock goods' domestic prices could remain at relatively low levels.

c) In the last months, energy prices rose significantly to new record highs. Nonetheless, they are expected to affect the subindex of administered prices moderately, concentrating their effect mainly on electricity prices and, to a lesser extent, on prices of gas for residential use. This is due to the following: i) domestic gasoline prices have exhibited monthly variations consistent with an annual increase of 3 percent. At the border, gasoline prices are fixed according to the nearest foreign city, considering the current price in the rest of Mexico as an upper limit. Since prices in different cities have reached such limit, the effects of the recent increases in international prices will not be passed on; ii) the setting of a monthly variation interval for propane prices from 0.75 to 1.75 percent, established at the beginning of the year, has limited the effect of the surge in its international reference; iii) the decree approving a maximum price for low-consumption natural gas for residential use since May; and, iv) high consumption residential electricity tariffs (DAC) are determined according to a formula that incorporates variations in energy and steel prices. During the third quarter of 2005, prices of energy rose while steel prices decreased moderately. Should the second trend continue, high consumption residential electricity tariffs might increase.

During the next year, the annual growth rate of the subindex of administered prices is expected to be above the upper limit of the variability interval set around the inflation target. Nonetheless, the federal government has announced that it will establish different measures to curb the domestic effect of the increase in international energy prices.

d) The annual variation of the subindex of regulated prices will reach a level similar to that of headline inflation, given that no significant increases in the items that have higher weights in this subindex -such as urban public transportation- are expected.

e) As anticipated, the annual variation of the education subindex fell during the third quarter, after fee increases corresponding to the new school year came into effect. Nonetheless, school fees have grown at a higher rate than the CPI for the last seven years. Even though this subindex is expected to grow at a lower annual rate, it will still be above the upper limit of the variability interval set around the inflation target.

Summing up, the non-core component is expected to contribute significantly to the reduction in headline inflation during 2005, given that the effects of the multiple shocks recorded in the previous year have gradually reverted, and several mechanisms to mitigate the effect of the increase in the international prices of energy have been implemented. During 2006, the non-core component is expected to grow at a faster rate than the CPI. However, provided that new shocks to agricultural prices do not arise and administered and regulated prices are not affected significantly, annual headline inflation is expected to continue to converge to its target.

Core inflation is expected to close 2005 at 3.3 percent and follow a slight downward trend during 2006. In this regard:

a) The annual variation of merchandise prices is expected to follow a downward path, due mainly to expectations of a moderate slowdown in the growth rate of processed food prices, as a result of more favorable conditions in this type of markets worldwide. Inflation for the rest of merchandises could follow a lateral trend.

b) The components of core services inflation are expected to exhibit differing trends. On the one hand, the housing price subindex is expected to grow at a slightly higher annual rate during the fourth quarter of 2005 and in the first half of 2006, mainly because of a reduced base of comparison. From then onward, the annual variation of this subindex is expected to decline. On the other hand, the growth rate of non-housing services prices is anticipated to slow down slightly for the remainder of 2005 and in 2006.

It is clear that the outlook for inflation has improved in recent months. Nonetheless, the following balance of risks must be considered:

a) International energy prices are expected to remain high and volatile.

b) Several agricultural prices could be subject to volatility due to the effects of the hurricanes that struck Mexico or to possible health problems related to poultry production.

c) Although food inflation has fallen, non- housing services inflation remains high.

d) Inflation expectations remain above the 3 percent target.

Finally, although wage negotiations apparently have not been contaminated by the inflationary rebound observed in 2004, Banco de México will monitor that nominal wage increases are strictly aligned with the inflation target and expected productivity growth. In this regard, the Board of Governors reiterates its conviction to conduct monetary policy in order to foster monetary conditions that propitiate the convergence of inflation to its target.

* * *

Banco de México's base scenario is subject to the following risks:

First, the significant increase in both the level and volatility of energy prices could likely generate a world inflationary rebound, especially in the U.S., as well as a considerable slowdown in economic activity. This could lead to higher interest rates worldwide and, consequently, to an increase in risk aversion and a reversion of capital flows destined to emerging economies.

Second, the wider U.S. current account deficit that has prevailed in recent years could become unsustainable. Although this risk is mostly considered for the medium-term horizon, once materialized it could have a significant impact worldwide. Under such setting, world economic activity could be affected considerably through a significant increase of volatility in international financial markets, therefore affecting emerging economies negatively.

Third, as 2006 elections near, political uncertainty in Mexico could increase. Several analysts have signaled that this could induce higher volatility in financial markets. Nonetheless, it should be noted that the Mexican economy has reduced its vulnerability in the last years, and therefore it is in a better position to face different shocks -domestic or external. This is a clear reflection of the benefits of a sound macroeconomic anchorage, of which monetary policy plays a key role.

Fourth, an imminent risk mentioned in previous reports, the likelihood that the increasing shares of China and other economies in global manufacturing production, continues to systematically displace manufacturing activity in Mexico. This scenario has deteriorated due to the lack of progress in boosting Mexico's competitiveness: Mexico is currently ranked as a country with low levels of competitiveness in practically all indexes regarding this subject, including the different classifications used in the construction of such indexes. The lack of competitiveness has already translated into a loss of market share of Mexican products in foreign and domestic markets. This phenomenon is affecting both the structure and opportunities of employment in Mexico.

Finally, stability is a necessary but not the only condition for sustained growth. In this regard, and as reiterated in previous occasions, progress must be done in the pending agenda of structural changes. As consensuses are reached and long-term structural reforms are approved, Mexico's loss of competitiveness accumulated during the last years might revert, setting the foundations for sound growth.

VI. Monetary Policy Announcements

VI.1. Modifying the Frequency of Monetary Policy Announcements

The Board of Governors of Banco de México determined that starting January 2003, and in the following years, monetary policy actions would be announced according to pre-established dates published in the Inflation Report of the third quarter of the previous year.[20]

Twenty-three monetary policy announcements per year were established in the Inflation Report of July-September 2002. The volatility to which the economy was subject at that time was a factor that increased the probability of frequent changes in the monetary policy stance. Nonetheless, as inflation and its uncertainty have significantly decreased, the Board of Governors deemed convenient to reduce the number of monetary policy announcements to twelve per year starting 2006. On the date of such announcements, a press release will be published explaining the reasons for the monetary decisions adopted. However, Banco de México reserves the right to modify its monetary policy stance in dates other than those pre-established, should there be extraordinary events that require the Central Bank's intervention.

Monetary policy announcements, monetary policy press releases and inflation reports for 2006 will be determined according to the following guidelines:

a) Any changes or maintenance of the monetary policy stance will be announced on the Friday previous to the last Monday of every month,[21] except in December, when it will be announced in advance. A press release explaining the reasons behind Banco de México's decision regarding its monetary policy stance will also be published.

b) Announcements (electronic or of any other sort) will be given at 9:00 a.m.

[20] The Inflation Report of July-September 2002 includes the first guidelines for determining monetary policy announcements and press releases.

[21] Should this day be a bank holiday, the announcement will be done in advance.

c) The quarterly Inflation Report will be published on Monday, Tuesday or Wednesday of January, April, July and October closest to the last day of those months.

d) Once the Inflation Report of the third quarter of the year is published, the calendar of monetary policy announcements, monetary policy press releases and Inflation Reports for the following year will be available on Banco de México's web page.

VI.2. Calendar of Monetary Policy Announcements in 2006

Table 13 **Calendar of Monetary Policy Announcements, Monetary Policy Press Releases and Inflation Reports in 2006**

Month	Monetary Policy Announcements and Press Releases	Inflation Reports
January	27	31 [1/]
February	24	
March	24	
April	21	26
May	26	
June	23	
July	28	31
August	25	
September	22	
October	27	31
November	24	
December	8	

1/ Includes the Monetary Program for 2006.