Inflation Report

January – March 2007

BANCO DE MEXICO

APRIL 2007

BOARD OF GOVERNORS

Governor

GUILLERMO ORTIZ MARTÍNEZ

Deputy Governors

EVERARDO ELIZONDO ALMAGUER

GUILLERMO GÜÉMEZ GARCÍA

JOSÉ JULIÁN SIDAOUI DIB

FOREWARNING

This text is provided for the reader's convenience only. Discrepancies may eventually arise from the translation of the original document into English. The original and unabridged Inflation Report in Spanish is the only official document.

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

CONTENTS

Inflation Report January-March 2007

1. Introduction

The world economy recorded high growth during 2006. The pace of the global economic expansion is expected to slowdown gradually in 2007. A favorable performance is nevertheless anticipated. As for the U.S., incoming information suggests that the slowdown in activity could be beyond the scenario projected by analysts at the beginning of the year. In particular, the deterioration of the real estate market, including the rising delinquency rates on subprime mortgage loans, have, at the margin, negatively affected the balance of risks of the U.S. economy.

World inflationary pressures are foreseen to diminish in 2007, due to the phase of the world business cycle and as a result of prospects of lower energy prices as compared with 2006. These developments have contributed to maintain inflation expectations in the main industrialized countries anchored. Nonetheless, energy prices rebounded slightly in the last weeks as a result of certain geopolitical risks, while other commodity prices have increased and exhibited volatility.

The combination of greater risks of a reduction of U.S. economic growth and inflationary risks that have not changed significantly, have contributed to increased liquidity in international financial markets. Thus, both the prices of several assets and currencies of emerging economies have exhibited positive results.

During the first quarter of 2007, the Mexican economy continued to show signs of slower growth rates, in line with the business cycle phase the U.S. is currently undergoing. In particular, production indicators weakened, mainly due to the lesser dynamism of external demand. As for domestic demand, consumption and investment expenditure continued growing, although at slower rates.

Since mid-2006, inflation has been affected by a number of consecutive supply shocks, which have prompted an increase in both annual headline and core inflation. As mentioned by Banco de México, the referred shocks have concentrated on a few products and their effect should be reflected in changes in relative prices. However, their magnitude, the fact that they have materialized in a short period, and the high weight of the prices of the affected products on the Consumer Price Index (CPI), have made annual headline inflation fall above the upper limit of the variability interval set around the 3 percent target.

The price increases of sugar and corn-tortillas stand out, affecting core inflations' merchandise component. In the case of corn-tortillas, although the price increases originated from the rise in corn's international price references, they were intensified by various distortions characterizing the corn-tortilla production chain. Under such conditions, during the first quarter of 2007, the federal government implemented several measures to foster an adequate supply of corn and an ordered determination of prices. On April 25, 2007 the Agreement to Stabilize Corn-tortilla Prices was extended to August 15, 2007.

During the first months of the year, the aforementioned shocks led the central bank to revise upward its inflation prospects for 2007. In particular, annual headline inflation is expected to be between 4 and 4.5 percent up to the third quarter of the year, and between 3.5 and 4 percent at the end of 2007. As for annual core inflation, it is expected to follow a downward trend, ending the year between 3.5 and 4 percent.

Up to now, the development of headline and core inflation has remained, in general terms, in line with its anticipated path, and no significant evidence of contamination in the price determination process has been revealed.[1] However, some food-related prices have been affected. In addition, the following risks must be considered:

i) The uncertainty associated with the price determination of some products, particularly corn-tortillas and other foods that use various grains as inputs, has increased.

ii) The expectation that inflation will remain above the variability interval for a long period of time increases the risk of contamination in the price and wage determination processes.

iii) International prices of grains and certain commodities have been subject to pressures and their volatility has increased. Energy prices have fluctuated markedly.

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

v) Inflation expectations remain above the 3 percent target.

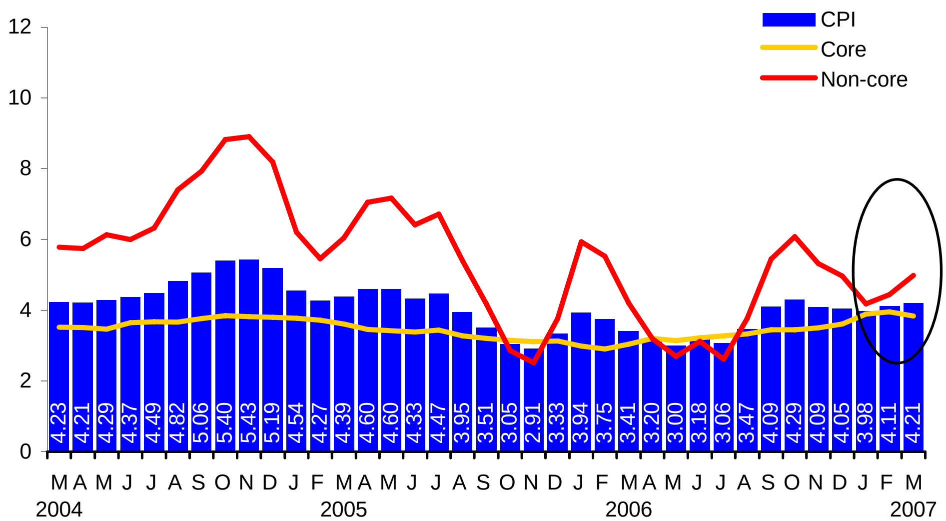
Consequently, although the slowdown of economic activity is a factor that could continue to mitigate the abovementioned risks, the Board of Governors deemed convenient to strengthen the monetary policy stance as a preemptive measure. After keeping the monetary conditions unchanged during the first quarter, in April it decided to tighten them by 25 basis points. The purpose is to achieve a better balance in terms of inflationary risks and to prevent the price and wage determination processes from being affected by the supply shocks that have taken place. With this measure, Banco de México aims to strengthen its commitment to price stability

[1] See section 2, footnote no.2.

2. Recent Developments in Inflation

During the first quarter of 2007, annual headline inflation was high, mainly as a result of supply shocks that took place since mid-2006 and whose effects have not dissipated. Just like in the previous quarter, inflationary pressures continued to concentrate on a few products, such as corn-tortillas, sugar, cigarettes, and onions. Annual headline inflation reached 4.21 percent in March 2007 (in December 2006, it was 4.05 percent, Graph 1).[2]

Graph 1
Consumer Price Index
Annual percentage change



These supply shocks affected mostly core inflation. In particular, the annual price variations of certain food, beverages and tobacco items increased significantly, making annual core inflation reach, in February 2007, 3.95 percent, its highest level in five years. This indicator started to decline since March, reaching 3.83 percent in that month. Excluding the items affected by the supply shocks (corn-tortillas, sugar and cigarettes) from the basket of core prices, and normalizing the weights of the rest of the items of that basket to add to one hundred, core inflation's annual variation in March would have been 3.45 percent (Table 1, Graph 2).[3]

---

[2] In the first half of April, the Consumer Price Index recorded a variation of -0.21 percent and an annual variation of 3.96 percent. This result is mainly explained by non-core inflation, which recorded a -0.70 percent variation that was due to a greater-than-seasonally-expected decline in the last years of electricity tariffs corresponding to the beginning of the summer season. Up to 2006, hot-weather electricity tariffs began in February in the city of Tapachula; in April, in 13 cities of the center-south region of the country; and, in May, in 13 cities of the north region. Nonetheless, based on temperature records, the Federal Electricity Commission (*Comisión Federal de Electricidad*, CFE) reclassified the cities of the CPI located in the states of Coahuila and Nuevo León so that they could start applying the referred tariffs in April when, as mentioned previously, they had traditionally done so in May. This led to a 0.16 percentage point reduction in inflation during the first half of April and in its corresponding annual rate. For details on CFE electricity tariffs and their going-into-effect date, refer to http://www.cfe.gob.mx.

[3] The CPI is composed of 315 items, and the core price index, of 232 items.

Table 1
Incidence of CPI Components on Annual Headline Inflation*
Percentage points

	Annual percentage change				Incidence percentage points				
	Dec-2006	Jan-2007	Feb-2007	Mar-2007	Dec-2006 (a)	Jan-2007 (b)	Feb-2007 (c)	Mar-2007 (d)	Difference (d-a)
CPI	**4.05**	**3.98**	**4.11**	**4.21**	**4.05**	**3.98**	**4.11**	**4.21**	**0.15**
Core	**3.61**	**3.89**	**3.95**	**3.83**	**2.43**	**2.60**	**2.65**	**2.58**	**0.15**
Merchandise	**3.38**	**3.80**	**3.83**	**3.78**	**1.19**	**1.33**	**1.34**	**1.33**	**0.14**
Food	5.10	6.17	6.05	5.92	0.76	0.92	0.90	0.88	0.12
Cigarettes	1.37	6.05	9.35	9.66	0.01	0.05	0.07	0.07	0.06
Corn-tortilla	13.82	19.13	15.49	14.31	0.19	0.26	0.22	0.20	0.01
Sugar	31.93	30.84	30.18	28.95	0.07	0.07	0.07	0.06	-0.01
Rest of merchandise	2.12	2.06	2.20	2.20	0.43	0.42	0.44	0.45	0.02
Services	**3.87**	**3.98**	**4.09**	**3.89**	**1.24**	**1.27**	**1.31**	**1.25**	**0.01**
Housing	3.73	3.78	3.81	3.59	0.65	0.66	0.66	0.63	-0.02
Own-housing	3.45	3.45	3.38	3.17	0.40	0.40	0.39	0.37	-0.03
Rest of services	4.02	4.21	4.41	4.25	0.59	0.62	0.65	0.63	0.03
Travel packages	3.70	4.81	5.89	7.10	0.03	0.04	0.05	0.06	0.03
Non-core	**4.96**	**4.17**	**4.44**	**4.98**	**1.62**	**1.38**	**1.46**	**1.63**	**0.00**
Agricultural	**8.30**	**5.55**	**5.83**	**8.67**	**0.71**	**0.48**	**0.50**	**0.73**	**0.02**
Fruits and Vegetables	**15.46**	**7.04**	**6.77**	**13.59**	**0.52**	**0.25**	**0.24**	**0.45**	**-0.07**
Tomato	10.18	-26.77	-39.38	-37.02	0.06	-0.19	-0.26	-0.17	-0.23
Onion	186.09	237.18	236.99	269.36	0.22	0.29	0.28	0.33	0.10
Lemon	-5.99	-12.16	23.73	74.96	-0.01	-0.02	0.03	0.09	0.10
Livestock	**3.69**	**4.53**	**5.19**	**5.53**	**0.19**	**0.23**	**0.27**	**0.28**	**0.09**
Egg	15.79	21.19	23.38	22.67	0.09	0.12	0.14	0.13	0.04
Beef	-0.40	-0.08	1.05	1.37	-0.01	0.00	0.03	0.03	0.04
Poultry	8.39	9.81	8.81	9.81	0.10	0.11	0.10	0.11	0.02
Administerred and Regulated	**3.14**	**3.03**	**3.39**	**3.07**	**0.57**	**0.55**	**0.62**	**0.56**	**-0.01**
Administered	**4.42**	**3.55**	**3.99**	**3.43**	**0.41**	**0.33**	**0.37**	**0.32**	**-0.09**
Low-octane gasoline	5.59	4.21	3.83	4.46	0.17	0.13	0.12	0.14	-0.03
High-octane gasoline	8.46	8.50	8.32	8.73	0.04	0.04	0.04	0.04	0.00
Electricity	5.07	4.52	3.98	3.87	0.15	0.14	0.12	0.12	-0.04
Residential-use gas	1.53	0.81	3.41	0.71	0.04	0.02	0.09	0.02	-0.02
Regulated	**1.83**	**2.49**	**2.77**	**2.69**	**0.16**	**0.22**	**0.25**	**0.24**	**0.08**
Urban bus	5.87	8.43	9.26	7.78	0.08	0.11	0.12	0.11	0.03
Education	**5.71**	**5.64**	**5.61**	**5.60**	**0.35**	**0.34**	**0.34**	**0.34**	**-0.01**

* Refers to the contribution (in percentage points) of each of the CPI components to headline inflation. Headline inflation is calculated using the weights of each subindex, as well as relative prices and their respective variations. In some cases, figures from some subindexes may not add up due to rounding.

The merchandise subindex grew from 3.38 percent in December 2006 to 3.78 percent in March 2007 in annual terms (Table 1 and Graph 2). This was mainly due to the price behavior of corn-tortillas, cigarettes, and sugar. Prices of corn-tortillas recorded an annual variation of 14.31 percent at the end of the first quarter of 2007, after having recorded a higher annual variation in January (19.13 percent). Due to the importance of this item in households' expenditure, the referred increase affected inflation significantly (Table 1).[4]

The increase in corn-tortilla prices between September 2006 and the first half of January 2007 originated from the hike in corn's international price references. Nonetheless, this increase escalated due to several distortions in the corn-tortilla production chain. The Agreement to Stabilize Corn-tortilla Prices between the federal government and various participants related to the corn-tortilla industry interrupted this upward trend (Graph 3). The Agreement, valid from January 18 to April 30, 2007, determined maximum prices for corn-tortillas and their raw materials (corn and flour).[5] Additional duty free import quotas for corn were also authorized. On April 25, the federal government and corn industry representatives renewed this Agreement to August 15, 2007.

---

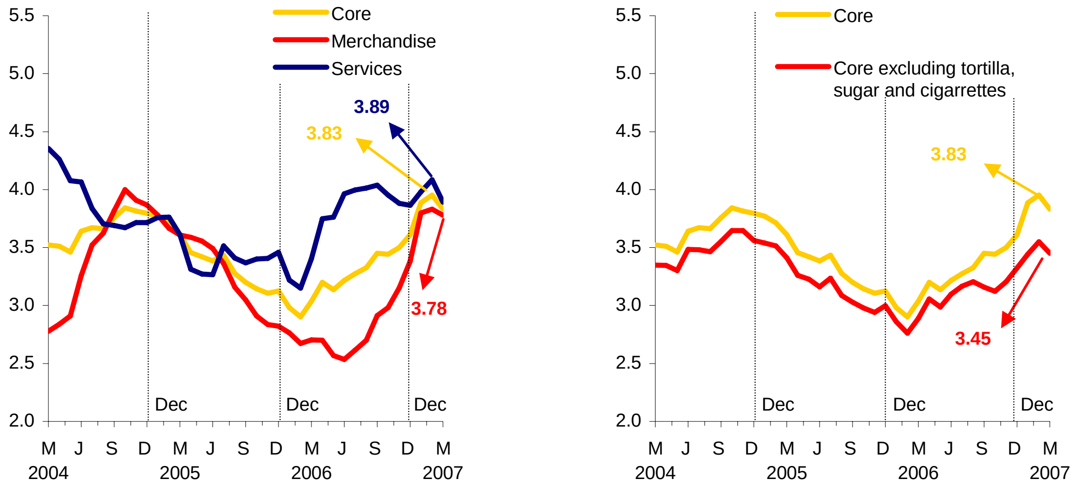
[4] Within the core price index, the weights of corn-tortilla, sugar, and cigarettes were 1.76, 0.30 and 0.86 percent (in the CPI, these weights are 1.23, 0.21 and 0.60 percent, respectively).

[5] For a detailed description of the maximum prices agreed see the Inflation Report October-December 2006, p.6.

Graph 2
Core Price Index

a) Core and Subindices
Annual percentage change

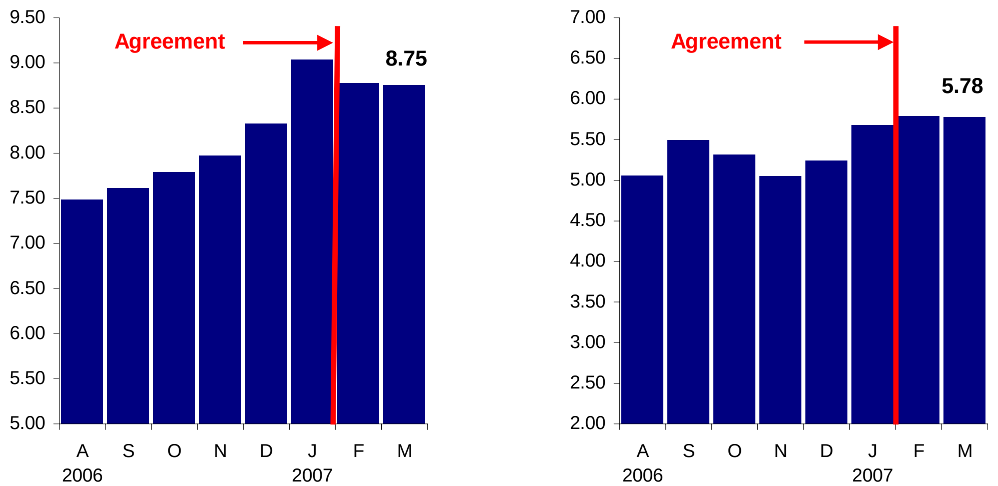
b) Core excluding Tortilla, Sugar and Cigarettes
Annual percentage change



Graph 3
Corn-tortilla Prices

a) Corn-tortilla Retail (*Tortillería)* Prices
Pesos/kilogram

b) Supermarket Prices
Pesos/kilogram



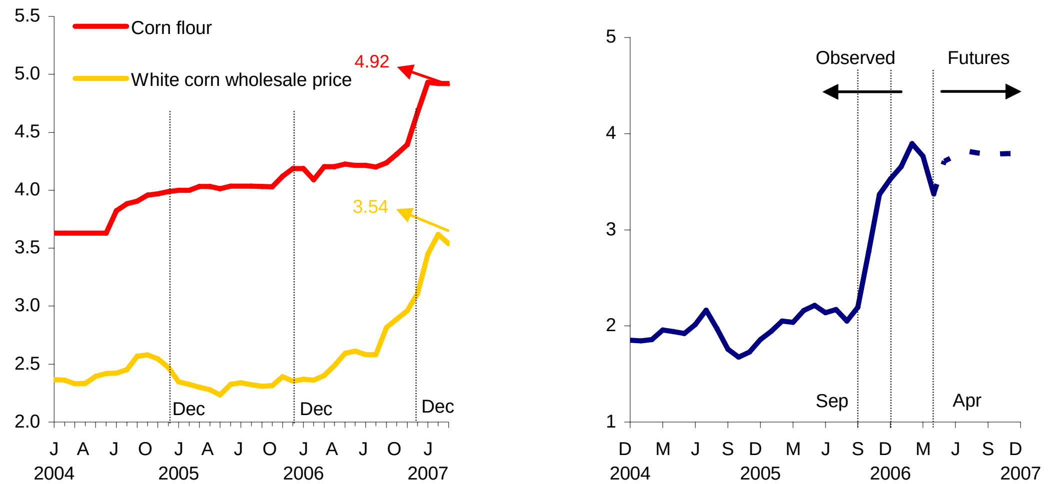
Despite the various measures implemented at the national level to limit the price increase of corn-tortilla and of its raw materials, white corn and white-corn flour quotes remained high. This was mainly due to the pressures that grains have been subject to in international markets, given the greater demand for their use in bioenergy production and animal feed (Graph 4).[6] This shock is expected to considerably affect annual inflation calculations, at least during the first eight months of 2007.

[6] For a detailed description of the development of grains' international prices, see section 3.3.3.

Graph 4
Tortilla Prices and Raw Material Costs

a) Tortilla Prices
Pesos per kilogram

b) International Prices of Yellow Corn
US dollars per bushel



Source: Banco de México.

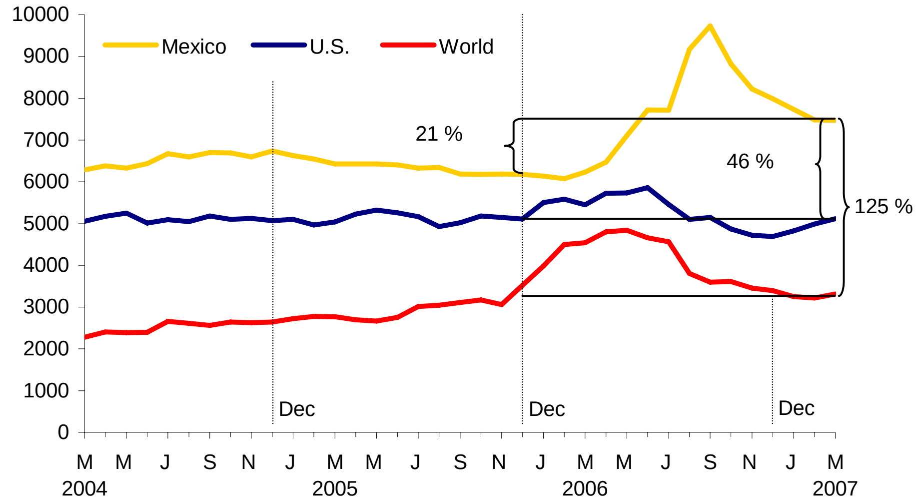
Source: U.S. Department of Agriculture and Chicago Board of Trade. Futures prices correspond to April 26, 2007.

During the referred quarter, cigarettes had the highest influence in annual core inflation, contributing by 41 percent to the observed increase. In March 2007, cigarette prices recorded an annual variation of 9.66 percent. This was due mainly to the increase in the Production and Services Tax (*Impuesto Especial sobre Producción y Servicios*, IEPS), which applies to the consumption of this product. The referred tax was set at 140 percent for 2007 (last year it was set at 110 percent). For 2008 and 2009 it is due to increase to 150 and 160 percent, respectively.

In March 2007, sugar prices increased 28.95 percent in annual terms. As a result, the contribution of this item to core inflation remained high (Table 1). Domestic prices of sugar behaved differently than their international references. At the end of the first quarter of 2007, international prices of sugar were at a level similar to that observed in December 2005, completely reverting the price increase that took place during the first quarter of 2006. In contrast, in March 2007, domestic wholesale prices of sugar were 21 percent above their level in December 2005, and 125 percent above their international reference (Graph 5).

The annual variation of the services subindex increased marginally, from 3.87 to 3.89 percent between December 2006 and March 2007. This was due to two offsetting trends: a) a greater contribution of services prices, of both food outlets (restaurants and cafeterias, among others) and travel packages (in the case of the latter, due to a change in the starting week of the Easter season, as compared to the previous year); and, b) a reduction in the annual variation of housing-related services, as the effects of the shocks that affected the prices of materials manufactured from steel and copper began to dissipate (Graph 6).

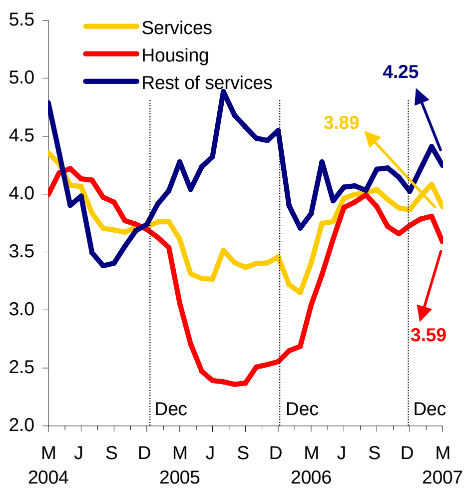
Graph 5
Domestic and International Prices of Sugar
Pesos per ton



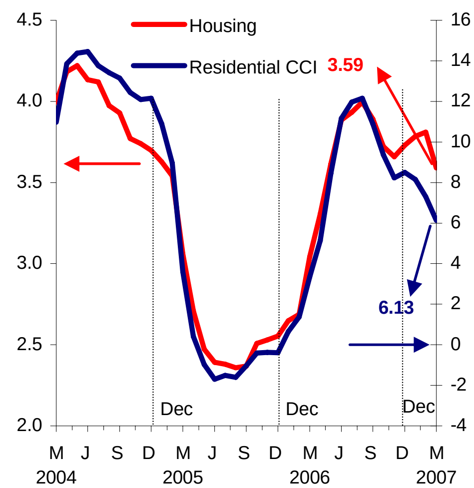
Source: National System of Information and Integration of Markets (*Sistema Nacional de Información e Integración de Mercados*, SNIIM). U.S. Department of Agriculture (U.S. and World).

Graph 6
Core Services Subindex

a) Services and Components
Annual percentage change

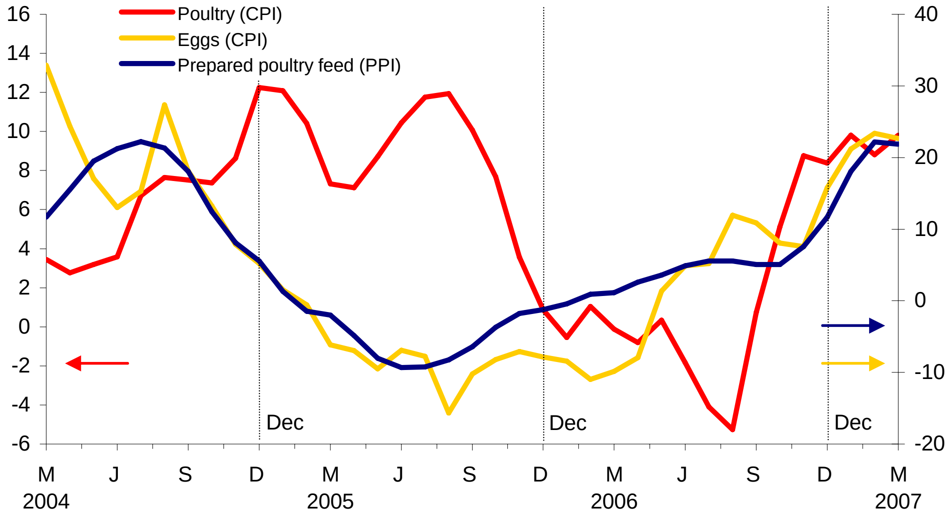


b) Housing and Residential Construction Cost Index
Annual percentage change

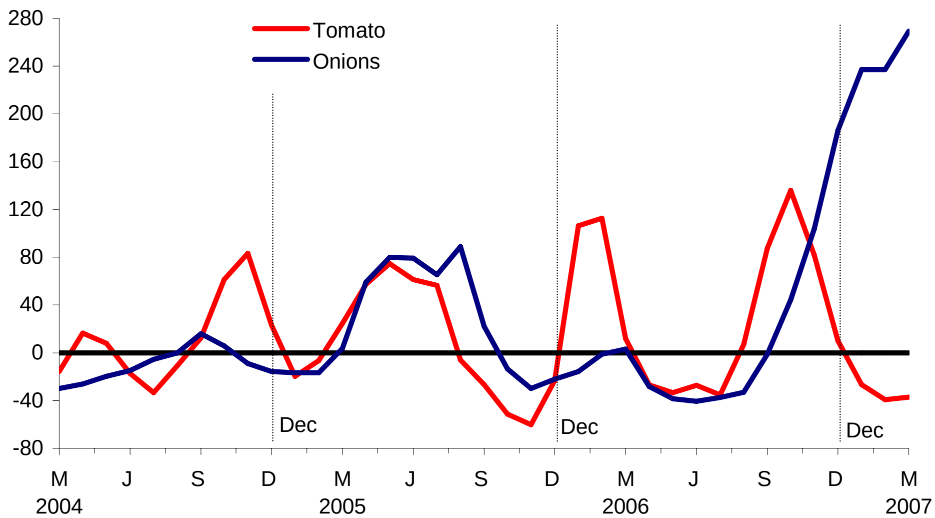


In March 2007, annual non-core inflation reached 4.98 percent, figure similar to that observed at the end of the previous quarter (4.96 percent). This result originated from the high variation in the agriculture subindex prices (8.67 percent). The latter was also the result of a diminished supply of lemons and onions due to damaged crops originated by adverse weather and, in the case of onions, to a lesser number of crops that were cultivated because of the low selling prices of this vegetable in previous years. Price variations of eggs and poultry also increased due to the higher costs of prepared feed meals (Graph 7 and Table 1). The significant reduction in tomato prices limited the aforementioned increases (Graph 8).

Graph 7
Egg and Poultry Price Index
Annual percentage change



Graph 8
Tomato and Onion Price Index
Annual percentage change



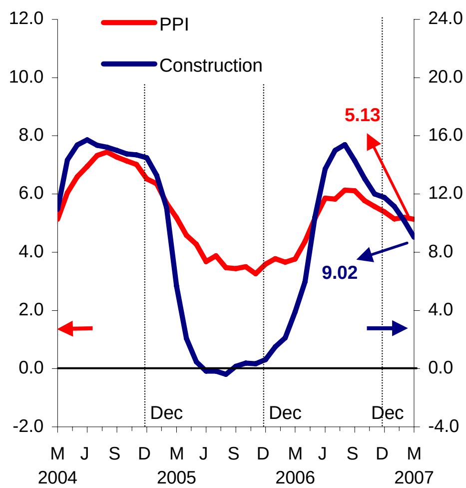
Between December 2006 and March 2007, the rest of the index components recorded the following annual variations: i) the subindex of administered prices fell from 4.42 to 3.42 percent, as a result of the path followed by the prices of goods and services set according to external references or to rules associated with such references (gasoline at border cities, natural gas and high-consumption electricity tariffs); ii) the subindex of regulated prices increased from 1.83 to 2.69 percent, mainly due to revisions in public transportation fees in some cities (Monterrey, Guadalajara, Torreón, and Hermosillo, among others); and iii) the education price subindex decreased from 5.71 to 5.60 percent. Section 3.3.2 further describes the path followed by the two subindexes.

2.1. Producer Price Index

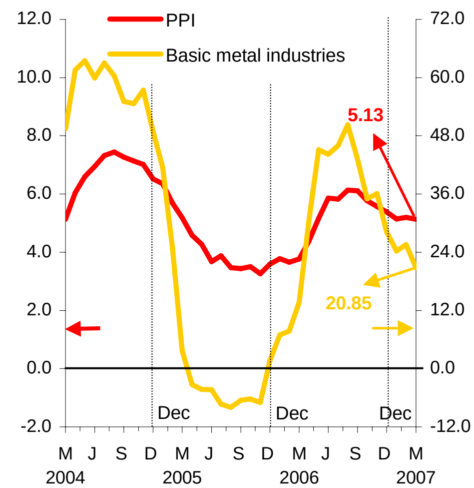
In March 2007, the Producer Price Index (PPI), excluding oil, recorded an annual variation of 5.13 percent, a decline of 0.26 percentage points in relation to the end of the previous quarter. This result was mainly influenced by the slowdown in the annual variations of the construction and basic metal industries price subindexes (Graph 9). The decline in construction price inflation mainly responded to the gradual decrease in copper and steel products whose prices exhibited significant increases last year.

Graph 9
Producer Price Index Excluding Oil:
Merchandise and Finished Goods

a) PPI and Construction
Annual percentage change



b) PPI and Basic Metal Industries
Annual percentage change



3. Main Determinants of Inflation

3.1. International Environment

The world economy grew significantly at the beginning of 2007, albeit seemingly less vigorously than in the last quarter of 2006. The main economies performed differently. In the U.S., economic activity continued to be affected, among other factors, by weak investment, especially in residential construction. Available information suggests that these developments took place as activity in other advanced economies exhibited sound growth –although at a less vigorous pace than in the previous quarter- and emerging economies grew robustly. The continuation of moderate wage pressures and the slowdown in global growth favored the containment of inflationary pressures and kept inflation expectations anchored, despite the volatility of oil prices. Under this context, and except for a brief episode of financial volatility in the middle of the quarter, conditions in international financial markets continued to be positive for issuers from emerging market economies.

3.1.1. Global Economic Activity

In the U.S., during the fourth quarter of 2006, GDP continued to show rates of growth (3.1 percent at an annual rate and 2.5 percent at an annualized quarterly rate) below those observed during the first half of the year, despite the expansion of consumption and of net exports. The latter factors mitigated the impact of both the contraction of fixed residential investment and of firms' capital expenditures (in the fourth relative to the third quarter of 2006) and of the process of adjustment in inventories. The inventory cycle had its strongest impact on the manufacturing sector, whose production index in December barely exceeded by 0.1 percent its level in August 2006. GDP growth further weakened during the first quarter of 2007 (2.1 percent at an annual rate and 1.3 percent at an annualized quarterly rate), as domestic demand grew 1.9 percent (the lowest figure in 16 quarters) in annual terms, and the trade balance deficit increased. Investment remained weak at the beginning of 2007. Although non-residential investment expanded modestly, residential investment once again recorded a marked decline (16.7 percent at an annual rate and 17 percent at an annualized quarterly rate) in a context of rising delinquency rates on subprime mortgage loans. On another front, consumption grew at a sound pace (3.4 percent at an annual rate and 3.8 percent at an annualized quarterly rate).

Favorable conditions for growth prevailed In the Euro area and Japan at the beginning of 2007. Although the Euro area is expected to slowdown during the January-March period as compared to the high growth attained during the last quarter of 2006 (3.3 percent at an annual rate), the region continued to benefit from increased domestic demand –boosted by employment growth and the recovery of investment- as well as by the significant strength of the external sector. As for Japan, GDP rebounded during the fourth quarter of 2006 (annual growth rate of 2.5 percent), as consumption and non-residential investment recovered. Available data suggests that these trends continued during the first quarter of 2007.

Emerging economies in general have maintained high rates of growth, supported by favorable financing conditions, dynamic growth of the manufacturing sector in Asia, and high commodity prices. In China, fixed investment slowed during the second half of 2006, in response to the measures adopted to prevent an excessive economic expansion. Nonetheless, the strong rate of growth of demand at the beginning of 2007 generated concerns of economic overheating, which prompted the central bank to increase its reserve requirements in January, February and April. Economic activity has remained strong in other Asian emerging economies.

Latin American economies recorded high growth rates in 2006, due to the strength of domestic demand, robust external demand, and a further improvement of the terms of trade. In particular, the current account balance recorded a surplus for the fifth consecutive year. The region is expected to continue to grow soundly in 2007, although at a slower pace than during 2006.

3.1.2. General Trends of Inflation

World inflationary pressures remained, in general terms, contained at the beginning of 2007, as a result of moderate wage pressures and the slowdown of various economies.

Oil prices continued to decline at the beginning of 2007, reaching, in the case of the WTI crude oil, around 50 US dollars per barrel in mid-January. Nonetheless, prices have increased since then, averaging 58.1 US dollars (47 US dollars for the Mexican crude-oil export mix) during the first quarter, i.e., slightly more than 1.7 US dollars below their average of the previous quarter (Graph 10).[7] At the end of the first quarter, the price of the WTI was 65.9 US dollars, remaining in April at levels above those observed on average during the period January-March.[8] Thus, energy prices pushed headline inflation upwards once more. On the other hand, the rate of increase of the IMF non-fuel commodities price index slowed during the first two months of the year, primarily because of a decline in the growth rate of metal prices,[9] which exhibited volatility in March and April.

[7] The increase of prices of other light crudes was even larger. For example, since the second week of March, the spread between the WTI and other reference crudes like the North Sea Brent turned negative, reaching 4 US dollars per barrel. This was partly due to a decline in the demand for WTI, due to maintenance of oil refineries in the Gulf of Mexico coast and in the U.S. Midwest. In addition, the level of inventories at the main WTI delivery point (Cushing, Oklahoma) was high during that period.

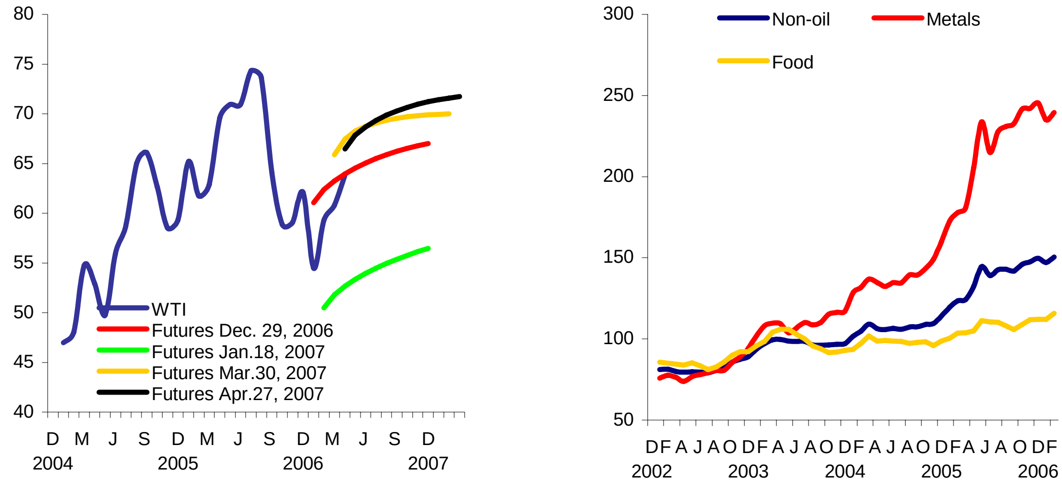
[8] Factors aiding the recovery of prices from their lowest levels in mid-January included: the announcement of measures to refill the U.S. Strategic Petroleum Reserve; new geopolitical tensions, particularly in Iran, the cold weather in the U.S. Northeast; difficulties in the oil refining process; and, the partial fulfillment of OPEC's oil production cuts commitments.

[9] In January-February 2007, the IMF non-fuel commodities price index increased at annual rates slightly above 20 percent, compared to the above 30 percent rates observed during the fourth quarter of 2006. The growth rate of metal prices slowed significantly (34.6 percent at an annual rate in February vs. 61.2 percent on average during the fourth quarter). Food prices increased 11.9 percent in February vs.13.6 percent during the fourth quarter. The annual increase of the prices of agricultural raw materials was 13.9 percent in February (11 percent during the fourth quarter).

Graph 10
Commodity Prices

a) Oil Prices: Spot and Futures
US dollars/ barrel

b) Commodity Prices
Índices 1995=100



Source: Bloomberg.

Source: IMF, Commodities Unit of the Research Department; Intereconomics, Economic Trends.

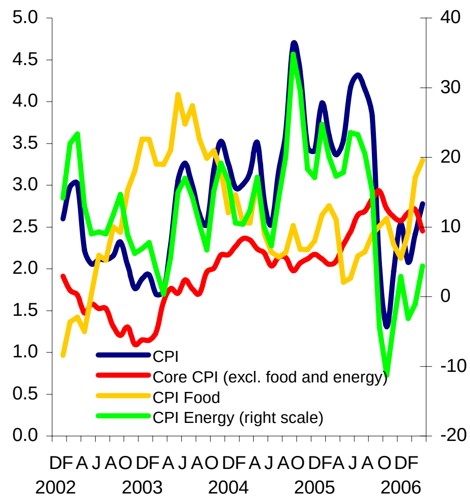
In the U.S., the increase in food and energy prices pushed headline inflation up, despite the relative stability exhibited by core inflation in recent months (Graph 11). Annual headline inflation moved from 2.5 percent in December, to 2.8 percent in March. Annual core inflation was 2.5 percent in March, a figure slightly below that observed at the end of 2006 (2.6 percent). Although core inflation remained relatively stable during the first months of 2007, March figures are significantly above those observed last year (2.1 percent), and the Federal Reserve considers its current level as relatively high.

Continuing moderate wage increases have contributed to mitigate inflationary pressures and to keep inflation expectations well anchored, despite the slight rebound in unit labor costs at the end of 2006, which recorded an annual growth of 3.4 percent during the fourth quarter. Information used to calculate these costs is relatively volatile and other indicators of the evolution of wages, such as the employment cost index, suggest lower wage pressures. In addition to the rapid increase in wages, the slower growth rate of productivity has also contributed to higher unit labor costs. Nonetheless, it is not clear if the latter constitutes a change in trend or only a normal cyclical development of this indicator.

In the Euro area, annual headline inflation remained below 2 percent during the first quarter of 2007, in line with the target of the European Central Bank (ECB), despite the rebound in oil prices at the end of the period. The ECB estimates that, should energy prices follow the path suggested by the futures market, headline inflation would decline in the coming months and then rebound to around 2 percent at the end of the year. The ECB warned that this scenario is subject to upward risks. In Japan, the increase in the consumer price index observed since the beginning of 2006 was interrupted, recording again negative annual variations in February and March. The annual rate of change of the consumer price index decreased from 0.9 percent in August 2006, to -0.1 percent in March 2007, mainly as a result of the fall in energy prices. The consumer price index excluding food and energy continued to record negative annual variations during the first quarter of 2007.

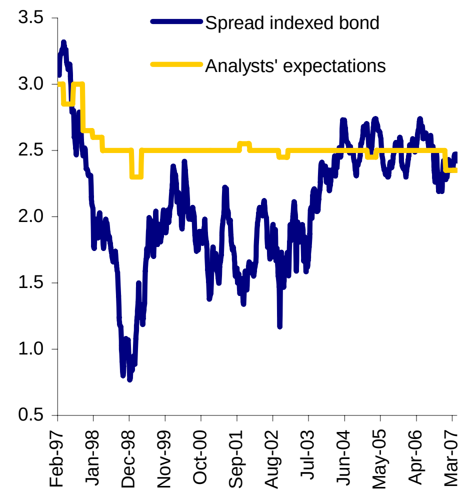
Graph 11
U.S.: Price Indexes and Inflation Expectations
Annual percentage change

a) Consumer Prices



Source: BLS.

b) Long-term Inflation Expectations



Note: The spread refers to the yield on the 10-year U.S. Treasury nominal bond minus the yield on the 10-year indexed bond. Analysts' expectations are obtained from the long-term inflation forecasts from the *Survey of Professional Forecasters, Philadelphia Fed.*
Source: Federal Reserve, and Philadelphia and St. Louis Fed.

Inflation in emerging economies has remained, in general terms, relatively low, although inflationary pressures have been observed in some cases. Inflation in China has rebounded since the end of 2006, as a result of the increase in food and housing prices, reaching 3.3 percent in March in annual terms. In Latin America, inflation followed a downward trend in 2006. In many countries, the latter was influenced by the appreciation of their currencies. Moderate inflationary pressures continued in various Latin American economies during the first quarter of 2007. However, in some of them, like Venezuela, the growth rate of prices rebounded.

3.1.3. Financial Markets

The low volatility in international financial markets was briefly interrupted at the end of February by a period of turbulence that continued up to the beginning of March. Some of the main central banks have adopted a more cautious stance in view of inflationary risks. Nonetheless, in general terms, ample liquidity conditions continued to prevail. Therefore, spreads on emerging economies' sovereign debt reached record lows at the beginning of April.

In both of Federal Open Market Committee meetings that took place during the first quarter of 2007, the Committee kept the policy rate unchanged, at the 5.25 percent level that has prevailed since last June. In its press releases, the Committee continued to single out inflation risks as the main concern. Various factors, such as the uncertainty generated by the correction of the subprime mortgage market, created the perception of greater downward risks for economic activity in the U.S. Under this setting, and considering that inflationary risks have remained relatively stable, the futures curve for the federal funds rate reflected a higher probability of a loosening of monetary policy during the second half of 2007. As soon as more positive figures of the path of U.S. economic activity were released, expectations of a reduction in the federal funds rate moderated (Graph 12). On the other hand, long-term interest rates, which had followed an upward trend in January, fell during the volatility episode of February and beginning of March. This fall was reverted during the rest of the quarter. On balance, during the January-March period, these interest rates were below the federal funds rate. The 10-year Treasury bonds rate was 4.70 percent on April 26, compared with 4.63 and 4.65 percent at the end of December 2006 and March 2007, respectively.

The European Central Bank continued to gradually withdraw monetary stimulus during the first quarter of 2007, while reiterating that this stimulus is still substantial and that significant long-term risks prevail for price stability. Reference rates increased by 25 basis points during the first quarter and remained unchanged after the ECB Board's meeting of mid-April. The Bank of Japan also increased by ¼ of a percentage point its policy rate in its February meeting. In the minutes of this meeting, the authorities explain that this measure will contribute to ensure sustained growth by preventing both excessive fluctuations in the economy and an inadequate allocation of resources. In its meetings of April 10 and 27, the Bank of Japan left its policy interest rate unchanged.

The US dollar continued to depreciate during the first quarter of 2007. The effective exchange rate index vs. the main currencies depreciated 1.2 percent, while the broad index decreased by 0.9 percent.[10] Stock markets fell during the period of turmoil in late February and early March. This episode was characterized by a reduction in the appetite for risk, which responded to various factors, including the continuous worsening of the subprime mortgage market in the U.S. and some concern about the outlook for growth in that country. Nonetheless, at the end of March, markets calmed down and, at the end of April, stock markets reached new record highs, with some exceptions, particularly in Asia.

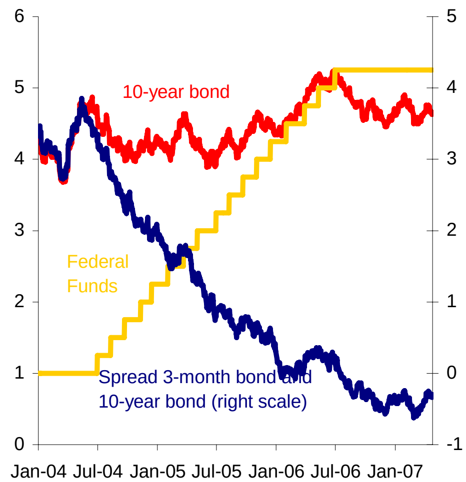
During the period of turmoil, sovereign debt indexes also came under pressure. From the end of November to the end of February, emerging economies' asset prices rebounded and sovereign country risk reached record lows in the two first months of 2007.[11] The period of volatility during the last days of February and beginning of March led to increases in sovereign risk spreads. Nonetheless, as markets calmed down, this trend reverted. Thus, spreads fell to new record lows at the beginning of April, remaining very low during the rest of the month.

[10] The Federal Reserve real effective exchange rate index of the US dollar vs. the main currencies is an average of the US dollar rates against the euro, the yen, the Canadian dollar, the pound sterling, the Swiss franc, the Australian dollar and the Swedish crown, weighted by the corresponding country's share in U.S. trade. The broad index includes the currencies of 26 countries.

[11] The EMBI Global showed a record low of 167 basis points on January 25, 2007. At the end of the first quarter, this indicator reached 170 basis points.

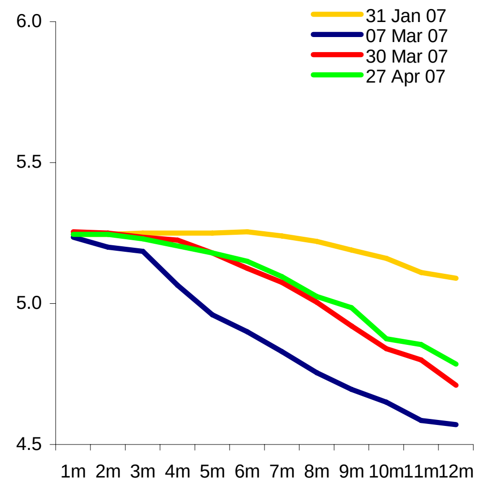
Graph 12
U.S.: Interest Rates
Annual percent

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



Source: Federal Reserve.

b) Federal Funds Futures



Source: Bloomberg.

3.1.4. Outlook

During 2007 and 2008, the world economy is expected to continue growing at a favorable rate, although with less dynamism than in 2006 and with a lower relative contribution from the U.S. economy. In addition, a decline in inflation is expected for the advanced economies where long-term expectations remain anchored at moderate levels.

This positive scenario faces various risks. On the one hand, a new episode of increases in energy prices cannot be discarded. On the other hand, pressures on core inflation could increase due to the high levels of capacity utilization and the uncertain trend for productivity in some economies. Under this scenario, unit labor costs could be subject to pressures and, therefore, monetary policy might need to be tightened.

Although the brief period of financial volatility that took place at the beginning of the year does not seem to have had a long-lasting impact, the risk lingers of a worsening in the subprime segment of the U.S. mortgage market. This could put further pressure on the real estate market. In the event, such deterioration could have an impact not only on residential investment in that country but also on consumption.

Finally, risks of a disorderly adjustment of the global current account imbalances have not disappeared. Although the probability of this taking place seems to be small, the related costs would be high. The depreciation of the U.S. dollar and the rebalancing in the sources of world growth observed so far are contributing to a gradual correction of these disequilibria.

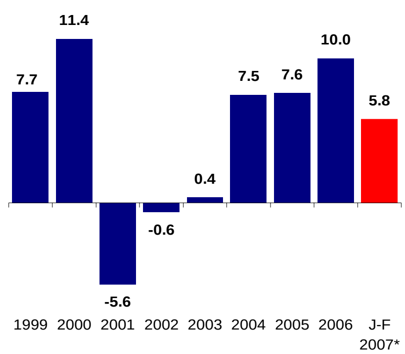
3.2. Aggregate Demand and Supply in Mexico

3.2.1. Indicators of Aggregate Demand and Supply

During the first quarter of 2007, economic activity grew moderately. The early signs of slowdown exhibited by GDP and aggregate demand during the second half of 2006 were more evident in the first months of the year, extending to all of their components. The main aspects characterizing aggregate demand during the first quarter of 2007 were: i) both components of aggregate demand –domestic and external- grew at slower annual rates; ii) within domestic demand, the moderate expenditure in consumption exhibited during the last quarter of 2006 continued during the first quarter of this year (Graph 13c);[12] iii) investment continued to grow significantly, but below figures of the last quarter of 2006 (which was the lowest observed during the entire 2006) (Graph 13a and 13b);[13] and, iv) exports of goods and services recorded a moderate annual variation, as a result of a greater slowdown of external demand as compared with the second half of 2006.

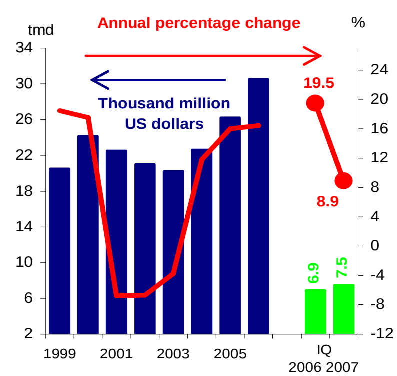
Graph 13
Domestic Demand Indicators

a) Gross Fixed Capital Formation
Annual percentage change



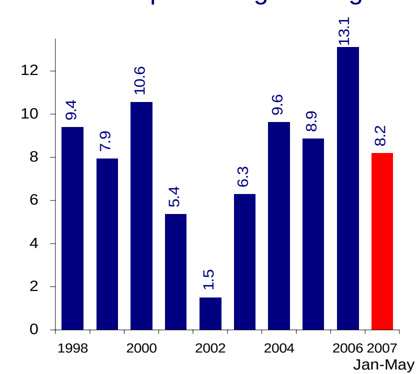
* Estimates.
Source: INEGI.

b) Capital Goods Imports



Source: Banco de México.

c) ANTAD Sales
Annual percentage change



Source: ANTAD.

During the first months of 2007, external conditions did not contribute –as they had done so from 2004 to 2006- to the growth of both domestic expenditure and domestic production. First, the slowdown of external demand -particularly that from the United States- worsened during the first months of the year, affecting Mexican exports negatively (Graph 14c). Second, export-oriented automotive production decreased worldwide in annual terms. Third, the oil trade balance surplus declined significantly as compared to the same period of last year. Finally, although workers' remittances increased during the first quarter of 2007, they did so but at a more moderate rate than in previous years.

---

[12] Private consumption indicators reveal that ANTAD sales during the first quarter of 2007 grew 9.4 percent in annual real terms, while during the fourth quarter of 2006, 12.7 percent, and 13.1 percent during the entire year. An additional indicator of consumption spending is car retail domestic sales, which during the first quarter of the year decreased slightly by 0.7 percent in annual terms, compared with increases of 0.7 percent, both in the fourth quarter of 2006 and during the entire 2006. These weak results partly reflect the high number of imported used units during that period (311,323 vehicles during the first quarter), which affected "subcompact" car sales.

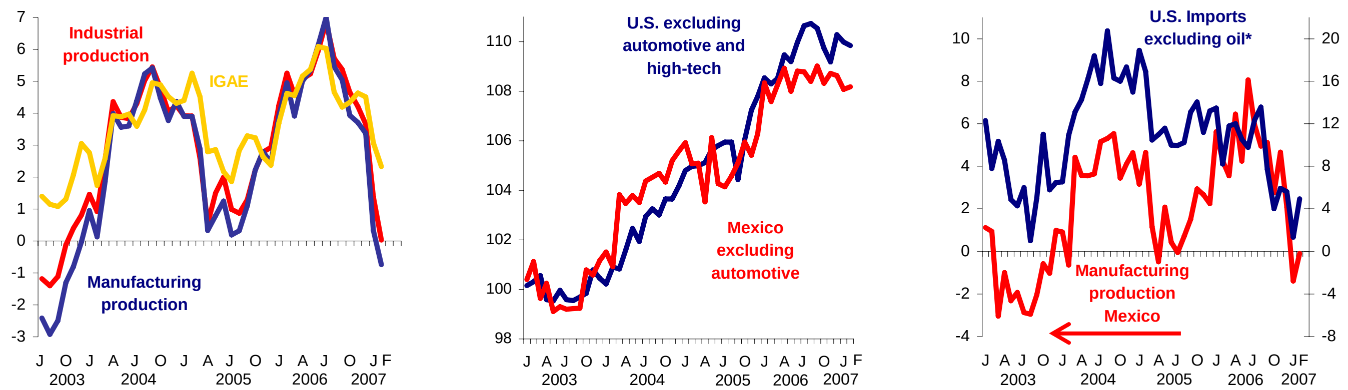
[13] Investment spending is expected to have increased 5.8 percent in annual terms during the first two months of 2007 (7.4 percent during the fourth quarter of 2006 and 10 percent during the entire 2006). On another front, capital goods imports increased 8.9 percent in current US dollars in annual terms, as compared with 16.4 percent during the entire 2006.

Graph 14
Production Indicators

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

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

c) Manufacturing Production in Mexico and U.S. Imports
Annual percentage change of seasonally adjusted data



Source: INEGI.

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

* Current U.S. dollar changes.
Source: Banco de México and Census Bureau (U.S. Department of Commerce).

Additional factors exist that might have contributed to moderate growth of both consumption and private investment during the first quarter of the year. On the one hand, confidence and business condition indicators (private sector economic analysts' consumer and business confidence indexes) lost strength in the last months of 2006, and this trend prevailed during the first two months of 2007. Nonetheless, in March these indicators improved at a monthly rate. On the other hand, during the reference quarter, and after having exhibited dynamism, private expenditure financing slowed. Private consumption spending might have also been affected by the slower rate of growth of job creation in the formal sector.

As for public expenditure, in 2006 it was favored by the higher public revenues that partly originated from the increased oil prices that prevailed in that year. Nonetheless, the value of crude oil exports fell significantly during the first quarter of 2007 (19.7 percent in US dollars). Incoming information on public expenditure for the first two months of 2007 suggests that it could have grown in annual terms more moderately than during the same period of last year. This would imply that this aggregate demand component contributed, at the margin, less to GDP growth during the same period of 2006.

Aggregate supply during the first quarter of 2007 was characterized by more moderate growth of both GDP and goods and services imports than those observed during the fourth quarter of 2006 and during the entire 2006.[14] As for merchandise imports, both intermediate –product-related inputs- and capital good imports grew soundly, albeit below second-half-of-2006 figures. During the first quarter of 2007, and unlike the fourth quarter of 2006, the agriculture sector did not contribute positively to annual GDP growth. This was mainly attributed to the fact that during the period covered by this Report, harvested land decreased in

[14] As for GDP indicators, the Global Indicator of Economic Activity (*Indicador Global de la Actividad Económica,* IGAE) recorded an annual increase of 2.8 percent during the first two months of 2007. This rate was influenced downward by the modest increases of its agriculture and industrial components (0.7 and 0.8 percent, respectively), while the services component increased by 3.9 percent.

annual terms because favorable weather conditions prompted harvesters to partially advance these activities at the end of the 2006.

A significant development of GDP during the first quarter of 2007 was the modest growth of industrial production, mainly in the manufacturing sector (Graph 14a).[15] After having achieved in 2006 its highest growth in six years, manufacturing production slowed. This loss of dynamism was a main reflection of the annual contraction of the automotive sector, although non-automotive manufacturing production also slowed significantly. In general terms, these results are mostly explained by the behavior of external demand (Graph 14b and 14c).

The terminal automotive industry grew significantly during the entire 2006. However, during that year it lost dynamism gradually, observing a marked downward trend in the first quarter of 2007 (Graph 15a). In December 2006 and during the first quarter of 2007 the number of Mexican-assembled vehicles fell considerably in annual terms (Graph 15b), as vehicle-exports decreased.[16] This decline partially mirrored the technical stops of various car-assembling companies for maintenance purposes and to adjust the production lines to assemble new car models. Nonetheless, these stops also responded to production adjustments, due to a weakening external demand.

The described results, as well as a broad range of economic activity indicators, allow for estimating that annual GDP growth during the first quarter of 2007 was close to 3 percent, after having been 4.3 percent during the fourth quarter of 2006 and 4.8 percent during the entire 2006.

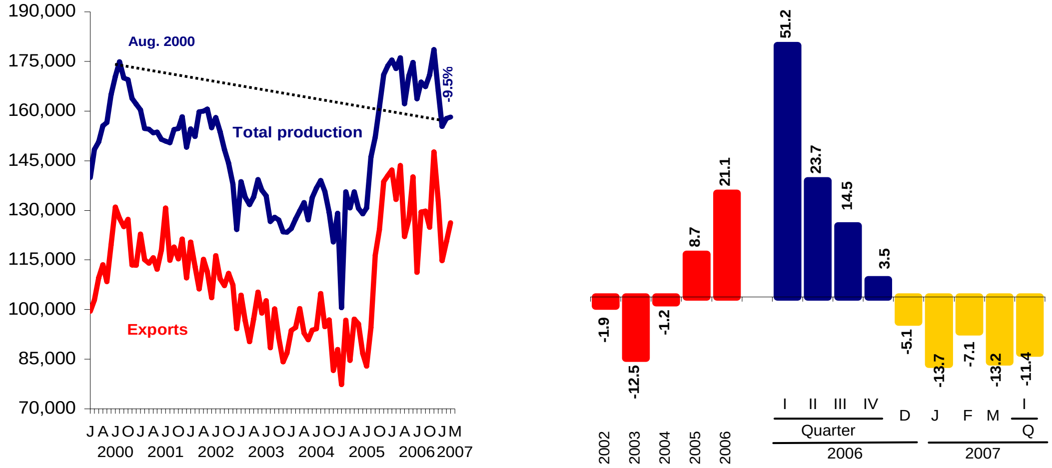
[15] During the first two months of 2007, industrial production grew at an annual rate of only 0.8 percent (5 percent in 2006), which originated from increases in 3 of the four components that make up the industrial sector. During the reference period, construction and electricity recorded increases of 2.4 and 5.4 percent, respectively (6.9 and 5 percent in 2006), while mining fell 0.1 percent in annual terms (2.2 percent growth in 2006). Manufacturing increased only 0.1 percent (4.7 percent in 2006), due to a 5 percent annual fall in automotive production (16.1 percent increase in 2006) and a 1.1 percent increase in non-automotive manufacturing production (2.8 percent in 2006).

[16] In December 2006 and during the first quarter of 2007 the number of Mexican-assembled vehicles declined at annual rates of 5.1 and 11.4 percent, respectively, after having increased 21.1 percent during the entire 2006.

Graph 15
Automotive Industry Indicators

a) Production and Exports
Units per month and seasonally adjusted data

b) Total Production
Annual percentage change of number of units



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

The moderate growth of the economy and aggregate demand during the first quarter of 2007 created lesser pressures on the use of production capacity. In this regard, the following stand out:

i) The moderate growth of economic activity during the reference quarter included both GDP and domestic expenditure, thus implying that the gap between both items will continue narrowing.

ii) In recent years, Mexico’s production capacity has strengthened, due to the significant recovery of investment expenditure, which has contributed not only to increase capital in the country, but also to channel it to more modern and productive uses. During the first quarter of 2007, in a context of economic slowdown, investment grew at rates above those of GDP. Another indicator related to the strength of production capacity is the percentage of companies that have increased their installed capacity in recent years. According to Banco de México’s half-yearly Survey on the Manufacturing Sector, in 2006, 37 percent of the surveyed companies mentioned that their production capacity exceeded that of the previous year, while in 2005, 2004, 2003 and 2002 it had been 33, 31, 29, and 26 percent, respectively.

iii) An indicator of the intense process investment in Mexico has undergone and its impact on production capacity is the increased value of capital goods imports. From the first quarter of 2003 to the same quarter of 2007, capital goods imports measured in current US dollars increased 62 percent.

Graph 16
Manufacturing Labor Shortage Indicators
2-month moving average of balance of responses

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

iv) The moderate growth of economic activity during the first quarter of 2007 and the consequent increase in employment did not lead to greater shortage of skilled labor. Banco de México monthly indicators show that during the first quarter of the year, manufacturing companies did not face difficulties to hire skilled labor in their production, sales, and management areas (Graph 16).[17] Results from Banco de México private sector economic analysts' monthly survey confirm that during the reference period, the shortage of skilled labor and unit labor costs were not significant as factors that could limit Mexican economic activity.[18]

3.2.2. Employment

The moderate growth of economic activity during the first quarter of 2007 eased the increase in the demand for labor and, in general terms, of employment indicators. In this quarter, employment creation in the formal sector, measured through indicators of workers insured by the IMSS, continued to grow significantly in annual terms, although slightly below observed figures for the last months of 2006. The increase in the national unemployment rate during the second half of 2006 continued during the first months of 2007. During economic slowdown periods, production usually grows moderately for some time before the employment indicators start to lose strength.

During the first quarter of 2007, the labor market was characterized by the following: i) more moderate growth of formal employment, measured by the number of workers insured by the IMSS; ii) an increase in new formal jobs, clearly

[17] These monthly indicators show that during the first quarter, manufacturing companies did not face significant difficulties to hire skilled labor in their production, sales, and management areas. No growing competition was observed between these firms neither to hire skilled labor.

[18] Altogether, during the first quarter of 2007, the "higher wage costs" and the "shortage of skilled labor" accounted for only 3 percent of the responses on the factors that could limit economic activity in the next six months. See the results of Banco de México's Survey of Private Sector Economic Analysts' Expectations.

reflected more in temporary than in permanent jobs in urban areas, although the gap between both of them narrowed; and iii) an increase in the national unemployment rate during the first months of 2007, as an extension of the development of this indicator during the second half of 2006.

At the end of the first quarter of 2007, the number of workers insured by the IMSS was 14,221,835, representing an annual increase of 869,011 workers (6.51 percent, Graph 17a). This variation was more moderate than in September (900,872) and December (879,533) of the previous year (6.92 and 6.72 percent, respectively). The referred increase at the end of the first quarter included 414,473 permanent jobs (annual increase of 3.7 percent) and 454,538 temporary jobs in urban areas (increase of 20.6 percent).[19] As for seasonally adjusted formal employment, during March this indicator recorded forty-two monthly increases in the last forty-four months, thus implying that it exceeded in 1,668,362 jobs its maximum level reached at the end of 2000.

The growth of formal employment during the first quarter of 2007 included almost all sectors. This growth was particularly significant in the construction industry (143,149 workers and 13.3 percent), the tertiary sector, especially in trade activities (173,725 workers and 6.7 percent) and other services (362,550 workers and 8.1 percent), and in the manufacturing industry (150,850 workers and 3.9 percent, Graph 17b).[20] The latter confirms that manufacturing employment continued to improve during the first months of 2007, as has done so since 2004, after the three consecutive years of contraction that preceded it. Nonetheless, at the end of March 2007, the total number of workers insured by the IMSS on a seasonally adjusted basis still fell by 429,000 (9.6 percent) as compared with October 2000. On the other hand, during the period covered by this Report, formal employment grew in all Mexican states, albeit differently. Formal employment grew at a low annual rate in Oaxaca (2,305 jobs and 1.6 percent), while it recorded high growth rates in states like the Federal District (155,705 jobs and 6.6 percent increase), Estado de México (87,687 jobs and 8.1 percent), and Nuevo León (80,560 jobs and 7.8 percent).

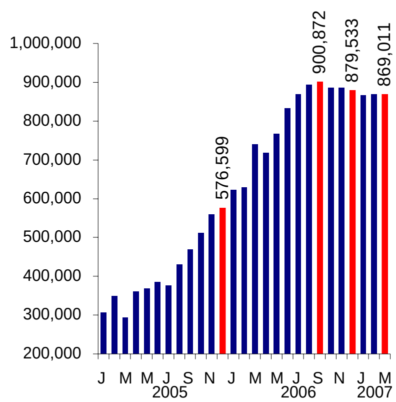
Formal employment growth during the first quarter of 2007 did not lead to a decline in the national unemployment rate. According to the Occupation and Employment Survey (*Encuesta Nacional de Ocupación y Empleo*, ENOE) conducted by INEGI, during the first quarter of 2007, this indicator measured on a seasonally adjusted basis was 3.92 percent (Graph 17c), after having been 3.82 percent during the fourth quarter of 2006. Under such context, the “rate of participation” (the ratio of the economically active population to the population age 14 and older) increased once more, thus contributing to raise the unemployment rate. The “rate of participation” was 58.4 percent during the first quarter of 2007, above the level observed during the same period of 2006 (58.2 percent). This increase was the result of a combination of an annual increase of 0.68 percentage points in the corresponding rate of women (from 40.51 percent during the first quarter of 2006 to 41.19 percent during the same quarter of 2007) and a reduction of -0.27 percentage points in that of men (from 78.27 percent to 78 percent during the same reference period).

[19] As mentioned in previous Inflation Reports, the increase in the number of workers insured by the IMSS could also be reflecting IMSS greater fiscalization efforts, considering that annual growth of this formal employment indicator has exceeded considerably annual GDP growth.
[20] The other services sector includes services for companies and individuals, and social and community services.

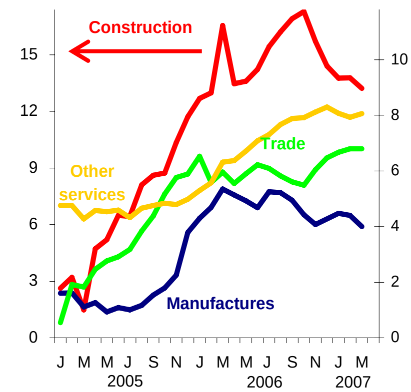
Graph 17
Labor Market Indicators

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

a) Annual change of original data

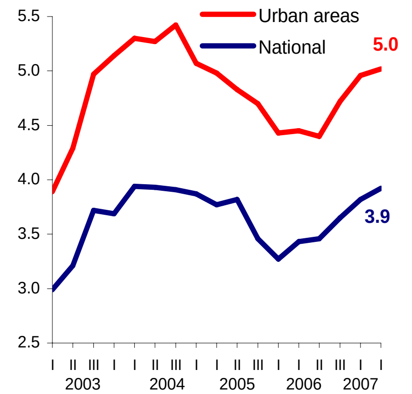


b) Annual change of seasonally adjusted data



Source: IMSS. Seasonal adjustments by Banco de México.

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



Source: INEGI. Seasonal adjustments by Banco de México.

3.2.3. External Sector

At the end of the first quarter of 2007, the trade and current account balances recorded deficit, as compared with the surplus recorded by both during the same period of 2006. These results mean that the balance of both accounts was not affected significantly by the moderate growth of economic activity, despite its impact on a slowdown of imports' growth rate, which was offset by the reduction of both the oil trade balance surplus and the value of automotive exports.

In general terms, during the first quarter of 2007, Mexico's external sector was characterized by the following:

a) Non-oil exports grew at a significantly lower annual rate (5.7 percent, Graph 18a), than in 2006 (15.7 percent).[21] These results are attributed to external demand's slowdown, which started since the second half of the previous year.

b) Terminal automotive exports declined during the first quarter of the year (Graph 18b), due to certain temporary factors ("technical stops" due to maintenance and changes in the production lines for new car models), and to weak domestic sales in the U.S., the main export market for Mexican-assembled vehicles.[22]

[21] During the first quarter of 2007, total exports grew only 2.2 percent in annual terms.

[22] During the three first months of 2007, automotive exports fell 5.8 percent in annual terms, while in 2006 they increased 16 percent (albeit such growth slowed gradually during the year).

c) The value of oil exports fell considerably in annual terms (14.9 percent during the first quarter), as a result of reductions in both the volume of crude oil exports and the average price of the Mexican crude oil export mix (Graph 18a).

d) The annual growth of merchandise imports decreased as compared with 2006.[23] These results responded to the slowdown of both GDP and aggregate demand. Imports items that recorded the most moderate growth were intermediate and capital goods (Graph 18c).

e) The trade balance recorded significant changes in annual terms (Graph 19a). While in the first quarter of 2007 it recorded a 2,640 million US dollar deficit, during the same period of last year, it exhibited a 733 million surplus. These results were mainly determined by reductions in the oil trade balance surplus and in the value of automotive exports.

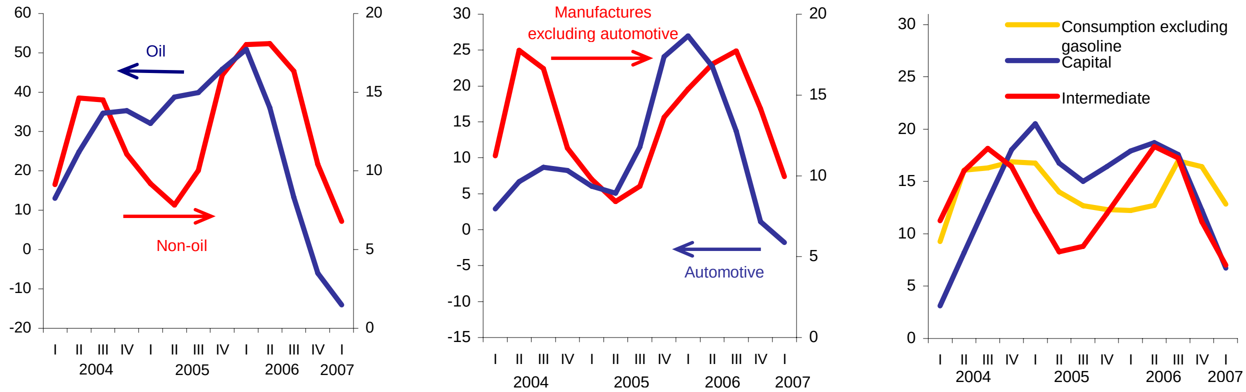
During the first two months of the year, the share of total Mexican exports in U.S. imports declined, contrasting with the significant growth exhibited during 2006. During the two months, Mexican exports to the U.S. grew moderately 1.31 percent in annual terms, figure below that for total U.S. imports (3.16 percent, Table 2). As a result, the referred share of Mexican exports fell from 10.69 percent during the first two months of 2006, to 10.5 percent during the same period of 2007. This reduction is due to a decline in oil exports, and to a weak performance of automotive exports. Excluding both of these items from the total, the rest of Mexican exports increased during the analyzed period 13.08 percent, figure above the 6.1 percent of total U.S. oil and automotive imports. The latter implied that the share of Mexican exports excluding oil and automotive in U.S. imports increased from 8.35 to 8.9 percent in annual terms.

During the first quarter of 2007, the current account of the balance of payments recorded a deficit, which was influenced by reductions in the surplus of the trade balance of both oil-related products and the automotive sector. In the first case, the surplus diminished from 5,376 million US dollars in the first quarter of 2006, to 3,750 million in the same period of 2007. As for the latter, during the referred period, the automotive trade balance surplus decreased from 5,830 million US dollars, to 4,295 million. A third factor affecting the result of the current account was a slowdown in worker remittances' revenues (Graph 19b), which amounted to 5,630 million US dollars (annual increase of 3.4 percent), after having grown 23.1 and 8.1 percent during the first and second semesters of 2006, respectively.

[23] During the first quarter of the year, merchandise imports grew at an annual rate of 8 percent, as a result of increases of 7.3, 11.1, and 8.9 percent in intermediate, consumption, and capital goods imports, respectively.

Graph 18
Merchandise Exports and Imports
Annual percentage change of trend data

a) Exports | b) Manufacturing exports | c) Imports



Source: Banco de México.

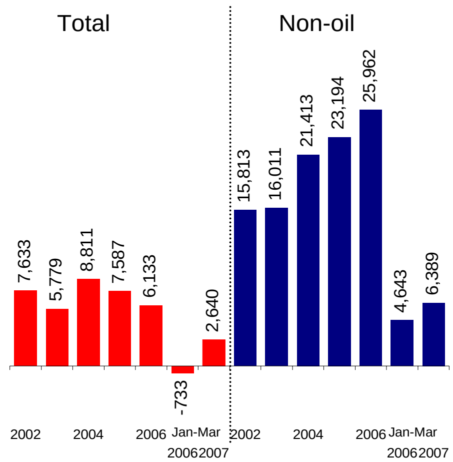
Table 2
U.S. Imports
Percent

	Share				Annual percentage change: 2007				
	January - Decembei		January - February		January - February				
	2005	2006	2006	2007	Total	Oil	Total excl. Oil	Automotive	Total excl. Oil and Automotive
Total	**100.00**	**100.00**	**100.00**	**100.00**	**3.16**	**-5.79**	**4.28**	**-5.26**	**6.10**
Total excl.Mexico	**89.14**	**89.16**	**89.31**	**89.50**	**3.38**	**-2.29**	**4.05**	**-4.38**	**5.47**
Total excl. Mexico and Chir	**75.98**	**72.64**	**75.32**	**72.71**	**-0.41**	**-1.93**	**-0.20**	**-4.38**	**0.68**
1. Canada	17.35	16.36	18.16	16.41	-6.76	7.34	-8.22	-10.72	-7.37
2. China	14.55	15.51	13.99	16.79	23.82	-79.11	24.14	--	24.14
3. Mexico	**10.17**	**10.69**	**10.69**	**10.50**	**1.31**	**-24.82**	**6.37**	**-8.97**	**13.08**
4. Japan	8.25	7.98	8.00	8.05	3.78	--	3.78	3.51	3.96
5. Germany	5.06	4.80	4.85	4.82	2.59	--	2.59	-13.58	9.61
Total 5 countries	55.38	55.34	55.69	56.57	4.80	-9.78	5.77	-6.76	9.33

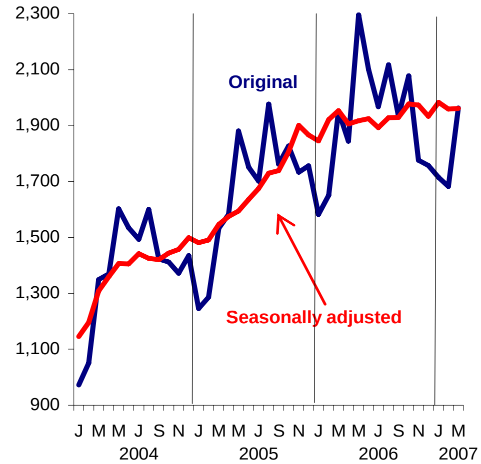
Source: Prepared by Banco de México with data from the Census Bureau (U.S. Department of Commerce).

Graph 19
External Sector Indicators

a) Total and Non-oil Trade Balance Deficit
Million US dollars



b) Workers' Remittances
Million US dollars per month; original and seasonally adjusted data



Source: Banco de México.

The aforementioned, together with incoming information on other items of the external accounts, allow for estimating that during the first quarter of 2007, the current account of the balance of payments recorded a deficit of approximately 1.9 thousand million US dollars. In annualized terms, this figure is slightly below one percentage point of GDP and contrasts with the surplus of 723 million observed during the same period of 2006. On another front, during the reported quarter the capital account is expected to have recorded a surplus of around 3.4 billion US dollars (including errors and omissions), as a net result of the following items: revenues from resources from foreign direct investment and external financing for Pidiregas projects; and, outflows from public sector's payment of foreign debt. Finally, during the first quarter of 2007, Banco de México's net international reserves increased by 1,516 million US dollars, thus implying that at the end of March, the stock of international reserves was 69,196 million US dollars.

3.3. Costs and Prices

3.3.1. Wages and Unit Labor Costs

During the first quarter of 2007, firms under federal jurisdiction negotiated with their workers an average wage increase of 4.2 percent, while in the same period of the previous year, 4.3 percent (Table 3). Wage revisions in private sector companies accounted for 81 percent of total wage revisions, and the average increase granted by them was 4.3 percent (in the same quarter of 2006 it was 4.4 percent). Public companies negotiated an average wage increase of 3.9 percent, figure slightly below that of the first quarter of last year. Up to now, wage negotiations have not been significantly affected by the recent developments in inflation.

Table 3
Contractual Wage Average Increases[1/] and Number of Workers Benefited by Type of Company

	2006					2007			
	I	II	III	IV	Jan-Dec	Jan	Feb	Mar	Jan-Mar
Contractual wage average increase (percent)[1/]									
Total	4.3	4.4	4.3	3.7	4.1	4.0	4.3	4.3	4.2
Public companies	4.0	4.0	4.1	3.6	3.8	3.8	3.8	4.0	3.9
Private companies	4.4	4.5	4.4	4.2	4.4	4.1	4.4	4.4	4.3
Number of workers benefited (percentage share)									
Total	100	100	100	100	100	100	100	100	100
Public companies	19	27	48	77	44	17	11	30	19
Private companies	81	73	52	23	56	83	89	70	81

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

During the fourth quarter of 2006, labor productivity in the non-maquiladora manufacturing industry began to slow down and even exhibited negative growth rates in January 2007 (Table 4). This was mainly due to the decline in automobile production.[24] Unit labor costs (ULC) in this sector decreased during the fourth quarter of 2006 and, in January 2007, recorded a positive variation. As for the maquiladora industry, during the fourth quarter of 2006 labor productivity decreased while ULCs increased.[25]

Table 4
Earnings, Labor Productivity and Unit Labor Costs by Sector [1/]
Annual percentage change

	2005	2006					2007
	Jan-Dec	I	II	III	IV	Jan-Dec	Jan[2/]
Non-maquiladora manufacturing industry							
Labor productivity	**2.1**	6.8	2.6	3.0	1.6	**3.5**	**-1.4**
Rean average earnings	**-0.2**	0.9	0.8	1.1	-0.8	**0.5**	**0.2**
ULC	**-2.2**	-5.5	-1.6	-1.9	-2.3	**-2.8**	**1.6**
Maquiladora industry							
Labor productivity	**-1.1**	1.3	0.1	-0.2	-0.3	**0.2**	**N.D.**
Real average earnings	**0.3**	2.2	2.3	0.4	1.9	**1.7**	**N.D.**
ULC	**1.4**	0.9	2.2	0.6	2.2	**1.5**	**N.D.**

1/ Maquiladora production estimates are based on total hours worked. Thus, average labor productivity per worker reflects labor intensity in the productive process.
2/ Non-maquiladora labor productivity calculations of January 2007 are based on the Index of Manufacturing Production's Physical Volume (*Índice de Volumen Físico de la Producción Manufacturera*, IVFPM) because INEGI interrupted its release of IVFPM transformation industry statistics.
N.A. Not available.
Source: Prepared by Banco de México with data from INEGI.

3.3.2. Administered and Regulated Prices of Goods and Services

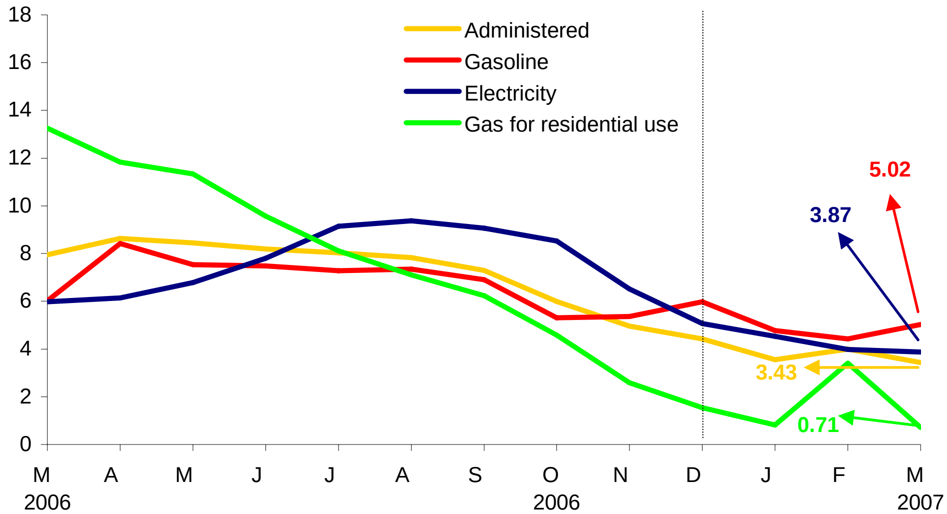
At the end of the first quarter of 2007, the subindex of administered prices recorded an annual variation of 3.43 percent, as compared with 4.42 percent in December 2006 (Graph 20). This reduction stemmed from developments in the prices of goods and services that are not fixed according to a predetermined rate of change. The fall in gasoline prices at border cities, natural gas (fixed according to its international reference), and high consumption

24 For a detailed description of manufacturing production, see Section 3.2.1.
25 No information on the maquiladora industry is available as of January 2007 because INEGI stop publishing it.

electricity tariffs (*Tarifas Eléctricas de Alto Consumo*, DAC) deserves mention. The sharp reduction in DAC tariffs was due to other factors that affect their calculation formula, particularly the decline in fuel-oil prices and in metal products price inflation.[26]

During the analyzed quarter, policies to determine propane prices and low-consumption electricity tariffs remained the same as in 2006, with a monthly rate of change of 0.33 and 0.32 percent, respectively. In contrast, prices of gasoline in non-border cities have increased more than during the same period of 2006.

Graph 20
Administered Prices Subindex
Annual percentage change

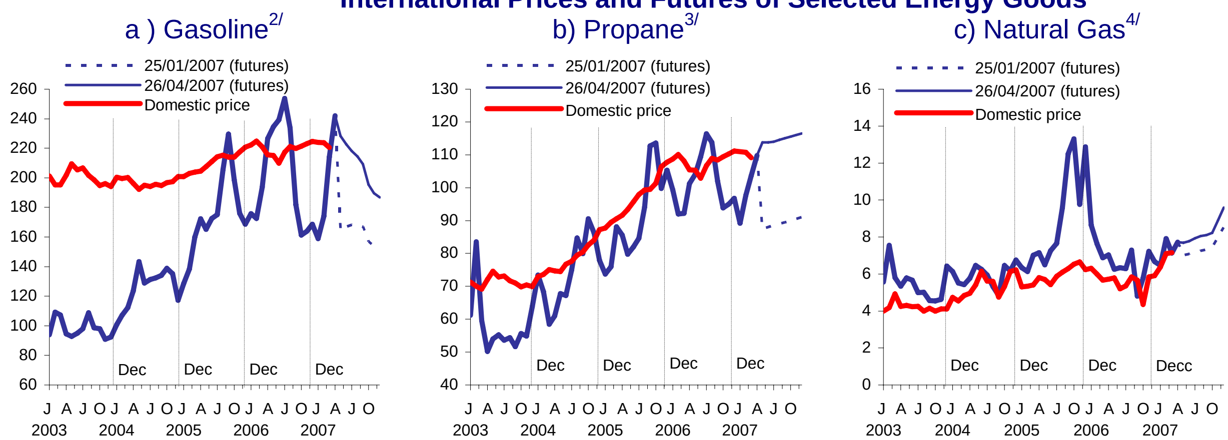


During the first quarter of 2007, international prices of gasoline and propane were, on average, very similar to those recorded during the same period of the previous year. Prices of natural gas were lower. Futures suggest that international prices of gasoline could decrease during the rest of the year. On the contrary, prices of propane and natural gas are expected to increase (Graph 21).

The subindex of regulated prices recorded an annual variation of 2.69 percent in March 2007, a 0.86 percentage point increase as compared with December 2006. The referred increase was due, mainly, to revisions in public transportation fares in urban areas in some cities like Monterrey, Guadalajara, Torreón, and Hermosillo, among others (Graph 22).

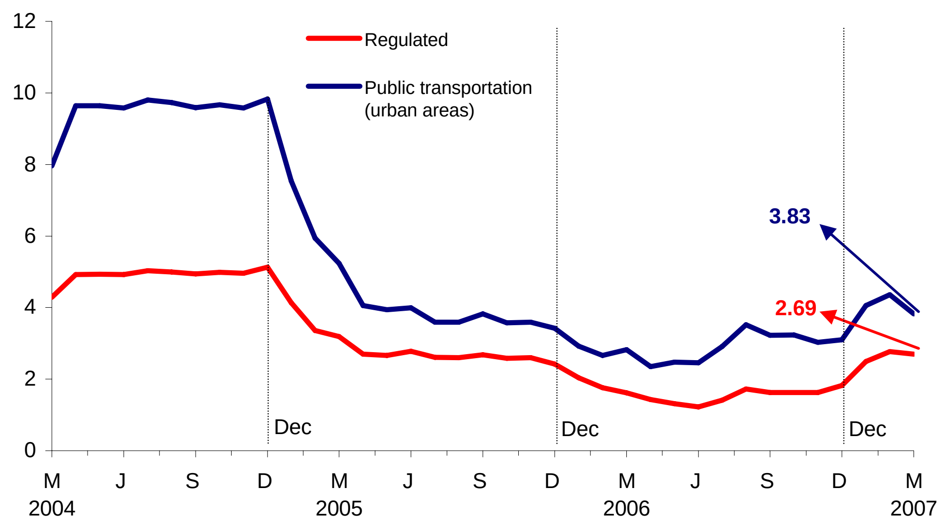
[26] High-consumption residential electricity tariffs are adjusted on a monthly basis according to the following formula: F = 0.8*TIP + 0.2*TCC. The first term in the equation (TIP), is comprised of three arithmetically averaged PPI subindexes: Metal Products, Machinery and Equipment, Basic Metal Industries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

Graph 21
International Prices and Futures of Selected Energy Goods 1/



1/ Futures prices of January 25 and April 26, 2006 (New York Mercantile Exchange).
2/ Texas. US cents per gallon.
3/ Mont Belvieu, Tx. US cents.
4/ Tetco, Tx. US dollars per MMBtu.

Graph 22
Regulated Prices Subindex
Annual percentage change



3.3.3. Metals and Food Commodities

During the analyzed period, international prices of grains recorded moderate growth as compared to the last quarter of 2006. In particular, corn's international prices increased by 6.8 percent during the first three months of 2007, while in the previous quarter, by 60.8 percent. At the moment of writing this Report, corn, wheat, and soy's futures prices were way above their current prices, especially wheat and soy (Graph 23a).

The recent increase in grains international prices is linked to a higher demand for these goods, in particular, to produce bioenergy goods and animal feed. These developments have responded to the greater levels of income of some emerging economies, whose population has modified its diet and are now consuming more meat.

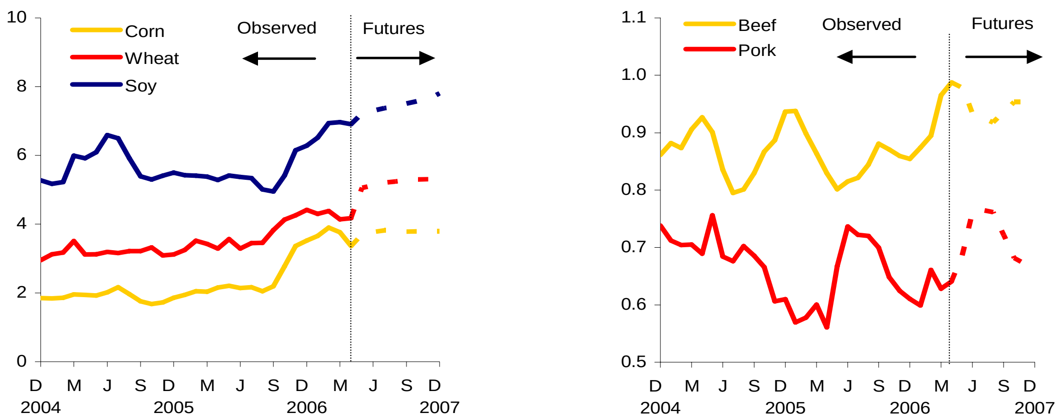
On the other hand, during the first quarter of 2007, international prices of meat were above their levels at the end of 2006. During the same period, international prices of pork slightly rebounded. Futures suggest that beef prices will remain relatively high for the rest of the year, while pork meat could increase in the next months and then revert towards the end of the year (Graph 23b).

During the first quarter of 2007, international prices of copper attained levels lower than those observed during the previous quarter. On the contrary, international prices of steel rod were slightly higher than in the last quarter, although above steel domestic prices (Graph 24).

Graph 23
International Prices of Agricultural Commodities [1/]

a) Grains
US dollars per bushel

b) Meats
US dollars per pound

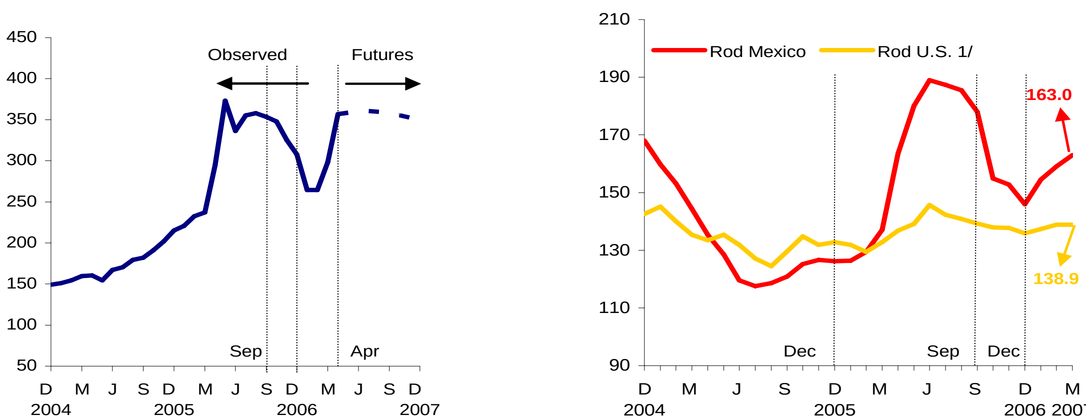


1/ Futures prices correspond to April 26, 2006. Grains values correspond to the Chicago Board of Trade, while meat values to the Chicago Mercantile Exchange.
Source: U.S. Department of Agriculture.

Graph 24
Indices of International Prices of Copper and Steel

a) Copper [1/]
US cents per pound

b) Rod
Indices, base December 2003=100



1/ Futures prices correspond to the Commodity Exchange Inc.(CMX) up to April 26, 2007. Observed prices are from the Metal Bulletin.

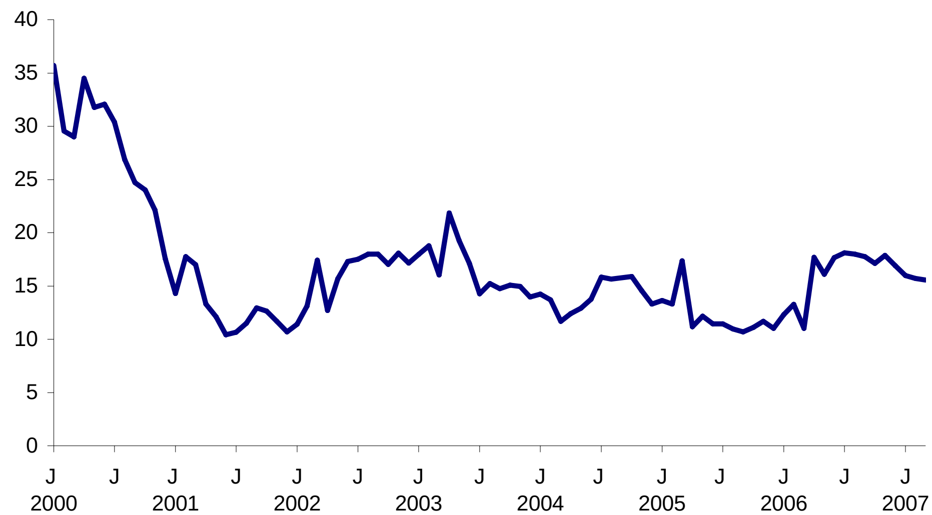
Source: Banco de México and Bureau of Labor Statistics (U.S.).
1/ includes all types of steel rod.

3.4. Monetary and Credit Aggregates

As mentioned in previous Inflation Reports, the remonetization process undergone by the Mexican economy in recent years, in which the narrow monetary aggregates, among them the monetary base, have increased significantly. In this context, during 2006, the monetary base grew, on average, 16.2 percent, figure above that observed in 2005 (12.1 percent). As mentioned in last quarter's Report, although an important part of the expansion observed in 2006 can be attributed to the faster rate of growth of economic activity and to a reduction in interest rates during the year, it could also be reflecting the effect of temporary factors such as the greater use of money that usually takes place during federal elections. By the end of 2006, the monetary base began to grow at a lower rate. This trend continued during the first months of 2007. In particular, during the first quarter of 2007, this aggregate grew, on average, 15.7 percent in annual terms, after having grown 17.3 percent in the fourth quarter of 2006 (Graph 25).[27]

During the first quarter of 2007, net international assets decreased by 421 million US dollars, reaching 75,882 million US dollars.[28] The monetary base decreased by 40,007 million pesos during the same period. As a result, Banco de México's net domestic credit fell by 34,918 million pesos during the period (Table 5).

Graph 25
Monetary Base
Annual nominal percentage change [1/]



1/ Based on the monthly average of daily stocks.

[27] Figures calculated based on the average of daily stocks.
[28] For a definition of international assets and international reserves refer to the glossary of the weekly press release on Banco de México's balance sheet. Banco de México's broad credit position vs. the domestic market (net domestic credit) is obtained by subtracting international assets from the monetary base; i.e., financing granted or received domestically by the central bank. The international reserves definition excludes Banco de México's short-term (less than six months) foreign currency liabilities.

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

	Stocks		Annual % change	Flows in 2007
	At 31 Dec. 2006	At 31 Mar. 2007	At 31 Mar. 2007	Accumulated in 31 Mar. 2007
(A) Monetary base (pesos)	449,821	409,814	16.1	-40,007
(B) Net international assets (pesos) [1/ 2/]	824,967	837,150	1.1	-5,090
Net international assets (US dollars) [2/]	76,304	75,882	-0.2	-421
(C) Net domestic credit (pesos) [(A)-(B)] [1/]	-375,145	-427,336	-10.1	-34,918
(D) International reserves (US dollars) [(E)-(F)] [3/]	67,680	69,196	2.5	1,516
(E) Gross reserves (US dollars)	76,330	75,851	-0.2	-479
PEMEX				2,573
Federal government				-2,132
Sale of US dollars to banks [4/]				-1,996
Other [5/]				1,076
(F) Liabilities with less than six months to maturity (US dollars)	8,650	6,655	-22.0	-1,995

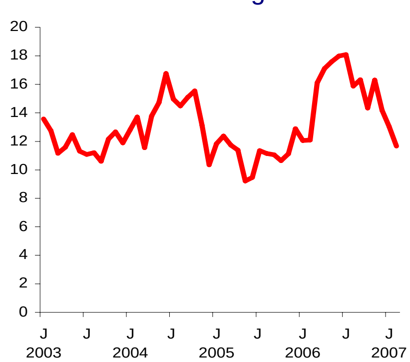
1/ Net international assets' cash flows in pesos are estimated based on the exchange rate applied to each transaction.
2/ Net international assets are defined as gross reserves plus credit agreements with foreign central banks with more than six months to maturity, minus total liabilities payable to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

3.4.1. Monetary Aggregates and Financing

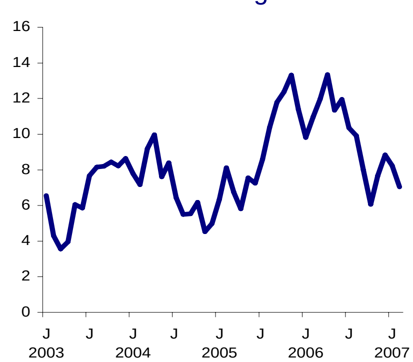
During the first months of the year, the rate of growth of the monetary aggregates followed a downward trend. In February 2007, the monetary aggregate M1 recorded an annual variation of 11.7 percent, compared to an average growth of 15.7 percent during the entire 2006 (Graph 26a). The stock of M2 grew at a real annual rate of 7 percent, 3 percentage points below its average growth in 2006 (Graph 26b). The growth of M2 was the result of a real annual increase of 7.2 percent in voluntary savings and 6.4 percent in compulsory savings. Compulsory savings are resources from the retirement funds savings system (*Sistema de Ahorro para el Retiro*, SAR) invested in domestic financial instruments. The increase in compulsory savings has been negatively affected by the fact that, during the last year, there has been an increase in SAR resources invested by Siefores in instruments that are not included in the monetary aggregate M2, particularly in variable-income securities (stocks), government securities issued abroad (UMS bonds), and foreign securities (Graph 26c).

Graph 26
Monetary Aggregates and Retirement Savings System

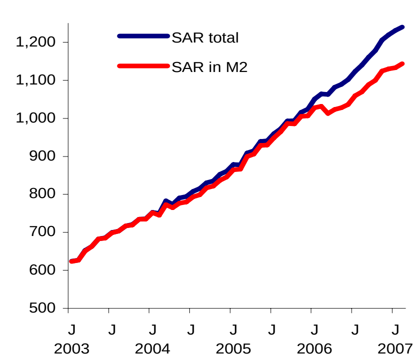
a) Monetary Aggregate M1
Annual nominal percentage change



b) Monetary Aggregate M2
Annual real percentage change



c) Retirement Savings System
Thousand million pesos



During 2006, the annual flow of financing resources accounted for 5.2 percent of GDP, 2.9 percentage points below last year's figure (Table 6). The reduction in total financing resources is mainly explained by a negative flow of foreign financing of 1.6 percent. The latter is a consequence of federal government operations to substitute foreign for domestic debt.[29] On another front, financing sources from savings in domestic financial assets (M4) amounted to 6.8 percent of GDP. Although this figure was below that in 2005 (7.5 percent), it exceeded the average for the period 2003-2005 (6.2 percent of GDP).

As for the use of resources during 2006, the public sector used 0.9 percent of GDP, 0.5 percentage points below the amount used in 2005. This result freed additional resources to finance the private sector, which increased its use of resources from 2.8 percent of GDP in 2005, to 4.6 percent in 2006. The most significant change was the increased flow of financing to firms, from 0.8 percent of GDP in 2005, to 2 percent in 2006.

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

	Annual Flow				Stock in 2006
	2003	2004	2005	2006	GDP %
Total sources	**5.4**	**5.9**	**8.1**	**5.2**	**72.1**
M4	5.5	5.4	7.5	6.8	54.9
Foreign financing	-0.1	0.5	0.6	-1.6	17.1
Total uses	**5.4**	**5.9**	**8.1**	**5.2**	**72.1**
International reserves [1/]	1.5	0.6	0.9	-0.1	7.8
Public sector (SHRFSP) [2/]	2.6	1.7	1.4	0.9	35.8
States and municipalities	0.3	0.2	0.1	0.0	1.4
Private sector	0.9	2.0	2.8	4.6	29.5
Households	1.2	1.9	2.0	2.6	13.7
Consumption	0.5	0.9	1.2	1.3	4.7
Housing [3/]	0.7	1.0	0.7	1.3	9.0
Firms	-0.3	0.1	0.8	2.0	15.8
Credit granted by financial intermediaries [4/]	-0.3	0.2	0.3	1.3	7.2
Issuance of debt instruments	0.5	0.2	0.0	0.1	1.9
External	-0.5	-0.4	0.6	0.6	6.7
Otros concepts [5/]	0.1	1.4	2.8	-0.2	-2.5

1/ As defined by Banco de México's Law.
2/ Historical Stock of Public Sector Borrowing Requirements (*Requerimientos Financieros del Sector Público, SHRFSP*), as reported by the Ministry of Finance.
3/ Total portfolio of financial intermediaries. Includes debt-restructuring programs.
4/ Total portfolio of financial intermediaries and of the National Employees' Housing Fund (*Instituto del Fondo Nacional de la Vivienda para los Trabajadores,* INFONAVIT). Includes debt-restructuring programs.
5/ Refers to non-sectorized assets, capital accounts and results, other assets and liabilities of both commercial and developments banks, Banco de México, non-bank financial intermediaries, and INFONAVIT, and non-monetary liabilities, among others.

Bank credit to the non-financial private sector continues to grow at high rates. In February 2007, direct performing credit to the non-financial private sector recorded a real annual variation of 29.1 percent. As for lending to firms, in February of this year it grew 24.7 percent in real annual terms. At sector level,

[29] In August 14, 2006, the federal government purchased 12,451 million US dollars from Banco de México's international reserves to prepay foreign debt, thus redeeming the sovereign bonds issued in international markets and the credits granted by the Inter American Development Bank and the World Bank. Resources for this operation were obtained through the placement of government bonds BONDES D for 135,051 million pesos. Through a simultaneous operation, Banco de México withdrew BREMs for the same amount. Through an additional operation, the federal government, issued warrants substituting foreign for domestic debt, for a total of 2,706 million US dollars. These warrants matured September 1, October 10, November 9, and November 22 of 2006. This operation swapped UMS bonds for Bonos M.

lending to services and construction firms has exhibited significative dynamism (Graph 27b), while that for manufacturing continues to recover.

Although bank credit to households continues to grow vigorously, since mid-2006 its growth rate has started to slow down (Graph 27a). In February 2007, the stock of direct performing consumption credit recorded a real annual variation of 31.7 percent (Graph 27c). Direct performing mortgage lending grew at a real annual rate of 36.4 percent (Graph 27c).[30]

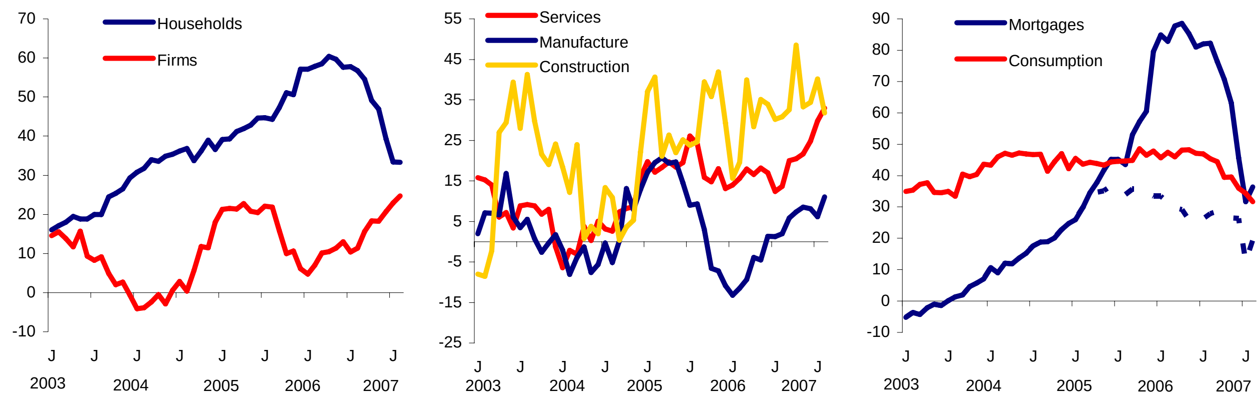
The growth of consumption credit has allowed more people to have access to bank credit. However, credit granted to riskier sectors and to individuals with no previous credit history has led to an increase in the number of delinquent loans. In February 2007, banks' delinquency rate for consumption credit was 4.6 percent, as compared with 3.1 percent during the same month of last year.[31]

Graph 27
Commercial Banks Performing Loans to the Private Sector
Annual real percentage change

a) Performing Loans to the Private Sector: Households and Firms [1/]

b) Performing Loans to Firms by Sector

c) Performing Loans to Households [2/]

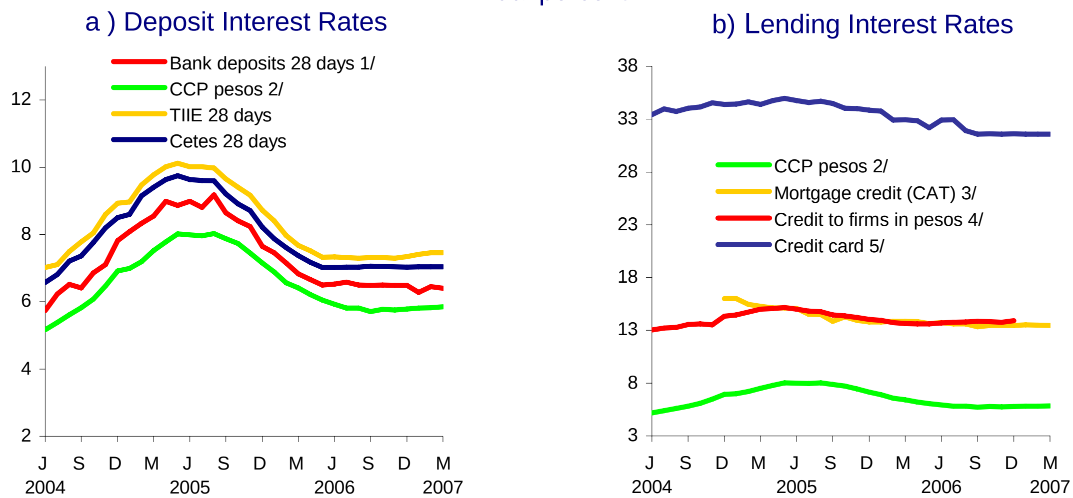


1/ Performing loan portfolio to households includes the purchase of Sofoles mortgage portfolio.
2/ The dotted line excludes the purchase of mortgage portfolio from Sofoles.

Lending interest rates for household credit, both consumption and mortgage credit, have remained stable in the last year (Graph 28). The spread between lending and deposit interest rates is still high, although it is partly due to the higher credit risk.

[30] Commercial banks' credit to households excluding the purchase of portfolio from Sofoles grew at an annual real rate of 19.2 percent in February 2007.
[31] Banks' delinquency rate for firm loans decreased from 1.6 percent in February 2006 to 1.2 percent in February 2007. The delinquency rate for mortgage loans was 2.4 percent in February 2007, figure similar to that observed the previous year. Banks' delinquency rate is defined as the ratio overdue direct portfolio to total direct portfolio.

Graph 28
Commercial Banks' Deposit and Lending Interest Rates in Pesos
Annual percent



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

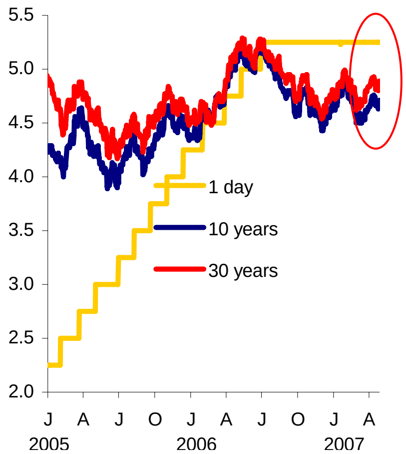
4. Monetary Policy

After exhibiting high growth during 2006, the world economy is expected to reduce its growth rate this year. However, it is still anticipated to be positive. Less inflationary pressures are also expected worldwide, due to the cyclical phase the world economy is currently undergoing and given the prospects of lower energy prices as compared with last year.

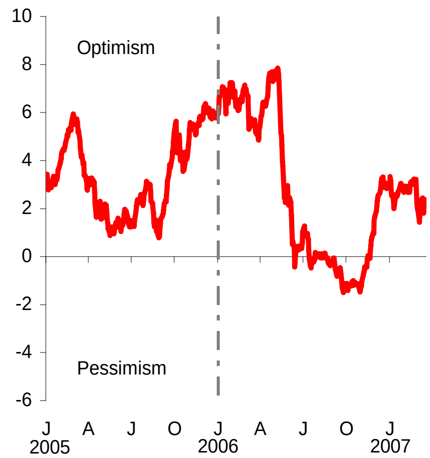
This environment has contributed to ample liquidity conditions in international financial markets. Nonetheless, during the first three months of 2007, some episodes of international financial volatility arose, mainly due to increased uncertainty about the development of the U.S. economy. However, these episodes were short-lived and have not affected considerably the demand for assets and currencies of emerging economies (Graph 29).

Graph 29
U.S. Interest Rates and Global Risk Appetite Index

a) 2005-2007
Annual percent



b) 2005-2007[1/]
Index



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

The inflationary outlook in Mexico has been affected in the last months by various supply shocks, which have affected both annual headline inflation and annual core inflation. In particular, the fact that the referred shocks have materialized in a short period, their magnitude, and the importance (in terms of weight) of the affected prices in the CPI, have prompted annual headline inflation to be, in the last months, above the upper limit of the variability interval for the 3 percent inflation target.

Under this setting, it is important to analyze if the rebound in inflation has affected the price determination process. For that purpose, Banco de México evaluates a broad range of indicators, some of which are mentioned in the following section.

First, and as mentioned in previous Reports, the effects of supply shocks have concentrated in a small number of items. This can be inferred from several inflation indicators, such as those that exclude the effect of item prices that have undergone extreme variations (both in the upper and lower limits), which are known as trimmed means of inflation. By construction, trimmed means reflect the trend of inflation.

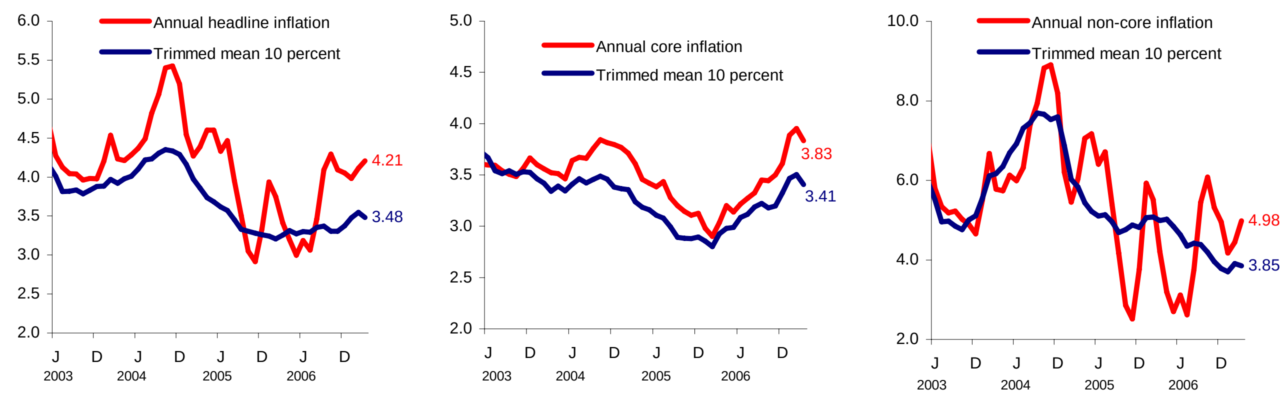
As shown in Graph 30b, annual core inflation's trimmed mean at 10 percent is below annual core inflation. This pattern has been observed in the last three years. Nonetheless, in the last year, this indicator has increased, up to nearly 3.5 percent. Annual non-core inflation's trimmed mean at 10 percent has been under annual non-core inflation for the last six months (Graph 30). In this case, although this indicator has followed a downward trend in the last years, it is still high, at levels around 3.85 percent.

Graph 30
Headline Inflation and Inflation Indicators excluding the Contribution of Extreme Upper and Lower Trimmed Means at 10 Percent /1

a) Headline Inflation and Trimmed Mean
Annual percent

b) Core Inflation and Trimmed Mean
Annual percent

c) Non-core Inflation and Trimmed Mean
Annual percent



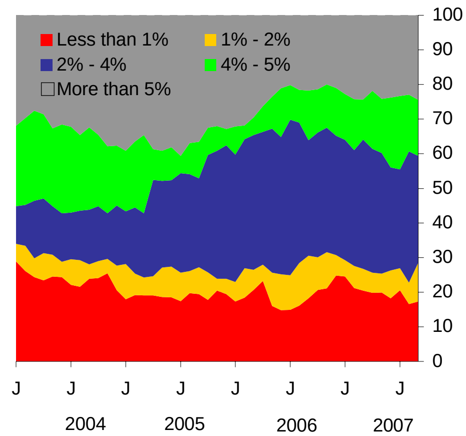
1/The trimmed mean excludes the contribution of extreme variations in certain items' prices from headline inflation. To strip these variations, the following calculations are done: i) monthly seasonally adjusted variations of CPI prices are arranged in descending order; ii) the items with the highest and lowest variation are excluded, considering up to 10 percent of the CPI basket, respectively, in each distribution tail; and, iii) with the remaining items, which, by construction, are located at the center of the distribution, the trimmed mean indicator is constructed. The trimmed mean is useful to identify if headline inflation variations respond to changes in some CPI products (this takes place when the trimmed mean does not show the upward trend followed by headline inflation).

Another set of indicators that offers information on the price determination process is constructed using the proportion of the CPI basket corresponding to those price items exhibiting annual variations in a specific range. Five ranges were chosen: one central, which includes growth between 2 and 4 percent; two upper ranges, which include growth between 4 and 5 percent and growth above 5 percent; and two lower ranges, which include growth between 1 and 2 percent and growth below 1 percent. To calculate these indicators, the CPI items whose prices record annual variations in a certain range are selected, for example between 2 and 4 percent, and for each range, each item's participation in the CPI is added.

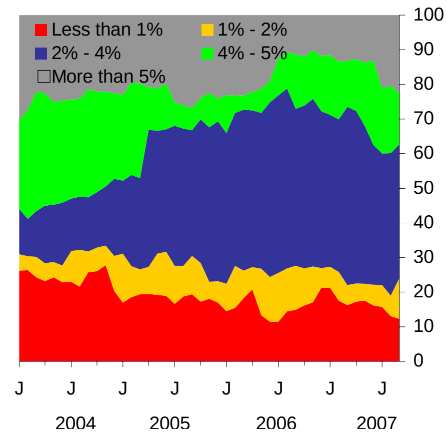
Indicators for headline and core inflation are shown in Graph 31a and 31b. What stands out from both graphs is the proportion of the basket, for both headline and core inflation, with annual variations between 2 and 4 percent, which has increased significantly in the last years. Nonetheless, in recent months, the participation of items whose prices have grown above 4 percent in annual terms has increased. These increases have concentrated mainly in products and services that use certain grains or their by-products as inputs.

Graph 31
Share of CPI Items with Annual Price Variations within a Range [/1]

a) Headline Inflation
Percent



b) Core Inflation
Percent



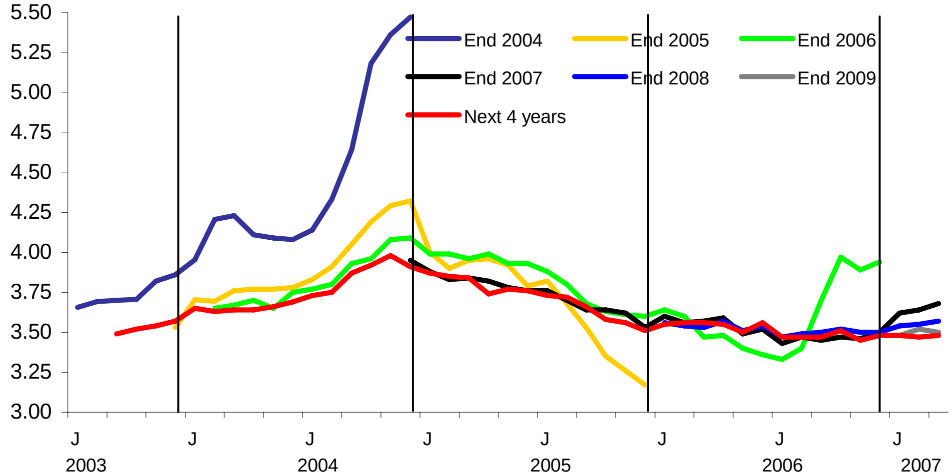
1/ The share of a price index's basket whose annual price variations fall within a range is calculated as follows: i) ranges are defined; ii) annual inflation of each of the items of the price index is calculated; iii) items are classified in the ranges according to their annual inflation; and, iv) the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

As a result of the effects of supply shocks on headline and core inflation, expectations for inflation for the end of 2007 from Banco de México's survey were revised upward: from 3.50 percent in the December survey to 3.68 percent in March (headline inflation), and from 3.30 to 3.57 percent (core inflation). Although inflation expectations for medium and longer terms remained stable during the quarter, they remain above the 3 percent target and at relatively high levels. Expectations for headline inflation for the end of 2008 and 2009, and for the average for the following 4 years have remained around 3.5 percent. Expectations for core inflation for the end of 2008 have remained close to 3.3 percent.[32]

The latter suggests that although supply shocks have affected both headline and core inflation, the impact on analysts' inflation expectations has concentrated on horizons under twelve months. Inflation expectations for longer terms have remained relatively stable, although around half a point above the 3 percent target for annual headline inflation. This contrasts with the supply shock episodes of 2004 and 2005, when medium and long-term inflation expectations were affected (Graph 32).

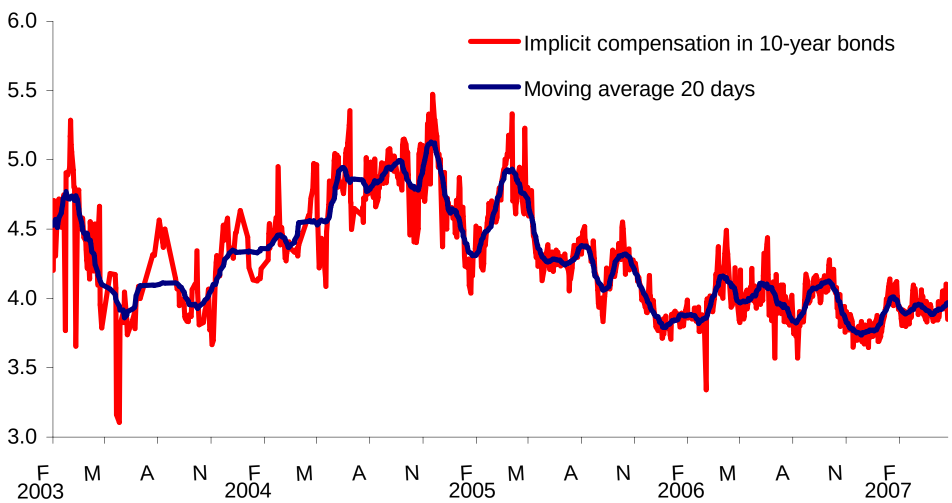
[32] Inflation expectations from the Infosel survey are similar. Headline inflation expectations for the end of 2007 were revised upward, from 3.53 percent on December 22, to 3.61 percent on April 27, while core inflation expectations were revised from 3.29 to 3.48 percent, respectively. Inflation expectations for the end of 2008, 2009 and the following 4 years have remained slightly below 3.5 percent. Finally, core inflation expectations for the end of 2008 have remained around 3.4 percent.

Graph 32
Headline Inflation Expectations: Banco de México Survey
Annual percent



Another indicator containing information about long-term inflation expectations is the compensation for inflation (inflation expectations plus a risk premium) that investors demand for holding peso-denominated long-term bonds. This indicator is obtained by subtracting the real yield associated with indexed-debt instruments (Udibonos) from the 10-year bond interest rate. Graph 33 shows that, after having reached lows by the end of the fourth quarter of 2006, this indicator increased slightly during the first weeks of 2007. Since then, it has followed a horizontal trend. The recent results of this indicator contrast with those of 2004. During that episode of supply shocks, the compensation for inflation increased significantly, thus suggesting that, despite the recent levels of annual headline inflation, long-term inflation expectations have remained relatively anchored.

Graph 33
Compensation for Inflation and Inflationary Risk on Long-term Bonds
Annual percent

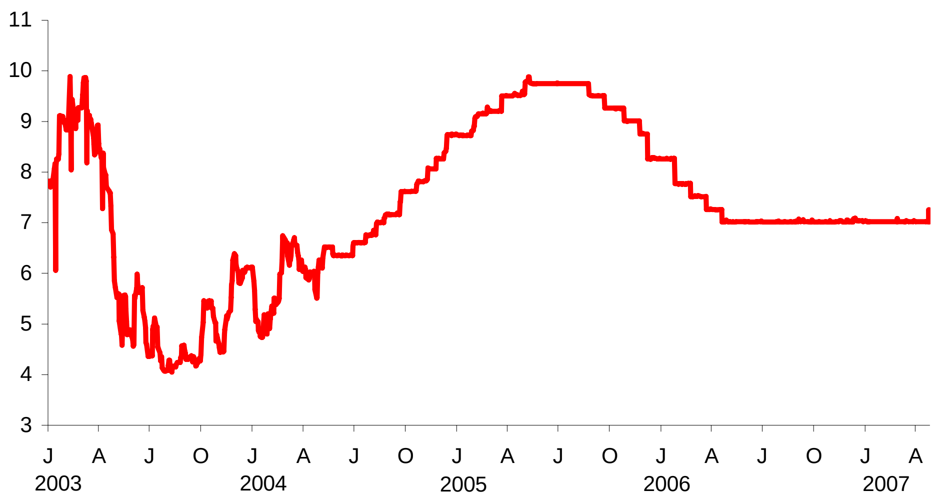


Although there seems to be no significant evidence of contamination in the price determination process, some food-related prices have been affected. In addition, some elements that have been included in the balance of risks for inflation have gained importance. In particular, the higher uncertainty associated with the determination of prices of some products, particularly corn-tortillas and other foods that use various grains as inputs, in a context where volatility of their international reference prices has increased. The prevision that annual headline inflation will be above the variability interval for a long period has also increased risks of contamination in the price and wage determination processes.

The Board of Governors thus deemed convenient to strengthen the monetary policy stance as a preemptive measure. After having kept the monetary conditions unchanged in January, February and March, the Board decided in April to tighten monetary conditions by 25 basis points. As a result, the bank funding rate reached 7.25 percent at the end of April (Graph 34). The purpose of adopting a tighter monetary stance is to have a better balance in terms of inflationary risks and to prevent inflation expectations, prices and wages from being affected by the supply shocks that have taken place. With this measure, Banco de México confirms its intention to reach the 3 percent inflation target.

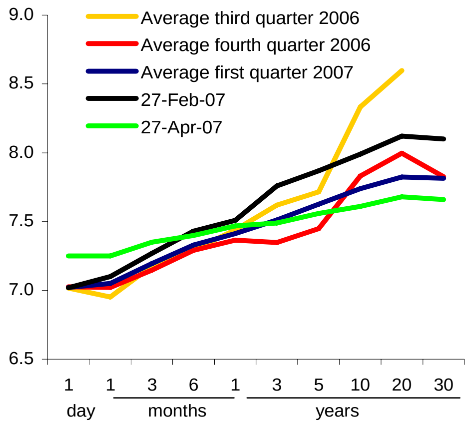
In the last months, international financial markets have remained loose. Nonetheless, towards the end of February an episode of volatility arose, mainly as a result of the perception of a worsening outlook for U.S. economic growth. As a result, long-term interest rates in Mexico increased significantly during the first weeks of March, generating a steeper yield curve (Graph 35). Later, when volatility dissipated, the referred increases in long-term yields in pesos began to revert gradually.

Graph 34
Bank Funding Interest Rates
Annual percent

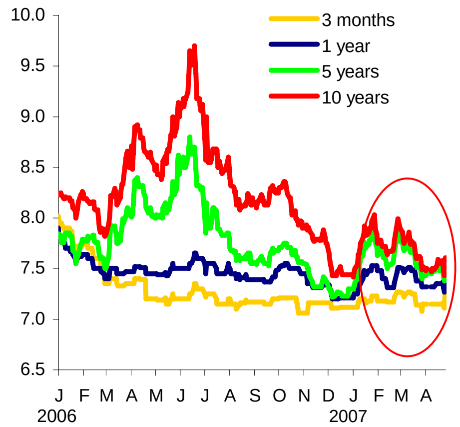


Graph 35
Interest Rates

a) Yield Curve in Mexico
Annual percent



b) Interest Rates in Mexico
Annual percent



5. Balance of Risks and Final Remarks

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

a) The growth rate of world economic activity is expected to slow down gradually during 2007. As for the U.S. economy, the current average of the main analysts' projections for GDP growth for this year is around 2.3 percent, below that observed in 2006 (3.3 percent). During the first quarter of 2007, GDP grew at a small rate, 1.3 percent at an annualized quarterly rate (2.1 percent at an annual rate). Prospects for GDP growth in the U.S. for 2007 are of a greater slowdown in the growth rate of industrial activity, from 4 percent on average during 2006, to around 2 percent in 2007. This scenario implies a lower growth of demand for Mexican exports and, therefore, of the Mexican economy.

b) Oil revenues are expected to decrease as compared with 2006, as a result of previsions of lower oil prices and a reduction in crude oil export production. Revenues from workers' remittances are also anticipated to grow at a slower rate as compared with last year. Consequently, the current account deficit is expected to widen this year. Nonetheless, since both revenue items will remain at historical high levels, the current account deficit is expected to remain at low levels in terms of GDP.

c) In general terms, favorable conditions for international financing are expected. Nonetheless, volatility in international markets could increase if greater uncertainty is perceived regarding the outlook for U.S. growth.

Based on the aforementioned macroeconomic environment, and on most recent information on the Mexican economy, Banco de México's baseline scenario for 2007 is as follows:

Growth: Between 3 and 3.5 percent; thus implying a downward adjustment in relation the previous Inflation Report (between 3.25 and 3.75 percent).

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

Current Account: Current account deficit of around 1 percent of GDP.

Inflation: Since mid-2006, the economy has been affected by continuous adverse supply shocks. These shocks basically reflect changes in relative prices and, therefore, are not expected to contaminate the price and wage determination processes. Nonetheless, since some of these shocks seem to be long-lasting, their effect on annual inflation will continue for twelve months since the moment they arose. Under this context, headline inflation is expected to be between 4 and 4.5 percent up to the third quarter of the year, and then fall to between 3.5 and 4 percent at the end of the year. Core inflation is also expected to follow a downward trend, reaching at the end of the year between 3.5 and 4.0 percent. In particular, the following stands out:

a) The recent development of the merchandise subindex was determined mainly by the shocks that affected the prices of few products, such as corn-tortillas, sugar, and cigarettes. In absence of additional shocks, these effects will begin to disappear from annual merchandise inflation calculations starting September. To a great extent, this result will depend on the stability of corn-tortilla prices. On April 25, 2007 the Agreement to Stabilize Corn-tortilla Prices was extended to August 15 of the same year.

b) Prices of non-food merchandise have been growing at a relatively stable rate since 2002, fluctuating slightly above 2 percent. This trend is expected to continue.

c) The subindex of housing services was subject to upward pressures in 2006 due to price increases in copper and steel construction materials. The effect of this shock on the annual variation of this subindex appears to have started to dissipate, being a determining factor for the decline in core inflation up to August.

d) As for non-housing services prices, their annual variation could continue to fluctuate around 4 percent, although with some volatility.

Summing up, the expected decreasing trend for annual core inflation will depend, mainly, on the development of corn-tortilla prices, on the end of inflationary pressures originated by grains' international prices, and on a reduction in the annual variation of the housing subindex.

e) The dynamics of the non-core index will continue to be determined by the development of fruits and vegetables prices. The incidence of these prices on headline inflation could increase during the second quarter of the year, due to their low levels recorded during the same period of the previous year.

f) The annual variations of livestock prices will increase during the rest of the year. This is due to the low prices observed in 2006 and costs pressures originated by higher prices of grains.

g) Since no considerable changes are expected in the elements that are used to determine administered prices, the latter will not pressure inflation significantly. Regulated prices, however, could grow at a faster rate due to the latest update to public transportation fares in some cities.

Up to now, the development of headline and core inflation has remained, in general terms, in line as anticipated, and no significant evidence of contamination in the price determination process has been revealed. However, some food-related prices have been affected. In this regard, the following must be considered:

i) The uncertainty associated with the price determination of some products, particularly corn-tortillas and other foods that use various grains as inputs, has increased.

ii) Expectations that inflation will remain above the variability interval for a long period increase risks of contamination in the price and wage determination processes.

iii) International prices of grains and certain commodities have been subject to pressures and their volatility has increased. Energy prices have fluctuated markedly.

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

v) Inflation expectations remain above the 3 percent target.

Consequently, although the slowdown of economic activity is a factor that could contribute to mitigate the abovementioned risks, the Board of Governors deemed convenient to strengthen the monetary policy stance as a preemptive measure, tightening monetary conditions in April by 25 basis points. The purpose of this action is to achieve a better balance in terms of inflationary risks and to prevent the price and wage determination processes from being affected by the supply shocks that have taken place. With this measure, Banco de México intends to strengthen inflation's converging trend to its target.

Other risk factors also prevail that could affect mainly the base scenario for GDP growth.

The main risk for the world economy and, particularly, for the Mexican economy, is the possibility that the U.S. growth rate slows down more than expected. In the last months, growth expectations and the balance of risks for economic activity in that country have been affected by the worsening of the real estate market, which has been reflected in the rising delinquency rates on subprime mortgage loans. If this sector undergoes a greater adjustment, household spending could be affected considerably, thus reducing the U.S. demand for foreign products, including those from Mexico. Expectations for industrial growth in the U.S. have also been revised downward in the last months. This decline in production could be more significant if the cyclical slowdown of demand for durable goods aggravates or if firms' investment expenditure weakens further. This scenario would affect considerably Mexican exports due to their close link to industrial activity in the U.S.

The balance of risks for growth in the short term also considers the possibility of public expenditure contributing less to the expansion of aggregate demand (as compared with last year), as has been the case when a new administration is installed.

Finally, Banco de México has emphasized for several years the importance of attaining the necessary agreements to flexibilize the country's productive sector and adjust the structure of incentives faced by the Mexican society in several aspects. This would boost both competitiveness and economic growth to take full advantage of the country's development opportunities. The reforms to the public workers' social security law (Ley del ISSSTE) in the last weeks have made progress in this direction. The legal and incentives framework must be adjusted continually, in order to revert the loss of competitiveness the economy has undergone in the last years. Progress in this direction will increase the possibilities of higher economic growth and more and better jobs.