

Inflation Report

October - December 2005

Monetary Program

for 2006

Summary

During 2005, the world economy exhibited a favorable performance and the outlook for growth continues to be positive. The U.S. economy is expected to continue to expand significantly at a rate close to potential. The strength of world economic growth -particularly of some Asian economies that make intensive use of different energy goods in their productive processes-together with restrictions to increase the supply of these products, led to a significant increase in energy prices during 2005. The hurricanes that affected the supply of some energy goods during the second half of the year also contributed to such results.

Although price increases of crude oil have been a source of inflationary pressures worldwide, the effects of such pressures have been limited, while core inflation indicators have remained at moderate levels. This has allowed to contain long-term inflation expectations.

International financial markets remained loose. Under such context, sovereign spreads for some emerging economies recorded historically low levels during the last quarter of 2005. Thus, prevailing conditions in international financial markets have contributed to the appreciation of assets and currencies in emerging economies.

Most recent indicators allow to anticipate that in 2005 the Mexican economy grew around 3 percent, figure below that recorded during the previous year. The latter was due to the slower growth rate of aggregate demand, mainly as a result of a slowdown of external demand. In particular, manufacturing exports have been affected by both the lower dynamism of industrial activity in the U.S. and the loss of competitiveness of Mexican products. In 2006, GDP is expected to grow at a real rate between 3.2 and 3.7 percent.

Headline inflation decreased significantly throughout 2005, reaching 3.33 percent in December. In particular, core inflation, which is a better indicator of the medium-term trend of headline inflation, fell significantly, reaching an annual variation of 3.12 percent at the end of 2005.

Headline inflation is expected to increase to levels close to 4 percent in the first months of 2006, as a result of the inherent volatility of the price subindex of fruits and vegetables. Nonetheless, it is anticipated to be between 3 and 3.5 percent towards December 2006.

Recent Developments in Inflation

During 2005, the behavior of inflation mainly reflected the effect of two factors: first, the reversion of the multiple supply shocks that affected the economy during 2004 and, second, the monetary policy actions adopted. These actions were oriented to prevent the referred shocks from contaminating the price determination process, and to foster favorable conditions for a reduction in core inflation.

In particular, annual headline inflation in 2005 exhibited a converging trajectory with the 3 percent target and, since August, it remained within the variability interval of plus/minus one percentage point determined around such target. In December, the referred indicator was 3.33 percent, 1.86 percentage points below the level recorded during the same month of the previous year. Headline inflation's behavior was mainly influenced by its non-core component. Core inflation also fell significantly.

During 2005, the annual growth rate of the non-core price index followed a declining trend, falling by December 2005 4.44 percentage points below the level reached at the end of 2004, from 8.20 to 3.76 percent. Such result was mainly determined by the significant reduction in the growth rates of both agricultural and regulated prices, as well as by the

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relatively contained passthrough of the surge in international energy prices to domestic energy prices. Additionally, non-core annual inflation fluctuated significantly during 2005, being fruits and vegetables the price subindex that exhibited the highest volatility.

Processed food prices increased during 2005 at a lower rate than that observed during the previous year. In general terms, the reduction in the annual variation of these prices was based, among other factors, to the fact that international prices of grains and meat products remained at levels below those observed in 2004. As a result, the reduction in food inflation in Mexico reflected the lesser pressures on international prices.

The annual variation of the services core subindex decreased during 2005 due to the lower contribution of housing services inflation during the first eight months of the year. This reduction is associated with a greater supply of housing -which has contributed to moderate the increase in rents- and with the fall in the prices of certain construction materials. Among the latter, one of the most important was steel prices, which had increased significantly during 2004.

In contrast, non-housing services inflation continued to be influenced adversely by the lagged effects of the increase in food prices observed during 2004, and therefore followed an upward trend. However, such trend reverted since August.

Main Determinants of Inflation

International Environment

The world economy continued to exhibit vigorous growth at the end of 2005, boosted mainly by production growth of the main industrial countries and of some emerging economies, particularly China. Although the fall in oil prices in the last months of 2005 translated into a decline in the rate of inflation of several economies, the risk of inflationary pressures continued to be a cause of concern for the authorities of some countries. Under such context, the Federal Reserve continued its policy of gradual increases in the federal funds rate. In December, the European Central Bank raised its policy interest rate for the first time in five years. Despite the increase in short-term interest rates, access conditions for emerging economies in international financial markets continued to be favorable.

Aggregate Demand and Supply

During 2005, aggregate demand, together with GDP, grew at a lower rate than in 2004. In general terms, in 2005 aggregate demand was characterized by: i) consumption expenditure grew slightly below 2004 figures; ii) investment grew at a similar rate than that observed during the previous year. However, within its components, private investment moderated its growth and public sector investment grew at a higher rate; and, iii) overall, exports of goods and services slowed their rate of growth during the year, albeit recovering during the last months. It is important to point out that just as in 2004, in 2005 the performance of domestic expenditure and economic activity benefited from the significant increase in Mexico's oil trade balance surplus and by revenues from workers' remittances. Workers' remittances have become very important for private consumption expenditure as confirmed by the fact that the amount received in 2005 was equivalent to 25 percent of wage earnings in the formal sector of the economy. In some states, workers' remittances exceeded formal wage earnings.

Interaction between domestic expenditure and production in 2005 does not suggest that significant pressures to production capacity arose. Such inference is based on the following: i) GDP growth slowed as compared with 2004; ii) gross capital formation and, therefore, production capacity, grew for two consecutive years at a higher annual rate than GDP; and, iii) in some sectors, such as manufacturing, the level of production measured with seasonally adjusted data at the end of 2005 was still below the maximum level reached at mid-2000. In addition, although domestic expenditure growth was above GDP growth in 2005, such results had not been observed in the last two years. In fact, in 2005, the growth rate of domestic expenditure was close to 4 percent, nearly the same rate observed in 2004.

Costs and Prices

Contractual wages in enterprises under federal jurisdiction exhibited an average increase of 4.4 percent during 2005, 0.3 percentage points above that observed in 2004. This difference is explained by the higher increases granted to workers in public enterprises, given that workers in private enterprises received, on average, the same contractual wage increase in both years. Thus, in general terms, wage negotiations were not affected by the supply shocks to headline inflation in 2004.

Administered prices are mainly affected by three factors: first, by their international references; second, by the prices of certain inputs used in their production process, such as steel in electricity; and third, by the policies determined by the public sector for these types of products.

During 2005, international energy prices rose significantly. Nonetheless, this phenomenon had a moderate passthrough to the domestic market due to different measures established by the federal government to reduce the volatility of domestic energy prices, among which the most important where: i) the setting of a maximum price for gasoline at border cities that should not exceed the price set for the rest of the country (which has a predetermined rate of change); ii) the adoption, at the beginning of the year, of a monthly variation interval between 0.75 and 1.75 percent for propane prices; iii) the implementation of a maximum price for natural gas for low-consumption residential use; and, iv) a decree that establishes a maximum price for natural gas for industrial use and natural gas distributors.

As for international prices of some metals, steel prices have a particular relevance due to their incidence on the cost of construction materials and the effect on the calculation of high consumption electricity tariffs. In this regard, it is important to mention that during 2004 the higher consumption of metal observed worldwide led to a significant increase in its prices. Nonetheless, this condition reverted in 2005, when the supply of steel began to rise and its prices started to follow a downward trend until September, when they began to increase at moderate rates.

As mentioned in previous paragraphs, during 2005, international prices of food commodities exhibited lower volatility than that recorded in 2004, posting lower prices in the case of both meat products and grains. This reflected into lower pressures from processed foods and some livestock products to consumer prices.

Monetary and Credit Aggregates

During 2005, the expansion of the broad monetary aggregates strengthened, recording increasing rates of growth throughout the year. This result was due to both the increase in residents' financial savings as well as the significant expansion of public securities' holdings by foreigners.

The greater availability of financial resources has been accompanied by an important change in its

final uses. In particular, the decline in public sector borrowing requirements and the slower rate of reserve accumulation by Banco de México have increased the availability of financial resources for the private sector. Under such setting, liquidity constraints for households have decreased gradually, and enterprises have been able to refinance their liabilities in better terms and conditions, strengthening their financial position to face different types of shocks.

Monetary Policy Actions

The outlook for inflation has improved. The different risks faced by the disinflation process apparently have had limited effects on wage negotiations and, in general terms, on the price determination process in the economy. The development of inflation expectations therefore suggests that the process of inflation abatement continues.

Global financial conditions are expected to continue to be favorable in the near future. In this regard, the inflow of funds destined to the acquisition of debt instruments in pesos has led to a reduction in interest rates, especially for long terms. Monetary policy actions have also contributed to this result by reducing inflation expectations and the risk premia that is usually discounted from this type of instruments.

The yield curve exhibited a significant reduction in all terms and a slight flattening in relation to its inverted position observed during the third quarter of 2005. Likewise, interest rate spreads between Mexico and the U.S. have declined considerably for all terms.

The concurrence of the previous elements allowed the Board of Governors of Banco de México to revert, since August 2005, part of the monetary restriction adopted during 2004 and in the first half of 2005.

In particular, in its press releases of the last months, Banco de México continued to allow a loosening in domestic monetary conditions: no more than 25 basis points in October and November, and no more than 50 basis points in December and January 2006. As a result of such actions, the one-day bank funding interest rate continued to fall, reaching a level of 7.75 percent.

The loosening in monetary conditions adopted by Banco de México is congruent with the reduction of inflation and its expectations and with the convergence of inflation to its target. However, although significant progress has been attained

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regarding the abatement of inflation, price formation and inflation expectations have still not consolidated around the Central Bank's target.

Balance of Risks and Final Remarks

Based on the above mentioned macroeconomic environment and on most recent information regarding the development of the Mexican economy, Banco de México's baseline scenario for 2006 is as follows:

GDP Growth: GDP growth is expected to be between 3.2 and 3.7 percent.

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

Current Account: The current account deficit of the balance of payments is expected to be of approximately 1.2 percent of GDP.

Inflation: Annual headline inflation is expected to increase at the beginning of 2006, to a level close to 4 percent, mainly as a result of the atypical behavior of prices of certain fruits and vegetables at the beginning of the previous year. Afterwards, headline inflation is expected to resume a decreasing trend, although with certain volatility from its non-core component, reaching between 3 and 3.5 percent at the end of the year. Annual core inflation is expected to remain stable at a level close to 3 percent.

In this regard, the following should be highlighted:

a) The high volatility characterizing the prices of some items included in the subindex of fruits and vegetables and the expected stability of annual core inflation implies that throughout the year annual headline inflation is anticipated to exhibit certain volatility, mirroring that of the referred subindex.

b) During the last months, international energy prices reached historically high levels. Nonetheless, the policies announced by the federal government to determine the prices of goods and services administered by the public sector will moderate the effect of international energy prices on inflation.

c) The rest of the goods that comprise the non-core price subindex are expected to behave in such a way that they will not entail significant inflationary pressures.

d) Expectations that core inflation will remain relatively stable are based on the assumption that the annual variation of merchandise and services

prices will remain at levels close to those recorded towards the end of 2005.

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

i) Although the higher prices of crude oil and its by-products have not led to an increase in world economies' core inflation, further increases in these prices could revert this condition. Should this occur, world's inflationary outlook, including that of Mexico, could deteriorate, therefore leading to an environment of higher interest rates in international financial markets.

ii) Futures prices of certain grains have increased. This could represent an obstacle for the reduction of processed food inflation.

iii) Extraordinary price increases of certain items included in the subindex of agricultural products should not be discarded.

iv) The annual variation of non-housing services' prices remains relatively high.

v) Inflation expectations remain above the 3 percent target.

The baseline scenario is subject to additional risk factors. Should any of these materialize, they would mainly affect the outlook for growth. Nonetheless, they could also have an impact on inflation.

First, the Chinese and other economies could continue to systematically displace manufacturing production in Mexico, which has lost share in both external and domestic markets. The possibility that this scenario could materialize has increased due to the lack of advances to enhance Mexico's competitiveness. At present, Mexico has fallen in practically all international competitiveness indexes. Although it is true that Mexico has grown due to a favorable international environment, the lack of competitiveness has limited taking full advantage of the favorable circumstances. This has been achieved by other countries that have implemented structural reforms and therefore their economies grow soundly. Should this trend of competitiveness slump continue in Mexico, the potential growth of the economy could be affected and, therefore, the opportunities and the quality of employment in the country.

Second, the high U.S. current account deficit could become unsustainable. Although this is a medium-term risk factor, if materialized it could have significant effects worldwide, and, given Mexico's trade integration with the U.S., on our outlook for growth.

Finally, as the electoral process of 2006 nears, political uncertainty in Mexico could increase. Certain analysts have pointed out that this could give way to higher volatility in financial markets. In this regard, it is important to point out that the implementation of prudent macroeconomic policies has allowed Mexico to be, at present, less vulnerable to external and domestic shocks.

Stability is a necessary but not the only condition to attain sustained growth. Progress towards a greater stability of the Mexican economy has had a significant influence through its effect on aggregate demand, allowing consumption and investment to expand and become more stable throughout the years. Nonetheless, the current challenge is to implement structural changes destined to increase the flexibility of the economy's productive structure and, hence, to raise its growth potential. Under such context, the need to advance in the pending agenda of structural changes in Mexico is evident. As broad consensuses regarding structural reforms with a long-term vision are attained, the lag in competitiveness that the Mexican economy has accumulated in recent years with respect to other economies might be reverted, therefore setting sounder foundations for the country's future growth.

Monetary Program for 2006

Monetary policy in Mexico is to be conducted based on an inflation targeting framework, of which the following elements deserve mention: a) the announcement of an explicit multi-annual inflation target; b) a systematic analysis of the current economic conditions and of inflationary pressures; c) a description of the instruments used by the Central Bank to attain its objectives; and, d) a communication policy that fosters monetary policy's transparency, accountability and effectiveness.

Banco de México's monetary policy is conducted to attain an annual CPI inflation of 3 percent and remain permanently around that level. Nonetheless, although monetary policy is implemented in order to reach these objectives, it is subject to a certain degree of uncertainty. This is due to the multiple shocks that can affect both the economy and the price determination process, and to the fact that the relationship between monetary policy actions and its results regarding inflation is imprecise. Therefore, a variability interval of plus/minus one percentage points has been set around the inflation target.

Central bank's monetary policy actions have a lagged effect on the economy, and especially, on the price level. Therefore, to reach the inflation target, the monetary authority must base its decisions on a

careful assessment of both the current economic conditions and the outlook for inflation.

Monetary policy decisions are based on a systematic analysis of the current economic conditions and of the inflationary pressures originated by such conditions, using a wide range of variables and indicators and different economic and statistical models. Such analysis allows for identifying the factors that affect the expected development of inflation in order to evaluate their impact on economic agents' inflation expectations and on the price determination process.

Banco de México implements monetary policy through different channels, which allow the Central Bank to communicate its monetary policy stance. In this regard, the following stand out: the modifications to Banco de México's objective for commercial banks' daily balances at the Central Bank (*corto*) and the statements included in its monetary policy press releases regarding domestic monetary conditions.

As mentioned in previous occasions, Banco de México has two main instruments to induce changes in the monetary policy stance: the determination of minimum levels or floors for domestic monetary conditions and the *corto*. Through the referred floors, Banco de México has been able to signal more clearly to the markets its monetary policy stance. Nonetheless, the *corto* is maintained as an available monetary policy instrument to be used by the Board of Governors whenever deemed convenient.

In order to attain price stability through an inflation targeting framework, the Central Bank must communicate clearly to the public its objectives, strategy and instruments. The announcement of inflation targets is important as it facilitates the convergence of economic agents' expectations to such targets. This is also reinforced by the Central Bank's commitment to take the necessary measures to attain its inflation target. Transparency in monetary policy decisions has allowed the Central Bank to explain the motives supporting its actions. Such transparency raises certainty among the public, fosters the attainment of the Central Bank's objectives and, in turn, reduces the cost of inflation abatement. Greater transparency together with the communication policy has contributed to strengthen the accountability of the Central Bank.