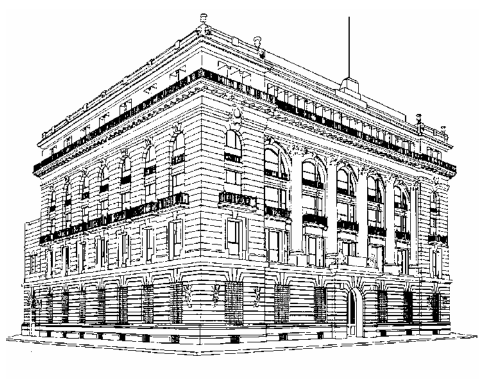
Inflation Report

January – March 2005



BANCO DE MEXICO

APRIL 2005

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FOREWARNING

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Unless otherwise stated, this document has been prepared using data available as of April 26, 2005. Figures are preliminary and subject to change.

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I. Introduction

World economic activity grew at a favorable pace during the first quarter of 2005. The U.S. economy and Asian emerging economies continued to be the main driving forces of world economic expansion. Under such environment, oil prices rose significantly. Nonetheless, main analysts continue to anticipate that world economic growth, particularly in the U.S., will slow down in 2005 as compared with the previous year.

During the first quarter of the year, U.S. aggregate demand exhibited a dynamic behavior -although exhibiting some weakening towards the end of the period- thus widening the external deficit and increasing industrial capacity utilization. Under such context, increases in producer prices of intermediate goods and in commodity prices generated concerns that such pressures on producers' costs could eventually be passed on to final consumers.

Although U.S. inflation has followed an upward trend, it has still remained within moderate levels. Confidence over U.S. authorities' conduct of monetary policy, the recent weakening of some economic activity indicators, and the prevision that the economy will slow down have contributed to contain inflation expectations.

During the last months, the outlook for inflation in the U.S. has become more complex. The same has been true regarding the corresponding reaction of the Federal Reserve, thus causing an increase in the volatility of long-term interest rates in the U.S.

Under such context, international markets have become cautious regarding riskier debt instruments. In particular, spreads on emerging markets' sovereign debt bonds and U.S. corporate bonds of similar risk has increased. Such reaction has responded, on the one hand, to the greater inflation uncertainty in the U.S. and, on the other, to the downgrade in credit ratings of certain U.S. corporate issuers, which increased risk aversion in international financial markets. Consequently, emerging markets access to financing in both external and domestic markets worsened, especially for sovereign and corporate issuers with lower credit ratings.

As for Mexico, domestic economic activity continued to expand during the first quarter of 2005. This was mainly attributed to different components of aggregate demand, both domestic and external. Consumption continued to grow significantly at an annual rate, while investment continued to expand.

Among the factors driving the expansion of domestic expenditure, both consumption and investment, is the ample availability of financial resources. The latter has responded to both the higher external revenues from oil exports and workers' remittances, as well as to the increasing availability of domestic financing. Regarding the latter, the expansion of consumption and mortgage credit and the recovery of credit to firms have exhibited significant dynamism.

The expansion of both aggregate demand and GDP raised imports of goods and services. Domestic expenditure is expected to have grown at an annual rate higher than GDP during the first quarter of 2005. Moreover, the recent behavior of the different components of aggregate demand suggests that domestic expenditure, rather than external demand, will be the main contributor to growth. Notwithstanding the aforementioned environment, available information does not allow to identify significant inflation pressures from this source.

External conditions have continued to affect headline CPI inflation in Mexico significantly. Although headline CPI inflation was affected by diverse supply shocks -mainly associated with international commodity and food prices- during the first quarter of 2005 some of these pressures have begun to revert. Moreover, the supply conditions of some agriculture products, which had exhibited significant price increases at the end of 2004, normalized.

As a result, annual headline CPI inflation fell from 5.19 percent at the end of 2004 to 4.39 percent in March 2005. Such result has led to a downward revision on inflation expectations for 2005 and 2006. Nonetheless, the following should be noted:

a) Core inflation and its expectations are still at relatively high levels with respect to its objective, thus suggesting that the inflation target has still not been incorporated in a widespread manner into the price determination process.

b) Core services inflation excluding housing has escalated as a result of the increase in food and energy prices observed during the past months.

c) International commodity prices (especially energy prices) and their volatility have rebounded.

Banco de México's Board of Governors considers of vital importance to contain any upward pressures from the diverse supply shocks in order to prevent any contagion on price determination and, particularly, on wage settlements. Accordingly, it remains attentive to any inflation pressures that might arise from the demand side. Based on such considerations, it continued to tighten its monetary policy stance during the first quarter of 2005.

II. Recent Developments and Main Determinants of Inflation January – March 2005

II.1. Recent Developments in Inflation

Annual headline CPI inflation was 4.39 percent at the end of the first quarter of 2005, 0.80 percentage points below that recorded in December of the previous year. Annual core and non-core inflation fell 0.19 and 2.16 percentage points, respectively, during the quarter, reaching 3.61 and 6.04 percent in March 2005. The decline in headline CPI inflation was therefore mostly due to its non-core component (Graph 1 and Table 1). The decline in non-core CPI inflation reduced the gap between non-core and core inflation, from 4.4 percentage points in December 2004 to 2.43 points in March 2005.

Graph 1 **CPI, Core and Non-core Price Indexes**

Annual percentage change

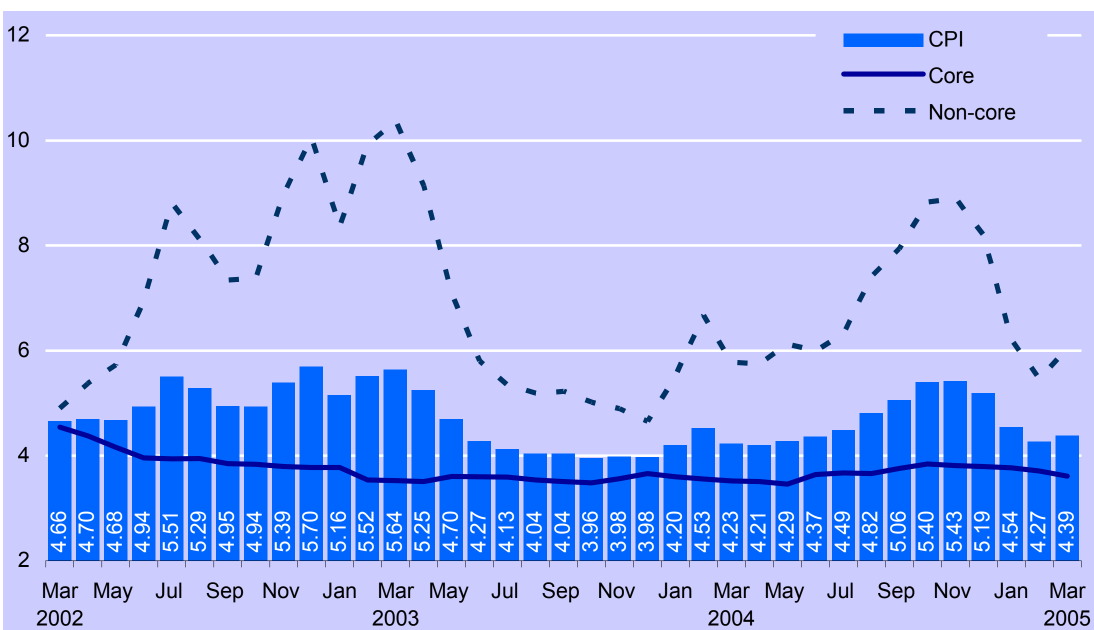


Table 1 **CPI Components**

Annual percentage change

	Dec-2003 Dec-2002 (a)	Dec-2004 Dec-2003 (b)	Jan-2005 Jan-2004 (c)	Feb-2005/ Feb-2004 (d)	Mar-2005/ Mar-2004 (e)	Difference Percentage points (b-a)	(e-b)
CPI	**3.98**	**5.19**	**4.54**	**4.27**	**4.39**	**1.2143**	**-0.8052**
Core	**3.66**	**3.80**	**3.77**	**3.71**	**3.61**	**0.1308**	**-0.1853**
Merchandise	**2.62**	**3.87**	**3.78**	**3.67**	**3.61**	**1.2489**	**-0.2587**
Food	4.70	7.04	6.59	6.18	5.90	2.3460	-1.1378
Other	1.24	1.69	1.83	1.92	2.00	0.4490	0.3158
Services	**4.84**	**3.72**	**3.76**	**3.76**	**3.61**	**-1.1250**	**-0.1044**
Housing	4.12	3.70	3.63	3.54	3.06	-0.4266	-0.6378
Other	5.72	3.74	3.92	4.03	4.28	-1.9788	0.5387
Non-core	**4.66**	**8.20**	**6.20**	**5.46**	**6.04**	**3.5405**	**-2.1556**
Agriculture	**3.65**	**10.11**	**3.49**	**3.06**	**5.73**	**6.4566**	**-4.3775**
Fruits and vegetables	-2.36	6.43	-5.75	-4.59	4.65	8.7948	-1.7780
Livestock	8.34	12.69	9.69	8.04	6.39	4.3506	-6.3026
Administered and Regulated Prices	**3.91**	**7.51**	**6.99**	**5.92**	**5.70**	**3.5997**	**-1.8020**
Administered	6.11	10.02	10.05	8.68	8.39	3.9038	-1.6245
Regulated	1.90	5.13	4.14	3.36	3.19	3.2296	-1.9432
Education	**8.59**	**7.50**	**7.81**	**7.59**	**7.55**	**-1.0956**	**0.0524**

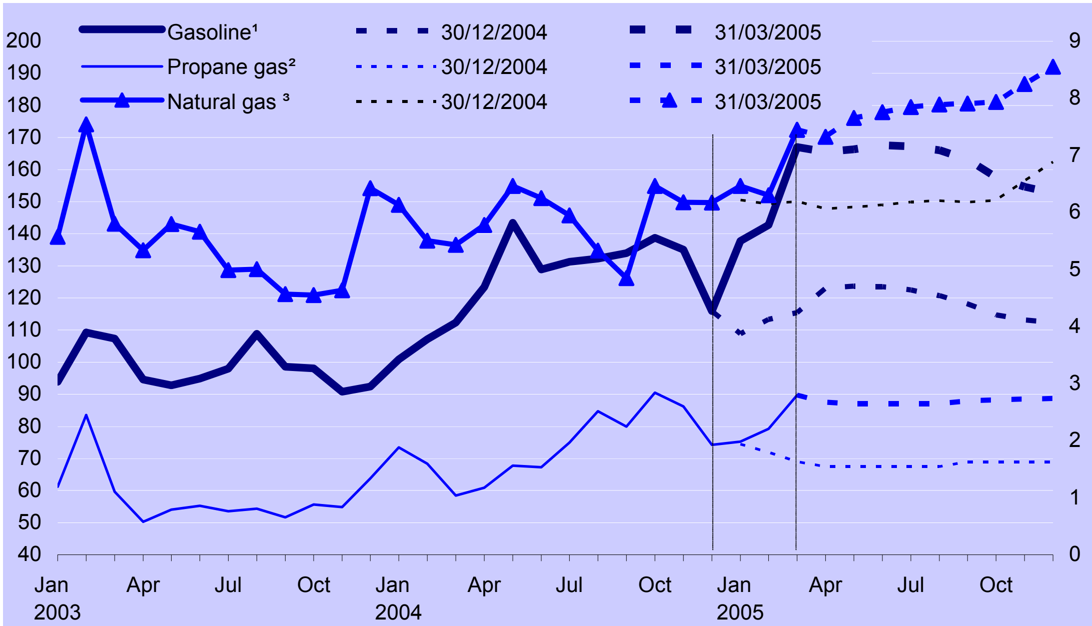
During 2004, annual headline CPI inflation in Mexico was affected by several supply shocks, such as: i) those associated with the rise in different international commodity prices (Graph 2); ii) those resulting from government's administrative decisions regarding the determination of local tariffs for certain goods and services regulated by the public sector (Graph 3);[1] and, iii) those stemming from certain agricultural production problems in Mexico and in the United States.[2] In the three cases, such shocks directly affected CPI's non-core subindexes (agriculture prices, and administered and regulated prices). In the first case, the effect was also transmitted to the prices of foods included in the core inflation subindex (Graph 3, Graph 4, and Table 1).

The abovementioned supply shocks affected non-core CPI inflation significantly in 2004 (Table 1). Some of these shocks have reverted in 2005, while others have been doing it gradually. Therefore, during the first quarter of 2005, annual non-core CPI inflation decreased 2.16 percentage points. Such reduction was driven by the lower growth rates of the agriculture price subindex, and of the administered and regulated price subindex.

1 Particularly, urban transportation, and water and land property taxes.

2 Tomato prices increased significantly.

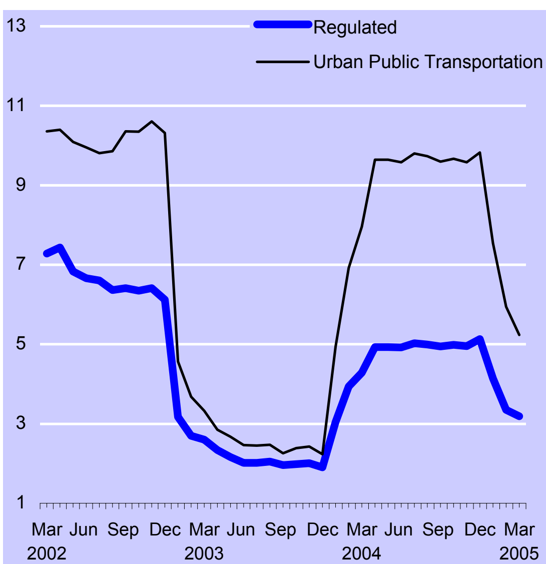
Graph 2 **Observed and Future International Energy Prices**



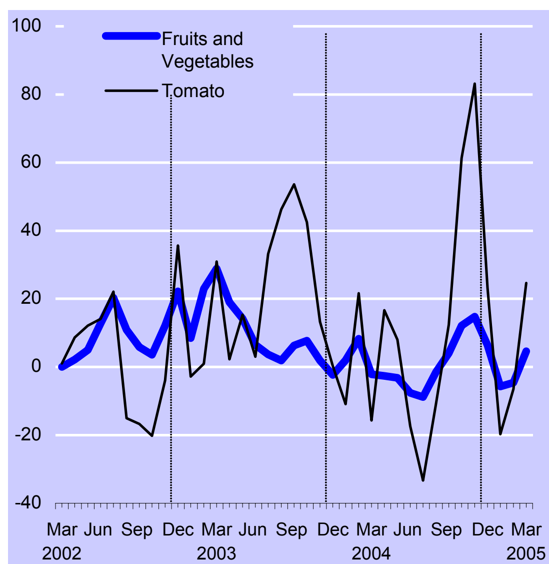
1/ Texas. US cents per gallon (left scale).
2/ Mont Belvieu. TX. US cents per gallon (left scale).
3/ TETCO. TX. US dollars per MMBtu (right scale).

Graph 3 **Subindexes of Regulated Prices and of Fruits and Vegetables**

a) Regulated
Annual percentage change

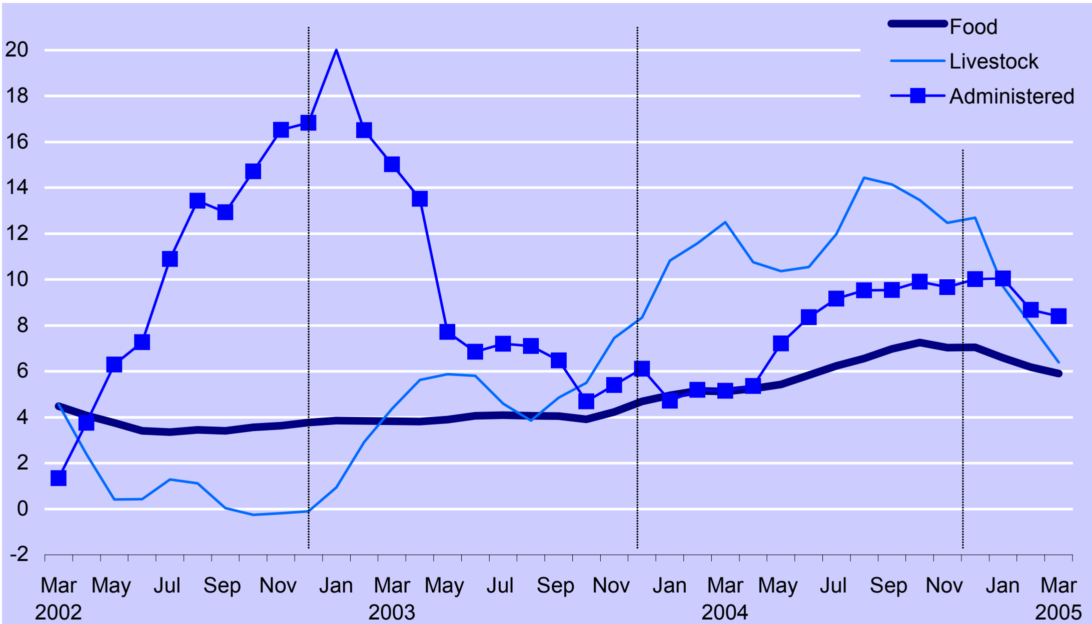


b) Fruits and vegetables
Annual percentage change



Graph 4 **Core Food Subindex and Selected Non-core Subindexes**

Annual percentage change



II.1.1. Non-core Inflation

During 2004, the subindex of administered prices was affected by the increase in international energy prices. Nonetheless, despite the fact that in the first months of 2005 international energy and energy by-products' prices rose, the government adopted several measures at the beginning of 2005 to make administered prices follow a more consistent path with the inflation target. Prices of some commodities that affect electricity rates have also decreased (Graph 5).

Consequently, during the first quarter of the year, the annual growth rate of the subindex of administered prices fell 1.63 percentage points as compared with the end of 2004, reaching 8.39 percent at the end of March 2005 (Graph 5). This result was due to the following factors: i) electricity tariffs contributed significantly to the decrease in the annual variation of the subindex; such contribution is explained by the unification of the two household tariffs for high consumption (*Tarifas Domésticas de Alto Consumo, DAC*) since February 2005, and the decline in the prices of certain inputs used for electricity generation;[3,4] ii) gasoline prices exhibited smaller monthly variations as compared with the same period of the previous year; and iii) prices of propane gas for 2005 were scheduled to increase every month between 0.75 and 1.75 percent based on a 12-month moving average of its international reference. If the monthly variation of the latter falls outside such interval, the nearest margin (either the highest or the lowest) is considered. Thus, during the first three months of the year, propane gas prices increased according to the lowest margin of the interval. However, even if propane gas price increases remain in the lowest margin of the interval for the rest of the year, their annual growth rate would reach 9.55 percent in December 2005. [5]

The annual variation of the subindex of regulated prices fell from 5.13 to 3.19 percent from December 2004 to March 2005. Such reduction was mainly due to the lower incidence of urban public transportation fare increases during the first quarter of 2005, as compared with the same quarter of 2004. Such result is attributed to the lower increases in public transportation fares, and that these changes occurred in cities that have a lower weight in the CPI (Graph 3).

From December 2004 to March 2005 the annual growth rate of the price subindex of agriculture goods fell from 10.11 to 5.73 percent. As for livestock goods' prices, the reduction in the prices of feed grains for livestock production and the normalization of meat supply in the U.S. have allowed prices of such products to grow at monthly rates significantly lower than those observed in the same period of 2004. The latter, together with an increase in egg supply, have led to a reduction in the annual growth rate of livestock goods' prices, from 12.69 to 6.39 percent (Table 1).

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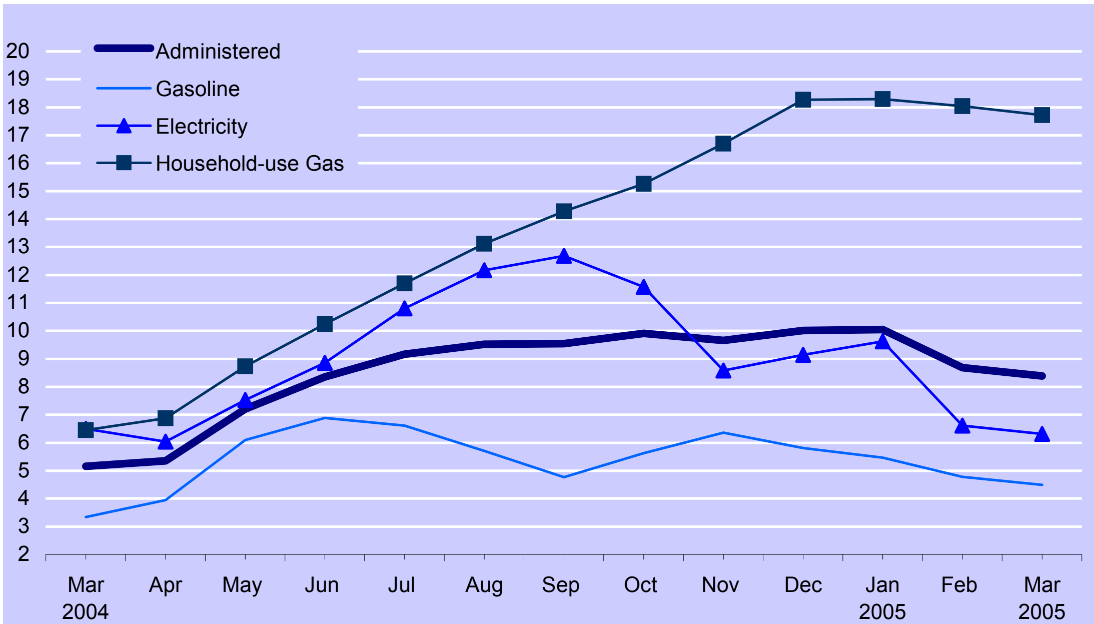
3 Household tariffs for high consumption are updated every month according to the following formula: F = 0.8*TIP + 0.2*TCC. The first part of the equation (TIP) comprises three subindexes from the Producer Price Index (PPI), which are averaged arithmetically: Machinery and Equipment, Basic Metal Industries, and Other Manufacturing Industries. The second part (TCC) represents the cost of fuels for electricity generation; such fuels are: imported and domestic fuel oil; natural gas; industrial diesel; and domestic and imported coal.

4 The PPI price subindex of basic metal industries and the prices of fuel oil (sold by PEMEX to CFE) fell.

5 The Daily Official Newsletter of December 30, 2004 released a law in which import duties on nearly 9,200 customs tariff classifications for countries with no trade agreement with Mexico are reduced. Among others, import duties on propane gas were eliminated.

Graph 5 **Subindex of Administered Prices**

Annual percentage change



As for fruits and vegetables, their annual price variation contracted 1.78 percentage points from December 2004 to March 2005, influenced by tomato prices, which rose significantly during the second half of 2004. Nonetheless, prices of such vegetable decreased significantly during the first six weeks of the year. This result was partially reverted during the rest of the quarter, following an upward trend in April (Graph 3).

II.1.2. Core Inflation

The decline in annual core inflation at the end of the first quarter of 2005, as compared with December 2004, was attributed to the lower growth rates of the subindexes of merchandise and services. Of both, the merchandise subindex contributed the most to such reduction: its annual growth rate declined from 3.87 percent to 3.61 percent. This result was the outcome of two opposite trends: the annual growth rate of food prices fell from 7.04 to 5.90 percent, while that of the rest of merchandises increased 0.31 points (from 1.69 to 2 percent).

In 2004, core inflation, especially the processed foods' group, was also affected by supply shocks. Price increases in grains and meat products in international markets affected processed food inflation significantly: its annual rate rose from 4.70 percent in

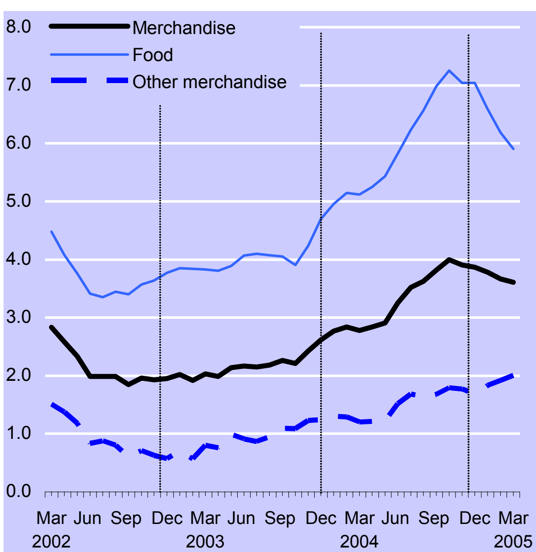
December 2003 to 7.04 percent in December 2004.[6] After having fallen to levels below those observed in 2004, and having stabilized those corresponding to certain meats, the annual growth rate of the subindex of foods fell to 5.90 percent in 2005 (Graph 4). Items from this group exhibiting the highest price increases in 2004, as well as the greatest reduction in the first three months of 2005, are those that are more dependent on the affected commodity imports, such as edible vegetable oils and fats, sweet bread, rice, and white bread, among others (Graph 7).

Annual core services inflation fell from 3.72 percent in December 2004 to 3.61 percent in March 2005. Such reduction was due to the 0.64 percentage points decline in the growth rate of the housing price subindex during that period, as a result of a significant decline in construction costs' growth rate (associated with steel prices). As for the prices of the rest of the services, their annual growth rate rose by 0.54 points during the period. These prices have been affected by the international price increases -which took place in 2004- in commodities used as production inputs. In addition, such subindex was also affected by the seasonal effect of tourism service prices, given that the Easter holiday took place in March, instead of April, as in 2004.

Graph 6 Core Subindex (Merchandise and Services)

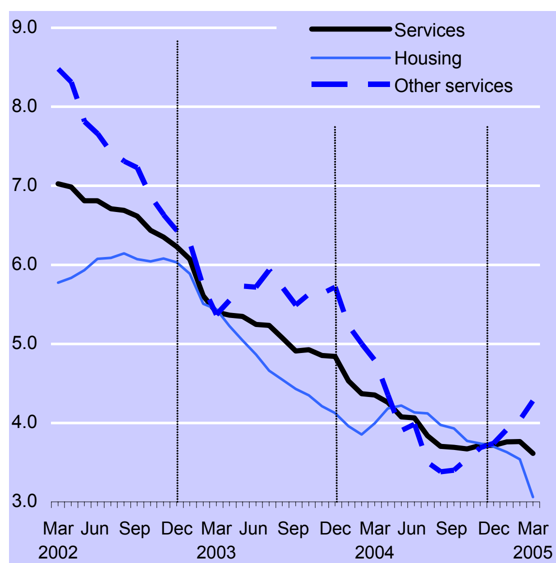
a) Merchandise

Annual percentage change



b) Services

Annual percentage change

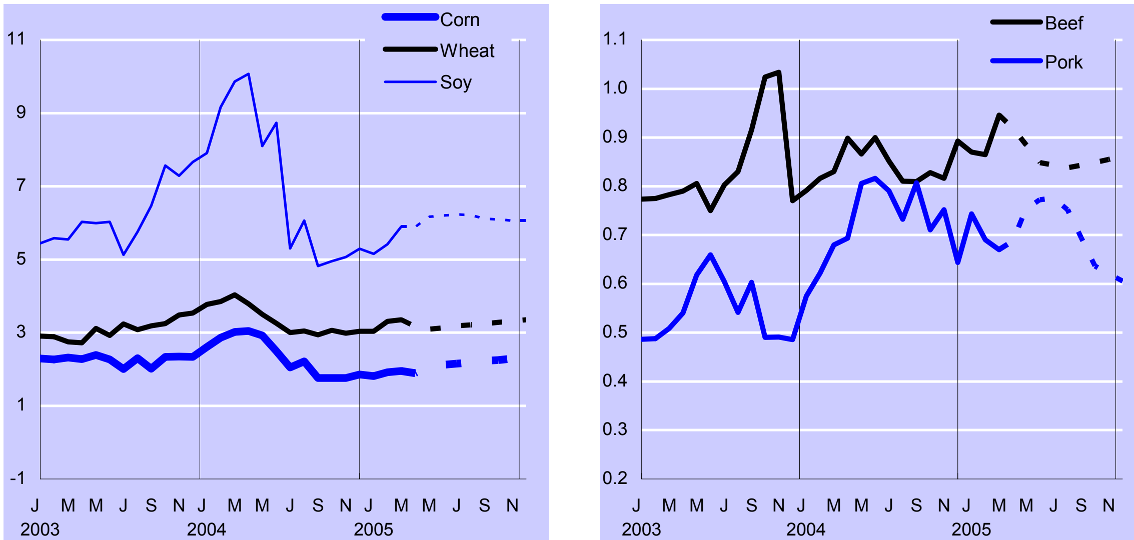


[6] Furthermore, metals' price increases affected the prices of canned foods.

Graph 7 International Observed and Futures Prices (Selected Commodities) 1/

a) Grains
US dollars per bushel

b) Meat
US dollars per sterling pound



Source: U.S. Department of Agriculture.
1/ Futures prices from April 2005.

II.1.3. Monthly Inflation

Monthly inflation was 0.0, 0.33 and 0.45 percent in January, February, and March, respectively. Results from the first two months were below projections from Banco de México's Survey of Private Sector Economic Analysts' Forecasts of December 2004; however, March's results were the opposite. The lower inflation rates observed in January and February of this year are mainly attributed to the development of inflation's non-core component, in contrast with results obtained during the same period of the previous year. This was due mainly to the evolution of agriculture prices, and of administered and regulated prices.

Table 2 Monthly CPI Inflation (Observed and Expected)

Percent

	2004				2005			
	Observed			Expected 1/	Observed			Expected 1/
Month	Non-core	Core	Headline	Headline	Non-core	Core	Headline	Headline
January	1.09	0.40	0.62	0.48	-0.77	0.38	0.00	0.52
February	0.86	0.48	0.60	0.26	0.15	0.42	0.33	0.39
March	0.19	0.41	0.34	0.35	0.75	0.31	0.45	0.34

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

II.1.4. Producer Price Index (PPI)

In March 2005, the annual growth rate of the Producer Price Index (PPI) excluding oil was 5.19 percent, 1.33 percentage points below the figure observed at the end of the previous quarter. This was mainly due to the significant reduction in the growth rate of the subindexes of the construction and basic metal industries comprising the secondary sector (Table 3). As for the tertiary sector, the lower annual growth rate of the subindex of transport and communications contributed the most to its reduction.

The lower growth rate of metal and wire prices during the first quarter of 2005 prompted a decline in the annual growth rate of the Residential Construction Cost Index, from 12.15 percent in December 2004 to 3.60 percent in March 2005.

Nevertheless, although the annual growth rate of the PPI excluding oil fell significantly during the first quarter of 2005, it is still at a high level, therefore putting an upward pressure on goods and services for household consumption.

Table 3 **PPI Excluding Oil**

Merchandise and final services, annual percentage change

ITEM	Annual Variation		Annual Incidence [1/]		
	Dec. 04	Mar. 05	Dec. 04 (a)	Mar. 05 (b)	Difference (b) - (a)
PPI	**6.52**	**5.19**	**6.52**	**5.19**	**-1.33**
Primary Sector	**8.58**	**7.99**	**0.31**	**0.29**	**-0.01**
Agriculture, forestry and fishing	8.08	8.16	0.26	0.27	0.01
Mining	13.12	6.50	0.05	0.02	-0.02
Secondary Sector	**7.78**	**5.12**	**3.23**	**2.15**	**-1.08**
Manufacturing	**5.10**	**4.88**	**1.51**	**1.43**	**-0.08**
Food, beverages and tobacco	7.27	6.01	0.69	0.57	-0.12
Textiles, apparel, and leather industry	2.88	2.99	0.08	0.08	0.00
Timber and by-products	8.68	9.06	0.03	0.03	0.00
Paper and by-products, printing and editorial	2.96	7.24	0.04	0.09	0.05
Chemical, oil, rubber and plastic industries	8.98	9.67	0.37	0.39	0.02
Non-metal minerals	1.59	1.97	0.02	0.02	0.00
Basic metal industries	48.86	3.70	0.14	0.01	-0.12
Metal products, machinery and equipment	1.43	2.27	0.14	0.22	0.08
Other manufacturing industries	2.68	3.36	0.01	0.02	0.00
Construction	14.49	5.68	1.72	0.72	-1.00
Tertiary Sector	**5.44**	**5.05**	**2.98**	**2.75**	**-0.23**
Electricity and Gas	11.32	7.30	0.19	0.12	-0.07
Restaurants and hotels	5.22	5.25	0.34	0.34	0.00
Transport and communications	8.23	6.66	1.21	0.98	-0.23
Real estate rental	3.63	3.10	0.40	0.34	-0.06
Personal, social and community services	4.03	4.70	0.84	0.96	0.12

1/ In some cases, figures may not add due to rounding.

II.2. Main Determinants of Inflation

II.2.1. International Environment

World economic activity continued to expand at a solid pace during the first quarter of 2005, after having posted n 2004 its highest rate of growth in 28 years. The U.S. economy and Asian emerging economies continued to be the main driving forces of world economic expansion, while the Japanese and euro economies continued to underperform. U.S. GDP is expected to have grown above its potential rate during the quarter. The increase in capacity utilization and oil prices at record highs, among other factors, increased uncertainty regarding the outlook for inflation in the United States. In this context, long-term interest rates in that country showed higher volatility. Furthermore, the downward trend of emerging economies' sovereign debt margins began to revert in March due to the greater inflation uncertainty in the United States and the increase in risk perception by investors.

II.2.1.1. Oil Prices

Oil prices increased during the first quarter of the year, reaching historically high levels in mid-March. The average price of the WTI was 49.92 US dollars per barrel during January-March (peaking at 56.82 US dollars per barrel on March 18, 2005), 1.67 US dollars above the average price of the fourth quarter of 2004. The average price of the Mexican oil export mix was 34.26 US dollars, 0.72 US dollars above the figure observed in the previous quarter.[7] The spread between the prices of the Mexican oil export mix and the WTI widened due to the higher demand for light oil in international markets.[8]

The behavior of international crude oil prices during the first months of 2005 responded mainly to the vigorous growth of world demand, in a context of reduced margins to expand supply (Graph 8). Concerns that such conditions will prevail for a long time have affected oil prices in futures markets. At the end of March, the WTI 12-month futures contract price reached 55.60 US dollars per barrel.

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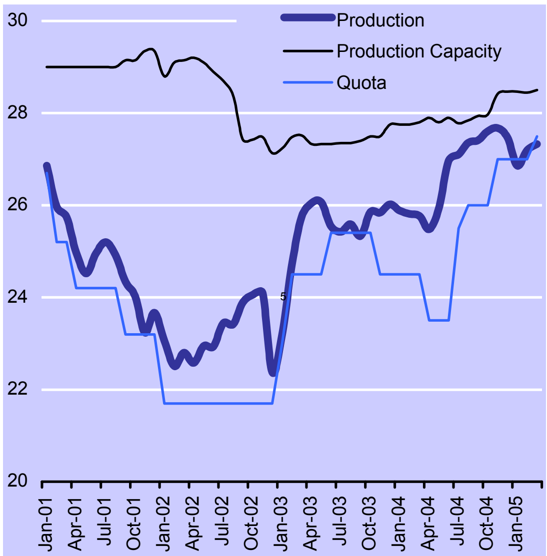
[7] Observed market prices during the period. On April 22, 2005, WTI and Mexican crude oil export mix prices were 54.31 and 41.61 US dollars per barrel, respectively.

[8] In the last days of March such spread narrowed. On April 22, it reached 12.70 US dollars. Such changes have partly mirrored PEMEX's sales policy in international markets. In December 2004, PEMEX reduced the adjustment factor in its price formulas in order to increase its market share. In recent months, such reduction has been partially reverted.

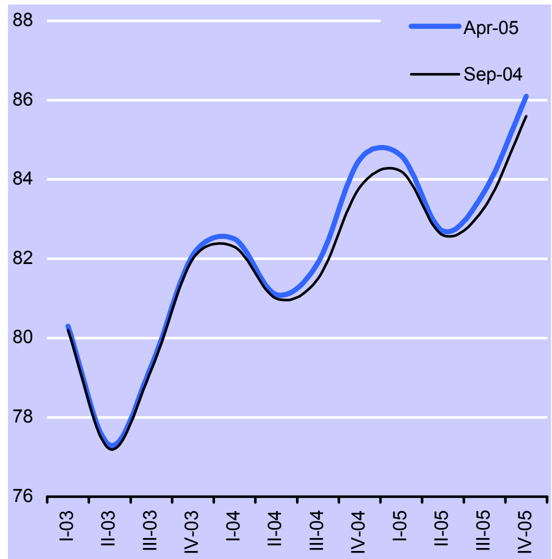
Graph 8 Oil Indicators

a) OPEC Crude Oil Production
Million barrels per day



Source: International Energy Agency.

b) Estimates of World Demand for Oil
Million barrels per day



Source: International Energy Agency.

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

During the last quarter of 2004, U.S. economic activity expanded at an annualized quarterly growth rate of 3.8 percent (3.9 percent at an annual rate). The expansion of domestic demand was the engine of growth. Consumption rose 4.2 percent at an annualized quarterly rate (3.8 percent at an annual rate), while non-residential investment, which grew above 10 percent at an annual rate every quarter of the year, rose 14.5 percent at an annualized quarterly rate (11.0 percent at an annual rate). The economy remained vigorous despite the significant deterioration of the external sector: the widening in the goods and services deficit contributed negatively with 1.4 percentage points to GDP's annualized quarterly growth rate. It is important to note that at the end of 2004, the U.S. economy had recorded thirteen consecutive quarters of growth.

Available indicators suggest that during January-March 2005 economic activity grew at a similar rate to that observed in the last quarter of the previous year. Such behavior was determined once more by domestic demand. Sustained growth of households' wealth and income boosted consumption expenditure: during January-February consumption rose at an annualized rate of 4.3 percent compared with October-November 2004. Nonetheless, the recent increases in energy prices affected households, and retail sales slowed during the last month of the quarter. Investment in software and equipment seems to have grown at high rates, as reflected by the strength of orders and shipments of capital goods. Furthermore, the path followed by the components of construction expenditure points to a significant contribution of residential investment to GDP growth. In contrast, the trade deficit continued to widen during January and February, thus implying that the external sector will contribute negatively to growth. Although available information during the quarter prompted analysts to revise upward their expectations for growth, such adjustment reverted once March indicators (which suggest that the higher costs of energy will have a significant effect on expenditure and economic activity) were published. Analysts estimate that GDP grew at an annualized quarterly rate of 3.9 percent (3.8 percent at an annual rate) during the first quarter of 2005 (Table 4).

Table 4

U.S. GDP and Industrial Production

Annual and annualized quarterly percentage change

	GDP				
	Expected at the end of the fourth quarter		Most recent data		
	I-2005 1/	2005 2/	I-2005 1/	2005 2/	2006 2/
Consensus Forecasts 3/	3.2	3.5	4.0	3.7	3.4
Blue Chip Economic Indicators 4/	3.3	3.5	3.9	3.7	3.4
	Industrial Production				
Blue Chip Economic Indicators 4/	4.3	4.2	4.3	4.1	4.0

1/ Annualized quarterly change (seasonally adjusted series).
2/ Annual percentage change.
3/ *Consensus Forecasts* (December 6, 2004, and March 14 and April 11, 2005).
4/ Blue Chip Economic Indicators (December 10, 2004 and April 10, 2005).

Industrial production growth during the quarter (3.8 percent at an annual rate) remained above its historical average (annual average rate of 2.8 percent for the period 1972-2004). Industrial production has been mostly boosted by the demand for investment goods. In particular, the high-tech component has been growing at an annual rate of around 20 percent since July 2003. In this context, capacity utilization rose from a minimum of 74.4 percent at the end of 2001 to 79.4 percent in March 2005 (Graph 9). As for the production of final goods, capacity utilization was 76.6 percent in March of this year, close to its historical average (77.9 percent for 1972-2004).[9] Analysts surveyed by Blue Chip expect industrial production to increase by 4.1 percent in 2005.

9 During the period 1972-2004, the capacity utilization index for final products reached a minimum of 70.6 percent in May 2003 and a maximum of 83.6 percent in December 1978.

The recovery of the economy resulted in a strengthening of the labor market during the first quarter of 2005. The nonfarm payroll rose by 477 thousand jobs during that period. Nonetheless, the average rate of job creation from June 2003 (date on which the unemployment rate reached its recent peak) to March 2005 was only 141 thousand jobs per month. Such figure is modest as compared with previous periods of cyclical recovery. Although the unemployment rate fell from 6.3 to 5.2 percent during the mentioned period, this outcome was almost entirely attributed to a reduction in the participation rate (i.e., the percentage of the economically active population which are working or declaring themselves as available for work). Manufacturing employment, which has contracted significantly in recent years, fell once more during January-March.

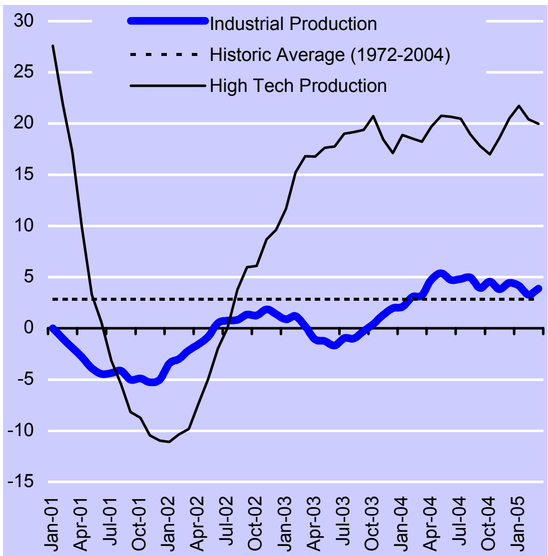
The continuous growth of the economy and the resulting increase in capacity utilization, among other factors, created concerns over a likely rebound in inflation. It has been pointed out that the decline in productivity growth rate was reflected towards the end of 2004 in higher unit labor costs, the main determinant of core CPI inflation in the U.S. In addition, the increase in prices of intermediate goods and materials could generate cost pressures, which could eventually be passed on to consumers. Risks regarding the increase in oil prices and, to a lesser extent, the cumulative depreciation of the US dollar since February 2002, also add to such concerns.

Nonetheless, the recent weakening of some indicators of economic activity seems to have diminished fears of a rebound in inflation. In this context, inflation has followed an upward trend, albeit remaining within a moderate range. The consumption deflator excluding food and energy, one of the indicators most frequently used by the Federal Reserve to measure inflationary pressures, recorded an annual growth rate of 1.6 percent in February 2005, 60 basis points above its recent minimum level (September 2003). Likewise, CPI inflation rose from 1.7 percent in March 2004 to 3.1 percent in March of this year, due mainly to the increase in energy prices (Graph 10). As for core CPI inflation, it has followed an upward trend since the beginning of last year, recording an annual rate of growth of 2.3 percent in March 2005, similar to the level of long-term inflation expectations (around 2.5 percent at an annual rate).

Graph 9 **U.S. Industrial Production and Capacity Utilization**

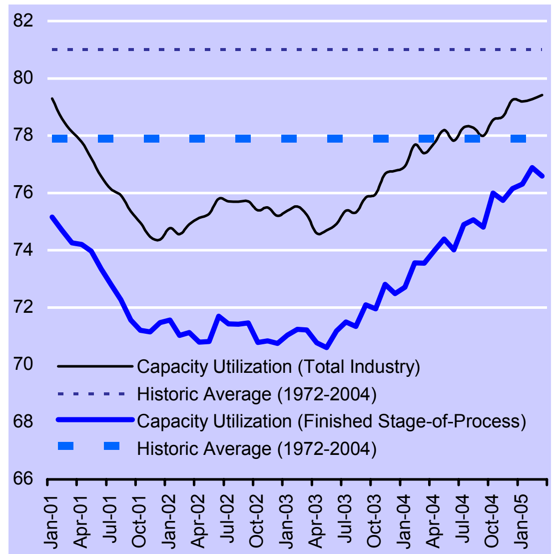
Annual percentage change and percent

a) Industrial Production



Source: Federal Reserve.

b) Capacity Utilization



Source: Federal Reserve.

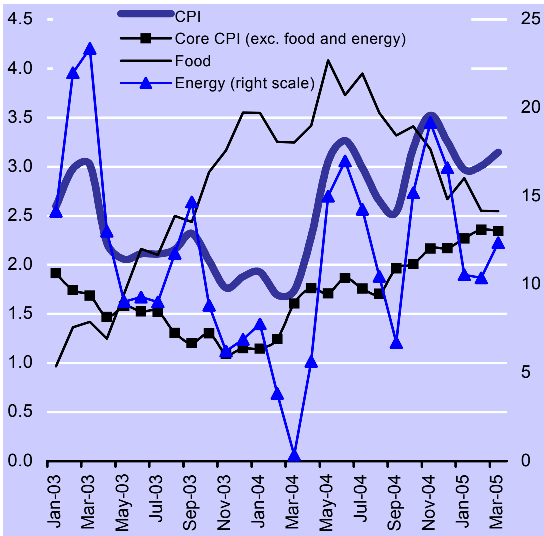
The Federal Reserve continued to reduce the monetary stimulus during the first months of 2005. In its meetings of February and March, the target for the federal funds rate was raised by 25 basis points on each occasion, up to a level of 2.75 percent. Since expectations for core CPI inflation remained contained, the Federal Open Market Committee (FOMC) continued to withdraw the monetary stimulus at a measured pace. In view of the current stage of the business cycle and the low level of the federal funds rate in real terms, short-term interest rates are expected to continue to increase throughout the year, while the Federal Reserve remains vigilant of inflationary pressures.[10]

[10] On April 22, 2005, the federal funds rate futures contract for December 2005 was 3.72 percent.

Graph 10 **U.S. Price Indexes**

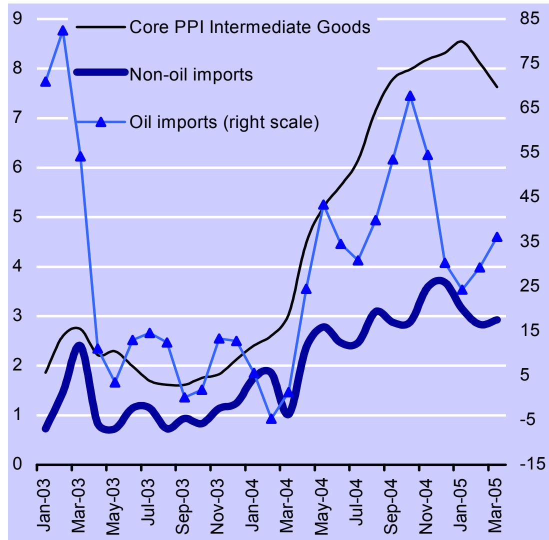
Annual percentage change

a) Consumer Prices



Source: BLS.

b) Producer and Imports Prices



Source: BLS.

Yields on 10-year U.S. Treasury bonds fluctuated around 4.2 percent from the end of the summer of 2004 to the beginning of February of this year, without being significantly affected by the increase in short-term interest rates. Nonetheless, after recording a minimum of 3.98 percent in mid-February, they began to follow an upward trend, reaching 4.48 percent at the end of March. Such rebound was partly influenced by comments of the Chairman of the Board of Governors of the Federal Reserve regarding the different path followed by short and long-term interest rates since June 2004. The perception of higher inflation risks by some analysts could also have affected investors' sentiment. The incipient increase in long-term interest rates was interrupted in mid-April by the release of data pointing to a weakening in expenditure and in manufacturing activity toward the end of the first quarter of the year.[11]

Developments in the stock markets during the first quarter were influenced by oil prices and U.S. interest rates. The Dow Jones and NASDAQ indexes fell 2.6 and 8.1 percent, respectively, with respect to the levels observed at the end of the previous year, shedding part of the gains recorded during 2004.[12] During the first months of 2005, the favorable outlook for growth in the U.S. and

[11] On April 22, 2005, the yield on 10-year Treasury bonds was 4.26 percent.

[12] In April, the stock market reached new lows for the year, against signals pointing to a stronger than expected slowdown of the economy. From the end of December 2004 to April 22, 2005 the Dow Jones and NASDAQ indexes fell 5.4 and 10.3 percent, respectively.

expectations regarding higher interest rate differentials with respect to other industrialized countries, among other factors, strengthened the value of the US dollar against the main currencies, despite the widening of the external deficit. From the end of 2004 to the end of the first quarter of 2005, the US dollar appreciated 2.9 percent in effective nominal terms against the main currencies. Nonetheless, at the end of March, the nominal effective US dollar exchange rate had depreciated 27.5 percent vis-à-vis such currencies as compared with its maximum level reached in February 2002.[13]

International organizations and private sector analysts continue to expect a slowdown in the U.S. economy in 2005 and 2006. GDP growth is expected to decrease from 4.4 percent in 2004 to 3.7 and 3.4 percent in 2005 and 2006, respectively (Table 4), while inflation expectations have remained relatively stable. Analysts expect an average CPI inflation of 2.6 and 2.4 percent during 2005 and 2006, respectively (2.7 percent in 2004).

Nonetheless, several risks prevail, including those derived from the current magnitude of imbalances in both the external sector and public finances. Likewise, there is some concern regarding the impact on inflation and, therefore, on interest rates of the growing pressures on resource utilization in the economy and of the recent surge in oil prices. Regarding external imbalances, the U.S. current account deficit has widened in recent years (mainly as a result of an increase in the fiscal deficit) and, after reaching record high levels in 2004, it is expected to continue to widen in 2005 and 2006. A sudden correction of the external deficit could give rise to problems for both international financial markets and the outlook for world growth. On the other hand, if such correction is postponed, future adjustments would entail higher costs. The challenges resulting from the high current account deficit appear to be even more demanding against the background of private sector analysts' concerns regarding the outlook for the fiscal deficit in that country, the weakness of economic activity of some of its main trading partners, and other countries' unwillingness to allow their exchange rates to reflect market conditions. It is clear that the U.S. current account deficit will remain high as long as the rest of the world is willing to accumulate assets in US dollars at the current interest rates.

[13] The US dollar remained relatively stable throughout April. On April 22, 2005, it depreciated 0.1 percent against the main currencies, compared with its level at the end of March.

II.2.1.3. Developments in the Rest of the World

After recording a rate of growth of 1.0 percent in the third quarter of 2004, the economy of the euro area grew 0.6 percent at an annualized quarterly rate in the fourth quarter of 2004. Although economic conditions differ among countries, the slowdown in regional economic activity was due mainly to the weakening of the external sector. Timely indicators of domestic demand, as well as the path of industrial production, suggest economic activity recovered slightly during the first quarter of 2005. Nonetheless, business confidence indicators interrupted their upward trend towards the end of the quarter. In addition, the recovery of the euro area faces a number of risks, among them those stemming from the appreciation of the exchange rate and higher oil prices, and from the fragile confidence among firms and consumers, especially in Germany. In this context, private sector analysts have adjusted downward their forecasts for economic growth in the region for 2005 to 1.5 percent (Table 5).[14]

After having contracted for two consecutive quarters (second and third quarters of 2004), the Japanese economy grew, albeit marginally (0.5 percent at an annualized quarterly rate), during October-December 2004. The household income and expenditure survey points to a strengthening of expenditure among households, and authorities consider that industrial production recovered during the first quarter. Thus, analysts expect the ensuing strengthening of economic activity to be reflected in the January-March figures). Nonetheless, the recent increase in the unemployment rate and falling wages could affect the expansion of expenditure. In addition, March's Tankan survey reveals a lesser optimism among firms. Consequently, GDP is expected to grow by only 1.0 percent in 2005.[15]

The Asian emerging economies grew vigorously during the last quarter of 2004.[16] In particular, China's GDP rose 9.5 percent at an annual rate during the period, a new rebound in economic activity despite the measures implemented to prevent an overheating of the economy. GDP growth was determined by the strengthening of exports and the expansion of investment. Most private sector analysts expect regional economic growth to slow down in 2005.[17] Nonetheless, available indicators for the first

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[14] Euro area GDP grew 2.1 percent in 2004.

[15] The Japanese economy grew 2.7 percent in 2004.

[16] Emerging Asian economies include Asian developing countries, Asian recently developed economies and Mongolia.

[17] The International Monetary Fund expects Asian emerging economies to grow 7.0 percent in 2005, while Asian Development Bank forecasts are 6.5 percent.

quarter of the year have still not reflected such an outcome. For example, Chinese GDP continued to grow above expectations (9.5 percent at an annual rate).

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

Annual and annualized quarterly percentage change

	Forecasts at the end of the fourth quarter		Most recent data Estimate		Forecast
	I-2005[1/]	2005[2/]	I-2005[1/]	2005[2/]	2006[2/]
Canada	2.4	3.0	1.2	2.6	2.9
Euro area	1.6	1.7	1.6	1.5	1.9
Japan	0.4	1.5	1.6	1.0	1.7
United Kingdom	2.0	2.5	2.0	2.5	2.3

1/ Annualized quarterly change (seasonally adjusted series).
2/ Annual percentage change.
Source: *Consensus Forecasts* December 6, 2004, and March 14 and April 11, 2005. Annualized quarterly rates are obtained from reported quarterly percentage change forecasts.

Latin American GDP growth in 2004 exceeded expectations as a result of a favorable external environment (reflected in an improvement in the terms of trade of several countries) and the rebound in domestic demand. In some cases, the latter responded to a recovery from crisis episodes. Thus, Latin America is expected to have grown by 5.7 percent during the year, the highest figure since 1980. Analysts anticipate GDP growth to slow down to 4.5 percent in 2005. In fact, the behavior of a number of economic indicators during the first months of the year suggests economic activity grew less vigorously in some countries. In Brazil, the annual growth rate of industrial production fell to 4.4 percent in February, far below that exhibited in mid-2004 (around 12 percent). Chile's monthly indicator of economic activity recorded in February an annual growth rate of 5.6 percent, below that observed in the second half of 2004. As for Argentina, the signs of a slowdown are less noticeable: the monthly indicator of economic activity grew in February at an annual rate of 8.6 percent. In some countries like Brazil and Argentina inflation expectations have increased above the target limits set by their respective central banks.

Emerging economies' access to external financing continued to be favorable during the first months of the year. Sovereign debt spreads for these countries (measured through the EMBI Global Index) fell to historically low levels (322 basis points) at the beginning of March. Nonetheless, since then, spreads have increased on both emerging market sovereign bonds and on U.S. corporate bonds of similar risk. This rebound appears to reflect both the uncertainty regarding the outlook for inflation in the U.S. -and the corresponding reaction of the Federal Reserve- and the credit rating downgrade of certain U.S. corporate issuers, which are leading to an increase in the perception of risk among investors and to a restructuring of investment portfolios. The increase in spreads has not affected emerging economies significantly, as many of them took advantage of the favorable conditions prevailing in 2004 to partially or fully pre-finance their external borrowing requirements for 2005. However, although the economic conditions of many of these countries have made them less vulnerable to increases in external interest rates, the possibility that a sudden increase in such rates could affect the conditions of access to international financial markets for some of these economies, especially those with the lowest credit rating, should not be discarded.[18]

II.2.2. Wages, Productivity and Employment

During the first quarter of 2005, wages and productivity in Mexico were characterized by the following:

a) Contractual wages increased, on average, the same as in the same period the previous year.

b) Unit labor costs (ULC) in maquiladora and non-maquiladora manufacturing industries, as well as in the retail sector, continued registering negative annual growth rates. In general terms, such result is attributed to productivity gains and reductions in real average earnings in the referred sectors.

II.2.2.1. Contractual Wages

During the period January-March 2005, contractual wages' average nominal increase negotiated by workers of companies under federal jurisdiction was 4.5 percent, equal to that negotiated in the same period of 2004. During the first quarter of the year, contractual wage increases in public and private enterprises were 3.6 percent and 4.7 percent, respectively (Table 6).

[18] A significant event during the quarter was the completion of Argentina's debt swap process at the end of February.

Table 6 **Contractual Wage Increases and Number of Workers Benefited by Type of Enterprise**

Percent

	2004					2005			
	Average[1/]					Average[1/]			
	I	II	III	IV	Jan-Dec	Jan	Feb	Mar	Jan-Dec
Contractual Wage Increase (percent)									
Total	4.5	4.5	4.3	3.4	4.1	4.3	4.5	4.6	4.5
Public Enterprises	3.9	3.9	4.0	3.0	3.5	3.4	3.3	4.0	3.6
Private Enterprises	4.6	4.6	4.7	4.3	4.6	4.6	4.7	4.7	4.7
Workers Benefited (percentage share)									
Total	100	100	100	100	100	100	100	100	100
Public Enterprises	20	21	48	72	42	20	10	24	19
Private Enterprises	80	79	52	28	58	80	90	76	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.

II.2.2.2. Earnings and Productivity

Between November 2004 and January 2005, unit labor costs in maquiladora and non-maquiladora industries, and in the retail sector, grew negatively at an annual rate. Such result is attributed to real average earnings' reductions and productivity gains in the three referred sectors (Table 7).

Unit labor costs in the non-maquiladora manufacturing industry fell at an annual rate of 5.6 percent during the period November 2004-January 2005 (Table 7 and Graph 11). Such result is attributed to an annual reduction in real average earnings (0.7 percent during the referred period) and, to a greater extent, to productivity gains. The latter indicator rose 5.2 percent on average during the period, due mainly to the vigorous growth of production in this sector (annual average growth rate of 4.1 percent during the referred months).

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

Original data, annual percentage change

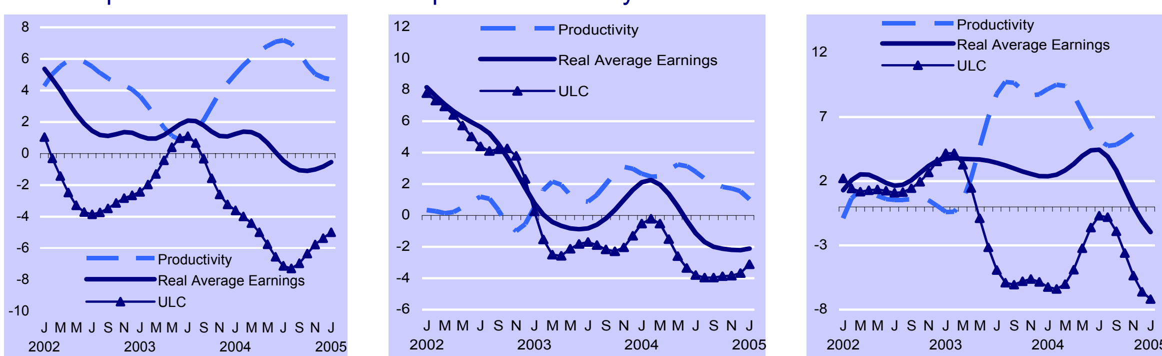
	Non-maquiladora Manufacturing Industry			Maquiladora Industry			Retail		
	Labor Productivity	Real Average Earnings	ULC	Labor Productivity	Real Average Earnings	ULC	Labor Productivity	Real Average Earnings	ULC
2004									
Jan	4.6	0.7	-3.7	1.2	2.3	1.2	7.7	-0.6	-7.7
Feb	6.0	1.7	-4.0	1.0	2.0	1.0	11.6	1.9	-8.7
Mar	10.1	1.7	-7.6	4.6	2.6	-2.0	9.7	2.0	-7.0
Apr	6.3	2.3	-3.8	4.6	1.6	-2.8	9.0	2.1	-6.3
May	4.8	-1.3	-5.8	4.0	0.2	-3.7	7.8	4.9	-2.7
Jun	8.7	0.5	-7.6	3.6	-0.1	-3.6	5.3	5.4	0.1
Jul	6.2	-1.0	-6.8	1.8	-1.7	-3.4	5.1	4.8	-0.3
Aug	7.5	-0.7	-7.7	1.1	-2.6	-3.7	3.7	12.0	7.9
Sep	6.7	1.0	-5.3	5.0	0.7	-4.1	7.2	-0.4	-7.1
Oct	2.5	-2.0	-4.4	-1.2	-3.1	-2.0	5.4	1.9	-3.3
Nov	7.1	-0.3	-6.9	-0.7	-4.1	-3.4	5.3	-1.2	-6.2
Dec	5.0	-1.3	-6.0	3.8	-0.3	-3.9	6.3	-0.6	-6.5
Jan-Dec	6.3	0.0	-5.8	2.4	-0.2	-2.6	6.9	2.6	-4.1
2005									
Jan	3.5	-0.5	-3.9	-1.1	-2.7	-1.6	6.1	-3.1	-8.7
Nov 2004-Jan 2005 */	5.2	-0.7	-5.6	0.6	-2.3	-3.0	5.9	-1.6	-7.1

*/ Latest quarter data available (between November 2004 and January 2005).
Source: Prepared by Banco de México with data from INEGI.

Graph 11 **Earnings, Labor productivity and ULC**

Trend, annual percentage change

Non-maquiladora / Maquiladora Industry / Retail



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

Unit labor costs in the maquiladora industry grew at an annual average growth rate of -3.0 percent during the period November 2004-January 2005. Such result is mainly attributed to a reduction in real average earnings of 2.3 percent, together with an increase in labor productivity of 0.6 percent (Table 7 and Graph 11). Labor productivity followed a downward trend, as a result of the recovery of employment in this sector.

Unit labor costs in the retail sector grew at an annual average growth rate of -7.1 percent during the period November 2004-January 2005. Such result is attributed, to a greater extent, to productivity gains, which grew at an annual average rate of 5.9

percent, and to a lesser extent, to a decline in real average earnings of 1.6 percent (Table 7 and Graph 11).

II.2.2.3. Employment

The expansion of economic activity observed during the first quarter of 2005 brought along an improvement in different labor market indicators. In general terms, the labor market was characterized by: a) an increase in formal employment (although such increase at an annual rate was mitigated in March by the effect of the Easter holiday); b) creation of more temporary than permanent jobs, especially in large enterprises; c) formal employment grew practically in all states, although more in the North region; d) the number of workers insured by the IMSS rose in most sectors; e) monthly surveys of manufacturing employment from INEGI show that maquiladora employment continued to recover significantly (1,143,644 workers in January 2005), although considerably below the historically high levels of 2000 (1,347,803 workers in October 2000); and, f) in the first two months of the year, the open unemployment rate in urban areas with original data increased as compared with the average level observed in the fourth quarter of 2004, while the seasonally adjusted open unemployment rate in urban areas exhibited a modest increase.

The number of workers insured by the IMSS was 12,612,825 at the end of March 2005, 103,399 above that recorded at the end of December of last year. Such increase is broken down into 17,883 workers insured in permanent positions, and 85,516 in temporary positions in urban areas. The fact that the number of workers insured in the second half of March fell (as a result of the Easter holiday) did not affect the above results. With seasonally adjusted data, the number of workers rose by 87,561 during the first quarter of 2005, as a net result of monthly increases in January and February, and a reduction in March.[19] The number of workers insured, with seasonally adjusted data, rose at a monthly rate in nineteen out of the last twenty months, thus translating into 467,334 new formal jobs. Thus, by the end of March, such indicator surpassed the level observed at the end of 2000 (Graph 12). At the end of March 2005, the number of workers insured by the IMSS rose by 293,010 as compared with same month of 2004. Such annual variation is below that observed at the end of

[19] It is difficult to seasonally adjust economic series when it comes to events such as the Easter holiday. In addition, such holiday took place in a different month than in 2004 and also coincided this year with the March 21 holiday.

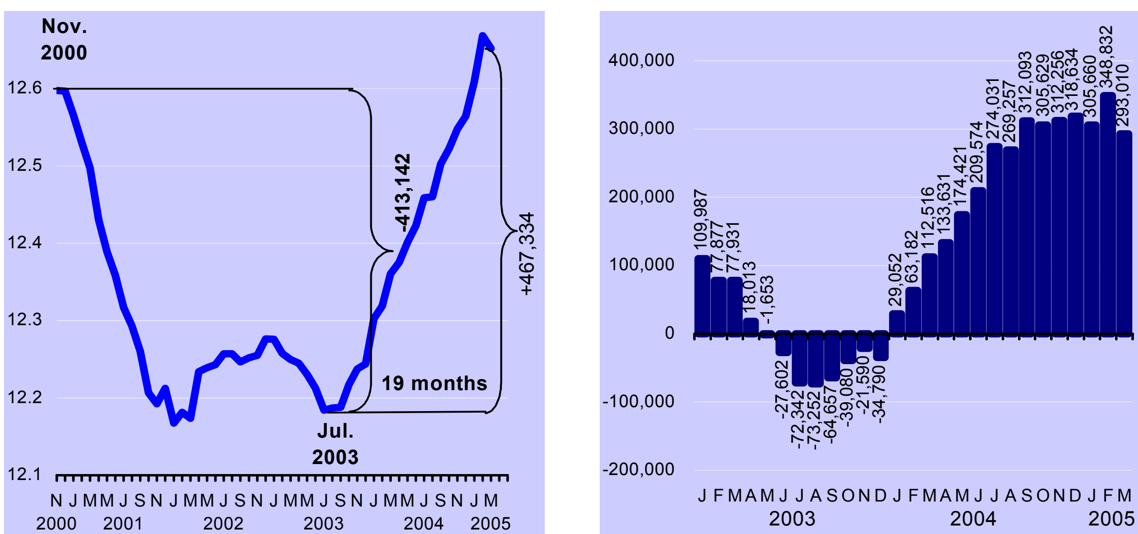
December 2004 (318,634 workers) [Graph 12], and, as previously mentioned, is attributed to the effect of the Easter holiday.

During the first quarter of 2005, formal employment creation included most states; however, it had a more significant impact in northern states (Graph 13).[20] Such result reflects, to a great extent, the favorable behavior of external demand, especially that from the U.S. During the first months of 2005, the recovery of formal employment continued to be more vigorous in larger companies (with 101 to 500 workers, and 501 or above); however, in the smallest ones (one to 15 workers), formal employment fell.

Graph 12 **Workers Insured by the IMSS: Permanent and Temporary in Urban Areas**

a) Million Workers Insured
Seasonally Adjusted Data

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



Source: IMSS. Seasonal adjustments by Banco de México.

Formal employment grew in most sectors. With seasonally adjusted data, formal employment grew in the retail sector (30,748 workers), in the construction sector (8,441 workers), in manufacturing (14,688 workers), and in many services.

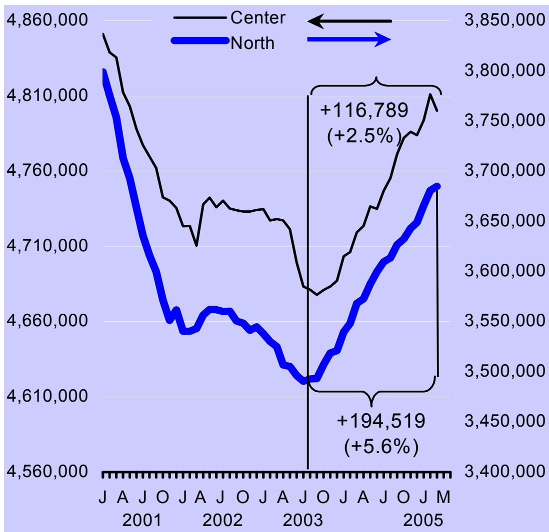
A significant characteristic of manufacturing employment in recent years has been its correlation with manufacturing employment in the U.S. (Graph 14). This is due to the close link between manufacturing production in Mexico and the U.S. Manufacturing employment contracted in both countries from 2001

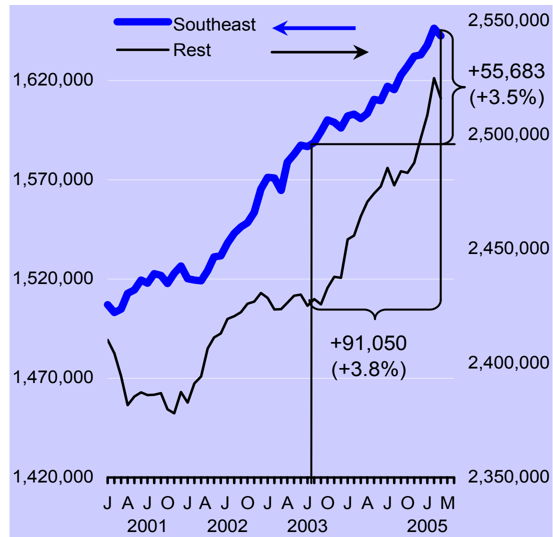
[20] Except for the states of Guanajuato, Campeche, Veracruz and Nayarit, were formal employment fell slightly during the quarter.

to 2003. Since 2004 such indicator has improved, albeit more significantly in Mexico.

Graph 13 **Formal Employment by Regions**[1]

Number of workers insured and seasonally adjusted figures



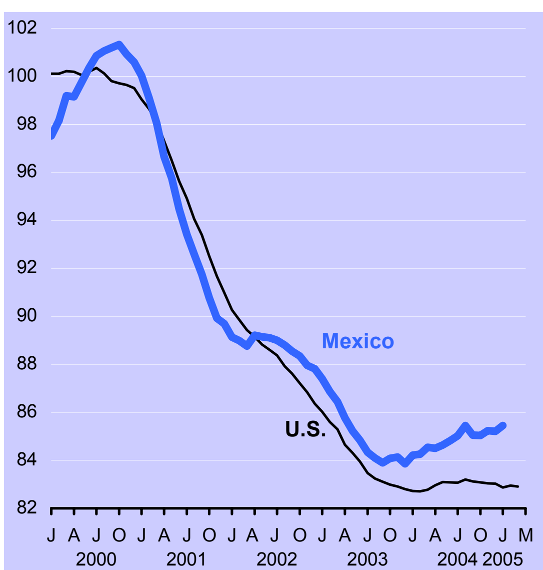


1 The Center region includes D.F., Guanajuato, Hidalgo, Estado de México, Morelos, Puebla, Querétaro and Tlaxcala; the North region includes Baja California, Baja California Sur, Coahuila, Chihuahua, Nuevo León, Sonora and Tamaulipas; the Southeast region includes Campeche, Chiapas, Guerrero, Oaxaca, Quintana Roo, Tabasco, Veracruz and Yucatán; Other regions include Aguascalientes, Colima, Durango, Jalisco, Michoacán, Nayarit, San Luis Potosí, Sinaloa and Zacatecas.

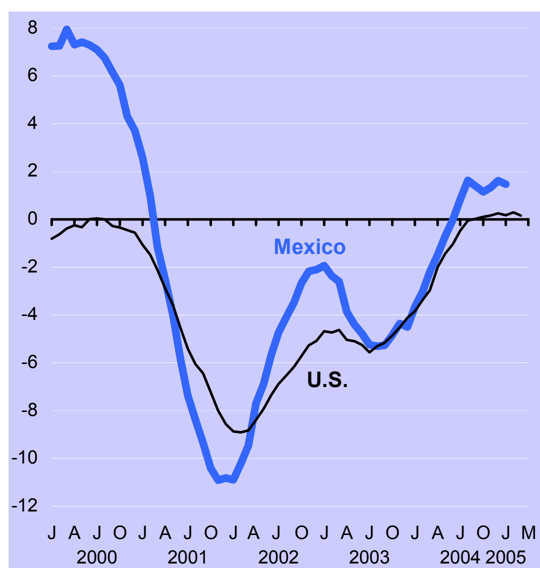
Source: IMSS. Seasonal adjustments and regional classification by Banco de México.

Graph 14 **Manufacturing Employment in Mexico and the U.S.**

a) Seasonally adjusted data 2000=100



b) Annual percentage change



Source: For Mexico: IMSS; seasonal adjustments by Banco de México. For the U.S.: Bureau of Labor Statistics, U.S. Department of Labor.

There are currently two monthly indicators of unemployment in Mexico. The first one includes the country's urban areas and is calculated with data from INEGI's Urban Employment Survey conducted in 32 cities. The second one measures the unemployment rate in the entire country (including both urban and rural areas), and is calculated with a new survey from INEGI called Occupation and Employment Survey (*Encuesta Nacional de Ocupación y Empleo, ENOE*), conducted since January of this year. Based on the abovementioned, during the first two months of 2005, the open unemployment rate in urban areas was 3.84 percent with original data and 3.79 percent with seasonally adjusted data. Considering the latter figure, such indicator rose compared with results from the fourth quarter of 2004 (3.69 percent). In the first two months of 2005, Mexico's new unemployment rate averaged 3.98 percent (there is no available information to make a comparison with 2004).

II.2.3. Aggregate Supply and Demand

During the first quarter of 2005, GDP grew significantly at an annual rate, although more moderately than in 2004 as a whole. Such result is attributed to all components of aggregate demand, both domestic and external. During such period, consumption expenditure grew significantly at an annual rate, while investment continued to expand (investment had already improved in the second half of 2004).

In general terms, economic activity benefited from favorable external conditions during the first quarter of 2005. In particular, external demand continued to grow, which was reflected in further annual increases in goods and services exports. Nonetheless, exports' growth rate slowed as compared with 2004, particularly in the second and third quarters of that year. Other factors also contributed to increase the availability of resources during the period in support of domestic expenditure. In particular, significant revenues from oil exports and workers' remittances were observed. Moreover, consumption and mortgage credit continued to grow considerably, and credit to enterprises began to recover. Overall, the above scenario contributed to maintain consumption expenditure vigorous and to raise investment.

Two additional aspects marked the performance of economic activity during the first quarter of 2005. First, the expansion of both aggregate demand and GDP raised imports of goods and services. The fact that domestic demand grew at an annual rate higher than GDP also fostered the increase in imports. Second, the recent behavior of the different components of aggregate demand and expectations of their performance throughout the present year suggest that domestic expenditure, rather than external demand, will be the main contributor to growth.

It will be difficult to evaluate economic figures for March and April 2005 accurately. This is due to the fact that in 2005 the Easter holiday (which reduces the number of working days) took place in March, while in 2004 it did so in April. Consequently, fewer working days were observed in the first quarter, which will lead to a significant reduction in the annual growth rate of economic activity indicators. On the contrary, opposite results are expected for the second quarter. Some indicators of production and expenditure recorded negative annual growth rates in March; consequently, in April, these are anticipated to be positive and relatively high.

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

a) The statistical effect of the Easter holiday on economic activity will affect GDP in the first quarter of the year by making it grow at a significantly slower annual rate than that exhibited in the previous quarter; however, opposite results are expected in the second quarter of 2005. Regarding available production indicators, the global indicator of economic activity (*Indicador Global de la Actividad Económica, IGAE*) grew at an annual rate of 3.7 percent during the first two months of the year, as a result of an expansion in its three components. The services sector recorded the highest growth (4.8 percent at an annual rate).

b) Domestic and external components of aggregate demand rose at an annual rate and are anticipated to have grown at higher rates than GDP. Nonetheless, the annual rates of these items will be below those observed in the previous quarter due to the effect of the Easter holiday.

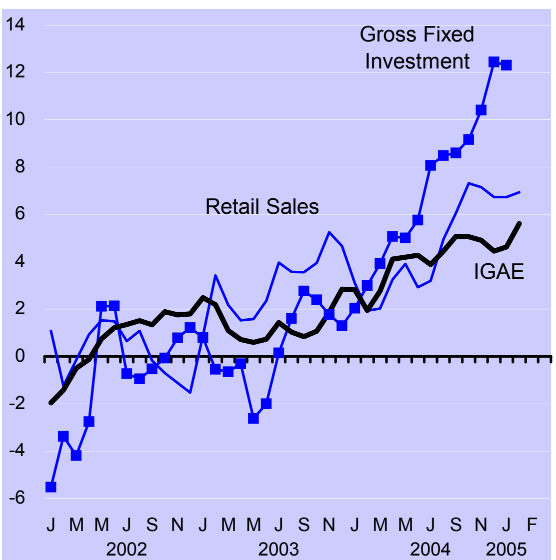
c) Private consumption growth was reflected in different sales' indicators: i) retail sales grew at an annual rate of 5.1 percent in the first months of the year; ii) ANTAD sales grew at an annual rate of 9.8 percent; and, iii) car retail sales grew at an annual rate of 2.2 percent (Graph 15a).

d) Just as in the second half of 2004, investment was the most dynamic component of domestic demand (Graph 15a). Investment grew at an annual rate of 10.2 percent in January (7.5 percent in 2004). All components contributed to such increase. During the first two months of the year, such indicator is expected to have grown approximately 8.6 percent. Imports of capital goods grew at an annual rate of 17.7 percent during the first quarter. Construction (which is included in investment expenditure) expanded 3 percent during the first two months of the year as a result of increased construction in housing and in public infrastructure. Nonetheless, construction's growth rate slowed from 5.2 percent in January to 0.7 percent in February.

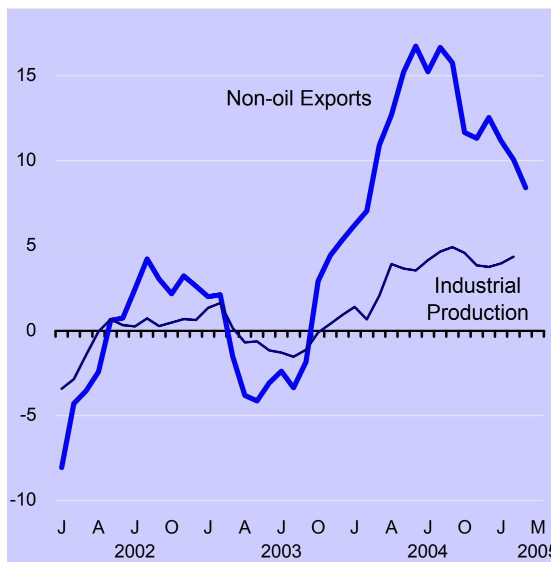
Graph 15 **Indicators of Aggregate Demand and Production**

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

a) Domestic Demand and Production



b) External Demand and Production



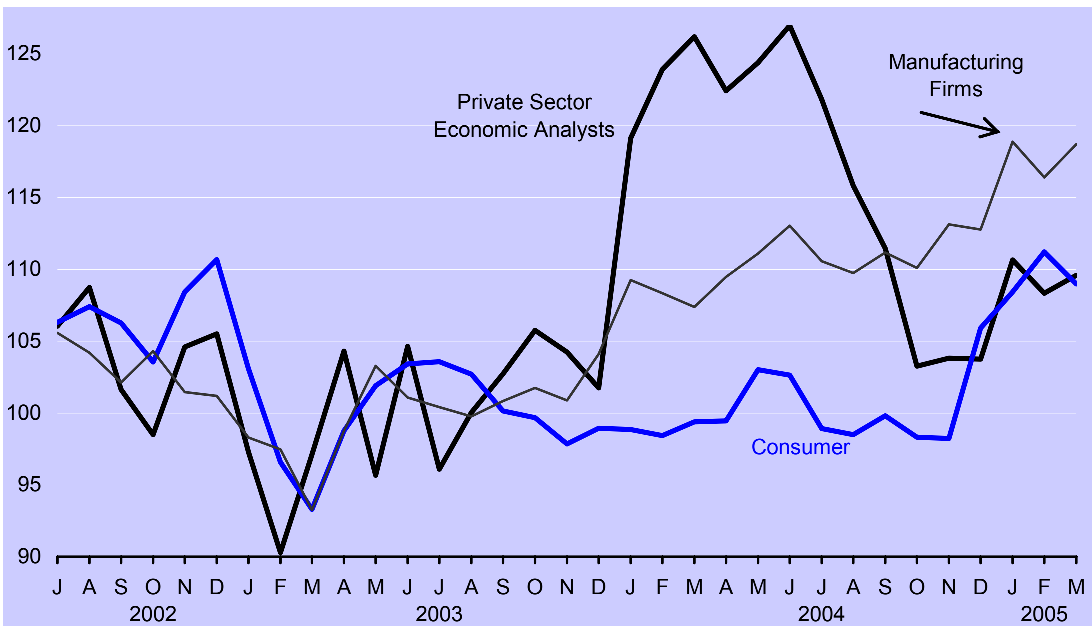
Source: a) INEGI and b) INEGI and Banco de México.

e) Industrial production continued to grow as a result of the expansion of its four sectors. Industrial and manufacturing production grew at an annual rate of 2.4 and 2.7 percent during January-February 2005, respectively. Nonetheless, both indicators are expected to have grown in March at significantly lower (even negative) rates than in the first two months the year due to the effect of the Easter holiday.

f) Mexico's three confidence indicators exhibited an improvement compared with their levels of the fourth quarter the previous year (Graph 16). The average level of private sector analysts' confidence index ended 5.7 percent above that of the fourth quarter of 2004. Business confidence and consumer confidence indexes also ended above previous quarter's levels (5.4 and 8.6 percent, respectively).

Graph 16 **Business Confidence and Business Climate Indicators**

Indexes 2003 = 100



Source: Banco de México and INEGI.

The significant recovery of investment expenditure in 2004, and especially in the second half of that year, has continued throughout 2005. In January, such indicator measured at constant prices and with seasonally adjusted data was above its historically high level of November 2000. Despite such improvement, in order to guarantee the sound and sustainable recovery of investment, progress must be done regarding structural changes, given that these raise investment profitability and open new opportunities for capital expenditure in different sectors. Moreover, they strengthen factor productivity and the country's competitiveness against other economies, both in domestic and external markets. In many of Banco de México's periodic surveys of the manufacturing sector and of foreign investment firms, and among economic analysts as well, such factor is constantly mentioned as the main obstacle to raise investment.

Summing up, the behavior of a wide range of indicators allows for estimating that annual GDP growth might have been close to 3 percent during the first quarter of 2005, a downward movement influenced the by the effect of the Easter holiday.[21] After adjusting for the referred statistical effect of the Easter holiday, annual GDP growth was close to 4 percent during the quarter.

Despite the significant expansion of aggregate demand in the first quarter of the year, available figures do not allow for identifying considerable inflation pressures. Nonetheless, Banco de México will continue to monitor carefully such pressures considering that, on the one hand, the economy is currently at the highest phase of its cycle, which implies that capacity utilization in many sectors has increased, and on the other, and just like in the fourth quarter of 2004, that domestic demand is expected to have grown at higher rate than GDP in the first quarter of 2005.

II.2.4. Balance of Payments and Capital Flows

During the first quarter of 2005, Mexico's external sector was characterized by the following: a) non-oil exports grew at a slower rate than in the second half of 2004; b) the value of oil exports rose significantly; c) imports grew at a slower rate than in the second half of 2004; this, in turn, was the result of a decline in the growth rate of intermediate good imports, while those of capital and consumer goods remained high; d) moderate trade and current account deficits, despite the significant expansion of domestic demand (such result partly responded to the seasonality of those balances, which implied a reduction in their deficits as compared with their levels observed in the last quarter of 2004); e) higher revenues from workers' remittances; f) a moderate capital account surplus; and, g) a small accumulation of international reserves.

Mexico's foreign trade during the first quarter of 2005 was influenced by the following: on the one hand, seasonal factors associated with the Easter holiday which this year took place in March; and, on the other, the slower growth rate of non-oil exports. The Easter holiday took place in March, while in 2004 it did so in April, therefore reducing the number of working days of the first quarter of 2005. Such factor prompted a reduction in the level of

[21] Latest official available information on GDP and aggregate demand and supply corresponds to the fourth quarter of 2004. In such period, exports of goods and services, private consumption, and gross capital formation grew significantly at an annual rate (10.3, 7 and 10.9 percent, respectively). The increase in gross capital formation resulted from the considerable expansion at an annual rate of both private investment (12.6 percent) and public investment (7.4 percent).

non-oil exports and merchandise imports during the quarter, and, consequently, in their annual growth rate.

Oil exports once more grew significantly at an annual rate during the quarter, mirroring the higher prices of crude oil. During the first quarter of 2005, the average price of Mexico's crude oil export mix was 34.26 US dollars per barrel, above its previous quarter's level (33.54 US dollars), and one of the highest historically observed. The reduction in merchandise imports' growth rates originated from intermediate goods' imports, as a result of a lesser dynamism of domestic production. Domestic production, in turn, was partly influenced by the slower growth rate of manufacturing exports.

Merchandise exports rose at an annual rate of 8.6 percent during the first quarter of the year, as a result of an increase in both oil and non-oil exports (28.5 and 6 percent, respectively). Among the latter, exports of manufactured products rose 5.6 percent. Merchandise imports grew 11.6 percent as compared with the same period of 2004. Such increase resulted from the annual growth exhibited by intermediate, capital, and consumption goods' purchases (8.4, 17.7 and 26 percent, respectively).

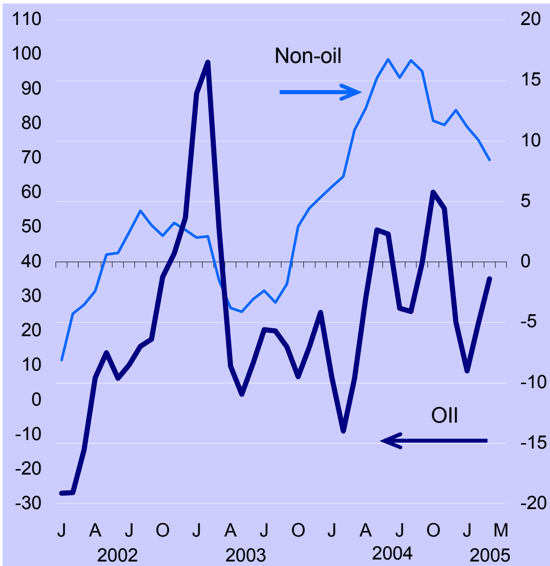
The slowdown of Mexico's foreign trade is clearly observed in seasonally adjusted data, which reveal that during the reference period non-oil exports grew at a slower annual rate than in the fourth quarter of 2004 (Graph 17). Such results are mainly attributed to the behavior of manufactured goods' exports during the period.

The trade deficit was 1.848 billion US dollars during the quarter, above that recorded in the same quarter of the previous year (498 million). As a result of the seasonal factors mentioned earlier, the trade deficit in the first quarter of the year was significantly below that observed in the last quarter of 2004 (4.907 billion).

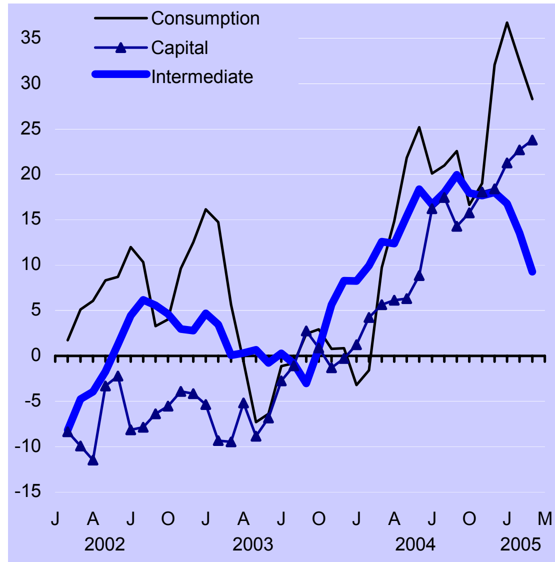
Graph 17 **Exports and Imports (Merchandise)**

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

a) Exports



b) Imports



Source: Banco de México.

During the first months of 2005, the share of Mexican exports in the U.S. market fell once more, as they grew at a slower rate than total exports from the other U.S. trading partners. Mexican exports grew 8.51 percent at an annual rate during the first two months of 2005, while those from the other U.S. trading partners did so by 18.92 percent (Table 8). Such result led to a reduction in the share of Mexican exports in U.S. imports, from 10.94 percent in the first two months of 2004 to 10.08 percent in the same period of 2005. Mexican automotive exports to the U.S. have not exhibited positive results in the last months. In the first two months of 2005, these contracted 1.59 percent at an annual rate. Mexican exports to the U.S., excluding oil and vehicles, increased 11.33 percent in the first two months of the year, below total exports from the rest of the U.S. trading partners (19.49 percent).

Table 8 **U.S. Imports**

Percent

	Share				Annual percentage changes: January-February 2005				
	2003	2004	Jan-Feb 2004	Jan-Feb 2005	Total	Oil	Total Excluding Oil	Automotive	Total Excluding Oil and Automotive
Total	**100.00**	**100.00**	**100.00**	**100.00**	**17.78**	**29.73**	**16.70**	**7.07**	**18.76**
Total excluding Mexico	**89.02**	**89.40**	**89.06**	**89.92**	**18.92**	**31.56**	**17.82**	**9.08**	**19.49**
Total excluding Mexico and China	**76.89**	**76.01**	**76.88**	**75.74**	**16.03**	**31.62**	**14.45**	**9.08**	**15.69**
1. Canada	17.63	17.41	18.21	17.77	14.91	17.69	14.70	12.38	15.60
2. China	12.13	13.38	12.18	14.18	37.16	9.51	37.20	--	37.20
3. Mexico	**10.98**	**10.60**	**10.94**	**10.08**	**8.51**	**18.60**	**7.31**	**-1.59**	**11.33**
4. Japan	9.39	8.82	9.31	8.63	9.19	--	9.19	3.47	12.77
5. Germany	5.42	5.26	5.32	5.07	12.19	--	12.19	1.87	17.81
6. United Kingdom	3.40	3.16	3.24	2.95	7.57	--	-0.94	18.59	-3.71
7. South Korea	2.96	3.14	3.09	3.07	17.05	--	17.05	21.15	15.39
8. Taiwan	2.51	2.36	2.36	2.25	12.05	--	12.05	19.34	11.68
9. France	2.32	2.16	2.17	2.11	14.57	--	14.57	--	14.57
10. Malaysia	2.02	1.92	1.92	1.81	10.64	294.65	9.68	--	9.68
Total 10 countries	68.77	68.21	68.73	67.91	16.37	29.92	15.87	6.71	18.46

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

Mexico received a significant amount of money in the first two months of 2005 via workers' remittances. This inflow totaled 2.533 billion US dollars, an annual growth rate of 25.2 percent (7.7 million transactions for an average value of 327 US dollars/each). Such figure equals 72 percent of the value of crude oil exports, and 81 percent of the maquiladora trade surplus.

Overall, the recent development of the external sector and available timely data allow for estimating that the current account deficit might have been around 2.6 billion US dollars in the first quarter of the year, above that of the same period of 2004. Nonetheless, three factors must be taken into consideration: i) the positive balance of the oil trade balance rose significantly from the first quarter of 2004 to the same period of 2005; ii) workers' remittances increased considerably during the referred period; and, iii) the fact that the Easter holiday took place in the first quarter of 2005 contributed to reduce the current account deficit. If these three factors had not occurred, the current account deficit would have widened significantly during the period, in line with the higher growth of domestic expenditure as compared with GDP.

Finally, the capital account of the balance of payments including errors and omissions is expected to have been around 2.9 billion US dollars during the first quarter of 2005. Such revenues came mainly from foreign direct and portfolio investment, being the latter mostly destined to the money market. International reserves rose slightly by 242 million US dollars during the quarter.

III. Monetary Policy

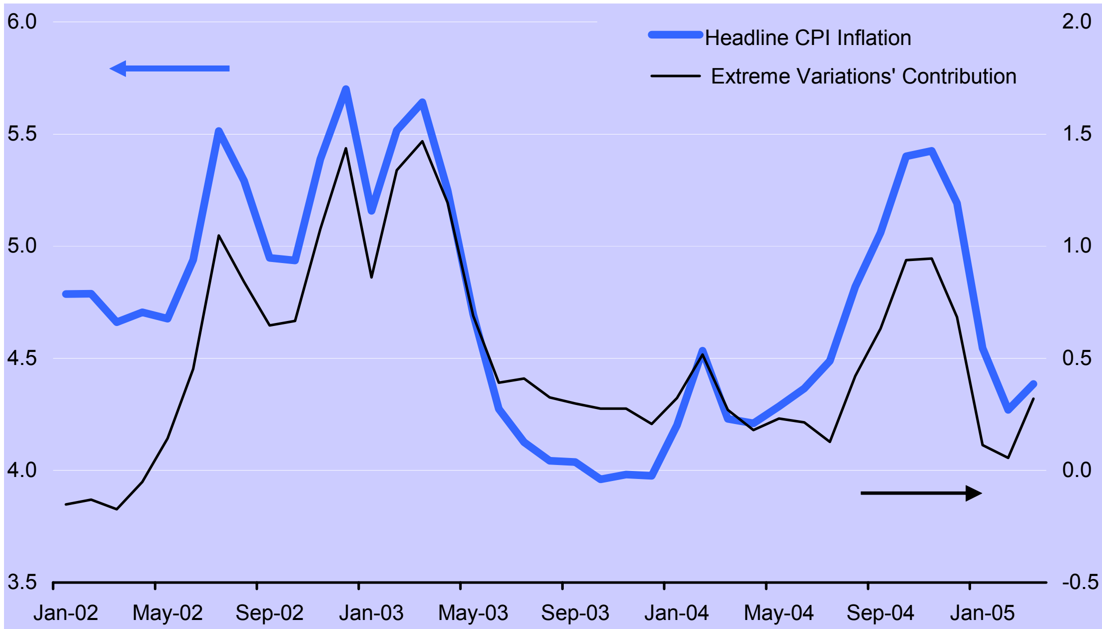
III.1. Monetary Policy Actions

Several supply shocks created considerable upward pressures on different CPI subindexes during 2004. Although these types of shocks usually do not affect prices in a widespread manner (in most cases they reflect adjustments in relative prices), the monetary authority must assure that shocks do not induce further increases in prices and wages. Such consideration gains relevance in economies like Mexico where economic agents have not fully incorporated the long-term inflation target in the price formation process.

Given the number and intensity of supply shocks observed in 2004, medium-term inflation expectations rose significantly. Accordingly, and taking into consideration the aforementioned factors, the Board of Governors of Banco de México tightened its monetary policy stance throughout 2004 and during the first quarter of 2005.

As expected, during the first quarter of 2005, inflation pressures associated with the increase in some international commodity prices began to dissipate. Also, supply conditions of certain agriculture products which had been affected by adverse weather conditions normalized. All of the above led to a reduction in annual headline CPI inflation, from 5.43 percent in November 2004 to 4.39 percent in March of this year (Graph 18). Consequently, expectations for headline CPI inflation for 2005 and 2006 were revised downward since January (Graph 19).

Graph 18 **Contribution of Items' Prices Extreme Variations (Maximum and Minimum) to Headline CPI Inflation***



* The contribution of extreme variations in the prices of some CPI items to headline CPI inflation is calculated as follows: i) seasonally adjusted monthly variations of CPI items are ordered from maximum to minimum according to the contribution of each variation to CPI's variation; ii) the 10 percent maximum and 10 percent minimum are selected; and iii) the contributions of the aforementioned extreme variations to headline CPI inflation are accumulated. The contribution of extreme variations is a useful indicator for identifying if the movement of headline CPI inflation is originated by the change in a reduced number of CPI items (which occurs when the contribution of extreme variations has a similar behavior to that of headline CPI inflation).

Nonetheless, the following deserves mention:

a) Core inflation and its expectations still remain high with respect to the 3 percent inflation target.

b) Core services inflation excluding housing has rebounded as a result of food and energy price increases that took place in the previous months.

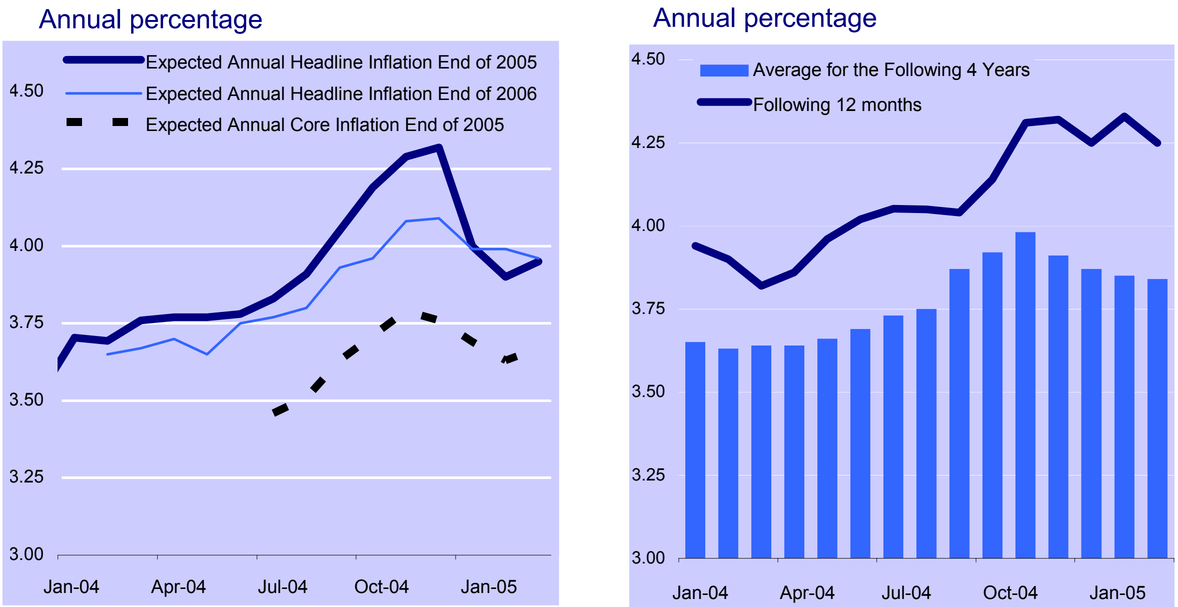
c) International energy prices and their volatility (both in spot and futures markets) have rebounded recently.

d) Despite the fact that available information does not point toward considerable demand-side inflation pressures, the risk that these could materialize as the economy transits through the high phase of its cycle could increase.

Graph 19 Inflation Expectations: Banco de México's Survey

a) Inflation expectations for the end of 2005 and for 2006

b) Inflation expectations for the following 12 months and average for 2005-2008



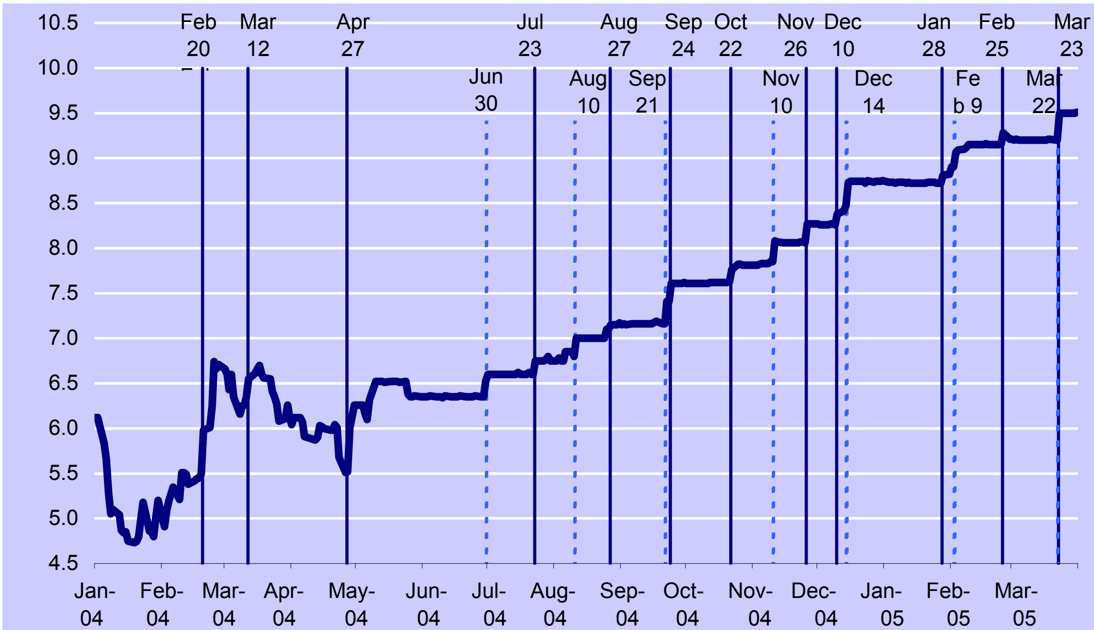
Considering the above, during the first quarter of 2005, the Board of Governors of Banco de México continued to tighten its monetary policy stance, mainly through two channels:

a) By increasing the *corto* (short position) on three occasions: on January 28, from 69 to 75 million pesos; on February 25, to 77 million pesos; and, on March 23, to 79 million pesos.

b) As stated in the press releases on monetary policy, the Board of Governors continued to point out that, until deemed necessary, domestic monetary conditions should at least reflect the greater monetary astringency observed in the United States.

As a result of such actions, short-term interest rates continued to increase. The daily bank funding rate rose from 8.75 percent on December 31, 2004 to 9.51 percent at the end of March, increasing 76 basis points during the quarter (Graph 20).

Graph 20 **Banks' Funding Rates, Change in the *Corto*, and Change in the U.S. Federal Funds Rate ***

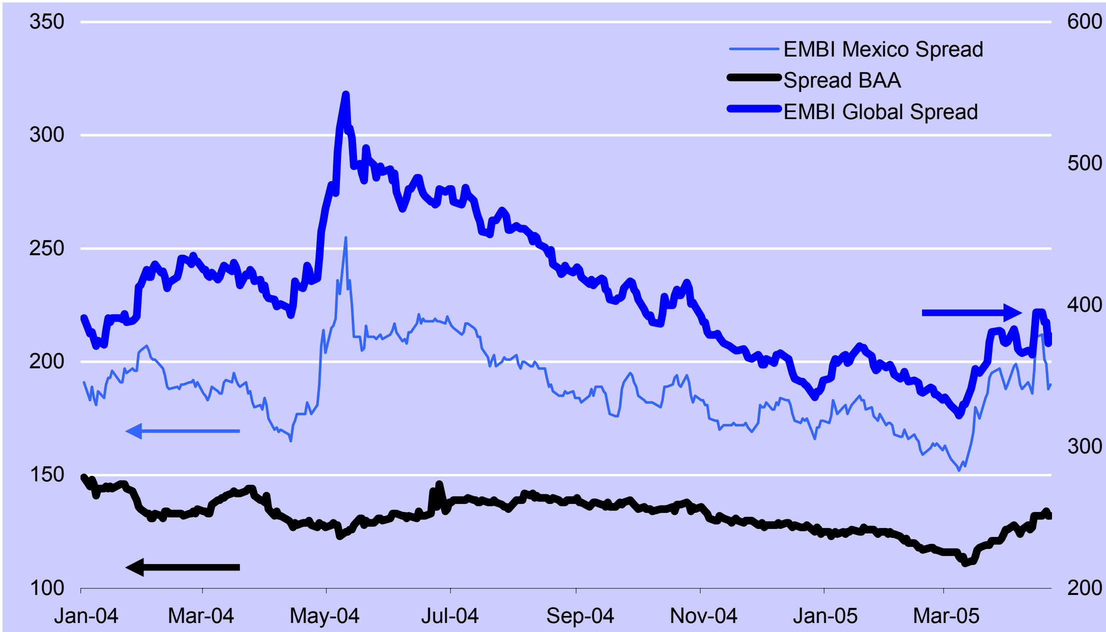


* Continuous vertical lines indicate changes in the *corto*. Dotted lines indicate changes in the U.S. federal funds rate.

In general terms, international financial market conditions continued to be relatively favorable during the first months of the year. Nonetheless, by the end of the first quarter financial conditions became more astringent, as a result of what is perceived to be an increase in risk aversion of investors.

The reduction in appetite for risk was mainly associated with two elements: on the one hand, the publication of certain economic indicators in the U.S. created, at the margin, greater uncertainty regarding the outlook for inflation in that country; and, on the other, the credit rating downgrade of certain U.S. corporate issuers which is leading to a restructuring in investment portfolios towards lower risk assets. The combination of these elements led to an increase in the spreads of emerging markets' sovereign bonds and U.S. corporate bonds of similar risk (Graph 21 and Box 1).

Graph 21 **Sovereign Risk and Corporate Debt Indicators**

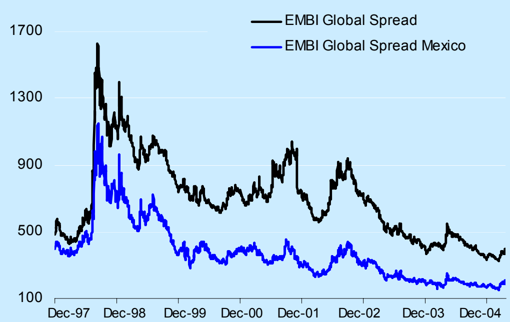


As expected, such situation prompted an increase in Mexico's yield curve, particularly for longer-term interest rates (Graph 22). The adjustment in the money market –which responded to greater uncertainty and risk aversion- had, as a starting point, a relatively flat yield curve. In February, for example, the average spread between the 1-day bank funding rate and the 20-year government bond was 88 basis points. At the end of March, such spread reached 135 basis points, i.e. the yield curve has steepened. Technical factors such as the reduced liquidity in long-term debt instruments that usually prevails in periods of greater uncertainty, and episodes when domestic risk perception has increased, have also contributed to such behavior.

Box 1
Financial Conditions for Emerging Economies

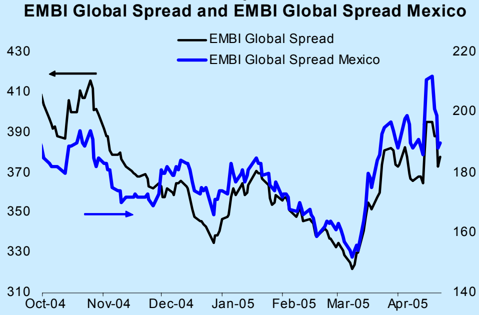
In recent years, emerging economies have faced favorable external financing conditions. Several factors have contributed to such results: a global environment of ample liquidity, which increased investors' risk appetite; and an improvement in macroeconomic conditions of most of these economies, which led to an upgrade in their credit ratings by different agencies. Consequently, sovereign risk premia of many of these economies fell significantly, reaching historically low levels in the recent past (Graph 1). Nonetheless, in the last weeks, the downward trend exhibited by such premia has reverted, although it still remains at relatively low levels.

Graph 1
EMBI Global Spread and EMBI Global Spread Mexico



The increase in emerging markets' yields since March 2005 (Graph 2) has been driven by several factors. First, the slack prevailing in international financial markets has narrowed. Second, uncertainty regarding the future path of U.S. interest rates has increased in the last weeks. This has partly responded to the high fiscal and trade imbalances observed, and to recent information regarding possible inflation pressures in that country. Third, the credit rating of certain U.S. corporate issuers has deteriorated.

Graph 2
EMBI Global Spread and EMBI Global Spread Mexico

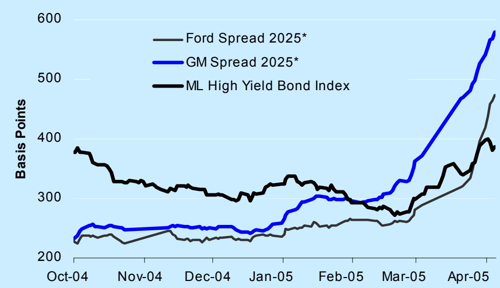


Regarding the aforementioned third factor, two significant cases of U.S. corporate issuers deserve mention: Ford Motor Company (Ford) and General Motors (GM). The financial position of both companies has deteriorated, due to a rigid and high cost structure (liabilities associated with social security services for their employees and pensioners), and to a loss of market share in the U.S. The latter has been exacerbated by the increase of gasoline prices, which, in turn, has translated into a lower demand for their most important products (high fuel consumption vehicles). In addition, steel prices have also affected their production costs significantly.

On March 16, 2005 Standard and Poor's and Fitch assigned a negative outlook for GM. Additionally, Fitch downgraded its debt rating from BBB to BBB-. Moody's did a similar adjustment on April 5, 2005 (from Baa2 to Baa3 with a negative outlook). On April 19, 2005 GM announced losses of 1.1 billion US dollars for the first quarter of 2005, its worst result of the first quarter of the year since 1992. On April 20, 2005 Ford announced a profit reduction of 38 percent for the first quarter of the year. In addition, the combined debt of both companies surpassed 450 billion US dollars, with maturities concentrating between 2005 and 2007 (in each company, approximately 50 percent of their total debt).

Consequently, different credit rating agencies such as Moody's, Standard & Poor's and Fitch downgraded their credit ratings for these companies to levels just above "investment grade". In tandem, bond yields of such companies have increased significantly (Graph 3) while the value of their stocks has plunged (in both cases, nearly 36 percent between January 1 and April 20, 2005).

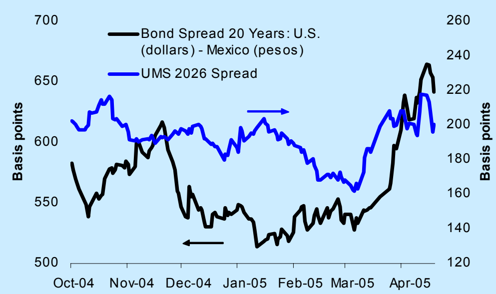
Graph 3
Ford and GM Bond Spreads and Merril Lynch High Yield Bond Index



*15-day moving average.

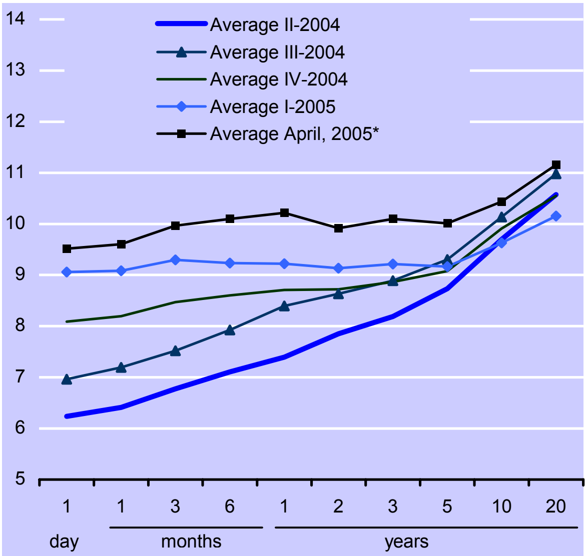
The deterioration of U.S. corporate issuers' credit position has led to an increase in the overall supply of riskier bonds; consequently, the spreads observed usually in riskier instruments have widened. This has been reflected in higher yields for emerging markets' sovereign bonds, such as those of Mexico (Graph 4). Such factors have also affected longer-term instruments in the domestic market.

Graph 4
Sovereign Interest Rate Spreads Between Mexico and the U.S.

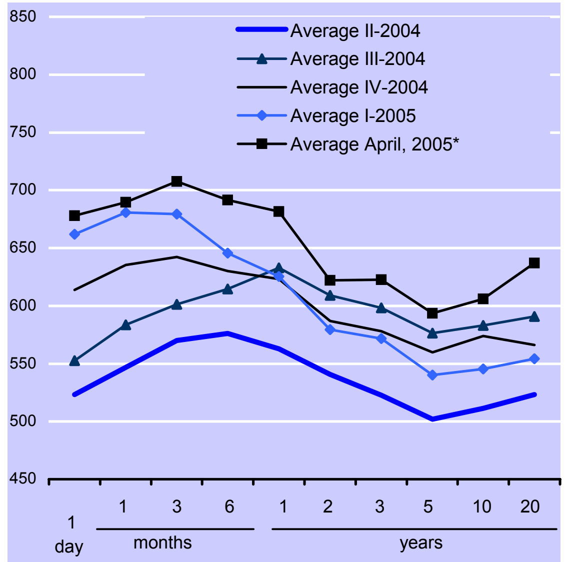


Graph 22 **Yield Curve in Mexico and Interest Rate Differential Between Mexico and the U.S.**

a) Yield Curve in Mexico
Annual percent



b) Yield Spread Between Mexico and the U.S.
Basis points



* Up to April 22, 2005.

One of the main objectives of Banco de México's monetary restriction during 2004 and in the first quarter of 2005 has been to contain any upward revisions in inflation expectations and to prevent them from contaminating wage settlements. Up to now, monetary policy has been effective in reducing inflation risk premia, which are usually discounted from fixed income instruments. In this regard, less uncertainty associated with the future development of inflation leaves domestic financial markets in better shape to cope with a more volatile environment. Nonetheless, it is important to point out that inflation expectations for the medium and long terms continue to be at levels above the inflation target.

III.2. Monetary and Credit Aggregates

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

The monetary base grew at an annual rate of 14.8 percent during the first quarter of 2005, above that of the previous quarter (14.5 percent).[22] The slight increase in the monetary base was due

[22] Changes calculated based on the average of daily stocks.

to the higher demand for money associated with the Easter holiday, which, in this year, fell in March as compared with 2004, when it fell in April (excluding such effect, the monetary base grew at an annual rate of approximately 13.6 percent during the quarter).

According to its seasonal behavior, the monetary base exhibited a reduction of 28.3 thousand million pesos during the first quarter of 2005. On March 31, 2005, international assets were 64.1 billion US dollars, a 0.1 billion reduction during the quarter. Consequently, Banco de México's net domestic credit fell by 27.6 thousand million pesos.

Table 9 **Monetary Base, Net International Assets and Net Domestic Credit**

Millions

	Stocks		Flows in 2005
	At Dec. 31, 2004	At March 31, 2005	Accumulated at March 31,2005
(A) Monetary Base (Pesos)	340,178	311,856	-28,322
(B) Net International Assets (Pesos) 1/ 2/	716,170	717,037	-721
Net International Assets (US dollars) 2/	64,233	64,145	-88
(C) Net Domestic Credit (Pesos) [(A)-(B)] 1/	-375,992	-405,181	-27,601
(D) International Reserves (US dollars) [(E)-(F)] 3/	61,496	61,739	242
(E) Gross Reserves (US dollars)	64,198	64,110	-87
PEMEX			2,497
Federal Government			-1,087
Sale of US dollars to Banks 4/			-1,380
Other 5/			-117
(F) Liabilities with less than six months to maturity (US dollars)	2,701	2,372	-330

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 slow the pace of international reserve accumulation (see Exchange Commission's Press Release of March 20, 2003).
5/ Includes yields on net international assets and other transactions.

International reserves rose by 242 million US dollars during the first three months of 2005. Such result came from a 87 million US dollar reduction in gross reserves, which was more than compensated by a decrease in Banco de México's liabilities with less than six months to maturity of 330 million US dollars.[23] The decline in gross reserves was mainly due to the net effect of the following: a) PEMEX sale of US dollars to Banco de México of 2.497 billion US dollars; b) the sale of US dollars through the mechanism to reduce international reserve accumulation (1.380

[23] International reserves equal gross reserves minus liabilities with less than six months to maturity.

billion); and, c) federal government's purchasing of 1.087 billion US dollars to service its external liabilities.

III.2.2. Monetary Aggregates and Financing

Domestic financial savings have increased significantly and also changed their allocation in the last years. In particular, the reduction in both public sector borrowing requirements and in Banco de México's international reserves has increased the availability of resources of domestic financing to the private sector (Table 10).

The increase in domestic financial savings (M4) was above 6 percent of GDP in 2004. Such aggregate grew at a real annual rate of 9.1 percent in February 2005. Non-residents' savings in long-term fixed rate government bonds have gained significance recently within such aggregate.[24] The Retirement Savings' System (*Sistema de Ahorro para el Retiro, SAR*) has also consolidated as a stable source of financial resources.

As for financial resources' uses, public sector borrowing requirements and international reserve accumulation have decreased. Such result is due to the significant oil revenues received by the federal government in the last years and to the mechanism adopted by the Exchange Commission to slow the pace of international reserve accumulation. As a result, additional domestic resources accounting for nearly 1.6 percent of GDP in 2004 were available for the private sector. The private sector has reduced its external borrowings due to the greater availability of domestic resources. Such condition places firms in a better financial position to face external shocks.

[24] In February 2005, non-residents' savings in domestic financial instruments totaled 108.2 thousand million pesos (88.4 thousand million pesos in long-term fixed rate bonds) and grew at a real annual rate of 87 percent.

Table 10 **Total Financial Resources (Uses and Sources)**

Flows revalued as a percentage of GDP

	2002	2003	2004
M4	**4.5**	**5.6**	**6.5**
Residents	**4.6**	**5.5**	**5.8**
SAR	1.6	1.8	1.6
SIEFORES	1.2	1.1	1.0
Other funds	0.4	0.7	0.6
Other	3.0	3.7	4.2
Non-residents	**-0.1**	**0.1**	**0.7**
Net External Financing	**0.3**	**0.5**	**-0.2**
Government 1/	**0.1**	**0.5**	**0.7**
Commercial banks 2/	**0.5**	**0.5**	**-0.6**
Private sector 3/	**-0.4**	**-0.5**	**-0.3**
Total Sources	**4.8**	**6.1**	**6.3**
International Reserves 4/	**1.1**	**1.5**	**0.6**
Public Sector(PSBR) 5/	**2.2**	**2.6**	**1.9**
Domestic	2.1	2.1	1.2
External	0.1	0.5	0.7
States and Municipalities	**0.2**	**0.3**	**0.6**
Private Sector	**1.8**	**0.7**	**2.5**
Domestic	2.2	1.2	2.8
Credit granted by financial intermediaries 6/	1.1	-0.1	1.8
Debt issues	0.5	0.6	0.4
Housing Funds (SAR) 7/	0.6	0.6	0.6
External 3/	-0.4	-0.5	-0.3
Other	**-0.5**	**1.0**	**0.7**
Total Uses	**4.8**	**6.1**	**6.3**
Memo: Financing to the Public Sector and International Reserves 8/	**3.5**	**4.4**	**3.1**

1/ Includes net external indebtedness from the federal government, public enterprises and institutions, and external PIDIREGAS. Includes external assets as reported in memoranda accounts.
2/ Commercial banks' net external liabilities excluding external assets. Excludes non-residents' bank deposits and external credits associated with PIDIREGAS.
3/ Includes loans and securities issued abroad by the private sector.
4/ Accumulated effective cash flows of international reserves as defined by Banco de México's Law.
5/ Public Sector Borrowing Requirements (PSBR) including non-recurrent revenues, as reported by Banco de México. PSBR definition is not affected by the exchange of promissory notes from the Portfolio Capitalization and Purchase Program (*Programa de Capitalización y Compra de Cartera, PCCC*).
6/ Includes direct portfolio from financial intermediaries. Does not include debt-restructuring programs.
7/ National Employees' Housing Fund (*Instituto Nacional del Fondo de Vivienda para los Trabajadores, INFONAVIT)*, and the Housing Operation and Banking Fund (*Fondo de la Vivienda del ISSSTE, FOVISSSTE*).
8/ PSBR including non-recurrent revenues, financing to states and municipalities, and international reserves.

All components of bank financing have increased in the last quarters (Graph 23).[25] Commercial banks' credit for consumption has continued to grow vigorously, up to 43.7 percent at a real annual rate in February 2005. Such increase, together with resources granted by non-bank financial intermediaries, commercial stores and workers' remittances have contributed to the significant expansion of consumption. Mortgage credit granted by commercial banks (real annual change of 29.9 percent in February 2005), special-purpose financial companies (*Sociedades*

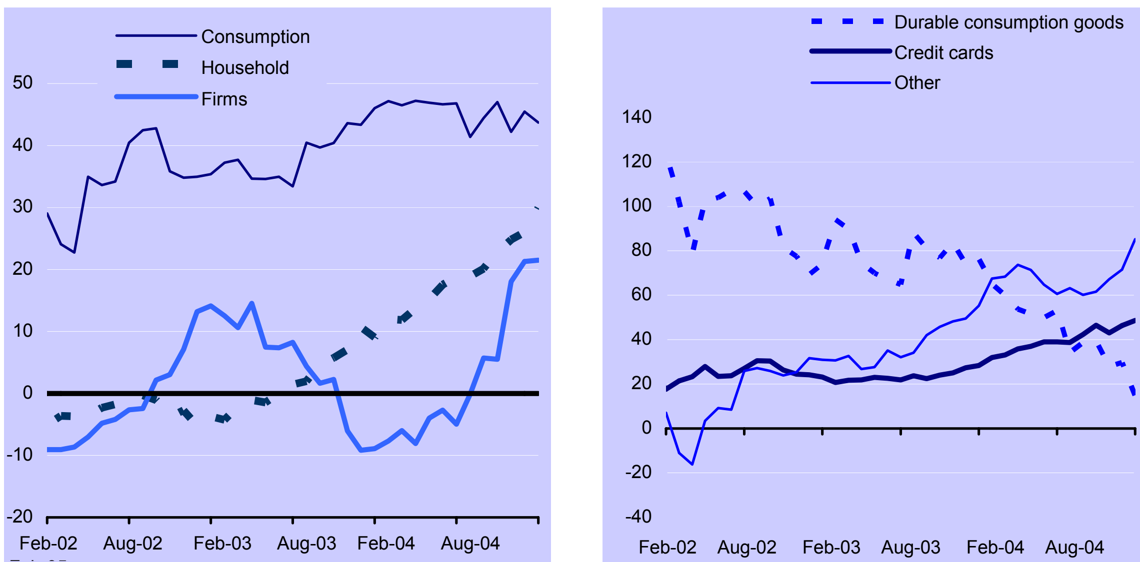
[25] Figures correspond to performing direct credit portfolio.

Financieras de Objeto Limitado, SOFOLES), and by the National Employees' Housing Fund (*Instituto Nacional del Fondo de Vivienda para los Trabajadores, INFONAVIT*) has significantly contributed to the expansion of the construction sector. Finally, bank credit to firms has recovered recently, growing at a real annual rate of 21.5 percent at the end of the first two months of 2005.

Graph 23 **Commercial Bank Credit Granted to the Non-bank Private Sector**

a) Direct Performing Credit[1/]
Real annual percentage change

b) Consumption Credit[2/]
Real annual percentage change



1/ Does not include portfolio associated with debt-restructuring programs.
2/ Total performing credit to consumption. The item "other" includes personal and payroll credits.

Commercial banks' credit to the private sector continues to expand (direct performing credit grew at a real annual rate of 29.8 percent in February 2005). Direct financing currently represents only around 9 percent of GDP, while in 1994 it accounted for 42.9 percent. After a long process of bank disintermediation, households and firms' access to financing has gradually recovered, which leads to believe that bank lending to the private sector could continue to expand.

IV. Private Sector Outlook for 2005-2006[26]

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

During the first quarter of 2005, the most significant aspects of private sector expectations for the main macroeconomic variables were: a) reduction in expected inflation for 2005 and 2006; b) upward revision in expected growth rate for 2005; and, c) improvement in business confidence and business climate indicators.

In the survey conducted in March, private sector economic analysts' forecasts were as follows: i) GDP is expected to grow 3.88 percent in 2005 (in the survey conducted in December 2004 estimates were 3.74 percent) [Table 11], and 3.64 percent in 2006; ii) in 2005 and 2006, 403 and 432 thousand jobs, respectively, are expected to be created in the formal sector; iii) expectations regarding interest rates for the next months were revised upward as compared with those forecasted in December; and iv) the expected level of the peso exchange rate for the following months and for the end of 2005 was adjusted slightly downward.

Analysts surveyed in the first quarter of 2005 continued to emphasize the need to advance in the implementation of pending structural reforms, as these would foster higher growth. Political uncertainty was mentioned as a second factor limiting economic growth and investment during the next months.

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

Table 11 **Private Sector Expectations: December 2004 and March 2005[1/]**

	December 2004	March 2005		December 2004	March 2005
Real GDP Growth in Mexico			**Exchange Rate (Pesos/US dollar, year-end)**		
2005	3.74%	3.88%	2005 (Banxico Survey)	11.86	11.68
2006	3.83%	3.64%	Futures [4/]	11.80	11.69
Trade Deficit (Million US dollars)			2006 (Banxico Survey)	12.25	12.04
2005	8,526	12,239	**Mexican Crude Oil Mix (Average US dollars per barrel)**		
Current Account Deficit (Million US dollars)			2005 (Banxico Survey)	27.58	30.93
2005	12,314	13,944	**Wage Increases**		
2006	n.a.	16,247	For April 2005	n.a.	4.51%
Foreign Direct Investment (Million US dollars)			For May 2005	n.a.	4.46%
2005	13,852	13,750	**Business Climate Index**		
2006	n.a.	13,599	1998=100 [5/]	128.2	135.5
Real GDP and Industrial Production Growth in the U.S. in 2005 and 2006					
GDP Growth in 2005			**GDP Growth in 2006**		
Banxico Survey	3.5%	3.6%	Banxico Survey	n.a.	3.4%
Consensus Forecasts [2/]	3.5%	3.7%	Consensus Forecasts [2/]	n.a.	3.4%
Blue Chip Economic Indicators [3/]	3.5%	3.7%	Blue Chip Economic Indicators [3/]	n.a.	3.4%
Industrial Production in 2005			**Industrial Production in 2006**		
Blue Chip Economic Indicators [3/]	4.2%	4.0%	Blue Chip Economic Indicators [3/]	n.a.	3.9%

n.a. not available.
1/ Unless otherwise stated, data are obtained from Banco de México's monthly Survey of Private Sector Economic Analysts' Forecasts.
2/ *Consensus Forecasts* (December 6, 2004 and March 14, 2005).
3/ Blue Chip Economic Indicators (December 10, 2004 and March 10, 2005).
4/ Exchange rate futures at September 31, 2004 and March 31, 2005.
5/ Average level of third and fourth quarters.

IV.1.1. Inflation Expectations

During the first quarter of 2005, private sector analysts revised downward their inflation forecasts for different terms. In the March 2005 survey, headline CPI inflation for 2005 is expected to be 3.95 percent, below that forecasted at the end of December 2004 (4.32 percent). Core CPI inflation for 2005 is expected to be 3.67 percent (in December 2004 it was 3.76 percent). From December 2004 to March 2005, inflation expectations were revised downward as follows: for 2006, from 4.09 to 3.96 percent; for 2007, from 3.95 to 3.84 percent; and for the annual average for 2006-2009, from 3.91 to 3.84 percent (Graph 19).

V. Balance of Risks and Final Remarks

Banco de México's expected scenario for 2005 is based on the following assumptions:

(a) The outlook for world growth continues to be positive. Although the U.S. economy is expected to slow down, it is anticipated to grow close to its potential rate. In particular, the average of economic analysts' forecasts for real GDP growth and industrial production is 3.7 percent, and 4.1 percent, respectively.

(b) International financial markets have become cautious regarding riskier debt instruments. Such reaction has responded, on the one hand, to the greater inflation uncertainty in the U.S. and, on the other, to the downgrade in credit ratings of certain U.S. corporate issuers –and the corresponding reaction of the Federal Reserve- which increased risk aversion in international financial markets. Consequently, access to financing in both external and domestic markets worsened, especially for sovereign and corporate issuers with lower credit ratings.

Based on the above considerations and on most recent information on the development of the Mexican economy, Banco de México's scenario for 2005 is as follows:

GDP Growth: GDP growth is expected to remain at levels between 3.5 and 4.0 percent.

Employment: Approximately 400 thousand jobs are expected to be created in the formal sector.

Current Account: A moderate current account deficit in the balance of payments of approximately 2 percent of GDP is expected.

Inflation: Annual headline CPI inflation at the end of the year is expected to fall within the variability interval set around the inflation target.

The inflationary effect of the supply shocks that took place in 2004, which affected mainly CPI's non-core component and foodstuffs from the core merchandise subindex, have started to revert. This was reflected in a decline in annual headline inflation, from 5.43 percent in November 2004 to 4.39 percent in March.

Such reduction in annual headline CPI inflation and the perception that this process will continue, are based on the following considerations:

(a) International prices of different agricultural commodities, which had risen significantly in 2004, have begun to exhibit a more favorable behavior (prices of some grains and cereals as well as other agricultural commodities have fallen, and meat product prices have stabilized). In addition, contracts for these goods in futures markets anticipate a relatively stable behavior for the remainder of 2005.

(b) CPI food inflation in the United States has declined.

(c) Production of several nondurable goods that were affected by severe weather conditions (e.g. tomato), normalized in Mexico and in the U.S. Nonetheless, prices of these goods are highly sensitive to a large variety of supply shocks, therefore enhancing their inflation volatility.

(d) International energy prices and energy futures prices rebounded during the first quarter of the year. Despite the fact that such prices have increased significantly, futures markets do not anticipate them to continue following the upward trend recently observed. Nevertheless, it is a risk factor that might affect the development of inflation.

(e) Several goods and services regulated by the public sector, such as public transportation fares in different cities of the country, are expected to exhibit lower price increases.

(f) Prices of several goods used as housing construction materials and as inputs for other products (steel and its by-products, and other metals) have fallen significantly. However, prices of such goods are, in general terms, volatile.

(g) As the effects of supply shocks have begun to dissipate and Banco de México's monetary policy stance has tightened, inflation expectations for different time horizons have begun to be revised slightly downward.

(h) Supply shocks that affected headline CPI inflation in 2004 have apparently had a limited effect on wage negotiations.

Based on the previous considerations, the outlook for inflation in the following months is as follows:

Regarding non-core CPI inflation:

(a) The recent and future price quotes of certain grains and cereals, and of meat products, suggests that livestock goods' annual inflation for 2005 will decline significantly as compared with the previous year.

(b) Regarding the subindex of administered prices, inflation of the different goods and services included in such subindex will be lower in 2005 as compared with 2004. Such prevision is based on the following facts: i) the federal government has adopted different measures to moderate increases in electricity rates; ii) gasoline prices at the border have matched those of the rest of the country; therefore, they can only be raised according to the increase determined for domestic gasoline prices; and, iii) given the relatively stable behavior of propane gas futures prices, prices of such energy good are expected to increase at a rate close to the lower margin of the interval determined by the authorities (0.75 to 1.75 percent per month).

(c) The annual growth rate of the price subindex of regulated goods and services is expected to continue to decline for the remainder of the year.

As for core CPI inflation:

(d) The annual growth rate of merchandise prices is expected to continue to decline. On the one hand, annual food inflation is anticipated to continue following a downward trend, in line with the behavior of these prices in international markets. On the other, the annual growth rate of the rest of merchandise prices is expected to follow a lateral trend.

(e) Core services inflation excluding housing has rebounded, due to the increase in the prices of several commodities used as inputs in these services' production. Such trend is expected to stabilize in the next months. The annual growth rate of housing service prices has declined as a result of lower construction costs (mainly steel), and the higher supply of housing. During the following two quarters, annual housing inflation is expected to follow a lateral trend and then, by the end of the year, rebound slightly as a result of the previous year's base of comparison.

Based on such considerations, annual headline CPI inflation for the following months is expected to continue exhibiting some volatility, reaching levels slightly above those observed at the end of the first quarter of the year. Such behavior would mainly reflect the unusual low prices of different nondurable goods observed in 2004. In the third quarter, headline CPI inflation would begin to follow a downward trend, falling within the variability interval by the end of the year. As for core CPI inflation, it is expected to exhibit a relatively stable behavior for the rest of 2005.

As previously discussed, the main elements contributing to the reduction in inflation are associated with the reversal of the effects of the supply shocks that took place in 2004. This is reflected in the significant contribution of CPI's non-core component to disinflation, and in the lower price increases in manufactured foods included in the core merchandise price subindex.

The convergence of inflation to its target still poses significant challenges. First, core CPI inflation and its expectations are still at relatively high levels, thus suggesting that the 3 percent inflation target has still not been incorporated in a widespread manner into the price determination process. Second, international energy prices and their volatility rebounded in the first quarter of the year. Although such developments have not affected inflation yet, Banco de México monitors them carefully. Finally, despite the fact that available information does not allow to identify considerable inflation pressures from aggregate demand, the economy is currently at the high phase of its cycle, and there is a higher risk that such pressures could arise.

Under such environment, Banco de México will continue to conduct its monetary policy so that monetary conditions propitiate the convergence of inflation to its target.

The main risk factors that could affect the baseline scenario are as follows:

First, energy prices could continue to remain high or increase in the near future. This could make the U.S. economy slow down further than expected. Such scenario, as well, could imply higher prices on the subindex of administered prices.

Second, the deterioration of credit quality of some U.S. corporate issuers could worsen and become more widespread than anticipated. This could lead to significant adjustments in investment portfolios worldwide, consequently affecting emerging markets' access to international financing.

Third, current global imbalances could put world growth sustainability at risk. The high and escalating deficit of the U.S. current account, which has reached unprecedented levels, is a cause of concern. If such imbalances should correct suddenly, strong recession pressures would arise worldwide and international financial markets would be subject to significant volatility, thus hampering emerging markets' access to financing.

Finally, many analysts have pointed out that political uncertainty in Mexico could increase as the 2006 elections near. This could have two sequels: on the one hand, financial markets would exhibit higher volatility; on the other, the necessary consensus to advance in the agenda of structural changes required by the country could become more difficult.

Nonetheless, it is important to note that the Mexican economy's current fundamentals make it more resilient to the aforementioned risk factors and the different scenarios that could derive from them. The economy has a strong macroeconomic anchorage, of which monetary policy plays a key role. However, it is essential that efforts towards macroeconomic stability be complemented with other policies and measures that foster a more balanced, vigorous and sustainable growth.

The international experience confirms that a more efficient and modern framework for economic activity strengthens the domestic sources of growth, raising productivity and increasing the demand for jobs, which is also reflected in higher growth rates. Many countries whose per capita GDP was similar or below that of Mexico some decades ago, have now surpassed it due to the vigorous and consistent implementation of reforms. Thus, every year that such changes are postponed, Mexico's position in today's competitive world economy is more at risk, loosing the opportunity to strengthen growth, reduce social inequality and strengthen the basis for future progress.

Banco de México will continue to make its greatest effort to accomplish its constitutional mandate of price stability, helping to foster an environment of certainty that will allow Mexico to face any external and domestic challenges and take advantage of its growth potential.