

Inflation Report

April - June 2006

Summary

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

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

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

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

changes in the prices of assets and currencies have partly reverted in the last weeks.

It is worth mentioning that the adjustment of international financial markets took place after several risk premia had reached historically low levels. In addition, several indicators on firms' profitability show that they maintain a strong financial position, while long-term interest rates in developed markets are still at relatively historically low levels. Under such context, the recent events in world financial markets seem to be reflecting a correction related to the phase of the cycle that is currently underway.

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

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

The inflation environment continues to be favorable: core inflation has remained for several months close to 3 percent and headline inflation, as anticipated, followed a downward trend during the second quarter.

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Recent Developments in Inflation

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

The Consumer Price Index (CPI) grew at an annual rate of 3.20, 3.00 and 3.18 percent in April, May and June, respectively. Fluctuations exhibited by this indicator were mainly determined by the behavior of its non-core component.

Annual non-core inflation was 3.12 percent at the end of the second quarter of 2006, 1.08 percentage points below the figure recorded at the end of the previous quarter. This indicator exhibited some volatility during the analyzed period, mainly reflecting the fluctuations in fruits and vegetables' prices. Fluctuations exhibited by annual non-core inflation were also influenced by the development of the prices of goods and services administered by the public sector, mainly by the increase observed at the beginning of the quarter in gasoline prices at border cities. This increase reverted partially afterwards, when the guidelines used by the government to determine such prices were modified.

During the analyzed quarter, annual core inflation rose 0.18 percentage points. This was due to the higher annual variation of the subindex of services, which was partially offset by a decline in the annual variation of the merchandise subindex. Within the merchandise subindex, the annual variations of processed foods and the rest of merchandises decreased.

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

Main Determinants of Inflation

International Environment

Available information suggests that global economic activity continued to grow at a higher rate during the second quarter of 2006, in tandem with some changes in the composition of world growth. The continuing world economic expansion led to greater capacity utilization and, together with other factors, to further price increases of raw materials. Several analysts consider that the past increases in international oil prices may have been reflected in the pressures observed in the core inflation indexes of the U.S. and Europe. This contributed to generate a perception of higher inflation risks among monetary authorities. In view of the likeliness of an extension to the restrictive cycle of monetary policy, international financial markets began to exhibit higher volatility since the second week of May. In emerging economies, this led to an increase in risk perception regarding these economies debt instruments, especially debt denominated in domestic currency. In general terms, there was a contraction in the prices of several assets, however, of different magnitude among countries. Although volatility diminished at the end of the quarter, greater geopolitical turmoil during July generated a new surge in energy prices and episodes of uncertainty in financial markets.

Aggregate Demand and Supply in Mexico

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

The growth of economic activity during the first half of the year was favored by several aspects characterizing the external environment. First, external demand exhibited a positive behavior, which was reflected in a higher growth of non-oil exports. Second, after significant investment projects consolidated in the automotive industry, production and exports of this sector increased

significantly. Third, and just as in the previous two years, during the first half of 2006, the dynamism of both domestic expenditure and production was favored by the higher surplus of the oil trade balance, and by the higher revenues from workers' remittances.

A significant aspect of the development of Mexican economic activity during 2006 is that the higher growth of both GDP and domestic demand have not implied pressures on the economy's production capacity, considering the following: i) GDP growth has included all sectors; ii) despite the progress of manufacturing production, its level during the second quarter of 2006 barely exceeded its maximum previous levels reached in mid-2000; iii) the branch of manufacturing that has exhibited greater dynamism in 2006 has been the automotive-production industry, due to the production of new models, after vehicle assembly companies made significant investments to modernize and expand their production capacity; and, iv) since 2004, production capacity has strengthened gradually, considering the significant recovery of investment, after three years of weak performance.

Costs and Prices

Wage increases negotiated by firms under federal jurisdiction during the second quarter of 2006 were, on average, the same as those granted during the same period of 2005 (4.4 percent).

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

As a result of several federal government measures, domestic prices of gasoline, propane and natural gas exhibited less volatility than their international references. Thus, price increases observed recently in international markets for both gasoline and propane have not led to significant inflationary pressures as compared with other countries.

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

International grain prices recorded moderate increases during the second quarter of 2006, although the futures curve indicates that, for the remainder of the year, they could follow an upward trend. As for pork meat, its international prices rose approximately 30 percent during the analyzed period. Nonetheless, in this case, the futures curve suggests that such an increase could revert in the following months. Consequently, the effect of pork meat's international references on both pork meat and pork by-products' domestic prices is uncertain. The international prices of beef have exhibited a similar behavior. Beef references have declined moderately as compared to their level at the end of the previous quarter, while futures indicate that they could increase in the following months.

Steel and copper prices rose significantly during the second quarter of 2006 as compared to their levels observed during the previous quarter. Between March and June, steel and copper recorded price increases of 12.1 and 71.2 percent, respectively. In both cases, such an increase responded to both the developments in international markets and the effect of labor conflicts that have been affecting production. Price increases in metals mainly affected both the prices of construction materials and high consumption electricity tariffs. Price increases in both metals and electricity have affected the costs faced by several merchandise manufacturers, and could eventually imply pressures on consumer prices.

Monetary and Credit Aggregates

During the first half of 2006, the monetary base grew at an annual average rate of 14.6 percent, above that observed during the same period of the previous year (13.2 percent). Recently, the growth of demand for monetary base has increased, partly due to the greater use of money that usually takes place during elections. In this regard, this aggregate is expected to reduce its dynamism during the second half of 2006.

The economy's financial deepening process continues. In particular, in May 2006 financial saving accounted for around 52 percent of GDP. Financial

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saving has been boosted by an environment of macroeconomic stability, by the increase in deposits through the Retirement Savings System and, recently, by the greater dynamism of economic activity. The greater supply of domestic financial resources and public sector's reduced demand for resources has allowed the non-financial private sector to increase its financing. In particular, the dynamism of household credit growth deserves mention.

In general terms, lending interest rates offered to most of the population remain high and have not fully reflected the fall in market leading interest rates due to the reduction of inflation. In this regard, Banco de México announced that, starting September 2006, a law for Banks and SOFOLES, which establishes transparency measures for granting credits, and other measures of protection for creditors, will come into effect. In this way, people will count on standardized information on different credit offerings, facilitating the selection of the lowest-cost alternative.

Monetary Policy Actions

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

The perception of a less accommodative global monetary environment has contributed to reduce investors' appetite for risk. This has also led to an adjustment in the prices of several assets and currencies, mainly in emerging economies. In these economies, the corresponding yields for long and medium-term debt instruments in domestic currency have increased, as compared with those recorded during the first quarter of the year. Nonetheless, such increases have been reverting in the last weeks. It is important to mention that long-term interest rates in developed economies are still at low levels as compared with their historic behavior. Thus, although global financial conditions have become less benign, a relative slackness prevails.

On another front, the inflation environment in Mexico continues to be favorable. In particular, during the first half of the year, core inflation remained close to 3 percent. As for headline inflation, and just as expected, during the second quarter it followed a downward trend, after having rebounded at the

beginning of the year. It is important to mention that core inflation has remained for several months close to 3 percent, while headline inflation volatility has mainly reflected the volatility characterizing the fruits and vegetables price subindex, and, to a lesser extent, the administered prices subindex. Consequently, the pass-through of supply shocks to the inflation trend apparently has been decreasing significantly.

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

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

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

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

increase in peso long-term interest rates and the adjustment of the exchange rate and other assets.

Balance of Risks and Final Remarks

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

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

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

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

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

In this regard, the following should be highlighted:

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

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

c) Although international energy prices have reached new historically high levels, they are expected to affect headline inflation moderately, due to the different policies adopted by the federal

government to mitigate the effect of international prices' volatility of these goods.

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

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

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

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

iii) International financial conditions are less favorable.

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

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

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

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

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

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

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