

Inflation Report

July- September 2005

Summary

World economic activity has exhibited a favorable development throughout the year. Although the economy has grown at a slower rate as compared with the previous year, the outlook remains positive (provided that risks mentioned further below do not materialize). The U.S. economy is expected to exhibit growth rates more in line with its potential rate during 2005 and in 2006. Economic analysts anticipate that the negative effects of the hurricanes that recently struck the U.S. South Coast will disappear rapidly.

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

U.S. industrial production has slowed down at a faster pace than GDP since mid-2004. During the third quarter, such results were heightened by the hurricanes that struck the Gulf of Mexico. Nonetheless, in general terms, industrial production continues to exhibit certain dynamism and capacity utilization margins remain close to their historical average.

The slackness in international financial conditions continued. Nevertheless, the balance of risks for U.S. inflation deteriorated recently, contributing to an increase in U.S. interest rates.

Mexico's economic activity during the year has been characterized by a slowdown of production and aggregate demand. Consumption and investment have lost strength, as well as external

demand. Manufacturing exports have been particularly affected by both the lesser dynamism of U.S. industrial activity and Mexico's loss of competitiveness. The declining share of Mexican products in the U.S. market clearly evidences this condition.

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

Recent Developments in Inflation

At the end of the third quarter of 2005, annual headline inflation was 3.51 percent, 0.82 percentage points below that recorded in June. Such results are attributed to the lower growth rate of core and non-core prices (an annual reduction of 0.18 and 2.24 percentage points, respectively, during the referred period). In general terms, the effects of the multiple supply shocks that affected inflation in 2004 continued to dissipate.

The non-core index was the component that mostly contributed to the decline in headline inflation. At the end of the third quarter of 2005, this indicator posted a 4.17 annual percentage change, figure below the 6.41 percent recorded at the end of the previous quarter. This result is attributed to the significant reduction in the annual growth rates of the subindex of agriculture products and to the decline in those corresponding to both the subindex of administered and regulated prices and the education subindex.

The annual growth rate of the price subindex of agriculture products moved from 11.95 percent in June to 4.53 percent in September. This reduction

was due mainly to the lower growth rate in fruits and vegetables' prices. From June to September, the annual growth rate of livestock products' prices moved from 7.16 percent to 4.65 percent, respectively. This result was due to the moderate quarterly increase in beef and pork prices, which, during the same period of the previous year, had increased considerably.

The subindex of administered and regulated prices rose at an annual rate of 3.14 percent in September 2005, 0.38 percentage points below that recorded in June. Due to their relevance, the moderation in price increases of both gas for residential use and electricity deserve mention. An additional factor contributing to the favorable behavior of this subindex was that, during the analyzed quarter, gasoline prices at the border were at the highest level set by their price updating rule; i.e., border gasoline prices increased at the same rate as in the rest of the country, without being affected by the increase in gasoline international references.

As for gas for residential use, increases in its international references had a limited passthrough on domestic prices, due mainly to two factors: i) the adoption at the beginning of the year of a monthly variation interval for propane prices from 0.75 to 1.75 percent; and, ii) the announcement on May 2005 of a maximum price for low-consumption natural gas for residential use. As for electricity, the jump in energy international references only affected high consumption residential electricity tariffs (*Tarifas Domésticas de Alto Consumo, DAC*), given that regular tariffs are fixed according to a predetermined rate of change (0.469 percent per month). The upward effect of energy costs was mitigated by the decline in steel prices and the elimination of the highest rate for the high consumption residential electricity tariff, officially announced since January 22, 2005.

The subindex of private education recorded an annual variation of 6.65 percent in September, 0.78 percentage points below that recorded in June. Despite the downward trend exhibited by such index, it is converging towards CPI's annual growth rate at a relatively slow pace. As a matter

of fact, since June 1999, the subindex of private education has been growing at a higher annual rate than that of the CPI, more than offsetting the relative fall exhibited by school fees in 1995.

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

Regarding the merchandise subindex, prices of processed foods moved from 5.32 percent in June to 4.53 percent in September. Such result reflects that the temporary increase in food commodities' price inflation has gradually reverted. The annual growth rates of the rest of merchandise prices decreased from 2.20 to 1.99 percent during the same period. This result was mainly due to two factors: i) the appreciation of the exchange rate during the year; and, ii) the lower increases in car prices, as a result of changes in the tax on new cars (*Impuesto sobre Automóviles Nuevos, ISAN*), that went into effect in August 22, 2005.

The jump in services inflation was due mainly to the increase in non-housing services' prices. Annual price inflation of non-housing services rose from 4.32 to 4.58 percent from June to September 2005. Within such group, food services contributed the most to such increase. Housing services inflation has remained low and practically unchanged, recording an annual variation from 2.39 to 2.37 percent during the analyzed period.

Main Determinants of Inflation

The world economy continued to grow significantly during the third quarter of 2005. U.S. GDP grew vigorously, despite the impact of the hurricanes that hit the Gulf of Mexico. Although the latter are expected to affect economic activity also during the fourth quarter, analysts consider their effects to be minimal and short-lived. U.S. economic activity is expected to

slow gradually during 2005 and 2006 as compared with 2004, closer to its potential growth rate. World economic growth during the July-September period was boosted by the dynamism of the Chinese and other Asian emerging economies and, to a lesser extent, by Japan's growth. The lack of vigor of the euro area economy continued during the analyzed period, and although most recent indicators suggest an improvement in domestic demand and exports during the third quarter, oil price increases are a risk factor for growth.

Despite its favorable performance and positive outlook in general terms, risks for the world economy have increased, mainly due to surging oil prices. This has translated into higher inflationary pressures in many countries and could affect the world economy's growth rate. On another front, interest rate spreads of emerging market sovereign debt instruments have rebounded recently, in line with an increase in inflationary pressures and the likelihood of higher interest rates in the U.S. Nonetheless, they remain close to the historically minimum levels reached at the end of September and beginning of October.

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During the year, economic activity in Mexico has slowed as compared with 2004 and, especially, with the second half of that year. Economic deceleration has included the three production sectors (industrial, services and agriculture) and also different components of aggregate demand (both external and domestic). Thus, the slowdown of expenditures' domestic components added to the reduced dynamism of external demand, already present since the second half of 2004.

The reduced dynamism of economic activity throughout 2005 is a clear reflection of the current economic conditions, such as the diminished strength of external demand, originated by the slower growth of the U.S. economy as compared with 2004. This setting has slowed export growth, which has also affected production in other sectors as well as domestic demand expenditure.

The slower growth of domestic production during 2005 also reflects that the lack of significant

progress in pending structural reforms continues to affect negatively the country's competitiveness, therefore hindering economic activity.

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During the third quarter of 2005, Mexico's external sector was characterized by the following: a) non-oil exports grew at an annual rate slightly above that of the first half of the year, but significantly below that observed in 2004. These results in the first nine months of the year responded to both the reduced strength of external demand and Mexico's loss of competitiveness in external markets; b) the annual increase in the value of oil exports continues to be very high; c) merchandise imports grew at a rate similar to that recorded in the first half of the year, but below that of 2004, partly due to the lower dynamism of domestic demand in 2005; d) Mexican products continued losing share in external markets; e) the trade deficit was small, although the non-oil trade balance continued to widen; f) a moderate current account deficit of the balance of payments; g) a significant inflow of workers' remittances; and, h) a capital account surplus and an accumulation of international reserves.

Monetary Policy Actions

The inflationary effects of the supply shocks that affected the economy in 2004 have been diminishing throughout the year as a result of both the reversion of such shocks and the monetary policy actions adopted. This has been clearly evidenced by the downward trend followed by headline and core inflation. In this context, the inflation episode of 2004 apparently had a limited effect on wage negotiations.

Under such conditions it is clear that the outlook for inflation has improved, as reflected by the sharp downward inflection exhibited by inflation expectations for all terms.

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

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

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

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

Banco de México's actions to revert part of the monetary restriction are consistent with an improved inflationary outlook, as well as with the gradual convergence of inflation to its target. Nonetheless, monetary policy will continue to be restrictive in order to reach and consolidate the attainment of the inflation target set by the Central Bank.

The slackness that prevailed during the third quarter in international financial markets passed on to domestic markets. Many foreign investors have sought in many emerging markets as alternatives to raise their portfolio yields. In particular, in Mexico, there was a significant inflow of resources to purchase debt instruments in local currency. This setting also reflects that

Banco de México's monetary policy actions have contributed to reduce inflation expectations, and therefore, risk premia that is usually discounted from fixed-yield securities. As a result, the slope of the yield curve increased its inverted position during the third quarter of 2005.

Private Sector Outlook: 2005-2006

During the third quarter of 2005, private sector economic analysts' forecasts were as follows: a) expected inflation for different terms followed a clear downward trend; b) interest rate expectations for Mexico at the end of 2005 and 2006 were revised downward as compared with those reported in the June survey; c) the expected level of the peso exchange rate for the end of 2005 was also adjusted downward (pesos per dollar); d) expectations for economic growth for 2005 were revised downward; and, e) business confidence and business climate indicators exhibited less strength.

In the survey conducted in September, private sector economic analysts' forecasts were as follows: i) GDP is expected to grow 3.01 percent in 2005 (in the survey conducted in June 2005 such figure was 3.57 percent), and 3.42 percent for 2006; ii) in 2005 and 2006, 445 and 436 thousand jobs, respectively, are expected to be created in the formal sector; iii) moderate trade and current account deficits are expected in 2005; and, vi) inflation expectations for different horizons were revised downward. Headline inflation for 2005 is expected to be 3.53 percent in September 2005, figure lower than that reported in the June survey (3.79 percent). Core inflation for the end of 2005 was revised downward from 3.42 percent in June to 3.24 percent in September. Inflation expectations were also revised downward during the same period: for 2006, from 3.93 to 3.68 percent; for 2007, from 3.76 to 3.64 percent; and for the annual average for the period 2006-2009, from 3.76 to 3.66 percent.

Balance of Risks and Final Remarks

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

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

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

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

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

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

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

c) In the last months, energy prices rose significantly to new record highs. Nonetheless, they are expected to affect the subindex of administered prices moderately, concentrating their effect mainly on electricity prices and, to a lesser extent, on prices of gas for residential use. This is due to the following: i) domestic gasoline prices have exhibited monthly variations consistent with an annual increase of 3 percent. At the border, gasoline prices are fixed according to

the nearest foreign city, considering the current price in the rest of Mexico as an upper limit. Since prices in different cities have reached such limit, the effects of the recent increases in the international prices of this fuel have been contained; ii) the setting of a monthly variation interval for propane prices from 0.75 to 1.75 percent, established at the beginning of the year, has limited the effect of the surge in propane international prices; iii) the decree approving a maximum price for low-consumption natural gas for residential use since May; and, iv) high consumption residential electricity tariffs (*DAC*) are determined according to a formula that incorporates variations in energy and steel prices. During the third quarter of 2005, prices of energy rose while steel prices decreased moderately. Should these trends continue, high consumption residential electricity tariffs could increase.

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

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

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

Summing up, the non-core component is expected to contribute significantly to the reduction in headline inflation during 2005, given that the effects of the multiple shocks recorded in the previous year have gradually reverted, and several mechanisms to mitigate the effect of the increase

in the international prices of energy have been implemented. During 2006, the non-core component is expected to grow at a faster rate than the CPI. However, provided that new shocks to agricultural prices do not arise and administered and regulated prices are not affected significantly, annual headline inflation is expected to continue converging to its target.

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

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

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

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

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

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

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

d) Inflation expectations remain above the 3 percent target.

Finally, although wage negotiations apparently have not been contaminated by the inflationary

rebound observed in 2004, Banco de México will monitor that nominal wage increases are strictly aligned with the inflation target and expected productivity growth. In this regard, the Board of Governors reiterates its conviction to conduct monetary policy in order to foster monetary conditions that propitiate the convergence of inflation to its target.

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

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

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

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

Fourth, an imminent risk mentioned in previous reports, the likelihood that the increasing shares of China and other economies in global manufacturing production, continues to systematically displace manufacturing activity in Mexico. This scenario has deteriorated due to the lack of progress in boosting Mexico's

competitiveness: Mexico is currently ranked as a country with low levels of competitiveness in practically all indexes regarding this subject, including the different classifications used in the construction of such indexes. The lack of competitiveness has already translated into a loss of market share of Mexican products in foreign and domestic markets. This phenomenon is affecting both the structure and opportunities of employment in Mexico.

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

Monetary Policy Announcements

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

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

The calendar for monetary policy announcements, monetary policy press releases and inflation reports for 2006 is as follows:

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

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

1/ Includes the Monetary Program for 2006.