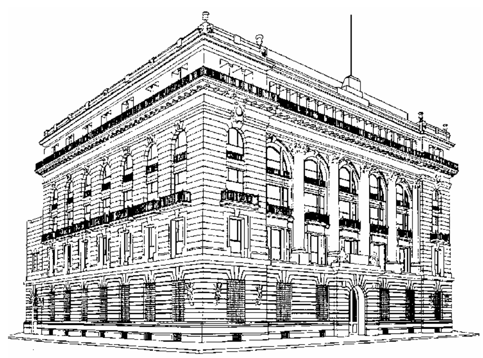
Inflation Report

April – June 2005



BANCO DE MEXICO

JULY 2005

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FOREWARNING

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

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Inflation Report April-June 2005

I. Introduction

Most recent information suggests that during the first half of 2005 world economic activity grew soundly, despite having slowed slightly as compared with the previous year. The outlook for world economic growth for the remainder of the year continues to be favorable. In addition, the increase in risk aversion observed in international financial markets towards the end of the first quarter has been dissipating. These developments have improved access to credit markets, both for sovereign and private issuers.

Available information indicates that during the second quarter of the year, the rate of growth of the U.S. economy slowed, mainly as a result of the new record highs attained by crude oil international prices. The latter affected both consumption and industrial production. Nonetheless, most recent data suggests that the economy gained strength once more towards the end of the quarter.

The U.S. industrial sector has been affected by the restructuring of worldwide manufacturing production. This phenomenon, which began a few decades ago, gained momentum with the increasing participation of China in international trade flows, contributing in recent years to a significant reduction in the international prices of manufactures and to an increase in those of energy-related commodities. In addition, in several economies such as the U.S. this change in relative prices has generated a greater dynamism in the services sector, regarding both production and job creation.

The aforementioned environment has affected the Mexican economy. On the one hand, manufacturing exports have been loosing share in international markets, due to the greater presence of Chinese products and the gradual loss of competitiveness of Mexican exports. As mentioned by Banco de México on numerous occasions, this decline of competitiveness reflects the lack of structural reforms that would raise productivity and efficiency, and which are essential to successfully face the increasing competition of countries like China in international trade flows. On the other, the reduced strength of external demand has been offset by crude oil international price increases and by the vigorous growth of workers' remittances, both of which constitute a significant source of financing of domestic expenditure. Under such context, it is likely that Mexico is also undergoing changes in its production and expenditure structure due to these external conditions.

The lower contribution of external demand has been offset by the expansion of both consumption and investment. As already mentioned, the evolution of these aggregates has been supported by the broad availability of resources from the sale of crude oil and from workers' remittances, as well as from an increase in domestic financing.

Nonetheless, the rate of growth of the Mexican economy is expected to slow slightly by the end of the year as compared with 2004. In particular, productive activity is anticipated to grow between 3.25 and 3.75 percent, mainly based on domestic sources.

As for headline inflation, during the second quarter of the year it fell slightly as compared with that observed at the end of the previous quarter (4.33 vs. 4.39 percent at an annual rate). Nonetheless, core inflation fell significantly, reaching in June an annual variation of 3.38 percent (3.61 percent in March 2005). The fall in core inflation was due mainly to the gradual dissipation of the effects of the supply shocks that affected the food price subindex, and to the reduction in the international prices of steel and its by-products, which has led to a lower growth rate of the price subindex of housing services.

In general, as inflation pressures associated with supply shocks of the previous year have been dissipating, inflation expectations have been revised downward. In particular, expectations for headline inflation at the end of 2005 have reached levels close to those recorded before the supply shocks took place. Nonetheless, inflation expectations for the longer terms have still not returned to the levels recorded at the end of 2004 and still remain relatively high in relation to Banco de México's 3 percent inflation target.

It is clear that all economies are permanently subject to risks, major or minor, in relation to the attainment of their inflation targets. This gains relevance in the case of economies, such as the Mexican, which still have not converged to their inflation target. Nonetheless, although the balance of risks has improved, the following must be pointed out:

a) Non-housing core services inflation is still high and has increased recently.

b) International energy prices and their futures have rebounded once more.

c) Although available information does not allow for identifying significant aggregate demand inflation pressures, the fact that the economy is undergoing its highest phase increases such risk.

Under such context, it is very important that the general process of price determination and wage negotiations, in particular, use both the 3 percent inflation target and the expected productivity growth as their reference. In this regard, Banco de México will continue to be attentive that any upward inflation pressures from supply shocks remain contained, and that no inflation pressures from expenditure arise.

II. Recent Developments and Main Determinants of Inflation April – June 2005

II.1. Recent Developments in Inflation

In June 2005, annual headline inflation reached 4.33 percent, while at the end of the previous quarter it was 4.39 percent (Graph 1 and Table 1). This reduction in headline inflation derives from a 0.23 percentage point contraction in annual core inflation, which at the end of the second quarter recorded an annual variation of 3.38 percent. The latter was partly driven by the fading effect of several shocks that affected inflation during the previous year. Regarding consumer prices during the second quarter of 2005, the following deserves mention:

a) The decline in international prices of food commodities, together with more stable prices of its commodity futures, contributed to reduce inflation of processed foods. Consequently, the rate of growth of foods within the core merchandise subindex during the second quarter of the year was 0.58 percentage points below that at the end of the first quarter.

b) A supply shock whose effects have started to dissipate is last year's metals price increments. In particular, the international price of scrap iron, which is used in Mexico as an input for steel production, declined (Graph 2). This was one factor that enabled the fall (0.67 percentage points) in the annual variation of the housing services core subindex between March and June 2005, as it contributed to reduce residential construction costs.

c) Nonetheless, during the second quarter of 2005 the rate of growth of the non-food core merchandise subindex and of the non-housing core services subindex increased.

d) The decline in steel prices contributed to the reduction in high-consumption residential electricity tariffs.[1] This factor, together with the unification of the two existing

[1] High-consumption residential electricity tariffs 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.

tariffs to their lower rate, was a determinant factor in the fall of electricity price inflation.

e) The greater stability of propane international prices has contributed to the lower growth rate of its domestic prices (Graph 3). Thus, between March and June 2005 the annual variation of household-use gas prices declined 3.13 percentage points (from 17.73 to 14.60 percent).

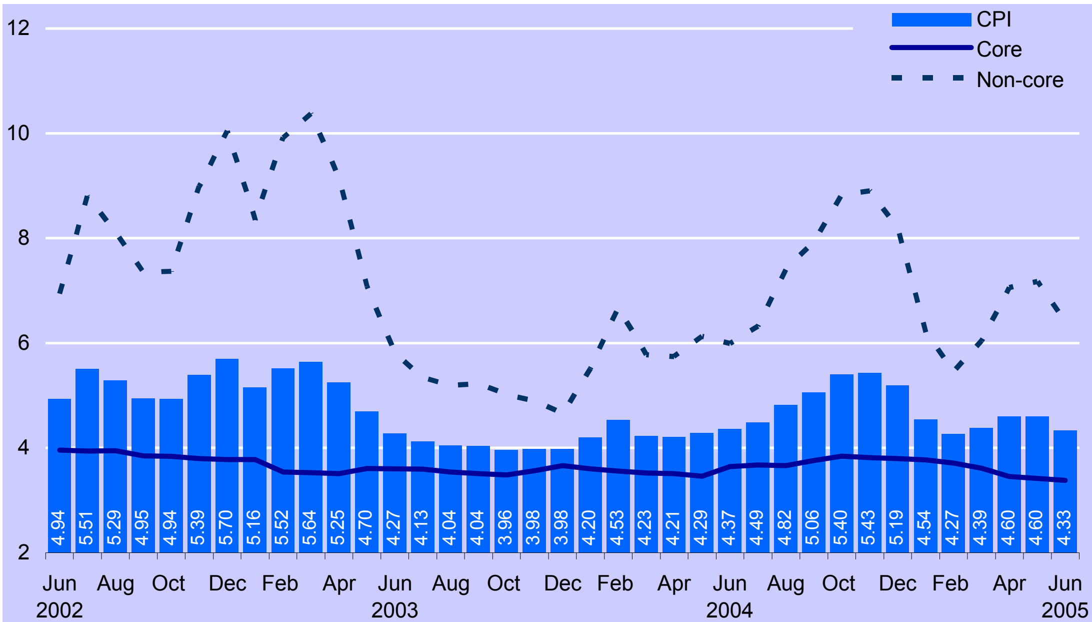
f) Gasoline prices at non-border cities have observed monthly variations in line with a 3 percent annual growth rate. At the border, gasoline prices are determined according to the nearest foreign city, with the price in the rest of the country as an upper limit. Gasoline prices at border cities have reached this upper limit. This has restricted the monthly increases of such prices, resulting in an accumulated variation that during the second quarter of 2005 was below that observed during the same period of the previous year.

g) The reduction in the annual growth rate of the regulated prices subindex (0.41 percentage points) also contributed to contain the upward movement in annual non-core inflation during the second quarter of 2005. This subindex exhibited annual variations of 3.19 percent in March 2005 and 2.78 percent in June. Such reduction was influenced mainly by the lower growth rates of public urban transportation fares as compared with the same period of the previous year, and to the fact that these took place in cities that have a lower weight in the CPI.

h) In contrast, the higher upward pressure on CPI prices came mainly from the item fruits and vegetables, whose annual variation rose from 4.65 percent in March 2005 to 20.47 in June of the same year. Significant price increases in certain items, such as tomato, contributed to these results. Bad harvests of tomato in both Mexico and the U.S. –as a result of adverse weather conditions- made tomato prices escalate.

Graph 1 **Consumer Price Index (CPI)**

Annual percentage change

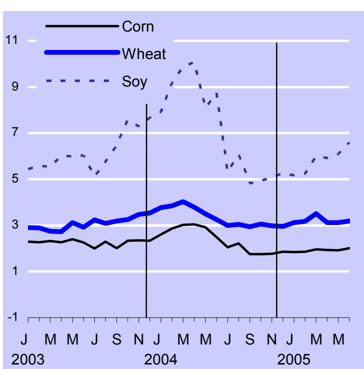


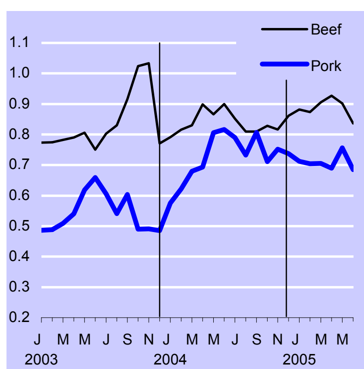
Graph 2 **International Prices of Selected Commodities**

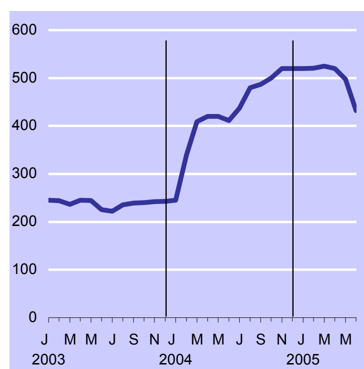
a) Grains
US dollars per bushel

b) Meat
US dollars per sterling pound

c) Steel (scrap)
Index







Source: (a) and (b) U.S. Department of Agriculture, and (c) Bureau of Labor Statistics.

Table 1 CPI Components

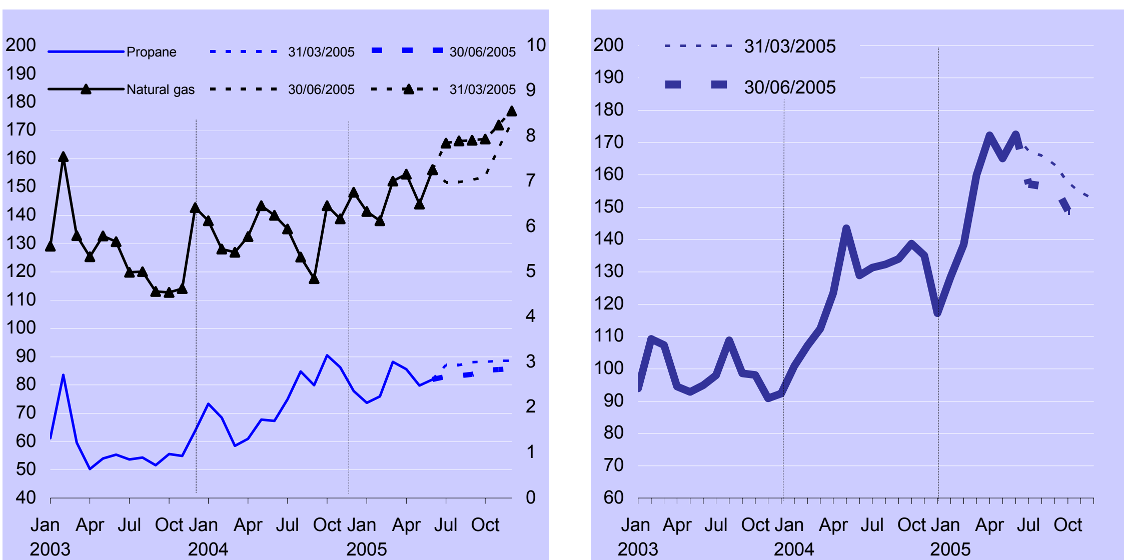
Annual percentage change

	Dec-2004/ Dec-2003 (a)	Mar-2005/ Mar-2004 (b)	Apr-2005/ Apr-2004 (c)	May-2005/ May-2004 (d)	Jun-2005/ Jun-2004 (e)	Difference in percentage points (e-b)
CPI	**5.19**	**4.39**	**4.60**	**4.60**	**4.33**	**-0.06**
Core	**3.80**	**3.61**	**3.46**	**3.42**	**3.38**	**-0.23**
Merchandise	**3.87**	**3.61**	**3.59**	**3.56**	**3.49**	**-0.12**
Food	7.04	5.90	5.67	5.50	5.32	**-0.58**
Other	1.69	2.00	2.13	2.19	2.20	**0.20**
Services	**3.72**	**3.61**	**3.31**	**3.27**	**3.27**	**-0.34**
Housing	3.70	3.06	2.71	2.47	2.39	**-0.67**
Other	3.74	4.28	4.04	4.24	4.32	**0.04**
Non-core	**8.20**	**6.04**	**7.06**	**7.17**	**6.41**	**0.37**
Agriculture	**10.11**	**5.73**	**11.33**	**14.24**	**11.95**	**6.22**
Fruits and Vegetables	6.43	4.65	19.48	26.47	20.47	**15.82**
Tomato	23.24	24.61	57.30	74.79	61.22	**36.61**
Other	2.51	2.13	13.11	16.94	14.29	**12.16**
Livestock	12.69	6.39	6.50	6.99	7.16	**0.77**
Administered and Regulated	**7.51**	**5.70**	**4.95**	**3.78**	**3.52**	**-2.18**
Administered	10.02	8.39	7.38	5.04	4.35	**-4.04**
Low-octane gasoline	5.42	4.22	4.25	3.50	3.20	**-1.02**
High-octane gasoline	8.47	6.38	6.45	5.94	3.04	**-3.34**
Electricity	9.15	6.31	3.57	-2.62	-3.35	**-9.66**
Household-use gas	18.27	17.73	17.10	15.39	14.60	**-3.13**
Regulated	5.13	3.19	2.70	2.67	2.78	**-0.41**
Education	**7.50**	**7.55**	**7.41**	**7.35**	**7.43**	**-0.12**

Graph 3 Observed and Future International Energy Prices [1/]

a) Natural Gas [2/] and Propane [3/]

b) Gasoline[4/]



1/ Futures prices correspond to March 31 and June 30, 2005.
2/ TETCO. TX. US dollars per MMBtu (right scale).
3/ Mont Belvieu, Tex. US cents (left scale).
4/ Texas, US cents per gallon.

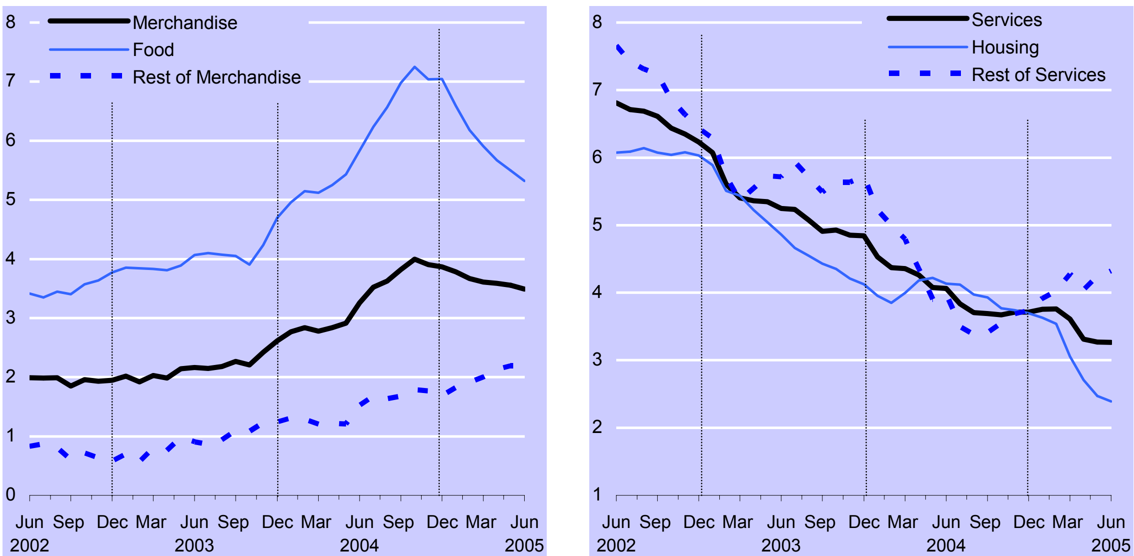
II.1.1. Core Inflation

In June 2005, annual core inflation was 3.38 percent, 0.23 percentage points below observed figures in March. Within the core index, the annual growth rate of both the merchandise and services subindexes fell (Graph 4). In the case of the former, it declined 0.12 points, reaching 3.49 percent in June. As for the latter, it decreased 0.34 points, reaching 3.27 percent at the end of the second quarter of the year.

Graph 4 **Core Merchandise and Services Subindex**

a) Merchandise
Annual percentage change

b) Services
Annual percentage change



As for the core services subindex, the group of housing prices exhibited a reduction in their annual growth rate (from 3.06 in March to 2.39 percent in June). This was due to two factors: first, a decline in the growth rate of construction materials' prices –particularly steel materials (bar, wire and wire rod, and wire mesh), cement, and ready-mixed concrete- and second, a greater supply of housing in almost all locations and more availability of mortgage financing, which has contributed to moderate the rate of growth of housing rents.[2] The non-housing services group rose from an annual rate of 4.28 percent in March to 4.32 percent in June 2005. In particular, food-related, entertainment and health care items were the ones that had the highest incidence on inflation during the quarter.

[2] The Residential Construction Cost Index exhibited an annual growth rate of -1.69 percent in June 2005, while in March it was 3.60 percent.

The decline in the annual growth rate of the core merchandise subindex resulted from a reduction in the annual variation of processed foods (from 5.90 percent in March to 5.32 percent in June). Nonetheless, this was partially offset by the increase in the annual growth rate of the rest of the items of the core merchandise subindex (from 2.00 percent in March to 2.20 percent in June). Among these items, the ones that had the highest incidence on inflation during the quarter are those related to household consumption.[3]

II.1.2. Non-core inflation

Annual non-core inflation was 6.41 percent in June 2005, while at the end of the previous quarter it amounted to 6.04 percent. This result was mainly due to the increase in the annual growth rate of the price subindex of agriculture products, which was partially compensated by the reduction in the annual variation of the subindex of administered and regulated prices.

Annual inflation of the agricultural products subindex was 11.95 percent in June 2005, figure above that of March (5.73 percent). Price growth of fruits and vegetables contributed significantly to such increase (their annual growth rate rose from 4.65 to 20.47 percent). Adverse weather conditions led to an increase in the annual variation of tomato prices, from 24.61 percent in March to 61.22 percent in June. During the reference period prices of other fruits and vegetables such as green tomato, onion, potato, melon, and different sort of green chili peppers also increased. As a result, the annual variation of the fruits and vegetables group reached its highest level in June since 2000 (Graph 5).

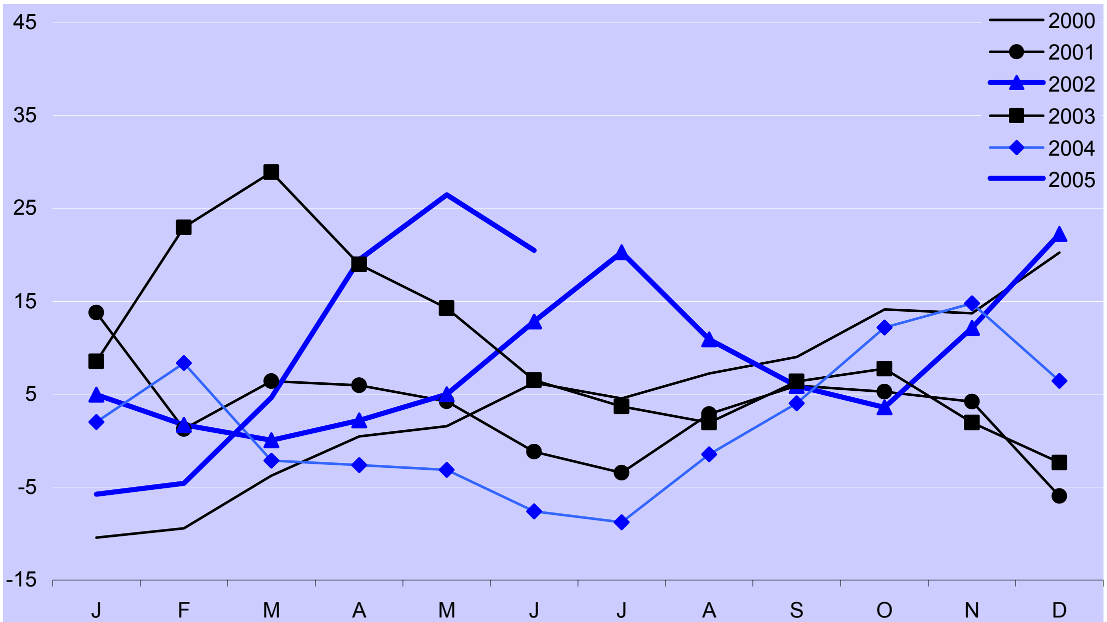
As for livestock products, its annual growth rate moved upward from 6.39 to 7.16 percent during the analyzed period. Such result is mainly attributed to the increase in poultry and beef prices. In the case of the former, the high temperatures raised mortality of poultry flocks, which, together with an outbreak of low-pathogenicity avian influenza in a northern producing region, led to a contraction in the supply of poultry. As for beef, its domestic price was affected by the increase in international prices at the beginning of the year, partly as a result of the recovery in the demand for this product in the U.S. (Graph 2). In contrast, egg supply continued to increase; thus, the annual rate of growth of this

[3] Among others, it includes handkerchiefs, curtains, storage batteries, pens and pencils, and pesticides.

item reached -6.92 percent at the end of the second quarter of the year (Graph 6).

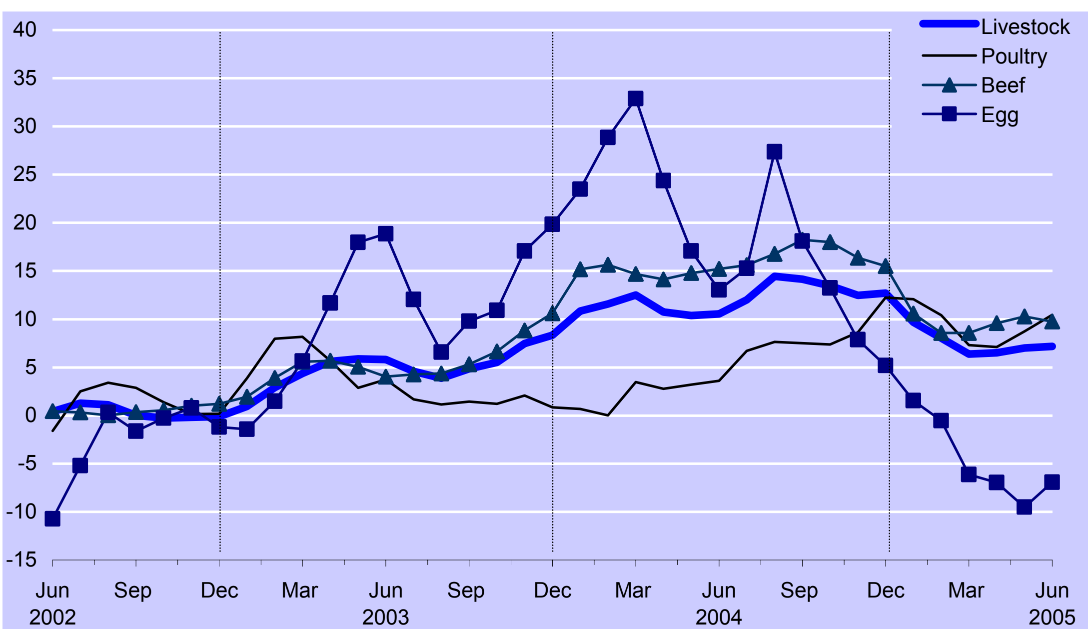
Graph 5 **Fruits and Vegetables Subindex**

Annual percentage change



Graph 6 **Livestock Products Subindex**

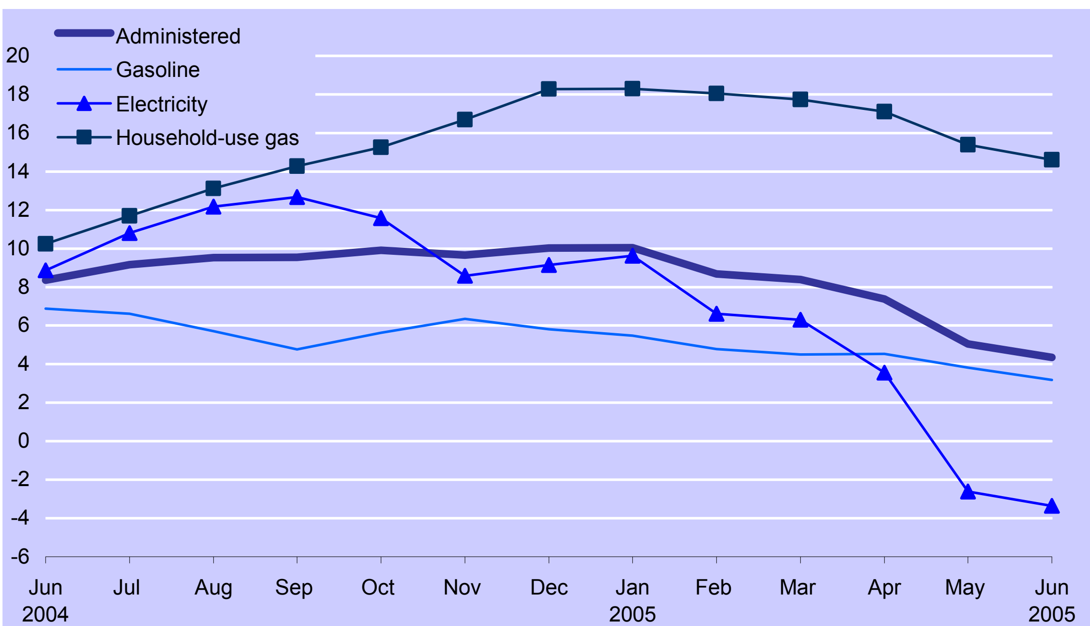
Annual percentage change



In June 2005, the administered prices subindex posted an annual variation of 4.35 percent, 4.04 percentage points below the rate in March. Electricity tariffs contributed the most to such reduction. This was due to the downward adjustment in high consumption residential tariffs, that resulted from the unification of the two existing tariffs to the lower rate in February 2005 and the reduction of some reference prices used for tariff determination.[4] The following also contributed to the lower growth rate of administered prices: i) at the beginning of the year, a monthly variation interval (0.75 to 1.75 percent) was determined for propane prices. Since such prices grew at a monthly rate of nearly 0.75 percent during the analyzed quarter, its accumulated variation during such period was below that observed during the same period of the previous year;[5] ii) during the second quarter of 2005, the average price of natural gas for household use closed below its level observed in March of the same year; and iii) gasoline prices exhibited a lower monthly variation as compared with that exhibited in the same period of the previous year (Graph 7).

Graph 7 **Subindex of Administered Prices**

Annual percentage change



The reduction in the annual growth rate of the regulated prices subindex was a factor that also contributed to contain the

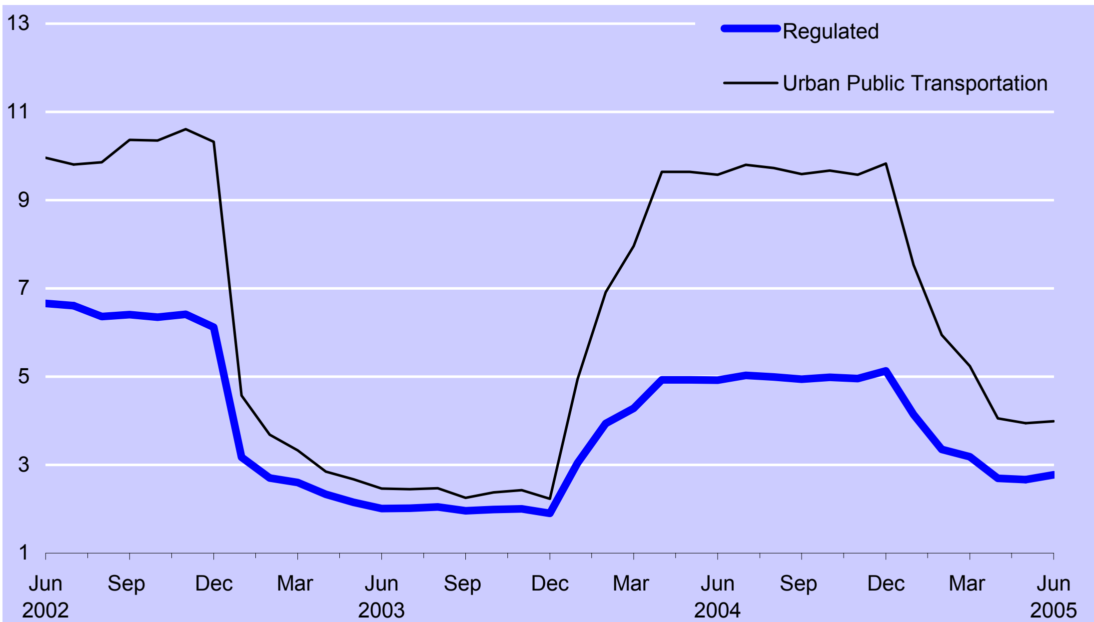
4 Significant reductions were observed in the PPI subindex of basic metal industries and in the price of fuel oil sold by PEMEX to CFE.

5 See Inflation Report January – March 2005, p.8.

upward movement in annual non-core inflation during the second quarter of 2005. This subindex exhibited annual variations of 3.19 percent in March 2005 and 2.78 percent in June. Such a decrease was influenced mainly by the lower growth rates of public urban transportation fares, and to the fact that these took place in cities that have a lower weight in the CPI (Graph 8).

Graph 8 **Subindex of Regulated Prices**

Annual percentage change



II.1.3. Monthly Inflation

Monthly inflation was 0.36, -0.25 and -0.10 percent, respectively, in April, May and June 2005. Except for April, monthly inflation during the second quarter ended below Banco de México private sector analysts' forecasts drawn in March. On the other hand, in general, the behavior of monthly inflation recorded during the second quarter of the year compares favorably with that observed during the same period of the previous year. In particular, the following deserves mention: in April, monthly headline inflation was below that of the previous year. This was due to the significant increase in non-core inflation, particularly regarding price increases of fruits and vegetables; and ii) in April, May, and June, monthly core inflation was below that recorded in the same months of the previous year.

Table 2 **Observed and Expected Monthly CPI Inflation**

Percent

	2004				2005			
	Observed			Expected 1/	Observed			Expected 1/
Month	Non-core	Core	CPI	CPI	Non-core	Core	CPI	CPI
April	-0.29	0.36	0.15	0.23	0.67	0.21	0.36	0.23
Mayo	-1.32	0.25	-0.25	0.08	-1.22	0.21	-0.25	-0.06
June	-0.13	0.29	0.16	0.18	-0.84	0.26	-0.10	0.21

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

At the end of the second quarter of 2005, the annual growth rate of the Producer Price Index (PPI) excluding oil reached 3.67 percent, 1.52 percentage points below the figure observed in March 2005. Construction, and metal products, machinery and equipment contributed the most to such reduction, mainly as a consequence of the downward adjustment in steel prices.

Table 3 **PPI Excluding Oil**

Merchandise and final services, annual percentage change

Item	Annual Variation			Annual Incidence 1/				
	Dec. 04	Mar. 05	Jun. 05	Dec. 04	Mar. 05	Jun. 05	Difference	
				(a)	(b)	(c)	(b)-(a)	(c)-(b)
PPI	**6.52**	**5.19**	**3.67**	**6.52**	**5.19**	**3.67**	**-1.33**	**-1.52**
Primary Sector	**8.58**	**7.99**	**12.75**	**0.31**	**0.29**	**0.44**	**-0.01**	**0.15**
Agriculture, forestry and fishing	8.08	8.15	13.68	0.26	0.27	0.43	0.01	0.16
Mining	13.12	6.50	4.86	0.05	0.02	0.02	-0.02	-0.01
Secondary Sector	**7.78**	**5.12**	**1.82**	**3.23**	**2.15**	**0.77**	**-1.08**	**-1.38**
Manufacturing	5.10	4.88	2.71	1.51	1.43	0.80	-0.08	-0.64
Food, beverages and tobacco	7.27	6.01	5.30	0.69	0.57	0.50	-0.12	-0.07
Textiles, apparel, and leather industry	2.88	2.99	1.59	0.08	0.08	0.04	0.00	-0.04
Timber and by-products	8.68	9.06	5.80	0.03	0.03	0.02	0.00	-0.01
Paper and by-products, printing and editorial	2.96	7.24	3.95	0.04	0.09	0.05	0.05	-0.04
Chemical, oil, rubber and plastic industries	8.98	9.67	7.73	0.37	0.39	0.32	0.02	-0.08
Non-metal minerals	1.59	1.97	0.59	0.02	0.02	0.01	0.00	-0.01
Basic metal industries	48.87	3.70	-4.32	0.14	0.01	-0.02	-0.12	-0.03
Metal products, machinery and equipment	1.43	2.27	-1.28	0.14	0.22	-0.13	0.08	-0.35
Other manufacturing industries	2.68	3.36	0.59	0.01	0.02	0.00	0.00	-0.01
Construction	14.49	5.68	-0.18	1.72	0.72	-0.02	-1.00	-0.74
Tertiary Sector	**5.44**	**5.05**	**4.54**	**2.98**	**2.75**	**2.46**	**-0.23**	**-0.29**
Electricity and Gas	11.32	7.30	-0.54	0.19	0.12	-0.01	-0.07	-0.13
Restaurants and hotels	5.22	5.25	4.56	0.34	0.34	0.30	0.00	-0.05
Transport and communications	8.23	6.66	6.00	1.21	0.98	0.89	-0.23	-0.10
Real estate rental	3.63	3.10	2.63	0.40	0.34	0.29	-0.06	-0.05
Personal, social and community services	4.03	4.70	4.87	0.84	0.96	1.00	0.12	0.03

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

II.2. Main Determinants of Inflation

II.2.1. International Environment

The world economy recorded strong growth during the first half of 2005, although at a slower pace than in 2004. In the U.S., the rate of growth of economic activity continued to decelerate towards more sustainable rates. Although during the April-June period GDP apparently exhibited less dynamism than expected, most recent data points to a new strengthening towards the end of that quarter. After having contracted during most of 2004, economic activity in Japan strengthened during the first half of the year. The euro-area economy continued weakening. On another front, although oil prices reached new record highs, inflation in the advanced economies continued recording moderate inflation rates. This contributed to maintain long-term interest rates at low levels and, therefore, to foster favorable conditions for emerging markets' access to external financing.

II.2.1.1. Oil Prices

The higher world demand for crude oil and distilled products, the perception of limited oil production and refining capacity, and the resurgence of certain geopolitical risks, pushed crude oil prices to new record highs during the April-June period. This, despite the fact that that the OPEC raised its production levels in relation to the first quarter of the year by 500 thousand barrels per day, and that crude oil inventories in advanced economies continued to increase during the second quarter. Furthermore, crude oil futures rose significantly and the spread between the WTI 24-month futures contract price and its spot price (which is usually negative) turned positive (Graph 9).

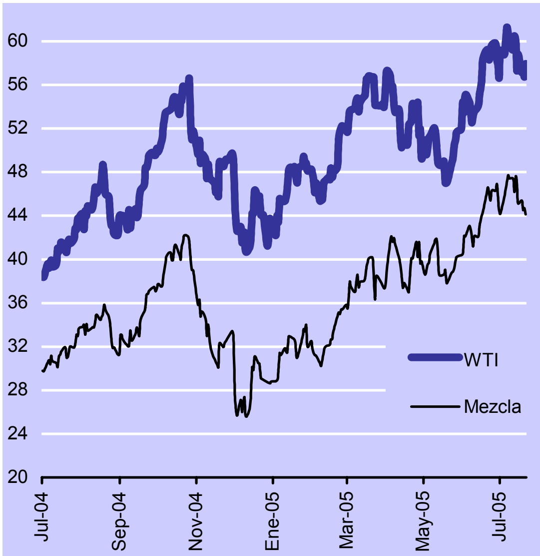
The price of WTI oil averaged 53.10 US dollars per barrel during the period April-June, reaching in June 27 a new record high of 59.80 US dollars. The average price during the period was 3.18 US dollars above that observed during the previous quarter. As for the Mexican crude oil export mix, its average price was 41.16 US dollars per barrel, 6.53 US dollars above the figure observed during the first quarter of the year.[6]

[6] In July 22, the prices of the WTI and the Mexican crude oil export mix were 57.85 and 44.41 US dollars per barrel, respectively.

Graph 9 **Oil Prices**

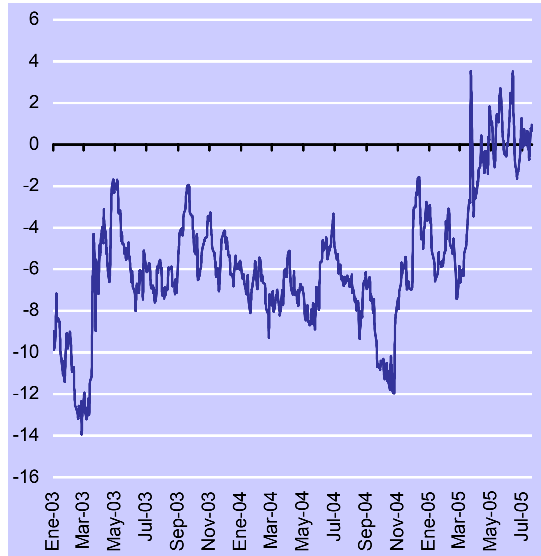
US dollars

a) Spot prices



Source: Reuters.

b) Spread between WTI 24-month futures contract price and spot prices



Source: Bloomberg.

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

During the first quarter of 2005, GDP grew at an annualized quarterly rate of 3.8 percent (3.7 percent at an annual rate), the same figure as that recorded in the last quarter of 2004, albeit below that observed on average during that year (4.4 percent). Consumption in that country continued growing vigorously at an annualized quarterly rate of 3.6 percent. Consumption growth was supported by both the gradual strengthening of the labor market and the increase in households' net wealth, brought about mainly by higher real estate prices. In contrast, non-residential private investment recorded its lowest annualized quarterly growth rate (4.1 percent) since the second quarter of 2003, when it began to expand during the current recovery. On another front, the poor results of net exports contributed once again negatively to GDP growth, albeit not as negatively as in the previous quarter. Inventory accumulation contributed significantly to U.S. growth during the January-March period. Nonetheless, part of such accumulation apparently was not planned and could therefore become a drag on economic activity in the following months.

Available information suggests that the pace of GDP growth slowed during the second quarter, although many indicators point to a new strengthening of U.S. economic activity towards the end of this period. Private consumption recorded an annualized growth rate of 3.2 percent during the April-May period, below that observed in the first quarter.[7] The behavior of retail sales in June suggests a rebound in consumption at the end of the quarter. As for investment, there are mixed signals: although data on orders and shipments of capital goods suggests a slowdown of investment in software and equipment, corporations' strong financial position and higher profits continued to support capital expenditures. In a similar fashion, while expenditure on residential private construction declined in April and May, indicators of real estate sales and mortgages remained strong. As for the external sector, the trade deficit narrowed during the period April-May and, should this trend continue in June, it would contribute to GDP growth in the second quarter of the year. Analysts surveyed by Consensus Forecasts at the beginning of July expected GDP to grow at an annualized quarterly rate of 3.2 percent in the second quarter (Table 4). Nonetheless, given the recovery observed at the end of that period, some analysts consider that such figure will be revised upward.

Table 4 **U.S. GDP and Industrial Production in 2005 and 2006**

Annual and annualized quarterly percentage change

	GDP					
	Expected at the end of the first quarter			Most recent data		
	II-2005[1/]	2005[2/]	2006[2/]	II-2005[1/]	2005[2/]	2006[2/]
Consensus Forecasts[3/]	3.6	3.7	3.4	3.2	3.6	3.2
Blue Chip Economic Indicators[4/]	3.6	3.7	3.4	3.2	3.6	3.3
	Industrial Production					
Blue Chip Economic Indicators[4/]	4.1	4.0	3.9	2.2	3.4	3.5

1/ Annualized quarterly change (seasonally adjusted series).
2/ Annual percentage change.
3/ *Consensus Forecasts* (March 14, 2004, June 13, and July 11, 2005).
4/ Blue Chip Economic Indicators (March 10, 2004 and July 10, 2005).

Despite the rebound recorded in June, U.S. industrial production has slowed down significantly since May 2004 (Graph 10), when it reached its highest annual growth rate during the current recovery (5.4 percent). Industrial production has grown at a much slower rate than GDP. Although industrial production was expected to decelerate gradually, its slowdown has been somewhat stronger, possible due to the higher price of oil and to inventory adjustments during the first quarter. In addition, the industrial sector has been affected by the restructuring of manufacturing production worldwide. Although some components of industrial

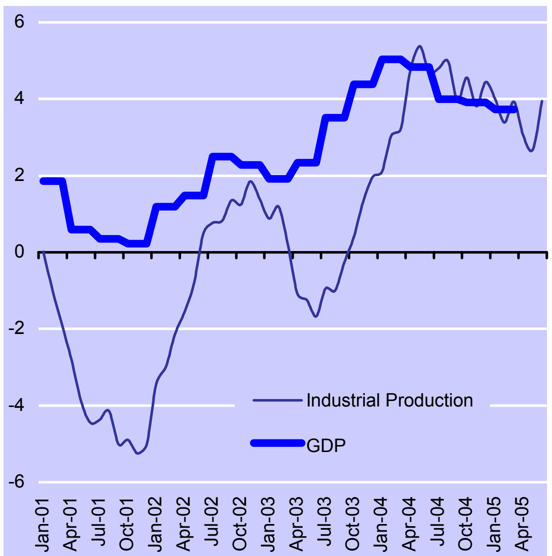
7 Refers to the increase observed during the period April-May vs. January-February (annualized).

production –such as high technology- have continued to grow at high annual rates, all sectors have been affected by the slowdown. As a result, forecasts for industrial production growth for 2005 were revised downward, from 5.2 percent in July 2004 to 3.4 percent in the same month of this year.[8]

Graph 10 **U.S. GDP, Industrial Production, and Oil Prices**

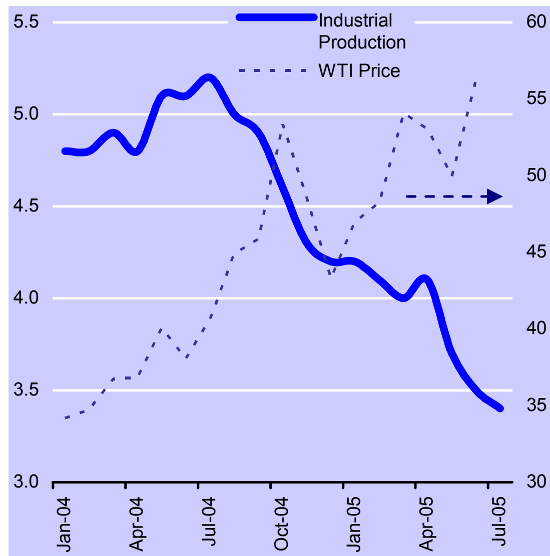
Annual percentage change and US dollars per barrel

a) GDP and Industrial Production



Source: BEA and Federal Reserve.

b) Expectations of Industrial Production Growth and WTI Price



Source: Consensus Forecasts and Bloomberg.

The labor market continued to recover during the second quarter, although exhibiting a mixed behavior as to job creation. During that period, 542 thousand new jobs were created, which yields a monthly average of 181 thousand jobs, above the figure observed during the current cycle (142 thousand monthly jobs from May 2003 to June 2005). Nonetheless, manufacturing employment contracted during the April-June period, remaining below the level it reached prior to the last recession.[9] In June, U.S. manufacturing employment reached record lows since August 1950, which mainly reflects the decreasing contribution of this sector to total employment as well as the intensification of this process in recent years (Box 1).

Inflation remained within moderate levels during the second quarter of 2005. Despite the surge in oil prices, the increase

[8] This forecast is based on a survey conducted previously to the announcement of the 3.9 percent increase in industrial production in June 2005.

[9] In June 2005, manufacturing employment amounted to 14.27 million jobs, below the figure recorded in February 2001 (17.03 million), just before the recession began.

in capacity utilization and the decline in the rate of growth of productivity, CPI's annual rate of growth declined from 3.4 percent in December 2004 to 2.5 percent in June 2005. Core inflation also remained relatively stable during that period (Graph 11). Inflation measured through the personal consumption expenditure deflator was 1.6 percent in May, below the Federal Reserve's forecasted interval for this year (1.75 to 2.0 percent).[10] Furthermore, long-term inflation expectations remained around 2.5 percent.

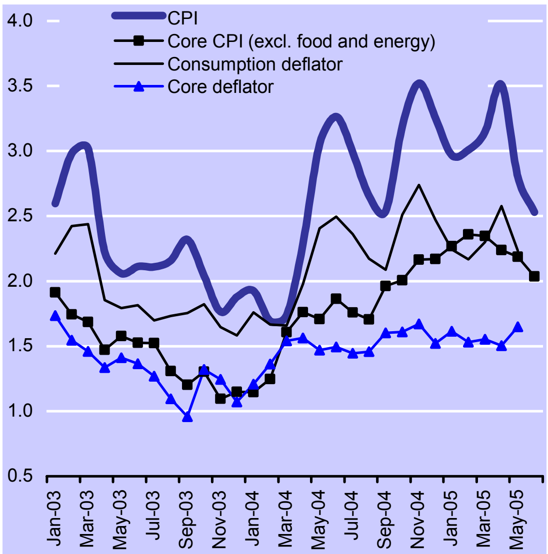
In its meetings of May and June, the Federal Reserve Board raised its target for the federal funds rate by 25 basis points up to 3.25 percent. In its press releases it stated that despite the increases in its target rate, monetary policy continues to be accommodative and announced its intention to continue to withdraw the monetary stimulus at a measured pace. In its semiannual monetary policy report to the Congress released in July it confirmed its outlook that monetary policy continues to be accommodative and that the economy will continue to grow at a reasonable pace in a low-inflation environment. Presently, futures markets suggest that the federal funds rate is most likely to be 4 percent at the end of 2005. This would imply a pause in the increase in the federal funds rate in any of the four meetings of Federal Open Market Committee programmed for the rest of the year.

[10] Inflation measured through the personal consumption expenditure deflator tends to be below CPI inflation due to the different methodologies used to calculate each index. Deflator-based inflation uses a chain-type method while CPI inflation is based on the Laspeyres method. U.S. authorities also release a CPI chain-type index, which yields a measure of inflation that is similar to that obtained using the deflator.

Graph 11 **U.S. Price Indexes and Inflation Expectations**

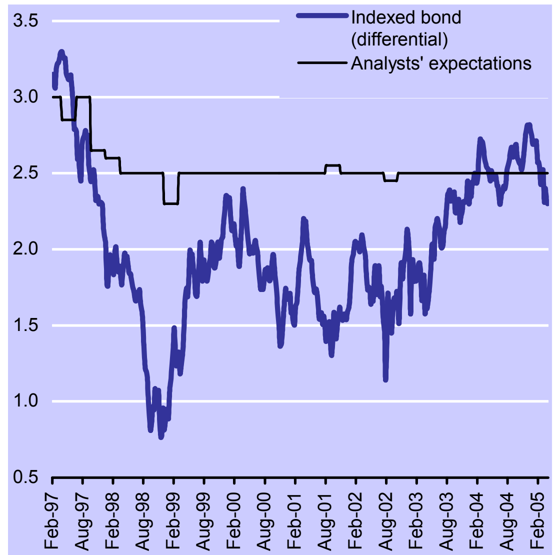
Annual percentage change and percent

a) Consumer Prices and Consumption Deflator



Source: BLS and BEA.

b) Long-term Inflation Expectations



Source: Federal Reserve, Philadelphia and St. Louis Fed.

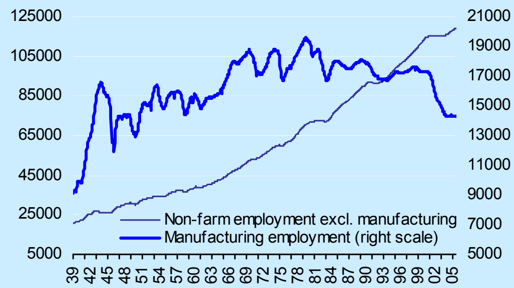
Note: The spread is obtained by subtracting the yield of the 10-year U.S. nominal bond and the 10-year indexed bond. Analysts' expectations are drawn from long-term inflation forecasts from the Survey of Professional Forecasters, Philadelphia Fed.

The Federal Reserve's withdrawal of the monetary stimulus was reflected in an increase in short-term interest rates. The yield on 3-month Treasury bills increased 35 basis points during the quarter. Long-term interest rates fell 56 basis points during the April-June period. The continuous decline in long-term interest rates, in a context of higher short-term interest rates, has been considered as a conundrum by the Federal Reserve Chairman. As a result of the above mentioned trends, the yield curve has flattened significantly. The spread between the yield on the 10-year Treasury bond and the 3-month rate averaged 124 points during the second quarter. The spread between U.S. corporate and Treasury bonds has remained low, despite the rebound recorded at the end of the first quarter (Graph 12).

Box 1
Manufacturing Employment in the U.S. and Mexico

Manufacturing employment in the U.S. deteriorated significantly during the last recession and, contrary to other indicators, it continued to fall until June 2005, when it reached levels similar to those of August 1950 (Graph 1).

Graph 1
Non-farm and Manufacturing Employment
Thousand jobs



Source: Bureau of Labor Statistics.

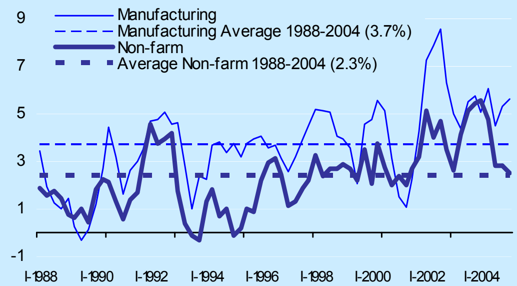
The reasons for such an unfavorable development are probably both cyclical and structural. First, employment has recovered at an unusually slow pace. While GDP resumed its expansion during the fourth quarter of 2001, non-manufacturing employment remained stagnant, exceeding the level observed at the beginning of the recession only until September 2003. Such results are poor as compared with previous cycles; however, the performance of manufacturing employment (which accounts for 11 percent of total employment) is even more disappointing.

A second factor is the poor performance of manufacturing compared with the rest of economic activity. The decline in manufacturing production in the U.S. occurred earlier, and it was sharper and longer than that of GDP. Manufacturing production fell 6.7 percent (from its previous peak to its cyclical trough), while GDP did so by 0.2 percent. In addition, industrial capacity utilization remains below its historical average.

In addition to the aforementioned, manufacturing employment has apparently been affected by other factors. Among them, the higher rate of productivity growth in manufacturing -which has increased in recent years- in relation to the rest of the economy (Graph 2). Furthermore, manufacturing employment has probably been affected in recent decades by a generalized trend to shift labor intensive processes to countries with lower labor costs, as technological changes have increased value chains by specializing in highly intensive capital and skilled-labor processes. Another factor that might have affected manufacturing employment is firms' trend to replace manufacturing jobs with services offered by firms from other sectors (outsourcing).

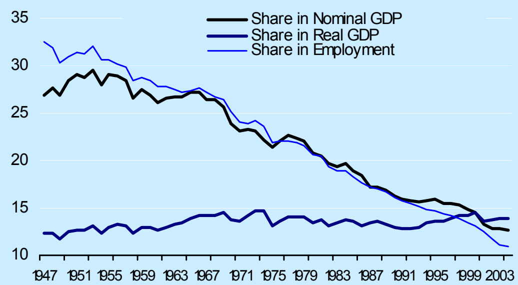
These structural factors have been reflected in a sharp fall of the share of manufacturing employment in total employment as well as in nominal GDP, despite the fact that in real terms its share in GDP has increased slightly (Graph 3).

Graph 2
Manufacturing and Non-farm Productivity
Annual percentage change



Source: Bureau of Labor Statistics.

Graph 3
Share of Employment and Manufacturing Output in Total Employment and GDP
Percent

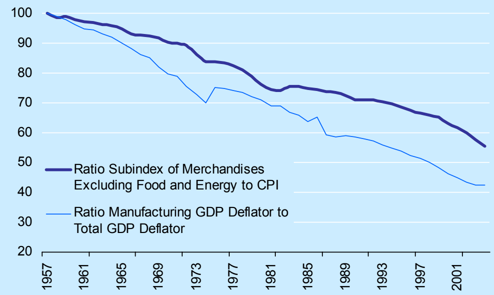


Source: BLS, BEA-NIPA and Federal Reserve.
Note: To calculate the share of real GDP, BEA series for the period 1977-2004 are used. For the period 1947-1976, the Federal Reserve's Industrial Production Index is used.

The differing behavior of the share of manufacturing production in GDP in nominal and real terms can be attributed to the term trend decline in the relative prices of manufactured goods (Graph 4). In fact, the rapid increase in manufacturing productivity and strong worldwide competition has slowed price increases of manufactures more than of other goods. Although the volume of manufacturing production has expanded at a rate similar to GDP, the dollar value of manufactured goods has declined relative to the value of total output.

The rapid growth of productivity in the U.S. manufacturing sector and strong competition worldwide has affected employment in many sectors. Labor intensive sectors (i.e., textiles) have contracted in both employment and production, while in others (computers and electronic goods) output has recorded higher growth rates on productivity gains (Table 1).

Graph 4
Manufacturing Relative Prices
Index 1956=100



Source: BLS, BEA and Federal Reserve.

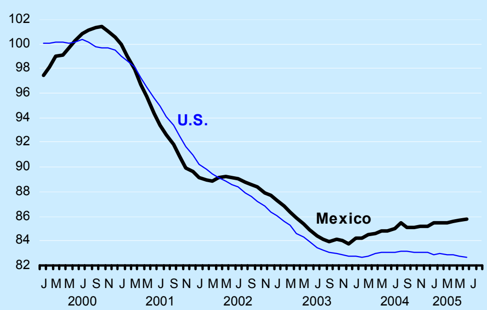
Table 1
Employment and Production by Sectors
Change in thousand jobs and percentage change

From May 2003 to June 2005	Employment			Production	
	Weight (%)	% Change	Absolute change	Weight (%)	% Change
Total 1/		2.9	3710.0		7.9
Manufacturing	100.0	-2.0	-285.0	100.0	9.8
Textiles	1.6	-15.6	-41.4	0.6	-11.6
Chemicals	6.2	-3.5	-32.0	6.0	8.0
Food	10.4	-1.8	-27.8	10.7	3.7
Printing materials	4.6	-3.9	-26.7	2.6	2.3
Computers and electronic equipment	9.4	-1.9	-25.6	9.7	35.7
Plastics	5.6	-2.1	-17.5	4.2	0.8
Transport equipment	12.4	-0.8	-14.3	13.4	13.1
Machinery	8.1	0.2	2.3	6.9	20.6
Metal products	10.7	2.7	39.6	6.7	5.2

1/ Total employment refers to non-farm employment. Production considers the change in real GDP from 2003-II to 2005-1.
Source: BEA, BLS and Federal Reserve.
Note: In May 2003, non-farm employment reached its lowest level during the current business cycle.

Manufacturing employment in Mexico has also contracted in recent years. In fact, its recent recovery resulting from increased production in this sector has been insufficient to offset its previous decline (Graph 5 and 6). Results of both INEGI surveys and IMSS statistics reveal a severe contraction of manufacturing employment as compared with 2000.

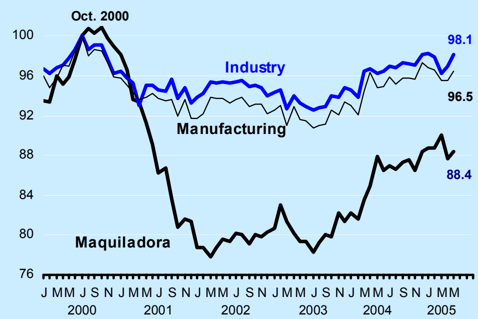
Graph 5
Manufacturing Employment in Mexico and the U.S.
Seasonally adjusted data, 2000=100



Source: Bureau of Labor Statistics for the U.S. and IMSS for Mexico.

The decline in manufacturing employment in the country and the insufficient rebound of production in this sector are partly due to the fact that exports of those products have not recovered vigorously. Mexican products have been losing share in external markets, particularly in the U.S. In this context, U.S. production of different export manufactures could be affected by two shocks: migration of certain production processes that were previously established in Mexico to more competitive economies with lower production costs. This could possibly be affecting highly labor intensive activities. On the other hand, other export production processes closely linked to production chains in the U.S. could also be affected by the migration of these chains to other countries.

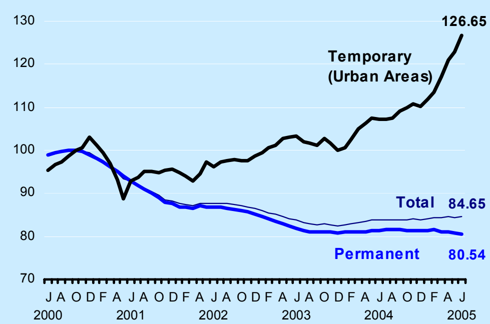
Graph 6
Manufacturing Output in Mexico
Seasonally adjusted data, July 2000=100



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

According to information regarding the number of workers insured by the IMSS, formal employment fell significantly in the manufacturing sector: 725,164 persons at the end of June 2005 as compared with its maximum level reached in October 2000. This figure reflected a reduction in the number of permanent workers (824,060 persons) and an increase in the number of temporary workers in urban areas (98,896). In the manufacturing industry, the following divisions recorded a significant contraction in formal employment: textile and apparel (297,643 workers); metal products, machinery and equipment (294,475 workers); food, beverages and tobacco (57,711 workers); and chemical, rubber and plastic industries (42,850 workers).

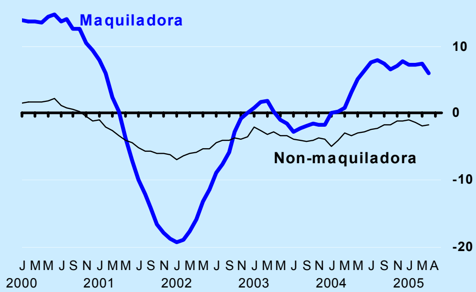
Graph 7
Manufacturing Workers Insured by the IMSS
Seasonally adjusted data, October 2000=100



Maquiladora manufacturing employment has contracted sharply (Graph 8), despite the fact that it recorded significant growth recently by increasing 5 percent at an annual rate in 2004 and 6.9 percent during the period January-April 2005. The maquiladora industry has thus exhibited a restructuring of production towards less labor intensive industries and significant gains in productivity in different industries. This sector has already exceeded export levels reached in 2000 with a lesser number of workers. In fact, in April of this year the maquiladora labor force was made up of 1,164,050 workers, 183,753 (13.6 percent) below its maximum level reached in October 2000 (1,347,803 workers).

Finally, it is important to note that investment returns in different sectors in the country together with gains in productivity have been affected negatively by the lag in adopting pending modernization and structural change measures.

Graph 8
Manufacturing Employment in Mexico
Annual percentage change, seasonally adjusted series

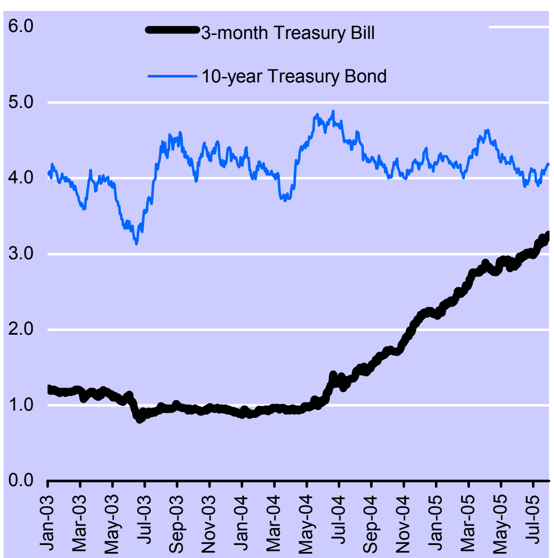


Source: INEGI.

Graph 12 U.S. Interest Rates

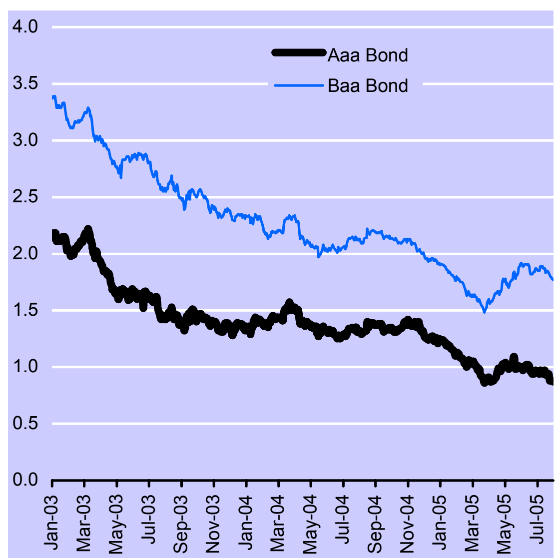
Percent

a) 10-year U.S. Treasury Bond and 3-month Treasury Bill



Source: Federal Reserve.

b) Spread Corporate Bonds vs. 10-year U.S. Treasury Bond



Source: Federal Reserve.

The US dollar gained strength during the April-June period, despite the high current account deficit. From the end of the first quarter to the end of the second, the US dollar appreciated 7.2 percent vs. the euro, 3.4 percent vs. the yen, 1.3 percent vs. the Canadian dollar, and 5.5 percent vs. the sterling pound. The nominal effective exchange rate index against the main currencies shows an appreciation of 4.5 percent.[11] Among the main reasons behind the US dollar's strength are a more optimistic outlook for growth as compared with other advanced economies and a favorable spread in short-term interest rates for the U.S. as compared with the previously mentioned currencies. Nonetheless, at the end of June, the US dollar nominal effective exchange rate vs. the main currencies had depreciated by 24.3 percent as compared with its level in February of 2002.[12]

Stock markets fell during the first half of the year influenced by the increase in oil prices. The Dow Jones Index fell 2.2 percent during the second quarter, declining 4.7 percent at the end of June as compared with its level at the end of 2004. The NASDAQ index rose 2.9 percent during the period April-June, which did not compensate the sharp fall accumulated from January to March (8.1 percent).[13]

Despite the fact that growth expectations for industrial production and investment have been revised downward, GDP growth forecasts for 2005 have remained relatively stable since last year. Private sector analysts' most recent forecasts for U.S. economic growth are 3.6 and 3.2 percent in 2005 and 2006, respectively. Such figures are similar to the average annual growth recorded during the 1995-2004 period (3.3 percent). Regarding inflation, consumer inflation is expected to decline from an average 3.0 percent in 2005 to 2.5 percent in 2006. Federal Reserve's forecasts released in July are similar to those of private sector analysts.[14]

In general, analysts consider that U.S. economic growth will slow gradually towards its potential rate, in an environment of moderate inflation. Nonetheless, such scenario faces several risks. One of the most important could arise from a sudden correction in the high current account deficit (6.4 percent of GDP during the first quarter of 2005). Although such deficit is expected to stabilize as a percentage of GDP during this year and the following, the likelihood of it widening more than expected has increased since March due to the strengthening of the US dollar against the main

[11] The Federal Reserve effective exchange rate index vs. the main currencies is an average of the rates of such currencies weighted by the share of each country in US foreign trade.

[12] Up to July 22, the exchange rate vs. the main currencies had appreciated by 0.2 percent compared to its level at the end of June.

[13] From the end of June to July 22, the Dow Jones and NASDAQ indexes rose by 3.7 and 6.0 percent, respectively.

[14] In its Monetary Policy Report to the Congress of July 20, 2005, the Federal Reserve forecasts GDP will grow at an annual rate of 3.5 percent during the fourth quarter of 2005 and between 3.25 and 3.5 percent in the last quarter of 2006. In addition, it also forecasts the core personal consumption expenditure deflator will record an annual growth rate of between 1.75 and 2.0 percent in the last quarter of 2005 and 2006.

currencies. Although a reduction in the fiscal deficit would diminish such fears, uncertainty regarding the development of public finances in the coming years prevails. Furthermore, the U.S. economy can also be affected by major increases in international oil prices and by the likelihood of a sharp adjustment in real estate prices (which has contributed to support consumption expenditure over the last years).

II.2.1.3. Developments in the Rest of the World

Euro area GDP grew 2.0 percent at an annualized quarterly rate during the first quarter of 2005, after having increased 0.8 percent during the previous quarter. Domestic demand remained in a slump and GDP growth was brought about by a higher trade surplus, which was in turn the result of a contraction of imports. The region's economies continued to show divergent performance. The German economy rebounded significantly while the Italian one contracted for a second consecutive quarter. Available indicators suggest economic activity remained weak during the April-June period (Table 5). In particular, industrial production contracted once more in May, consumer and firms' confidence remained weak, and retail sales came to a standstill during the April-May period. Given the behavior of prices (annual inflation was 2.1 percent in June) and weak domestic demand, private sector analysts anticipate that the European Central Bank will not raise interest rates for the rest of the year.

Japanese GDP growth during the first quarter of 2005 was 4.9 percent at an annualized quarterly rate. This result was mainly determined by temporary factors that raised disposable income and boosted consumption. Although some uncertainty regarding the soundness of the recovery prevails, most recent information points to a moderate expansion of economic activity in the next quarters. The recovery of the labor market has boosted consumption. Employment has risen (in particular, full-time employment, after having contracted for seven years), and contractual wages have began to increase in recent months. Furthermore, corporate profits have strengthened and, as confirmed by the Bank of Japan's last business survey (TANKAN), entrepreneurs' confidence has gained improved.

The Asian emerging economies continued to slow down during the first quarter of 2005. As a result, forecasts for growth for this year (excluding China) have been revised downward, despite the fact that the region is expected to continue to grow at higher rates than the rest of the world. Within the region there is a disparate performance. In particular, GDP in China continued to expand at high rates during the second quarter (9.5 percent at an annual rate). Despite government measures to slow the economy, the risk of overheating has not disappeared. Although consumer inflation fell from 5.2 percent at an annual rate in September 2004 to 1.6 percent in June of this year, a new hike in inflation should not be discarded due mainly to growing pressures on prices faced by the industry. It should the mentioned that, at the end of July, Chinese authorities eliminated the fixed exchange rate regime and adopted a controlled floating foreign exchange regime with a peg to a currency basket.[15] Malay authorities also announced on that same date the adoption of a controlled floating foreign exchange regime for its currency, the ringgit.

The persistence of low long-term interest rates in advanced economies and intense competition in the market for investment funds drove investors to search for higher yields in international markets during the second quarter. As a result, and given the improvement in many emerging economies' fundamentals, the access of these countries to international financing remained favorable during that period. After having recovered and reached 345 basis points (excluding Argentina) in mid-April (as recorded by the EMBI+ composed), emerging economies sovereign spreads fell to 297 basis points at the end of June.[16] Emerging economies continued to take advantage of these favorable conditions to cover their borrowing requirements for 2005, and some countries have started to prefinance their financial needs for 2006. Although the outlook for emerging markets access to international financing for the rest of the year is favorable, risks still prevail in the current environment.

[15] Chinese authorities announced the renminbi would be revalued initially by 2 percent vs. the US dollar and that they will allow it to float every day by ± 0.3 percent around the central parity published by the central bank at the end of the previous day. A floating exchange rate band for the renminbi vs. other currencies was also announced; however, the composition of the currency reference basket has still not been released.

[16] Sovereign spread indexes plummeted in mid-June, mirroring JP Morgan's replacement of Argentina's past due bonds for new restructured bonds. Thus, in June 14, Argentina's subindex fell more than 5,700 basis points, reaching 906 bp. As a result, the EMBI+ composed fell 52 bp, reaching 316 bp, while the EMBI+ Latin fell 86 basis points, reaching 367 basis points on that same day. In order to isolate this event from indexes' fundamental trends, the EMBI+ excluding Argentina is considered.

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

Annual and annualized quarterly percentage change

	Forecasts at the end of the first quarter			Most recent data Estimate		Forecast
	II-2005 1/	2005 2/	2006 2/	II-2005 1/	2005 2/	2006 2/
Canada	4.4	2.6	3.0	2.0	2.7	2.9
Euro area	2.0	1.6	2.0	0.8	1.3	1.7
Japan	0.8	0.9	1.7	0.0	1.5	1.5
United Kingdom	2.4	2.6	2.4	1.5 3/	2.1	2.3

1/ Annualized quarterly change (seasonally adjusted series).
2/ Annual percentage change.
3/ Observed.
Source: Consensus Forecasts March 14, 2004, and June 13 and July 11, 2005. Annualized quarterly rates are obtained from reported quarterly percentage change forecasts.

Economic activity in Latin America slowed during the first months of 2005 compared with the high growth rates recorded in previous months. After having grown 9.3 percent in the last quarter of 2004, Argentinian GDP grew at an annual rate of 8.0 percent during the first quarter of 2005. At the same time, the annual inflation rate rose from 6.1 percent at the end of 2004 to 9.0 percent in June of this year. Brazil's GDP grew at an annual rate of 2.9 percent during the first quarter, below the 4.7 percent figure observed during the fourth quarter of 2004. During May, industrial production grew far below the rates observed in mid-2004. In June, the inflation rate reached its lowest level in seven months (7.3 percent), although still above the central bank's target for the end of the year. Chile's GDP growth fell from 7.3 percent in the last quarter of 2004 to 5.8 percent in the first three months of 2005, despite the fact that industrial production recovered at the beginning of the second quarter. The annual inflation rate (2.7 percent in June) remained within the official target (3 +/-1 percent), although following an upward trend.

II.2.2. Wages, Productivity and Employment

Based on information available up to the second quarter of 2005, wages and unit labor costs in Mexico were characterized by the following:

a) Contractual wages rose, on average, 4.4 percent, 0.1 percentage points below the previous quarter's observed figures and those recorded in the same quarter of the previous year.

b) During the period January-April 2005, unit labor costs (ULC) in maquiladora and non-maquiladora manufacturing industries, and in the retail sector, recorded negative annual growth rates.

II.2.2.1. Contractual Wages

During the period April-June 2005, contractual wages' average nominal increase negotiated by workers of companies under federal jurisdiction was 4.4 percent, 0.1 percentage points below the figure observed both in the previous quarter and in the same quarter of 2004. During the period January-June 2005, contractual wage increases in public and private enterprises were the same as those negotiated during the first half of the previous year (4.5 percent on average).

By type of enterprise, contractual wage increases posted different results during the second quarter of 2005. Wage revisions in private enterprises recorded an average increase of 4.6 percent, 0.6 percentage points above that obtained in public enterprises (Table 6). During the same period, 78 percent of workers subject to wage revisions were from the private sector and only 22 percent from the public sector.

Table 6 **Contractual Wage Increases [1/] and Number of Workers Benefited by Type of Enterprise**

Percent

	2004						2005					
	T I	T II	Jan-Jun	T III	T IV	Jan-Dec	T I	Apr	May	Jun	T II	Jan-Jun
Contractual Wage Increase (percent)[1/]												
Total	4.5	4.5	4.5	4.3	3.4	4.1	4.5	4.4	4.5	4.5	4.4	4.5
Public Enterprises	3.9	3.9	3.9	4.0	3.1	3.5	3.6	4.0	4.5	3.3	4.0	3.8
Private Enterprises	4.6	4.6	4.6	4.7	4.3	4.6	4.7	4.6	4.5	4.6	4.6	4.6
Workers Benefited (percentage share)												
Total	100	100	100	100	100	100	100	100	100	100	100	100
Public Enterprises	20	21	21	48	72	42	19	33	1	3	22	20
Private Enterprises	80	79	79	52	28	58	81	67	99	97	78	80

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 January and April 2005, unit labor costs in maquiladora and non-maquiladora manufacturing industries, and in the retail sector, grew negatively at an annual rate. In general terms, this fall was below that observed in the same period of 2004. Such result is mainly attributed to reductions in average labor productivity.

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-Apr	6.7	1.6	-4.8	2.3	1.9	-0.4	9.5	1.3	-7.4
Jan-Dec	6.3	0.1	-5.8	2.1	-0.2	-2.2	7.0	2.7	-4.0
2005									
Jan-Apr	**2.6**	**-0.7**	**-3.0**	**-1.4**	**-1.9**	**-0.4**	**4.9**	**1.7**	**-3.0**

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

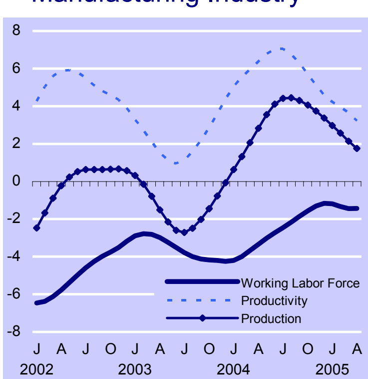
Unit labor costs in the non-maquiladora manufacturing industry fell at an annual rate of 3.0 percent during the period January-April 2005 (Table 7). Such result is attributed to an annual reduction in real average earnings (-0.7 percent during the referred period), and to productivity gains (2.6 percent). However, productivity gains were 4.1 percentage points below those observed in the same period of 2004, partly due to the slowdown in non-maquiladora manufacturing production during the period (Graph 13 and 14).

Unit labor costs in the maquiladora industry fell at an annual average rate of 0.4 percent during the period January-April 2005 (Table 7). Such result is mainly attributed to a reduction in real average earnings (-1.9 percent on average), which more than compensated the contraction in labor productivity (-1.4 percent). Labor productivity followed a downward trend due to the significant recovery of employment in this sector, whose dynamism outpaced that of production (Graph 13 and 14).

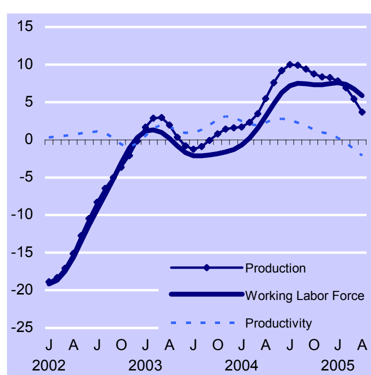
Graph 13 **Production, Working Labor Force and Labor Productivity**

Trend, annual percentage change

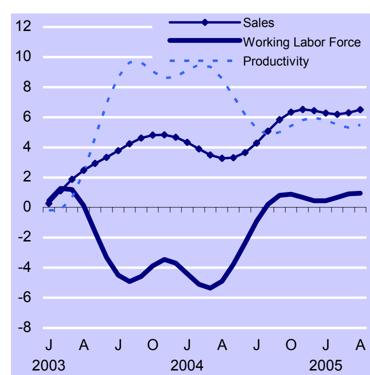
a) Non-maquiladora Manufacturing Industry



b) Maquiladora Industry



c) Retail

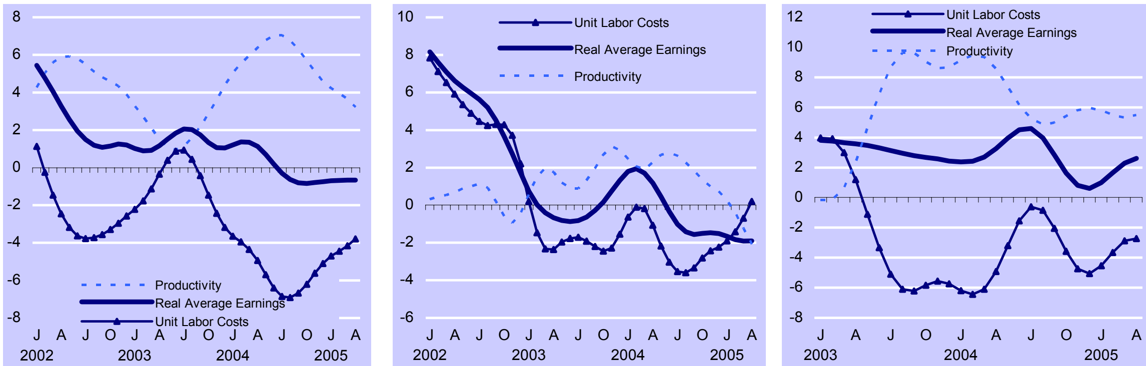


Source: Prepared by Banco de México with data from INEGI.

Graph 14 **Earnings, Labor Productivity and ULC**

Trend, annual percentage change

a) Non-maquiladora b) Maquiladora c) Retail



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

Unit labor costs in the retail sector fell at an annual average rate of 3.0 percent during the first four months of 2005, below that observed during the same period of 2004 (-7.4 percent). ULC results during the period January-April 2005 are explained by the growth in real average earnings (annual average rate of 1.7 percent), which also ended below that of labor productivity (4.9 percent on average).[17] Nonetheless, when comparing the results of the latter indicator in relation to the same period of the previous year, labor productivity slowed down its trend. This is mainly due to the recovery of retail employment, particularly in supermarkets and department stores.

II.2.2.3. Employment

The expansion of economic activity observed during the first half of 2005 raised the demand for labor. This was reflected in an improvement in some employment indicators, although others exhibited signs of weakness. In general terms, the most significant aspects of the labor market during the second quarter of the year were the following: a) the strengthening of formal employment, as reflected by the increase in its annual growth rates during the quarter; b) more new jobs were created for temporary than permanent workers, and in larger-size companies; c) formal job creation included different regions of the country; however, it was more vigorous in the Northern region. In contrast, formal job creation in the Center region exhibited less strength in its annual comparison and concentrated in temporary jobs; d) the increase in

[17] Productivity in the trade sector is calculated according to sales and employed workers and, therefore, the resulting indicator does not compare strictly with that of manufacturing, which considers production and employed workers.

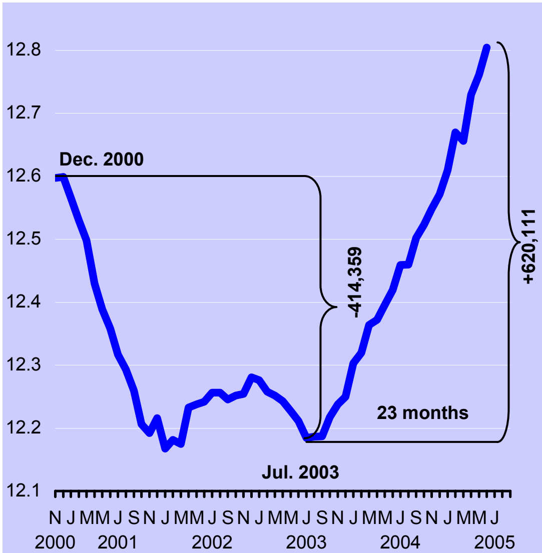
the number of workers insured by the IMSS included most sectors; however, it was higher in trade and services-related activities; e) maquiladora employment continued to recover, despite the fact that at the end of April it was still significantly below the maximum levels reached during the fourth quarter of 2000; f) non-maquiladora manufacturing employment fell once more at an annual rate; and, g) the national open unemployment rate fell as compared to the first quarter of the year.

At the end of June 2005, 12,799,783 workers were insured by the IMSS, 186,958 workers more than at the end of March. The number of workers insured, with seasonally adjusted data, rose at a monthly rate in twenty-two of the last twenty-three months. Thus, this indicator recorded an increase of 620,111 workers insured during that period. Such improvement allowed formal employment to end June 2005 206,000 jobs above the maximum level reached at the end of 2000 (Graph 15).

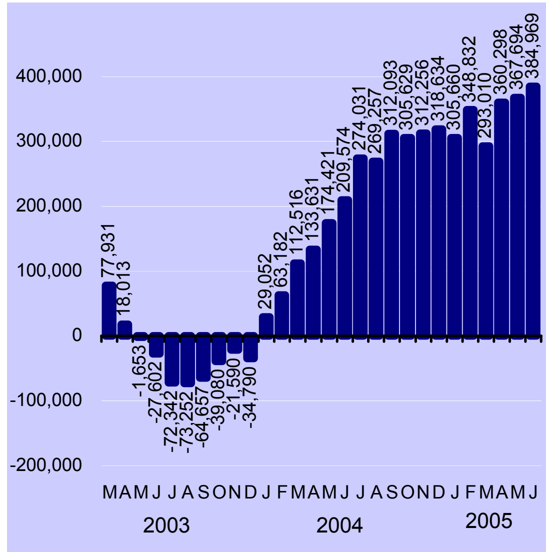
At the end of June 2005, the number of workers insured by the IMSS rose by 384,969 at an annual rate. This variation originated from annual increases of 166,713 permanent workers (1.55 percent) and 218,256 temporary workers in urban areas (13.25 percent). On another front, formal jobs were created in all regions of the country, although more in northern states. The share of temporary workers in formal employment rose significantly in all four regions; however, in the Center region it constituted the main component of job creation (Graph 16).

Graph 15 **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.

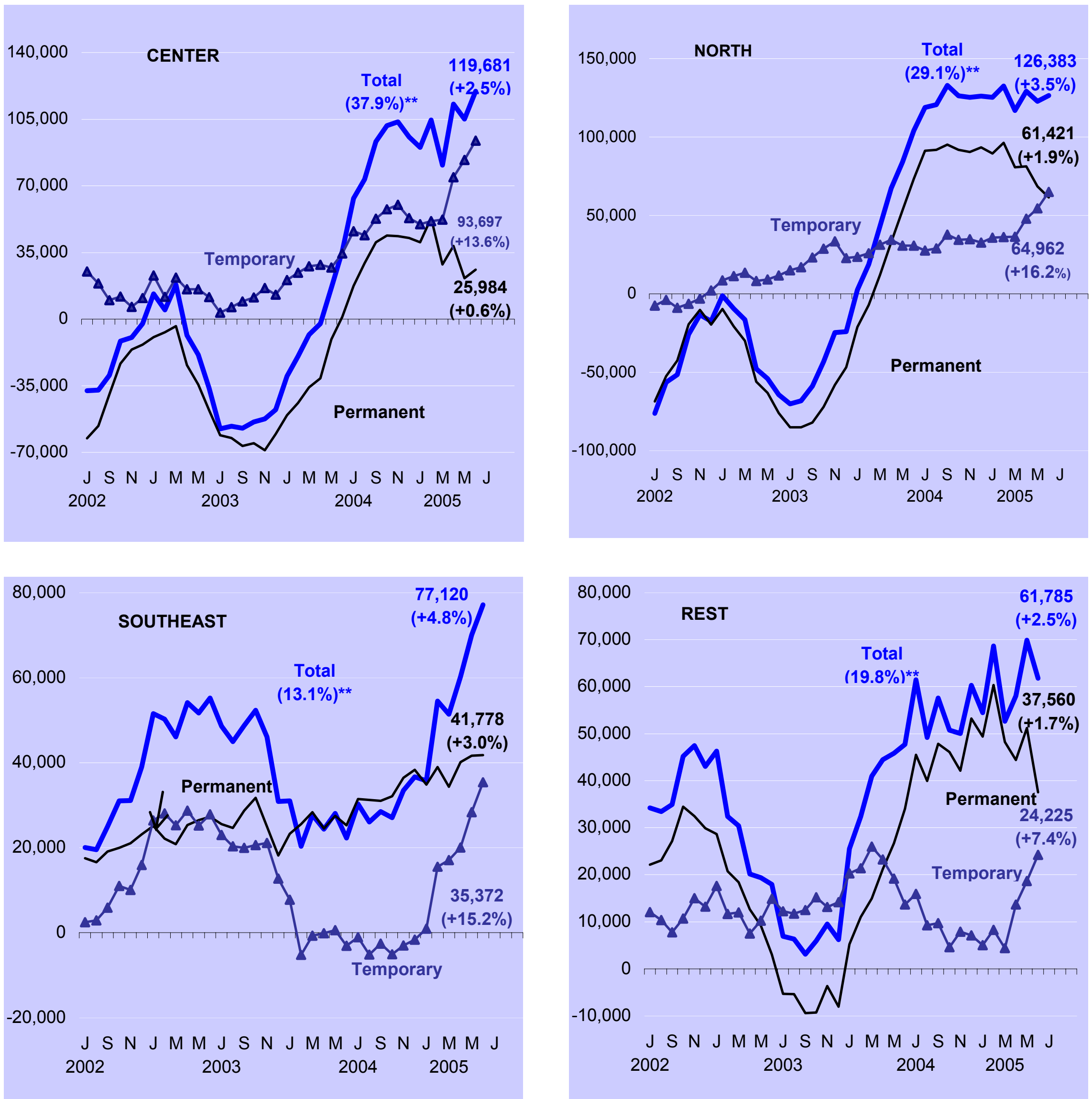
During the second quarter of 2005, formal job creation included most sectors; however, the highest annual increases were observed in the following sectors: trade (69,302 workers), other services (188,010 workers), construction (60,609 workers), and manufacturing (45,236 workers in the maquiladora and non-maquiladora industries). The higher number of manufacturing workers insured by the IMSS resulted from an annual reduction in the number of permanent workers insured, which was offset by the increase in the number of temporary workers insured in urban areas.

INEGI began to conduct a new employment survey called Occupation and Employment Survey (*Encuesta Nacional de Ocupación y Empleo, ENOE*), which measures the unemployment rate in the entire country.[18] After having recorded 3.85 percent during the first quarter of the year, such rate was 3.53 percent on average during the second quarter of 2005.

[18] The ENOE will replace 2 surveys in the future: The Employment Survey (*Encuesta Nacional de Empleo, ENE*), which is conducted on a quarterly basis and represents the entire country and the Urban Employment Survey (*Encuesta Nacional de Empleo Urbano)*, conducted on a monthly basis and which covers 32 cities.

Graph 16 **Formal Employment by Regions**[1]

Annual variation of number of workers



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.

** Percentage in ( ) for each region's total represents the share in May 2005 in the total number of workers insured by IMSS.

Source: IMSS. Regional classification by Banco de México.

II.2.3. Aggregate Supply and Demand

During the second quarter of 2005, economic activity expanded significantly at an annual rate, above that observed in the first quarter. Nonetheless, the behavior of production in both periods was influenced by the statistical effect associated with the Easter holiday. This implied that the number of working days in the second quarter rose as compared with the same period of the previous year, while the number of working days in the first quarter decreased as compared with the first quarter of 2004. Consequently, such effect raised GDP's annual rate of growth during the second quarter and reduced that corresponding to the first quarter of the year. After adjusting GDP figures for such effect, during the second quarter, and just as in the first quarter of this year, economic activity grew more moderately as compared with the entire 2004, and particularly, as compared with the performance of the economy during the second half of that year.

All components of aggregate demand, both domestic and external, contributed to GDP growth during the second quarter of 2005. Four aspects must be considered in such contribution. First, domestic expenditure's dynamism in consumption and investment prevailed during the second quarter; however, at a more moderate rate than that observed during the second half of the previous year. Second, exports of goods and services grew at the significant annual rate during the second quarter, although also below that recorded during the second half of the previous year. Such conditions mirrored the slowdown of external demand, particularly from the U.S. Third, the expansion of both aggregate demand and GDP raised imports of goods and services. Finally, the behavior of the different components of aggregate demand during the first half of 2005 allows for estimating that during that period the relative contribution of domestic expenditure to GDP growth increased as compared with that of external demand.

During the second quarter of 2005, the external environment exhibited mixed results regarding its contribution to the development of domestic economic activity. On the one hand, higher external revenues from oil exports and workers' remittances contributed to raise domestic expenditure, both in consumption and investment. Such expenditure was also favored by foreign private capital flows. On the other, and as already mentioned, although exports of goods and services grew at an annual rate during the period, they did so less vigorously than in 2004. It should be mentioned that additional factors contributed to consumption expenditure growth and to foster the expansion of investment during the quarter. Among those, commercial banks and chain stores' credit to consumption, together with mortgage financing -that continued to grow vigorously- and commercial banks' credit to firms, which has also recovered.

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

a) GDP grew at a significantly higher annual rate than during the first quarter of the year, although such result was influenced upward (while that of the first quarter, downward) by the statistical effect of the Easter holiday. Nonetheless, both in the second quarter of the year as well as in the first half of the year, GDP growth was below the figures recorded during the second half of 2004. On another front, available indicators of production show that during the period April-May, the Global Indicator of Economic Activity (*Indicador Global de la Actividad Económica, IGAE*) recorded an annual increase of 4.3 percent, as a result of annual increases in the three sectors that make up such index, being the most relevant those of the industrial and services sectors (4.1 and 4.7 percent, respectively). Nonetheless, with seasonally adjusted figures, the referred annual rate during such period was 3 percent. In fact, this indicator has lost strength in recent months (Graph 17a).

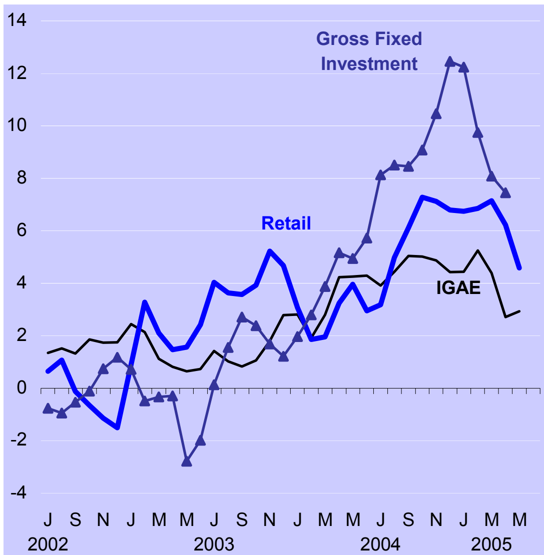
b) Numerous indicators reveal an expansion in private consumption: i) during the period April-May retail sales rose at a significantly annual rate of 6.1 percent; ii) ANTAD sales grew at an annual rate of 8 percent; and iii) car retail sales grew at an annual rate of 4.9 percent (Graph 17a).

c) Just as in the first quarter, investment was the most dynamic component of domestic demand. In April, it grew at an annual rate of 12.3 percent (7.2 percent with seasonally adjusted data). Such result originated from increases in both components of machinery and equipment (17.6 percent) and of construction (6.5 percent). Investment is expected to have grown above 8 percent during May.

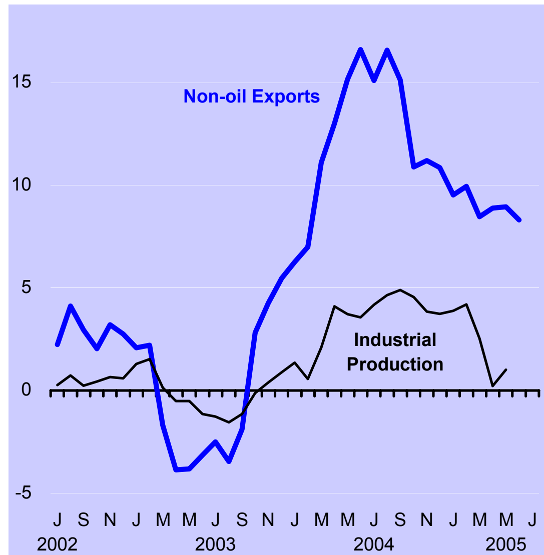
Graph 17 **Indicators of Aggregate Demand and Production**

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

a) Domestic Demand and Production



b) External Demand and Production



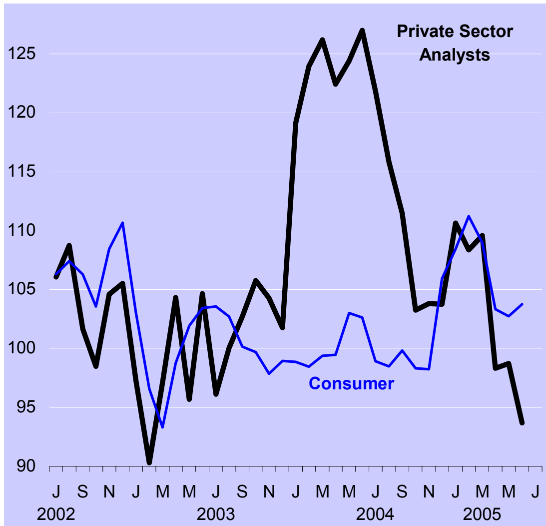
Source: a) INEGI and b) INEGI / Banco de México.

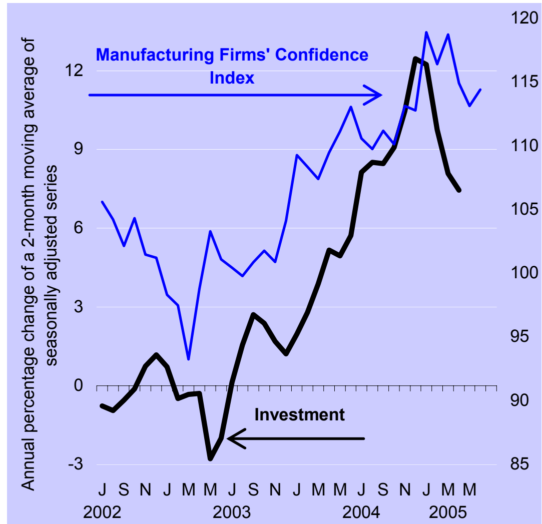
d) Industrial production grew at an annual rate of 4.1 during the period April-May (5.2 and 3 percent in April and May, respectively), while manufacturing production grew at an annual rate of 4 percent (5.4 and 2.7 percent in April and May). April increases were influenced upward by the statistical effect of the Easter holiday. Thus, with seasonally adjusted data, industrial production during the period April-May grew only 1 percent. Overall, during the first five months of 2005, industrial production grew at an annual rate of 1.6 percent, below that recorded during the second half of 2004 (4.2 percent) (Graph17b).

e) Confidence indicators weakened as compared with their average levels of the first quarter (Graph 18). In June, two out of three indicators for Mexico –Consumer Confidence and Business Confidence- exhibited monthly rate improvements.

Graph 18 **Confidence and Business Climate Indicators**

Indexes 2003 = 100





Source: Banco de México and INEGI.

After having remained in a slump for three years and recovered in 2004 and in the first months of 2005, investment measured at constant prices and with seasonally adjusted data ended April 2005 3.8 percent above its maximum level reached in November 2000. Nonetheless, within this aggregate mixed results were observed. In April, construction expenditure was 10.8 percent above its level in November 2000, while investment in machinery and equipment was still slightly lagging (1.4 percent). Under such context, it is important to point out, as Banco de México has reiterated on numerous occasions, that the lack of advance structural change measures continues to be a factor which inhibits a more robust recovery of investment expenditure.

The behavior of a wide range of indicators allows for estimating that annual GDP growth surpassed 4 percent during the second quarter of 2005, figure above that recorded during the previous quarter (2.4 percent).[19] Both figures were influenced by the statistical effect of the Easter holiday (the first one was influenced upward while the second one downward). Nonetheless, overall, GDP growth is expected to have been around 3.5 percent

[19] Latest official available information on GDP and aggregate demand and supply corresponds to the first quarter of 2005. In such period, private consumption and gross capital formation grew significantly at an annual rate (5.4 and 6.5 percent, respectively). The increase in gross capital formation resulted from the considerable expansion at an annual rate of public investment (18.6 percent) while private investment grew at a slower rate (4.4 percent). Exports of goods and services grew at an annual rate of 4.8 percent, more moderately than during the previous quarter.

during the first half of 2005, while for the second half of 2004 GDP growth was 4.7 percent.

II.2.4. Balance of Payments and Capital Flows

During the second quarter of 2005, Mexico's external sector performed very similarly to the first quarter and was characterized by the following: a) non-oil exports and total imports grew at a slower rate than in the second half of 2004; b) the value of oil exports rose significantly; c) moderate trade and current account deficit; d) significant revenues from workers' remittances; e) a moderate capital account surplus; and, f) a small accumulation of international reserves.

Just like other economic indicators, Mexico's foreign trade during the second quarter of 2005 was influenced by the statistical effect of the Easter holiday.[20] The arithmetic impact of such effect was an increase in the annual growth rate of both non-oil exports and merchandise imports during the second quarter, and a decline in the corresponding annual growth rates of the previous quarter.

Merchandise exports rose at an annual rate of 13.4 percent during the second quarter of the year, as a result of an increase in both oil and non-oil exports (34.2 and 10.6 percent, respectively). Among the latter, exports of manufactured products rose 9.9 percent. The surge in oil exports mirrored the upward trend followed by international oil prices, which reached record high levels. The average price of the Mexican crude oil export mix during the quarter was 41.16 US dollars per barrel, far above the previous quarter price (34.63 US dollars).[21]

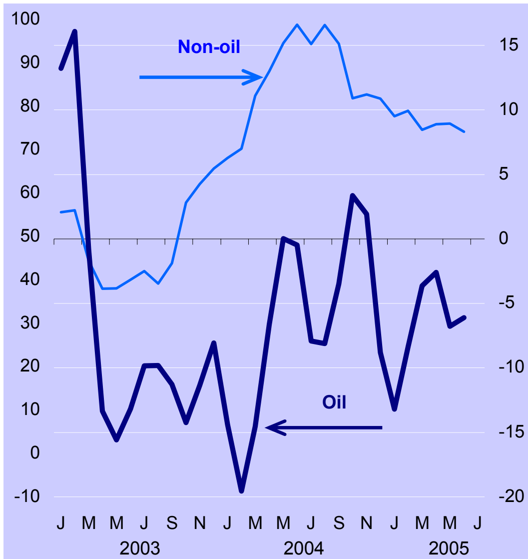
[20] During 2004, the Easter holiday took place during the second quarter of the year and therefore reducing the number of working days during that period. In contrast, in 2005 this holiday took place during the first quarter, therefore increasing the number of working days during the second quarter of the year. As a result, the rate of growth of both non-oil exports and merchandise imports rose during this period and decreased during the first quarter.

[21] The volume of crude oil exports has slightly decreased in 2005. During the first half of the year such volume was, on average, 1.831 million daily barrels, while in the same period of 2004 it was 1.838 million.

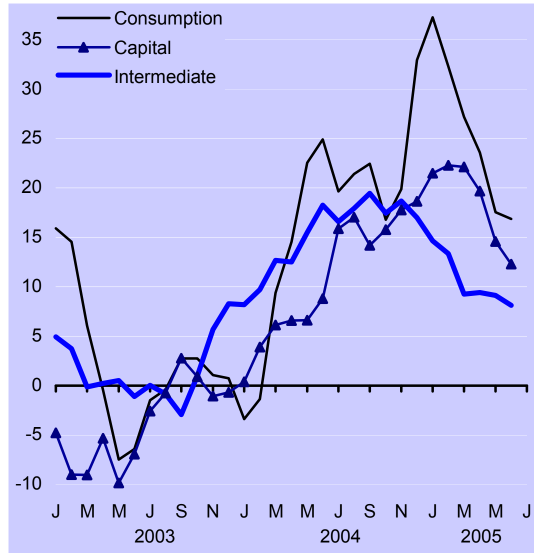
Graph 19 **Exports and Imports (Merchandise)**

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

a) Exports



b) Imports



Source: Banco de México.

During the first half of 2005 oil-related exports as well as oil-related imports grew significantly at an annual rate of 32.2 and 51.6 percent, respectively. In fact, during the first half of the year, the value of oil exports (including petrochemical exports) rose by 3.446 billion US dollars (from 10.707 billion in the first half of 2004 to 14.153 billion during the same period of 2005). Oil imports during the reference period rose by 2.368 billion US dollars (from 4.593 to 6.961 billion), 958 million of which corresponded to gasoline imports. Such results implied an oil trade surplus of 7.191 billion US dollars during the first half of 2005, 1.078 billion above that observed during the first half of 2004.

Merchandise imports grew at an annual rate of 12.2 percent during the second quarter of 2005. Such increase resulted from the annual growth exhibited by its three components: intermediate, capital, and consumption goods' imports (10, 16.3 and 22.6 percent, respectively).

Foreign trade seasonally adjusted data shows that during the second quarter of 2005 the rate of growth of non-oil exports slowed as compared with that recorded during the second half of 2004 (Graph 19). Such developments were due, to a great extent, to the less vigorous expansion of external demand, particularly that from the U.S. As is well known, U.S. industrial production is a very important determining factor of Mexico's external demand. Therefore, the slower dynamism of the U.S. industry led to a slowdown in Mexican non-oil exports. However, this has also responded to the gradual loss of share of Mexican products in its main export market (Box 2).

Merchandise imports with seasonally adjusted data grew significantly during the second quarter of the year, albeit at a more moderate rate than in the previous quarters and, particularly, than in the second half of previous year. This was the net result of two trends: on the one hand, the significant growth of domestic demand; on the other, the slowdown of domestic production, which was also offset by the well-known less vigorous development of external demand. All imports components slowed down.

During the second quarter of 2005, the trade deficit totaled 700 million US dollars, figure below that observed during the same period of 2004 (1.12 billion). Such result is attributed to oil exports, whose value rose during the second quarter of the year by 1.954 billion US dollars as compared with the same period of 2004. This implied an increase in the trade deficit excluding oil, which reflects the fact that, during the second quarter, domestic expenditure kept growing more than GDP in annual terms.

During the period January-May 2005, Mexican exports to the U.S. grew significantly at an annual rate of 8.7 percent, fueled by higher oil exports. Nonetheless, such expansion was below that recorded by imports from the rest of the U.S. trading partners (15.12 percent) (Table 8). Consequently, the share of Mexican exports in U.S. imports continued to weaken by falling from 10.91 percent during the period January-May 2004 to 10.37 percent during the same period of 2005. Excluding the value of Mexican crude oil exports to the U.S., the relative performance of Mexican products in the U.S. market continues to be unfavorable. In particular, automotive exports grew only 0.18 percent in annual terms during the reference period, below that of total U.S. automotive imports (3.02 percent). Table 8 and Graph 20 show that even when excluding Chinese exports to the U.S., the relative performance of Mexican exports in U.S. imports still deteriorates, considering that during the reference period Mexican products lost market share compared with the rest of the U.S. trading partners (excluding China).

Box 2
Mexico's Competitiveness

During the second quarter of the year, Banco de México and the Ministry of the Economy conducted a survey among Mexico's most important foreign-owned companies. The survey was aimed, first, at drawing an estimate of Foreign Direct Investment (FDI) inflows to Mexico in 2005 and, second, at obtaining companies' point of view regarding different aspects of the Mexico's competitiveness. As for the former, responses from 364 of the country's most important foreign-owned companies allow for estimating that in 2005 they will invest approximately 16.447 billion US dollars (FDI flows of 12.281 billion US dollars when considering financing sources). This figure falls within the lower limit of FDI inflows to the country expected during the year, considering that for the rest of foreign-owned companies no estimates of investment for this year were obtained.

Regarding the latter issue of competitiveness, the main results were as follows:

a) **Factors limiting FDI flows to the country.** Companies agreed that factors currently discouraging FDI inflows to the country are, mainly, structural. According to foreign subsidiaries in Mexico, factors limiting FDI are: the lack of advance in pending structural reforms (fiscal, labor, and energy); the prevailing domestic political uncertainty; the lack of fiscal incentives to invest; legal uncertainty; and public insecurity problems (Table 1).

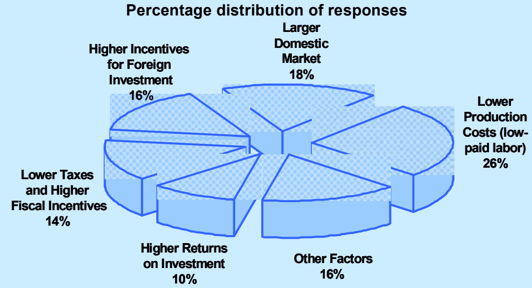
Table 1
Factors Limiting FDI Flows to Mexico
Percentage distribution of responses

Factor	Percentage structure
1. Lack of fiscal reform	13
2. Domestic political uncertainty	8
3. Lack of energy reform	8
4. Lack of fiscal incentives to invest	8
5. Lack of labor reform	7
6. Legal uncertainty	7
7. Public insecurity problems	7
8. Excessive regulations	6
9. Uncertainty regarding Mexico's current economic conditions	6
10. Weak domestic market	6
11. Expensive and low quality primary services (electricity, water, etc.)	5
12. Uncertain regulatory framework	4
13. Authorities' corruption	4
14. Other	11
Total	100

b) **Chinese competition.** Thirty eight percent of surveyed companies pointed out that their corporate groups have also invested in China. From this amount, 42 percent mentioned that in the last three years investments to that country have negatively affected the amount of inflows to Mexico. Forty-one percent stated that the demand for their products in Mexico has been affected by Chinese competition.

Companies whose investments in Mexico have been affected negatively by their headquarters decision to invest in China mentioned that the main factors determining investments in that country were the following: lower production costs, mainly labor; a larger domestic market; and, in general, more incentives for foreign investment (Graph 1).

Graph 1
Main Factors which have Fostered Increased Investments in China in Detriment of Inflows to Mexico
Percentage distribution of responses



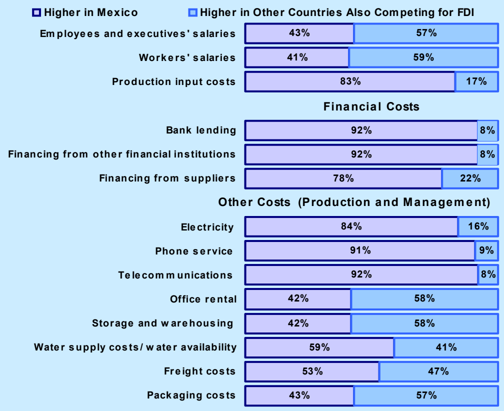
c) **Factors affecting firms' competitiveness.** Foreign-owned companies in Mexico mentioned the following as factors affecting significantly their competitiveness against other countries: the lack of structural reforms; excessive regulation; bureaucracy inefficiency; and, the country's legal framework (Table 2). On the other hand, 70 percent of companies pointed out that both environmental regulations and availability of credit and skilled labor have not affected the country's competitiveness significantly.

Table 2
Factors Affecting Competitiveness in Mexico vs. Other Countries
Percentage distribution of responses

Factor	Many	Few or Zero	Total
1. Lack of structural reforms	78	22	100
2. Excessive regulations	65	35	100
3. Bureaucracy inefficiency	56	44	100
4. Legal framework	56	44	100
5. Corruption	48	52	100
6. Security for enterprises' premises and employees, and in transportation	41	59	100
7. Customs regulations	36	64	100
8. Domestic political conditions	35	65	100
9. Non-custom restrictions to foreign trade	34	66	100
10. Requirements for setting up new businesses	33	67	100
11. Lack of infrastructure	29	71	100
12. Skilled labor available	24	76	100
13. Lack of domestic suppliers	24	76	100
14. Credit availability	24	76	100
15. Environmental regulations	9	91	100

d) **Production Costs in Mexico and Other Countries.** Companies stated that many costs such as financial, electricity, phone and telecommunications, water supply, and freight costs; and those involving certain inputs, are higher in Mexico than in other countries competing for FDI inflows (Graph 2).

Graph 2
Production Costs in Mexico vs. Other Countries that also Compete for FDI
Percentage structure



a) **Security Costs.** Outlays for security have affected companies' costs significantly. Eighty-five percent of surveyed companies pointed out that security expenditures accounted for up to 4 percent of their revenues and 9 percent indicated that such costs represent between 5 and 8 percent of their total revenues (Table 3).

Table 3
Security Costs* as a Percentage of Total Sales/Revenues
Percentage distribution of responses

Security Costs	Percentage of Enterprises
Up to 4%	85%
From 5 to 8%	9%
From 9 to 12%	3%
From 13 to 16%	1%
Over 16%	2%

* Includes costs of security for firms, employees, equipment, freight guard, etc.

b) **Quality of Electricity Supply.** Sixty-seven percent of companies mentioned that they frequently suffer from blackouts or voltage variations (Graph 3). Consequently, they incur in many costs, such as: the purchasing of power-generating plants and voltage-regulating equipment; production line failures; electronic data losses; repair or replacement of damaged equipment; etc.

Graph 3
Quality of Electricity Supply to Firms
Percentage distribution of responses

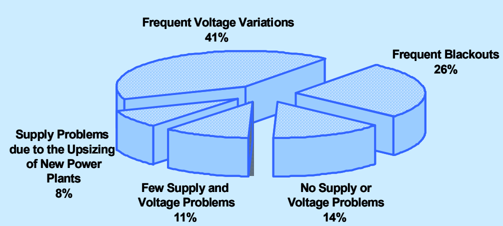


Table 4
Costs Faced by Companies due to Voltage Variations and Blackouts
Percentage distribution of responses

	Percentage Structure
1. Purchase of power plants and voltage-regulation equipment	15
2. Production line failures	14
3. Electronic data losses	12
4. Repair or replacement of damaged equipment	10
5. Telecommunication systems affected	9
6. Fall in productivity due to production line failures	9
7. Product delivery problems	9
8. Production losses	7
9. Damage to industrial plant hardware	7
10. Material waste	5
11. Lower quality of final goods	2
12. No cost	1
Total	100

c) **Evaluation of Other Aspects of Competitiveness.** Companies were requested to evaluate different factors that could affect their competitiveness, such as: the prevailing infrastructure; the supply of human resources and hiring practices; the formalities for setting up new businesses in Mexico, as well as the quantity and quality of domestic suppliers. The percentage distribution of companies' responses was converted into a rating grade that ranged between 2.5 and 10 points.[1] Several aspects of competitiveness rated low (Table 5), particularly, those regarding the process for setting new businesses (4.2 points); rail infrastructure availability (3.7 points); and, hiring and firing practices (5 points). On the contrary, aspects regarding the availability of skilled labor (7.1 points); work discipline among less-skilled workers (6.2 points); and the availability of domestic suppliers (6.0 points) as well as the quality of their products (6.5 points) rated high.

Table 5
Rating of Different Issues Regarding Competitiveness

Issue	Rating
INFRASTRUCTURE	
* General infrastructure	5.2
* Airports and air freight	5.7
* Sea ports	5.4
* Rail infrastructure	3.7
HUMAN RESOURCES	
* Supply of engineers, managers, and technical professionals	7.1
* Work discipline and the desire to learn among less-skilled workers	6.2
* Hiring and firing practices	5.0
TAXES	
* Tax system	3.5
OTHER	
* Domestic suppliers' quality	6.5
* Availability and variety of domestic suppliers	6.0
* Uncomplicated formalities to set up businesses	4.2

[1] Companies ranked each aspect of competitiveness from 1 to 4, from least (1) to most (4). For example:

Total infrastructure	:	Hardly developed and inefficient	1	2	3	4	Best suited to needs

A number **1** marked response means that the company **totally** agreed with the answer on the left; a number **2** marked response means it **somewhat agreed** with the answer on the left. On the contrary, if it chose number **3** as an answer it means that it **somewhat agreed** with the answer on the right; and number **4**, that it **totally** agreed with the answer on the right. Response options were given the following score: number 1=2.5 points; number 2=5 points; number 3=7.5 points; and number 4=10 points. This score was weighted by the frequency of responses corresponding to each of the four options and it applied to all aspects of competitiveness.

Mexico's inflows via workers' remittances totaled 5.214 billion US dollars during the second quarter (annual growth rate of 15.7 percent vs. 20.5 percent during the first quarter of the year). During the first six months of 2005, revenues from remittances totaled 9.278 billion US dollars, an annual growth rate of 17.8 percent, below that recorded in 2004 (24 percent). Such amount originated from 27.7 million transactions for an average value of 334 US dollars/each, equal to almost 75 percent of revenues from crude oil exports recorded during that period.

Table 8 **U.S. Imports**

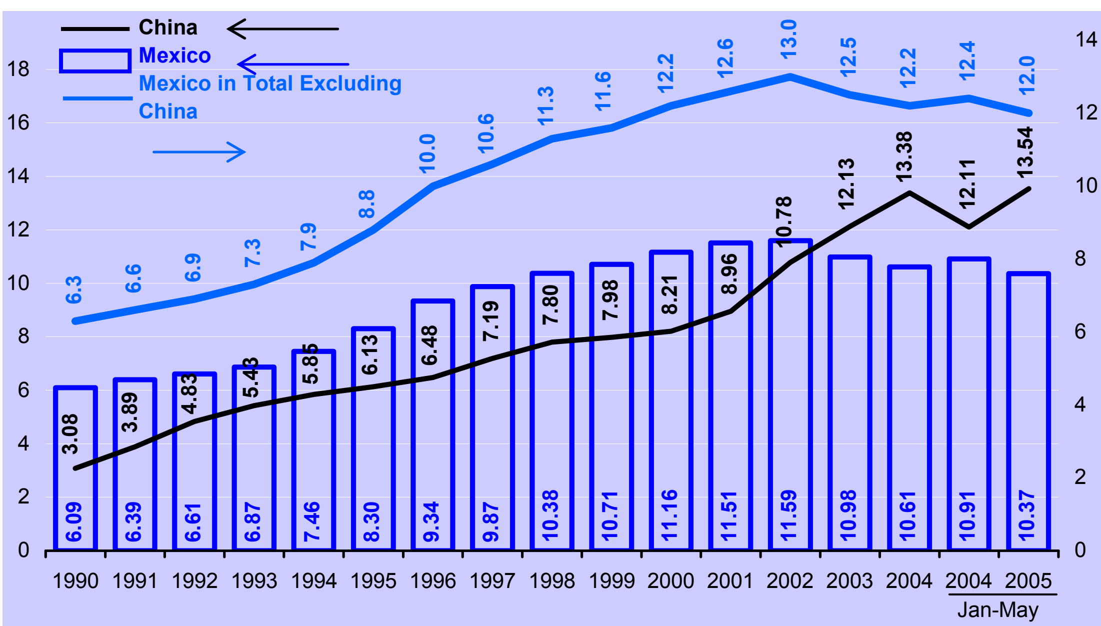
Percent

	Share				Annual percentage changes: January-May 2005				
	2003	2004	Jan-May 2004	Jan-May 2005	Total	Oil	Total Excluding Oil	Automotive	Total Excluding Oil and Automotive
Total	**100.00**	**100.00**	**100.00**	**100.00**	**14.42**	**33.66**	**12.66**	**2.51**	**14.89**
Total excluding Mexico	**89.02**	**89.39**	**89.09**	**89.63**	**15.12**	**34.31**	**13.43**	**3.02**	**15.48**
Total excluding Mexico and China	**76.89**	**76.01**	**76.98**	**76.10**	**13.11**	**34.14**	**10.94**	**3.02**	**12.84**
1. Canada	17.63	17.44	18.18	17.50	10.16	18.31	9.59	1.71	12.79
2. China	12.13	13.38	12.11	13.54	27.88	149.78	27.78	--	27.78
3. Mexico	**10.98**	**10.61**	**10.91**	**10.37**	**8.70**	**29.59**	**6.23**	**0.18**	**8.90**
4. Japan	9.39	8.83	9.18	8.67	8.00	--	8.00	5.80	9.38
5. Germany	5.42	5.26	5.45	5.24	9.95	--	9.95	-3.34	17.41
6. United Kingdom	3.40	3.15	3.33	3.10	6.41	206.22	-0.50	8.72	-2.07
7. South Korea	2.96	3.14	3.14	2.81	2.40	--	2.40	5.95	1.05
8. Taiwan	2.51	2.36	2.35	2.14	4.18	--	4.18	15.83	3.54
9. France	2.32	2.15	2.12	2.09	12.66	--	12.66	--	12.66
10. Malaysia	2.02	1.92	1.87	1.89	15.48	134.32	15.22	--	15.22
Total 10 countries	68.77	68.24	68.65	67.34	12.23	32.82	11.46	2.29	14.11

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

Graph 20 **Share of Mexican and Chinese Exports in U.S. Imports**

Percent



The above mentioned information as well as that corresponding to other external accounts' items allow for estimating that the current account deficit might have been around 0.1 billion US dollars during the second quarter of the year, as a result of both the significant increase in oil exports and a higher inflow from workers' remittances. The overall effect of both factors on the current account offset the impact of the higher value of imports that originated from the growth of domestic demand. Considering the above, the current account deficit during the first half of 2005 would be of approximately 3 billion US dollars.

Finally, the capital account of the balance of payments including errors and omissions is expected to have recorded a small surplus of 0.1 billion US dollars during the second quarter of 2005. Such revenues came mainly from private sector inflows (mostly, from foreign direct and portfolio investment) and from a reduction in public sector's foreign indebtedness. International reserves rose slightly by 35 million US dollars during the reference period.

III. Monetary Policy

III.1. Monetary Policy Actions

Inflation pressures originated by the numerous supply shocks that arose in 2004 continued to dissipate in 2005. As a result, inflation has resumed its downward trend, decreasing from 5.43 percent in November 2004 to 4.33 percent in June 2005.

Core inflation has also declined significantly due mainly to the following factors:

a) Supply shocks that affected the food price subindex have gradually disappeared. For example, annual food price inflation in the U.S. fell from 4.08 percent in May 2004 to 2.20 percent in June 2005.

b) The combination of a significant increase in the supply of housing, the greater availability of mortgage credit, and a considerable decline in the international prices of steel and its by-products, have fostered a reduction in the rate of growth of prices of housing-related services.

c) The monetary restriction adopted since 2004 has limited the impact of supply shocks on price determination and wage negotiations.

Under such conditions, inflation expectations have also been revised downward. In particular, Banco de México's surveys indicate that headline inflation expectations for the end of 2005 have declined from 4.32 percent in December 2004 to 3.79 percent in June 2005, level close to that observed before the supply shocks of the previous year took place. Expectations for core inflation for the end of the year decreased from 3.76 to 3.42 percent during the same period. Nonetheless, expected inflation for a longer time horizon still remains at relatively high levels compared with the 3 percent inflation target (Graph 21).

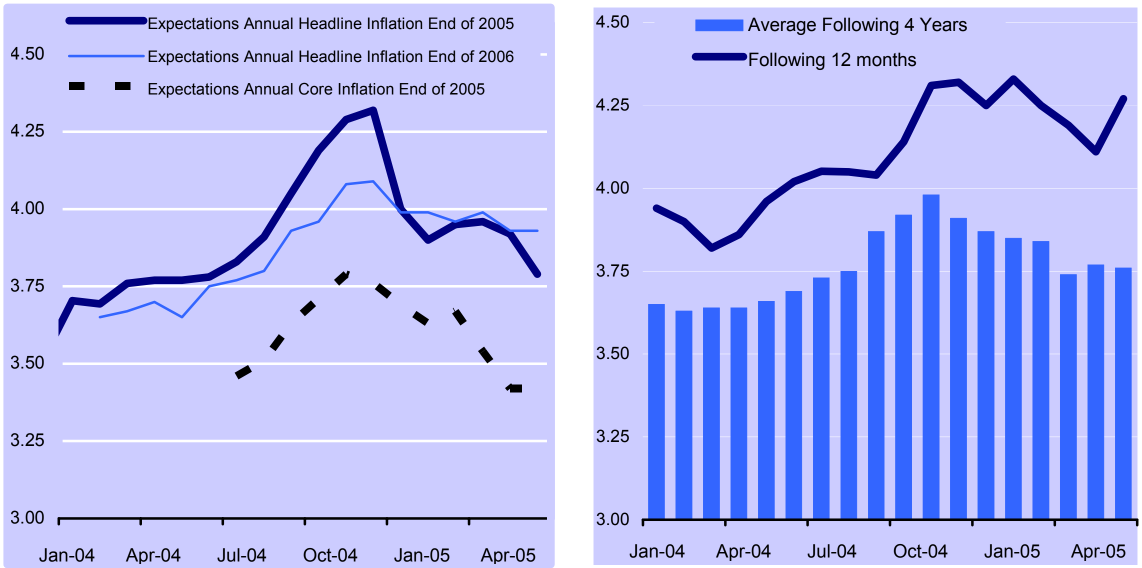
Graph 21 **Inflation Expectations: Banco de México's Survey**

a) End of 2005 and 2006

Annual percentage

b) Following 12 months and Average for the Following 4 Years

Annual percentage



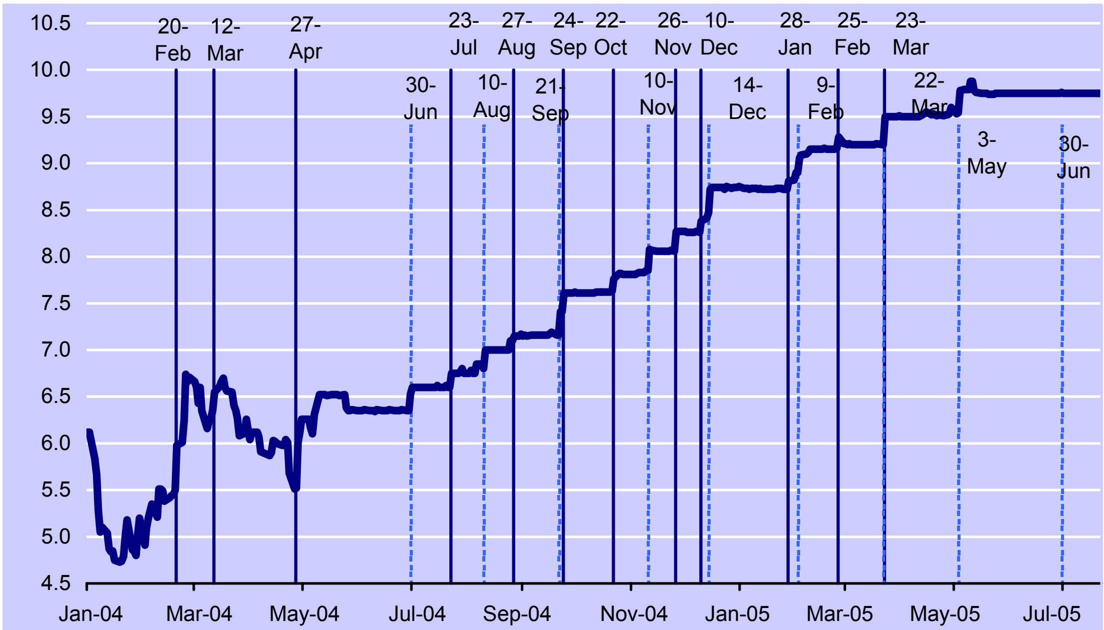
Taking into account the previous considerations, Banco de México decided to modify the process it had been using to determine its monetary policy stance. During the last quarters, the Board of Governors of Banco de México had tightened its monetary policy stance through two channels: i) by increasing the *corto* (non-borrowed reserves target); and, ii) by stating in its monetary policy announcements that, as deemed necessary, domestic monetary conditions should reflect, at least, the greater monetary astringency in the U.S.

During the period April-June, the Board of Governors of Banco de México decided to leave the *corto* unchanged and, since the press release on monetary policy of June 24, it stopped making reference to item ii) of the above mentioned paragraph. Nonetheless, in the same press release it stated that, as deemed necessary, domestic monetary conditions should not loosen.

As a result of such actions, the one-day bank funding rate rose from 9.25 to 9.75 percent during the second quarter of the year, remaining at that level since May 3 (Graph 22).

Graph 22 **Banks' Funding Rates, Change in the *Corto*, and Change in the U.S. Federal Funds Rate** 1/

Annual percentage



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

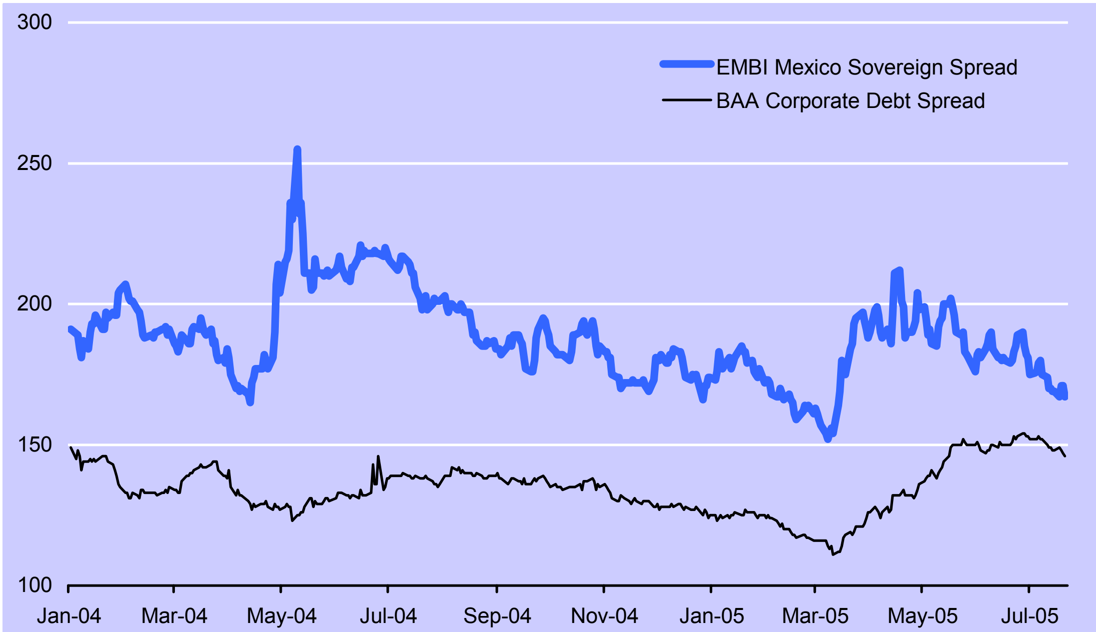
On another front, the yield curve in Mexico has been clearly influenced by global liquidity conditions and the consequent appetite for risk prevailing in international financial markets.

The conditions in international financial markets have been subject to surging volatility during the past months. Towards the end of the first quarter, uncertainty regarding the outlook for inflation in the U.S., and therefore, for long-term interest rates in that country, increased. In addition, some important debt issuers in the U.S. financial market began to exhibit a significant decline in their credit ratings, therefore increasing risk aversion in international financial markets (Graph 23). These events implied, at that time, higher costs for medium and long-term financing by sovereign and private issuers, both in external and domestic markets.

Nonetheless, during the second quarter the aforementioned conditions reversed and, consequently, long-term interest rates in the U.S. fell significantly and appetite for risk in international financial markets began to increase.

Graph 23 **Sovereign Risk and Corporate Debt Indicators** 1/

Basis points



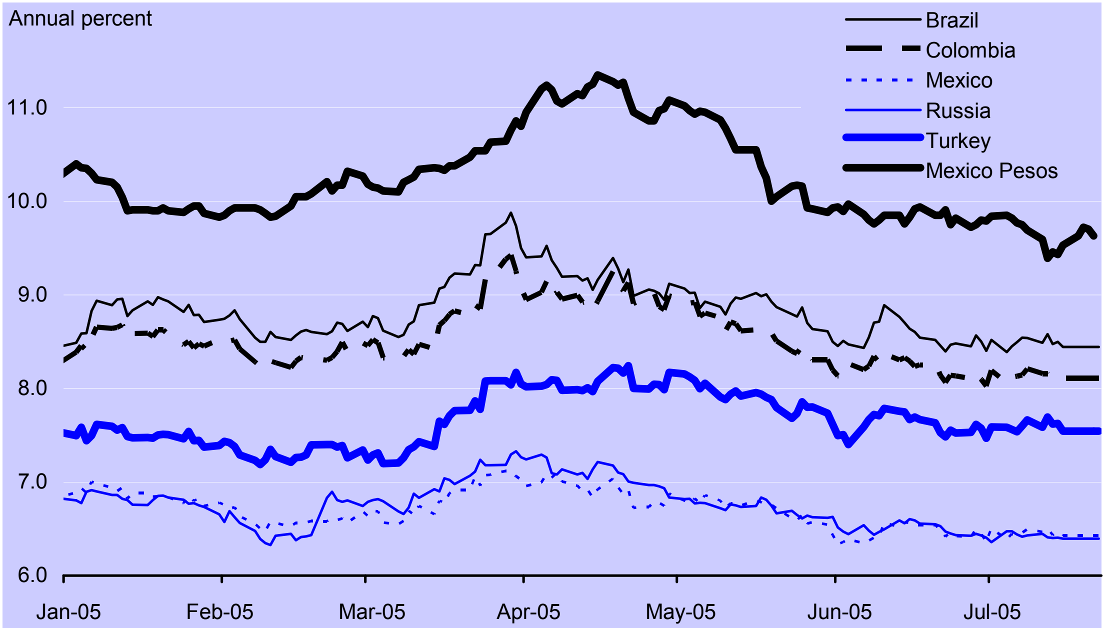
1/ Latest data: July 21.

This process generated a significant increase in the demand for debt instruments issued by emerging market economies, both in external and domestic markets. Numerous foreign investors have searched in the domestic markets of many emerging economies, particularly in Mexico, for alternatives to increase the yield of their portfolios. This has led to an increase in capital inflows to purchase longer-term debt instruments in domestic currency (Graph 24). In fact, the opportunity to finance emerging market domestic securities with short-term liabilities in foreign currency has supported increased capital inflows.

Thus, during the second quarter of the year, Mexico's yield curve continued to flatten as a result of both, an increase in short-term interest rates and a reduction in the rate of longer-term instruments. Towards the end of June, the slope of Mexico's government yield inverted (Graph 25).

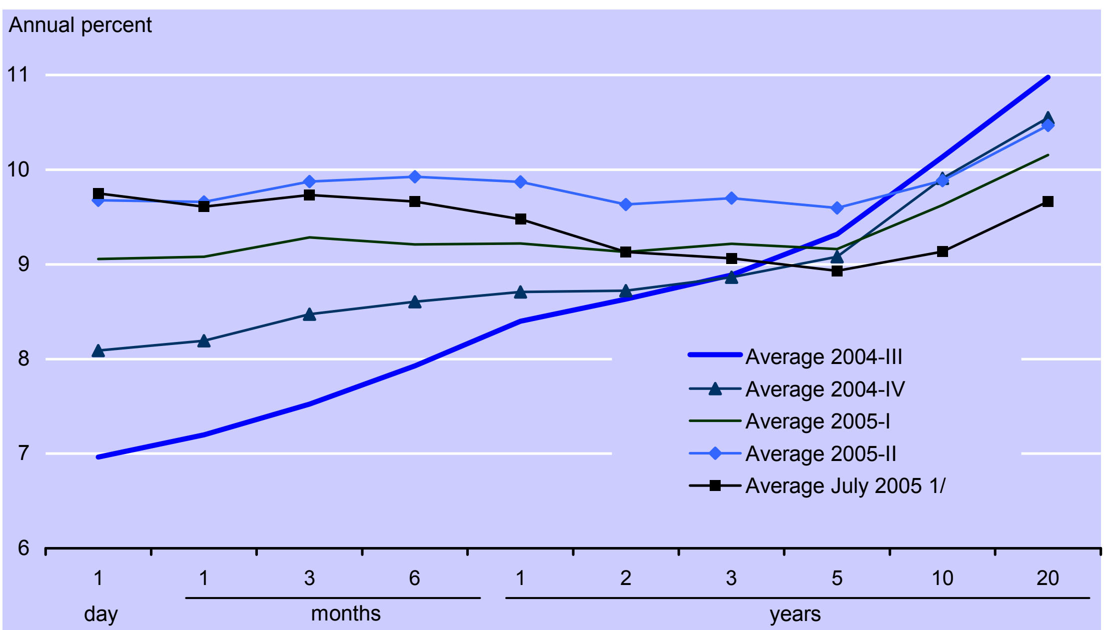
Finally, the aforementioned conditions in international financial markets have significantly contributed to the appreciation of the nominal exchange rate.

Graph 24 **Yield on 20-year Sovereign Bonds in US dollars and 20-year Fixed Rate Bond in Pesos** [1/]



1/ Source: Bloomberg.

Graph 25 **Yield Curve in Mexico**



1/ Latest data: July 22.

III.2. Monetary and Credit Aggregates

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

In June, the average stock of the monetary base was 306.9 thousand million pesos (3.9 percent of GDP), posting an annual variation of 11.4 percent, below that observed in December 2004 (13.3 percent).[22] As already mentioned in previous inflation reports, such behavior reveals that although the process by which the monetary base has increased as a percentage of GDP (remonetization) prevails, it has lost strength in the last years. Furthermore, the rise in interest rates observed during the last quarters has contributed to reduce the growth of demand for money.[23]

During the period April-June, the monetary base rose by 2.3 thousand million pesos. International assets rose by 1.5 billion US dollars, reaching a stock of 65.6 billion in June 30, 2005.[24] As a result, Banco de México's net domestic credit decreased by 13.1 thousand million pesos (Table 9).

International reserves remained practically unchanged during the second quarter of 2005, by increasing only by 35 million US dollars. Such result came from a 1.492 billion US dollar increase in gross reserves, which was almost totally compensated by an increase in Banco de México's liabilities with less than six months to maturity of 1.457 billion US dollars. The increase in gross reserves was mainly due to the following: the net effect of PEMEX sale of US dollars to Banco de México of 3.931 billion US dollars; the sale of US dollars through the mechanism to reduce international reserve accumulation (1.159 billion); and, federal government's purchasing of 1.754 billion US dollars to service its foreign liabilities.

[22] Average of daily stocks. The average of the last four quarters (2004-II to 2005-I) is used for GDP calculations.

[23] Historical evidence confirms that in low inflation economies: i) shocks on income and interest rates are reflected more slowly on the demand for money; and ii) such demand tends to become more sensitive to changes in interest rates. See Inflation Report April-June 2003.

[24] For a definition of international assets and international reserves refer to the glossary of the press release on Banco de México's balance sheet (weekly release).

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

Millions

	Stocks		Flows in 2005		
	At Dec.31, 2004	At June 30, 2004	Quarter I	Quarter II	Accumulated at June 2005
(A) Monetary Base (Pesos)	340,178	314,149	-28,322	2,293	-26,029
(B) Net International Assets (Pesos) [1/ 2/]	716,170	707,244	-720	15,368	14,648
Net International Assets (US dollars) [2/]	64,233	65,636	-88	1,491	1,403
(C) Net Domestic Credit (Pesos) [(A)-(B)] [1/]	-375,992	-393,095	-27,602	-13,075	-40,676
(D) Internatiomal Reserves (US dollars) [(E)-(F)] [3/]	61,496	61,774	242	35	277
(E) Gross Reserves (US dollars)	64,198	65,602	-87	1,492	1,405
PEMEX			2,497	3,931	6,428
Federal Government			-1,087	-1,754	-2,841
Sale of US dollars to Banks [4/]			-1,380	-1,159	-2,539
Other [5/]			-117	474	357
(F) Liabilities with less than six months to maturity (US dollars)	2,701	3,829	-330	1,457	1,127

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

III.2.2. Monetary Aggregates and Financing

Domestic financial savings (M2) increased 12.3 percent during the period April-May as compared with same period of the previous year. Nonetheless, its components followed divergent trends: high liquidity instruments have been growing at a slower rate (measured through the monetary aggregate M1), while the rest of the instruments included in the definition of M2 have remained strong (Graph 26). The behavior of base money (M1) is partly explained by the higher interest rates, which implied an increase in the opportunity cost of liquid assets. [25] In this regard, among M1 components, current account deposits was the only item that increased its annual growth rate during the period April-May, as compared with the previous year, prompted by the bancarization process carried out through payroll bank accounts.

It is important to note that progress towards low and stable inflation, and the different financial reforms adopted in recent years, have fostered a widespread access to credit under better conditions, both for debtors and creditors. In particular, two trends regarding the availability of resources for the private sector are observed: a) households' growing access to credit, both for consumption and housing; and b) firms' replacement of liabilities,

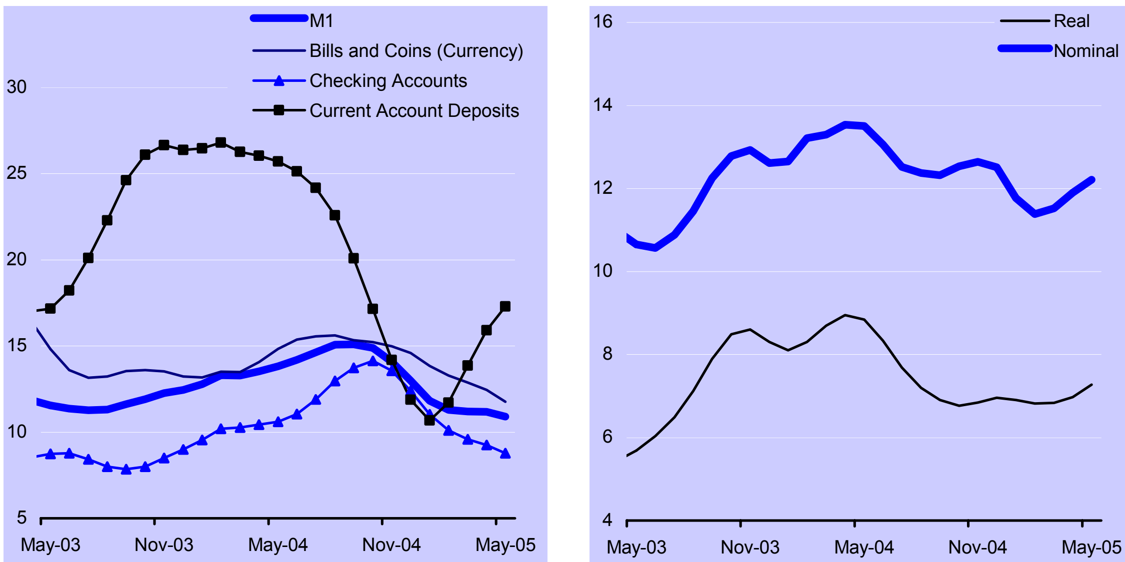
[25] For example, the spread between the time-deposit and demand-deposit interest rate rose by 189 basis points from May 4 to May 5. Considering the spread between the demand-deposit interest rate and 28-day CETES averate rate, the spread increased by 212 basis points.

increasing domestic financing and reducing the use of foreign resources (Table 10).

Graph 26 **Monetary Aggregates M1 and M2**

Annual percentage change of trend stocks

a) M1 Components b) M2



Consumption credit has grown vigorously, especially that granted through credit cards and that destined to purchase durable goods. Commercial banks, other financial intermediaries (mainly SOFOLES) and department stores have contributed to such results. Mortgage credit has also expanded vigorously, fueled by different financial intermediaries (banks and SOFOLES) and by the housing funds (INFONAVIT and FOVISSSTE).

The most relevant aspects of firms’ access to financing were as follows: a) in the last quarters, firms have increased their peso-denominated liabilities; therefore, foreign liabilities have become less important; b) the issuance of securities in the domestic market has consolidated as an alternative source of financing; and c) commercial bank’s credit to firms has started to recover (Table 10 and Graph 27b). As a result of the aforementioned, firms have a wider array of financing alternatives to manage their liquidity and exchange rate risks more efficiently.

Table 10 Total Financing to the Private Sector

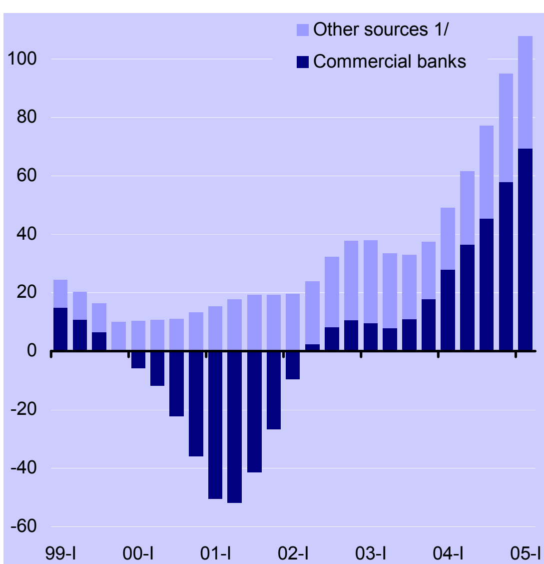
	Stocks in tmp		GDP %		Flows in tmp		Annual real growth %	
	Mar.04	Mar.05	Mar.04	Mar.05	Mar.04-Mar.05	Dec.04-Mar.05	Dec.03-Dec.04	Mar.04-Mar.05
Total financing	**2,091.6**	**2,267.6**	**29.7**	**29.1**	**176.0**	**21.8**	**3.4**	**3.9**
Foreign 1/	576.9	559.8	8.2	7.2	-17.1	0.9	-8.6	-7.0
Domestic	1,514.7	1,707.8	21.5	21.9	193.2	20.9	8.1	8.0
Total financing	**2,091.6**	**2,267.6**	**29.7**	**29.1**	**176.0**	**21.8**	**3.4**	**3.9**
Households	**762.7**	**919.0**	**10.8**	**11.8**	**156.3**	**53.5**	**14.4**	**15.4**
From commercial banks	263.5	331.9	3.7	4.3	68.4	19.4	17.0	20.7
Other sources 2/	499.2	587.1	7.1	7.5	87.9	34.1	13.0	12.7
Firms	**1,328.8**	**1,348.6**	**18.9**	**17.3**	**19.8**	**-31.7**	**-2.5**	**-2.8**
Foreign 1/	576.9	559.8	8.2	7.2	-17.1	0.9	-8.6	-7.0
Domestic	752.0	788.9	10.7	10.1	36.9	-32.6	2.1	0.5
From commercial banks	369.3	413.2	5.2	5.3	43.9	-1.9	4.6	7.2
Direct performing	288.5	365.3	4.1	4.7	76.9	1.2	18.0	21.3
Direct past due	30.8	14.6	0.4	0.2	-16.2	-0.7	-55.5	-54.6
Restructuring programs 3/	50.0	33.3	0.7	0.4	-16.8	-2.4	-33.8	-36.3
Debt issues	158.1	156.1	2.2	2.0	-2.0	-6.8	5.7	-5.4
Other 4/	224.6	219.6	3.2	2.8	-4.9	-23.9	-4.0	-6.3
Memo:								
Foreign financing (US dollars) 5/	51.6	50.1	--	--	-1.5	0.0	-3.1	-3.0
Households	762.7	919.0	10.8	11.8	156.3	53.5	14.4	15.4
Consumption	155.2	231.8	2.2	3.0	76.6	18.1	41.5	43.0
Housing	607.5	687.2	8.6	8.8	79.7	35.4	7.7	8.4

1/ Includes firms' foreign suppliers, credit granted by foreign banks and other creditors, commercial paper, bonds and emissions placed abroad. Source: Balance of Payments, excluding PIDIREGAS-PEMEX.
2/ Includes development banks, non-bank financial intermediaries, and mortgage portfolio from INFONAVIT.
3/ Includes Debtor Support Programs (*Acuerdo de Apoyo a Deudores, ADES*), UDIs and portfolio programs affecting the FOBAPROA program.
4/ Includes development banks, non-bank financial intermediaries and firms' foreign suppliers.
5/ Stocks in billion US dollars. Annual nominal growth rate.

Graph 27 Total Financing

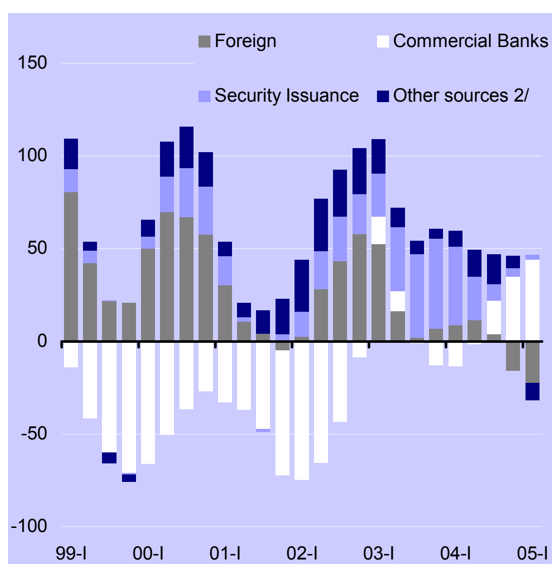
Flows accumulated in 12 months in t.m.p., trend series

a) Financing to Households



1/ Includes financing to development banks and non-bank financial intermediaries. Does not include INFONAVIT due to the lack of quarterly data for the entire selected period.

b) Financing to Firms



2/ Includes development banks, non-bank financial intermediaries, and firms' foreign suppliers.

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

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

During the second 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) slightly downward revision in the expected growth rate for 2005; and, c) lesser strength in business confidence and business climate indicators. In the survey conducted in June, private sector economic analysts' forecasts were as follows: i) GDP is expected to grow 3.57 percent in 2005 (in the survey conducted in March 2005 such figure was 3.88 percent) (Table 11), and 3.50 percent for 2006; ii) in 2005 and 2006, 419 and 433 thousand jobs, respectively, are expected to be created in the formal sector; iii) expectations regarding interest rates for the next months were revised slightly upward as compared with those reported in the March survey; iv) the expected level of the peso exchange rate for the end of 2005 was adjusted downward; and v) moderate trade and current account deficits are expected at the end of 2005.

Analysts surveyed in the first quarter of 2005 continued to mention the lack of advance in structural change measures and domestic political uncertainty as the two main factors that could limit economic growth during the next months. They also conveyed that the advance in structural change measures would contribute to induce higher investments in the country and, consequently, to attain higher growth.

[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: March and June 2005[1/]

	March 2005	June 2005		March 2005	June 2005
Real GDP Growth in Mexico			**Exchange Rate (Pesos/US dollar, year-end)**		
2005	3.88%	3.57%	2005 (Banxico Survey)	11.68	11.40
2006	3.64%	3.50%	Futures [2/]	11.69	11.07
Trade Deficit (Million US dollars)			2006 (Banxico Survey)	12.04	11.79
2005	12,239	10,451	**Mexican Crude Oil Mix (Average US dollars per barrel)**		
Current Account Deficit (Million US dollars)			2005 (Banxico Survey)	30.93	38.08
2005	13,944	12,070	**Wage Increases**		
2006	16,247	15,405	For July 2005	4.51%	4.33%
Foreign Direct Investment (Million US dollars)			For August 2005	4.46%	4.37%
2005	13,750	14,270	**Business Climate Index**		
2006	13,599	13,548	1998=100 [3/]	135.5	119.9

1/ Unless otherwise stated, data are obtained from Banco de México's monthly Survey of Private Sector Economic Analysts' Forecasts.
2/ Exchange rate futures in March 31, 2004 and June 30, 2005.
3/ Average level of first and second quarters.

IV.2. Inflation Expectations

During the second quarter of 2005, inflation expectations for different horizons were revised downward. Headline CPI inflation for 2005 is expected to be 3.79 percent in June 2005, figure lower than that reported in the March survey (3.95 percent). Core CPI inflation for 2005 was revised downward from 3.67 percent in March to 3.42 percent in June. Inflation expectations were also revised downward: for 2006, from 3.96 to 3.93 percent; and for 2007 and for the annual average for the period 2006-2009, from 3.84 to 3.76 percent (Graph 21).

V. Balance of Risks and Final Remarks

Banco de México's expected scenario for the remainder of 2005 is based on the following elements:

a) Expectations for world growth continue to be positive, although the rate of growth is expected to be below that observed in 2004. As for the U.S. economy, it is anticipated to grow close to its potential rate. Nonetheless, expectations for U.S. industrial production for 2005 have been revised downward significantly, from 4.2 percent at the end of the fourth quarter of 2004 to 3.4 according to most recent data.

b) Favorable access to financing for sovereign and private issuers, both in external and domestic markets, is expected to continue.

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

GDP Growth: GDP growth is expected to be between 3.25 and 3.75 percent.

Employment: Approximately 430 thousand jobs are expected to be created in the formal sector.[27]

Current Account: A moderate current account deficit of the balance of payments of approximately 1.5 percent of GDP is expected.

Inflation: Annual headline inflation is expected to continue its downward trend and end the year below 4 percent, as long as episodes of extreme volatility do not arise, especially concerning the non-core price subindex. In this regard, the following deserves mention:

a) Prices of fruits and vegetables rose significantly during the second half of 2004, due to extremely adverse weather conditions. As long as these conditions do not repeat, the annual variation of these items is anticipated to decrease in the second half of the year. Nonetheless, it is important to point out that prices of this group of products are

[27] Economic activity has a lagged effect on formal job creation, given that in the short-term man-hours worked tend to increase more significantly than the number of workers. As economic recovery is sustained, the demand for jobs increases.

characterized for being very volatile and difficult to anticipate.

b) The recent behavior of meat international and futures prices suggests that the annual growth rates of meat domestic prices could decline in the following months.

c) The impact of international energy prices on the administered prices subindex is expected to be limited, mostly affecting the electricity item. This is mainly due to the following: i) gasoline prices at the border are practically at the same level of those in the rest of Mexico and, therefore, any new increases in the international prices of this fuel would have a limited effect on inflation; ii) futures prices of propane exhibited a stable behavior; therefore increases in the domestic prices of this fuel are expected to be set near the lowest limit of the variability interval determined by the authorities (0.75 to 1.75 percent per month); and, iii) in contrast, residential high consumption electricity tariffs are determined according to a formula which includes prices of different fuels, such as natural gas and, therefore, any price increases of this fuel could affect them.

d) Annual inflation of the subindex of regulated prices is expected to remain at levels close to those recorded, on average, during the first half of 2005.

e) Education prices are expected to reduce their annual growth rate during the third quarter of the year, as the increase in school fees for the new academic year go into effect. Nonetheless, school fees are expected to grow at a higher rate than that of the CPI.

Core inflation for the rest of 2005 is expected to be lower than its average level recorded during the first half of the year. However, the contribution of merchandise prices is expected to decline, while the opposite is anticipated to occur for the services subindex. In particular, the following deserves mention:

a) The reduction in the annual growth rate of merchandise prices is expected to reflect the slower growth rate of processed foods, originated by reduced inflationary pressures for this type of goods worldwide. Inflation of the rest of the merchandise group is expected to follow a lateral trend, given that no significant pressures from the international prices of these products have been detected recently.

b) Core services inflation could increase slightly during the rest of the year. On the one hand, prices of non-housing services have followed an upward trend, due to, among other reasons, price increases in different goods used as inputs. On the other, the annual growth rate of housing prices is expected to follow a lateral trend during the third quarter and to increase moderately during the fourth due to a reduction in its base of comparison.

Although the outlook for inflation has improved in recent months, the convergence of inflation to its target still faces significant challenges, such as:

a) Medium-term expectations for headline inflation remain above 3 percent.

b) Prices of crude oil and other energy goods, and their futures prices, remain high.

c) Although available information does not allow for identifying considerable pressures from aggregate demand, domestic expenditure is expected to have grown at a higher rate than GDP for three consecutive quarters; however, this difference narrowed in the second quarter of the year.

Banco de México will remain vigilant that no inflationary pressures from the demand side arise and that any upward pressures originated by the supply shocks that took place last year remain contained. In this regard, the Board of Governors reiterates its conviction to conduct monetary policy in such a way that monetary conditions propitiate the convergence of inflation to its target.

* * *

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

First, although most recent data suggests that economic activity in the U.S. strengthened towards the end of the quarter, there is the possibility that it may slow down sharply. This outcome could arise if prices of crude oil and oil by-products increase further, or else, if real estate prices fall significantly, situation that would lead to an adjustment in consumption growth. Under such scenarios, the Mexican economy would be affected by the lower demand for its exports, which would reduce the outlook for growth and employment. Furthermore, should the economic slowdown derive from significant increases in energy prices, inflation would also be affected negatively.

Second, the high U.S. current account deficit could become unsustainable. Strong recession pressures would arise worldwide and international financial markets would become more volatile. Such conditions would affect emerging economies significantly.

Third, the share of China and other Asian economies in global manufacturing production could continue to displace this type of activity, both in the U.S. and Mexico. This risk -due partly to the lack of progress to increase Mexico's competitiveness- would have severe consequences. In the case of Mexico, the industrial sector, especially manufacturing, has played a crucial role in the economy's expansion since the beginning of the nineties.

Finally, some analysts have pointed out that political uncertainty in Mexico could increase as the 2006 elections near, inducing higher volatility in domestic financial markets. In this regard it is important to mention that the Mexican economy has reduced its vulnerabilities significantly and, therefore, it is in a better position to cope with external and domestic shocks.

The strong macroeconomic anchorage, of which monetary policy has and will continue to be a key element, has brought such benefits to the Mexican economy.

Stability is a necessary, although not the only, condition for sustained growth. Under such context, it is even more imperative to advance in Mexico's pending agenda of structural change. Economic activity needs urgently a modern regulatory framework that translates into greater incentives for investment, gains in productivity, increased demand for employment and, therefore, into higher growth rates.

In recent years, the Mexican economy has accumulated competitive shortfalls with respect to other emerging economies. As consensus over structural change measures with a long-term vision are attained, Mexico will be able to amend its lag in competitiveness. Progress in structural reforms will allow the Mexican economy to take better advantage of its strategic position and increase the scope of its social policies.