Inflation Report

October – December 2006

and

Monetary Program

for 2007

BANCO DE MEXICO

JANUARY 2007

BOARD OF GOVERNORS

Governor

GUILLERMO ORTIZ MARTÍNEZ

Deputy Governors

EVERARDO ELIZONDO ALMAGUER

GUILLERMO GÜÉMEZ GARCÍA

JOSÉ JULIÁN SIDAOUI DIB

FOREWARNING

This text is provided for the reader's convenience only. Discrepancies may eventually arise from the translation of the original document into English. The original and unabridged Inflation Report in Spanish is the only official document.

Unless otherwise stated, this document has been prepared using data available as of January 29, 2007. Figures are preliminary and subject to change.

CONTENTS

Inflation Report October-December 2006

1. Introduction

The world economy grew vigorously in 2006. A positive performance is foreseen for 2007, although growth is expected to slow down gradually. As for the U.S., despite a weaker real estate market, the expansion of aggregate demand is expected to continue. This is partly due to the effects of both reduced oil prices and higher employment on private consumption. Although risks of a greater-than-expected slowdown in the U.S. economy prevail, on balance recent information suggests that economic activity during the fourth quarter of 2006 grew at a higher-than-expected rate.

Worldwide inflationary pressures have started to diminish, as a result of both the downward phase of the business cycle currently underway and the reduction in oil prices. In particular, world headline inflation has declined in recent months, and inflation expectations for the medium and long terms remain well anchored. Consequently, market participants and analysts expect the U.S. federal funds rate to remain at its current level in the coming months.

These factors have contributed to the maintenance of favorable financial conditions, as reflected by the low levels of long-term interest rates in the U.S. and greater risk appetite in international capital markets.

Under such conditions, during the last quarter of 2006, economic activity in Mexico continued to grow, although slightly below the rate recorded in the first three quarters. On the domestic aggregate demand side, the strength of consumption and the dynamism of investment stand out. As for external demand, its growth rate began to slow down. Among the factors contributing to domestic expenditure growth are the significant revenues from both workers' remittances and oil exports, and a considerable expansion in private sector's access to financing.

During the last months of 2006, diverse supply shocks arose and prompted a rebound in annual headline inflation. These pressures affected both core and non-core inflation.

Regarding the former, worth mentioning are the increases in tomato and onion prices in September and December, respectively, due to adverse weather conditions. As for core inflation, sugar and corn-tortilla prices rose. Price increases in corn-tortillas were initially triggered by the rise in corn's international price reference. This increase escalated due to certain distortions characterizing the corn-tortilla production chain. In this regard, the Federal Government implemented several actions to promote a greater supply of corn in order to stabilize prices.

The increase in sugar and corn-tortilla prices accounted for around two thirds of the 0.49 percentage points increase in core inflation in 2006. Both items could continue to pressure headline inflation during the first half of 2007, which is expected to be between 4 and 4.5 percent. However, the effects of these shocks have been confined to a few products, and although they have implied changes in relative prices, they are not expected to contaminate the price and wage

determination processes. Up to now, analysts' inflation expectations for the medium and long terms apparently have not been affected.

Given the aforementioned scenario, Banco de México's Board of Governors decided to leave monetary conditions unchanged, as mentioned in the central bank press releases of October, November, December, and January. Nonetheless, given the rebound of inflation, the Board will closely monitor prices and inflation expectations, particularly those for the medium term, as well as their possible effects on wages. As mentioned by the Board in Banco de México's press release of January 26, should supply shocks affect these variables negatively, the Board will adjust monetary policy so that inflation can resume its converging trend towards its target.

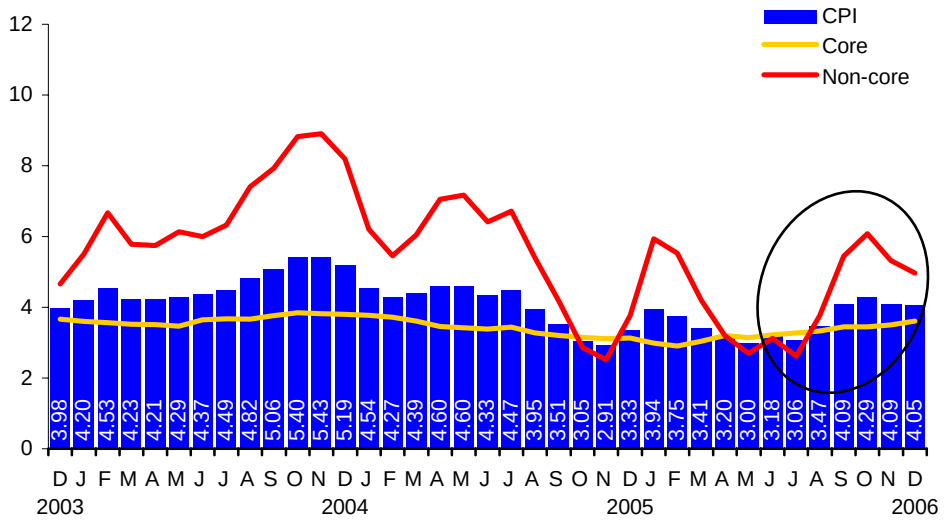
2. Recent Developments in Inflation

2.1. Inflation

During the third and fourth quarters of 2006, certain supply shocks prompted a rebound in annual headline inflation, which ended the year at 4.05 percent (in June and September annual headline inflation recorded 3.18 and 4.09 percent, respectively). Pressures concentrated in a reduced number of items of both core and non-core components (Graph 1 and Table 1).

Annual core inflation reached 3.61 percent in December 2006, figure above those observed in June and September (3.22 and 3.45 percent, respectively). This increase was mainly determined by the behavior of corn-tortillas and sugar prices. In particular, the referred price increases accounted for 70.8 percent of the increase of this indicator during the second half of the year.

Graph 1
Consumer Price Index
Annual percentage change



The core merchandise and services subindices recorded diverging results during the second half of 2006. The annual variation of the merchandise subindex followed an upward trend, due to significant increases in the prices of a reduced number of foods that have a high weight in the index, reaching in December 3.38 percent (in June and September, 2.53 and 2.91 percent, respectively). In contrast, the annual variation of the services subindex decreased slightly, ending the year at 3.87 percent (in June and September, 3.96 and 4.04 percent, respectively).

The annual variation of the services subindex decreased mainly as a result of a decline in the growth rate of housing prices.[1] This was due to the price reduction of certain materials manufactured from steel, generated by the fall in the

[1] The housing subindex includes own housing, rentals, home maintenance services, house keeping, and other home services.

international price reference of this metal and to the normalization of steel domestic production (Table 1).[2]

Table 1
Incidence of CPI Components on Annual Headline Inflation[1/]

	Annual percentage change			Incidences percentage points				
	Jun-2006	Sep-2006	Dec-2006	Jun-2006 (a)	Sep-2006 (b)	Dec-2006 (c)	Difference (c-a)	Difference (c-b)
CPI	**3.18**	**4.09**	**4.05**	**3.18**	**4.09**	**4.05**	**0.87**	**-0.04**
Core	**3.22**	**3.45**	**3.61**	**2.19**	**2.34**	**2.43**	**0.24**	**0.09**
Merchandise	**2.53**	**2.91**	**3.38**	**0.90**	**1.03**	**1.19**	**0.29**	**0.16**
Food	3.46	4.13	5.10	0.52	0.62	0.76	0.24	0.14
Corn-tortilla	6.76	11.06	13.82	0.09	0.15	0.19	0.10	0.04
Sugar	2.09	32.78	31.93	0.00	0.08	0.07	0.07	0.00
Rest of food	3.15	2.91	3.74	0.42	0.39	0.50	0.08	0.11
Rest of merchandise	1.86	2.03	2.12	0.38	0.42	0.43	0.05	0.01
Services	**3.96**	**4.04**	**3.87**	**1.28**	**1.30**	**1.24**	**-0.04**	**-0.06**
Housing	3.88	3.89	3.73	0.68	0.68	0.65	-0.03	-0.03
Rest of services	4.06	4.21	4.02	0.60	0.62	0.59	-0.01	-0.03
Non-core	**3.12**	**5.44**	**4.96**	**1.00**	**1.76**	**1.62**	**0.63**	**-0.13**
Agriculture	**-2.04**	**7.47**	**8.30**	**-0.18**	**0.65**	**0.71**	**0.88**	**0.06**
Fruits and Vegetables	**-3.95**	**17.84**	**15.46**	**-0.13**	**0.60**	**0.52**	**0.65**	**-0.08**
Tomato	-27.23	87.55	10.18	-0.16	0.40	0.06	0.22	-0.34
Onion	-40.65	-1.23	186.09	-0.07	0.00	0.22	0.29	0.23
Other fruits and vegetables	3.68	7.41	8.85	0.10	0.20	0.23	0.14	0.03
Livestock	**-0.83**	**0.89**	**3.69**	**-0.04**	**0.05**	**0.19**	**0.23**	**0.14**
Poultry	-1.83	0.72	8.39	-0.02	0.01	0.10	0.12	0.09
Egg	4.90	10.88	15.79	0.03	0.07	0.09	0.07	0.03
Rest of livestock	-1.43	-0.81	-0.05	-0.05	-0.03	0.00	0.05	0.03
Administered and Regulated	**4.54**	**4.35**	**3.14**	**0.79**	**0.76**	**0.57**	**-0.22**	**-0.19**
Administered	**8.18**	**7.29**	**4.42**	**0.68**	**0.61**	**0.41**	**-0.27**	**-0.20**
Low-octane gasoline	7.74	7.15	5.59	0.24	0.22	0.17	-0.07	-0.05
High-octane gasoline	5.74	5.31	8.46	0.03	0.03	0.04	0.01	0.01
Electricity	7.79	9.06	5.07	0.17	0.21	0.15	-0.02	-0.05
Residential-use gas	9.58	6.23	1.53	0.23	0.15	0.04	-0.19	-0.11
Regulated	**1.22**	**1.63**	**1.83**	**0.11**	**0.15**	**0.16**	**0.05**	**0.02**
Education	**6.51**	**5.70**	**5.71**	**0.38**	**0.35**	**0.35**	**-0.04**	**-0.01**

1/ Refers to the contribution (in percentage points) of each of the CPI components to headline inflation. Headline inflation is calculated using the weights of each subindex, as well as relative prices and their respective variations. In some cases, figures from some subindices may not add up due to rounding.

During the second half of 2006, the merchandise subindex grew at a higher annual rate, mainly as a result of price increases in corn-tortillas and sugar.[3] In fact, excluding both items from annual core inflation calculations, and normalizing the weights of the rest of the items that make up this basket, this indicator would have been 3.30 percent (as compared with 3.61 percent, Graph 2).

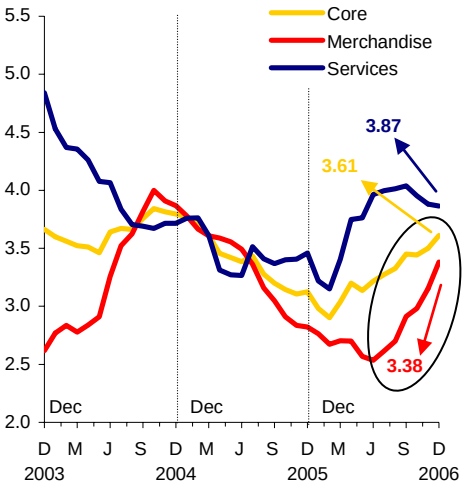
In December 2006, corn-tortilla prices recorded an annual increase of 13.82 percent (Graph 3). This was initially driven by the rise in corn's international prices, as a result of a higher demand for this grain to produce bioenergy goods like ethanol (Graph 20a). Nonetheless, this influence was exacerbated by several distortions characterizing the corn-tortilla production chain in Mexico (import restrictions and a poorly competitive industrial structure).

[2] Steel domestic production normalized after wage conflicts that affected the steel industry between February and September 2006 settled.

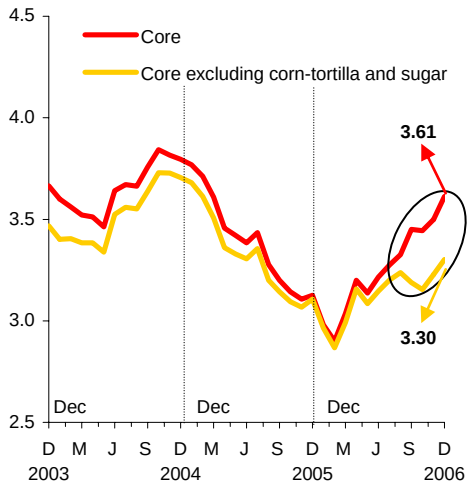
[3] CPI weights of corn-tortillas and sugar are 1.2265 and 0.2073 percent, respectively.

Graph 2
Core Price Index

a) Core and Subindices
Annual percentage change



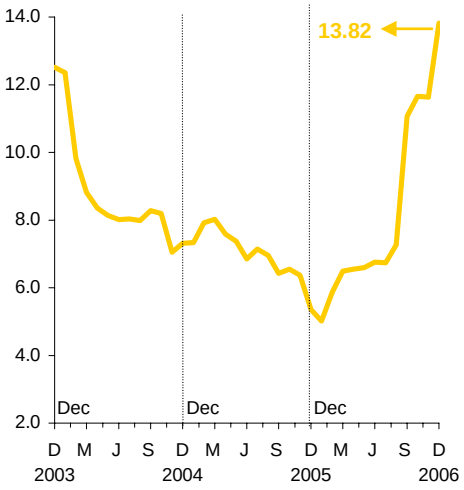
b) Core excluding Corn-tortilla and Sugar [1/]
Annual percentage change



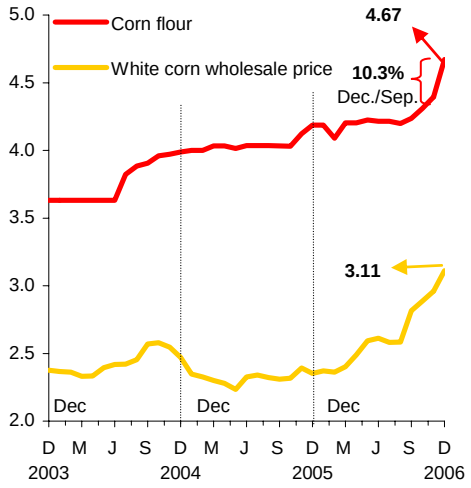
1/ Core inflation excluding corn and sugar was estimated by excluding both items from calculations and normalizing the weights of the rest of the items included in this basket.

Graph 3
Tortilla and Tortilla Raw Material Prices

a) Tortilla Price Index
Annual percentage change



b) Tortilla Raw Material Prices
Pesos per kilogram



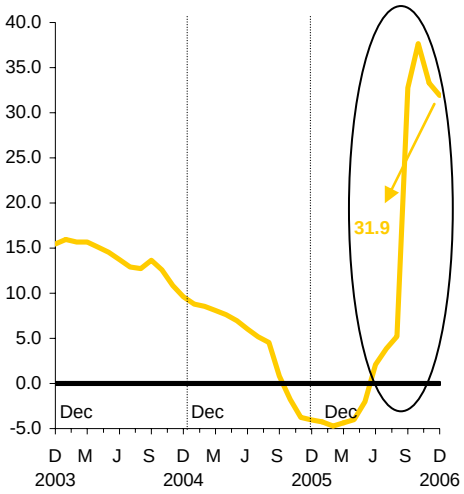
In response to the corn-tortilla price increase, in January 18, 2007, the federal government, along with producers and distributors of the corn-tortilla production chain, agreed on several measures to stabilize the price of corn-tortillas at a maximum of 8.50 pesos per kilogram in *tortillerías* (tortilla retailers), and 6.00 pesos in supermarkets. The federal government also determined that Diconsa would sell corn-tortillas at 3.50 pesos per kilogram. These measures were complemented with duty-free import quotas for corn, and the setting of maximum prices for corn and corn flour. This agreement will be revised April 30, 2007. Preliminary information suggests that these actions have contributed to limit corn-tortilla price increases.

Between June and December sugar prices recorded an annual variation from 2.09 to 31.93 percent (Graph 4). The price increase of sugar was not associated with increments in sugar international references. In response to the increase, import quotas were authorized as of August 30. In addition, the availability of sugar increased as a result of the sugar cane harvest that began in November. Nonetheless, the decline in sugar prices was limited: in December 2006, sugar domestic prices were above their international references by 136 percent.[4]

Graph 4
Sugar Price Index

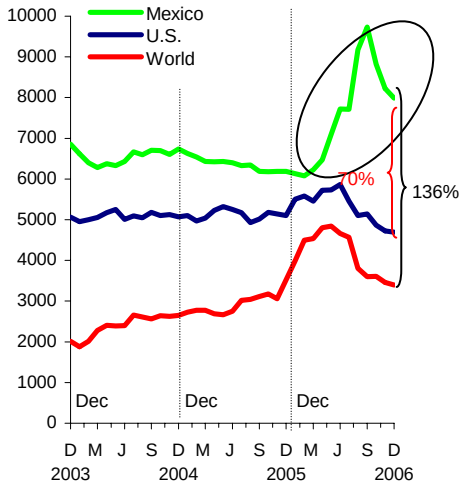
a) Sugar Price Index

Annual percentage change



b) Domestic and International Prices of Sugar (Wholesale)

Pesos per ton



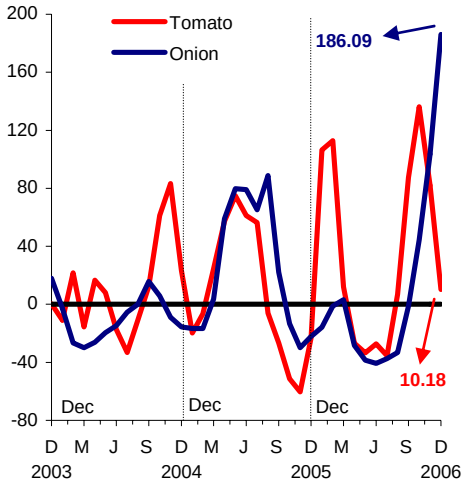
Source: Sistema Nacional de Información e Integración de Mercados (Mexico). Department of Agriculture (U.S.).

Annual non-core inflation was 4.96 percent at the end of 2006, 1.84 percentage points above June figures. Greater pressures on this index were observed during the third quarter of the year, mainly as a result of the price increase in tomato, due to adverse weather conditions. During the fourth quarter, these pressures began to decrease, when the supply of this product began to normalize. Nonetheless, the effect of inflation was partially reverted by a significant increase in onion prices, which recorded an annual variation of 186.09 percent in December. This was due to the effect of an extreme rainy season in onion-producing states (Chihuahua, Guanajuato and Baja California). Onion prices contribution to inflation was of such magnitude that if they were excluded from CPI calculations and the rest of the weights of the basket normalized, annual headline inflation would have been 3.83 percent (Graph 5). An additional factor that indirectly limited the decline in non-core inflation during the fourth quarter was the price increase in grains, particularly corn, which are used in prepared feed meals and, in turn, prompted a rise in poultry and egg prices (Table 1).

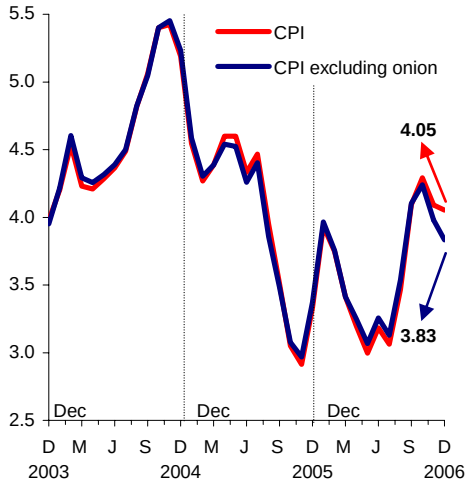
[4] Preliminary data from the Sugar and Alcohol Industry Chamber (*Cámara de las Industrias Azucarera y Alcoholera*) shows that from the 267,606 tons of duty-free sugar import quotas authorized since August 30, 2006, 124,226 tons had been imported by December 31, 2006. The Ministry of the Economy allocated 221,007 tons of the import quotas.

Graph 5
Tomato and Onion Price Indexes

a) Tomato and Onion
Annual percentage change



b) CPI excluding Onion [1/]
Annual percentage change



1/ The CPI excluding onion was estimated by excluding this item from calculations and normalizing the weights of the rest of the items included in this basket.

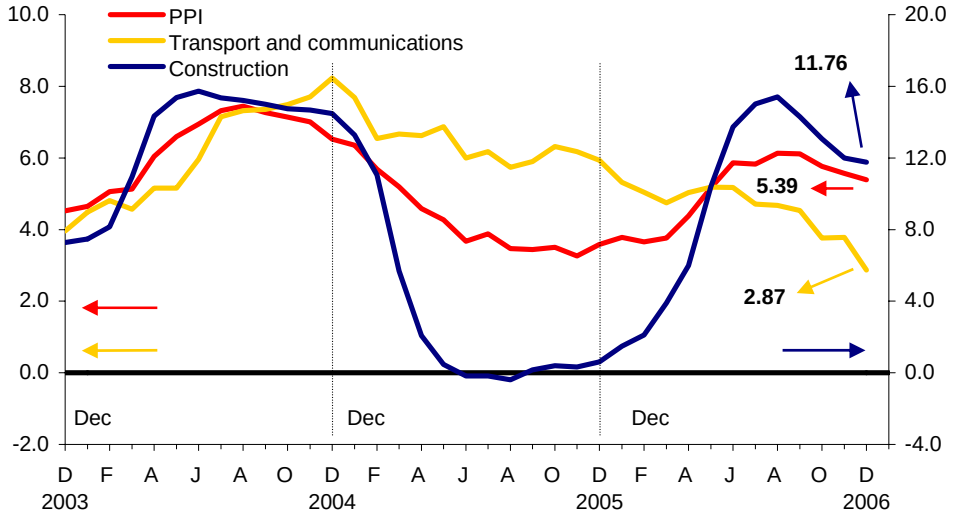
The behavior of the subindex of administered prices was a factor that helped to contain the rise in non-core price inflation during the second half of 2006. This subindex recorded an annual growth rate of 4.42 percent at the end of 2006 (in June and September this figure was 8.18 and 7.29 percent, respectively). The behavior of this subindex is explained in detail in Section 3.3.2. Its reduced growth rate was influenced by the lower prices of natural gas, low-octane gasoline at border cities, and by the reduction in high consumption electricity tariffs *(Tarifas Eléctricas de Alto Consumo*, DAC).[5] In line with these results, the subindex of regulated prices recorded an annual variation of 1.83 percent in December.

2.2. Producer Price Index

In December 2006, the Producer Price Index (PPI) excluding oil exhibited an annual variation of 5.39 percent, reverting the increase observed during the third quarter (in June and September it increased 5.86 and 6.11 percent, respectively). The decrease in this indicator during the fourth quarter is explained mainly by the lower annual growth rate of several construction-material prices (rod, rod-wire, pipes, structures and cement) and of transport and communications (air passenger transportation, taxi, land freight transportation, and sea freight transportation, Graph 6).

[5] High-consumption residential electricity tariffs are adjusted on a monthly basis according to the following formula: F = 0.8*TIP + 0.2*TCC. The first term in the equation (TIP), is comprised of three arithmetically averaged PPI subindices: Metal Products, Machinery and Equipment, Basic Metal Industries and Other Manufacturing Industries. The second term (TCC) represents the price of the following fuels used for electricity generating: imported and domestic diesel; natural gas; industrial diesel; and, imported and domestic coal. Natural gas is included in the formula as a 4-month moving average of its price with a one-period lag.

Graph 6
Producer Price Index Excluding Oil, Merchandise and Finished Goods
Annual percentage change



3. Main Determinants of Inflation

3.1. International Environment

The world economy expanded significantly during the fourth quarter of 2006. Although U.S. GDP growth seems to have been below the rate observed in the first half-of-the-year, incoming information suggests that both Euro area and emerging market economies grew vigorously, while growth in Japan recovered from the slow pace recorded during the third quarter. The decline in oil prices from record highs reached in July alleviated inflationary pressures considerably. In this environment, emerging economies continued to face favorable conditions for international financing and risk premia on bonds from emerging market issuers fell to historical lows.

3.1.1. Global Economic Activity

World economic activity remained vigorous despite a gradual slowdown. In the U.S., most recent data suggest economic activity in the fourth quarter grew at a slower rate than during the first half of the year, although forecasts have been undergoing upward revisions. The main components of aggregate demand exhibited mixed results. Residential investment continued to be affected by the correction in the real estate market and recorded another contraction. . Economic activity was also affected by the inventory correction in the industrial sector, especially in the automotive industry. Personal consumption remained strong at the end of 2006 despite the decline in the use of real estate assets as a source of financing as a result of the weakening of their prices. Non-residential investment seems to have continued growing, although at a more moderate rate than in the previous quarter. The trade deficit decreased due to a weaker US dollar and to the dynamism of growth among the trading partners of the U.S., among other factors. On balance, most recent estimates point to a transitory acceleration of GDP growth during the fourth quarter (from 2 percent during the third quarter to 3 percent at an annualized quarterly rate, the annual rate would therefore increase from 3 to 3.3 percent).

Economic activity in the Euro area continued to expand vigorously at the end of 2006, albeit at a more moderate rate than in the first half of the year. Domestic demand boosted GDP growth (2.7 percent in annual terms and 2.1 percent at an annualized quarterly rate) during the third quarter. The behavior of employment, retail sales and industrial production, together with strength in confidence indexes for firms and households suggest that economic activity remained vigorous during the October-December period. In Japan, growth slowed over the first nine months of the year. GDP grew 1.6 percent in annual terms during the third quarter (0.8 percent at an annualized quarterly rate). Nonetheless, incoming information suggests that the weakness in consumption spending during the July-September period reverted in the fourth quarter, while private investment grew soundly during the period.

Emerging economies recorded high growth during the second half of 2006, as a result of a persistently strong global demand for their exports. GDP growth in China decreased from an annual rate of 11.5 percent during the second quarter, to 10.6 percent during the third, and 10.4 percent during the

fourth, as a result of the measures implemented by the government to prevent economic overheating. Other Asian emerging economies also showed significant dynamism.

Latin American economies exhibited robust growth, above their historic average. The region is expected to have grown around 5 percent during 2006. Thus, the current expansionary cycle is the most vigorous since the seventies. Domestic demand has recently become the main engine of growth, fueled by private consumption and investment, and by public expenditure.

3.1.2. General Trends of Inflation

Global inflationary pressures were tempered by the decline in oil prices during the October-December period. Wage pressures remained moderate, thus helping to contain pressures on core inflation.

Oil prices followed a downward trend during the fourth quarter, which was briefly interrupted in November when OPEC announced cuts in its oil production and oil inventories in the U.S. fell more than expected (Graph 7). At the end of 2006, the price per barrel of WTI oil was 61 US dollars (48.7 US dollars for the Mexican crude oil export mix), 16 dollars below the record high (in current US dollars) reached in mid-July (16 US dollars for the Mexican oil mix as compared to the record high recorded in August). The latter was mainly the result of warmer-than-usual weather in some regions, expectations of lower-than-previously anticipated growth in oil demand from certain oil-importing countries, the recovery of crude oil and oil-derivative inventories, and, in general, of lesser concerns regarding oil supply. The IMF price indices for non-oil commodities increased markedly during the fourth quarter, mainly as a result of continuing price increases in some metals and of higher food prices.[6]

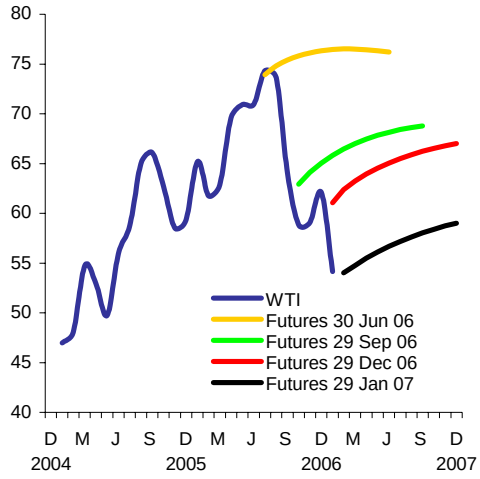
As crude oil prices fell, headline inflation in the U.S. declined, from above 4 percent at the beginning of the third quarter, to 2.5 percent in December (Graph 7). Core inflation indicators also followed a downward trend during the last quarter of the year. After having reached annual variations of 2.9 percent in September, due mainly to higher prices for shelter, annual core inflation was 2.6 percent in December (Graph 8). Incoming information suggests that wage pressures continued being moderate during the second half of 2006, in spite of the maintenance of low levels of unemployment during a considerable period of time. Notwithstanding a slower pace of increase for labor productivity, unit labor costs increased by slightly less than 3 percent in annual terms during the third quarter. In spite of the recent reduction in core inflation, the Federal Reserve believes inflation is still high.

[6] During the fourth quarter of 2006, the IMF indices for prices of non-oil commodities increased by 33.7 percent in annual terms. Industrial metal prices continued to increase considerably (61.2 percent in annual terms), while the subindex for food increased at a higher rate (from 10.3 percent in annual terms during the previous quarter to 13.7 percent in annual terms) as some components recorded substantial gains. For example, corn prices increased by 55.6 percent in annual terms. Prices of agricultural raw materials increased by 13.1 percent during that period.

Graph 7
Prices

a) Oil Prices: Spot and Futures

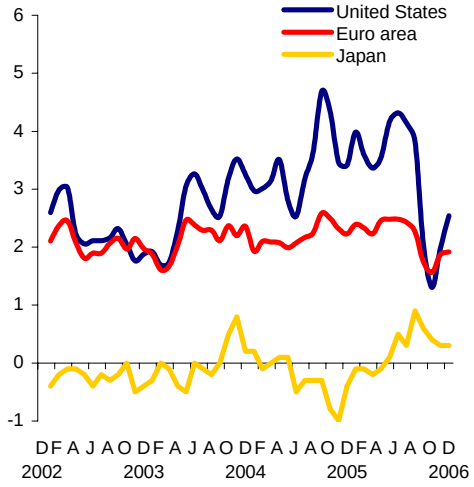
US dollars per barrel



Source: Bloomberg.

b) Consumer Prices in the U.S., the Euro area, and Japan

Annual variation



Source: Bureau of Labor Statistics, Eurostat and Statistics Bureau.

Euro area headline inflation fell below its reference value of slightly less than 2 percent since September, mainly as a result of the fall in oil prices and base effects. In December, the headline and the core indexes recorded annual variations of 1.9 and 1.5 percent respectively. In Japan, core inflation was 0.1 percent in annual terms in December, below that recorded in September (0.2 percent), while headline inflation decreased from 0.6 to 0.3 percent during the same period.

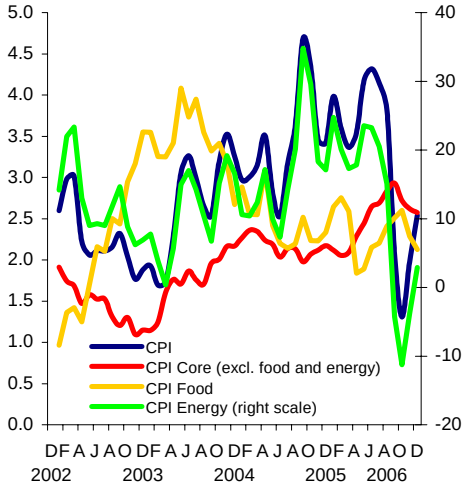
In general, inflation remained low in Asian economies during the fourth quarter. However, in China, annual inflation increased from 1.5 percent in September to 2.8 percent in December. Latin American countries were subject to moderate inflationary pressures at the end of 2006. In some of them, Argentina and Venezuela in particular, inflation was significantly above the average for the region.

3.1.3. Financial Markets

Favorable financing conditions continued to prevail in international capital markets during the fourth quarter, and sovereign risk spreads of emerging markets fell to historical lows.

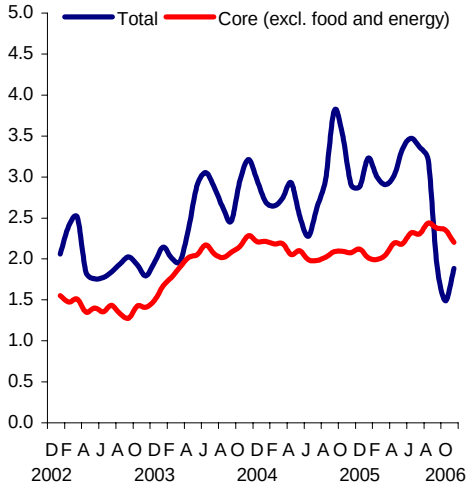
Graph 8
Price Indexes
Annual percentage change

a) U.S. Consumer Prices



Source: BLS.

b) Consumption Deflator



Source: Bureau of Economic Analysis.

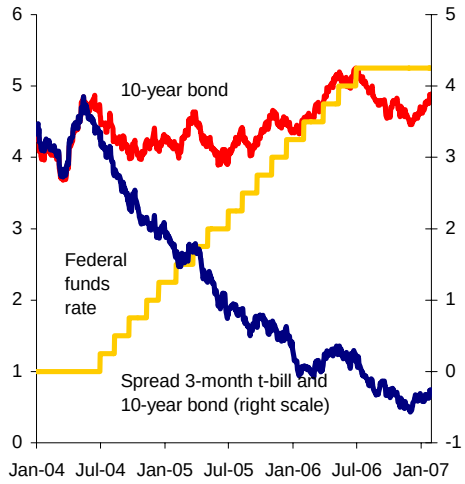
During the last quarter of 2006, the Federal Reserve kept the federal funds rate unchanged at the level set in June 2006 (5.25 percent), when the last of 17 consecutive increases took place. In its press releases of October and December, the Federal Open Market Committee stated that although core inflation remains high, the reduced impetus from energy prices, the fact that inflation expectations remain well anchored, the cumulative effect of past monetary policy tightening, and other factors restraining aggregate demand, are expected to contain further increases. Nonetheless, the Committee judges that some inflation risks prevail and that the extent and timing of any additional measures that may be needed to address these risks will depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information.

After having raised above 5 percent in early July, the interest rate on 10-year Treasury bonds fell to 4.46 percent on December 4. Since then, it has followed an upward trend, reaching 4.71 percent at the end of the year.[7] The yield curve remained inverted (Graph 9). At the end of 2006, the spread between the rates on 10-year and the 3-month Treasuries was -0.31 basis points.[8] The futures yield on the federal funds rate suggests market participants anticipate this rate to remain stable in the next months.

[7] The yield on 10-year bonds was 4.89 percent in January 29, 2007.
[8] In the last 53 years, the average spread between the 10-year and the 3-month rates has been 1.2 percentage points. The monthly average for the spread turned negative in August 2006, reaching minimum levels in November (-0.47 percentage points).

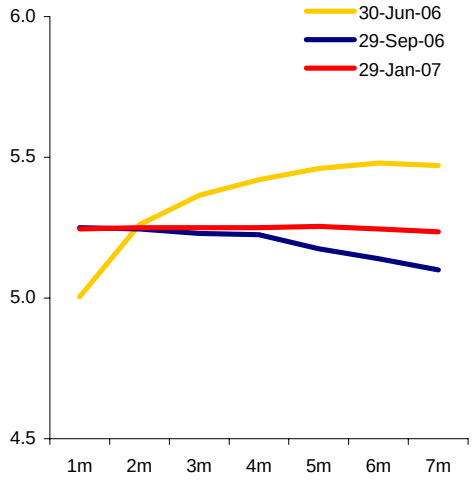
Graph 9
U.S. Interest Rates
Annual percent

a) Yield on 10-year U.S. Treasuries Bond and Federal Funds Rate, and Spread for 10-year Bond and 3-month T-bill



Source: Federal Reserve.

b) Federal Funds Rate Futures



Source: Bloomberg.

In the Euro area, the European Central Bank (ECB) continued to gradually withdraw the monetary stimulus, raising its reference rates by 25 basis points in both October and December. These actions were taken in a context of inflation expectations for the beginning of 2007 above reference value, strong growth, and upward risks for medium-term inflation, partly originated by what the ECB considers to be a rapid growth of the monetary and credit aggregates.[9] As for Japan, the Bank of Japan maintained its reference rate unchanged after an increase in July. As a result, financial conditions in that country remained accommodative.

In foreign exchange markets, the US dollar continued to depreciate on a real effective basis during the last quarter of 2006. During the year, the US dollar depreciated 4.7 percent. Thus, the cumulative depreciation of the US dollar since February 2002 reached 17 percent. The latter may contribute to reduce the global current account imbalances. However, the adjustment of the US dollar was mainly with respect to the euro and the pound sterling. The yen depreciated in real effective terms during 2006, thus continuing the trend followed since 2000. The upward trend followed by stock markets at the end of July continued. During the fourth quarter, the Dow Jones and NASDAQ indexes increased by 6.7 and 6.9 percent, respectively.

[9] The ECB left its reference rates unchanged during its meeting of January 2007. No significant changes were announced to its assessment of inflationary risks.

Emerging economies in general faced favorable international financing conditions during the fourth quarter. Net bond issuance from emerging economies' increased as compared with the previous quarter and risk premia continued to decrease after the turbulence of May-June.[10] The EMBI Global index reached new lows on December 28 (170 basis points). Spreads declined despite an episode of turbulence in mid-December following the establishment by Thailand of limits on the mobility of capital.

3.1.4. Outlook

The global economy is expected to grow vigorously in 2007. As for the advanced economies, the U.S. economy is expected to grow below its historic average, while the expansion of the Euro area and Japanese economies is expected to continue, although at rates closer to those sustainable in the long term. Analysts expect emerging economies, particularly those in Asia, to continue growing at high rates during the year. Latin America is expected to grow at a rate of more than 4 percent, but below that observed in other emerging regions. Although a moderate slowdown is expected in the U.S. economy, risks prevail of a sharper decline. Although households' financial position remains strong and various analysts consider that the deterioration in the real estate market is coming to an end, the possibility remains of a larger impact on the broader economy or of a significant further weakening of the real estate market.

The prospects for inflation are favorable. Analysts expect overall inflation to decline in both advanced and emerging economies during 2007. Nonetheless, several risks persist. A rebound in oil prices can not be discarded. In addition, high levels of capacity utilization in the U.S., slower productivity growth, and an acceleration of wages are factors that could make inflation rise, and therefore, prompt the Federal Reserve to make further adjustments in its monetary policy stance.

The convergence of the growth rates of the main economies' and the depreciation of the US dollar can be expected to help contain global current account imbalances. Nonetheless, risks prevail of a disordered adjustment in international financial markets originated by the accumulated effect of these imbalances.

3.2. Aggregate Demand and Supply in Mexico

3.2.1. Indicators of Aggregate Demand and Supply

Mexico's economic activity expanded significantly in 2006. GDP growth was the highest in six years and the same results were observed in some of the most important components of aggregate demand. Nonetheless, the dynamism of GDP and demand decreased slightly during the second half of the year and, particularly, during the fourth quarter. The main aspects that characterized aggregate demand in 2006 were: i) both components of aggregate demand -domestic and external- grew significantly at annual rates; as for domestic demand, consumption expenditure recorded an annual variation that exceeded that observed in the previous five years;[11] ii) investment growth -both public and

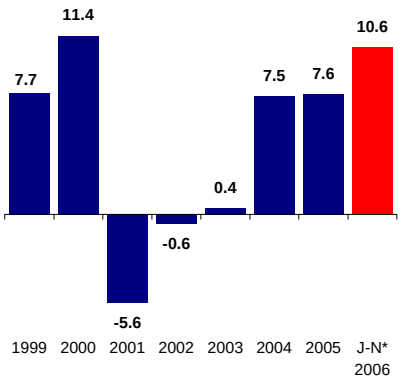
[10] The turbulence period of May-June lasted shortly. Emerging economies asset prices recovered after the event.

[11] Private consumption indicators show that ANTAD sales annual growth during the fourth quarter was 12.7 percent in real terms. Thus, in 2006, ANTAD sales increased by 13.1 percent (Graph 10c), the highest

private- was also high; of its components, imported capital goods exhibited the highest growth rates (Graph 10 and 10b);[12] and, iii) during the entire year, exports of goods and services recovered as compared with 2005. Export sales improved despite the slowdown in imports by the U.S. (main destination of Mexican exports) during the second half of 2006.

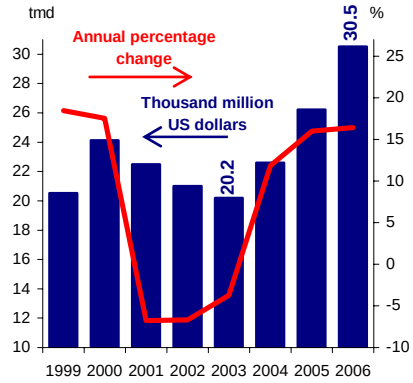
Graph 10
Domestic Demand Indicators

a) Gross Fixed Capital Formation
Annual percentage change



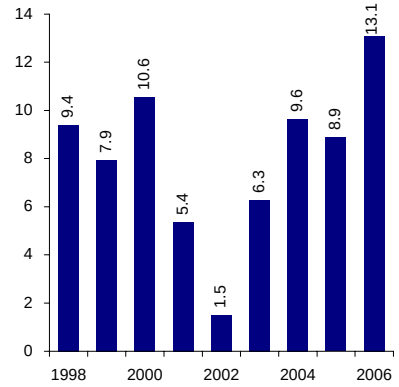
*Estimated.
Source: INEGI.

b) Capital Goods Imports



Source: Banco de México.

c) ANTAD Sales
Annual percentage change



Source: ANTAD.

Just like in 2004 and 2005, in 2006, domestic expenditure and domestic production benefited from different aspects characterizing the external environment. On the one hand, external demand for Mexican products, especially from the U.S., exhibited positive results. In the case of the automotive sector, several elements, such as investments done in previous years, allowed exports of vehicles to grow significantly most of the year. On the other hand, domestic expenditure, particularly for private consumption, was boosted by increases in revenues from both workers' remittances and the high surplus of the oil trade balance. Nonetheless, both items lost strength during the second half of the year, especially during the fourth quarter. Private consumption expenditure was also boosted by the improvement of employment, the higher real earnings in some sectors, and by increased financing from commercial banks, financial intermediaries and from the country's chain stores. As for public expenditure, its expansion in 2006 was favored by increased public revenues, partly originated by the higher oil prices during the year (see Box 1).

During the fourth quarter of 2006, aggregate demand and GDP grew at annual rates below those observed, in average, during the first nine months of the year.[13] This result was partly influenced by the lesser number of working days in

figure since 1997, when this indicator was first measured. In 2006, ANTAD sales, together with Walmart sales, accounted for more than one third of retail sales in Mexico, excluding vehicle, automobile parts and fuels.

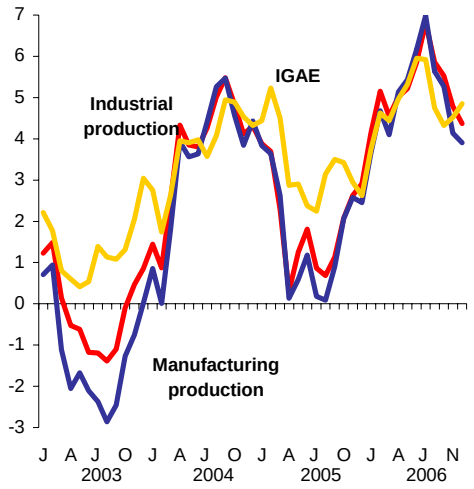
[12] Investment indicators reveal capital goods imports grew by 9.9 percent in annual terms during the period October-November. During the first eleven months of 2006 this item reached 10.6 percent, figure above that observed in the previous five years and close to that of 2000. During the fourth quarter, capital goods imports, measured in current US dollars, grew in annual terms 13.2 percent.

[13] The Global Indicator of Economic Activity *(Indicador Global de la Actividad Económica, I*GAE) grew at an annual rate of 5 percent during the period October-November. This result was influenced upward by a strong increase (14.5 percent) in its agricultural component. As a result, the IGAE excluding agriculture rose 4.4 percent in annual terms during this period.

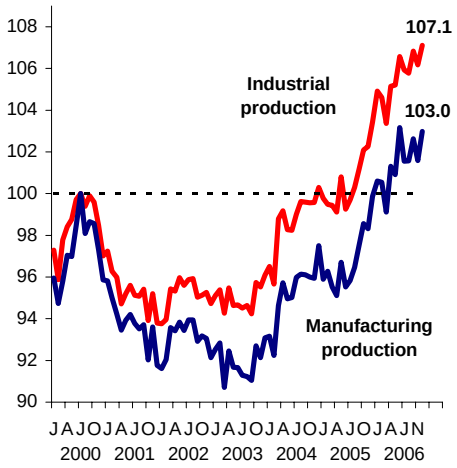
2006 as compared with the same period of the previous year. This affected significantly the growth of industrial production, particularly, manufacturing production and construction. Moreover, automotive exports slowed. The lesser dynamism of industrial activity during the fourth quarter also affected services production, mainly in transportation and commerce. On another front, during the referred quarter, agricultural GDP growth in annual terms was very high, thus reflecting the statistical effect of the same period of 2005, when it fell due to adverse weather conditions.

Graph 11
Production Indicators

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



b) Seasonally Adjusted Series
July 2000=100



Source: INEGI.

As for aggregate supply, the following stand out: on the one hand, output grew significantly during the year, although its growth rate eased during the second semester, especially during the fourth quarter; and, on the other, imports' dynamic behavior. Imports of intermediate goods (production-related inputs) slowed in the last months of the year.

A significant aspect that stands out regarding output during 2006 is the significant improvement of industrial production (Graph 11a and 11b), although its expansion lost strength during the last months of the year. The recovery of industry during the entire year responded to the positive behavior of the four sectors comprising it, especially manufacturing, construction, and electricity. In fact, during 2006, industrial production grew above figures observed in each of the previous five years. As for the slowdown observed during the fourth quarter, it was more evident in manufacturing activities.[14] The latter mainly responded to reduced growth in the automotive industry. During 2006, manufacturing production excluding the automotive industry grew above 2005 figures.

[14] During the period October-November 2006, industrial and manufacturing production grew by 4.6 and 4.2 percent in annual terms, respectively, while in the first nine months of the year, by 5.5 and 5.4 percent. During the period January-September, automotive industry production increased by 20.1 percent in annual terms, while during the period October-November, by 10.1 percent. The number of Mexican manufactured vehicles increased by 21.1 percent. However, during the fourth quarter, it did so by only 3.5 percent in annual terms.

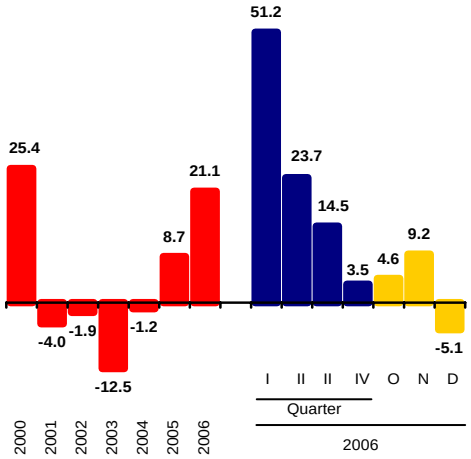
The automotive industry is particularly relevant for the Mexican economy due to its production value, the jobs it creates, and its incidence in Mexico's foreign trade (it has recorded a significant trade surplus). In the last months of 2005 and in the first of 2006, vehicle production in Mexico increased considerably (Graph 12a). These developments were the result of significant investments done by the main car-assembly companies in Mexico to modernize their production lines to fabricate new models, mainly, for the U.S. market. This allowed exported Mexican-assembled vehicles to increase their share in U.S. imports, given the significant decline of vehicle production in the U.S. Nonetheless, after the first months of 2006, levels of both production and vehicle exports did not increase further. Thus, vehicle production's high annual growth attained during the first quarter of the year (51.2 percent, Graph 12b) lost dynamism the rest of the year. As a result, very low annual growth was recorded during the fourth quarter (3.5 percent).

Based on the aforementioned, and on other indicators of economic activity, GDP is expected to have grown above 4 percent in annual terms during the fourth quarter of 2006. This expansion, together with the significant growth recorded during the first three quarters of the year (4.9 percent), would imply that GDP grew approximately 4.8 percent in 2006.

Graph 12
Automotive Industry Indicators

a) Production and Exports
Units per month and seasonally adjusted data

b) Total Production
Annual percentage change of number of units



Source: Prepared by Banco de México with data from AMIA and ANPACT.

Regarding the development of economic activity in Mexico, both GDP and domestic demand grew at higher rates than in 2005. Nonetheless, as mentioned further, these developments did not affect considerably the economy's production capacity:

i) Output growth was similar among all sectors of the economy (agricultural, industry and services activities).

ii) The reduction in the economy's growth rate during the fourth quarter included both GDP and domestic expenditure. Thus, the gap between the annual growth rate of both items did not widen in 2006; in fact, it narrowed by the end of the year.

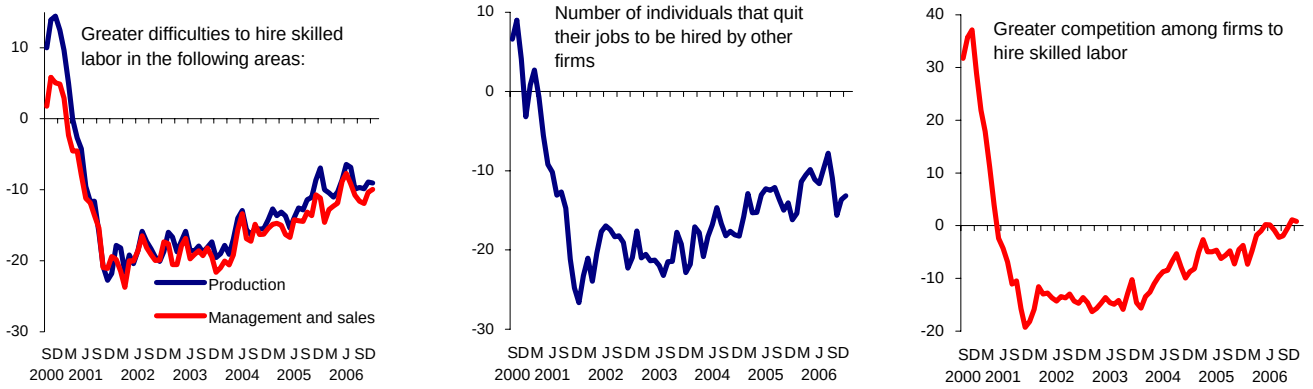
iii) The positive results of industrial activity in 2006 were due to the higher levels of production attained by the four sectors that comprise it, especially construction and manufacturing. During the previous year, construction had attained modest results. Manufacturing had also exhibited a weak performance in the previous years. Its improvement is mainly related to the favorable evolution of external demand for different type of manufacturing products. In fact, official statistics show that the level attained by manufacturing production during the period October-November 2006 barely exceeded its previous maximum achieved in mid-2000.

iv) Labor manufacturing productivity has recently increased in various sectors, thus strengthening their production capacity. This process has intensified in highly exporting activities.

v) Production capacity has gradually strengthened since 2004 following the significant recovery of investment, which grew at annual rates above GDP. An indicator that shows the intensity of the investment process and of the modernization efforts and its potential impact on Mexico's production capacity is the high growth of capital goods' imports. From 2003 to 2006, imports of capital goods measured in current US dollars increased by 51 percent.

vi) Skilled-labor shortage has not increased further, as revealed by Banco de México's monthly labor market indicators for the manufacturing sector for 2006 (Graph 13).[15] Banco de México's monthly Survey of Private Sector Economic Analysts' Expectations shows that, both skilled-labor shortage and labor costs were not identified in 2006 as factors that could hinder economic activity.[16]

Graph 13
Labor Shortage Indicators (Manufacturing Sector)
2-month moving average of balance of responses



Source: Results from Banco de México's Monthly Trend Survey of the Manufacturing Sector. Balance of responses refers to the weighted average of companies mentioning to have faced greater competition from other firms to hire skilled labor (or companies mentioning that the number of workers that resigned to be hired by other firms increased) less those mentioning to have faced less competition from other firms to hire workers. As for the right-hand graph, the balance of responses refers to the weighted percentage of firms mentioning to have faced greater difficulty to hire labor less those mentioning to have faced less difficulty.

[15] Monthly indicators show that in 2006, manufacturing companies did not face significant difficulties to hire skilled labor in their production, sales, and administrative areas, or high competition among themselves to hire skilled personnel.

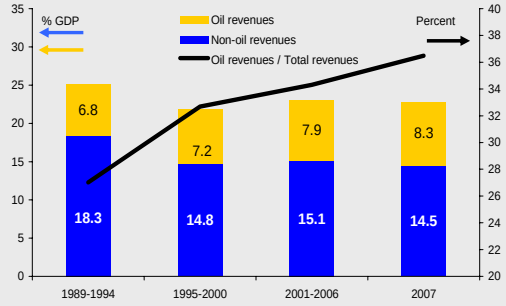
[16] Overall, during 2006, "higher wage costs" and "skilled-labor shortage" accounted for only 1.64 percent of answers regarding factors that could limit economic activity in the next six months (2 and 1.28 percent in the first and second half of the year, respectively). See Banco de México's monthly Survey of Private Sector Economic Analysts' Expectations for 2006.

Box 1

Mexican Public Finance's Dependence on Oil Revenues

Public finance dependence on oil revenues has increased in the last years due to weak non-oil tax collection and high revenues from crude oil exports as a result of higher oil prices. In terms of GDP, oil revenues have increased, from 6.8 percent on average during the period 1989-1994, to 7.9 percent on average during the period 2001-2006 (Graph 1). On the contrary, non-oil revenues decreased from 18.3 percent to 15.1 percent during the same period. The same trend prevails in the 2007 budget: oil revenues are expected to account for 8.3 percent of GDP, while non-oil revenues, for 14.5 percent. Weak tax collection is also evident when analyzing the composition of public revenues. During the period 1989-1994, oil revenues accounted, on average, for 27 percent of total revenues. During the period 2001-2006, their participation increased to 34.3 percent of total revenue. According to the budget approved for 2007, this trend will be likely to continue, given that oil revenues are estimated to account for 36.5 percent of total revenue.

Graph 1
Public Sector Revenues in Mexico 1/
Percentage of GDP and Percent of Total



1/ For 2006, expected year-end figures were used as presented in the 2007 Economic Policy Guidelines (*Criterios Generales de Política Económica, CGPE*). For 2007, information on the budget approved by Congress was used.
Source: Ministry of Finance (*Secretaría de Hacienda y Crédito Público*, SHCP).

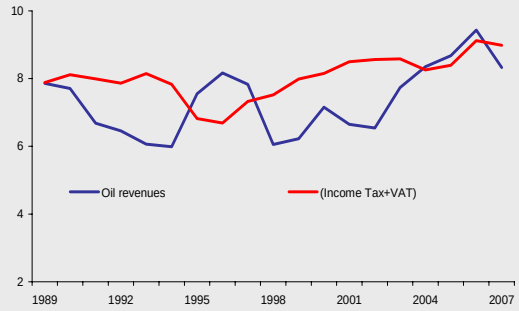
Public sector dependence on oil revenues clearly reveals public finance's vulnerability. In particular, three risk factors deserve mention:

i) The presence of higher oil revenues has allowed for an increase in public expenditure in spite of not having a significant non-oil tax collection. For example, although Income Tax and VAT collection have increased in recent years, oil revenues exceeded them between 2004 and 2006 (Graph 2). These additional resources have been allocated, mainly, to finance higher expenditure, particularly, current expenditure. Given that this type of expenditure is difficult to reduce, a likely decline in oil revenues could lead to a deterioration of public finances.

ii) PEMEX crude oil production capacity started to decline since 2005 (Graph 3). This is mainly explained by the drop in oil production of some of the current oil wells, and by the lack of investment to prospect new oil deposits. At present, the main crude oil reserves are located in oilfields whose exploitation costs far exceed the current ones.

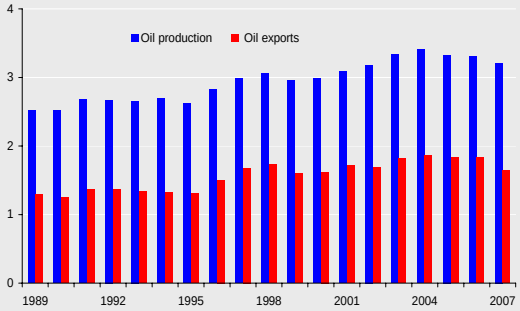
iii) The recent adjustment in oil prices and market volatility anticipate that public finances could face uncertain scenarios in coming years.

Graph 2
Oil Revenues and Income Tax and VAT Collection in Mexico 1/
Percent of GDP



1/ For 2006, expected end-year figures were used as presented in the 2007 Economic Policy Guidelines (*Criterios Generales de Política Económica, CGPE*). For 2007, information on the budget approved by Congress was used.
Source: Ministry of Finance (*Secretaría de Hacienda y Crédito Público*, SHCP).

Graph 3
Crude Oil Production and Exports in Mexico during 1989-2007 1/
Million daily barrels on average



1/ For 2006, expected end-year figures were used as presented in the 2007 Economic Policy Guidelines (*Criterios Generales de Política Económica, CGPE*). For 2007, information on the budget approved by Congress was used.
Source: Ministry of Finance (*Secretaría de Hacienda y Crédito Público,* SHCP).

Even though the dependence of public finance on oil revenues is a vulnerability factor for the Mexican economy, oil exports' importance in Mexico's external accounts has declined. In terms of GDP, oil exports increased by 0.6 percentage points between the periods 1989-1994 and 2001-2006, while manufacturing exports did so by 12.1 points between the same periods. In addition, oil exports have reduced their participation in total exports in the last years. During the period 1989-1994, oil exports accounted, on average, for 18.6 percent of total exports, while for the period 2001-2006, they did so, on average, for 12 percent of total exports. On the contrary, manufacturing exports have increased their participation in total exports, from 75.2 percent on average during the period 1989-1994, to 84.8 percent on average during the period 2001-2006. Finally, the oil sector has had a small participation in Mexico's economy, which has not changed significantly in the last years. In particular, in the National Accounts, Oil Mining accounted, on average, for 0.8 percentage points of GDP during the period 1989-1994, while, on average, for 0.7 percentage points of GDP during the period 2001-2006.

3.2.2. Employment

The significant expansion of economic activity during 2006 generated more demand for labor. This fact led to an improvement of several employment indicators, such as formal employment, which included most sectors of economic activity. The only labor market indicator that did not exhibit any improvement in 2006 was the national unemployment rate, which rose during the second half of the year. This indicator was influenced by an increase in the "rate of participation", i.e., the ratio of economically active population to population age 14 and older. The latter also reflected a higher participation of women in the economically active population.

The most significant aspects characterizing the labor market during 2006 and, particularly, during the fourth quarter of that year, were as follows: i) an increase in formal employment, measured by the number of workers insured by the IMSS. This implied higher annual percentage variations in the first three quarters of the year, which eased during the fourth quarter together with the economy's growth rate; ii) within formal employment, more temporary rather than permanent jobs were hired in urban areas; iii) a higher number of workers insured by the IMSS was observed in the services and construction sectors. In the manufacturing sector it was also significant; iv) an increase in the national unemployment rate during the second half of the year; and, v) INEGI statistics indicate that the percentage of population employed in informal activities remained high, although a slight downward trend was observed throughout the year.

At the end of 2006, 13,965,558 workers were insured by the IMSS, thus implying an annual increase of 879,533 workers (6.72 percent). Nonetheless, the rate of growth of this indicator (number of workers insured by the IMSS) eased during the fourth quarter (at the end of the first two weeks of September it had reached 6.94 percent). The total variation recorded in 2006 by this indicator was the highest observed at the end of the year in more than two decades. By breakdown, it comprised 405,416 permanent workers (3.7 percent annual increase) and 474,117 temporary workers in urban areas (23.3 percent increase).[17] The latter could be reflecting that, given the rigidities in the labor market, companies are flexibilizing their productive processes by hiring temporary workers. At the end of 2006, formal employment with seasonally adjusted data recorded thirty-nine monthly increases in the last forty-one months, exceeding by 1,452,713 its maximum level of formal jobs attained at the end of 2000 (Graph 14a). However, and according to INEGI, during the same period, the economically active population in Mexico rose by approximately 5 million. As a result, during that period, only 30 percent of the new entries in the labor market were hired in the formal sector.

The growth of formal employment during 2006 comprised almost all sectors, being particularly significant in construction (147,401 hired workers and 14.5 percent), the tertiary sector, especially in trade activities (170,139 hired workers and 6.6 percent), other services (360,904 hired workers and 8.3 percent), and the manufacturing industry (164,921 hired workers and 4.3 percent, Graph 14b).[18] Thus, after having undergone three consecutive years of contraction, manufacturing employment continued the recovery that began in 2004.

[17] As mentioned in previous Inflation Reports, the growing number of workers insured by the IMSS could also be reflecting IMSS greater fiscalization efforts.

[18] The other services sector comprises services for companies and individuals, as well as social and community services.

Nonetheless, on a seasonally adjusted basis, and up to the end of December 2006, the total number of manufacturing workers insured by the IMSS fell by 466 thousand (10.4 percent) as compared to its level in October 2000. Although formal employment growth in 2006 comprised all states, in Oaxaca and Tlaxcala, formal employment growth levels were very small.

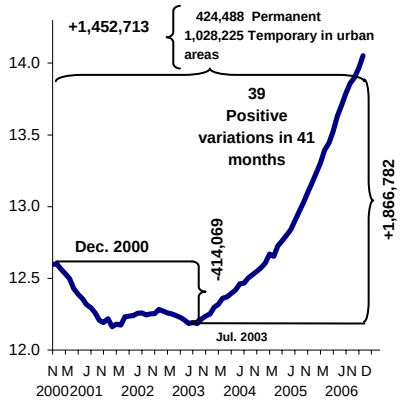
The significant growth of formal employment in 2006 did not prevent unemployment from rising. According to the Occupation and Employment Survey (*Encuesta Nacional de Ocupación y Empleo*, ENOE) conducted by INEGI, during the fourth quarter of 2006, the national unemployment rate on a seasonally adjusted basis was 3.91 percent (Graph 14c). During the second and third quarters it had been 3.4 and 3.66 percent, respectively. Under such context, the "rate of participation" (the ratio of economically active population to population age 14 and older) increased in 2006, making the unemployment rate rise. After having been 57.92 percent in 2005, the national unemployment rate was, on average, 58.7 percent in 2006. The 0.78 percentage point increase in the "rate of participation" resulted from 1.11 and 0.46 percentage point increases in the corresponding rates of women and men. During the third quarter of 2006, the percentage of population working in informal activities was 26.8 percent, while in the same period of 2005, 28 percent.

Graph 14
Labor Market Indicators

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

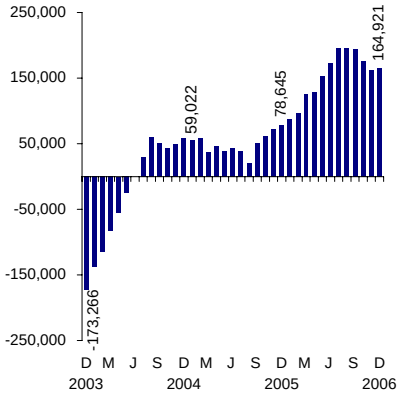
a) Million Workers

Seasonally adjusted data

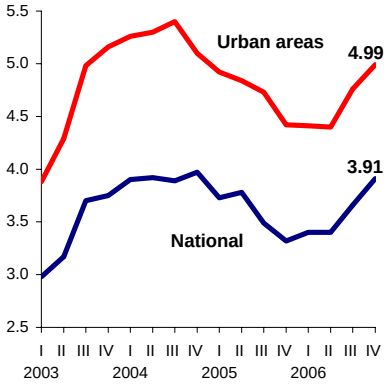


b) Manufacturing Industry

Annual variation (original data)



c) Unemployment Rate (National and in Urban Areas)
Percentage in relation to economically active population and seasonally adjusted data



Source: IMSS. Seasonal adjustments by Banco de México.

Source: INEGI. Seasonal adjustments by Banco de México.

3.2.3. External Sector

The significant growth of aggregate demand and GDP during 2006 has not implied a widening in trade and current account balances as compared with 2005. In fact, in relation to GDP, both trade and current account deficit were the lowest in 25 years, as they are expected to have been 0.7 and 0.2 percentage points, respectively. Nonetheless, in 2006, these results were influenced downward by two factors: the increase in the oil trade balance surplus and, in the

case of the current account, the higher resources from workers' remittances (see Box 2). Excluding the higher resources from both items, both deficits increased.

During 2006 and, particularly, during the fourth quarter of 2006, the current account of the balance of payments and its main items were characterized by the following:

a) Non-oil exports grew more (15.8 percent during the year) than during 2005 (11 percent). Nonetheless, their growth rate moderated during the fourth quarter of the year.[19] Despite several indicators, which suggest that external demand slowed during the second half of the year, non-oil exports grew significantly in 2006.

b) Terminal automotive industry exports rebounded during the year, therefore boosting manufacturing exports.[20] However, throughout the second half of the year and, especially, during the fourth quarter, automotive exports lost dynamism.

c) Oil exports grew significantly in 2006 (22.7 percent), albeit at a slower rate during the last months of the year. In fact, during the fourth quarter, the value of oil exports fell in annual terms. This reduction was partly associated with a decline in the volume of crude oil exports.

d) Higher growth of GDP and aggregate demand in 2006 as compared with 2005 fostered a considerable expansion of merchandise imports, which eased during the fourth quarter. Imports growth included its three components (intermediate goods, capital goods, and consumption goods),[21] being the most dynamic, capital goods.

e) The non-oil trade deficit increased during the year, due to the greater dynamism of domestic expenditure as compared with GDP.

f) The federal government made significant external-debt payments. In particular, during the fourth quarter of the year, a considerable amount of these flows were part of the foreign-debt prepayment program that began in July.

[19] During the fourth quarter of 2006, total merchandise exports rose at an annual rate of 8.7 percent, as a result of both an increase of 11.3 percent in non-oil exports and a reduction of 5.9 percent in oil exports. For the whole year, the corresponding growths were 16.8, 15.8 and 22.7 percent, whereas in 2005 these rates were 14, 11, and 34.8 percent.

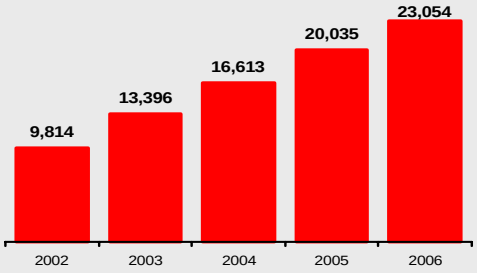
[20] During the fourth quarter of 2006, automotive exports grew at an annual rate of 3.5 percent, figure below those of 33, 20.5 and 11.2 percent recorded during the first, second, and third quarters of the year.

[21] In 2006, merchandise imports grew at an annual rate of 15.5 percent (12.7 percent in 2005), as a result of respective increases of 15, 17.3, and 16.4 percent in imports of intermediate, consumption and capital goods.

Box 2
Workers' Remittances

In recent years, workers' remittances have increased their participation in Mexico's external accounts, particularly, in terms of revenues of the balance of payments' current account. In 2005, remittances amounted to 20,035 million US dollars (20.6% annual increase) (Graph 1). In 2006, remittances amounted to 23,054 million US dollars (15% annual increase). The rapid growth of remittances in recent years has been due to a better coverage of transaction records, and to a genuine increase in remittances.

Graph 1
Workers' Remittances
(Million US dollars)



Basic Facts

Starting 2000, Banco de México began to increase and improve the coverage of worker remittances' statistics. Up to a few years ago, within Banco de México, and also among remittances' intermediaries, there was a widespread perception that statistics of remittances in Mexico were underestimated.

a) **Improvement of statistics coverage.** Starting 2001, in its quarterly press releases of the balance of payments, annual reports, and in its inflation reports, Banco de México began to report an improvement in the coverage of remittances' records, stating that such an improvement meant that, for a time, remittances' growth would be high. Intermediaries also improved their remittances' records, which allowed them to have a better understanding of the potential magnitude of this growing market, its business opportunities, the instruments that they would need to offer to increase their share in the market, and the changes that would need to be implemented to process the transactions and apply cross-information systems to prevent irregularities.

b) **Incorporating informal transactions to the formal market.** A large number of transactions that used to be done through informal channels were incorporated to the formal market of remittances. This also helps to explain the significant growth of workers' remittances since 2000.

Table 1
Total Cost of Money Transfers from U.S. to Mexico of an Average Amount of 300 US dollars from a Sample of Enterprises by City of Origin
(US dollars per transfer)

Annual Average	Chicago	Dallas	Los Angeles	Miami	New York	Sacramento	Total
1999	21.8	27.1	28.3	27.4	27.0	32.4	28.5
2000	18.8	24.3	23.7	22.6	21.6	17.1	23.2
2002	13.3	14.6	13.9	16.4	14.2	15.3	14.9
2004	11.2	12.3	11.4	12.0	12.2	12.2	11.9
2005	10.1	11.7	10.6	10.3	11.0	10.7	10.7
2006	9.3	11.5	10.2	10.1	10.8	9.8	10.5

*Source: Profeco.

c) **Cost of remittance transactions.** Another factor that has contributed to raise the flow of remittances to Mexico, and to its formalization, has been the reduction of remittance sending charges (Table 1). The factors that have contributed to this reduction are: a) an increase in the number of intermediaries that offer this service to the rapidly-growing Mexican-origin population in the U.S., and the increasing competition among intermediaries; b) better information regarding costs of different instruments and services offered by intermediaries; and, c) a greater use of international wire transfers.

d) **Regulation.** On October 29, 2002, Banco de México issued rules to improve the statistics on workers' remittances. These rules enforced all money transfer firms to provide Banco de México with monthly information on the amount of workers' remittances transferred to Mexico, classified by recipient state. This allowed for generating high quality information on workers' remittances, both at the national and state level, which is used to prepare the statistics of Transfers included in Mexico's Current Account of the Balance of Payments.

Banco de México's remittance statistics only include transactions between individuals, and are subject to strict controls by intermediaries. Both bank and non-bank intermediaries have developed platforms to process money-transfer transactions, with data systems to identify and prevent irregularities. This allows for measuring the frequency and the amount of the transfers sent and received. A significant number of remittances' agents have also established as a routine procedure getting to know their regular customers.

e) **Amount and number of transactions.** Remittances have increased in number and quantity. The average value of individual transactions has remained in a stable 320-360 USD range for the last five years (Table 2).

Table 2
Revenues from Workers' Remittances
(Amount, Number of Transactions and Average Remittance)

	1995	2000	2002	2004	2005	2006
Amount of Remittances [1/]	3,673	6,573	9,814	16,613	20,035	23,054
Number of Remittances [2/]	11,263	17,999	29,954	50,874	58,739	65,843
Average Remittance [3/]	326	365	328	327	341	350

[1/] Million US dollars; [2/] Thousand operations; [3/] US dollars.

f) **Instruments used to send remittances and percentage structure of those resources**. In recent years, there has been a significant change in the type of instruments used to send remittances. The amount of remittances has increased rapidly (Table 2), as a result of technological advances in telecommunications and computer systems, and to greater competition among different intermediaries. The latter have began to offer more efficient, rapid, and safer electronic transfers, at lower prices.

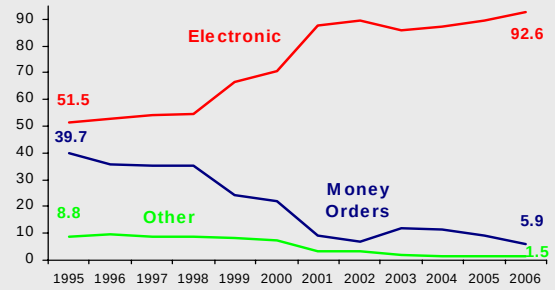
Table 3
Revenues from Workers' Remittances and Structure
(Million US dollars and percents)

	1995	2000	2002	2004	2005	2006
Million US dollars						
Total Remittances	3,673	6,573	9,814	16,613	20,035	23,054
Money Orders	1,456	1,434	687	1,883	1,867	1,357
Checks	26	9	10	0	0	0
Electronic Transfers	1,891	4,642	8,798	14,496	17,895	21,350
Direct Transfers*	299	488	320	234	273	347
Percentage structure						
Total Remittances	100.0	100.0	100.0	100.0	100.0	100.0
Money Orders	39.7	21.8	7.0	11.3	9.3	5.9
Checks	0.7	0.1	0.1	0.0	0.0	0.0
Electronic Transfers	51.5	70.6	89.6	87.3	89.3	92.6
Direct Transfers	8.1	7.4	3.3	1.4	1.4	1.5

* Goods and money transfers.

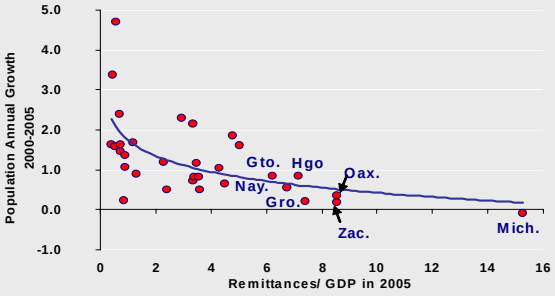
Currently, 98.5% of remittances and transactions recorded by Banco de México come from intermediaries' accounting records; i.e., from banks and enterprises offering money transfer services (Graph 2). The remaining 1.5% of resources is direct transfers; i.e., in cash and/or kind (goods) recorded by Banco de México through its survey of international travelers, which has been done continuously since several decades.

Graph 2
Revenues from Workers' Remittances
(Percentage structure by instrument)



g) **Back-up of remittance statistics with accounting records.** The fact that nearly the entire measurement of remittances recorded by Banco de México is obtained from accounting records makes them reliable. This fact has been acknowledged by institutions involved in the methodology to measure and analyze these flows (International Monetary Fund, World Bank, and Inter American Development Bank).

Graph 3
Population Growth in States and Workers' Remittances as a Percentage of State GDP



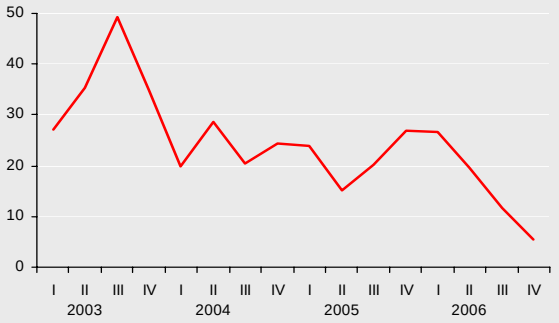
Source: INEGI and Banco de México.

h) **Migration, population growth, and workers' remittances.** In country states where remittances account for a higher percentage of GDP, population tends to grow less. Graph 3 shows that in Michoacán, Zacatecas and Oaxaca, where remittances accounted for the highest percentage of state GDP, the annual population growth was almost zero, and the inverse relation between both variables is maintained when considering 10 states with higher remittances and with the lowest population growth. This result reflects two aspects of the same phenomenon: a strong migration to the United States from states receiving higher relative revenues from remittances.

Recent Slowdown of Workers' Remittances

During 2006, the growth rate of workers' remittances slowed significantly. These revenues increased at an annual rate of 27.5 and 19.7 percent during the first and second quarters, and 10.6 and 5.5 percent during the third and fourth quarters, respectively (Graph 4). These results are explained by several factors: a) the improvement in the coverage of remittance transactions had a positive (upward) influence in such statistics in previous years; however its effect has gradually disappeared; b) Mexican workers face more difficulties to migrate to the U.S. due to greater surveillance at the border; and, c) Mexican illegal immigrants in the U.S. face greater difficulties to find jobs, due to stricter official controls in a context of U.S. economic slowdown.

Graph 4
Workers' Remittances
(Annual percentage change of seasonally adjusted data by quarter)

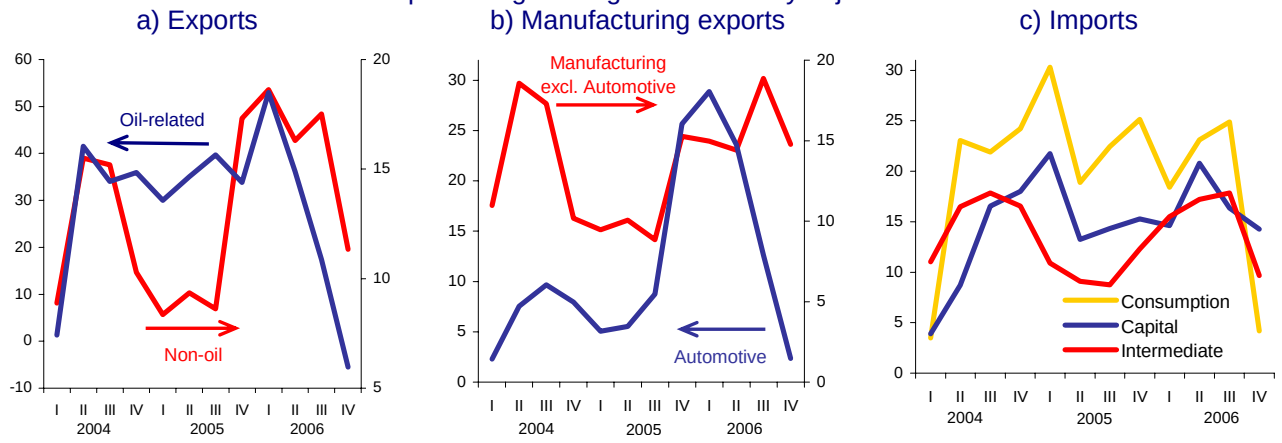


Final Remarks

Workers' remittances have contributed to improve significantly the welfare of Mexican recipient families, considering that: a) they have affected positively their income, and therefore, their consumption levels; b) they constitute a significant source of resources for these families to invest in human capital, health services, and even physical capital; and, c) they have facilitated recipient families to have access to better financing conditions, allowing them to ease their consumption levels and invest in small businesses. These effects have been more significant in states with a high concentration of recipient families. Nonetheless, the migration process that generates revenues from remittances also entails negative effects, such as the loss of lives when trying to cross the border to the U.S.; the social cost of family separation; and, the impact in Mexican domestic production associated with the loss of human resources that migrate, among others.

Finally, Banco de México together with the Federal Reserve, have designed the mechanism "Directo a México", which is an efficient and low-priced transfer mean from the U.S. to Mexico that fosters financial deepening (bancarization) of both, the sender and the recipient of remittances. In February 2004, both central banks connected their payments systems, allowing U.S. banks to offer the "Directo a México" service to their customers in order to send money transfers from their bank accounts to beneficiaries in Mexico that also own a bank account. Up to date, more than 160 banks in 32 states in the United States have adopted this mechanism. This service is ideal for recurrent transfers from the U.S. to Mexico, such as workers' remittances and retirement allowances. The main advantages of "Directo a México" is that the sender in the U.S. pays a lower sending cost (1 to 5 USD per transfer), charges are transparent, the recipient can withdraw the funds more rapidly (1 working day after the day of the transfer), and it offers a competitive USD/peso exchange rate (FIX minus 0.21 percent). Up to know, "Directo a México" has been used mainly by the U.S. federal government for payment of retirement allowances of U.S. retired citizens living in Mexico, but it has a very high potential for remittance transfers.

Graph 15
Merchandise Exports and Imports
Annual percentage change of seasonally adjusted data



Source: Banco de México.

Mexican exports to the U.S. improved during 2006. As a result, their share in U.S. imports increased, after having decreased from 2003 to 2005. This increase prevails even after excluding oil and automotive exports from total exports to the U.S. In particular, during the October-November period, Mexican exports to the U.S. grew at an annual rate of 11.53 percent, above that of U.S. total imports (4.83 percent) (Table 2), thus prompting Mexican exports' share in U.S. imports to increase, from 10.19 percent during the October-November 2005 period, to 10.84 percent during the same period of 2006. Mexico's higher share in the U.S. market in recent months was mainly due to a positive performance of U.S. industrial production, which continued to affect favorably Mexican non-oil exports. It is well known that Mexican industrial production and manufacturing exports are closely linked to U.S. industrial production. Since private consumption and GDP growth have been slowing more than industrial production in the U.S., Mexican exports have been able to grow considerably in that market.

Table 2
U.S. Imports
Percent

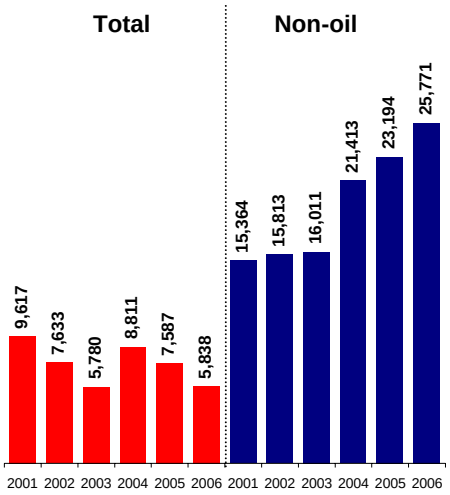
	Share				Annual Percentage Change: 2006					
					October-November					Jan-Nov
	January-November		October-November		Total	Oil	Total excl. Oil	Automotive	Total excl.Oil and Automotive	Total excl. Oil and Automotive
	2005	2006	2005	2006						
Total	**100.00**	**100.00**	**100.00**	**100.00**	**4.83**	**-1.79**	**5.64**	**1.39**	**6.45**	**10.43**
Total excl./Mexico	**89.82**	**89.26**	**89.81**	**89.16**	**4.07**	**-3.33**	**4.95**	**0.00**	**5.79**	**10.05**
Total excl./Mexico and China	**75.24**	**73.82**	**74.53**	**71.39**	**0.40**	**-2.93**	**0.89**	**0.00**	**1.08**	**7.87**
1. Canada	17.28	16.39	17.66	15.67	-7.01	18.64	-9.56	-11.61	-8.81	3.93
2. China	14.58	15.45	15.28	17.77	21.95	-73.09	22.29	--	22.29	18.22
3. Mexico	**10.18**	**10.74**	**10.19**	**10.84**	**11.53**	**9.00**	**11.92**	**7.51**	**13.80**	**14.65**
4. Japan	8.26	7.95	7.87	8.31	10.71	--	10.71	19.83	5.02	3.38
5. Germany	5.05	4.76	4.93	4.69	-0.29	--	-0.29	-16.26	8.13	8.72
Total 5 countries	55.35	55.29	55.93	57.28	7.37	12.62	7.07	0.21	9.00	10.96

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

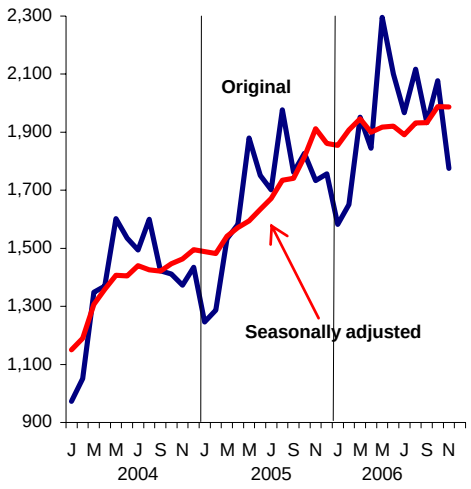
The current account of the balance of payments recorded a moderate deficit during the fourth quarter of 2006 and during the entire year. This result was favored by both the higher surpluses of the oil trade balance and the revenues from workers' remittances during the reference period. The oil surplus went from 15,607 million US dollars in 2005 to 19,933 million in 2006, while inflows from workers' remittances increased from 20,035 million US dollars in 2005 to 23,054 million in 2006. The annual growth of workers' remittances slowed in 2006: from 27.5 and 19.7 percent during the first and second quarters of the year, to 10.6 and 5.5 percent during the third and fourth quarters (Graph 16).

Graph 16
External Sector Indicators

a) Trade Balance Deficit (Total and Non-oil)
Million US dollars



b) Workers' Remittances
Million US dollars per month; original and seasonally adjusted data

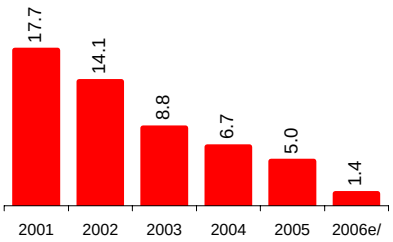


Source: Banco de México.

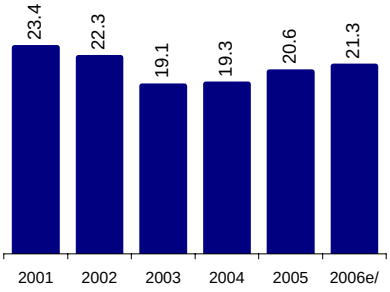
Based on the aforementioned, as well as on incoming information on other components of the external accounts, the current account of the balance of payments is estimated to have recorded a deficit of approximately 2 billion US dollars during the fourth quarter of 2006. Such results imply that the current account ended 2006 with a moderate 1.4 billion US dollar deficit (0.2 percentage points of GDP), which was below that observed in 2005 (5.039 billion US dollars and 0.7 percentage points of GDP). The capital account (including errors and omissions) is expected to have recorded a surplus of around 2.4 billion million US dollars during the fourth quarter of 2006 and, during the entire year, 0.4 billion. The latter was the result of, on the one hand, resources from foreign investment inflows, both direct and portfolio, net foreign financing for the non-bank private sector, and foreign financing for Pidiregas projects, and, on the other hand, outflows from a reduction of foreign debt from commercial banks and, significantly, the public sector. Finally, during the fourth quarter of 2006, Banco de México's net international reserves increased by 377 billion US dollars. At the end of 2006, the stock of international reserves was 67.680 billion US dollars.

Graph 17
Current Account Deficit of the Balance of Payments
Billion US dollars

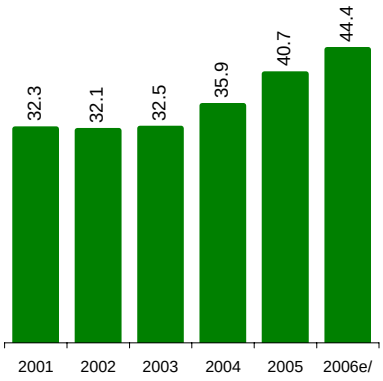
a) Current Account



b) Non-oil Current Account*/



c) Non-oil Current Account excluding Workers' Remittances**/



e/ Estimated.
*/ Excluding oil trade balance; **/ Excluding oil trade balance and revenues from workers' remittances.

3.3. Costs and Prices

3.3.1. Wages and Unit Labor Costs

During 2006, a 4.1 percent wage increase was granted to firms under federal jurisdiction, 0.3 percentage points below that granted during the previous year (Table 3), due to slower wage growth in both public and private companies.

The minimum wage agreed by the Minimum Wage Commission (*Comisión Nacional de los Salarios Mínimos*, CONASAMI) starting January 2007 increased by 3.9 percent in the three geographic regions. The average minimum wage was 48.88 pesos per day (Table 4).

Table 3
Contractual Wage Average Increases[1/] and Number of Workers Benefited by Type of Company

	2005					2006							
	I	II	III	IV	Jan-Dec	I	II	III	IV	Oct	Nov	Dec	Jan-Dec
Contractual Wage Increase (Percent)1/													
Total	4.5	4.4	4.4	4.2	4.4	4.3	4.4	4.3	3.7	3.6	4.0	4.7	4.1
Public companies	3.6	4.0	4.1	4.0	4.0	4.0	4.0	4.1	3.6	3.5	3.9	4.0	3.8
Private companies	4.7	4.6	4.7	4.7	4.6	4.3	4.5	4.4	4.2	4.2	4.2	4.7	4.4
Number of Workers Benefited (Percentage Share)													
Total	100	100	100	100	100	100	100	100	100	100	100	100	100
Public companies	19	22	46	72	41	19	27	48	77	85	45	1	44
Private companies	81	78	54	28	59	81	73	52	23	15	55	99	56

1/Average weighted by number of workers benefited during the period.
Source: Prepared by Banco de México with data from the Ministry of Labor.

Table 4
Nominal Minimum Wage
Pesos per day and annual percentage change

Period	Pesos per day				Annual percentage change			
	General	Geographic region			General	Geographic region		
		A	B	C		A	B	C
2001	37.57	40.35	37.95	35.85	6.99	6.50	8.09	9.68
2002	39.74	42.15	40.10	38.30	5.78	4.50	5.70	6.90
2003	41.53	43.65	41.85	40.30	4.50	3.56	4.36	5.22
2004	43.30	45.24	43.73	42.11	4.25	3.64	4.50	4.50
2005	45.24	46.80	45.35	44.05	4.50	3.50	3.70	4.60
2006	47.05	48.67	47.16	45.81	4.00	4.00	4.00	4.00
2007	48.88	50.57	49.00	47.60	3.90	3.90	3.90	3.90

Source: Minimum Wage Commission (*Comisión Nacional de los Salarios Mínimos*, CONASAMI).

During the January-October 2006 period, labor productivity and real average earnings in the manufacturing sector, in both, maquiladora and non-maquiladora industries, recorded annual average variations above those observed during the same period of 2005. In the non-maquiladora manufacturing industry, productivity grew more than earnings. As a result, unit labor costs (ULCs) in this industry recorded a negative variation. In contrast, in the maquiladora industry, earnings grew more than productivity. Thus, ULCs in this industry recorded a positive variation (Table 5). These figures, however, should be interpreted with caution due to their construction methodology.[22]

Table 5
Earnings, Labor Productivity and Unit Labor Costs in the Manufacturing Industry[1/]
Annual percentage change

	2004	2005		2006				
	Jan-Dec	Jan-Oct	Jan-Dec	I	II	III	Oct	Jan-Oct
Non-maquiladora Manufacturing Industry								
Labor Productivity	**7.1**	**1.8**	**1.9**	6.9	2.6	3.2	2.0	**4.0**
Rean Average Earnings	**0.3**	**-0.3**	**-0.2**	0.9	0.8	1.1	-0.6	**0.8**
ULC	**-6.3**	**-2.0**	**-2.0**	-5.6	-1.6	-2.0	-2.6	**-3.0**
Maquiladora Industry								
Labor Productivity	**2.5**	**-1.5**	**-1.0**	1.2	0.1	-0.2	-0.8	**0.3**
Rean Average Earnings	**-0.2**	**-0.1**	**0.3**	2.2	2.3	0.4	0.7	**1.5**
ULC	**-2.6**	**1.4**	**1.4**	0.9	2.2	0.6	1.6	**1.3**

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

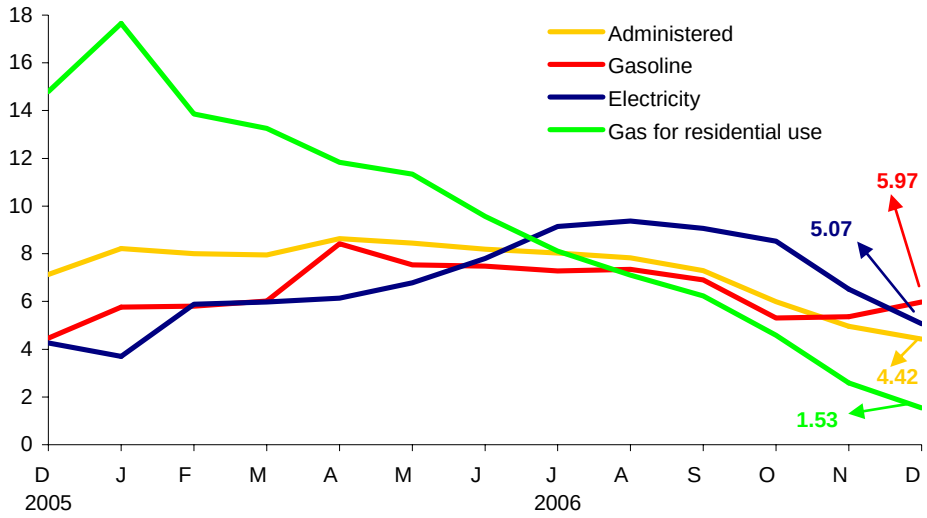
3.3.2. Administered and Regulated Prices of Goods and Services

The subindex of administered prices recorded an annual variation of 4.42 percent at the end of 2006 (8.18 and 7.29 percent in June and September, respectively). The reduction observed during the second half of the year was influenced by the decline in the international prices of several energy products. The decrease in gasoline prices at border cities contributed to such decline, regardless of the additional fee set for high octane gasoline in order to finance production of a new low-sulfur fuel (Graph 18). In addition, the reduction in natural gas prices at the end of the third quarter contributed to the fall in the growth rate of gas for residential use and high consumption electricity tariffs (*Tarifas Eléctricas*

[22] Maquiladora production calculations are based on number of hours worked. Labor average productivity per worker thus reflects labor intensity in the productive process.

de Alto Consumo, DAC). The reduction in steel prices, which are included in DAC electricity tariffs calculations,[23] also contributed to the decline in these tariffs.

Graph 18
Administered Prices Subindex
Annual percentage change



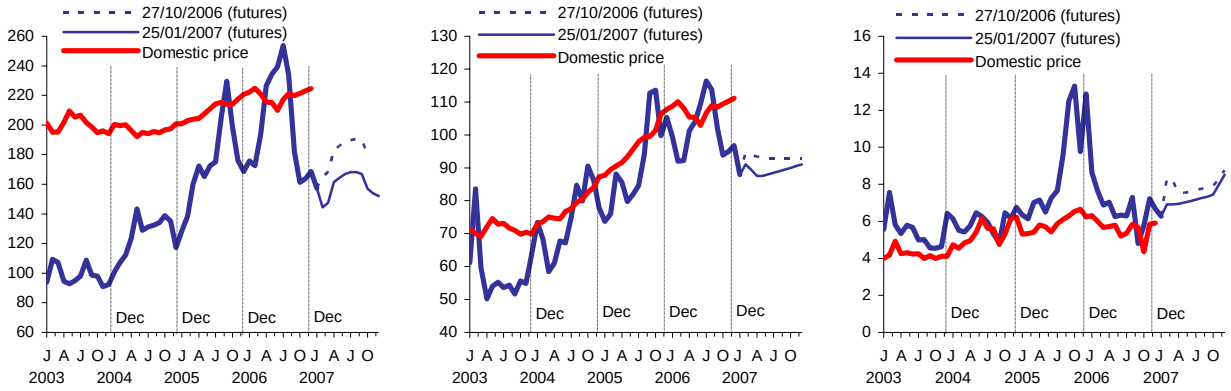
During the fourth quarter of 2006, international prices of gasoline and propane decreased (Graph 19). In contrast, prices of natural gas increased. This recent increase will affect the behavior of both domestic gas and electricity in the first months of 2007, due to its lagged effect on natural gas prices and on the formula to determine DAC electricity tariffs.

The subindex of regulated prices recorded an annual variation of 1.83 percent in December 2006 (in June and September, 1.22 and 1.63 percent, respectively). The absence of revisions in public transportation tariffs in cities that have a high weight in the CPI basket contributed to the low level of this indicator during the year.

[23] For the methodology to calculate high consumption electricity tariffs, see Section 1.1.

Graph 19
International Prices and Futures of Selected Energy Goods [1/]

a) Gasoline[2/] b) Propane[3/] c) Natural gas[4/]



1/ Futures prices of October 27, 2006 and January 25, 2007 (New York Mercantile Exchange).
2/ Texas. US cents per gallon.
3/ Mont Belvieu, Tx. US cents.
4/ Tetco, Tx. US dollars per MMBtu.

3.3.3. Metals and Food Commodities

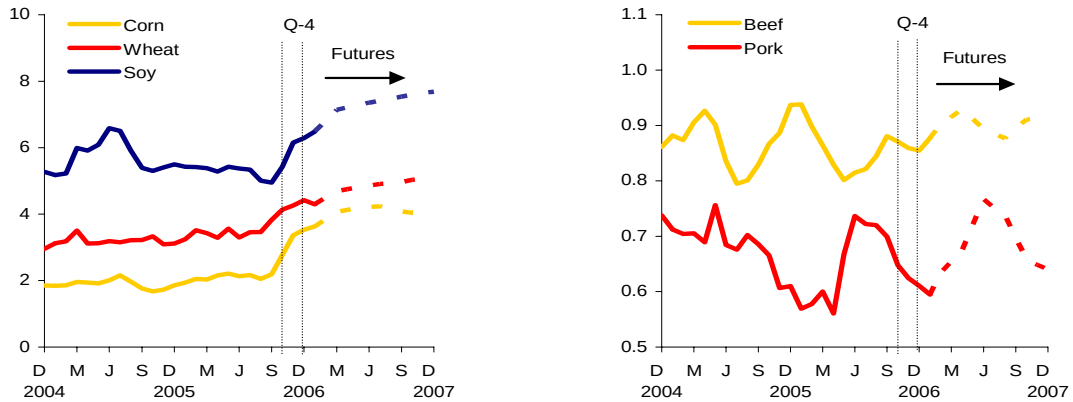
International prices of grains rose significantly during the fourth quarter of 2006 and their futures suggest that they could remain high for the next year (Graph 20a). In contrast, international references of beef and pork meat declined during the September-December 2006 period; nonetheless, futures of both commodities suggest that these could increase in 2007 (Graph 20b).

As for metal prices, the international references of various materials manufactured from steel followed a downward trend. Steel domestic prices were influenced by the settlement of the labor conflict that affected the steel industry between February and September 2006, therefore helping to regularize steel production in the country (Graph 21).

Graph 20
International Prices of Food Commodities[1/]

a) Grains
US dollars per bushel

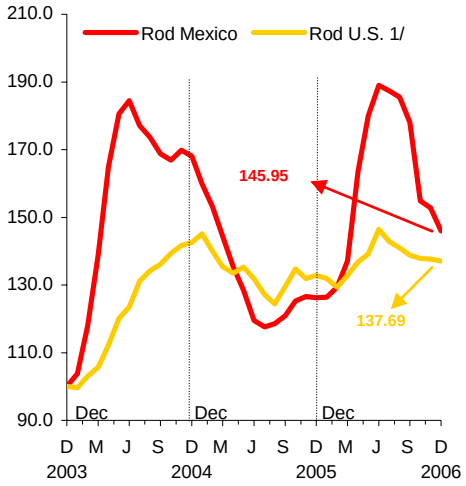
b) Meats
US dollars per pound



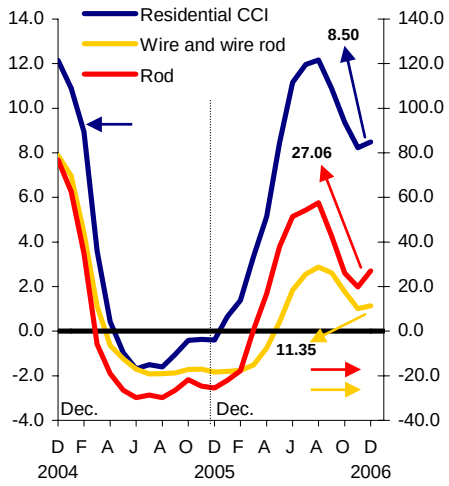
1/ Price information was obtained from the U.S. Department of Agriculture. Futures prices correspond to January 25, 2007. Value of grains was obtained from the Chicago Board of Trade. Value of meats was obtained from the Chicago Mercantile Exchange.

Graph 21
Prices of Steel Materials and Residential Construction Cost

a) Rod Producer Prices [1/]
Indexes



b) Residential Construction Cost [2/]
Annual percentage change



Source: Banco de México (México) and Bureau of Labor Statistics (U.S.).
1/ Based on producer prices. The U.S. index includes all types of steel rod.
2/ Based on prices of construction material distributors.

3.4. Monetary and Credit Aggregates

3.4.1. Monetary Base, Net Domestic Credit and International Assets

As mentioned in previous reports, in economies where inflation declines significantly, and where this decline is perceived as permanent, remonetization processes are commonly observed in periods in which the public increases its holding of monetary stocks. This is the case of the Mexican economy, where the narrow monetary aggregates, among them the monetary base, have increased considerably in recent years (see Box 3). During 2006, the monetary base grew on average 16.2 percent in annual terms, above 2005 figures (12.1 percent).[24] Although part of this increase can be explained by the faster rate of growth of the economy, and by the further reduction of interest rates, it could also be reflecting temporary factors like a greater use of cash, which usually is associated with federal elections.

Net international assets rose by 2,189 million US dollars at the end of 2006, reaching 76,304 million at December 31, 2006.[25] The monetary base rose by 69,788 million pesos during 2006. As a result, Banco de México's net domestic credit increased by 43,847 million pesos during the year (Table 6).

[24] Figures calculated based on the average of daily stocks.
[25] For a definition of international assets and international reserves refer to the glossary of the weekly press release on Banco de México's balance sheet. Banco de México's broad credit position vs. the domestic market (net domestic credit) is obtained by subtracting international assets from the monetary base; i.e., financing granted or received domestically by the central bank. The international reserves definition excludes Banco de México's short-term (less than six months) foreign currency liabilities.

Table 6
Monetary Base, International Assets and Net Domestic Credit
Millions

	Stocks		Annual % Change	Flows in 2006				
				Quarter				Accumulated at Dec.31,2006
	At Dec.31 2005	At Dec.31 2006	At Dec.31 2006	I	II	III	IV	
(A) Monetary Base (Pesos)	380,034	449,821	18.4	-26,990	16,029	-1,933	82,681	69,788
(B) Net International Assets (Pesos) 1/ 2/	788,167	824,967	4.7	21,062	100,276	-17,312	-78,085	25,941
Net International Assets (US dollars) 2/	74,115	76,304	3.0	1,931	8,934	-1,530	-7,146	2,189
(C) Net Domestic Credit (Pesos) [(A)-(B)] 1/	-408,133	-375,145	-8.1	-48,051	-84,248	15,380	160,766	43,847
(D) International Reserves (US dollars) [(E)-(F)] 3/	68,669	67,680	-1.4	-1,182	11,256	-11,440	377	-989
(E) Gross Reserves (US dollars)	74,110	76,330	3.0	1,914	8,922	-1,492	-7,124	2,220
PEMEX				6,420	10,555	6,295	3,427	26,698
Federal Government				-3,556	-932	-6,873	-8,831	-20,192
Sale of US dollars to banks 4/				-1,407	-1,550	-2,465	-2,592	-8,014
Other 5/				456	848	1,552	872	3,728
(F) Liabilities with less than six months to maturity (US dollars)	5,441	8,650	59.0	3,096	-2,334	9,949	-7,501	3,209

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 Foreign Exchange Commission's Press Release of March 20, 2003).
5/ Includes yields on net international assets and other transactions.

3.4.2. Monetary Aggregates and Financing

From January to November 2006, the monetary aggregate M1 exhibited more dynamism than during the same period of 2005. However, in the last months of 2006, this dynamism began to slow down (Graph 22a). As for the monetary aggregate M4, during 2006 its growth rate decreased approximately 8 percent in real terms, figure similar to the average recorded during the previous four years (7.7 percent) (Graph 22b).

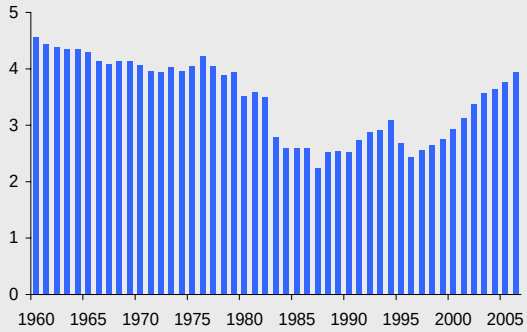
Up to the third quarter of 2006, the annual flow of financing sources accounted for 6.3 percent of GDP (Table 7). Although this figure is similar to the average observed flows in recent years (6.2 percent between 2003 and 2005), there has been a significant redistribution of resources. Public sector's lesser borrowing requirements have freed resources, which have been shifted to the private sector. Thus, in the last years, the annual flow of financing to firms has increased, accounting for 1.4 percent of GDP up to the third quarter of 2006. The annual flow of financing to households has also increased (2.6 percent of GDP in the third quarter of 2006).

Box 3
Recent Developments in the Monetary Base

At the end of 2006, the monetary base grew at an annual rate of 18.4 percent. Its average growth during the year was 16.2 percent. The ratio monetary base to GDP increased, from 3.77 percent in 2005, to 3.94 percent in 2006.[1]

The significant reduction of inflation in recent years has led to an increase in the demand for base money by economic agents. This has prompted an increase in the monetary base as a percentage of GDP (remonetization process) (Graph 1). This phenomenon has taken place in other countries, especially when the economy is transiting from high inflation -which erodes currency's purchasing power, therefore discouraging its demand- to a low and stable inflation environment –in which economic agents gradually replenish their demand for banknotes and coins.

Graph 1
Monetary Base
Percentage of GDP



In the economic literature, the demand for money is mainly explained by a) the level of transactions in the economy, which is usually measured by a scale variable like income or consumption; and, b) the opportunity cost of holding money, measured with an interest rate. The econometric models most commonly used to estimate the demand for money include a long-term relationship between the amount of money and the variables mentioned, with an additional specification of the short-term dynamics between these variables (error-correction models). This type of models allow for estimating economic agents' speed of adjustment for their money holdings to their desired level.

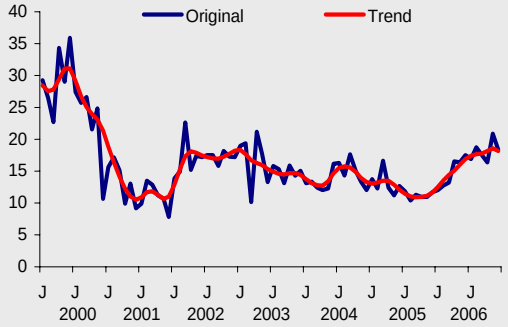
When estimating the demand for money in Mexico using this type of models, the remonetization process can be explained, among others, by three factors:

i) The convergence to low and stable inflation has contributed to a decreasing trend of nominal interest rates in the last years, standing out the reductions observed in 2002 and 2003.

ii) In a lower inflation environment, economic agents are more sensitive to the opportunity cost of holding money as reserve value. In addition, as macroeconomic stability entails greater financial market development, the demand for money should become more sensitive to changes in the interest rate. Empirical evidence suggests that in the last decade the demand for money has indeed become more sensitive to changes in the interest rate.

iii) During high inflation, economic agents get rid faster of any unwanted monetary stocks, to avoid the loss of purchasing power. In a low-inflation environment, like Mexico's case in the last years, economic agents' speed of adjustment of their monetary stocks to their desired levels has been reduced. In an environment where, given the former two elements, the demand for money is increasing considerably, this third factor would imply that monetary base growth extends for a longer period.

Graph 2
Monetary Base
Annual nominal percentage change

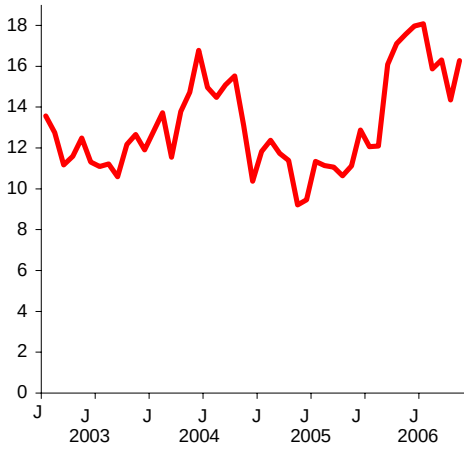


Although monetary base growth has followed a downward trend in the last years, this trend was interrupted with the increase observed in 2006 (Graph 2). Although a significant part of this increase in 2006, as compared with 2005, can be explained by the faster rate of growth of the Mexican economy, as well as by the further reduction of interest rates, it could also be reflecting temporary factors such as an increased use of money, usually associated with federal elections.

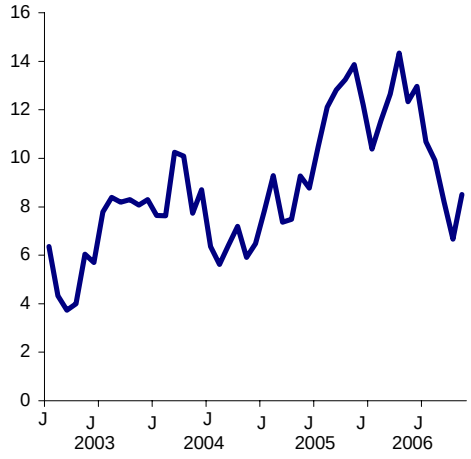
1 Calculations based on the annual average of the monetary base. Nominal GDP for 2006 is estimated.

Graph 22
Monetary Aggregates

a) Monetary Aggregate M1
Nominal annual variation



b) Monetary Aggregate M4
Real annual variation



Commercial banks' performing credit to firms has recovered in the last months, growing 17.8 percent in real annual terms in November 2006, as compared with 6.6 percent on average during the first quarter of the year (Graph 23a). At sector level, credit granted to manufacturing has recovered significantly, growing at a real annual rate of 8.5 percent in November 2006. From January to November 2006, bank financing to the services and construction sectors continued to grow considerably, at average real annual rates of 17.0 percent and 31.9 percent, respectively (Graph 23b).

Commercial banks' credit to households remains strong. In November 2006, the performing credit portfolio to households grew at a real annual rate of 47 percent, as a result of real growth in consumption and housing credit of 39.5 and 63.1 percent, respectively (Graph 23c).[26] Credit to households has consolidated as the most significant component of banks' loans to the non-financial private sector, reaching 53.8 percent of total bank loans in November 2006.

The delinquency ratio of commercial banks' credit to firms was 1.0 percent in November 2006, 1.1 percentage points below that recorded during the same period of the previous year.[27] The corresponding delinquency ratio for mortgage loans granted by commercial banks decreased from 2.5 percent in November 2005, to 2.2 percent in November 2006. Although the delinquency ratio for consumption credit of the banking sector remains at low levels, it increased from 3.2 to 4.4 percent during the same reference period.[28]

[26] Commercial banks' lending to households excluding the purchasing of portfolio from Sofoles grew at a real annual rate of 26.5 percent in November 2006.

[27] The delinquency ratio of commercial banks' credit to firms is defined as the ratio overdue (or non-performing) direct portfolio to total direct portfolio.

[28] In terms of the components of banks' consumption credit, the delinquency ratio for credit card loans increased from 3.1 percent in November 2005 to 5.5 percent in November 2006. During the same period, the delinquency ratio for credit for durable goods decreased from 5.2 to 2.9 percent. Nonetheless, from November to December 2005, there was some cancellation of past due portfolio of credit for durable goods, which explains the reduction of the delinquency ratio from 5.2 to 2.4 percent.

Table 7
Total Financial Resources of the Economy (Uses and Sources)

GDP Percentage

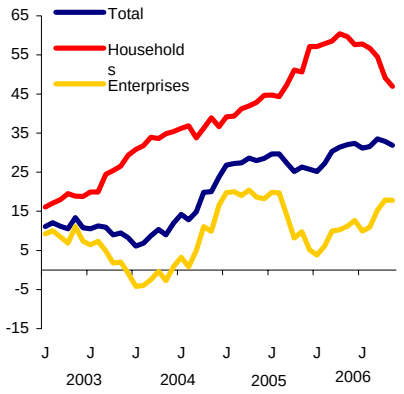
	Annual Flow: Q-III				Stock in 2006-III
	2003	2004	2005	2006	GDP %
Total sources	**5.3**	**5.6**	**7.7**	**6.3**	**72.2**
M4	5.3	5.1	7.6	5.9	53.9
Foreign financing	0.0	0.5	0.1	0.3	18.3
Total uses	**5.3**	**5.6**	**7.7**	**6.3**	**72.2**
International reserves 1/	1.1	0.8	0.7	0.6	8.3
Public sector (HSPSBR) 2/	2.3	1.8	1.5	0.3	36.0
States and municipalities	0.2	0.2	0.2	0.0	1.5
Private sector	1.1	1.6	2.4	4.0	29.1
Households	1.3	1.6	1.9	2.6	13.6
Consumption	0.5	0.8	1.1	1.4	4.5
Housing 3/	0.8	0.9	0.8	1.2	9.1
Companies	-0.1	-0.1	0.6	1.4	15.5
Credit granted by financial intermediaries 4/	-0.1	0.3	0.0	1.0	6.9
Issuance of debt instruments	0.7	0.1	0.1	0.0	1.8
External	-0.7	-0.4	0.5	0.4	6.8
Otros concepts 5/	0.5	1.3	2.8	1.4	-2.7

1/ As defined by Banco de México's Law.
2/ Historical Stock of Public Sector Borrowing Requirements (*Saldo Histórico de los Requerimientos Financieros del Sector Público*, SHRFSP) and flow of Public Sector Borrowing Requirements (PSBR), as reported by the Ministry of Finance (SHCP).
3/ Total portfolio of financial intermediaries. Includes debt-restructuring programs.
4/ Total portfolio of financial intermediaries and of the National Employees' Housing Fund (*Instituto del Fondo Nacional de la Vivienda para los Trabajadores, INFONAVIT).* Incluyes debt-restructuring programs.
5/ Refers to non-sectorized assets, capital accounts and results, technical reserves' accounts, other assets and liabilities from commercial banks, development banks and Banco de México, non-bank financial intermediaries and INFONAVIT, as well as non-monetary liabilities from IPAB, among other concepts.

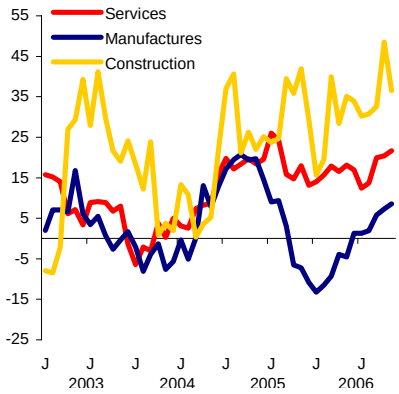
Graph 23
Commercial Bank Performing Loans to the Private Sector

Real annual percentage change

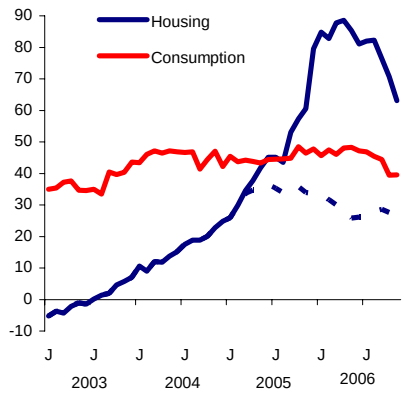
a) Households and Companies 1/



b) Companies, by Sector



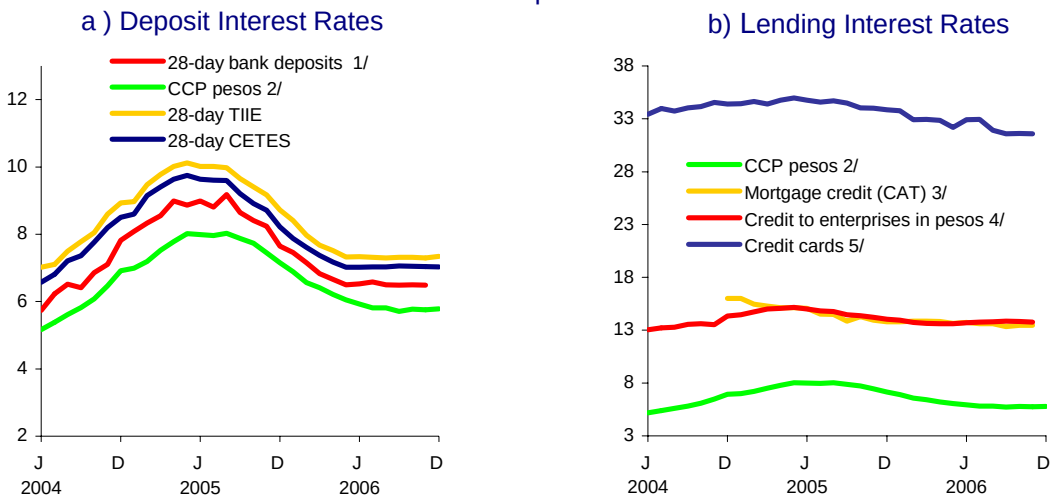
c) Households 2/



1/ The performing loan portfolio to households includes the purchase of mortgage portfolio from Sofoles.
2/ The dotted line excludes the purchase of mortgage portfolio from Sofoles.

In general terms, lending rates to the private sector are still high and there is a wide spread between deposit rates paid by banks and lending rates. While in November 2006, interest rates on 28-day fixed term deposits was 6.5 percent (Graph 24a), the average rate charge on traditional credit cards was 31.6 percent, mortgage credits' total annual cost (*Costo Annual Total*, CAT) was 13.5 percent, and interest rates on credit to firms in pesos was 13.8 percent (Graph 24b).

Graph 24
Commercial Bank Deposit and Lending Interest Rates in Pesos
Annual percent



1/ Monthly average of payable rates (individuals and firms) settled in over-the-counter and trading floor operations.
2/ Includes term liabilities of banks in pesos, except liabilities from subordinate liabilities to be converted into capital, from the granting of guarantees, and from operations among credit institutions.
3/ Average of indicator that summarizes the Annual Percentage Rate of Charge or APRC (*Costo Annual Total, CAT*) and comprises costs due to interest rates, commissions, bonuses, obligatory insurance, and other financial services. Mortgage lending figures are obtained from the Simulator of Mortgage Credits available at Banco de México's web page (http://www.banxico.org.mx).
4/ Simple average of nominal interest rates on credits granted by commercial banks in pesos during the period. Information obtained from the regulatory report R04C of the National Banking and Securities Commission (*Comisión Nacional Bancaria y de Valores*, CNBV).
5/ Simple average of interest rates excluding VAT charged by banks including all credit card traditional products according to the report "Bancos: tasas de interés de tarjetas de crédito" by Infosel.

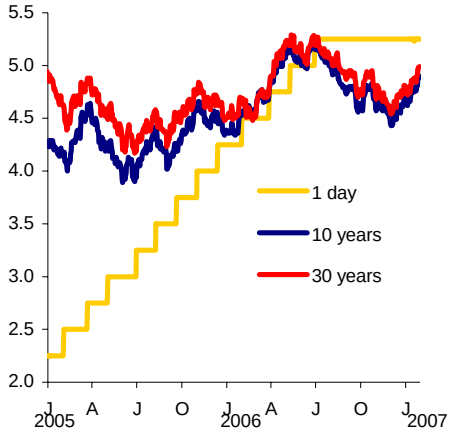
4. Monetary Policy

Prospects for the global economy continue to be positive, although a gradual world slowdown is expected. In particular, the U.S. economy is expected to grow at a slower rate. Oil prices have declined, due to both the phase of the business cycle the world economy is undergoing and the high temperatures in some regions of the U.S. As a result, inflation pressures worldwide are anticipated to remain moderate and inflation expectations well anchored.

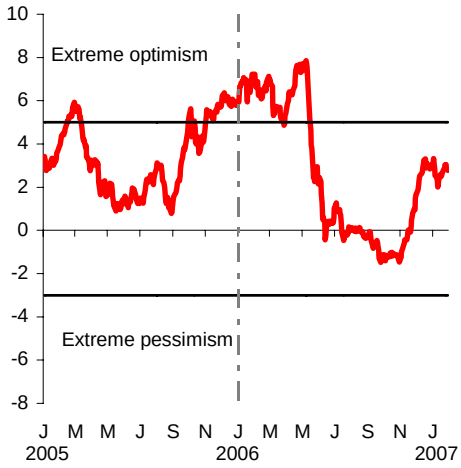
Under this environment, both analysts and markets expect the U.S. Federal funds rate to remain stable in the next months. As a result, international financial markets have remained with favorable conditions, fostering a greater appetite for risk in benefit of various emerging economies' asset prices (Graph 25).

Graph 25
U.S. Interest Rates and Global Risk Appetite Index

a) Interest Rates (annual percent)



b)Index[1/]



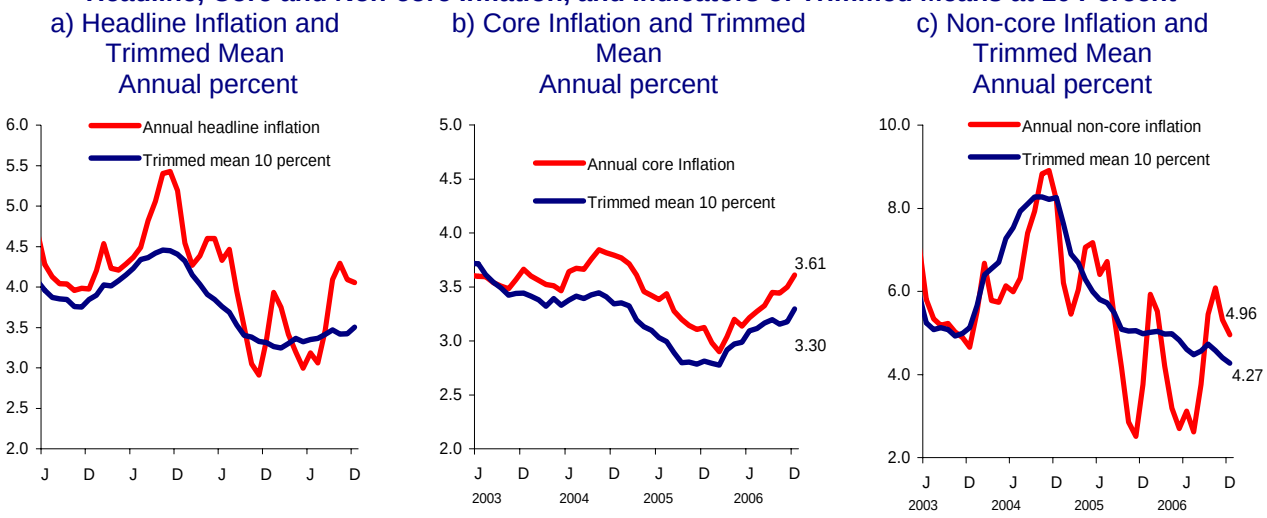
1/ Source: Credit Suisse. The index compares risk-adjusted returns on 64 assets. For each asset, both a 6-month excess return over cash and 12-month volatility are calculated. Then, a cross-sectional linear regression is run, where volatility is the independent variable and return is the dependent variable. The slope of the regression line is the value of the risk appetite index at that point in time. During periods of high investor risk appetite, risky assets such as developed equities and emerging markets typically have very high returns, while government bonds of advanced economies tend to have low or negative returns. The opposite is true during periods of low investor risk appetite.

As mentioned in previous sections of this Report, several supply shocks affected both non-core and core inflation in Mexico in the last months of 2006. Regarding core inflation, the price increases in two items (sugar and corn-tortillas) accounted for more than two thirds of the rebound of core inflation during 2006. This can be observed when constructing inflation indicators that exclude items whose prices have recorded extreme variations (both, the highest and the lowest). When extreme variations are eliminated, a trimmed mean for inflation is obtained. Since this indicator exhibits, by construction, a stable trajectory, it is an indicator of the trend of inflation.

As Graph 26b shows, core inflation's trimmed mean at 10 percent is below core inflation, and it has been following this pattern since practically the end

of 2003. Recently, these developments have been due, mainly, to the significant increases in sugar and tortilla prices. Core inflation's trimmed mean was 3.3 percent in December 2006, 0.31 percentage points below core inflation, albeit having followed a certain upward trend. As Graph 26 shows, during the last months, non-core inflation's trimmed mean has also been below non-core inflation. This has been due to the increase in tomato and onion prices, which is expected to revert rapidly.

Graph 26
Headline, Core and Non-core Inflation, and Indicators of Trimmed Means at 10 Percent /1



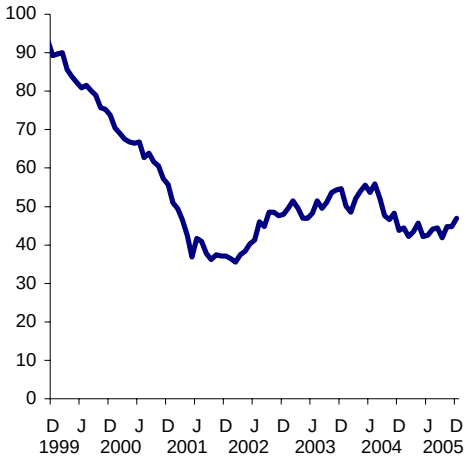
1/The trimmed mean excludes the contribution of extreme variations in certain items' prices from headline inflation. To strip these variations, the following calculations are done: i) monthly seasonally adjusted variations of CPI prices are arranged in descending order; ii) the items with the highest and lowest variation are excluded, considering up to 10 percent of the CPI basket, respectively, in each distribution tail; and, iii) with the remaining items, which, by construction, are located at the center of the distribution, the trimmed mean indicator is constructed. The trimmed mean is useful to identify if headline inflation variations respond to changes in some CPI products (this takes place when the trimmed mean does not show the upward trend followed by headline inflation).

An additional exercise that allows for analyzing if the rise in inflation is due to the increase in the prices of certain items or to a generalized price increase consists in calculating the percentage of the 315 items that make up the CPI that have recorded annual price variations above the inflation target. If the economy were subject to a generalized increase in prices, the rise in inflation would be accompanied by an upward trend in this indicator. On the contrary, if the jump in inflation were the result of isolated increases in the prices of a reduced number of items (supply shocks), the percentage of items with annual price variations above the inflation target would be expected to remain relatively stable.

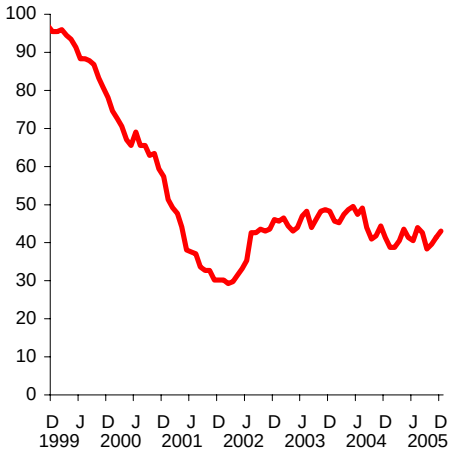
This indicator, computed for both the CPI and core inflation, has followed an horizontal trend in the last months (Graph 27), thus suggesting that the recent increase in headline and core inflation, apparently has not contributed, up to now, to initiate a trend where the number of items with price variations above 3 percent gradually increases.

Graph 27
Percentage of Items with an Annual Price Variation above 3 Percent

a) CPI
Percent



b) Core Index
Percent



1/ To calculate the percentage of items with an annual price variation above 3 percent the following is done: i) the annual variation of each of the CPI items is calculated; ii) the items that have an annual price variation above 3 percent are identified; and, iii) the percentage that such items represents in relation to the corresponding index (CPI or core subindex) is calculated.

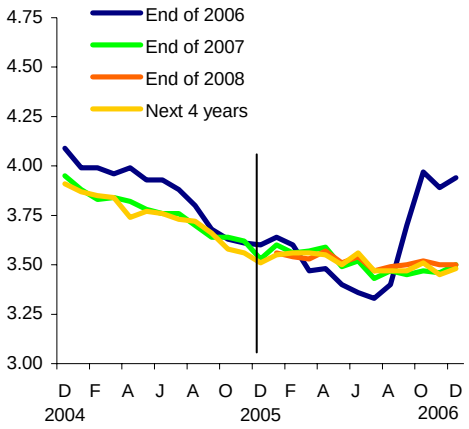
As expected, in response to the aforementioned recent supply shocks, inflation expectations for horizons under twelve months were revised upward in the last months of 2006. Nonetheless, those corresponding to longer horizons remained stable during the last quarter of 2006 (Graph 28). In particular, during the fourth quarter, expectations for annual headline inflation for the end of 2007, 2008, and for the average for the following 4 years, from Banco de México and Infosel surveys, remained around 3.5 percent, level similar to that observed during the previous quarter (Graph 28). Expectations for annual core inflation for the end of both 2007 and 2008 were around 3.25 percent during the last two quarters of the year.

As a result of the increase in corn-tortilla prices during the first weeks of January 2007, indicators of inflation expectations for horizons below twelve months were revised upward. In particular, those corresponding to headline inflation for the end of 2007 from the Infosel survey were revised, from 3.51 percent in January 5, to 3.67 percent in January 26. Since tortillas are included in the core index, during the same period, expectations for this subindex for the end of 2007 were revised, from 3.30 to 3.45 percent.

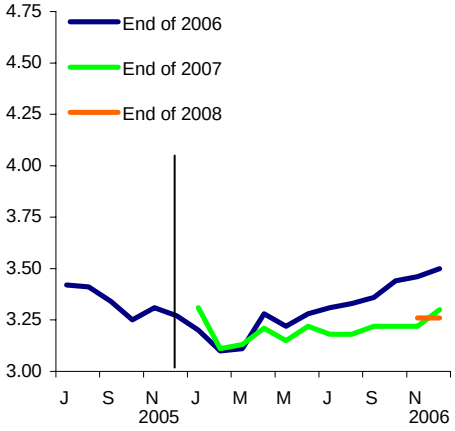
However, expectations for horizons beyond 12 months were revised significantly less. That is, from January 5 to January 26, expectations for headline inflation for the end of 2008 from the Infosel survey were revised from 3.51 to 3.54 percent, while those for core inflation were revised from 3.28 to 3.34 percent. Finally, expectations for average headline inflation for the next four years remained practically unchanged (from 3.47 to 3.46 percent). This suggests that, up to now, analysts expect supply shocks to affect inflation only temporarily.

Graph 28
Inflation Expectations: Banco de México Survey

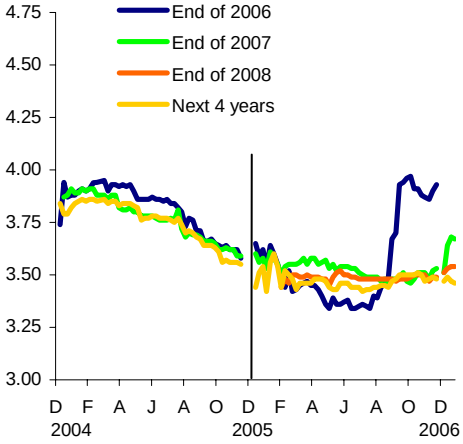
a) Banco de México Survey
Headline Inflation
Annual percent



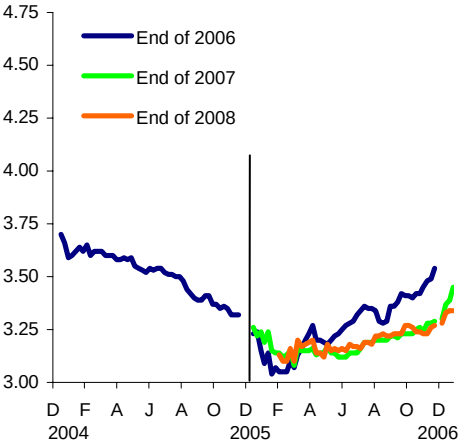
b) Banco de México Survey
Core Inflation
Annual percent



c) Infosel Survey
Headline Inflation
Annual percent



d) Infosel Survey
Core Inflation
Annual percent

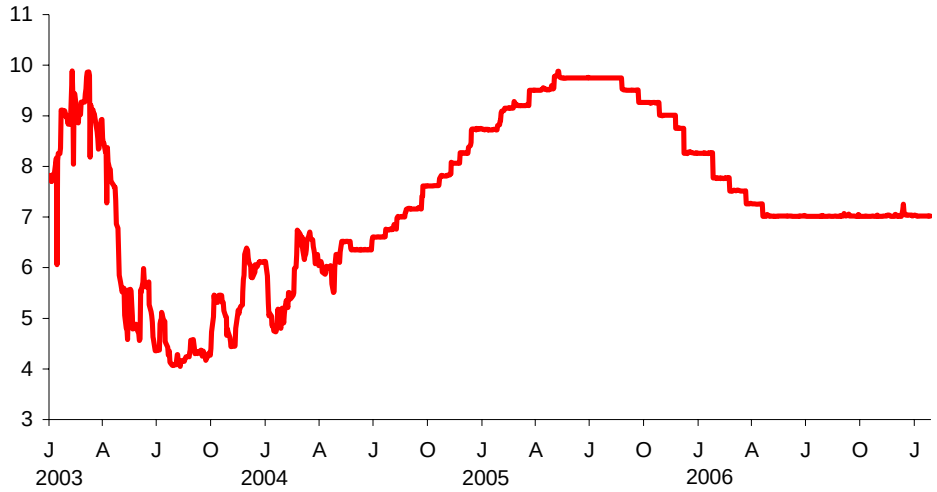


Under the present inflation pressures, the monetary authority should make decisions based on a careful assessment of the current economic conditions and on the outlook for the inflationary conditions. Under an inflation targeting framework, when inflationary pressures originate from the demand side, the recommended response is that the central bank should tighten its monetary policy stance. In this case, inflationary pressures could be generalized and, if not contained, could lead to a permanent rebound in inflation.

When inflation pressures originate from the supply side, they usually reflect changes in relative prices, which should affect inflation temporarily. Since their effects on inflation will disappear, the monetary authority should not try to offset these pressures. However, should these pressures contaminate inflation expectations and, in general, the price setting process, the central bank must tighten monetary policy to prevent further price increases (second round effects).

Based on the aforementioned, Banco de México's Board of Governors decided to leave the monetary conditions unchanged, as specified in its press releases of October, November and December 2006, and January 2007. The overnight bank funding rate thus remained at 7 percent (unchanged as compared with the previous quarter) (Graph 29).

Graph 29
Bank Funding Interest Rates
Annual percent

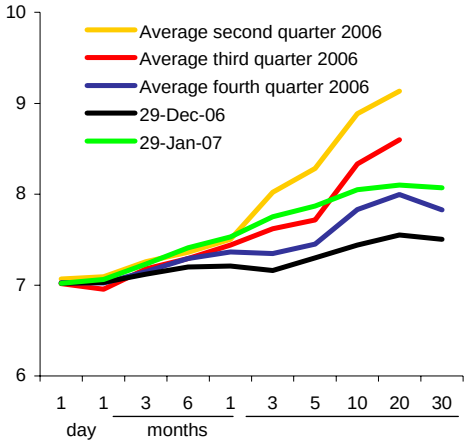


Nonetheless, given the higher inflation levels, together with the outlook for continuous increases in international grain prices, the risks of contamination to other prices have escalated. Thus, the Board of Governors of Banco de México will surveil any coming developments in prices and inflation expectations, particularly those for the medium term. Should a negative impact be expected from supply shocks on these variables and, in general, on the determination of prices and wages, the Board will adjust its monetary policy stance, so that inflation can resume its converging trend to its target.

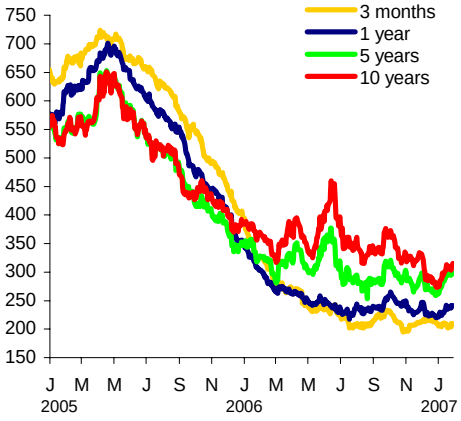
During the last quarter of 2006, domestic financial markets benefited from favorable global financial conditions and from greater appetite for risk as compared with previous quarters. As a result of the aforementioned environment and the stability of Mexico's overnight bank funding rate, during the fourth quarter, the yield curve flattened (Graph 30a) and interest rate spreads in relation to the U.S. decreased (Graph 30b). Nonetheless, during the first weeks of January 2007, long-term interest rates in Mexico increased, and therefore, part of the flattening of the yield curve that was observed during the previous quarters reverted. Despite the aforementioned, domestic spreads between one-day and long-term interest rates (10, 20, and 30 years) remain at relatively low levels.

Graph 30
Interest Rates

a) Yield Curve in Mexico
Annual percent



b) Spread Mexico – U.S.
Basis points



5. Balance of Risks and Final Remarks

Banco de México's expected scenario for 2007 is based on the following conditions:

a) World economic activity is expected to slow down gradually in 2007. The average of the main analysts' forecasts for U.S. growth for 2007 is around 2.4 percent, while that for industrial activity is 2.6 percent. As a result, the demand for Mexican exports is expected to slow down, therefore affecting the country's growth rate.

b) Oil revenues are expected to fall significantly, due to the reduction in both oil reference prices and Mexican oil exports. The growth rate of workers' remittances is also expected to decrease. Nonetheless, since both revenues will remain at historically high levels, the current account deficit of the balance of payments is expected to remain low as a proportion of GDP. Favorable conditions for access to international financing are anticipated to prevail.

Based on the aforementioned, and on most recent information on the Mexican economy, Banco de México's baseline scenario for 2007 is as follows:

GDP Growth: Between 3.25 and 3.75 percent.

Employment: Creation of approximately 750 thousand jobs in the formal sector (number of workers insured by the IMSS).

Current Account: Current account deficit of around 1.4 percent of GDP.

Inflation: The aforementioned supply shocks could likely affect inflation during the first half of 2007. Consequently, during this period, headline inflation is expected to be between 4 and 4.5 percent, and core inflation could be above 4 percent. Two elements will contribute to this result. First, it is important to remember that both annual headline inflation and annual core inflation were at low levels during the first half of 2006. With this base of comparison, inflation is expected to be high for the same period of 2007. Second, changes in relative prices affect annual inflation during twelve months. Since the increase in corn-tortilla prices is partially reflecting the increase in corn's international references, it will contribute to maintain annual core inflation relatively high during the first half of 2007. The mentioned shocks have affected few products. Therefore, although they have implied changes in relative prices, they are not expected to contaminate the price and wage determination processes of the economy. Thus, both headline and core inflation are expected to close the year at levels between 3.5 and 4 percent. In particular, the following stands out:

c) Annual food inflation, a component of the core subindex, was 5.10 and 6.07 percent at the end of December 2006 and first half of January 2007, respectively, after having reached 3.46 percent in June 2006. This upward trend has not been observed in our main trading partner, and, as mentioned before, it can be accounted for by a reduced number of items, particularly sugar and corn-tortillas. In the next

months, as several actions to adjust conditions in both markets take effect, lesser pressures on food prices could be expected.

d) The annual variation of merchandise prices (excluding food) has remained stable for a long period (around 2 percent).

e) The price subindex of housing services has started to record lower annual variations and these are expected to follow a downward path during 2007. The price subindex for the rest of services is anticipated to record similar annual variations to those observed during 2006 (around 4 percent).

The development of core inflation will depend, mainly, on the path followed by corn-tortilla and sugar prices and, in general, on the behavior of grains' international prices.

f) The rate of growth of the non-core price subindex will continue to be determined, mostly, by the development of the fruits and vegetables price subindex. The volatility of these prices is well known to have a sharp influence on headline inflation.

g) The growth rate of the subindex of administered and regulated prices is expected to follow a similar path as last year, as no significant modifications in the determination of the goods and services prices that compose it are anticipated. Nonetheless, regulated prices could be affected by possible increases in public transportation fares in some cities.

Inflation prospects are subject to the following risks:

h) Although energy prices have declined, they are still high and remain strongly volatile.

i) International prices of grains have been subject to demand pressures in the last months that could affect certain processed foods and livestock goods. In fact, for some months, food prices have been pushing core inflation upward. This risk gains relevance when considering the importance of these products in the population's consumption basket, and the various distortions that characterize these sectors in Mexico.

j) The growth rate of services prices remains high.

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

Although uncertainty regarding inflation in the short term has increased, analyst expectations for the medium and long terms have remained stable. Nonetheless, contamination risks have increased due to three factors: i) price increases in certain products like sugar and corn-tortillas have been significant and have taken place in a disorderly fashion; ii) currently, international markets perceive further increases in grains' reference prices; and, iii) a significant number of supply shocks have taken place since the beginning of last year (domestic prices of steel, tomato, corn-tortillas, sugar, and onion). Therefore, the Board of Governors will remain alert of the price behavior of products other than those mentioned, of inflation expectations (mainly those for the medium term), and their possible impact on wages. Should there be a negative effect of supply shocks on

these variables the Board will adjust monetary policy so that inflation can resume its converging path to the target.

Other factors that could mainly affect the base scenario for GDP growth prevail.

A risk factor for the world economy, and particularly, for the Mexican economy, is the likelihood that economic activity in the U.S. slows down more than currently expected. Up to now, aggregate demand weakness has stemmed, mainly, from the real estate market. If this sector undergoes a greater correction, household expenditure could be significantly affected. Under such scenario, U.S. demand for external products would decrease, therefore affecting Mexican exports considerably.

Global current account imbalances continued to widen in 2006. Thus, risks of a sudden adjustment in the medium term prevail. Nonetheless, the U.S. dollar has depreciated, and more balanced growth among the main economies -as well as lower oil prices- is expected for 2007. This will contribute, at the margin, to improve the outlook for an orderly realignment of the global economy.

An additional risk factor that could affect economic growth is the significant reduction in oil prices. Under such setting, public finances could be subject to pressures and a significant source of resources for the economy would diminish, therefore affecting growth.

Banco de México has pointed out on several occasions that a risk factor that hampers the possibility to generate higher growth and more and better-paid jobs is the economy's loss of competitiveness. A key element to boost competitiveness and economic development is the structure of incentives in the society. In particular, in the economic front, this structure must include the following elements: i) markets that operate under competitive conditions; ii) flexibility in resource allocation; iii) an institutional framework that can align incentives of the economic agents with higher social benefit activities (accumulation of physical and human capital, and research and development); and, iv) effective public policies to fight poverty. Up to now, progress in these fronts has been insufficient and has not allowed Mexico to take full advantage of its development opportunities.

Monetary Program for 2007

Article 51 of Banco de México's Law states that in January of each year Banco de México must send to both the President and Congress a report on monetary policy for the following year.

Monetary policy in Mexico will be conducted under an inflation targeting framework, which is characterized by: a) the announcement of an explicit multi-annual inflation target; b) a systematic analysis of the current economic conditions and of inflationary pressures; c) a description of the instruments used by the central bank to attain its objectives; and, d) a communication policy that fosters monetary policy's transparency, credibility, and effectiveness.[29]

1. Objectives

Banco de México's monetary policy is conducted to attain an annual CPI inflation of 3 percent and to remain around that level. Nonetheless, although monetary policy is implemented to reach this objective, it is subject to a certain degree of uncertainty. This is due to the multiple shocks the economy is exposed to, and to the fact that the relationship between monetary policy actions and its results regarding inflation is imprecise.

A variability interval of plus/minus one percentage point has thus been set around the 3 percent inflation target. The referred interval around the inflation target was not set as a margin of indifference or tolerance for the monetary authority. It only represents explicitly the inaccuracy that inexorably surrounds the achievement of the inflation target, due to the different shocks and deviations that can affect CPI inflation. Banco de Mexico's monetary policy actions will be oriented towards achieving the 3 percent inflation target. Nonetheless, given the volatility of CPI inflation, in the short term, such actions might deviate temporarily from the target.

2. Monetary Policy Decisions

Central bank's monetary policy actions have a lagged effect on the economy, and especially, on the price level. Therefore, to reach the inflation target, the monetary authority must base its decisions on a careful assessment of both the current economic conditions and the outlook for inflation.

Under an inflation targeting regime, when inflation pressures come from the demand side, the monetary authority should tighten the monetary policy stance in order to promptly contain such pressures from becoming widespread and therefore prevent a permanent rebound in inflation.

On the other hand, when inflation pressures originate from the supply side, they usually reflect changes in relative prices, which affect inflation temporarily. In such case, the monetary authority should not try to counter such pressures, as these only have a temporary effect on inflation. Nonetheless, if such

[29] For some considerations on the choice of inflation targeting, see the Monetary Program for 2001.

pressures contaminate inflation expectations and the determination of other prices, the central bank must tighten monetary policy to prevent subsequent price increases (second round effects).

An accurate identification of the origin of inflation pressures and its possible effects on economic agents' expectations is crucial for monetary policy decisions. Banco de México's monetary policy decisions are based on a systematic analysis of the current economic conditions and of the inflationary pressures originated by such conditions, using a wide range of variables and indicators, as well as different economic and statistical models.[30] Such analysis allows for identifying the factors that affect the expected development of inflation in order to evaluate their impact on economic agents' inflation expectations and on the price determination process, which are key elements to determine the monetary policy stance.

3. Monetary Policy Implementation

Central banks have different instruments to conduct monetary policy, which are used to affect monetary conditions so that the stance of monetary policy is consistent with the attainment of the inflation target.

Banco de México implements monetary policy through different instruments that allow the central bank to communicate its monetary policy stance. Banco de México has two main instruments to induce changes in this stance: a) the setting of explicit references for monetary conditions, and, b) the *corto*.[31] Through the former, Banco de México has been able to signal more clearly its monetary policy stance. Nonetheless, the *corto* remains an available monetary policy instrument that can be used by the Board of Governors whenever deemed convenient.

4. Communication Policy

In order to attain price stability through an inflation targeting framework, the central bank must clearly communicate to the public its objectives, strategy and instruments. The announcement of inflation targets is important as it facilitates the convergence of economic agents' expectations to the targets. This responds to the central bank's commitment to take the necessary measures to attain its inflation target. Transparency in monetary policy decisions has allowed Banco de México's Board of Governors to explain the reasons supporting its actions. Such transparency generates more certainty among the public and fosters the attainment of the central bank's objectives. Greater transparency, together with the communication policy, has contributed to strengthen the accountability of the central bank.

Among the main documents that support Banco de México's communication strategy are the Monetary Program and the Inflation Reports. In addition, since 2003, Banco de México has been announcing on pre-established

[30] For a general reference on monitoring the current economic conditions, see the forecast for the monetary base for 2007, available at Banco de México's web page (www.banxico.org.mx).

[31] For a detailed description of the *corto* (daily balances objective for banks' current accounts at Banco de México), see the Monetary Programs of previous years.

dates its monetary policy decisions, together with a press release explaining the Board of Governors' decisions regarding the monetary policy stance.[32]

[32] These dates are published in the Inflation Report of the third quarter of the previous year.