

# Inflation Report

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July – September 2006



BANCO DE MEXICO

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OCTOBER 2006



*BOARD OF GOVERNORS*

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*Unless otherwise stated, this document has been prepared using data available as of October 27, 2006. Figures are preliminary and subject to change.*



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## 1. Introduction

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Prospects for world economic activity remain positive, despite an expected moderation in the pace of the expansion. In the U.S., the slowdown may have been partly mitigated by the stimulus to private consumption from lower gasoline prices and rising employment. These factors have eased the impact of falling real estate prices. On another front, economic recovery in Europe and Japan continued, while emerging market economies continued to exhibit a favorable performance, notably in Asia.

Economic growth has led to rising resource utilization in some developed economies. Nonetheless, the perception prevails that the U.S. economy is currently at the mature stage of its cycle. Consequently, growth in the U.S., and, therefore, in the world economy, is expected to moderate. In this context, international prices of oil and other commodities have begun to yield; however, they still remain at relatively high levels. On balance, although concerns prevail of a rebound in world inflation, expectations for the medium and long terms in most economies remain well anchored.

This environment has prompted a decline in long-term interest rates in the U.S., thereby improving international financing conditions for emerging market economies. The spike in investors' risk aversion recorded during the second quarter of the year has reverted, therefore contributing to the recovery of asset prices and currencies of most of these economies.

The performance of financial markets in Mexico during the third quarter reflected both the reduction of risk premia in international capital markets and the dissipation of uncertainty regarding Mexican elections this year. As a result, long-term interest rates decreased, hence leading to a flattening of the yield curve.

Under such conditions, Mexico's economic activity continued to expand. In particular, all components of aggregate demand exhibited positive results: on the domestic side, the strength of consumption and the dynamism of investment stand out; on the external side, the increase in manufacturing exports, especially from the automotive industry, deserve mention. Domestic expenditure continues to be favored by the high revenues from workers' remittances and oil exports.

As for recent developments in inflation, during the third quarter of the year, supply shocks arose, generating a rebound in annual headline inflation. Among these, adverse weather conditions that affected the tomato harvest in Mexico's Northwest region; sugar supply problems; and, the increase in tortilla prices by some retailers. These phenomena prompted annual inflation to climb to 4.09 percent in September, 91 basis points above June figures.

In the following two months, the effects of these factors will add to the anticipated rebound in annual headline inflation, as a result of a reduced base of comparison. In October and November of the previous year, the annual variation of fruits and vegetables' prices was atypically low. Consequently, annual headline



inflation is expected to remain close to 4.5 percent in those months, and then follow a downward trend.

Since the referred shocks are temporary, they are not expected to affect inflation expectations for 2007 and the following years. Although inflation expectations for the end of 2006 have been revised upward, those for the medium and long terms have remained stable.

Given the abovementioned scenario, Banco de México's Board of Governors decided to maintain the monetary conditions during the third quarter unchanged. Nonetheless, as has been mentioned in the press releases on monetary policy, some risks that might affect inflation, which are listed in the final section of this Report, prevail.

The Board of Governors will therefore stay alert that inflation expectations remain anchored, reassuring its intention to foster and to consolidate the convergence of inflation to its target.

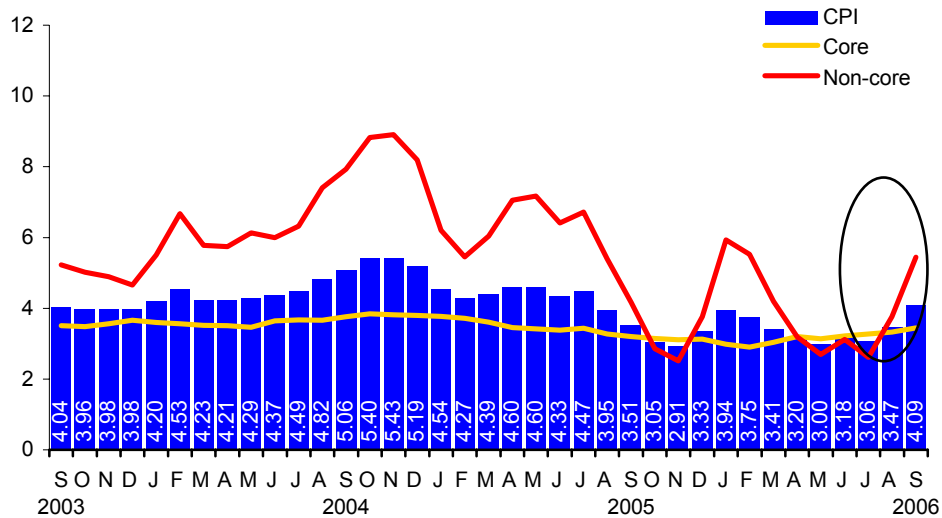
## 2. Recent Developments in Inflation

### 2.1. Inflation

At the end of the third quarter, annual headline inflation was 4.09 percent, 0.91 percentage points above June figures (Graph 1 and Table 1). This rebound is mainly explained by the price behavior of tomato (0.56 points), sugar (0.07 points), and tortilla (0.06 points). Prices of these products, which have a high weight in the Consumer Price Index (CPI), were affected by supply shocks. In the former case, these were attributed to weather factors, while in the last two cases, they were due to various problems related to the commercialization of both products.

The sugar and tortilla price trajectory affected the evolution of the core component of the CPI, while the path followed by tomato prices affected the non-core component. Given their importance for household spending, in Mexico, processed foods are included in the core component.<sup>1</sup> Thus, in September, the annual variations of the core and non-core indices were 3.45 and 5.44 percent (in June, these figures were 3.22 and 3.12 percent, respectively).

**Graph 1**  
**Consumer Price Index**  
Annual percentage change



<sup>1</sup> The weight of food in the CPI is 22.74 percent, of which, processed food (included in the core index) accounts for 14.67 percentage points, and fresh food (included in the non-core index) for 8.07 percentage points.

**Table 1**  
**Incidence of CPI Components on Annual Headline Inflation<sup>1/</sup>**  
 Percentage points

|                                   | Dec-2006     | Mar-2006<br>(a) | Jun-2006<br>(b) | Jul-2006<br>(c) | Aug-2006<br>(d) | Sep-2006<br>(e) | Difference<br>(e-b) |
|-----------------------------------|--------------|-----------------|-----------------|-----------------|-----------------|-----------------|---------------------|
| <b>CPI</b>                        | <b>3.33</b>  | <b>3.41</b>     | <b>3.18</b>     | <b>3.06</b>     | <b>3.47</b>     | <b>4.09</b>     | <b>0.91</b>         |
| <b>Core</b>                       | <b>2.11</b>  | <b>2.05</b>     | <b>2.19</b>     | <b>2.22</b>     | <b>2.26</b>     | <b>2.34</b>     | <b>0.15</b>         |
| <b>Merchandise</b>                | <b>1.00</b>  | <b>0.96</b>     | <b>0.90</b>     | <b>0.93</b>     | <b>0.96</b>     | <b>1.03</b>     | <b>0.13</b>         |
| Food                              | 0.55         | 0.54            | 0.52            | 0.55            | 0.56            | 0.62            | 0.10                |
| Sugar                             | -0.01        | -0.01           | 0.00            | 0.01            | 0.01            | 0.08            | 0.07                |
| Tortilla                          | 0.07         | 0.09            | 0.09            | 0.09            | 0.10            | 0.15            | 0.06                |
| Other                             | 0.38         | 0.33            | 0.29            | 0.29            | 0.30            | 0.26            | -0.03               |
| Rest of merchandise               | 0.45         | 0.42            | 0.38            | 0.38            | 0.40            | 0.42            | 0.03                |
| <b>Services</b>                   | <b>1.11</b>  | <b>1.10</b>     | <b>1.28</b>     | <b>1.30</b>     | <b>1.30</b>     | <b>1.30</b>     | <b>0.02</b>         |
| Housing                           | 0.45         | 0.53            | 0.68            | 0.69            | 0.70            | 0.68            | 0.00                |
| Rest of services                  | 0.66         | 0.56            | 0.60            | 0.61            | 0.60            | 0.62            | 0.02                |
| <b>Non-core</b>                   | <b>1.23</b>  | <b>1.36</b>     | <b>1.00</b>     | <b>0.84</b>     | <b>1.21</b>     | <b>1.76</b>     | <b>0.76</b>         |
| <b>Agriculture</b>                | <b>-0.02</b> | <b>0.13</b>     | <b>-0.18</b>    | <b>-0.34</b>    | <b>0.02</b>     | <b>0.65</b>     | <b>0.83</b>         |
| <b>Fruits and Vegetables</b>      | <b>-0.07</b> | <b>0.17</b>     | <b>-0.13</b>    | <b>-0.25</b>    | <b>0.07</b>     | <b>0.60</b>     | <b>0.73</b>         |
| Tomato                            | -0.18        | 0.05            | -0.16           | -0.21           | 0.03            | 0.40            | 0.56                |
| Onion                             | -0.04        | 0.00            | -0.07           | -0.06           | -0.07           | 0.00            | 0.07                |
| Avocado                           | -0.01        | 0.00            | -0.01           | -0.05           | 0.04            | 0.04            | 0.05                |
| Green tomato                      | -0.01        | -0.13           | -0.05           | -0.06           | -0.03           | 0.01            | 0.05                |
| Other fruits and vegetables       | 0.16         | 0.25            | 0.15            | 0.13            | 0.10            | 0.16            | 0.00                |
| <b>Livestock</b>                  | <b>0.05</b>  | <b>-0.04</b>    | <b>-0.04</b>    | <b>-0.08</b>    | <b>-0.05</b>    | <b>0.05</b>     | <b>0.09</b>         |
| <b>Administered and Regulated</b> | <b>0.85</b>  | <b>0.85</b>     | <b>0.79</b>     | <b>0.79</b>     | <b>0.81</b>     | <b>0.76</b>     | <b>-0.03</b>        |
| <b>Administered</b>               | <b>0.64</b>  | <b>0.71</b>     | <b>0.68</b>     | <b>0.67</b>     | <b>0.65</b>     | <b>0.61</b>     | <b>-0.07</b>        |
| Low-octane gasoline               | 0.14         | 0.19            | 0.24            | 0.23            | 0.24            | 0.22            | -0.02               |
| High-octane gasoline              | 0.02         | 0.02            | 0.03            | 0.03            | 0.03            | 0.03            | 0.00                |
| Electricity                       | 0.13         | 0.18            | 0.17            | 0.21            | 0.21            | 0.21            | 0.03                |
| Residential-use gas               | 0.35         | 0.32            | 0.23            | 0.20            | 0.18            | 0.15            | -0.08               |
| <b>Regulated</b>                  | <b>0.22</b>  | <b>0.15</b>     | <b>0.11</b>     | <b>0.13</b>     | <b>0.16</b>     | <b>0.15</b>     | <b>0.04</b>         |
| <b>Education</b>                  | <b>0.39</b>  | <b>0.38</b>     | <b>0.38</b>     | <b>0.38</b>     | <b>0.38</b>     | <b>0.35</b>     | <b>-0.03</b>        |

<sup>1/</sup> 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 subindexes may not add up due to rounding.

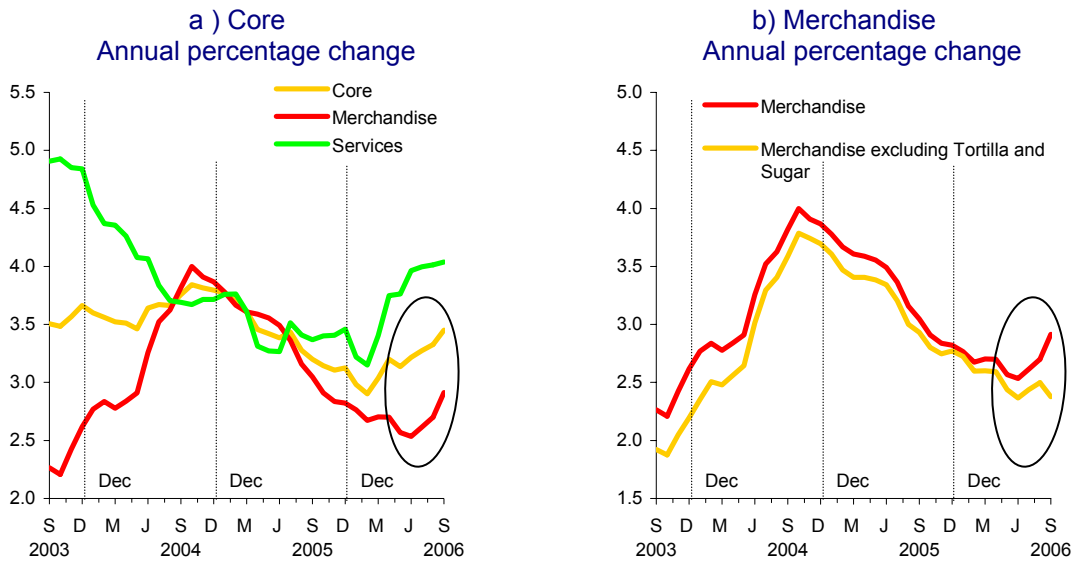
As previously mentioned, annual core inflation rose 0.23 percentage points between June and September. This contributed by 0.15 percentage points to headline inflation's increase during the analyzed period. The merchandise subindex contributed with 0.13 percentage points to this result, by increasing its annual variation from 2.53 to 2.91 percent during the same period (due mainly to the impact of the upward movement in sugar and tortilla prices). As for the services subindex, during the third quarter, its annual variation increased slightly, from 3.96 to 4.04 percent, contributing by 0.02 percentage points to the rise in headline inflation (Table 1 and Graph 2).

Sugar prices accumulated an increase of 28.7 percent during the referred quarter (Graph 3), associated with a significant stock reduction. In response to this phenomenon, the Ministry of the Economy authorized, starting August 30, sugar import quotas, in order to complement domestic supply.<sup>2</sup> This measure, together with the new sugar cane harvest cycle that starts in November, suggests that during the next months, sugar price increases could revert.

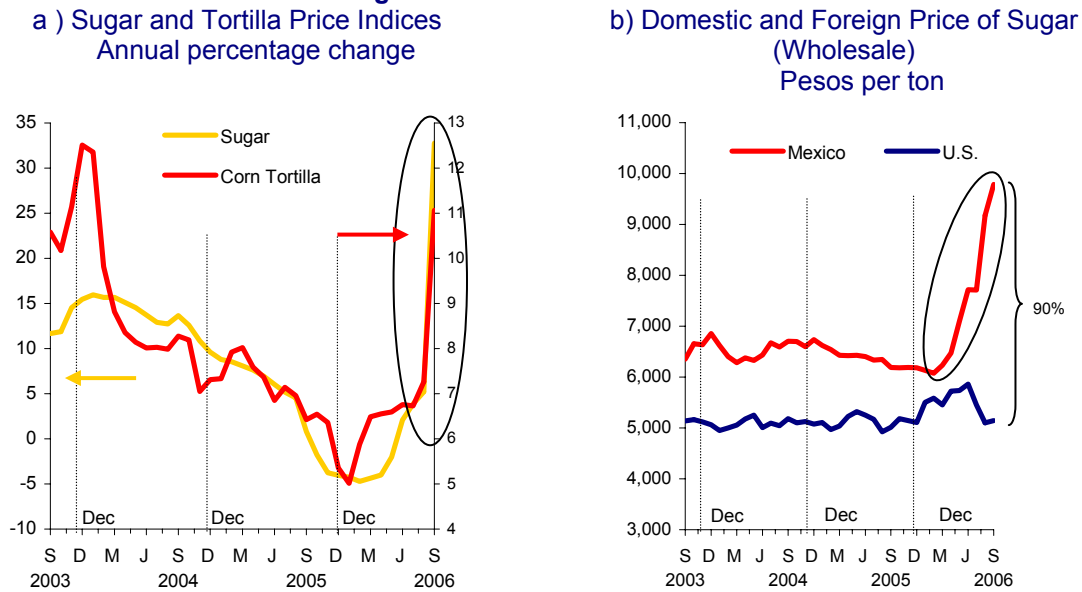
During the third quarter, tortilla prices accumulated an increase of 4.73 percent (Graph 3a). Two elements seem to have influenced this upward movement: i) a reduction in field corn inventories, due to the unexpectedly high level of field corn grain exports, which raised uncertainty regarding the supply for the domestic market; and ii) significant price increases in some retail outlets.

<sup>2</sup> Three import quotas totaling 267,606 tons. from the U.S., Costa Rica, and Nicaragua, were authorized. For these quotas, the existing import duties on product from North and Central America were also eliminated.

**Graph 2**  
**Core Price Index**



**Graph 3**  
**Sugar and Tortilla Price Indices**

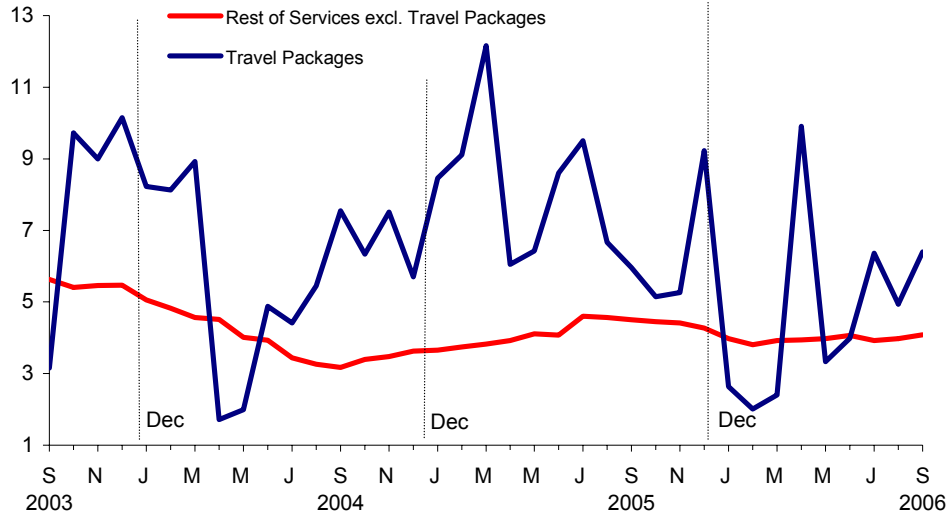


Source: National Information and Market Integration System (Mexico). Department of Agriculture (U.S.).

The annual variation of the core services subindex increased 0.08 percentage points between June and September. Considering the two components that make up this subindex, housing and rest of services, the annual growth rate of the former remained practically unchanged at 3.89 percent in September (in June this figure was 3.88 percent). As for the latter component, it increased 0.15 percentage points, reaching 4.21 percent in September (4.06 percent in June). In this case, 0.13 percentage points of the increase was

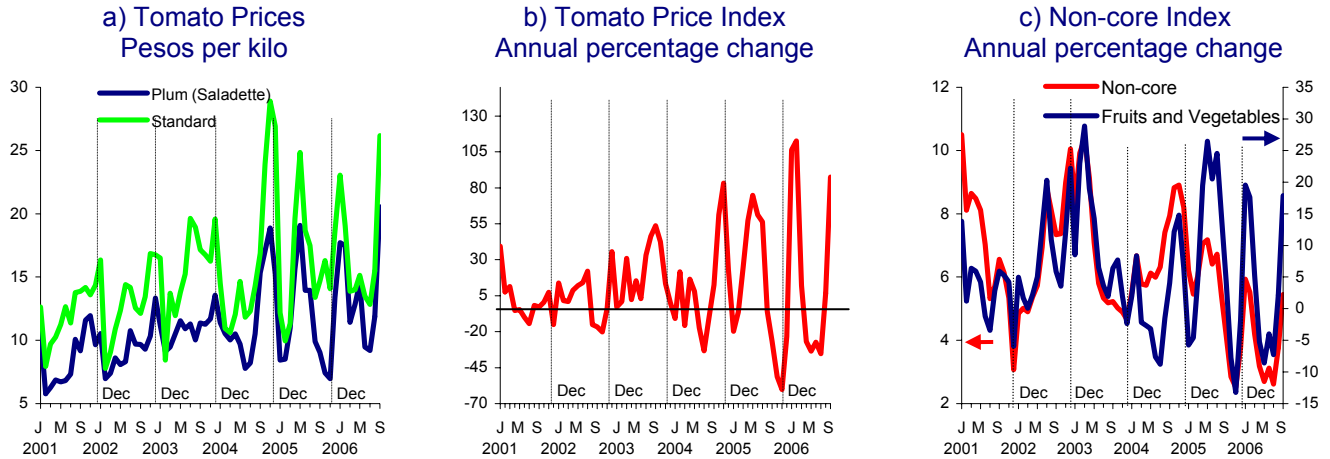
attributed to the item travel packages, whose annual price variation increased, mostly, as a result of the fuel-oil price increase. (Graph 4).

**Graph 4**  
**Core Services Subindex Excluding Housing**  
 Annual percentage change



Annual non-core inflation results explained, for the most part, the increase exhibited by annual headline inflation during the third quarter of 2006. This was mainly due to fruits and vegetables' price trajectory, whose annual variation was determined by two factors: first, the significant increases in the prices of some vegetables such as tomato, whose supply was affected by plagues, heavy rain, and the Hurricane Lane; and second, by the fall of certain products' prices recorded during the same period of the previous year, which led to a lower base of comparison to calculate annual inflation.

In September 2006, tomato prices recorded an annual variation of 87.55 percent, as compared to -27.23 percent in June (Graph 5). Tomato prices recorded in September their highest annual growth figures in the last 10 years. By itself, this fact affected by 0.56 percentage points the 0.91 point increase recorded by annual headline inflation during the quarter. Harvests of onion, avocado and green tomato were also affected. As a result, their prices increased, contributing with 0.17 percentage points to the referred inflation hike (Table 1).

**Graph 5**
**Tomato Price Indices**


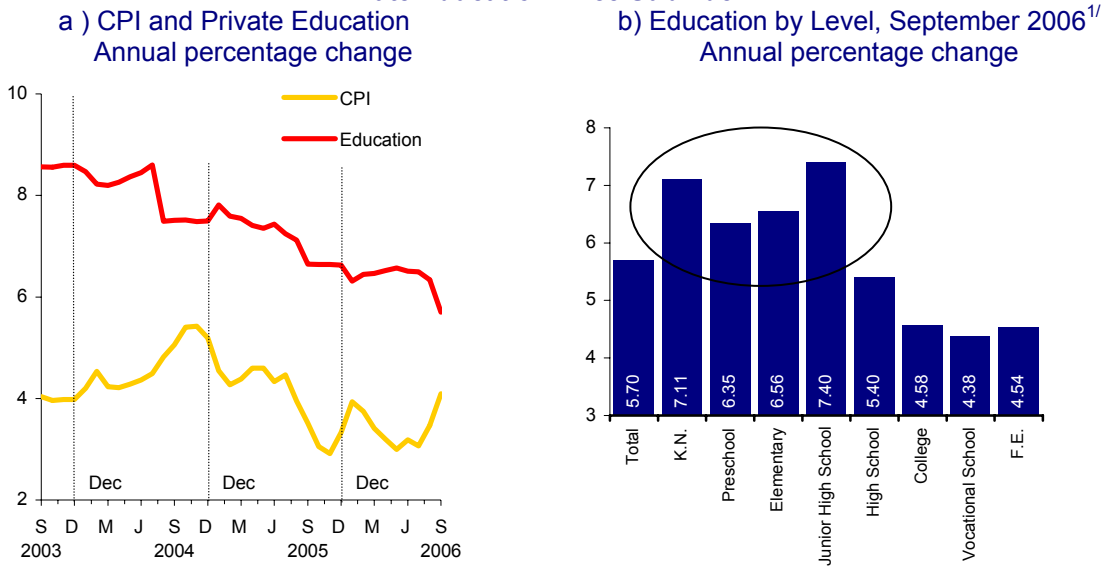
A factor that also affected the CPI non-core component was the livestock products subindex, whose annual variation fluctuated from -0.83 to 0.89 percent between June and September. The result was influenced by price increases in eggs, poultry, and beef, which contributed with 0.09 percentage points to the upward movement in annual headline inflation (Table 1).

In contrast, the annual variation of the subindex of administered and regulated prices declined from 4.54 to 4.35 percent between June and September. The annual growth rate of regulated prices followed an opposite trend as to that of administered prices. Regulated prices were affected by the increase in public transportation fares, while administered prices reflected the reductions in natural gas and gasoline prices in certain border cities (see Section 3.3.2).

The private education price subindex recorded an annual variation of 5.70 percent in September, 0.81 percentage points below its level in June (Graph 6a). This indicator has converged slowly to headline inflation. The most evident case has been basic education (Graph 6b). The latter has been mainly due to the increasing demand for private education services observed for some years.<sup>3</sup>

<sup>3</sup> Data from the National Household Income and Expenditure Survey indicates that 42 percent of families had paid school fees in 2004 as compared with 1998 (only 34 percent).

**Graph 6**  
**Private Education Price Subindex**

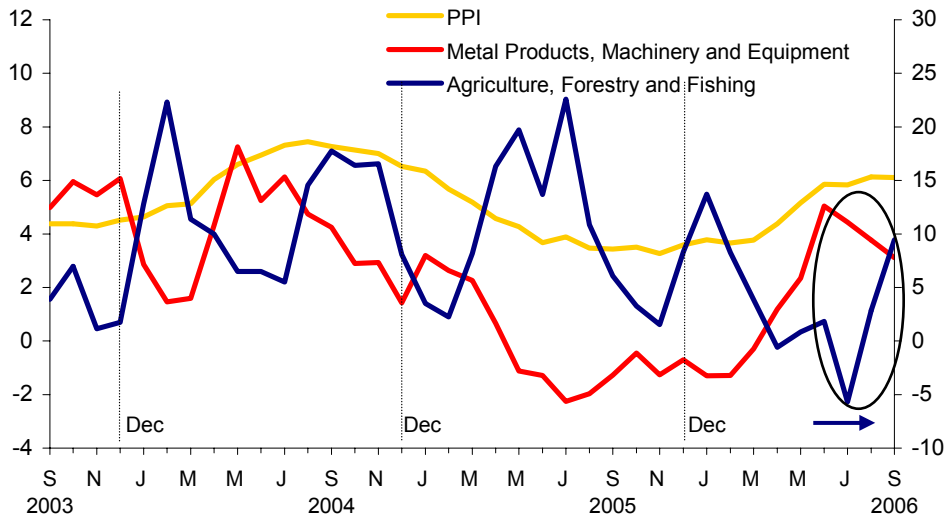


1/ K.N. Kindergarten and Nursery, F.E.. Further Education.

**2.2. Producer Price Index**

The Producer Price Index (PPI) excluding oil recorded an annual variation of 6.11 percent in September, an increase of 0.25 percentage points as compared with figures recorded at the end of the previous quarter (Graph 7). This result was mainly influenced by the significant price increases in certain agricultural products, being the most significant tomato. The mentioned increases were mitigated by the decline in steel and copper prices, which was reflected in a reduction in the annual growth rate of both metallic goods, and machinery and equipment prices.

**Graph 7**  
**Producer Price Index Excluding Oil, Merchandise and Finished Goods**  
Annual percentage change





## 3. Main Determinants of Inflation

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### 3.1. International Environment

The world economy expanded at a brisk pace during the third quarter of 2006. The latest data suggest that, parallel to the slowdown of the U.S. economy, the European and Japanese economies continued to recover, while emerging market economies, particularly those of Asia, had a favorable performance. On another front, the moderate rate of growth of the U.S. economy has contributed to reduce upward risks on inflation. The latter have also been influenced by the correction in oil prices with respect to the peaks reached during July and August. In this context, after the episode of financial market turbulence recorded during the second quarter, long-term interest rates in international markets declined during the July-September period, stock markets rebounded, and spreads on emerging economies' sovereign debt fell.

#### 3.1.1. Global Economic Activity

The slowdown of U.S. economic activity continued during the third quarter. GDP grew at an annual rate of 2.9 percent (1.6 percent at an annualized quarterly rate). The components of aggregate expenditure displayed unequal strength. On the one hand, rising employment and the correction of energy prices boosted consumption. Non-residential investment rebounded, supported by firms' sound financial position. In contrast, residential investment deteriorated further, falling -7.7 percent in annual terms (-17.4 percent at an annualized quarterly rate), as real estate prices continued to record negative annual variations in September. After having contributed to GDP growth during the second quarter, net exports were a drag on growth during the July-September period. On the other hand, although industrial production is expected to continue to expand at a faster pace than GDP, available indicators and analysts' expectations suggest that its growth rate will decelerate during the remainder of the year and in 2007.

As for the Euro area, economic expansion continued to consolidate. After the recovery of economic activity during the second quarter, when GDP grew 2.7 percent in annual terms (3.6 percent at an annualized quarterly rate), the European Commission expects robust growth to prevail during the second half of the year, albeit at more moderate rates.<sup>4</sup> During the third quarter, the expansion of private expenditure continued to be the motor of growth for the Japanese economy. The labor market tightened thereby strengthening household expenditure. Firms continued to increase capital expenditure. Thus, despite the weaker conditions observed during the second quarter, the outlook is positive.

Emerging economies grew solidly during the first half of 2006. This dynamism is expected to continue for the remainder of 2006. Chinese economic growth slowed during the second and third quarters (from 11.3 to 10.4 percent in annual terms). Although measures to stop the rapid expansion of investment have been adopted, the growth of domestic demand is expected to remain very robust. The Asian, European, and Latin American emerging economies continued to

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<sup>4</sup> The European Commission expects the Euro area to grow between 0.4 and 0.8 percent at a quarterly rate during the third quarter and between 0.2 and 0.7 percent during the fourth.

exhibit strong growth; although Latin America continues to be the region with the lowest growth rate amongst emerging market economies.

### 3.1.2. General Trends of Inflation

Worldwide inflationary pressures are still a cause of concern. Nonetheless, the moderation in growth in advanced economies' and the fall in international oil prices are expected to help contain upward pressures on inflation.

After having increased significantly during the second quarter of the year, prices of non-oil commodities have remained relatively stable. In September, the IMF price indices for basic metals, food, and agricultural raw materials were below their maximum levels reached during the second quarter (for beverages, the recent maximum was attained during the first quarter of the year). On another front, oil prices stopped increasing during the third quarter (Graph 8). After the price of WTI crude oil reached nearly 77 US dollars per barrel at the beginning of August, oil prices fell to nearly 60 US dollars per barrel at the end of September, after uncertainty regarding supply conditions for crude oil and gasoline diminished.

U.S. core inflation rebounded during the third quarter. In particular, the core consumer price index reached 2.9 percent in September; i.e., 0.3 percentage points above its level in June (Graph 9a). Although the modest increase in goods' prices has contributed marginally to the upturn in inflation, growth in services' prices has been the determining factor. In particular, core inflation has been boosted by price increases in housing-related services, which account for 58 percent of the core services index.<sup>5</sup>

Certain uncertainty prevails regarding inflationary pressures in the U.S. originated by recent wage developments. During the second quarter, the unit labor cost index recorded its highest annual variation in six years (5.0 percent in annual terms). Nonetheless, the measurement of unit labor costs is subject to various distortions, and alternative measures of wage behavior do not show similar results. The growth rate of the employment cost index has remained relatively stable.<sup>6</sup> Although the level of current wage pressures is uncertain, the relatively low level of unemployment constitutes a risk for core inflation.

Euro area inflation dropped to an annual rate of 1.7 percent in September, as a result of the fall in oil prices. Although this figure is close, albeit under, 2 percent (thus meeting the European Central Bank's definition of price stability), the ECB's most recent forecasts point to average inflation between 2.3 and 2.5 percent for 2006.<sup>7</sup> In Japan, prospects for a gradual increase in prices

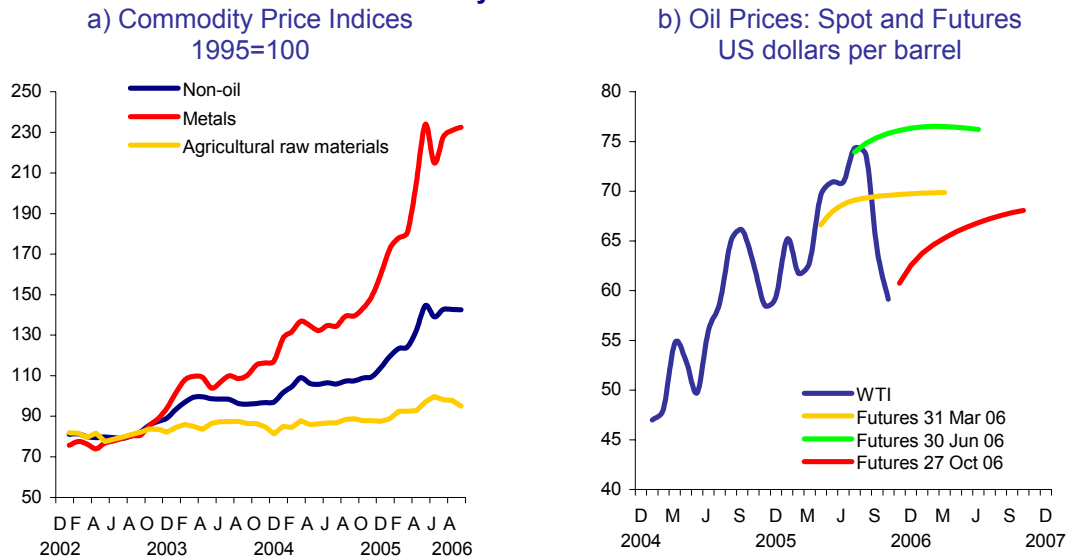
<sup>5</sup> In the CPI, the most important concepts included in housing services are paid rents and owner equivalent rents for owner-occupied housing. The indices for both concepts are calculated using data on rental housing prices. The recent increases in real estate prices could be driving up rental prices, after a period in which expectations of a fast appreciation of homes provided an added incentive for home ownership over rental housing. Nonetheless, the recent cooling of the real estate market and higher interest rates have made rental housing more attractive, thereby increasing its cost.

<sup>6</sup> The measure of compensation per hour used to calculate unit labor costs includes payments related to business executives' decision to exercise their options, which could be distorting the measurement of wage costs. In contrast, the employment cost index measures paid salary rates.

<sup>7</sup> The decline in inflation in the Euro area in September is the result of both a favorable base of comparison and the recent fall in oil prices. Expectations of a new rebound in inflation are based, among other factors, on oil futures prices and on the expected increase in the German VAT rate.

prevail, despite revised indicators for core inflation showing that deflation came to an end in June of this year, and not in November 2005, as previously estimated.

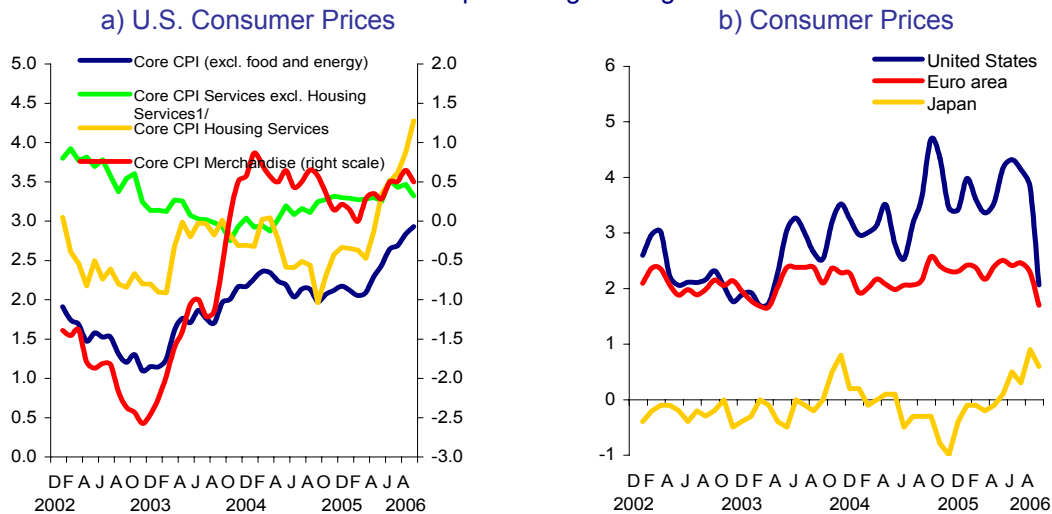
**Graph 8  
Primary Goods Prices**



Note: The non-oil price index includes prices of food, beverages, agricultural raw materials, and metals.  
Source: International Monetary Fund.  
1/ Includes cotton, wool, rubber, wood, and leather.

Source: Bloomberg.

**Graph 9  
Price Indices  
Annual percentage change**



1/ Banxico calculations based on data from BLS.  
Source: Bureau of Labor Statistics (BLS).

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

Inflation has remained low in emerging market economies in general. Despite fast growth, the Chinese economy continues to exhibit low rates of inflation (1.5 percent in September). In various countries, actions to tighten monetary policy have contributed to keep inflation low. Nonetheless, some emerging economies are facing inflationary pressures after having undergone

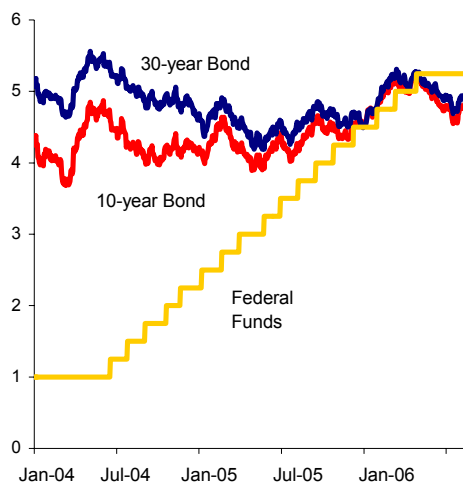
sustained periods of rapid growth (Argentina, India, Russia, and Venezuela), or sharp exchange rate depreciation (Turkey).

### 3.1.3. Financial Markets

Easier financing conditions prevailed in international capital markets during the third quarter, as the effects of the turbulence recorded during the months of May and June dissipated. Valuation of emerging market assets tended to recover during the third quarter, while long-term interest rates decreased considerably in advanced economies. The yield on 10-year U.S. Treasuries declined by 0.62 percentage points from a peak of 5 ¼ percent reached at the end of June (Graph 10).<sup>8</sup> This adjustment took place against the backdrop of a shift in the balance of risks for both growth and inflation, which, in turn, modified expectations regarding the future path of monetary policy.

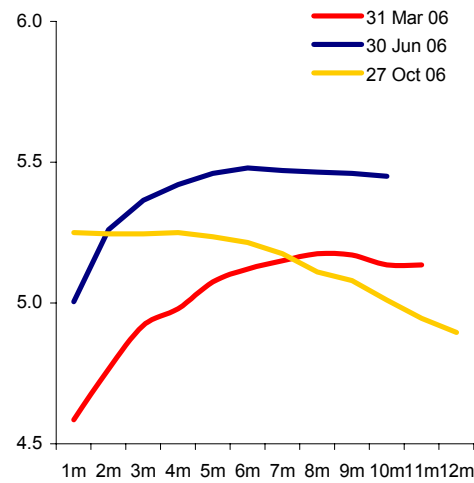
**Graph 10**  
**U.S. Interest Rates**  
Annual percent

a) Yield on U.S. Treasuries and Federal Funds Rate



Source: Federal Reserve.

b) Federal Funds Futures



Source: Bloomberg.

At its August meeting, the Federal Open Market Committee (FOMC) made a pause in the process of raising interest rates. Thus, the target for the federal funds rate was left unchanged at 5 ¼ percent. The pause was extended at the September and October meetings, and the FOMC reiterated its warning that any additional firming that may be needed to address upward risks to inflation will depend on incoming information regarding the outlook for inflation and economic growth. In this context, futures on the federal funds rate declined and most market participants expect the reference rate to remain stable for the rest of the year.

In the Euro area, the monetary stimulus continued to be gradually withdrawn. The European Central Bank (ECB) increased its reference interest rates by 25 basis points in August and in October, in a context of robust economic growth, expected average rates of inflation for 2006 and 2007 above the ECB's

<sup>8</sup> In October 27, 2006, the yield on 10-year Treasuries was 4.68 percent.

reference value, and upward risks for inflation over the medium term. On another front, the Bank of Japan put an end to an extended period of zero-interest rates by increasing its reference rate by  $\frac{1}{4}$  point in July. Following the publication of revised data, showing that the rate of price changes has been lower than previously estimated, the Bank of Japan left its reference interest rate unchanged in its meetings of August, September, and October.

After having been under pressure during the episode of financial turmoil in May and June, stock markets recovered during the reference period. In the U.S., the performance of the stock market stands in contrast to the downward revision to growth forecasts. Analysts have pointed out that evidence of a robust expansion of corporate earnings in that country, together with the reduction in long-term interest rates, has contributed to boost valuations for listed firms.

After the volatility observed in May and June, emerging equity and currency markets strengthened. Likewise, there was a reversal of the widening of spreads on sovereign debt instruments that was observed during the months of turbulence. EMBI Global spreads rose by 58 basis points, from their minimum at the beginning of May to their maximum level at the end of June, reaching 232 basis points. At the end of the third quarter, spreads had fallen to 208 basis points.

#### 3.1.4. Outlook

The outlook for the world economy, in general, is positive for the rest of the year and for 2007, even though growth is anticipated to be below that observed during the first half of 2006. Forecasts for growth in the U.S. for the last quarter of 2006 and for 2007 are slightly below estimates for potential growth. The economies of Japan and the Euro area are expected to continue to expand, while the Chinese economy is anticipated to continue to grow vigorously. Analysts consider that the moderation in energy prices, together with a slowdown of economic activity, will reduce inflationary pressures.

Despite the favorable scenario, some analysts are concerned about the possibility of a sharper slowdown in the U.S. economy, given the rapid weakening of the real estate market. The negative impact of such weakening could be offset by the effect of the reduction in gasoline prices and of rising employment on private consumption, and by firms' sound financial position. Although a greater-than-expected slowdown in the U.S. economy could affect other economies, such as the Chinese (which are highly dependant on U.S. exports), the sound conditions of the Japanese and the Euro area economies -and the fact that their growth dynamics depend less on external demand- are a stabilizing factor. On another front, although inflationary pressures apparently have diminished, the likelihood of a further rebound cannot be discarded, due to the volatility in commodity prices and the high levels of capacity utilization in some economies. An additional risk emanates from current account global disequilibria, which are still unsustainable in the medium term.

### 3.2. Aggregate Demand and Supply in Mexico

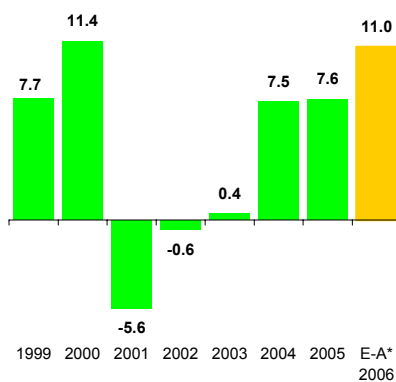
#### 3.2.1. Indicators of Aggregate Demand and Supply

Several indicators suggest that during the third quarter of 2006, economic activity in Mexico grew significantly in annual terms, albeit slightly below

that recorded during the first half of the year. In general terms, aggregate demand was characterized by the following aspects: i) both components of aggregate demand –domestic and external- grew significantly at an annual rate; ii) within domestic demand, consumption expenditure grew considerably, but not as dynamically as in the first half of the year;<sup>9</sup> iii) investment increased markedly (Graph 11a and Graph 11b); however, its annual growth slightly slowed. Imported goods continued to be the most dynamic component of investment;<sup>10</sup> and, iv) exports of goods and services grew at a rate close to that exhibited during the first half of the year, despite the slowdown of U.S. imports, Mexico's main export market.

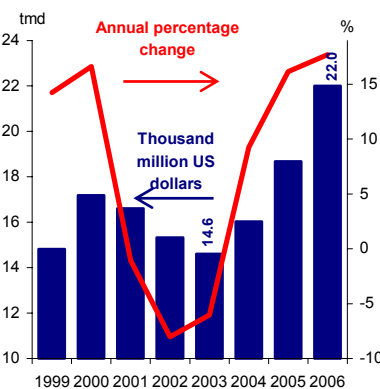
**Graph 11**  
**Domestic Demand Indicators**

a) Gross Fixed Capital Formation  
Annual percentage change



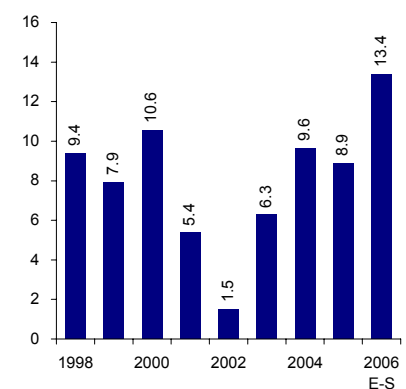
\* Estimates.  
Source: INEGI.

b) Capital Goods Imports



Source: Banco de México. Comprises the period January-September of each year.

c) ANTAD Sales  
Annual percentage change



Source: ANTAD.

The development of aggregate demand and, in general, of economic activity during the third quarter, benefited from certain aspects characterizing the external environment. In particular, the external demand for Mexican products had positive results. In the case of the automotive industry, the considerable investments done previously allowed for vehicle exports to grow significantly in annual terms. Nonetheless, the corresponding annual rate decreased, given that the most significant increase in the number of exported vehicles took place at the end of the previous year. On the other hand, country's domestic expenditure also benefited by the high oil trade surplus and by new increases in revenues from workers' remittances. Thus, private consumption expenditure continued to be boosted by these resources. Under such context, private consumption expenditure -under the cyclical process the Mexican economy is currently undergoing- has recorded its most vigorous growth of the last two and a half

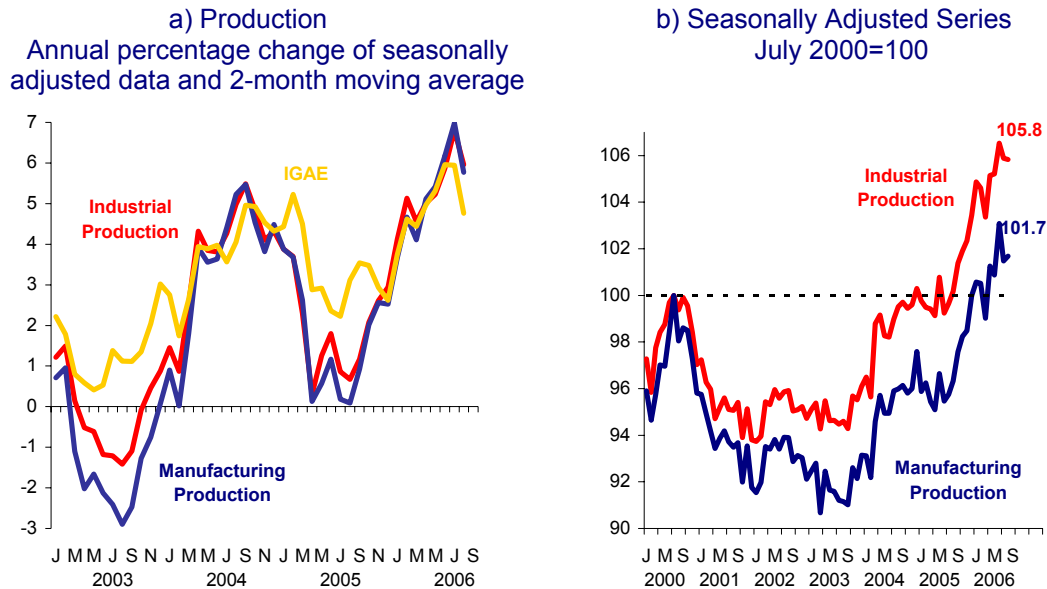
<sup>9</sup> Regarding private consumption indicators, during the third quarter, ANTAD sales grew 13.2 percent in real terms. As a result, during the first nine months of 2006, these sales rose by 13.4 percent (Graph 11c). This rate is above those recorded since 1997, year in which this indicator began measuring. Sales of ANTAD, together with those of Wal-Mart, account for more than one third of retail sales in the country, excluding vehicles, spare parts, and fuels from the latter.

<sup>10</sup> Regarding investment indicators, during the period July-August, this type of expenditure grew at an annual rate of around 10.4 percent. During the third quarter, imports of capital goods, measured in current US dollars, grew at annual rate of 15.9 percent. The expansion of investment expenditure during the first eight months of 2006 (11 percent) was above that observed during the previous five years, and very close to that recorded in 2000.

decades. The significant increase in financing to private consumption has contributed to the latter development.

As for aggregate supply during the third quarter of 2006, the following must be highlighted: i) the significant growth of GDP, slightly below that observed during the first half of the year;<sup>11</sup> and, ii) the dynamism of imports of goods and services.

**Graph 12**  
**Production Indicators**



Source: INEGI. Seasonal adjustments by Banco de México.

The considerable improvement of industrial production observed in the first half of the year prevailed during the third quarter of 2006. This is a result of the significant annual growth in the four sectors that comprise this activity, especially in construction and manufacturing (Graph 12).<sup>12</sup> Regarding the latter, the recovery observed during the present year was boosted by a strong annual recovery of automotive production, especially export-oriented automotive production. Manufacturing production, excluding the automotive industry, grew modestly in annual terms, albeit above 2005 figures.

The abovementioned developments, as well as a broad number of indicators of economic activity, allow for estimating that GDP annual growth during

<sup>11</sup> As for GDP indicators, the Global Indicator of Economic Activity (*Indicador Global de la Actividad Económica*, IGAE) recorded an annual increase of 4.74 percent during the July-August period. During the third quarter of 2006, the agriculture sector grew modestly at an annual rate, which reflected that during the same period of 2005, surface area harvested increased markedly, after lack of rain and draught affected some regions during the second quarter.

<sup>12</sup> During July and August 2006, industrial and manufacturing production grew at an annual rate of 5.9 and 5.7 percent, respectively. Thus, during the first eight months of the year, both grew at an annual rate of 5.5 percent. During the period January-August, growth in the manufacturing industry was based on annual increases of 21.7 and 2.8 percent in automotive and non-automotive manufacturing production, respectively. During 2006, industrial and manufacturing production grew at annual rates above those attained in the previous five years.

the third quarter of 2006 might have been close to 4.5 percent, after having been 5.1 percent in the first half of the year.

Growth of both GDP and domestic demand during 2006 has not implied considerable pressures on the economy's production capacity. Under such context, the following must be highlighted:

- i) The improvement in the industrial sector's rate of production has reflected, at the margin, higher manufacturing production, after the modest results of the previous years. This progress is mainly due to the favorable behavior of external demand in various sectors, together with the recovery of terminal automotive industry manufacturing exports.
- ii) Despite the recent progress of manufacturing production, its level during the third quarter of 2006 barely exceeded its previous maximums reached in mid-2000.
- iii) Of all manufacturing branches, the terminal automotive industry exhibited the greater dynamism in annual terms during 2006. Nonetheless, with seasonally adjusted data, the number of Mexican-manufactured vehicles has not changed significantly since the beginning of this year, thus meaning decreasing annual rates since the second quarter. This trend will continue during the fourth quarter of the year.
- iv) Production capacity has gradually strengthened since 2004, considering that investment has recovered significantly, after three consecutive years of weakness. An indicator of this investment process, as well as of the modernizing efforts of capital accumulation and of its potential impact on the country's production capacity, is the higher value of capital goods' imports. From the period January-September 2003 to the same period of 2006, imports of capital goods measured in current US dollars rose by 51 percent.

Although domestic expenditure has grown more than GDP since the third quarter of 2004, in the two previous years, it did not, thus making more feasible that domestic expenditure would undergo a period of greater dynamism as compared with GDP. The gap between the annual growth rate of both items has also not widened in 2006, and the gradual moderation of economic growth during the fourth quarter is expected to take place with similar results in terms of domestic expenditure.

Higher growth as compared with the previous year has not led to a greater shortage of skilled labor, considering the development of Banco de México's manufacturing labor market indicators (Graph 13).<sup>13</sup> Results from Banco de México's monthly Survey of Private Sector Economic Analysts' Forecasts indicate that both the shortage of skilled labor and labor costs are not considered

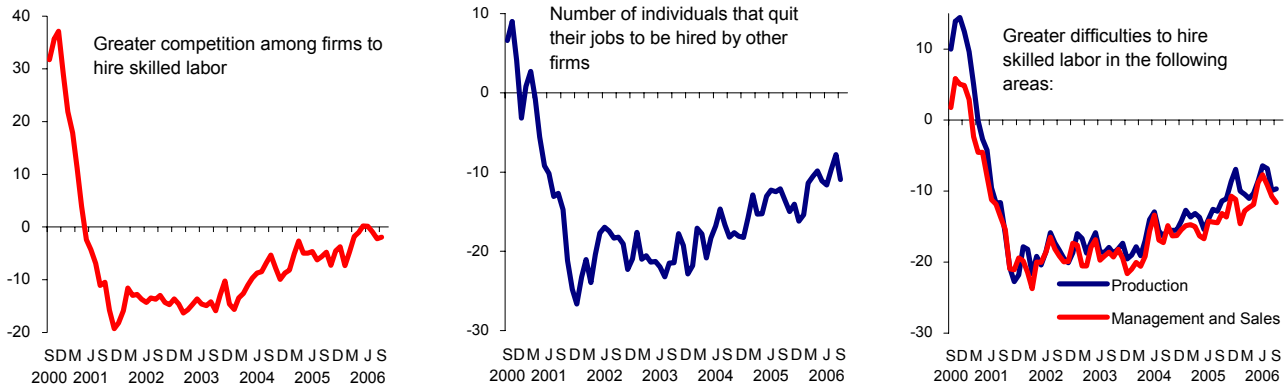
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<sup>13</sup> Monthly indicators show that during the third quarter of the year, enterprises in this sector did not face significant difficulties to hire skilled labor in their production, sales, and administrative areas, or high competition among themselves to hire personnel.



as factors that can limit the rate of growth of economic activity during the next months.<sup>14</sup>

**Graph 13**  
**Labor Market Indicators**  
 Manufacturing Sector: Labor Shortage Indicators  
 2-month moving average of balance of responses



Source: Results from Banco de México's Monthly Tendency Survey of the Manufacturing Sector. Balance of responses refers to the weighted average of enterprises mentioning to have faced greater competition from other firms to hire skilled labor (or enterprises 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. In the case of the right-hand graph, the balance of responses refers to the percentage (weighted) of firms mentioning to have faced greater difficulty to hire labor less those mentioning to have faced less difficulty.

### 3.2.2. Employment

Annual growth of economic activity has contributed to a positive development of various indicators of employment. However, there were other employment indicators that did not improve during the quarter. This was the case of the national unemployment rate, which increased slightly during the period. Recently, such indicator has been influenced upward by an increase in the "rate of participation", i.e., the ratio of the economically active population to the population age 14 and older.

At the end of September 2006, 13,921,617 workers were insured by the IMSS, thus implying an annual increase of 900,872 workers (6.9 percent) (Graph 14a). This absolute variation is the highest variation observed since October 1998. By breakdown, it comprised 403,119 permanent workers (3.7 percent annual increase), and 497,753 temporary workers in urban areas (24.9 percent increase).<sup>15</sup> The development of formal employment with seasonally adjusted data reveals that at the end of September of this year, this indicator had surpassed by 1,263,337 jobs its maximum level attained at the end of 2000 (Graph 14b). During the same period, the economically active population in the country increased by nearly 4 million.

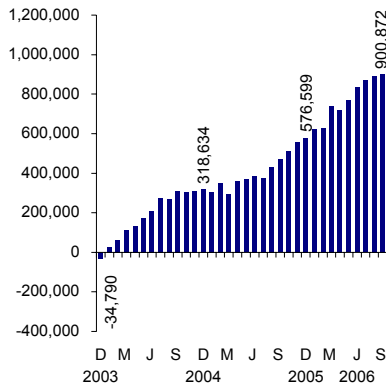
<sup>14</sup> As a whole, during the third quarter of 2006, "higher wage costs" and "shortage of skilled labor" accounted for only 1.45 percent of the responses as factors that could limit economic activity in the next six months. See results of September 2006 Survey of Private Sector Economic Analysts' Forecasts.

<sup>15</sup> As mentioned in previous Inflation Reports, the increase in the number of workers insured by the IMSS could also be reflecting IMSS greater fiscalization efforts.

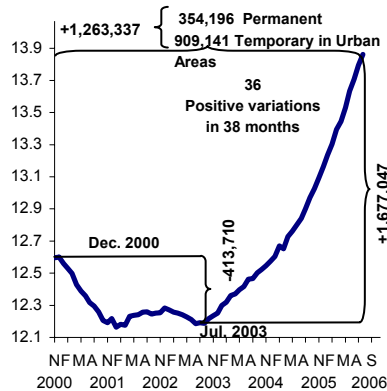
### Graph 14 Labor Market Indicators

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

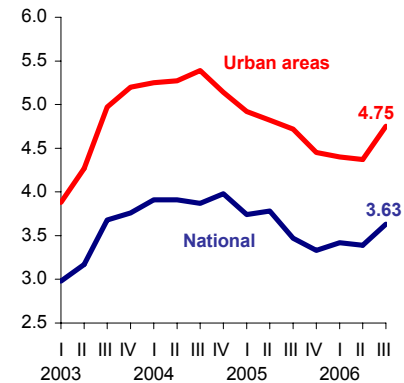
a) Annual change  
Original data



b) Million Workers  
Seasonally adjusted 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.

The growth of formal employment during the third quarter of the year comprised all sectors of economic activity and was particularly high in construction (174,874 workers and 16.9 percent), trade activities (142,992 workers and 5.6 percent), other services (340,840 workers and 7.9 percent),<sup>16</sup> and manufacturing (194,922 workers and 5.1 percent). Thus, the recovery of manufacturing employment that began in 2004 continued. Nonetheless, on a seasonally adjusted basis, and up to the end of September 2006, the total number of manufacturing workers insured by the IMSS fell by 472 thousand (10.5 percent) as compared to its level in October 2000.

According to the Occupation and Employment Survey (*Encuesta Nacional de Ocupación y Empleo*, ENOE) conducted by INEGI, during the third quarter of 2006, both national and urban unemployment rates increased. On a seasonally adjusted basis, the former went from 3.39 percent during the second quarter, to 3.63 percent in the third (Graph 14c). Under such context, the “rate of participation” (the ratio of the economically active population to the population age 14 and older) has increased in 2006, which tends to raise the unemployment rate (even with seasonally adjusted data).

#### 3.2.3. External Sector

The significant growth of aggregate demand and GDP during 2006 has not implied a broadening in the trade and current account balances as compared with 2005. In fact, during the first three quarters of the year, the trade deficit was below that observed during the same period of 2005, while the current account had a slight surplus. The latter resulted from surpluses in the first two quarters and a deficit in the third.

<sup>16</sup> The Other Services sector comprises services for enterprises and individuals, as well as social and community services.

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

- a ) Non-oil exports continued to record high growth in annual terms (Graph 15a), although slightly lower than the one shown in the first half of 2006.<sup>17</sup> Several indicators suggest that external demand could slow down for the rest of the year.
- b ) Terminal automotive industry manufacturing exports continued to grow significantly in annual terms, although their growth rate followed a declining trend (Graph 15b).<sup>18</sup> In fact, during the third quarter, non-automotive industry manufacturing exports (both maquiladora and non-maquiladora) surpassed those of the automotive sector.
- c ) The persistently high prices of crude oil in international markets made crude oil export values remain high. Nonetheless, during the quarter, crude oil exports also grew at a slower annual rate.
- d ) Merchandise imports showed a significant growth (Graph 15c), even though at lower rates than during the first half of the year.<sup>19</sup>
- e ) Banco de México's net international reserves decreased, mainly due to the sale of foreign currency to the federal government (12.451 billion US dollars), destined to prepay public external debt (see Section 3.4.1 of this Report).

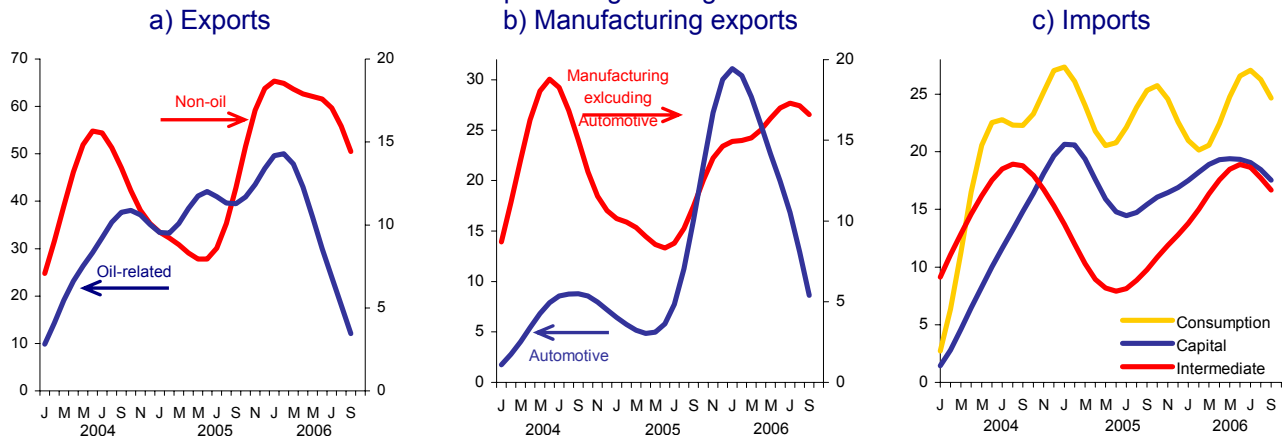
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<sup>17</sup> During the third quarter of 2006, total merchandise exports rose at an annual rate of 16.9 percent (21.6 percent during the first half of the year), as a result of increases in oil and non-oil exports (17 percent and 16.9 percent, respectively). Regarding the latter, manufacturing exports rose 16.6 percent.

<sup>18</sup> During the third quarter of 2006, automotive manufacturing exports grew at an annual rate of 11.2 percent, while in the first and second quarters, they did so at 33 and 20.5 percent, respectively.

<sup>19</sup> Merchandise imports grew at an annual rate of 17.7 percent during the third quarter of 2006, (18 percent during the first half of 2006). This result was due to increases in intermediate, capital, and consumption goods of 16.8, 15.9, and 24.3 percent, respectively. Just like in previous quarters, growth of consumption goods was influenced upward by the increase in gasoline and vehicle imports. After deducting both items, the rest of consumption goods' imports increased during the reference quarter by 10.9 percent in annual terms. During that period, used vehicles accounted for 13.4 percent of total vehicle imports.

**Graph 15**  
**Merchandise Exports and Imports**  
 Annual percentage change of trend data



Source: Banco de México.

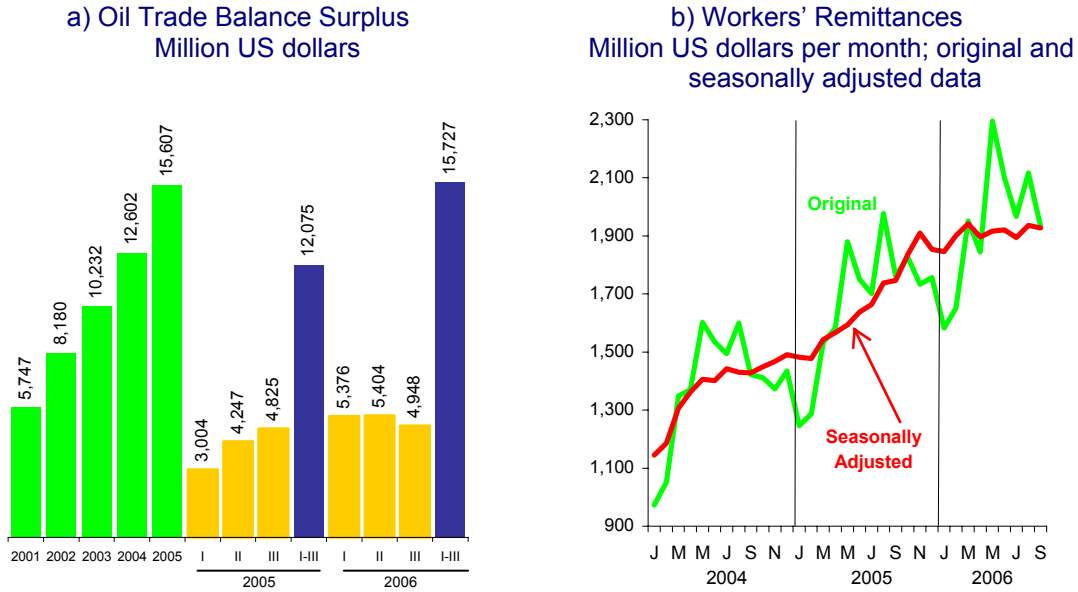
During the first eight months of the year, the share of Mexican exports in the U.S. market increased. In particular, during the July-August period, Mexican exports grew 21.2 percent in annual terms, figure above the 15.25 percent of total U.S. imports (Table 2). Thus, the share of Mexican exports also increased, from 9.76 percent during the period July-August 2005, to 10.26 percent during the same period of this year. This improvement responded not only to the positive results of oil and automotive exports. Even after excluding both items, the rest of Mexican exports also increased their market share, from 8.01 percent during the July-August 2005 period, to 8.41 percent during the same period of 2006. This improvement occurred in a scenario of a clear slowdown of U.S. merchandise imports, and mainly responded to the positive evolution of industrial production and its impact on non-oil Mexican exports. It is well known that Mexican industrial production and manufacturing exports are closely linked to U.S. industrial production. Thus, given that both private consumption expenditure and GDP growth have been slowing more than industrial production in the U.S., Mexican exports have been able to grow steadily in that market. Under such setting, Mexican intermediate goods (products associated with industrial processes in the U.S.) have a higher share in the structure of non-oil exports to the U.S. than Chinese intermediate goods. On the contrary, Chinese consumption goods have a higher share in non-oil exports to the U.S. than those from Mexico.

**Table 1**  
**U.S. Imports**  
 Percent

|   | Share            |               |               |               | Annual Percentage Change: 2006 |              |                     |              |                                    |                                    |
|---|------------------|---------------|---------------|---------------|--------------------------------|--------------|---------------------|--------------|------------------------------------|------------------------------------|
|   | January - August |               | July - August |               | July - August                  |              |                     |              | Jan - Aug                          |                                    |
|   | 2005             | 2006          | 2005          | 2006          | Total                          | Oil          | Total excluding Oil | Automotive   | Total excluding Oil and Automotive | Total excluding Oil and Automotive |
| <b>Total</b>                            | <b>100.00</b>    | <b>100.00</b> | <b>100.00</b> | <b>100.00</b> | <b>15.25</b>                   | <b>34.23</b> | <b>12.79</b>        | <b>5.84</b>  | <b>14.01</b>                       | <b>12.01</b>                       |
| <b>Total excluding Mexico</b>           | <b>89.79</b>     | <b>89.28</b>  | <b>90.24</b>  | <b>89.74</b>  | <b>14.60</b>                   | <b>33.79</b> | <b>12.21</b>        | <b>3.95</b>  | <b>13.52</b>                       | <b>11.75</b>                       |
| <b>Total excluding Mexico and China</b> | <b>75.59</b>     | <b>74.69</b>  | <b>74.80</b>  | <b>73.98</b>  | <b>13.99</b>                   | <b>33.81</b> | <b>10.94</b>        | <b>3.95</b>  | <b>12.36</b>                       | <b>10.41</b>                       |
| 1. Canada                               | 17.10            | 16.67         | 16.30         | 15.00         | 6.02                           | 37.25        | 2.58                | -7.08        | 5.70                               | 8.68                               |
| 2. China                                | 14.20            | 14.59         | 15.44         | 15.75         | 17.55                          | 24.34        | 17.55               | --           | 17.55                              | 16.99                              |
| <b>3. Mexico</b>                        | <b>10.21</b>     | <b>10.72</b>  | <b>9.76</b>   | <b>10.26</b>  | <b>21.20</b>                   | <b>37.19</b> | <b>18.38</b>        | <b>15.04</b> | <b>19.63</b>                       | <b>14.75</b>                       |
| 4. Japan                                | 8.48             | 7.92          | 8.08          | 7.70          | 9.89                           | --           | 9.89                | 15.29        | 6.53                               | 2.85                               |
| 5. Germany                              | 5.18             | 4.84          | 5.17          | 4.67          | 3.98                           | --           | 3.98                | -6.18        | 9.21                               | 9.49                               |
| <b>Total 5 countries</b>                | <b>55.18</b>     | <b>54.73</b>  | <b>54.76</b>  | <b>53.38</b>  | <b>12.36</b>                   | <b>37.16</b> | <b>10.87</b>        | <b>4.22</b>  | <b>12.61</b>                       | <b>11.81</b>                       |

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

**Graph 16**  
**External Sector Indicators**



Source: Banco de México.

During the third quarter of 2006, the current account of the balance of payments recorded a moderate deficit. This result was favored by both the higher surpluses of the oil trade balance and revenues from workers' remittances during the reference period. In the former case, the trade surplus went from 4.825 billion US dollars during the third quarter of 2005, to 4.948 billion during the same period of 2006 (Graph 16a). Revenues from workers' remittances rose to 6.018 billion US dollars during the third quarter, an increase of 578 million dollars as compared with the same period of 2005. The annual growth of workers' remittances has slowed down in 2006: from 27.5 and 19.7 percent during the first and second quarters of the year, to 10.6 percent during the third. In fact, with seasonally adjusted data, the level of these revenues was practically the same during the second and third quarters of 2006 (Graph 16b).

Based on the aforementioned, as well as on information available of other components of the external accounts, the current account of the balance of payments is estimated to have recorded a moderate deficit of approximately 1.2 billion US dollars during the third quarter of 2006. Such results imply that the accumulated current account surplus during the first nine months of 2006 might have been of 0.7 billion US dollars (a deficit of 2.610 billion US dollars was recorded in the same period of 2005). The capital account (including errors and omissions) is expected to have recorded a deficit of around 10.2 billion US dollars during the third quarter of 2006. This result was mainly a consequence of a significant increase in the assets item, originated by an increase in federal government's deposits at Banco de México destined to prepay foreign debt.<sup>20</sup> During the third quarter of 2006, the capital account was also characterized by a

<sup>20</sup> The federal government purchased 12.451 billion US dollars from Banco de México, an amount which was then deposited in a foreign currency-denominated current account at Banco de México. Changes in this account are recorded in the item of assets of the capital account of the balance of payments. As the federal government uses these deposits to pay foreign debt, the external assets account will also be reduced.

net outflow of resources from portfolio foreign investment, and by net inflows from foreign direct investment. During the reference quarter, Banco de México's net international reserves decreased by 11.440 billion US dollars as a net result of various operations that increased international reserves, as well as of Banco de México's sale of 12.451 billion US dollars to the federal government. At the end of September, the stock of international reserves was 67.303 billion US dollars.

### 3.3. Costs and Prices

#### 3.3.1. Wages and Unit Labor Costs

During the third quarter of 2006, wage increases negotiated by firms under federal jurisdiction were on average, 4.2 percent, 0.2 percentage points below those granted during the same period of 2005 (Table 3). Such decline was the result of lower wage increases granted by private enterprises (4.4 percent during the analyzed period as compared with 4.7 percent during the third quarter of 2005). In contrast, during both periods, public enterprises granted wage increases of 4.1 percent.

**Table 2**  
**Contractual Wage Average Increases<sup>1/</sup> and Number of Workers Benefited by Type of Enterprise**

|   | 2005 |     |     |     |         | 2006 |     |     |     |     |      |         |
|---|------|-----|-----|-----|---------|------|-----|-----|-----|-----|------|---------|
|   | I    | II  | III | IV  | Jan-Dec | I    | II  | III | Jul | Aug | Sep  | Jan-Sep |
| <b>Contractual Wage Increase (Percent)<sup>1/</sup></b> |      |     |     |     |         |      |     |     |     |     |      |         |
| <b>Total</b>  | 4.5  | 4.4 | 4.4 | 4.2 | 4.4     | 4.3  | 4.4 | 4.2 | 4.9 | 4.1 | 4.3  | 4.3     |
| <b>Public Enterprises</b>                               | 3.6  | 4.0 | 4.1 | 4.0 | 4.0     | 4.0  | 4.0 | 4.1 | *   | 4.1 | 4.2  | 4.0     |
| <b>Private Enterprises</b>                              | 4.7  | 4.6 | 4.7 | 4.7 | 4.6     | 4.3  | 4.5 | 4.4 | 4.9 | 4.2 | 4.3  | 4.4     |
| <b>Number of Workers Benefited (Percentage Share)</b>   |      |     |     |     |         |      |     |     |     |     |      |         |
| <b>Total</b>  | 100  | 100 | 100 | 100 | 100     | 100  | 100 | 100 | 100 | 100 | 100  | 100     |
| <b>Public Enterprises</b>                               | 19   | 22  | 46  | 72  | 41      | 19   | 27  | 48  | 0   | 73  | 0.1  | 29      |
| <b>Private Enterprises</b>                              | 81   | 78  | 54  | 28  | 59      | 81   | 73  | 52  | 100 | 27  | 99.9 | 71      |

<sup>1/</sup> Average weighted by number of workers benefited during the period.

\* No wage negotiations were conducted during the period.

Source: Prepared by Banco de México with data from the Ministry of Labor.

During the January-July 2006 period, labor productivity in the manufacturing sector, both maquiladora and non-maquiladora, recorded an annual average variation above that observed during the same period of 2005 (Table 4). Real earnings by worker also increased in both cases. Increases in the manufacturing non-maquiladora and maquiladora industries were below and above productivity, respectively. As a result, unit labor costs (ULC) decreased in the non-maquiladora industry while they increased in the maquiladora industry.

**Table 3**  
**Earnings, Labor Productivity and Unit Labor Costs by Sectors<sup>1/</sup>**

|   | 2004    | 2005    |         | 2006 |      |      |      |      |      |      |         |
|---|---------|---------|---------|------|------|------|------|------|------|------|---------|
|   | Jan-Dec | Jan-Jul | Jan-Dec | Jan  | Feb  | Mar  | Apr  | May  | Jun  | Jul  | Jan-Jul |
| <b>Non-maquiladora Manufacturing Industry</b> |         |         |         |      |      |      |      |      |      |      |         |
| Labor Productivity                            | 7.1     | 1.9     | 2.0     | 6.4  | 4.9  | 10.6 | -2.0 | 5.6  | 5.6  | 3.4  | 4.9     |
| Real Average Earnings                         | 0.3     | -0.3    | -0.1    | 0.3  | 1.0  | 0.2  | 0.9  | 1.3  | -0.1 | 0.7  | 0.6     |
| ULC   | -6.3    | -2.0    | -2.0    | -5.7 | -3.7 | -9.4 | 3.0  | -4.0 | -5.4 | -2.6 | -4.0    |
| <b>Maquiladora Industry</b>                   |         |         |         |      |      |      |      |      |      |      |         |
| Labor Productivity                            | 2.5     | -2.0    | -1.0    | 1.7  | -0.1 | 2.1  | -1.1 | 0.7  | 0.7  | -1.9 | 0.3     |
| Real Average Earnings                         | -0.2    | -0.8    | 0.3     | 1.5  | 1.8  | 3.2  | 2.5  | 2.6  | 1.8  | 0.4  | 2.0     |
| ULC   | -2.6    | 1.3     | 1.4     | -0.2 | 1.9  | 1.1  | 3.6  | 1.8  | 1.1  | 2.4  | 1.7     |

<sup>1/</sup>Manufacturing production estimates are based on total hours worked. Thus, average labor productivity per worker reflects labor intensity in the productive process.

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

### 3.3.2. Administered and Regulated Prices of Goods and Services

In September 2006, the administered price subindex posted an annual variation of 7.29 percent, 0.89 percentage points below June figures (Graph 16). This reduction is mainly attributed to a contraction in the growth rate of propane prices and to a fall in natural gas and gasoline prices in cities like Ciudad Juárez, Matamoros, and Ciudad Acuña. In these cities, gasoline prices were below their maximum level set by the federal government.<sup>21</sup> The reduction in natural gas and gasoline prices was offset by an increase in the annual variation of electricity tariffs, particularly those corresponding to high consumption (whose updating factor was affected by increases in copper prices, which are applied with a lag).<sup>22</sup>

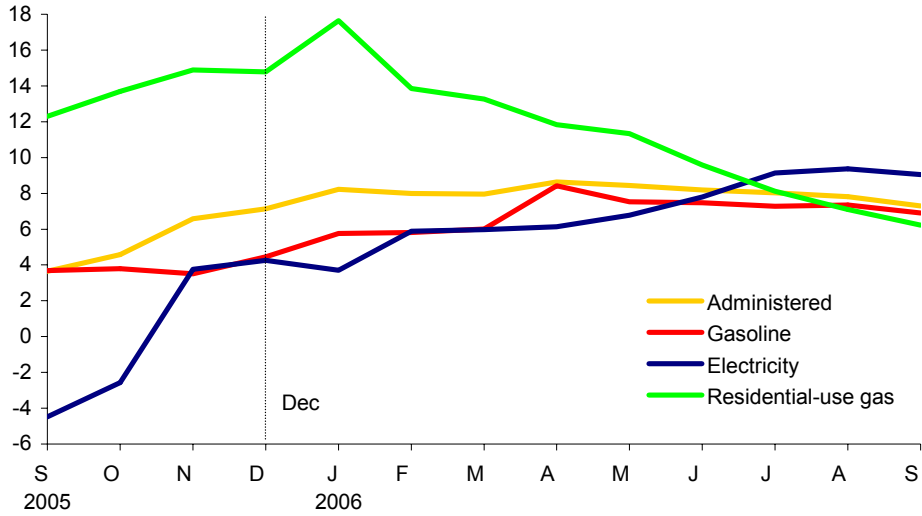
At the end of the quarter, international prices of gasoline, propane, and natural gas were below their June levels (Graph 17). Energy futures for the end of the year also decreased significantly. As long as the decline in international prices of energy prevails, domestic prices will be subject to lesser pressures.<sup>23</sup>

<sup>21</sup> In a press release of May 6, 2006, the federal government determined the maximum price for gasoline in northern border cities to be 7.41 pesos per liter. This price will apply during the period in which international references are above the referred price.

<sup>22</sup> High-consumption residential electricity tariffs are adjusted on a monthly basis according to the following formula:  $F = 0.8 \cdot TIP + 0.2 \cdot TCC$ . The first term in the equation (TIP), is comprised of three arithmetically averaged PPI subindexes: Metal Products, Machinery and Equipment, Basic Metal Industries and Other Manufacturing Industries. The second term (TCC) represents price costs of the following fuels used for electricity generating: imported and domestic diesel; natural gas; industrial diesel; and, imported and domestic coal.

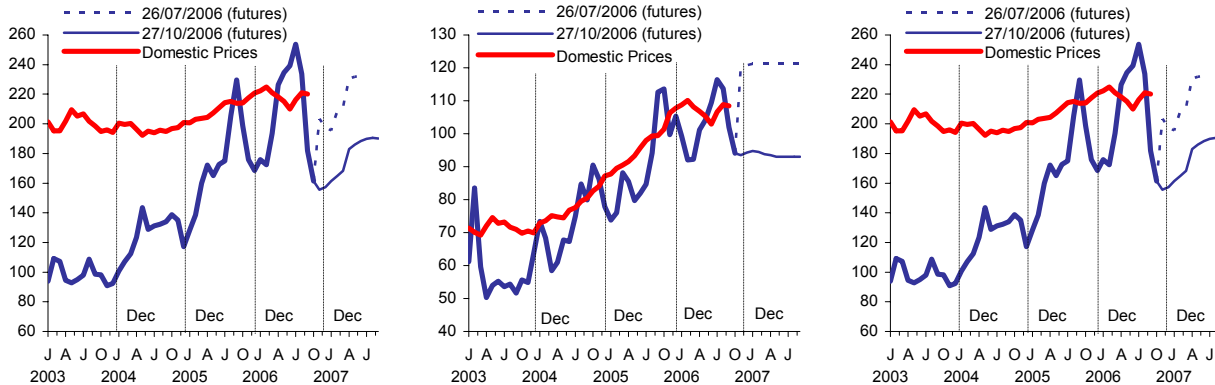
<sup>23</sup> For further detail on the measures implemented by the federal government to limit the impact of the increase in international energy prices see the Inflation Reports of April-June 2006 and January-March 2006.

**Graph 17**  
**Administered Prices Subindex**  
 Annual percentage change



At the end of the third quarter of 2006, the annual variation of the price subindex of regulated prices was 1.63 percent, 0.41 percentage points above June figures (Graph 19). This increase was due, mainly, to the upward movement in urban bus fares, among which the following cities made the highest contributions: Tijuana, Acapulco, Monclova, Huatabampo, Hermosillo, and Iguala.

**Graph 18**  
**International Prices and Futures of Selected Energy Goods <sup>1/</sup>**  
 a) Gasoline <sup>2/</sup>      b) Propane <sup>3/</sup>      c) Natural Gas <sup>4/</sup>



1/ Futures prices of July 26, and October 27, 2006 (New York Mercantile Exchange).

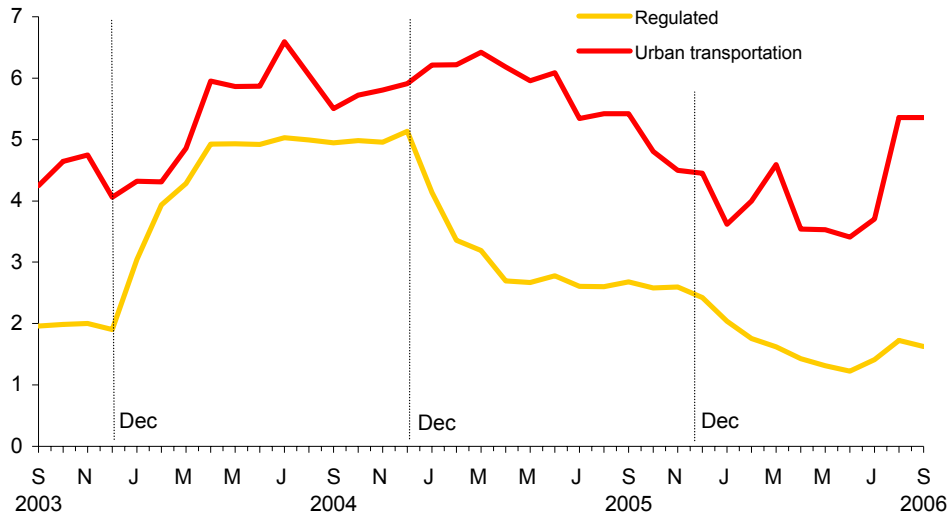
2/ Texas. US cents per gallon.

3/ Mont Belvieu, Tx. US cents.

4/ Tetco, Tx. US dollars per MMBtu.



**Graph 19**  
**Regulated Prices Subindex**  
 Annual percentage change



### 3.3.3. Metals and Food Commodities

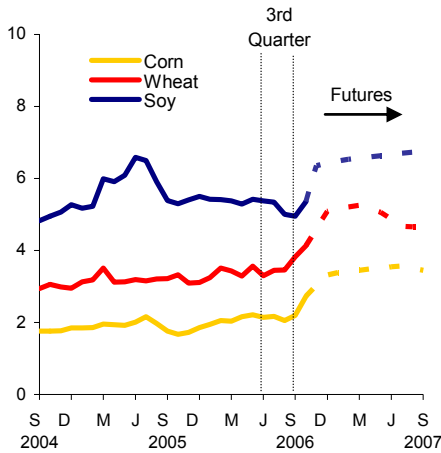
Most recent information on futures indicates that wheat, corn and soy prices for the following 12 months will be above their current levels. In addition, between June and September, wheat reference prices rose by 16.11 percent. Thus, the behavior of grain prices and futures suggests likely pressures on their domestic references, and also on the processed foods that used them as inputs (Graph 20a). In contrast, future prices of pork meat are below their levels recorded at the end of the third quarter, and beef prices remain at a similar level (Graph 20b).

During the third quarter, the upward movements in the domestic prices of copper and certain steel products, such as rod, partially reverted (Graph 21).<sup>24</sup> These developments will contribute to reduce the growth rate of construction material prices and, in the next months, could also favor the decline in high consumption electricity tariffs.<sup>25</sup>

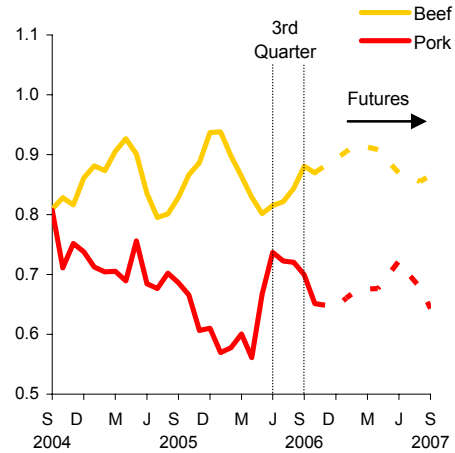
<sup>24</sup> The federal government decreed a reduction in customs tariffs for several steel and copper products (2 percentage points in the case of steel and 3 points in the case of copper). The measure is effective starting September 30, 2006.

<sup>25</sup> The effect of the downward adjustment in metal prices on high consumption electricity tariffs takes place with a 2-month lag because the updating factor is constructed with PPI subindexes with a two-period lag (see Section 3.3.2).

**Graph 20**  
**International Prices of Agricultural Commodities <sup>1/</sup>**  
 a) Grains  
 US dollars per bushel

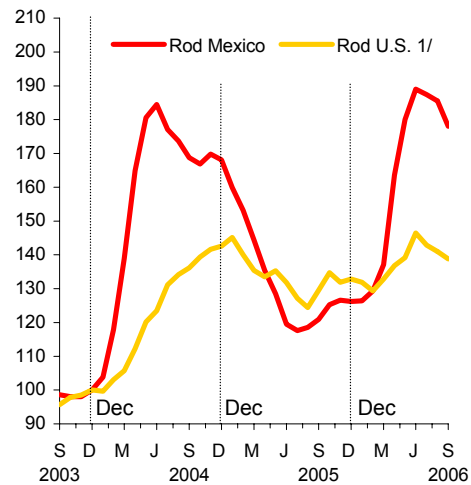
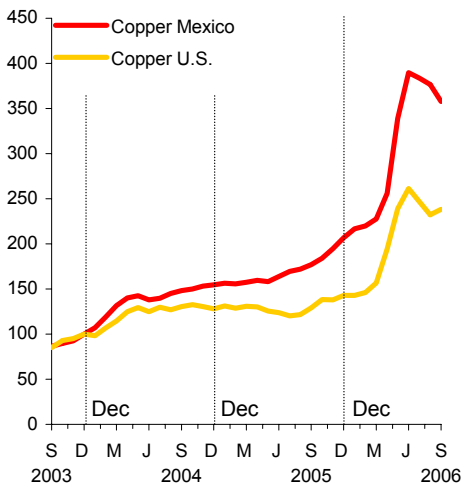


b) Meat  
 US dollars per pound



<sup>1/</sup> Futures prices correspond to July 26, 2006. In the case of grains, values correspond to the Chicago Board of Trade, while in the case of meat, to the Chicago Mercantile Exchange.  
 Source: U.S. Department of Agriculture.

**Graph 21**  
**Indices of Domestic and External Prices of Copper and Steel By-products**  
 a) Copper Indexes  
 b) Rod Indexes



Source: Banco de México (México) and Bureau of Labor Statistics (U.S.).  
<sup>1/</sup>Includes all types of rod.

### 3.4. Monetary and Credit Aggregates

#### 3.4.1. Monetary Base, Net Domestic Credit and International Assets

During the third quarter of 2006, the monetary base grew, on average, 18 percent as compared with the same period of last year, slightly above the

figure observed during the previous quarter (17.1 percent).<sup>26</sup> Monetary base growth was above that anticipated, due partly to the higher growth of economic activity and to the fact that the increase of the monetary base that usually takes place prior to Mexico's elections lasted longer than expected.

As for quarterly flows, the monetary base decreased by 1,933 million pesos during the third quarter of 2006. Net international assets decreased by 1,530 million US dollars during such period to 83,450 million US dollars at September 30, 2006.<sup>27</sup> As a result, Banco de México's net domestic credit rose by 15,380 million pesos during the quarter (Table 5).

**Table 5**  
**Monetary Base, International Assets and Net Domestic Credit**  
Millions

|   | Stocks             |                    | Annual     | Flows in 2006 |         |         |                                      |
|---|--------------------|--------------------|------------|---------------|---------|---------|--------------------------------------|
|   | At Dec.31,<br>2005 | At Sep.30,<br>2006 | percentage | Quarter       |         |         | Accumulated<br>by<br>Sep.30,<br>2006 |
|   |                    |                    | change     | I             | II      | III     |                                      |
| (A) Monetary Base (Pesos)   | 380,034            | 367,140            | 17.5       | -26,990       | 16,029  | -1,933  | -12,894                              |
| (B) Net International Assets (Pesos) <sup>1/2/</sup>                  | 788,167            | 917,408            | 21.4       | 21,062        | 100,276 | -17,312 | 104,026                              |
| Net International Assets (US dollars) <sup>2/</sup>                   | 74,115             | 83,450             | 19.2       | 1,931         | 8,934   | -1,530  | 9,335                                |
| (C) Net Domestic Credit (Pesos) [(A)-(B)] <sup>1/</sup>               | -408,133           | -550,268           | 24.2       | -48,051       | -84,248 | 15,380  | -116,920                             |
| (D) International Reserves (US dollars) [(E)-(F)] <sup>3/</sup>       | 68,669             | 67,303             | 7.1        | -1,182        | 11,256  | -11,440 | -1,366                               |
| (E) Gross Reserves (US dollars)                                       | 74,110             | 83,454             | 19.3       | 1,914         | 8,922   | -1,492  | 9,344                                |
| PEMEX   |                    |                    |            | 6,420         | 10,555  | 6,295   | 23,271                               |
| Federal Government  |                    |                    |            | -3,556        | -932    | -6,873  | -11,361                              |
| Sale of US dollars to banks <sup>4/</sup>                             |                    |                    |            | -1,407        | -1,550  | -2,465  | -5,422                               |
| Other <sup>5/</sup>   |                    |                    |            | 456           | 848     | 1,552   | 2,856                                |
| (F) Liabilities with less than six months<br>to maturity (US dollars) | 5,441              | 16,151             | 126.1      | 3,096         | -2,334  | 9,949   | 10,710                               |

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.

During the third quarter, Banco de México's international reserves decreased by 11,440 million US dollars. This reduction was the result of the Ministry of Finance's purchase of 12,451 million US dollars destined to prepay foreign debt.<sup>28</sup> Resources for this purchase were obtained from the government's issuance of BONDES D for 135,051 million pesos. Simultaneously, Banco de México withdrew from circulation an equivalent amount of BREMs. As a result of these operations, the stock of international reserves and BREMs decreased, reducing both, assets and liabilities from Banco de México's balance sheet. After this operation, Banco de México has been placing BONDES D for monetary-

<sup>26</sup> Variations calculated based on the average of daily stocks.

<sup>27</sup> 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.

<sup>28</sup> Banco de México's balance sheet weekly bulletin (*Boletín Semanal sobre el Estado de Cuenta del Banco de México*), Banco de México, August 22, 2006 (available only in Spanish).

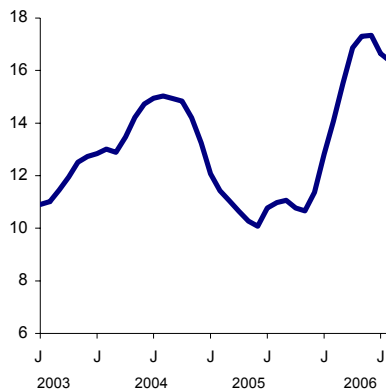
regulation purposes. With these actions, BREMs will be substituted according to their maturity date.

### 3.4.2. Monetary Aggregates and Financing

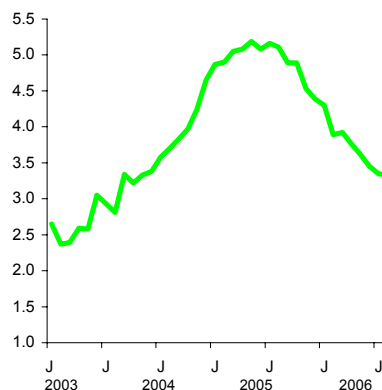
In economies where inflation declines significantly, and where such decline is perceived as permanent, remonetization processes (periods in which people gradually increase their holdings of monetary stocks) are commonly observed. This applies to the Mexican economy, where monetary aggregates have increased significantly in the last years. The growth of economic activity has also contributed to such an increase. The monetary aggregate (M1) has grown more than the broad monetary aggregates (M4). This is partly due to the decline in the opportunity cost of holding liquid financial assets (Graph 22a and Graph 22b). In particular, the spread between the interest rate of liquid deposits and time deposits has decreased since June 2005 by around 180 basis points.

**Graph 22**  
**Monetary Aggregates and Interest Rates**

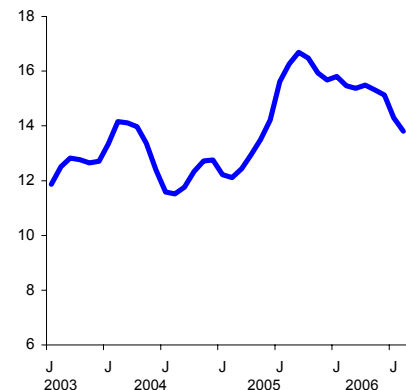
a) Monetary Aggregate M1  
Annual percentage change of trend series



b) Spread between Interest Rates on Time Deposits and Liquid Instruments<sup>1/</sup>  
Annual percent



c) Monetary Aggregate M4  
Annual percentage change of trend series



<sup>1/</sup> Defined as the difference between the cost of taking peso-denominated time deposits (*costo de captación a plazo, CCP*) and checking accounts' interest rates.

At the end of the first half of 2006 (Table 6), the annual flow of the economy's financial resources accounted for nearly one percentage point of GDP (7.9 percentage points) above that observed at the end of the first half of the previous year (7 percent of GDP). This result can be attributed to an increase in the flow of financial savings (M4), from 6.2 to 7.2 percent of GDP. Although the stock of financial savings had recorded annual variations above 13 percent since the second half of 2005 (Graph 22c), the level of this aggregate as a percentage of GDP is still low as compared with other economies (50.2 percent during the second quarter of 2006).<sup>29</sup>

The greater availability of financial resources and public sector's lesser borrowing requirements allowed an increase in available resources to finance the private sector. Annual flows of total financing to households rose from 1.9 percent of GDP during the first half of 2005 to 2.3 points during the same period of 2006.

<sup>29</sup> Financial savings account for nearly 71 percent of GDP in Brazil and 82 percent in Chile.

Total financing to firms decreased from 1 to 0.8 percent of GDP, due mainly to a reduction in foreign financing (Table 6).<sup>30</sup>

**Table 6**  
**Total Financial Resources (Uses and Sources)**  
 GDP percentage

|  | Annual Flow: 2nd Quarter |            | Stock in 2006 II |              |
|--|--------------------------|------------|------------------|--------------|
|  | 2005                     | 2006       | GDP %            | % Structure  |
| <b>Total sources</b>                                     | <b>7.0</b>               | <b>7.9</b> | <b>69.1</b>      | <b>100.0</b> |
| M4   | 6.2                      | 7.2        | 50.2             | 72.7         |
| Foreign financing  | 0.8                      | 0.7        | 18.9             | 27.3         |
| <b>Total uses</b>  | <b>7.0</b>               | <b>7.9</b> | <b>69.1</b>      | <b>100.0</b> |
| International reserves <sup>1/</sup>                     | 0.4                      | 2.1        | 9.4              | 13.6         |
| Public sector (SHRFSP) <sup>2/</sup>                     | 2.0                      | 0.6        | 34.9             | 50.5         |
| States and municipalities                                | 0.2                      | 0.1        | 1.4              | 2.0          |
| Private sector   | 2.8                      | 3.1        | 26.7             | 38.6         |
| Households   | 1.9                      | 2.3        | 12.2             | 17.7         |
| Consumption  | 1.0                      | 1.3        | 3.9              | 5.7          |
| Housing <sup>3/</sup>                                    | 0.9                      | 1.0        | 8.3              | 12.0         |
| Enterprises  | 1.0                      | 0.8        | 14.5             | 21.0         |
| Credit granted by financial intermediaries <sup>4/</sup> | 0.4                      | 0.5        | 6.2              | 9.0          |
| Debt instruments issued                                  | -0.1                     | 0.1        | 1.7              | 2.5          |
| Foreign financing  | 0.6                      | 0.2        | 6.6              | 9.5          |
| Other concepts   | 1.5                      | 2.1        | -3.2             | -4.7         |

1/ As defined by Banco de México's Law.

2/ Historical stock of Public Sector Borrowing Requirements (*Requerimientos Financieros del Sector Público, SHRFSP*), as reported by the Ministry of Finance.

3/ Total portfolio of financial intermediaries and of the National Employees' Housing Fund (*Instituto del Fondo Nacional de la Vivienda para los Trabajadores, INFONAVIT*). Includes debt-restructuring programs.

4/ Total portfolio of financial intermediaries. Includes debt-restructuring programs.

Commercial banks' credit to households and firms has exhibited a strong dynamism. Financing to households (housing and consumption) grew at a real annual rate of 56.7 percent in August 2006, similar to that observed in previous months. Credit to firms continues to recover by growing at a real annual rate of 11.4 percent during the same period.

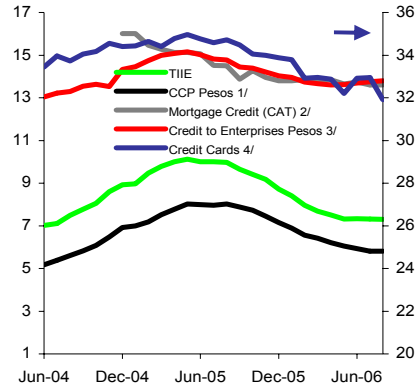
Credit to firms has mainly concentrated on the services and construction sectors. Nonetheless, credit to manufacturing has started to grow at positive rates. In August 2006, the annual flow of performing direct credit to services and construction was 46.2 billion pesos, while the flow of financing to manufacturing was 6.5 billion pesos.

Graph 23a shows the main interest rates commercial banks charge for their credits, as well as those paid by commercial banks on deposits. For example, while in August 2006 the cost of time deposits in pesos was 5.8 percent in annual terms, the average interest rate banks charged on traditional credit cards was 31.9 percent, and the interest rate for credit to firms in pesos was 13.8 percent (Graph 23b).

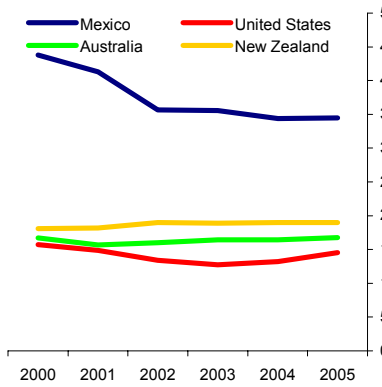
<sup>30</sup> Total financing to firms is composed of commercial banks and other financial intermediaries' credit (including debt-restructuring programs), issuance of debt instruments, and foreign financing.

**Graph 23**  
**Comercial Banks' Deposit and Lending Interest Rates in Pesos**  
**and International Comparison**  
 Annual percent

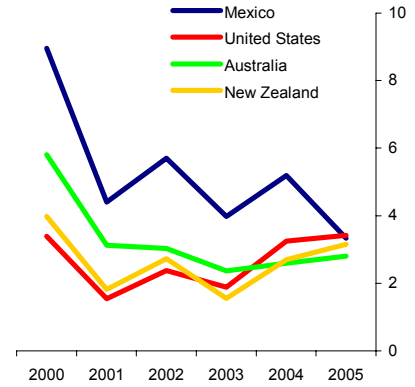
**a) Commercial Banks' Deposit and Lending Interest Rates in Pesos**



**b) Credit Card Interest Rates, Selected Countries**



**c) Consumer Price Index Variation**



1/ The cost of time deposits (*Costo de Captación a Plazo de Pasivos en Moneda Nacional, CCP*) includes commercial banks' term liabilities in pesos, except for convertible notes, guarantees, and operations between credit institutions (interbank credits). This indicator began publishing in February 1996.  
 2/ This indicator summarizes the average of the total annual cost of credit (CAT) and includes costs related to interest rates, commissions, obligatory insurance, and other financial services-related charges. Mortgage indicator figures are calculated with the Simulator of Mortgage Credits available at Banco de México's web page (<http://www.banxico.org.mx>).  
 3/ Simple monthly average of nominal interest rates of credits in pesos granted by banks to enterprises.  
 4/ Simple average of interest rates (excluding VAT) charged by banks, which includes all traditional credit card products according to the report "Bancos: tasas de interés de tarjetas de crédito" by INFOSEL.  
 Source: Banco de México, InfoSEL, Federal Reserve System, Reserve Bank of Australia, and Reserve Bank of New Zealand.

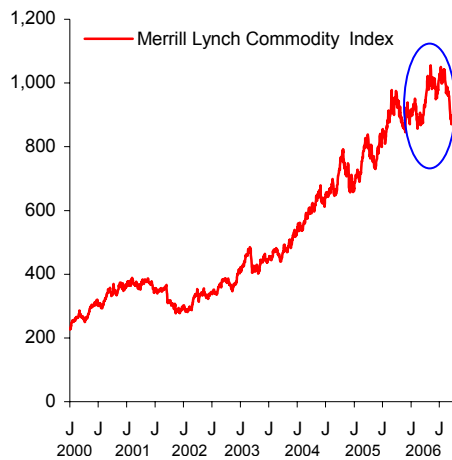
## 4. Monetary Policy

In general, during the last months, the balance of risks for world inflation has improved. Although the outlook for the global economy continues to be positive, the phase of the cycle it is currently undergoing allows for anticipating a deceleration of the world economy for the remainder of 2006 and for 2007. Moreover, the cooling of the real estate market in the U.S. has increased risks of a greater-than-expected slowdown of economic activity in that country. On another front, after having increased considerably during the second quarter, energy and other commodity prices have decreased in recent months (Graph 24). Under these conditions, medium and long-term inflation expectations in industrialized economies remain well anchored.

This environment has contributed to reduce inflationary pressures and risks worldwide and, therefore, uncertainty regarding the main central banks' monetary policy actions. In particular, markets seem to anticipate that the Federal Reserve's tightening cycle has come to an end. The aforementioned conditions have led to a reduction in long-term interest rates in the U.S.

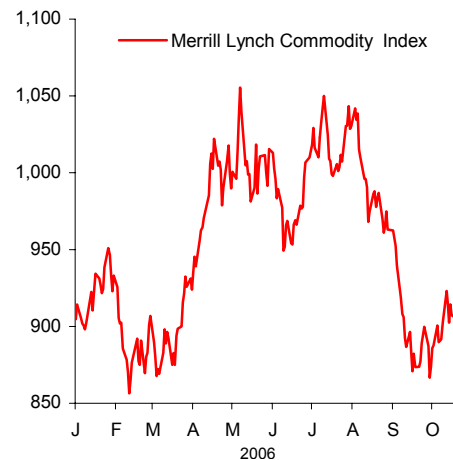
**Graph 24**  
**Commodity Price Indices**

a) Commodity Price Indices 2000-2006<sup>1/</sup>  
(1990=100)



1/ Merrill Lynch Commodity Index Extra (MLCX). Includes prices of energy, grains, copper, aluminum, and gold, among others. Source: Merrill Lynch.

b) Commodity Price Indices 2006<sup>1/</sup>  
(1990=100)



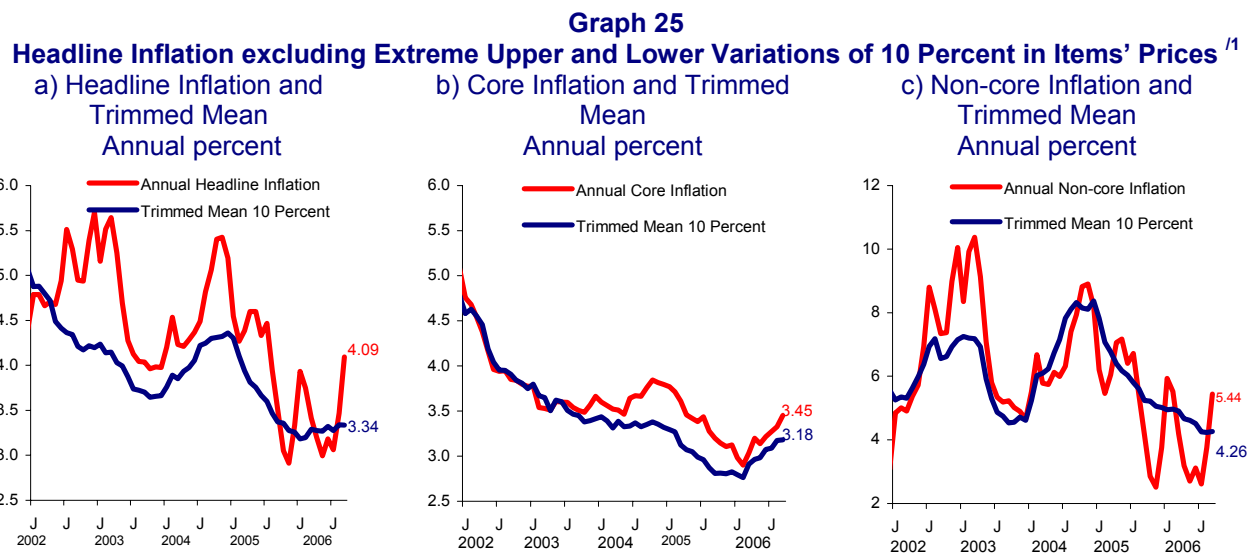
1/ Merrill Lynch Commodity Index Extra (MLCX). Includes prices of energy, grains, copper, aluminum, and gold, among others. Source: Merrill Lynch.

During the third quarter, certain supply shocks to a reduced number of food goods prompted a rebound in headline inflation in Mexico. This rebound is expected to be temporary and should not contaminate inflation expectations for longer horizons. In particular, non-core inflation was influenced by the effects of adverse weather conditions in Mexico's Northwest region on the supply of tomato, while core inflation was affected by sugar supply problems and by the impact of an increase in tortilla prices.

It should be stressed that, up to now, price increases have concentrated in the referred items and are not expected to lead to a generalized price increase.

This can be assessed by excluding the items that have had extreme variations in their prices (both the highest and the lowest) from headline inflation calculations. When extreme variations are eliminated, a trimmed mean for inflation is obtained, which is an indicator of the trend of inflation.

Graph 25a, which shows the results of this exercise, reveals two issues that must be highlighted. First, the trimmed mean of inflation follows a relatively stable path and therefore is a reliable indicator of the trend of inflation. Second, in the last month, the increase in inflation concentrated in a reduced number of items, given that the trimmed mean is below headline inflation. Graphs 25b and 25c show the results when the exercise is performed separately for core and non-core inflation. In the former case, the following results are obtained: first, the trimmed mean of core inflation has been below that observed for a long period; and, second, recently, the trimmed mean has followed a slight upward trend, although it is at levels close to 3 percent. In the case of non-core inflation, and as expected (due to the volatility of this component), the results are very similar to those for headline inflation.



<sup>1/</sup>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 upper and lower 10 percent are selected; and, iii) the contributions of the previous extreme variations are computed. 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).

Under these conditions, the rebound in inflation should not contaminate long-term inflation expectations. Graph 26 shows that although inflation expectations for the end of 2006 have increased, expectations for the following twelve months and for the end of 2007 have remained stable. Thus, analysts expect that the impact of the aforementioned supply shocks on inflation will gradually dissipate in the following months. Likewise, longer term inflation expectations have not been affected.

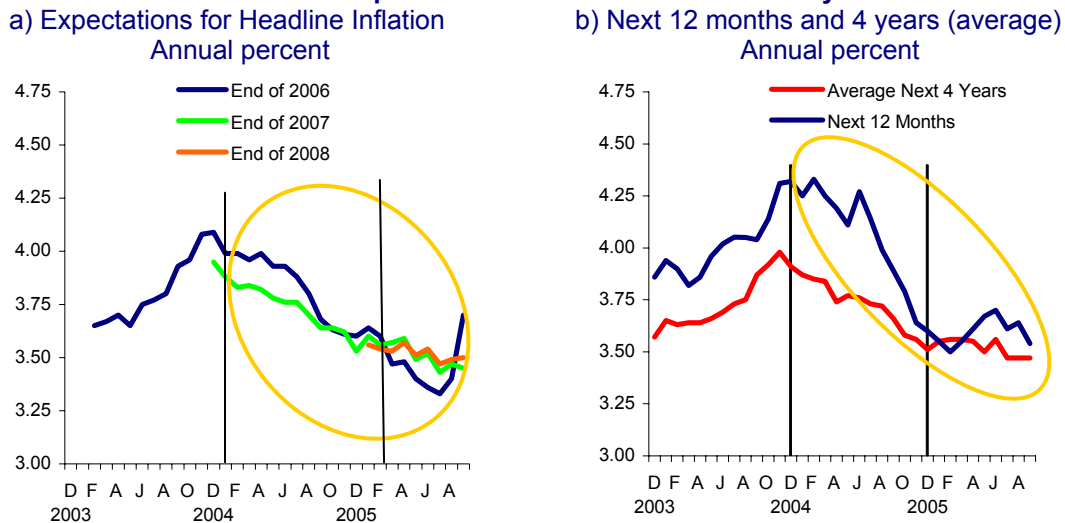
Specifically, headline inflation expectations from Banco de México's Survey in September show that although those for the end of 2006 were revised upward, from 3.36 percent in June to 3.70 percent in September, those corresponding to the end of 2007 and 2008 were revised downward, from 3.52 and 3.54 percent, to 3.45 and 3.50 percent, respectively. On the other hand, core



inflation expectations for 2006 and 2007 were around 3.30 percent. Other surveys on inflation expectations show similar results.<sup>31</sup>

**Graph 26**

**Inflation Expectations: Banco de México Survey**



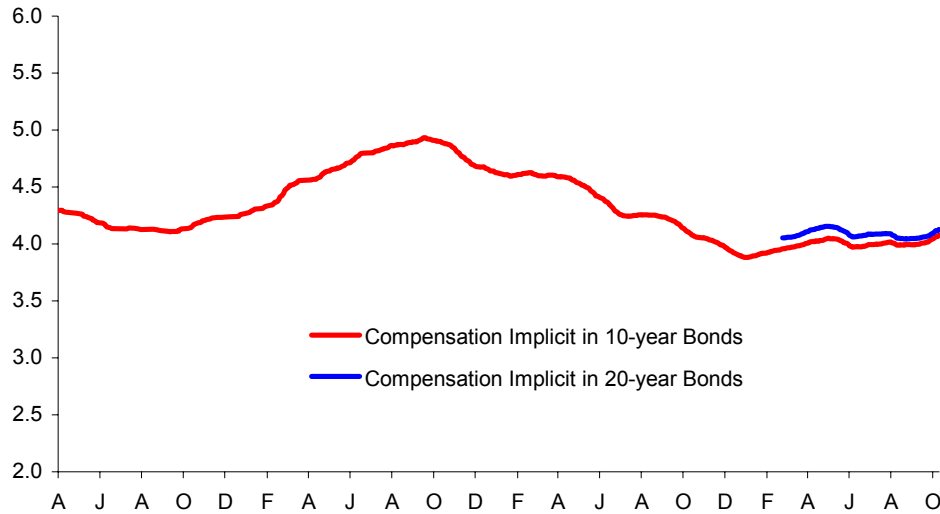
Another indicator that signals that long-term inflation expectations are well anchored can be obtained by calculating the inflation compensation (inflation expectations plus a risk premium) that investors demand for holding peso-denominated long-term bonds. Thus, when subtracting the real yield associated with 10-year indexed-debt instruments (UDIBONOS) from the 10-year bond interest rate, inflation compensation has remained stable during the year (Graph 27).

Given the abovementioned scenario, and as stated in its press releases, Banco de México's Board of Governors decided to maintain the monetary conditions unchanged during July, August, September, and October. As a result, the bank funding rate remained at 7 percent (Graph 28a). Nonetheless, the Board of Governors will stay alert that inflation expectations remain well anchored.

During the third quarter, domestic capital markets were favored by the improvement in global financial conditions. In particular, the increases in risk premia that took place in the previous quarter began to revert. In addition, the uncertainty associated with this year's elections gradually dissipated. These elements enabled the recovery of prices of several domestic assets.

<sup>31</sup> Infosel surveys show that on October 27, expectations for headline inflation were 3.96 percent for the end of 2006 and 3.47 and 3.48 for the end of 2007 and 2008, respectively. As for core inflation, expectations for the end of 2006, 2007, and 2008 were 3.41 percent, 3.23 percent, and 3.27 percent, respectively.

**Graph 27**  
**Inflation Compensation and Inflationary Risk Implicit in Long-term Bonds**  
 Annual percent, 90-day moving average

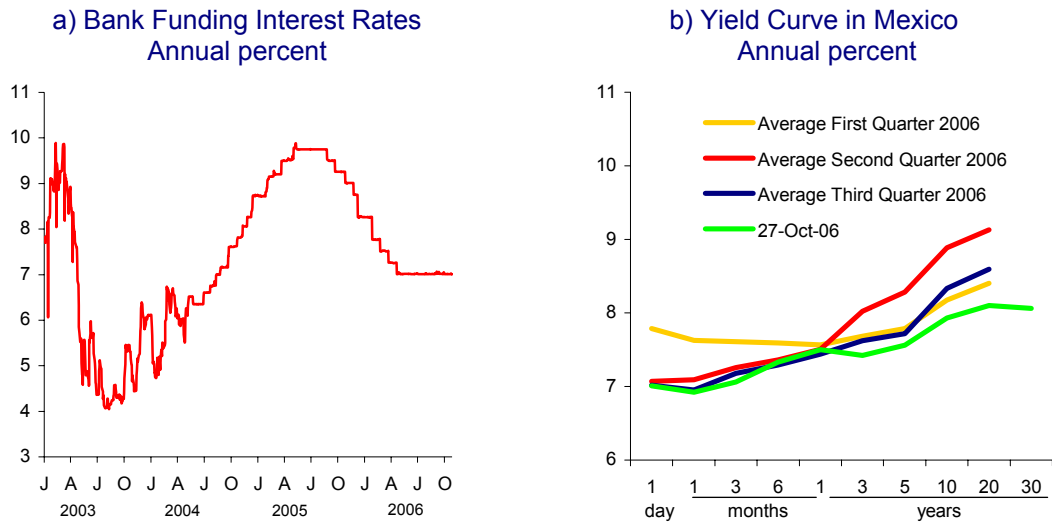


Interest rates for long-term bonds fell significantly, leading to a flattening of the yield curve (Graph 28b). The spread between the 20-year bond interest rate and the overnight bank funding rate moved from an average of 206 basis points in the second quarter, to 158 basis points in the third quarter of 2006. As part of a strategy to extend the maturity of the federal government debt, and to contribute to the development of domestic debt markets, for the first time, on October 24, a fixed-interest rate peso-denominated 30-year bond was auctioned. The rate of return of this bond (8.08 percent) was below that for the 20-year bond. Furthermore, since medium and long-term interest rates have declined more in Mexico than in the U.S., the interest rate spreads between both countries have narrowed (Graph 29).<sup>32</sup>

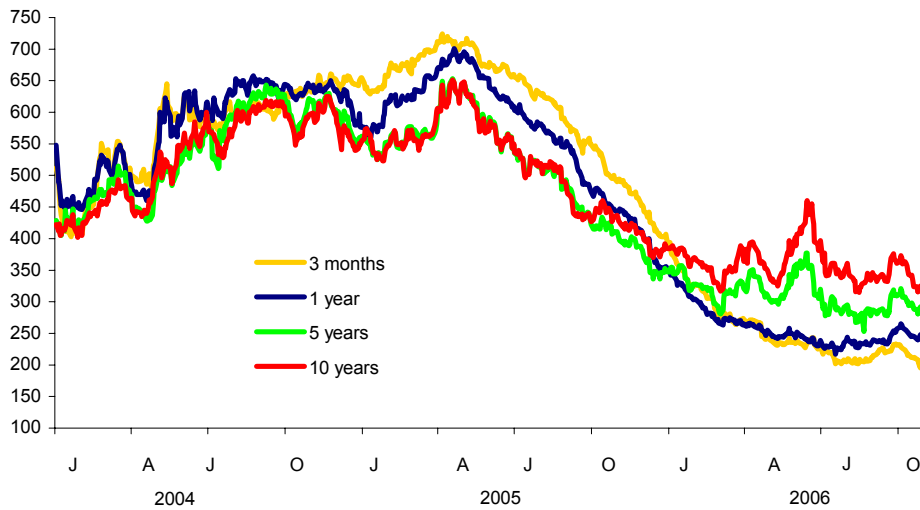
<sup>32</sup> The spread between Mexico and the U.S. 5-year interest rates moved from an average of 329 to 287 basis points, from the second quarter to the third quarter. The spread between 10-year interest bonds moved from an average of 381 to 344 basis points during the same period.



**Graph 28**  
**Interest Rates**



**Graph 29**  
**Interest Rate Spreads between Mexico and the U.S.**  
Basis points



## 5. Balance of Risks and Final Remarks

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Banco de México's expected scenario for the remainder of 2006 and 2007 is based on the following conditions:

- a) The outlook for the world economy continues to be favorable. Nonetheless, world economic expansion is expected to slow down gradually. Regarding the U.S. economy, the average of the main analysts' forecasts for growth for 2006 and 2007 are around 3.4 and 2.6 percent, while those for industrial activity are 4.4 and 3.2 percent, respectively. In consequence, the demand for Mexican exports is expected to slow down, thereby reducing the pace of economic expansion in the country.

Risks of a greater-than-expected reduction in the growth rate for the U.S. economy have increased, due to both the phase of the cycle the U.S. economy is currently undergoing and the nature of the factors that are inducing the slowdown.

- b) Although international crude oil prices have started to decline, Mexico's external accounts are expected to continue to be favored by the considerable revenues from crude oil exports. Workers' remittances are also anticipated to continue to be a significant source of revenues for the country.

In general terms, the prospects for the external environment in 2007 continue to be positive, despite the anticipated slowdown of the world economy, particularly of the U.S. economy. In this regard, the progress in macroeconomic management and the current deepening of Mexican financial markets imply that Mexico is in a sounder position to face the world economy's stage characterized by low growth.

Based on the abovementioned conditions, and on most recent information on the Mexican economy, Banco de México's baseline scenario for the rest of 2006 and for 2007 is as follows:

**GDP Growth:** GDP growth for 2006 is expected to be between 4.3 and 4.8 percent, and for 2007, between 3.25 and 3.75 percent.

**Employment:** Approximately 900 thousand jobs are expected to be created in the formal sector (number of workers insured by the IMSS) in 2006, and 750 thousand in 2007.

**Current Account:** The current account deficit of the balance of payments is expected to be 0.6 and 1.3 percent of GDP in 2006 and 2007.

**Inflation:** Annual headline inflation is expected to end the year below 4.0 percent, and annual core inflation, between 3 and 3.5 percent. Nonetheless, given the effects of supply shocks on the prices of certain foods, together with a reduced base of comparison, during October and November 2006, annual headline inflation is expected to remain at levels close to 4.5 percent. For 2007, core inflation is expected to be around 3 percent while headline inflation is

anticipated to resume its downward trend, ending the year at a level below 3.5 percent.

In particular, the following should be highlighted:

- a) As the effects of the shocks that have affected its path in the last two quarters gradually dissipate, core inflation will be subject to lesser pressures.
- b) As for inflation in services, a slower growth rate is expected in the prices of housing-related services, given that the pressures on the prices of several copper and steel-related construction materials have started to revert. This is the outcome of both a downward adjustment in the international prices of copper and certain steel by-products and the favorable settlement of labor disputes that affected the production of these materials. As for the rest of services, the annual variation of the price subindex of rest of services is expected to end 2006 at levels slightly below 4 percent.
- c) As for merchandises included in the core price subindex, the item processed foods has been recently affected by the increase in sugar prices. Under such context, these prices could decrease in the following months due to both the new sugar harvest cycle and the sugar import quotas authorized by the Ministry of the Economy (see Section 2.1 of this Report). Nonetheless, the recent price increases in certain grains could be a pressure factor for processed foods' prices. On another front, the annual variation of the prices of merchandise excluding foods is expected to remain stable around 2 percent.
- d) Non-core inflation will continue to be determined, for the most part, by the behavior of fruits and vegetables price inflation. The effects originated by the shortage of certain vegetables –whose production was affected by weather conditions– are expected to begin to fade by the end of the year (see Section 2.1 of this Report).
- e) On the other hand, the subindex of administered and regulated prices could grow at a rate similar to that observed this year, although with some differences in terms of its components. On the one hand, administered prices could put less pressure on headline inflation due mainly to the reduction in low consumption electricity tariffs and in gasoline prices at border cities. On the other hand, regulated prices could increase its incidence if public transportation fares are raised in several cities.

Summing up, annual headline inflation is expected to be below 4 percent by the end of the year. Nonetheless, this result will be mainly determined by how fast the supply shocks that affected agricultural prices revert.

As part of the assessment of inflation expectations, following are the main inflationary risks:

- i) Although the prices of energy and other raw materials have moderated recently, they are still fluctuating and remain at high levels. Agricultural prices have behaved similarly.
- ii) The growth rate of services prices remains high.

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

Although the trend of inflation has evolved as expected, short-term inflation has rebounded. The Board of Governors of Banco de México considers the unexpected pressures on certain prices to be temporary and, therefore, not to pass on to inflation expectations for 2007 and onward. However, the Board will surveil that inflation expectations remain well anchored, reiterating its intention to foster the convergence and consolidation of inflation to its target.

On another front, various risk factors prevail that could mainly affect the base scenario for economic expansion described in this section.

In recent years, real estate prices have increased considerably in several developed economies. In particular, in the U.S., this contributed significantly to strengthen households' financial balances and, therefore, their spending. Nonetheless, in recent months, real estate markets in the U.S. have lost dynamism and this trend is expected to continue. Should this sector undergo a major and/or sudden correction, household spending, and, consequently, the pace of economic activity could be significantly affected. This scenario would undermine industrial production in the U.S., and, therefore, the demand for Mexican non-oil exports. Under such setting, economic activity and job creation in Mexico would be affected more negatively than currently expected.

The risk of an abrupt adjustment to the cumulated global imbalances cannot be ruled out. The U.S. current account deficit continues to widen. Nonetheless, this is a medium-term risk factor.

As pointed out in other Inflation Reports, the loss of competitiveness is an element that has affected the rate of growth of the Mexican economy and, therefore, the creation of more and better jobs. In particular, progress has not been sufficiently attained in strengthening the domestic sources of growth, and, therefore, the country's potential has not been fully exploited. Mexico's decline in the different international scales of competitiveness, and investment attractiveness among countries, reveals the costly effect of postponing the necessary economic and institutional changes required by the country. Many nations have actively become part of the globalization process, implementing significant changes in their economies. Consequently, the need to undertake the necessary reforms to increase the flexibility and competitiveness of Mexico's industry becomes even more urgent. If these relevant issues are not tackled, the fight against some of the country's endemic problems, such as poverty and the highly unequal distribution of income, will be considerably more difficult.

## 6. Monetary Policy Announcements

### 6.1. Calendar of Monetary Policy Announcements

According to Banco de México's guidelines,<sup>33</sup> following is the calendar of monetary policy announcements, monetary policy press releases, and inflation reports for 2007.

#### Calendar of Monetary Policy Announcements, Monetary Policy Press Releases, and Inflation Reports for 2007

| Month     | Monetary Policy Announcements and Press Releases | Inflation Reports |
|-----------|--|-------------------|
| January   | 26   | 31 <sup>1/</sup>  |
| February  | 23   |                   |
| March     | 23   |                   |
| April     | 27   | 30                |
| May       | 25   |                   |
| June      | 22   |                   |
| July      | 27   | 31                |
| August    | 24   |                   |
| September | 21   |                   |
| October   | 26   | 31                |
| November  | 23   |                   |
| December  | 7  |                   |

<sup>1/</sup> Includes the Monetary Program for 2007.

<sup>33</sup> Inflation Report July-September 2005.