

# Inflation Report

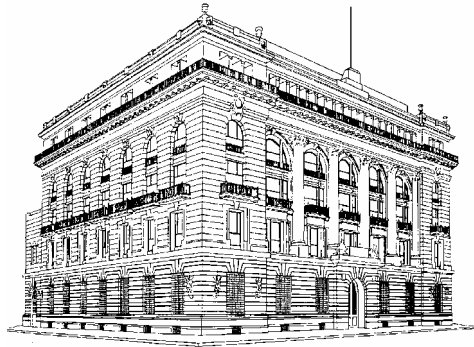
*October – December 2005*

and

# Monetary Program

*for 2006*

---



BANCO<sup>DE</sup>MEXICO

---

JANUARY 2006



*BOARD OF GOVERNORS*

**Governor**

GUILLERMO ORTIZ MARTÍNEZ

**Deputy Governors**

EVERARDO ELIZONDO ALMAGUER

GUILLERMO GÚÉMEZ GARCÍA

JESÚS MARCOS YACAMÁN

JOSÉ JULIÁN SIDAOUI DIB



## **FOREWARNING**

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

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



## CONTENTS

### Inflation Report October-December 2005

|   |           |
|---|-----------|
| <b>1. Introduction .....</b>  | <b>1</b>  |
| <b>2. Recent Developments in Inflation .....</b>                            | <b>3</b>  |
| 2.1. Inflation .....  | 5         |
| 2.2. Producer Price Index.....  | 6         |
| <b>3. Main Determinants of Inflation .....</b>                              | <b>7</b>  |
| 3.1. International Environment .....  | 7         |
| 3.1.1. Global Economic Activity .....                                       | 7         |
| 3.1.2. General Trends of Inflation .....                                    | 8         |
| 3.1.3. Financial Markets.....   | 10        |
| 3.1.4. Outlook .....  | 11        |
| 3.2. Aggregate Demand and Supply .....                                      | 12        |
| 3.2.1. Indicators of Aggregate Demand and Supply .....                      | 12        |
| 3.2.2. Employment.....  | 15        |
| 3.2.3. External Sector .....  | 18        |
| 3.3. Costs and Prices .....   | 20        |
| 3.3.1. Wages and Unit Labor Costs .....                                     | 20        |
| 3.3.2. Administered and Regulated Prices of Goods<br>and Services .....     | 21        |
| 3.3.3. Metals and Food Raw Materials .....                                  | 23        |
| 3.4. Monetary and Credit Aggregates.....                                    | 24        |
| 3.4.1. Monetary Base, Net Domestic Credit and<br>International Assets ..... | 24        |
| 3.4.2. Monetary Aggregates and Financing .....                              | 25        |
| <b>4. Monetary Policy .....</b>   | <b>29</b> |
| <b>5. Balance of Risks and Final Remarks .....</b>                          | <b>32</b> |

### Monetary Program for 2006

|   |           |
|---|-----------|
| <b>Monetary Program for 2006 .....</b>  | <b>35</b> |
| 1. Objectives.....                      | 35        |
| 2. Monetary Policy Decisions .....      | 35        |
| 3. Monetary Policy Implementation ..... | 36        |
| 4. Communication Policy .....           | 36        |







## 1. Introduction

---

During 2005, the world economy exhibited a favorable performance and the outlook for growth continues to be positive. The U.S. economy is expected to continue to expand significantly at a rate close to potential. The strength of world economic growth -particularly of some Asian economies that make intensive use of energy goods in their productive processes- together with restrictions to increase the supply of these products, led to a significant increase in energy prices during 2005. The hurricanes that affected the supply of some energy goods during the second half of the year also contributed to such results.

Although price increases of crude oil have been a source of inflationary pressures worldwide, the effects of such pressures have been limited, while core inflation indicators have remained at moderate levels. This has allowed long-term inflation expectations to be contained.

International financial markets remained loose. Under such context, sovereign spreads for some emerging economies recorded historically low levels during the last quarter of 2005. Thus, prevailing conditions in international financial markets have contributed to the appreciation of assets and currencies in emerging economies.

Most recent indicators allow for anticipating that in 2005 the Mexican economy grew around 3 percent, figure below that recorded during the previous year. The latter was due to the slower growth rate of aggregate demand, mainly as a result of a slowdown of external demand. In particular, manufacturing exports have been affected by both the decrease of industrial activity in the U.S. and the loss of competitiveness of Mexican products. Nonetheless, automotive production and exports have rebounded in the last months, due to the beginning of the productive cycle of new models of certain car manufacturers in the country. GDP is expected to grow at a real rate between 3.2 and 3.7 percent in 2006.

Headline inflation decreased significantly throughout 2005, reaching 3.33 percent in December. This mainly reflects both the reversion of the supply shocks that affected the economy in 2004 and the effects of the monetary policy actions. The atypical behavior of the prices of certain fruits and vegetables also contributed to the swift reduction of inflation in the last months of 2005. Core inflation, which is a better indicator of the medium-term trend of headline inflation, fell significantly, reaching an annual variation of 3.12 percent at the end of 2005. These results have contributed to a reduction in inflation expectations for all terms.

Headline inflation is expected to reach levels close to 4 percent in the first months of 2006, as a result of the inherent volatility of the fruits and vegetables price subindex. However, headline inflation is anticipated to be between 3 and 3.5 percent towards December 2006. Core inflation is expected to remain close to 3 percent throughout 2006.

Although the Mexican economy faces favorable external and domestic conditions, the outlook for both inflation and growth is not exempt of risks. Among these are the high prices of energy goods, and the wide deficit in the U.S. external



accounts. Different geopolitical risks also deserve mention, in particular, the probability that some uncertainty regarding federal elections by mid-year may arise.

Summing up, the evident improvement in the inflationary outlook for the Mexican economy and a benign global financial environment have created favorable conditions for the Board of Governors of Banco de México to begin to revert its stance of monetary astringency adopted during 2004 and in the first half of 2005.

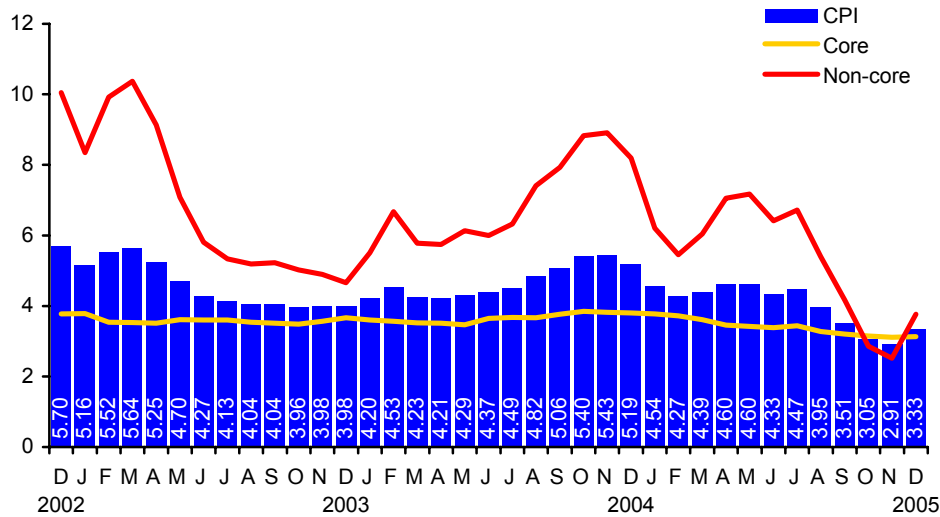
A lesser restrictive monetary policy is congruent with the reduction of inflation and its expectations. Nonetheless, although significant improvements have been observed regarding inflation abatement, inflation expectations are still above the 3 percent target set by Banco de México. Under such context, monetary policy will continue to focus on propitiating the convergence of inflation to its target.

## 2. Recent Developments in Inflation

During 2005, the behavior of inflation mainly reflected the effect of two factors: first, the reversion of the multiple supply shocks that affected the economy during 2004 and, second, the monetary policy actions adopted. These actions were geared towards both preventing the referred shocks from contaminating the price determination process and fostering favorable conditions for the reduction of core inflation.

In particular, annual headline inflation in 2005 exhibited a converging trajectory with the 3 percent target and, starting August, it remained within the variability interval of plus/minus one percentage point determined around such target. In December, the referred indicator was 3.33 percent, 1.86 percentage points below the level recorded during the same month of the previous year (Graph 1). Headline inflation's behavior was mainly influenced by its non-core component. Core inflation also decreased significantly (Table 1).

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

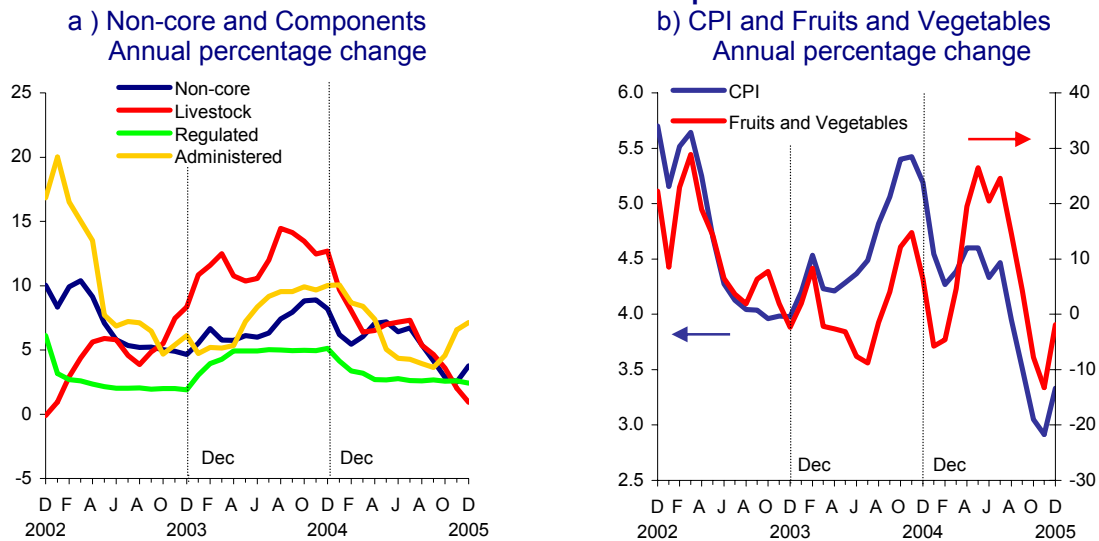


During 2005, the annual growth rate of the non-core price index followed a declining trend, falling by December 2005 4.44 percentage points below the level reached at the end of 2004, from 8.20 to 3.76 percent. This result was mainly determined by the significant reduction in the growth rates of both agricultural and regulated prices, as well as by the relatively contained passthrough of the surge in international energy prices to its domestic counterparts. Additionally, non-core annual inflation fluctuated significantly during 2005, being fruits and vegetables the price subindex that exhibited the highest volatility (Graph 2 and Table 1).

**Table 1**  
**CPI Components**  
Annual percentage change

|                                   | Dec-2004<br>(a) | Sep-2005<br>(b) | Oct-2005<br>(c) | Nov-2005<br>(d) | Dec-2005<br>(e) |
|-----------------------------------|-----------------|-----------------|-----------------|-----------------|-----------------|
| <b>CPI</b>                        | <b>5.19</b>     | <b>3.51</b>     | <b>3.05</b>     | <b>2.91</b>     | <b>3.33</b>     |
| <b>Core</b>                       | <b>3.80</b>     | <b>3.20</b>     | <b>3.14</b>     | <b>3.11</b>     | <b>3.12</b>     |
| <b>Merchandise</b>                | <b>3.87</b>     | <b>3.05</b>     | <b>2.91</b>     | <b>2.84</b>     | <b>2.82</b>     |
| Food                              | 7.04            | 4.53            | 4.18            | 3.97            | 3.69            |
| Other                             | 1.69            | 1.99            | 2.00            | 2.02            | 2.19            |
| <b>Services</b>                   | <b>3.72</b>     | <b>3.37</b>     | <b>3.40</b>     | <b>3.41</b>     | <b>3.46</b>     |
| Housing                           | 3.70            | 2.37            | 2.51            | 2.53            | 2.55            |
| Other                             | 3.74            | 4.58            | 4.48            | 4.46            | 4.55            |
| <b>Non-core</b>                   | <b>8.20</b>     | <b>4.17</b>     | <b>2.85</b>     | <b>2.52</b>     | <b>3.76</b>     |
| <b>Agriculture</b>                | <b>10.11</b>    | <b>4.53</b>     | <b>-1.05</b>    | <b>-4.31</b>    | <b>-0.18</b>    |
| <b>Fruits and Vegetables</b>      | <b>6.43</b>     | <b>4.35</b>     | <b>-7.75</b>    | <b>-13.25</b>   | <b>-1.86</b>    |
| Tomato                            | 23.24           | -26.65          | -51.40          | -60.26          | -23.18          |
| Other                             | 2.51            | 11.75           | 6.51            | 3.39            | 4.12            |
| <b>Livestock</b>                  | <b>12.69</b>    | <b>4.65</b>     | <b>3.58</b>     | <b>2.01</b>     | <b>0.93</b>     |
| <b>Administered and Regulated</b> | <b>7.51</b>     | <b>3.14</b>     | <b>3.54</b>     | <b>4.57</b>     | <b>4.76</b>     |
| <b>Administered</b>               | <b>10.02</b>    | <b>3.65</b>     | <b>4.58</b>     | <b>6.57</b>     | <b>7.13</b>     |
| Low-octane gasoline               | 5.42            | 3.73            | 3.81            | 3.52            | 4.47            |
| High-octane gasoline              | 8.47            | 3.40            | 3.62            | 3.42            | 4.39            |
| Electricity                       | 9.15            | -4.48           | -2.57           | 3.76            | 4.27            |
| Residential-use gas               | 18.27           | 12.31           | 13.70           | 14.89           | 14.79           |
| <b>Regulated</b>                  | <b>5.13</b>     | <b>2.68</b>     | <b>2.58</b>     | <b>2.60</b>     | <b>2.43</b>     |
| <b>Education</b>                  | <b>7.50</b>     | <b>6.65</b>     | <b>6.64</b>     | <b>6.64</b>     | <b>6.63</b>     |

**Graph 2**  
**Non-core Price Index and Components**



Core inflation fell significantly, reaching at the end of the year an annual variation of 3.12 percent, 0.68 percentage points below the figure observed in December 2004. The declining trend of core inflation was mainly influenced by the slower growth rates of processed food prices and housing-services prices (Graph 3).

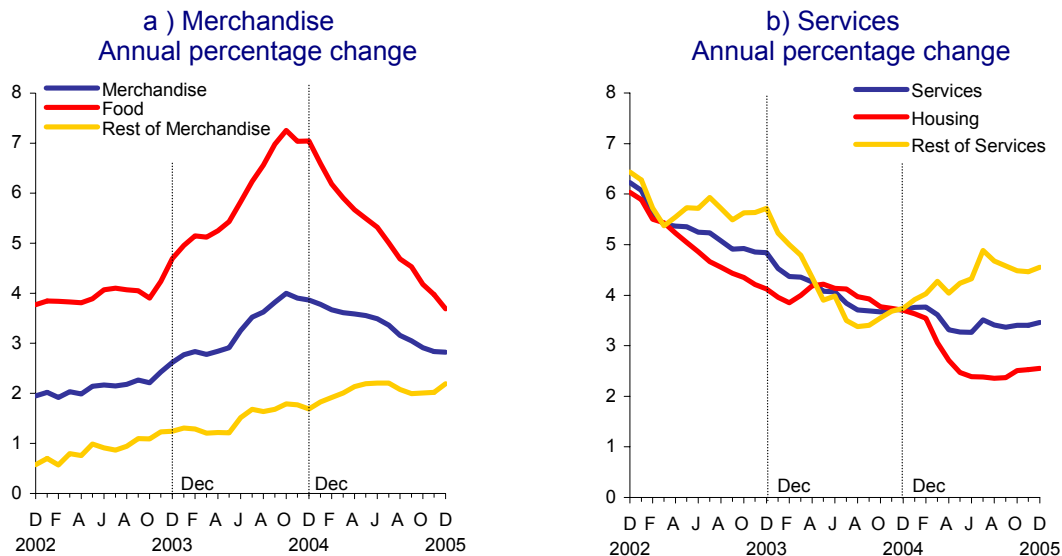
Processed food prices increased in 2005 at a lower rate than in the previous year. In general terms, the reduction in the annual variation of these

prices was based, among other factors, to the low levels observed in the international prices of grains and meat products, which remained at levels below those observed in 2004. As a result, the reduction in food inflation in Mexico reflected the diminished pressures on international prices.

The annual variation of the core services subindex decreased during 2005 due to the lower contribution of housing services inflation during the first eight months of the year. This reduction is associated with a greater supply of housing -which has contributed to moderate the increase in rents- and with the fall in the prices of certain construction materials. Among the latter, one of the most important was the price of steel, which had increased significantly during 2004.

In contrast, non-housing services inflation continued to be influenced adversely by the lagged effects of the increase in food prices observed during 2004, and therefore followed an upward trend.<sup>1</sup> However, such trend began to revert in August (Graph 3).

**Graph 3**  
**Merchandise and Services Core Subindexes**



**2.1. Inflation**

During the fourth quarter of 2005, annual headline inflation remained at levels close to 3 percent, although exhibiting some volatility. In October, November and December it posted 3.05, 2.91 and 3.33 percent, respectively. Annual core inflation exhibited more stability, reaching in the referred months 3.14, 3.11 and 3.12 percent, respectively. Volatility exhibited by headline inflation was determined by the behavior of CPI's non-core component, particularly by the fluctuations recorded by the annual variation of fruits and vegetables' prices. Such result mainly responded to the adverse weather during the second half of 2004, which damaged a reduced number of vegetables. As a result, prices of fruits and vegetables recorded very high variation rates in the in the last quarter of 2004,

<sup>1</sup> This responds to the fact that processed foods are an important input for food services and their prices have a lagged effect on such services.

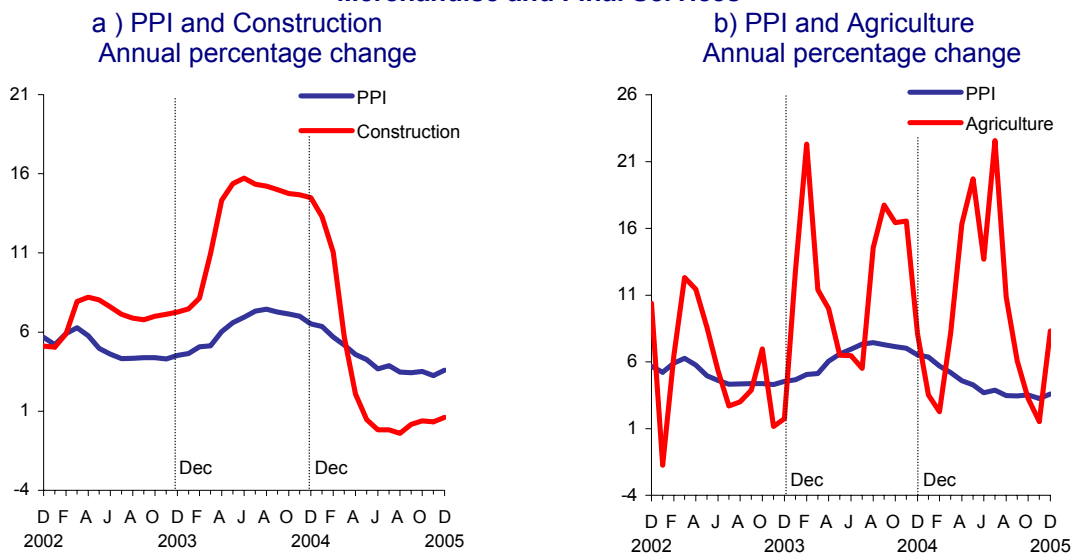
affecting the comparison base for the calculation of annual inflation during the same period of 2005. Consequently, the referred subindex exhibited lower annual variations by the end of the year. On another front, the subindex of administered prices had an increasing contribution to headline inflation during the reference period, due mainly to a jump in the annual growth rate of high consumption electricity tariffs (Table 1).

## 2.2. Producer Price Index

During 2005, Producer Price Index (PPI) inflation excluding oil followed a downward trend, reaching 3.59 percent at the end of the year. The most significant reduction was observed during the first half of the year and was influenced by a slower growth rate of the construction price subindex (Graph 4a).

In October, November and December 2005, the PPI grew at an annual rate of 3.51, 3.26 and 3.59 percent, respectively. Fluctuations observed during this period were attributed to changes in the corresponding growth rate of agricultural prices. The same phenomenon was observed in the CPI (Graph 4b).

**Graph 4**  
**Producer Price Index Excluding Oil:**  
**Merchandise and Final Services**



## 3. Main Determinants of Inflation

---

### 3.1. International Environment

The world economy continued to exhibit vigorous growth at the end of 2005, boosted mainly by the expansion of production in the main industrial countries and some emerging economies, particularly China. Although the fall in oil prices in the last months of 2005 led to a decline in the rate of inflation in several economies, the risk of inflationary pressures continued to be a cause of concern for the authorities of a number of countries. In this context, the Federal Reserve continued its policy of gradual increases in the federal funds rate. In December, the European Central Bank raised its policy interest rates for the first time in five years. Despite higher short-term interest rates, emerging economies continued to benefit from very favorable conditions of access to international financial markets.

#### 3.1.1. Global Economic Activity

Global economic activity continued to grow vigorously during the last months of 2005. In some regions, such as the euro area and Japan, growth rebounded since the beginning of the second semester, and prospects for future growth also improved. The strengthening of production in these economies allowed for a broadening of the world economy's sources of growth.

During the third quarter, U.S. GDP grew at an annualized quarterly rate of 4.1 percent (3.6 percent at an annual rate), thus surpassing expectations despite the damage caused by the hurricanes that struck the Gulf of Mexico. Nonetheless, during the fourth quarter, the pace of GDP growth moderated significantly, by posting an annualized quarterly rate of 1.1 percent (3.1 percent at an annual rate). This seems to be associated to a large extent to temporary factors, including the lagged effect of the hurricanes. Due to its relevance for Mexico, it is important to mention that industrial production recovered during the October-December period, after having fallen in September, as a result of the hurricanes and the strike at an important aeronautical company. Thus, during the year, industrial activity grew 3.1 percent as compared with 2004 –rate close to its historical average.

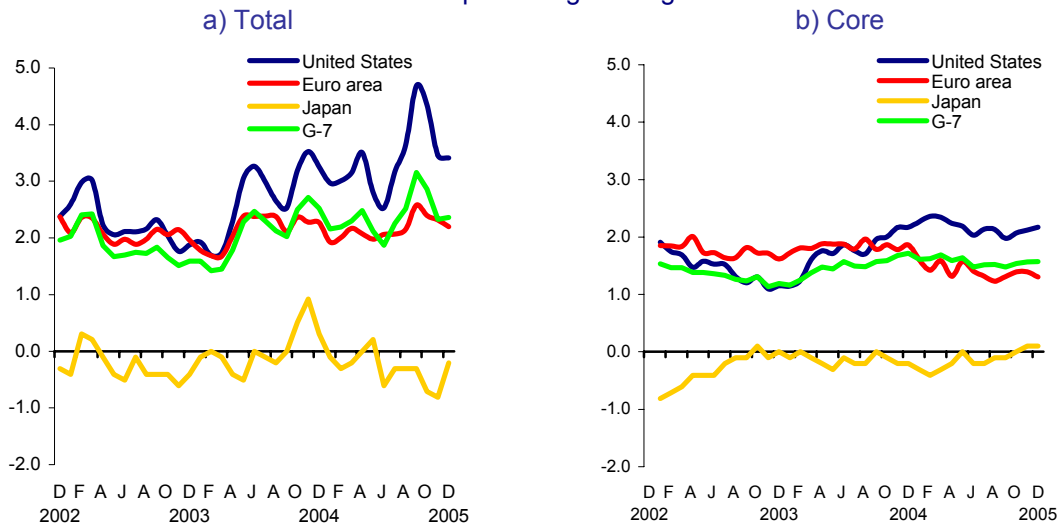
Economic activity in the euro area rebounded during the third quarter: GDP grew 2.6 percent at an annualized quarterly rate (1.5 percent at an annual rate). This improvement is explained both by a strengthening of the external sector and the growth of domestic demand –particularly of investment. Recent data suggests that economic activity remained strong during the fourth quarter of 2005, partly reflecting the dynamism of global demand. In Japan, GDP grew less than expected (1.0 percent at an annualized quarterly rate) during the July-September period. Such result is attributed to the lower contribution of inventories, given that both household consumption and private investment remained strong. Available information suggests a recovery in GDP growth during the fourth quarter of 2005.

Asian emerging economies also exhibited solid growth during the second half of 2005. In China, GDP rose 9.9 percent at an annual rate during the fourth quarter (after having increased 9.8 percent during the third), mainly as a result of the performance of exports and investment. As for Latin America, although economic activity continued to show dynamism, it expanded at a more moderate rate than in the previous year -the most noteworthy case being Brazil.

### 3.1.2. General Trends of Inflation

Inflation moderated in several countries during the last months of 2005 (Graph 5). Moreover, core inflation and long-term inflation expectations remained at relatively low levels. No significant wage-related pressures were observed in the main economies. Thus, oil price increases during the first nine months of the year apparently have not generated second round effects that could have a more lasting impact on inflation.

**Graph 5**  
**Consumer Price Index <sup>1/</sup>**  
**Annual percentage change**



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

<sup>1/</sup> Original series, not seasonally adjusted.

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

The downward trend followed by global inflation during the fourth quarter was mainly determined by the behavior of oil prices. After having followed an upward trend throughout 2005 and having reached record highs during the third quarter, international prices of crude oil fell on average during the October-December period, albeit exhibiting some fluctuations during that period. These results reflected the gradual fading of the impact of the hurricanes that struck the Gulf of Mexico, the moderation in the growth rate of crude oil demand, and an improvement in oil supply levels. The price of WTI oil averaged 60 US dollars per barrel during the quarter; i.e., 3.4 US dollars below the figure observed in the previous quarter. It is important to note that the persistent restrictions to an increase in oil production capacity, the expected recovery of demand and the presence of speculative factors point to the continuation of high crude oil prices during the coming months.



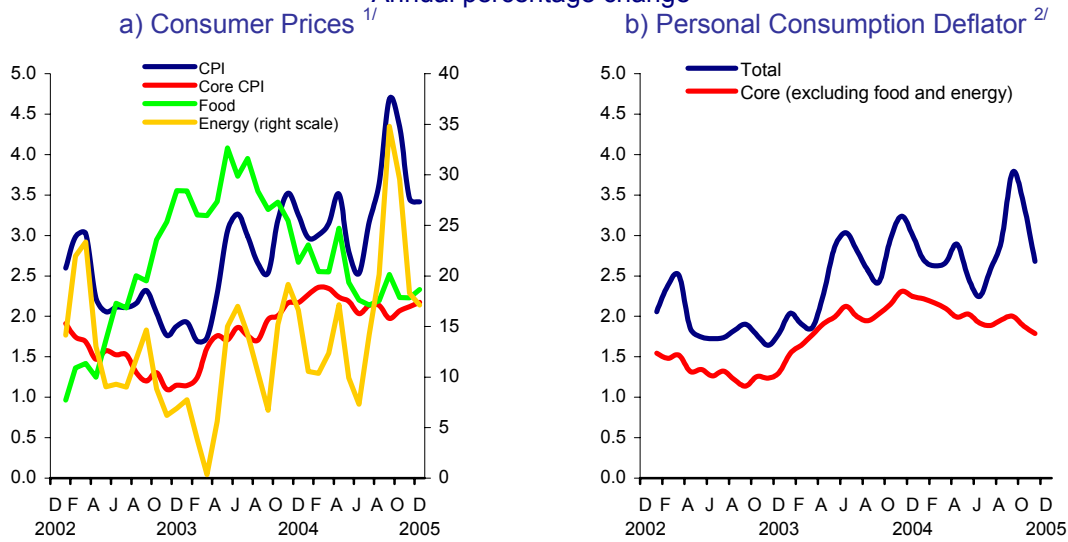
During the last quarter, the prices of certain non-oil commodities, such as metals, rose significantly. Nonetheless, prices of other commodities, such as food and beverages, declined during the October-December period. Overall, commodity prices, including crude oil, fell during the period under analysis.

In this context, U.S. headline inflation moderated during the fourth quarter. Thus, annual CPI inflation decreased from 4.7 percent in September to 3.4 percent in December (Graph 6). Similarly, the annual variation of the personal consumption deflator fell from 3.8 percent in September to 2.7 percent in November. Core inflation indexes recorded lower figures, fluctuating around 2 percent during the second half of the year, while long-term inflation expectations remained around 2.5 percent. Headline inflation is expected to converge to the latter figure once the effects of the increase in energy prices fade.

**Graph 6**

**U.S.: Price Indexes**

Annual percentage change



Source: BLS.  
1/Original series, not seasonally adjusted.

Source: BLS.  
2/ Seasonally adjusted series.

In the U.S., historically, the larger pressures on core inflation have originated from the prices of services.<sup>2</sup> This trend has become more evident in recent years, as the core merchandise component, which excludes food and energy, has recorded very low annual variations -currently close to zero. The reduced increases in this component reflect to a large extent the high rate of productivity growth in the manufacturing sector and the more intense competition in these products worldwide.

A gradual decrease in inflationary pressures was also observed in the euro area throughout the fourth quarter. The annual rate of increase of consumer prices decreased from 2.6 percent in September to 2.2 percent in December, figure still above the European Central Bank's reference value. In Japan, signs pointing to an end of the deflationary process were observed: core inflation recorded a positive annual variation in November and December (0.1 percent in each month), which had not been observed in more than two years. However, this

<sup>2</sup> This is due to the fact that both, its weight (71 percent of total core inflation) and its average rate of historical inflation are higher than those corresponding to merchandises.

result could be biased upwards by the increase in energy prices. Regarding the emerging economies, the low growth rate of prices in China (annual rate of 1.6 percent in December), as well as the rebound of inflation in some Latin American countries -especially in Argentina - towards the end of the year deserve mention.

Some central banks are concerned about the increasing demand-related pressures on inflation that could originate in a context of solid growth. Risks vary from one country to another. While in certain economies, such as those of the euro area and Japan, significant margins of unused industrial capacity prevail, in other cases, especially the U.S., the authorities have recently pointed out that a greater utilization of resources could lead to an increase in inflationary pressures.

### 3.1.3. Financial Markets

Despite the overall moderation of inflation in the fourth quarter as compared to the third, some of the world's main central banks continued to be concerned about possible upward inflationary risks.

The Federal Reserve Bank raised its target for the federal funds rate by 25 basis points in each of the two meetings of the Federal Open Market Committee during the quarter. Thus, such rate reached 4.25 percent in December -its highest level since May 2001. In its last press release of the year, the Committee mentioned that although core inflation has remained relatively low and long-term inflation expectations are contained, the likely increase in resource utilization and the high prices of energy could generate inflationary pressures. The Committee considered that additional policy measures would likely be needed to keep risks to the attainment of both sustained growth and price stability roughly in balance. In addition, the reference made on previous occasions to the withdrawal of the monetary stimulus at a moderate pace was eliminated, emphasizing that future decisions would be determined by changes in economic prospects. Markets interpreted this announcement as a sign that the process of increases in the federal funds rate will come to an end shortly. The futures curve for the federal funds rate currently anticipates that the Federal Reserve will continue to increase its target rate during the first half of 2006, although at a slower pace than in 2005.

In the euro area, the persistence of inflationary risks, mainly related to the trajectory of oil prices and its potential effects, prompted the European Central Bank to increase its policy interest rates by 25 basis points in December. This represents the first modification of these rates in more than two years and the first increase in more than five. In Japan, many analysts expect the deflationary process to end during 2006 and, consequently, a revision of the monetary policy stance of the Bank of Japan.

Despite the recent increase in short-term interest rates in industrialized economies, overall long-term interest rates remained at low levels. For example, the yield on 10-year U.S. Treasuries was 4.35 percent at the end of the quarter. Although the causes of this phenomenon are complex, in general terms, the spread between long and short-term interest rates tends to decrease in the higher stages of the business cycle, leading to a tightening of monetary policy.<sup>3</sup> During

---

<sup>3</sup> In fact, the spread between 10-year interest rates and some of shorter maturities has recently recorded negative figures in the U.S. In the past, an inverted yield curve was considered as a leading indicator of a recession. Nonetheless, for different reasons, most analysts consider that it would be a mistake to establish a link of such a sort on this occasion.

2005, the spread averaged 1.05 percentage points and reached 30 basis points in December, its lowest level since the beginning of 2001.

The ample liquidity and higher risk appetite in financial markets continued to favor emerging economies. The latter combined with a decline in external borrowing requirements in many of them, thus contributing to a reduction in sovereign risk spreads (EMBI Global), which reached record lows in November 2005, despite the increase in short-term interest rates in the U.S.<sup>4</sup> Several emerging economies took advantage of such a favorable environment to reduce the share of their foreign currency debt, extend the average maturity of their liabilities and cover their external borrowing requirements for 2006. As a result, gross financing to these countries through bonds, loans and equities rose to record levels in 2005.

As for foreign exchange markets, during the quarter the US dollar appreciated in relation to the main currencies, despite the widening of the trade deficit in that country. The nominal effective exchange rate of the US dollar against the main currencies appreciated 2.0 percent during the October-December period and 8.4 percent during the year. On the other hand, the main stock markets had a positive performance during the quarter, especially since November, when uncertainty in oil markets began to decline. Unlike the situation observed in other industrialized economies, the U.S. stock markets recorded a modest improvement.

#### 3.1.4. Outlook

In general terms, analysts expect the world economy to have a good performance in 2006. The main brokerage firms anticipate U.S. GDP's growth rate to slow down slightly, from 3.5 percent in 2005 to 3.4 percent in 2006. The U.S. industrial sector is expected to continue to recover during the next months, and to grow at a rate of 3.4 percent in 2006. The favorable performance of economic activity is expected to be accompanied by lower inflationary pressures. Analysts expect CPI inflation to decline at an annual average rate, from 3.4 percent in 2005 to 2.8 percent in 2006.

The lower growth forecasted for the U.S., the improvement in the economic outlook for the euro area and Japan, and the expected trajectory of economic activity in China suggest that during 2006 the recent trend towards more diversified sources of world economic growth will continue. GDP in the euro area is expected to grow at a faster rate (1.9 percent in the year), while a dynamic expansion of economic activity is anticipated in Japan (2.2 percent). At the same time, the Chinese economy is expected to reduce its growth rate, from 9.9 percent in 2005 to 8.7 percent this year. In general terms, analysts consider that this scenario will also be accompanied by moderate inflation. While the rate of inflation is expected to be stable in the euro area (around 2 percent), it is projected to be slightly positive in Japan and moderately higher in China.

Risks mentioned repeatedly by analysts and international organizations regarding this scenario continue to prevail, particularly those associated with external disequilibria. Forecasts show that the U.S. current account deficit as a share of GDP will remain high during 2006. Although demand for U.S. assets from

---

<sup>4</sup> The EMBI posted a new record low at the beginning of 2006.

the rest of the world has provided, up to now, the necessary flow of capital to finance such deficit, the likelihood of a significant correction cannot be discarded. On the other hand, risks associated with the higher prices of real estate in the U.S., whose correction could negatively affect both residential investment and consumption expenditure, also prevail. In addition, despite the fact that the impact of surging oil prices on growth and core inflation worldwide has been limited, risks associated with a new rebound in such prices should not be ignored, especially in a context of narrow margins of idle capacity in oil markets, high demand for crude oil and geopolitical turmoil.

## **3.2. Aggregate Demand and Supply**

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

During 2005, aggregate demand and GDP grew at a lower rate than in 2004. In general terms, aggregate demand was characterized by the following: i) consumption expenditure grew slightly below 2004 figures; ii) investment grew at a similar rate than that observed during the previous year. However, within its components, private investment grew at a moderate rate, while public sector investment did so at a higher rate; and, iii) overall, exports of goods and services grew at a slower rate during the year, albeit recovering during the last months. Just like in 2004, during 2005 the performance of domestic expenditure and economic activity benefited from the significant increase in Mexico's oil trade balance surplus and by revenues from workers' remittances. Workers' remittances have become very important for private consumption expenditure as confirmed by the total inflow of remittances received in 2005, which was equivalent to one third of wage earnings in the formal sector of the economy. In some states, workers' remittances exceeded formal wage earnings.

Indicators of aggregate demand exhibited the following developments during the fourth quarter of 2005: a) indicators of private consumption expenditure recorded annual rate increases, below those recorded in the first three quarters of the year (Graph 7);<sup>5</sup> b) investment grew at an annual rate, close to that observed in the first nine months of the year;<sup>6</sup> and, c) non-oil exports exhibited greater dynamism, mirroring the improvement of external demand. Such improvement included the different export sectors; however, the most noteworthy was automotive exports.

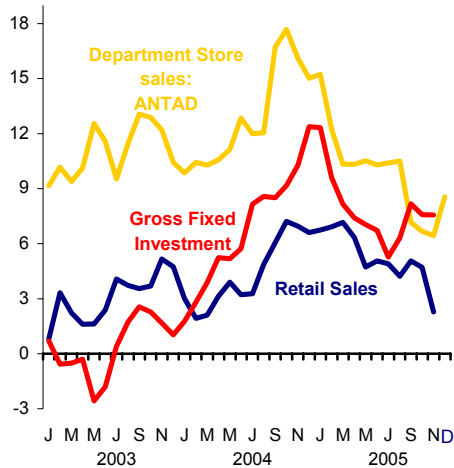
---

<sup>5</sup> Private consumption indicators reveal that ANTAD sales grew at an annual rate of 8.5 percent during the fourth quarter of 2005, while in the first three quarters of that year and in 2004, 9.1 and 9.6 percent respectively. During the fourth quarter of 2005, car retail sales remained practically unchanged in annual rate terms, while in the first nine months of the year they recorded 4.7 percent (12.1 percent in 2004).

<sup>6</sup> According to investment indicators, investment is expected to have grown at an annual rate of 8 percent during the October-November 2005 period, while in the first three quarters of that year, 7.3 percent. During the fourth quarter of 2005, imports of capital goods measured in current US dollars grew at an annual rate of 14.6 percent (16.6 percent in the first three quarters).

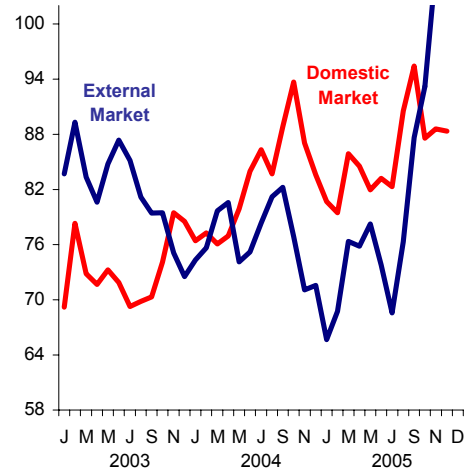
**Graph 7**  
**Domestic Demand and Production Indicators**

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



Source: ANTAD, INEGI and seasonal adjustments by Banco de México.

b) Vehicle Production for Domestic and External Markets  
October 2000=100 and 2-month moving average of seasonally adjusted data



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

Regarding aggregate supply in 2005, GDP grew at a moderate rate as compared with 2004 figures and with the mixed results observed throughout the year, considering that in the first half of the year, GDP grew at a significantly slower annual rate as compared with that observed in 2004 and, especially, with that reached in the second half of that year. This slowdown responded mainly to a moderation of external demand. In the second half of 2005, the economy rebounded, as evidently observed by the quarterly variations of GDP with seasonally adjusted data. Such improvement responded to an improvement of external demand.

Another aspect characterizing the development of GDP in 2005 is that growth was unbalanced among the economic sectors. The services sector expanded significantly, the agricultural sector recorded high volatility, while the performance of the industrial sector was modest, particularly of its manufacturing production component (Graph 8).<sup>7</sup> Nonetheless, the latter activity recorded an improvement in annual terms during the fourth quarter of the year. Under such context, it is important to mention that the reduced expansion of the manufacturing sector in 2005 continued to reflect the lack of advances in implementing pending structural reforms. This situation continued to affect the country's competitiveness and, therefore, economic activity. An aspect of reduced competitiveness, as mentioned further in the external sector section, is that Mexican products once more, in 2005, lost share in the U.S. market, which is the main export destination of Mexican products.

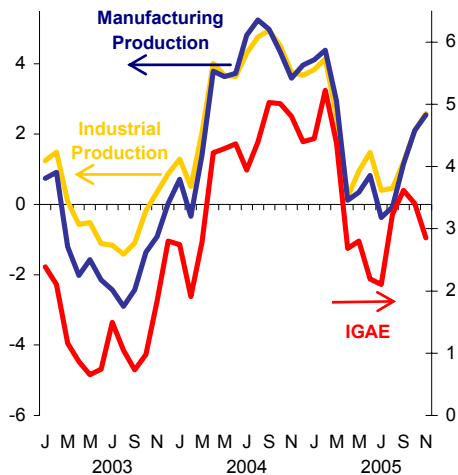
<sup>7</sup> During the October-November period, industrial and manufacturing production grew at an annual rate of 2.7 percent, while in the first three quarters of the year, 1.1 and 0.9 percent, respectively. Nonetheless, in November 2005, seasonally adjusted industrial production was barely above by 1.6 percent its maximum level reached in July 2000.

During the fourth quarter, economic activity was affected by hurricanes Stan and Wilma, which struck the country's southeastern region in October. Hurricane Stan mostly affected the states of Veracruz, Chiapas and Oaxaca, damaging the agriculture sector, as well as housing and road infrastructure. Wilma struck the state of Quintana Roo, affecting tourism and, to a lesser extent, trade and transport.<sup>8</sup> According to estimates, the effect of the hurricanes on GDP growth during the fourth quarter was relatively small. As for Quintana Roo, the negative impact was partially compensated by both expenditure associated with the initial reconstruction efforts and by the substitution of tourism flows from Cancún and Cozumel to other beach resorts in the country.

The aforementioned, together with a broad range of economic activity indicators, allow for estimating that GDP growth during the fourth quarter of 2005 might have been close to that observed in the third quarter and that, on a seasonally adjusted basis, might have increased at an annual rate. Such increase would add to the significant recovery observed in the third quarter, therefore implying that GDP growth in 2005 would have been approximately 3 percent (4.4 percent in 2004).

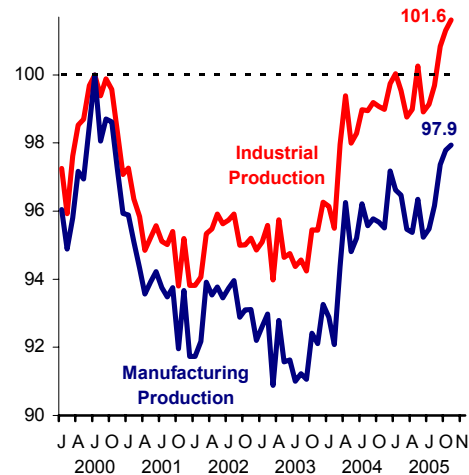
**Graph 8**  
**Production Indicators**

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



Source: INEGI. Seasonal adjustments by Banco de México.

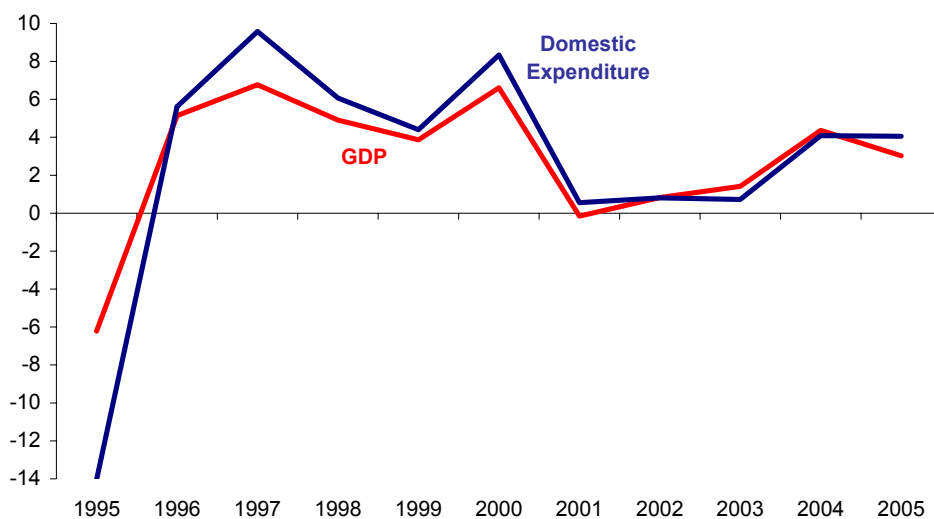
b) Seasonally adjusted series;  
July 2000=100



Source: INEGI and seasonal adjustments by Banco de México.

<sup>8</sup> Agriculture production contracted at an annual rate in the fourth quarter of 2005, mainly as a result of the drought that affected the country's Center and North states, especially, Chihuahua, Durango, Zacatecas, Guanajuato and Puebla. The effects of hurricane Stan also added to the aforementioned.

**Graph 9**  
**Gross Domestic Product and Domestic Expenditure: 1995-2005**  
 Annual percentage change



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

Summing up, interaction between domestic expenditure and production in 2005 does not suggest that significant pressures to production capacity arose. Such inference is based on the following: i) GDP growth slowed as compared with 2004; ii) gross capital formation and, therefore, production capacity, grew for two consecutive years at a higher annual rate than GDP; and, iii) in some sectors, such as manufacturing, the level of production measured with seasonally adjusted data at the end of 2005 was still below the maximum level reached at mid-2000 (Graph 8). In addition, although domestic expenditure growth was above GDP growth in 2005, such results had not been observed in the last two years (Graph 9). In fact, in 2005, the growth rate of domestic expenditure was close to 4 percent, nearly the same rate observed in 2004.

### 3.2.2. Employment

The expansion of economic activity in 2005 was reflected in an increase in the demand for labor, which contributed to an improvement of different employment indicators. In this regard, the significant increase in formal employment –which included most sectors of economic activity - deserves mention. Available information suggests that employment growth has not led to a greater shortage of skilled labor, considering that monthly indicators for the manufacturing sector prepared by Banco de México reveal that, in 2005, enterprises did not face any difficulties in hiring skilled labor for their production, sales, and administrative areas (Graph 10).

**Graph 10**  
**Labor Market Indicators**

a) National Open Unemployment Rate  
Percentage in relation to economic active population



b) Manufacturing: Labor Shortage Indicators  
2-month moving average of balance of responses



Source: a) INEGI; seasonal adjustments and trend by Banco de México; and b) Results obtained by Banco de México through its Monthly Survey of the Current Economic Conditions in the Manufacturing Sector. Balance of responses refer to the weighted percentage of enterprises mentioning to have faced greater competition from other enterprises to hire skilled labor (or enterprises mentioning that the number of persons that resigned in order to work in other firms increased) minus the weighted average of those mentioning to have faced lesser competition in the hiring process.

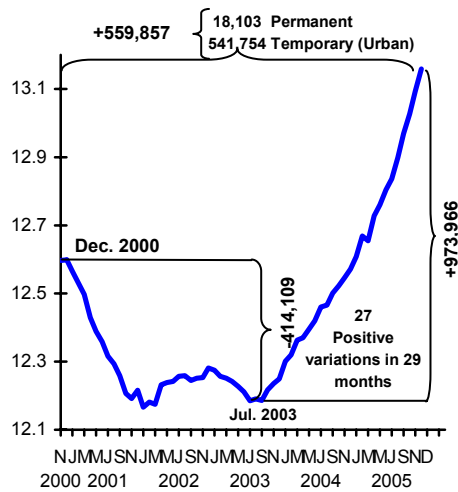
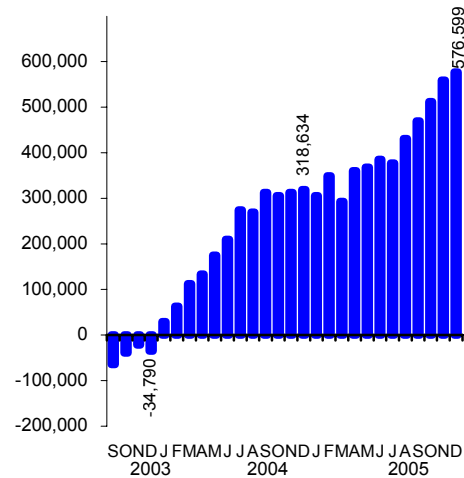
In general terms, during 2005 -particularly during the fourth quarter- the labor market was characterized by the following: a) a significant increase in the number of workers insured by the IMSS, which led to increasing annual percentage variations throughout the year; b) formal employment growth was more evident in temporary jobs in urban areas, whereas in permanent jobs it was reduced; c) the number of workers insured by the IMSS rose in most sectors, albeit exhibiting more dynamism in the tertiary and construction sectors, while in the manufacturing industry it exhibited more moderate growth; d) job creation practically included all states; and, e) the national open unemployment rate with seasonally adjusted data followed a downward trend throughout the year. Nonetheless, the percentage of workers employed considered as underemployed or working in informal-related activities remained high.

In 2005, the number of workers insured by the IMSS increased by 576,599 in annual terms (from December 2004 to December 2005, Graph 11), therefore implying an annual growth of 4.61 percent, the highest in the last 60 months.<sup>9</sup> Nonetheless, such figure is broken down into 184,954 permanent workers (1.7 percent annual increase) and 391,645 temporary workers in urban areas (23.8 percent increase). Therefore, two thirds of the increase corresponded to temporary jobs in urban areas. On the other hand, considering the evolution of seasonally adjusted formal employment, from July 2003 to the end of December 2005, this indicator accumulated an increase of 973,966 workers. This allowed formal employment to surpass at the end of 2005 its maximum level reached at the end of 2000 by 559,857 jobs (Graph 11).

<sup>9</sup> The increase in the number of workers insured could also be reflecting the results of greater fiscalization efforts by the IMSS.



**Graph 11**
**Workers Insured by the IMSS: Permanent and Temporary in Urban Areas**

 a) Million Workers Insured  
 Seasonally adjusted data

 b) Number of Workers Insured by the IMSS  
 Annual variation of original data


Source: IMSS. Seasonal adjustments by Banco de México.

The improvement of formal employment in 2005 was notable in most economic sectors, although the most significant growth was recorded in trade (145,109 workers and 5.9 percent) and other services (205,245 workers and 4.9 percent).<sup>10</sup> Formal employment in the industrial sector increased at a more moderate rate, reflecting employment growth in construction (105,930 workers and 11.7 percent) and manufacture (130,830 workers and 3.6 percent). The latter allowed the improvement already observed in manufacturing employment in 2004 to continue, after having contracted for three years in a row. Nonetheless, at the end of 2005, the number of manufacturing workers insured by the IMSS with seasonally adjusted data fell by 580,000 as compared with its level of October 2000 (Graph 12).

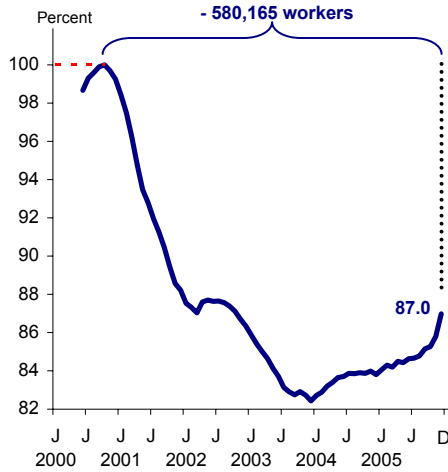
According to the Occupation and Employment Survey (*Encuesta Nacional de Ocupación y Empleo, ENOE*) conducted by INEGI, during the fourth quarter of 2005, the national unemployment rate on a seasonally adjusted basis was 3.33 percent. This indicator had previously recorded 3.49 percent in the third quarter and 3.75 percent in the second. In the last quarter of the year, the percentage of working population which considered themselves as underemployed was 6.39 percent, while that working in informal-related activities was 28.2 percent in the third quarter of the year.<sup>11</sup> Although formal employment increased significantly in 2005, its share in the economic active population and in the working population was relatively small (Graph 12).

<sup>10</sup> The sector Other Services includes services for enterprises and individuals, as well as social and community services.

<sup>11</sup> According to the Occupation and Employment Survey, the underemployed population is made up of individuals that need to work and are available for working more hours than the number of hours they are currently working. As for the working population in the informal sector, it includes individuals participating in economic market activities operating with their own household resources, but not established as enterprises with a status independent from households. In such production units there are no accounting practices and no distinction is made between household and enterprise wealth.

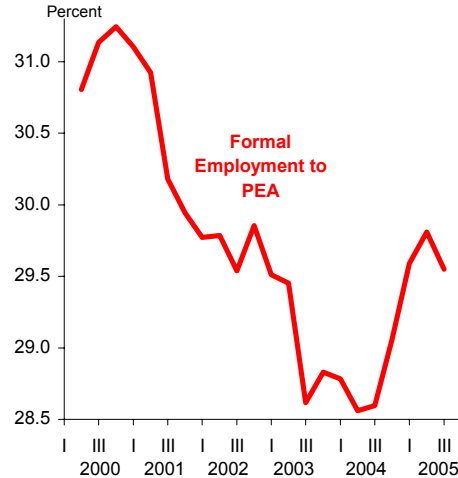
**Graph 12**  
**Formal Employment Indicators**

a) Number of Manufacturing Workers Insured by the IMSS  
October 2000=100



Source: IMSS. Seasonal adjustments by Banco de México.

b) Share of Formal Employment in Economic Active Population (PEA)



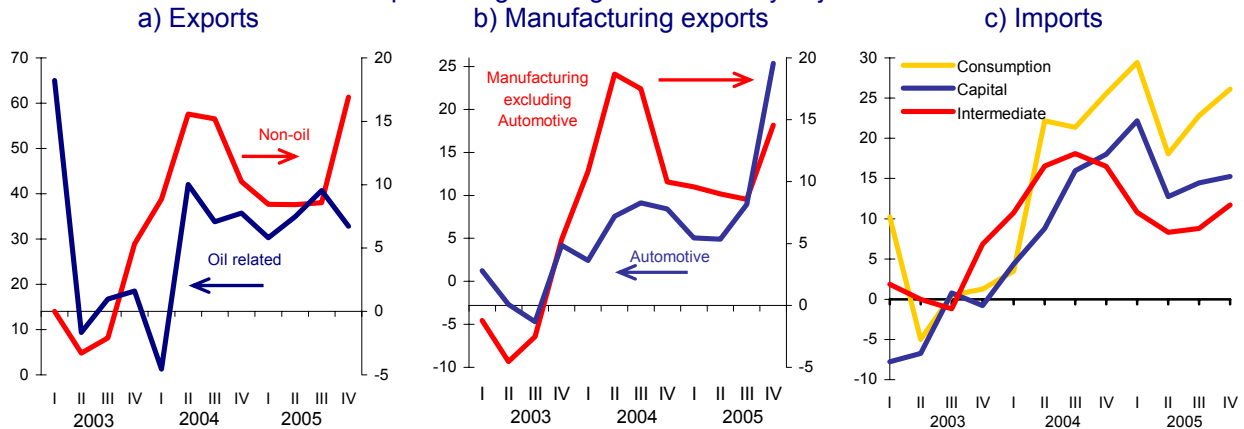
Source: INEGI. Seasonal adjustments by Banco de México.

### 3.2.3. External Sector

The growth of both, aggregate demand and GDP, in 2005 did not imply an increase in the trade and current account deficit of the balance of payments as compared with that recorded in 2004. In fact, in 2005, when measured in relation to GDP, such deficit was the smallest in 25 years (1 and 0.8 percentage points, respectively). Nonetheless, it is important to note that these figures were influenced downward significantly by the high growth of the oil trade surplus, and, in the case of the current account, also by the considerable inflow of workers' remittances. After deducting in 2005 the higher revenues from abroad from the referred deficit, these widen significantly, consistent with the higher growth of domestic expenditure observed during the year as compared with that of GDP.

**Graph 13**  
**Merchandise Exports and Imports**

Annual percentage change of seasonally adjusted data



Source: Banco de México.

During the fourth quarter of 2005, the current account of the balance of payments and its main items were characterized by the following aspects:

- a) A higher growth of non-oil exports, which partly responded to the recovery of automotive exports.<sup>12</sup> Nonetheless, during the entire year, non-oil exports grew less than in 2004, due to the slowdown of external demand in the first half of 2005 and the persistent loss of competitiveness of Mexican products in external markets.
- b) A higher value of oil exports; however, during the referred quarter its annual variation moderated in relation to the previous quarter.
- c) A higher annual growth of merchandise imports with respect to that observed in the first three quarters of 2005, although below that recorded in 2004.
- d) A moderate trade and current account deficit, although significantly above that recorded during the third quarter of that year, partly due to seasonal factors.
- e) A new widening in the non-oil trade deficit, even on a seasonally adjusted basis, due to the higher growth of domestic expenditure as compared with that of GDP.

During the October-November 2005 period, and just like in the first three quarters of that year, the performance of Mexican exports to the U.S. weakened, despite the improvement observed in November. Thus, during the October-November period, Mexican exports to the U.S. grew at an annual rate of 9.8 percent (Table 2), less vigorously than total exports of the rest of U.S. trading partners (13.8 percent). As a result, the share of Mexican products in U.S. imports decreased, from 10.53 percent in the period October-November 2004, to 10.20 percent in the same period of 2005.

**Table 2**  
**U.S. Imports**  
**Percent**

|   | Share         |               |               |               | Annual Percentage Change: October-November 2005 |             |                     |            |                                    |
|---|---------------|---------------|---------------|---------------|---|-------------|---------------------|------------|------------------------------------|
|   | Jan-Nov 2004  | Jan-Nov 2005  | Oct-Nov 2004  | Oct-Nov 2005  | Total   | Oil         | Total excluding Oil | 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>13.4</b>                                     | <b>25.9</b> | <b>12.0</b>         | <b>8.8</b> | <b>12.7</b>                        |
| <b>Total excluding Mexico</b>           | <b>89.32</b>  | <b>89.80</b>  | <b>89.47</b>  | <b>89.80</b>  | <b>13.8</b>                                     | <b>29.1</b> | <b>12.2</b>         | <b>8.8</b> | <b>12.9</b>                        |
| <b>Total excluding Mexico and China</b> | <b>75.98</b>  | <b>75.20</b>  | <b>74.85</b>  | <b>74.49</b>  | <b>12.9</b>                                     | <b>28.7</b> | <b>10.8</b>         | <b>8.8</b> | <b>11.3</b>                        |
| 1. Canada                               | 17.54         | 17.18         | 16.80         | 17.34         | 17.1  | 35.8        | 15.4                | 12.2       | 16.7                               |
| 2. China                                | 13.35         | 14.60         | 14.62         | 15.31         | 18.8  | 135.0       | 18.6                | --         | 18.6                               |
| <b>3. Mexico</b>                        | <b>10.68</b>  | <b>10.20</b>  | <b>10.53</b>  | <b>10.20</b>  | <b>9.8</b>                                      | <b>7.6</b>  | <b>10.1</b>         | <b>8.7</b> | <b>10.8</b>                        |
| 4. Japan                                | 8.83          | 8.27          | 8.56          | 7.90          | 4.6   | --          | 4.6                 | 7.1        | 3.1                                |
| 5. Germany                              | 5.23          | 5.06          | 5.19          | 4.94          | 7.9   | --          | 7.9                 | 6.4        | 8.7                                |
| Total 5 countries                       | 55.62         | 55.31         | 55.70         | 55.69         | 13.4  | 22.2        | 12.9                | 9.2        | 14.0                               |

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

<sup>12</sup> During the fourth quarter of 2005, merchandise exports grew at an annual rate of 19 percent, as a result of increases in both oil and non-oil exports (32.8 and 16.9 percent respectively). The increase in non-oil exports was influenced by the improvement in automotive exports. As for merchandise imports, these grew at an annual rate of 13.8 percent.

In 2005, the current account deficit was influenced downward by the significant increase in the oil trade surplus, which moved from 12.602 billion US dollars in 2004 to 15.615 billion in 2005. The other item of the current account that contributed to moderate its deficit was workers' remittances. During the fourth quarter this item recorded 5.316 billion US dollars, and during the entire 2005, 20.035 billion. This amount of resources equaled 128 percent of the oil trade surplus.

During the fourth quarter of 2005, the current account of the balance of payments recorded a small deficit is anticipated to have been 5.8 billion (0.8 percentage points of GDP). This figure was below that recorded in 2004: 7.3 billion US dollars and 1.1 percentage points of GDP. Under such context, in 2003, 2004 and 2005, the oil trade surplus and revenues from workers' remittances rose, overall, by 0.9, 0.8 and 0.85 percentage points of GDP, respectively.

The moderate current account deficit in 2005 was financed by the significant surplus of the capital account. The favorable environment in international financial markets, characterized by ample liquidity and higher risk preference, contributed to such surplus. Considering the aforementioned, during the fourth quarter of 2005, the capital account surplus is expected to have been 8.3 billion US dollars (including errors and omissions) and, during the entire year, 12 billion. This figure resulted from the combination of private sector net inflows (financing to the private sector and foreign direct investment) and public sector's net outflows originated by a reduction of foreign debt. During the fourth quarter, Banco de México's net international reserves increased by 5.833 billion US dollars and during the entire 2005, by 7.173 billion. At the end of 2005, the stock of international reserves was 68.669 billion US dollars.

### 3.3. Costs and Prices

#### 3.3.1 Wages and Unit Labor Costs

Contractual wages in enterprises under federal jurisdiction recorded an average increase of 4.4 percent during 2005, 0.3 percentage points above that observed in 2004. This difference is explained by the higher increases granted to workers in public enterprises, given that workers in private enterprises received, on average, the same contractual wage increase in both years (Table 3). Thus, in general terms, wage negotiations were not affected by the supply shocks to headline inflation in 2004.

**Table 3**  
**Contractual Wage Average Increases <sup>1/</sup> and Number of Workers Benefited by Type of Enterprise**

|  | 2004 |     |     |     |         | 2005 |     |     |     |         |
|--|------|-----|-----|-----|---------|------|-----|-----|-----|---------|
|  | I    | II  | III | IV  | Jan-Dec | I    | II  | III | IV  | Jan-Dec |
| <b>Contractual Wage Increase (percent) <sup>1/</sup></b> |      |     |     |     |         |      |     |     |     |         |
| <b>Total</b>   | 4.5  | 4.5 | 4.3 | 3.4 | 4.1     | 4.5  | 4.4 | 4.4 | 4.2 | 4.4     |
| <b>Public Enterprises</b>                                | 3.9  | 3.9 | 4.0 | 3.1 | 3.5     | 3.6  | 4.0 | 4.1 | 4.0 | 4.0     |
| <b>Private Enterprises</b>                               | 4.6  | 4.6 | 4.7 | 4.3 | 4.6     | 4.7  | 4.6 | 4.7 | 4.7 | 4.6     |
| <b>Number of Workers Benefited (percentage share)</b>    |      |     |     |     |         |      |     |     |     |         |
| <b>Total</b>   | 100  | 100 | 100 | 100 | 100     | 100  | 100 | 100 | 100 | 100     |
| <b>Public Enterprises</b>                                | 20   | 21  | 48  | 72  | 42      | 19   | 22  | 46  | 72  | 41      |
| <b>Private Enterprises</b>                               | 80   | 79  | 52  | 28  | 58      | 81   | 78  | 54  | 28  | 59      |

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

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

In December 2005, Mexico's Minimum Wage Commission (*Comisión Nacional de Salarios Mínimos, CONASAMI*) determined an increase of 4.0 percent for the minimum wage for 2006 for the three geographic areas (the weighted increase for 2005 was 4.5 percent). Thus, the average minimum wage was 47.05 pesos per day.

During the period January-October 2005, labor productivity in the manufacturing industry (maquiladora and non-maquiladora), and in the retail sector, grew at a lower annual rate than in the same period of 2004 (Table 4). Real average earnings also grew at a lower annual rate. Nonetheless, although Unit Labor Costs (ULC) in the non-maquiladora manufacturing industry also grew at a lower rate, they did so but it in a smaller proportion than in the same period of 2004. ULC in the maquiladora industry increased. On the other hand, ULC in the retail sector fell during the referred period.

**Table 4**  
**Earnings, Labor Productivity and Unit Labor Costs by Sectors**  
 Annual percentage change

|                | Non-maquiladora Manufacturing Industry |                       |             | Maquiladora Industry |                       |            | Retail             |                       |             |
|----------------|--|-----------------------|-------------|----------------------|-----------------------|------------|--------------------|-----------------------|-------------|
|                | Labor Productivity                     | Real Average Earnings | ULC         | Labor Productivity   | Real Average Earnings | ULC        | Labor Productivity | Real Average Earnings | ULC         |
| <b>2004</b>    |  |                       |             |                      |                       |            |                    |                       |             |
| Jan-Oct        | 7.0                                    | 0.5                   | -6.0        | 2.3                  | 0.2                   | -2.0       | 7.2                | 3.4                   | -3.5        |
| Jan-Dec        | 6.9                                    | 0.3                   | -6.1        | 2.1                  | -0.2                  | -2.2       | 7.0                | 2.7                   | -4.0        |
| <b>2005</b>    |  |                       |             |                      |                       |            |                    |                       |             |
| Jan            | 3.5                                    | -0.4                  | -3.8        | -1.6                 | -2.2                  | -0.6       | 6.1                | -3.1                  | -8.7        |
| Feb            | 3.9                                    | 0.0                   | -3.8        | -0.9                 | -2.0                  | -1.1       | 2.7                | 4.1                   | 1.3         |
| Mar            | -4.5                                   | 0.2                   | 4.9         | 0.3                  | 0.0                   | -0.2       | 3.3                | 2.5                   | -0.7        |
| Apr            | 7.0                                    | -1.8                  | -8.2        | -2.8                 | -3.4                  | -0.7       | 7.5                | 3.4                   | -3.8        |
| May            | 4.0                                    | 0.1                   | -3.8        | -4.2                 | 1.0                   | 5.4        | 2.4                | -4.8                  | -7.0        |
| Jun            | 0.5                                    | 1.3                   | 0.9         | 1.0                  | 1.2                   | 0.2        | 5.5                | 1.7                   | -3.7        |
| Jul            | -1.6                                   | -1.5                  | 0.1         | -2.6                 | 0.2                   | 2.8        | 2.5                | -1.7                  | -4.0        |
| Aug            | 2.8                                    | 0.4                   | -2.3        | 1.9                  | 4.2                   | 2.2        | 5.2                | -3.6                  | -8.4        |
| Sep            | 0.9                                    | -0.8                  | -1.7        | -0.1                 | 2.0                   | 2.1        | 6.4                | 4.7                   | -1.5        |
| Oct            | 3.1                                    | 0.6                   | -2.4        | -0.4                 | -0.2                  | 0.2        | 3.9                | 0.0                   | -3.7        |
| <b>Jan-Oct</b> | <b>2.0</b>                             | <b>-0.2</b>           | <b>-2.0</b> | <b>-0.9</b>          | <b>0.1</b>            | <b>1.0</b> | <b>4.5</b>         | <b>0.3</b>            | <b>-4.0</b> |

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

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

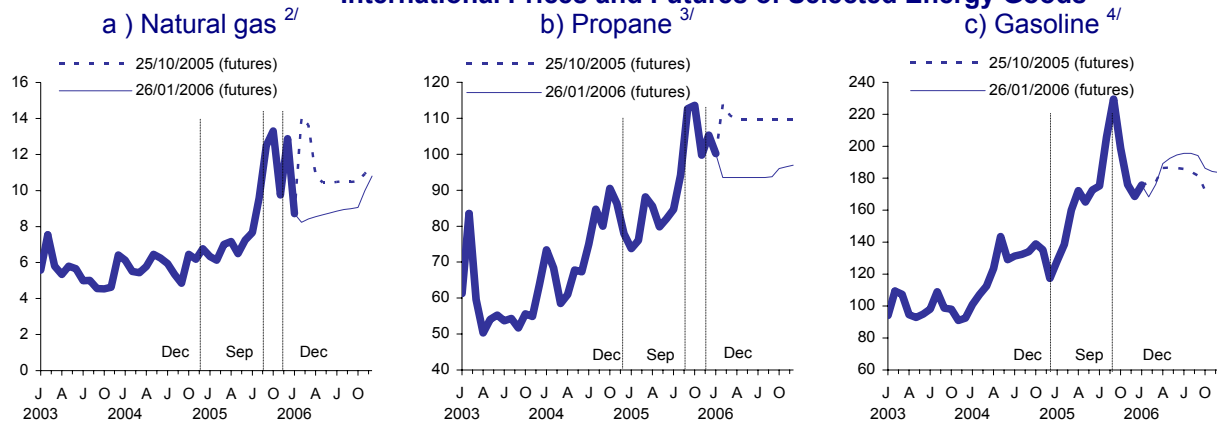
Administered prices are mainly affected by three factors: first, by their international references; second, by the prices of certain inputs used in their production process, such as steel in electricity; and third, by the policies determined by the public sector for these types of products.

During 2005, international energy prices rose significantly (Graph 14). Nonetheless, this phenomenon had a moderate passthrough to the domestic market due to different measures established by the federal government to reduce the volatility of domestic energy prices, among which the most important where: i) the setting of a maximum price for gasoline at border cities that should not exceed the price set for the rest of the country (which has a predetermined rate of change); ii) the adoption, at the beginning of the year, of a monthly variation interval between 0.75 and 1.75 percent for propane prices; iii) the implementation of a maximum price for natural gas for low-consumption residential use;<sup>13</sup> and, iv)

<sup>13</sup> Decree published in the Mexico's Official Newsletter (*Diario Oficial de la Federación*), May 16, 1005. This decree establishes a maximum price for concessionaries of low-consumption gas for residential

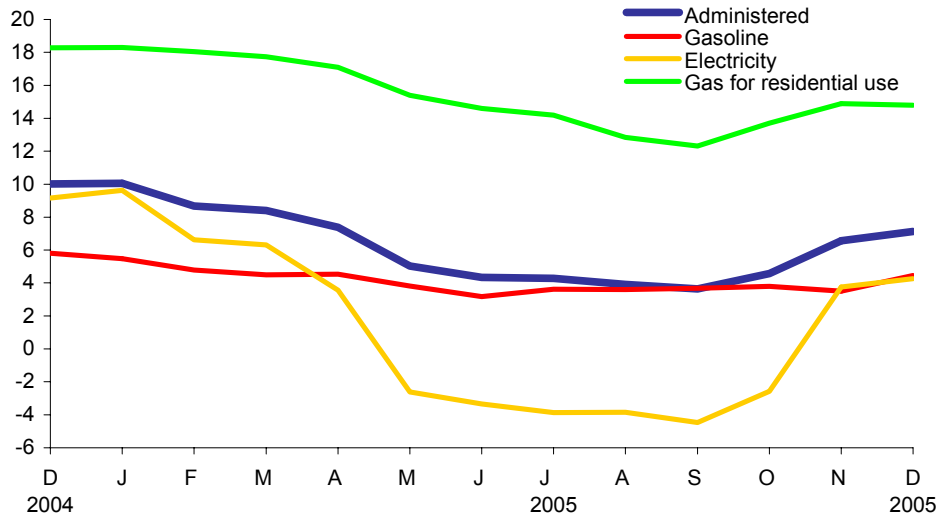
a decree that establishes a maximum price for natural gas for industrial use and natural gas distributors.<sup>14</sup> As a result, the annual variation of administered prices followed a downward trend between January and September 2005, and then rebounded in the fourth quarter (Graph 15).

**Graph 14**  
**International Prices and Futures of Selected Energy Goods**<sup>1/</sup>



1/ Futures prices correspond to October 25, 2005 and January 26, 2006.  
2/ TETCO, TX. US dollars per MMBtu.  
3/ Mont Belvieu, TX. US cents.  
4/ Texas, US cents per gallon.

**Graph 15**  
**Administered Prices Subindex**  
**Annual percentage change**



The significant price increases in public transportation in urban areas observed in the first four months of 2004 in cities that have a high weight in the

use. A reduction of 28 percent was established on the price of natural gas for residential use with monthly consumptions up to 47m<sup>3</sup>. This discount is established with a downward rate of change criterion and does not apply to consumptions above 60m<sup>3</sup>. This measure ends September 30, 2006.

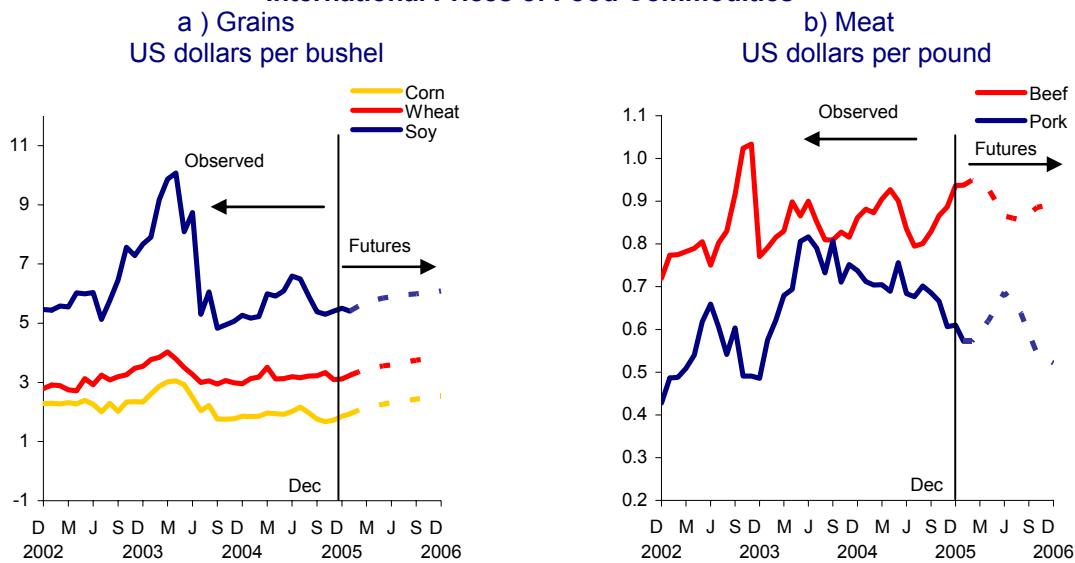
<sup>14</sup> Decree published in the *Diario Oficial de la Federación*, September 12, 2005. Such decree will remain in force until production of U.S. natural gas in the Gulf of Mexico is re-established (region affected by hurricane Katrina).

CPI, such as Mexico City and Toluca, did not repeat in 2005. Consequently, the subindex of regulated prices reduced its incidence on inflation during 2005.

### 3.3.3 Metals and Food Raw Materials

As for international prices of some metals, steel prices have a particular relevance due to their incidence on the cost of construction materials and its effect on the calculation of high consumption electricity tariffs. In this regard, during 2004 the higher consumption of metals observed worldwide led to a significant increase in its prices. Nonetheless, this condition reverted in 2005, when the supply of steel began to rise and its prices started to follow a downward trend until September, when they began to increase at moderate rates.

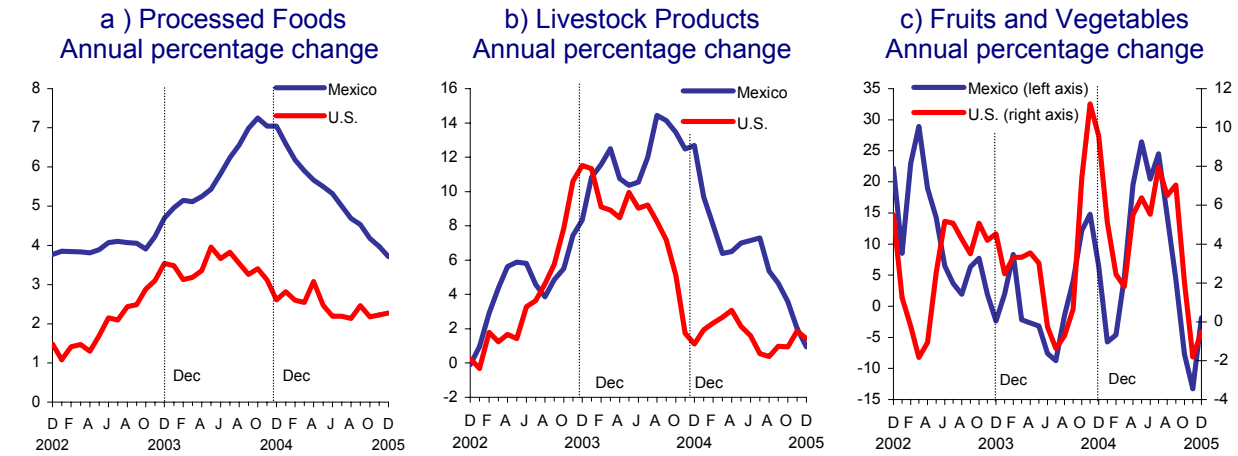
**Graph 16**  
**International Prices of Food Commodities <sup>1/</sup>**



<sup>1/</sup> Futures prices of January 26, 2006.  
Source: U.S. Department of Agriculture.

As mentioned in previous paragraphs, during 2005, international prices of food commodities exhibited reduced volatility as compared with 2004, recording lower prices in the case of both meat products and grains (Graph 16). Thus, prices of processed foods and some livestock products exerted less pressure on consumer prices. Processed foods and livestock products prices evolved in line with their corresponding prices in the U.S. (Graph 17).

**Graph 17**  
**Food Prices in Mexico and U.S.**



### 3.4. Monetary and Credit Aggregates

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

At the end of 2005, the stock of the monetary base was 380 thousand million pesos. During 2005, this aggregate grew at an average annual rate of 12.1 percent, 2 percentage points below its previous year figures (Graph 18a).<sup>15</sup> This suggests, as mentioned in previous reports, that although the process by which the monetary base has increased as a percentage of GDP (remonetization) continues, it has lost strength in the last years (Graph 18).<sup>16</sup>

At the end of 2005, international assets rose by 9.881 billion US dollars. Thus, the stock of international assets accumulated by December 31, 2005 was 74.115 billion US dollars.<sup>17</sup> The monetary base increased by 39,856 million pesos in 2005. As a result, Banco de México's net domestic credit decreased by 65,062 million pesos during the year (Table 5).<sup>18</sup>

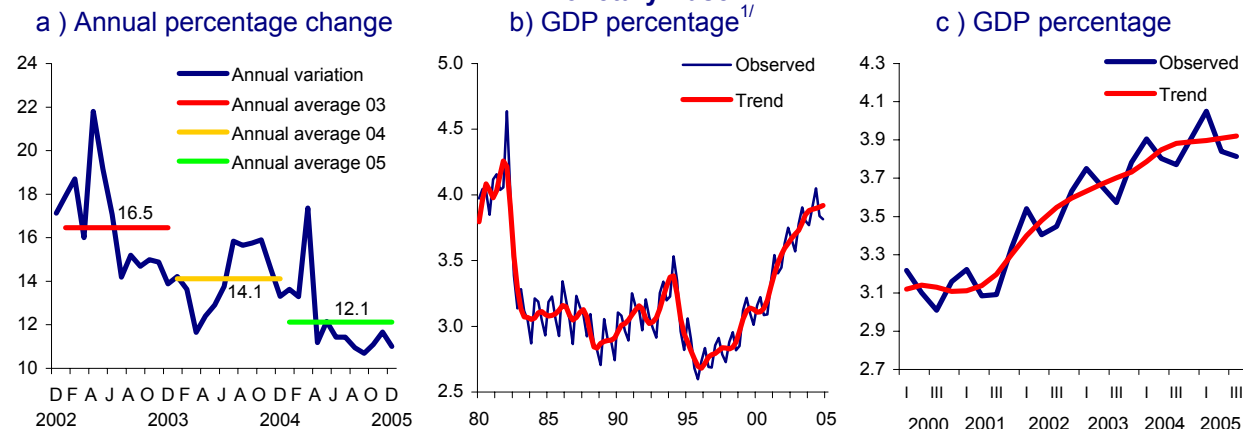
<sup>15</sup> Variations calculated based on the average of daily stocks.

<sup>16</sup> Historical evidence confirms that in low inflation economies: i) shocks on income and interest rates are reflected more slowly on the demand for money; and ii) such demand tends to become more sensitive to changes in interest rates. See Inflation Report April-June 2003.

<sup>17</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 after deducting international assets from the monetary base; i.e., financing granted or received domestically by Banco de México. The international reserves definition excludes Banco de México's short-term foreign currency liabilities (less than six months).

<sup>18</sup> International reserves increased by 5.833 billion US dollars during the fourth quarter of 2005.



**Graph 18  
Monetary Base**


<sup>1/</sup> Currency in circulation is considered for the period 1980-1993.

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

|  | Stocks          |                 | Flows in 2005 |         |         |        | Accumulated at Dec. 31 2005 |
|--|-----------------|-----------------|---------------|---------|---------|--------|-----------------------------|
|  | At Dec. 31 2004 | At Dec. 31 2005 | I             | II      | III     | IV     |                             |
| (A) Monetary Base (Pesos)  | 340,178         | 380,034         | -28,322       | 2,293   | -1,674  | 67,559 | 39,856                      |
| (B) Net International Assets (Pesos) <sup>1/ 2/</sup>              | 716,170         | 788,167         | -720          | 15,368  | 46,922  | 43,349 | 104,918                     |
| Net International Assets (US dollars) <sup>2/</sup>                | 64,233          | 74,115          | -88           | 1,491   | 4,377   | 4,102  | 9,881                       |
| (C) Net Domestic Credit (Pesos) [(A)-(B)] <sup>1/</sup>            | -375,992        | -408,133        | -27,602       | -13,075 | -48,596 | 24,210 | -65,062                     |
| (D) International Reserves (US dollars) [(E)-(F)] <sup>3/</sup>    | 61,496          | 68,669          | 242           | 35      | 1,062   | 5,833  | 7,173                       |
| (E) Gross Reserves (US dollars)                                    | 64,198          | 74,110          | -87           | 1,492   | 4,378   | 4,129  | 9,913                       |
| PEMEX  |                 |                 | 2,497         | 3,931   | 7,117   | 6,833  | 20,378                      |
| Federal Government   |                 |                 | -1,087        | -1,754  | -2,159  | -2,290 | -7,290                      |
| Sale of US dollars to banks <sup>4/</sup>                          |                 |                 | -1,380        | -1,159  | -849    | -1,014 | -4,402                      |
| Other <sup>5/</sup>  |                 |                 | -117          | 474     | 269     | 600    | 1,227                       |
| (F) Liabilities with less than six months to maturity (US dollars) | 2,701           | 5,441           | -330          | 1,457   | 3,316   | -1,703 | 2,740                       |

<sup>1/</sup> Net international assets' cash flows in pesos are estimated based on the exchange rate applied to each transaction.

<sup>2/</sup> 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.

<sup>3/</sup> As defined by Banco de México's Law.

<sup>4/</sup> Daily sales of US dollars according to the mechanism to reduce the pace of international reserve accumulation (see Exchange Commission's Press Release of March 20, 2003).

<sup>5/</sup> Includes yields on net international assets and other transactions.

### 3.4.2. Monetary Aggregates and Financing

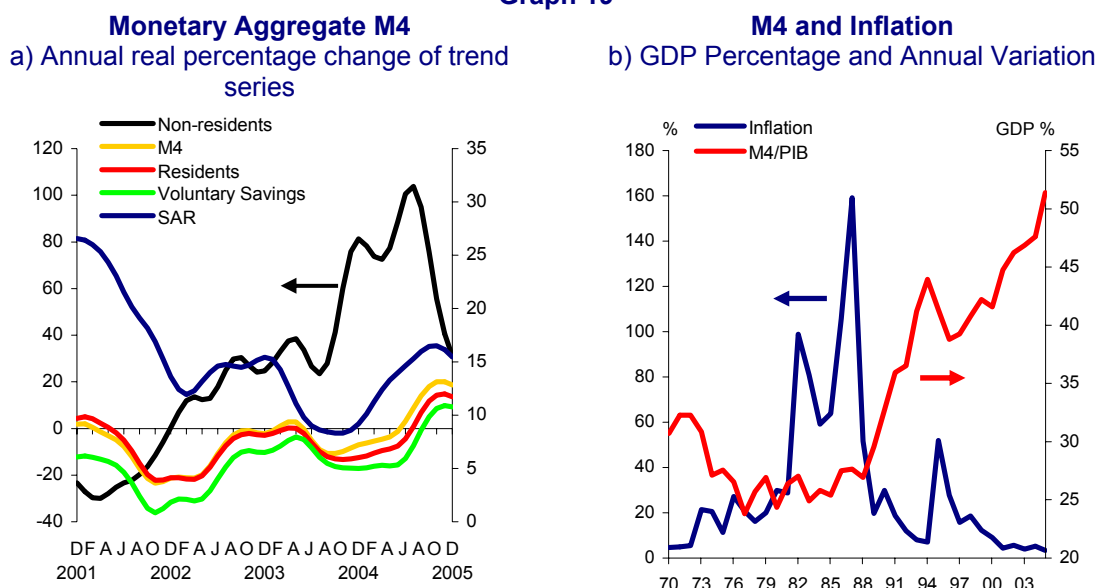
The monetary aggregate M1 grew at a slower rate throughout 2005, recording an annual average variation of 11.3 percent, below that observed in 2004 (13.9 percent). The slower growth rate of the narrow monetary aggregate was observed in its main components. In 2005, currency in circulation and checking accounts recorded annual variations of 12.3 and 9.6 percent, respectively, figures below those recorded in 2004 (14.5 and 11.5 percent). Such results are partly explained by the increase in interest rates on commercial banks' term deposits, which, throughout the year, increased the cost for holding liquid assets.

During 2005, the expansion of the broad monetary aggregates strengthened. In December, the monetary aggregate M4, which measures financial savings in domestic instruments, recorded an annual real variation of

11.5 percent, almost twice the growth rate recorded at the end of 2004 (6.5 percent at an annual real rate).

This result was due to both the increase in residents' financial savings and the significant expansion of public securities' holdings by foreigners (Graph 19a). The strength of financial savings in domestic instruments is due to both the ample liquidity characterizing international financial markets and to progress towards low and stable inflation, which reduces uncertainty associated with the yield on such instruments. Macroeconomic stability attained in recent years has led to a significant recovery of financial savings, which reached in 2005 historically high levels as a percentage of GDP (Graph 19b). Such stability has been crucial for the development of the Mexican financial market, as evidenced by the placement of government securities at longer-term fixed interest rates.<sup>19</sup> The latter has not only contributed to increase the certainty of financial resources for the public sector, but also allowed for sellers and bidders of financial resources to have a reference in pesos to issue long-term debt instruments.

Graph 19



The greater availability of financial resources has been accompanied by an important change in its final uses. In particular, the decline in public sector borrowing requirements and the slower pace of reserve accumulation by Banco de México have increased the availability of financial resources for the private sector (Table 6). Thus, while in 2003, the increase in total financing to the private sector accounted for only 0.2 percent of GDP, in 2004 and 2005 it rose to 2.2 and 2.7 percent of GDP, respectively.<sup>20</sup>

Under such environment, liquidity constraints faced by households have decreased gradually. Mortgage and consumption credit have grown vigorously, although from a small level, reaching stocks of 8.7 and 3.5 percent of GDP in

<sup>19</sup> In December 2005, the average maturity term of government debt increased by 12.9 percent in annual terms, while the share of fixed-rate government securities (*BONOS*) did so by 5.4 percentage points.

<sup>20</sup> Effective flows as a percentage of GDP. For 2005, the variation September 04-September 05 is considered.

September 2005, respectively. This has been achieved despite the fact that lending interest rates still remain relatively high (Table 7). Enterprises have also been able to refinance their liabilities in better terms and conditions, therefore improving their debt profile. In particular, during the last years external liabilities have been substituted by domestic ones, while debt maturity terms have also been extended. As a result, enterprises have been able to strengthen their financial positions to face different types of shocks.

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

|  | Stock       |            | Annual Flow |                 |
|--|-------------|------------|-------------|-----------------|
|  | Sep-2005    | 2003       | 2004        | Sep.04 - Sep.05 |
| <b>Total sources</b>                                     | <b>72.9</b> | <b>5.4</b> | <b>6.0</b>  | <b>7.8</b>      |
| M4   | 52.8        | 5.5        | 5.5         | 7.7             |
| Held by residents  | 51.1        | 5.4        | 4.8         | 6.9             |
| Held by non-residents                                    | 1.7         | 0.1        | 0.7         | 0.7             |
| Financing abroad   | 20.1        | -0.1       | 0.5         | 0.1             |
| Public sector <sup>1/</sup>                              | 12.8        | 0.5        | 0.7         | -0.4            |
| Commercial banks <sup>2/</sup>                           | 0.4         | -0.1       | 0.1         | -0.1            |
| Private sector <sup>3/</sup>                             | 6.9         | -0.5       | -0.3        | 0.6             |
| <b>Total uses</b>  | <b>72.9</b> | <b>5.4</b> | <b>6.0</b>  | <b>7.8</b>      |
| International reserves <sup>4/</sup>                     | 8.4         | 1.5        | 0.6         | 0.7             |
| Public sector (SHRFSP) <sup>5/</sup>                     | 38.5        | 2.5        | 1.7         | 1.7             |
| Domestic   | 25.6        | 2.0        | 1.1         | 2.1             |
| External   | 12.8        | 0.5        | 0.7         | -0.4            |
| States and municipalities                                | 1.6         | 0.3        | 0.2         | 0.2             |
| Credit granted by financial intermediaries <sup>6/</sup> | 1.4         | 0.1        | 0.2         | 0.2             |
| Securities issued by states and municipalities           | 0.2         | 0.1        | 0.0         | 0.0             |
| Private sector   | 27.8        | 0.2        | 2.2         | 2.7             |
| Households   | 12.2        | 1.2        | 1.9         | 1.9             |
| Consumption  | 3.5         | 0.5        | 0.9         | 1.1             |
| Housing <sup>7/</sup>                                    | 8.7         | 0.7        | 1.0         | 0.8             |
| Enterprises  | 15.7        | -1.0       | 0.2         | 0.8             |
| Credit granted by financial intermediaries <sup>6/</sup> | 6.0         | -1.2       | 0.1         | 0.0             |
| Private securities in circulation                        | 2.8         | 0.6        | 0.4         | 0.2             |
| External   | 6.9         | -0.5       | -0.3        | 0.6             |
| Other concepts <sup>8/</sup>                             | -3.3        | 0.9        | 1.3         | 2.4             |

1/ Includes net external indebtedness from the federal government, public enterprises and institutions, and PIDIREGAS placed abroad, as reported by the Ministry of Finance.

2/ Commercial banks' net external liabilities. Excludes non-residents' bank deposits.

3/ Includes loans and securities issued abroad by the private sector.

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

5/ Historical stock of Public Sector Borrowing Requirements (SHPSBR) and flow of Public Sector Borrowing Requirements (PSBR), as reported by the Ministry of Finance.

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

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

8/ Refers to non-sectorized assets, capital accounts and results, technical reserves' accounts, capital reserves, financial intermediaries' physical assets, preventive reserves, equity investment, commercial banks' external assets, financing to non-residents, INFONAVIT liabilities excluding resources from workers' contributions, liabilities of non-banking financial intermediaries excluding credit granted to commercial banks, trusts net position with banks, difference in domestic financing of development banks to the private sector and financial intermediation, and changes in IPAB non-financial liabilities, among other concepts.

Note: Totals may not add up due to rounding. Average GDP of the four quarters is used for calculations.

**Table 7**  
**Commercial Banks Deposit and Lending Interest Rates in Pesos**  
 Percent

|   | 2004  | 2005  |       |       |       |
|---|-------|-------|-------|-------|-------|
|   | Dec   | Mar   | Jun   | Sep   | Nov   |
| <b>Deposit Rates</b>  |       |       |       |       |       |
| Checking Accounts <sup>1/</sup>                                       | 2.27  | 2.47  | 2.91  | 2.99  | 2.92  |
| Bank term Deposits<br>(Costo de Captación a Plazo, CCP) <sup>2/</sup> | 6.92  | 7.52  | 7.99  | 7.88  | 7.45  |
| <b>Lending Rates</b>  |       |       |       |       |       |
| Credit to Firms <sup>3/</sup>   | 14.33 | 15.00 | 15.02 | 14.45 | 14.21 |
| Mortgage Credit (Costo Anual Total, CAT) <sup>4/</sup>                | 16.01 | 15.28 | 15.07 | 13.87 | 13.96 |
| Credit Cards <sup>5/</sup>  | 34.41 | 34.40 | 34.76 | 34.48 | 34.00 |

1/ Monthly average of payable rates (individuals and enterprises) before income tax deductions.

2/ Includes term liabilities of banks in pesos, except liabilities from: subordinate obligations to be converted to capital, granting of guarantees, and operations among credit institutions.

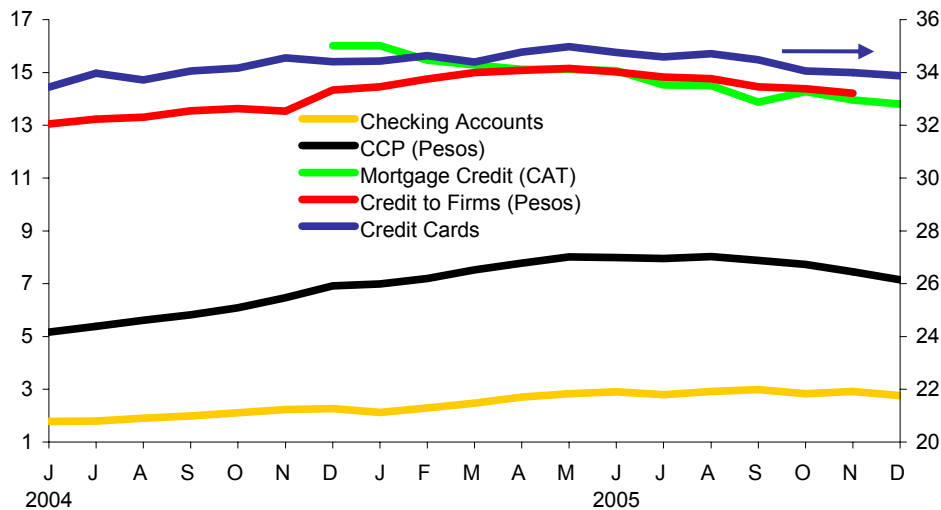
3/ Simple average of nominal rates of credits in pesos granted during the period.

4/ This indicator equalizes the present value of all commitments, future or existing agreed upon by the creditor and the borrower including interest rates, commissions, obligatory insurance and other charges due to financial services. The CAT (or APRC, Annual Percentage Rate of Charge) and nominal mortgage interest rates are calculated based on a credit with the following characteristics: a 15-year credit granted to a 35-year old individual seeking to acquire a property in Mexico City with a total cost of one million pesos, giving a down payment of 20%. Mortgage indicator figures are calculated with the Simulator of Mortgage Credits available in Banco de México's web page (<http://www.banxico.org.mx>).

5/ Simple average rate, excluding VAT, charged by banks including all traditional credit card products according to the report "Bancos: tasas de interés de tarjetas de crédito" by INFOSEL.

Note: Preliminary data subject to revisions.

**Graph 20**  
**Commercial Banks Deposit and Lending Interest Rates in Pesos**  
 Annual percent



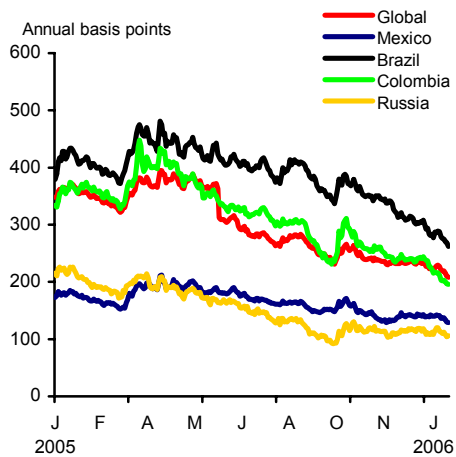
## 4. Monetary Policy

The development of Mexican financial markets has been mainly determined by the looser conditions in international financial markets. Such environment has allowed for an extension in the search for higher yields worldwide, therefore enabling the demand for emerging economies' instruments (both external and domestic) to remain vigorous.

In this regard, sovereign spreads for some emerging economies recorded historically low levels during the last quarter of 2005 (Graph 21). The relative abundance of liquidity worldwide has fostered the appreciation of assets and currency in emerging markets (Graph 21). Exchange rate behavior has also been influenced by an improvement in the terms of exchange of some emerging economies in view of the price increases in certain primary goods exported by such economies.

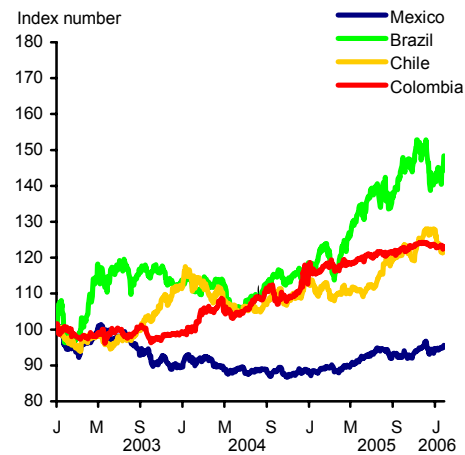
**Graph 21**

a) Interest Rate Spreads (Different Countries vs. U.S.)<sup>1/</sup>



<sup>1/</sup> EMBI global: sovereign spread.  
Source: Bloomberg.

b) Nominal Effective Exchange Rate<sup>1/</sup>



<sup>1/</sup> An increase in the index indicates an appreciation.  
Source: J.P. Morgan (January 2003 = 100).

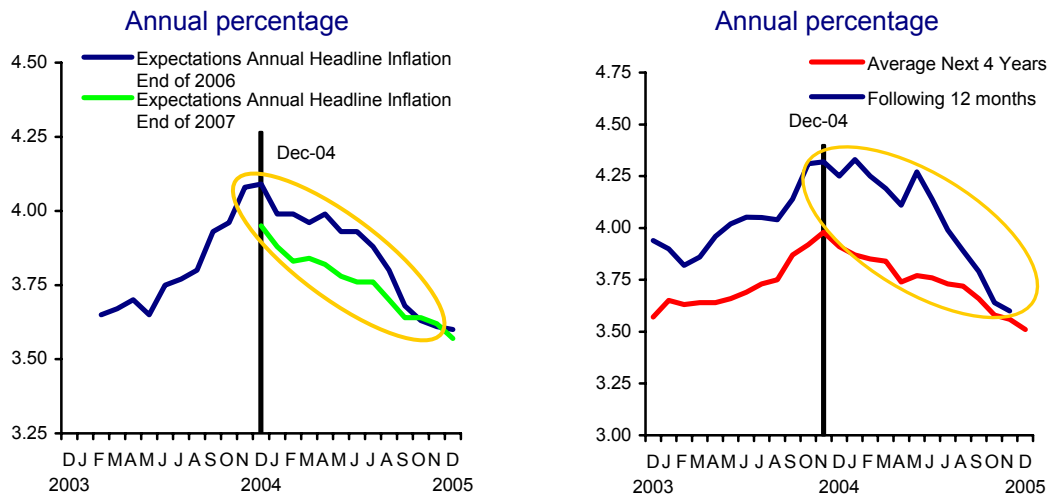
The convergence of the external environment with the reversion of several shocks observed in 2004, together with the effects of the monetary policy actions adopted, have led to significant reductions in headline and core inflation. In December, both recorded annual variations of 3.33 and 3.12 percent, respectively.

As a result, inflation expectations for all terms have been revised downward considerably. Expectations for headline inflation for the end of 2006 and 2007 were revised downward from around 4 percent in December 2004, to 3.60 and 3.53 percent in the same month of 2005, respectively (Graph 22). In December 2005, expectations for core inflation for the end of 2006 were 3.27 percent (Graph 22).

**Graph 22**
**Inflation Expectations: Banco de México Survey**

a) End of 2006 and 2007

b) Following 12 Months and Average for the Next 4 Years



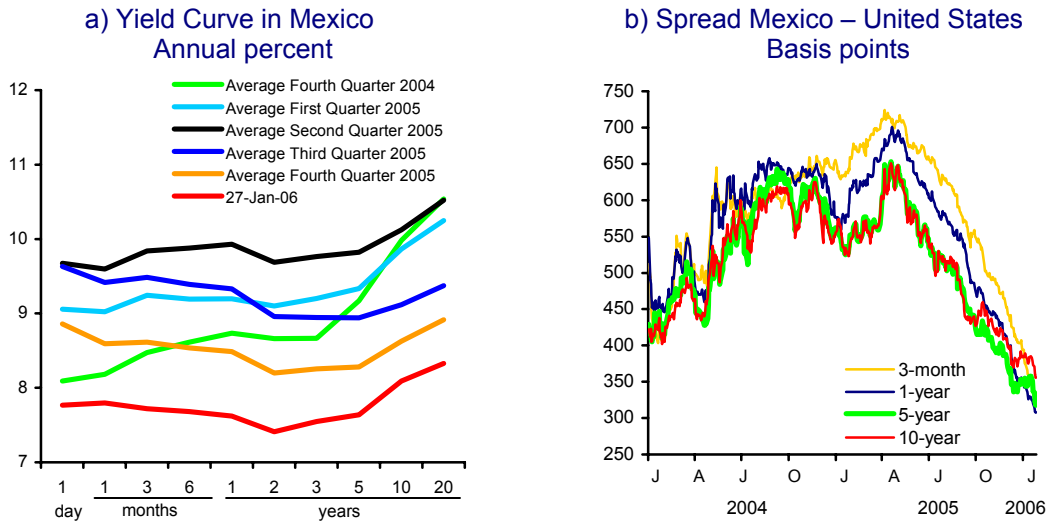
The outlook for inflation has improved. The different risks faced by the disinflation process apparently have had limited effects on wage negotiations and, in general terms, on the price determination process in the economy. The development of inflation expectations therefore suggests that the process of inflation abatement continues.

Global financial conditions are expected to continue to be favorable in the near future. In this regard, the inflow of funds destined to the acquisition of debt instruments in pesos has led to a reduction in interest rates, especially for long terms. Monetary policy actions have also contributed to this result by reducing inflation expectations and the risk premia that is usually discounted from this type of instruments.

The yield curve exhibited a significant reduction in all terms and a slight flattening in relation to its inverted position observed during the third quarter of 2005 (Graph 23a). Likewise, interest rate spreads between Mexico and the U.S. have declined considerably for all terms (Graph 23b).

The concurrence of the previous elements allowed the Board of Governors of Banco de México to revert, since August 2005, part of the monetary restriction adopted during 2004 and in the first half of 2005.

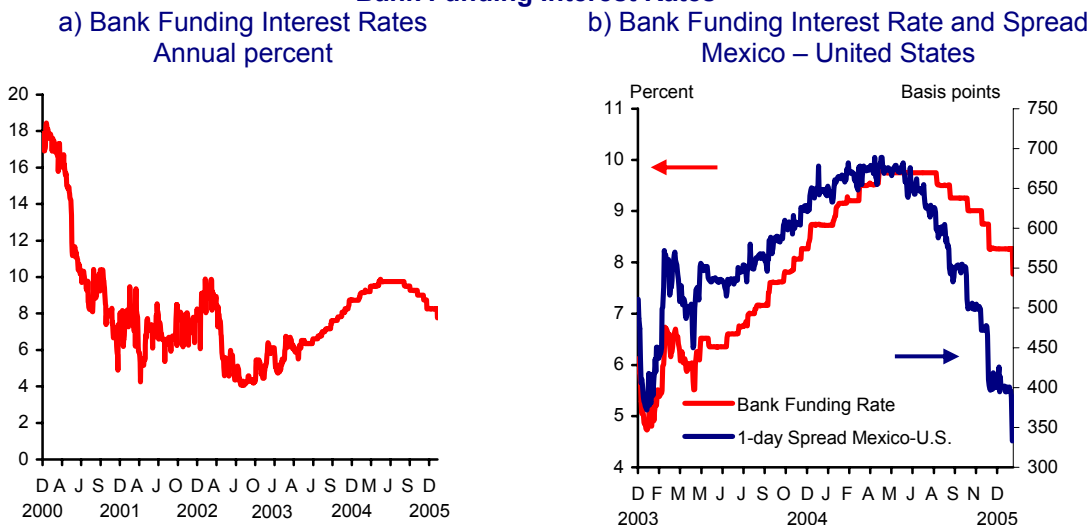
**Graph 23**  
**Yield Curve in Mexico and Interest Rate Spread between Mexico and the U.S.**



In particular, in its press releases of the last months, Banco de México continued to allow a loosening in domestic monetary conditions: no more than 25 basis points in October and November, and no more than 50 basis points in December and January 2006. As a result of such actions, the one-day bank funding interest rate continued to fall, reaching a level of 7.75 percent (Graph 24).

The loosening in monetary conditions adopted by Banco de México is congruent with the reduction of inflation and its expectations and with the convergence of inflation to its target. However, although significant progress has been attained regarding the abatement of inflation, price formation and inflation expectations have still not consolidated around the Central Bank's target.

**Graph 24**  
**Bank Funding Interest Rates**



## 5. Balance of Risks and Final Remarks

---

Banco de México's expected economic scenario is based on the following assumptions:

- a) The outlook for the world economy will continue to be favorable. In particular, the U.S. economy is anticipated to grow at a rate close to potential (3.4 percent on average according to the main analysts). Industrial production is expected to grow at a similar rate than GDP.
- b) External accounts have been favored by oil revenues and by workers' remittances. International financial markets are expected to continue exhibiting slackness. As a result, the economy is anticipated to continue to observe an ample availability of resources for its financing.

Based on these considerations, and on most recent information, the expected scenario for 2006 is as follows:

**GDP Growth:** GDP growth is expected to be between 3.2 and 3.7 percent.

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

**Current Account:** The current account deficit of the balance of payments is expected to be approximately 1.2 percent of GDP.

**Inflation:** Annual headline inflation is expected to increase at the beginning of 2006, to a level close to 4 percent, mainly as a result of the atypical behavior of prices of certain fruits and vegetables at the beginning of the previous year. Afterwards, headline inflation is expected to resume a decreasing trend, although with certain volatility from its non-core component, reaching between 3 and 3.5 percent at the end of the year. Annual core inflation is expected to remain stable at a level close to 3 percent.

In this regard, the following should be highlighted:

- a) The high volatility characterizing the prices of some items included in the fruits and vegetables subindex and the expected stability of annual core inflation implies that throughout the year annual headline inflation is anticipated to exhibit certain volatility, mirroring that of the referred subindex.
- b) During the last months, international energy prices reached historically high levels. Nonetheless, the policies announced by the federal government to determine the prices of goods and services administered



by the public sector will moderate the effect of international energy prices on inflation.<sup>21</sup>

- c) The rest of the goods that comprise the non-core price subindex are expected to behave in such a way that they will not entail significant inflationary pressures.
- d) Expectations that core inflation will remain relatively stable are based on the assumption that the annual variation of merchandise and services prices will remain at levels close to those recorded towards the end of 2005.

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

- i) Although the higher prices of crude oil and its by-products have not led to an increase in world economies' core inflation, further increases in these prices could revert this condition. Should this occur, world's inflationary outlook, including that of Mexico, could deteriorate, therefore leading to an environment of higher interest rates in international financial markets.
- ii) Futures prices of certain grains have increased. This could represent an obstacle for the reduction of processed food inflation.
- iii) Extraordinary price increases of certain items included in the subindex of agricultural products should not be discarded.
- iv) The annual variation of non-housing services' prices remains relatively high.
- v) Inflation expectations remain above the 3 percent target.

The baseline scenario is subject to additional risk factors. Should any of these materialize, they would mainly affect the outlook for growth. Nonetheless, they could also have an inflationary impact.

First, the Chinese and other economies could continue to systematically displace manufacturing production in Mexico, which has lost share in both external and domestic markets. The possibility that this scenario could materialize has increased due to the lack of advances to enhance Mexico's competitiveness. At present, Mexico has fallen in practically all international competitiveness indexes. Although it is true that Mexico has grown due to a favorable international environment, the lack of competitiveness has limited taking full advantage of the favorable circumstances. This has been achieved by other countries that have implemented structural reforms and therefore their economies grow soundly.

---

<sup>21</sup> The Federal Government announced that low consumption electricity tariffs in 2006 will be adjusted according to an annual rate of 4 percent, while high consumption electricity tariffs are expected to fluctuate according to the formula used in the last years (see Inflation Report July-September 2004). Propane prices will increase at an annual rate of 4 percent at the end of the year. Natural gas prices are subject to both changes in their international reference prices and to the rules established to limit their volatility (see *Diario Oficial de la Federación* May 16, 2005). As for gasoline prices, these are anticipated to increase during the year 3 percent in non-border cities, while in northern border cities the price will be determined according to the level reached by this fuel in the nearest U.S. border cities.

Should this trend of competitiveness slump continue in Mexico, the potential growth of the economy could be affected and, therefore, the opportunities and the quality of employment in the country.

Second, the high U.S. current account deficit could become unsustainable. Although this is a medium-term risk factor, if materialized it could have significant effects worldwide, and, given Mexico's trade integration with the U.S., on our outlook for growth.

Finally, as the electoral process of 2006 nears, political uncertainty in Mexico could increase. Certain analysts have pointed out that this could give way to higher volatility in financial markets. In this regard, it is important to point out that the implementation of prudent macroeconomic policies has allowed Mexico to be, at present, less vulnerable to external and domestic shocks.

Stability is a necessary but not the only condition to attain sustained growth. Progress towards a greater stability of the Mexican economy has had a significant influence through its effect on aggregate demand, allowing consumption and investment to expand and become more stable throughout the years. Nonetheless, the current challenge is to implement structural changes destined to increase the flexibility of the economy's productive structure and, hence, to raise its growth potential. Under such context, the need to advance in the pending agenda of structural changes in Mexico is evident. As broad consensus regarding structural reforms with a long-term vision are attained, the lag in competitiveness that the Mexican economy has accumulated in recent years with respect to other economies might be reverted, therefore setting sounder foundations for the country's future growth.

## Monetary Program for 2006

---

Banco de México's Law states that in January the Central Bank must send the President and Congress a report on monetary policy for the corresponding year.<sup>22</sup> In compliance with such legislation, following are monetary policy's principles and guidelines to be followed during 2006.

Monetary policy in Mexico is to be conducted based on an inflation targeting framework, of which the following elements deserve mention: a) the announcement of an explicit multi-annual inflation target; b) a systematic analysis of the current economic conditions and of inflationary pressures; c) a description of the instruments used by the Central Bank to attain its objectives; and, d) a communication policy that fosters monetary policy's transparency, accountability and effectiveness.

### 1. Objectives

Banco de México's monetary policy is conducted to attain an annual CPI inflation of 3 percent and remain permanently around that level. Nonetheless, although monetary policy is implemented in order to reach these objectives, it is subject to a certain degree of uncertainty. This is due to the multiple shocks that can affect both the economy and the price determination process, and to the fact that the relationship between monetary policy actions and its results regarding inflation is imprecise. Therefore, a variability interval of plus/minus one percentage points has been set around the inflation target.

It is important to reiterate that the referred interval around the inflation target was not set as a margin of indifference or tolerance for the monetary authority. It only represents explicitly the inaccuracy that inexorably surrounds the attainment of the inflation target, due to the different shocks that can affect CPI inflation. In this regard, Banco de México's monetary policy actions are oriented towards achieving the 3 percent inflation target. Nonetheless, given the volatility of CPI inflation, such actions might always deviate temporarily from the target.

### 2. Monetary Policy Decisions

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

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

---

<sup>22</sup> See Article 51 of Banco de México's Law.

On the other hand, when inflation pressures originate from the supply side, they usually reflect changes in relative prices, which affect inflation temporarily. In such case, the monetary authority should not counter such pressures, as these only have a temporary effect on inflation. Nonetheless, if such pressures contaminate inflation expectations and determination of other prices, the Central Bank must tighten monetary policy to prevent subsequent price increases (second round effects).

An accurate identification of the origin of inflation pressures and its possible effects on economic agents' expectations is crucial for monetary policy decisions. Banco de México carries out a systematic analysis of the current economic conditions and of the inflation pressures originated by such conditions, using a wide range of variables and indicators and different economic and statistical models.<sup>23</sup> Such analysis allows for identifying the factors that affect the expected development of inflation in order to evaluate its impact on economic agents' inflation expectations and on the price determination process.

### 3. Monetary Policy Implementation

Central banks have different instruments to conduct monetary policy, which are used to foster monetary conditions congruent with the attainment of the inflation target.

Banco de México implements monetary policy through different channels, which allow the Central Bank to communicate its monetary policy stance. In this regard, the following stand out: the modifications to Banco de México's objective for commercial banks' daily balances at the Central Bank (*corto*) and the statements included in its monetary policy press releases regarding domestic monetary conditions.<sup>24</sup> As mentioned in previous occasions, Banco de México has two main instruments to induce changes in the monetary policy stance: the determination of minimum levels or floors for domestic monetary conditions and the *corto*. Through the referred floors, Banco de México has been able to signal more clearly to the markets its monetary policy stance. Nonetheless, the *corto* is maintained as an available monetary policy instrument to be used by the Board of Governors whenever deemed convenient.

### 4. Communication Policy

In order to attain price stability through an inflation targeting framework, the Central Bank must communicate clearly to the public its objectives, strategy and instruments. The announcement of inflation targets is important as it facilitates the convergence of economic agents' expectations to such targets. This is also reinforced by the Central Bank's commitment to take the necessary measures to attain its inflation target. Transparency in monetary policy decisions has allowed the Central Bank to explain the motives supporting its actions. Such transparency raises certainty among the public, fosters the attainment of the Central Bank's objectives and, in turn, reduces the cost of inflation abatement.

<sup>23</sup> A forecast for the monetary base for 2006 (which can serve as a general reference to monitor the current economic conditions) can be found in Banco de México's web page ([www.banxico.org.mx](http://www.banxico.org.mx)).

<sup>24</sup> For a detailed description on the *corto*, see the Monetary Programs of previous years.



Greater transparency together with the communication policy has contributed to strengthen the accountability of the Central Bank.

Among the documents that support Banco de México's communication strategy are the Monetary Program and the Inflation Reports. In addition, since 2003, the Central Bank has been announcing on pre-established dates its monetary policy decisions, together with a press release explaining the Board of Governors' decisions regarding the monetary policy stance.<sup>25</sup>

---

<sup>25</sup> These dates are announced in the Inflation Report of the third quarter of the previous year.