

Situación

Economic Research Department

Second Quarter 2005



U.S.: potential growth at the speed of a cruise ship
Domestic demand boosts Mexican growth
Meeting inflation target depends on volatile factors
Is the end near for interest rate increases?
Challenges for pensions in Mexico

In the past few months, the strength of Mexico's economy has left few doubts that the main source of growth in 2005 will be domestic demand, displacing the external sector. This is good news, not only because it bolsters the expansion cycle that was consolidated in 2004 (with GDP growing at rates of 4.4%), but also given that it could reflect more solid bases for growth in the future.

Many factors have come together to support this economic strength, but of particular importance are the increase in credit to the private sector and on a more structural level, continued monetary and fiscal stability. In addition, we should also recall the importance of the first steps toward the reform of the country's pension systems to allow long-term private savings. Many years of efforts to achieve these solid bases of growth are beginning to bear fruit.

It would be a shame that, in this context of strong economic activity, the economic authorities would not take the necessary measures to assure a higher rate of growth in the medium term. The good news is that today the importance of monetary and fiscal stability for growth (although fiscal revenue should be increased and its structure improved toward more stable sources, other than oil revenue) and the role of the private sector in the productive process is not being questioned in Mexico. Another positive development is that the banks are solid and can continue their dynamics of granting more credit, without incurring in risks for the financial system. However, there is room for improvement in many areas. In addition to building on the reform of the pension systems, as pointed out in an article in this issue, spaces for private sector participation in different economic sectors can still be expanded, and there is a long way to go on the road to implement structural reforms.

There are also other factors that require attention in this context of growth in domestic demand. Specifically, the risk of inflationary pressures is of no minor concern and will take on greater importance in the future. The target set by the Banco de México for 3% growth in prices (with allowance for a band of one percentage point in either direction) is quite ambitious, but it is a goal on which the central bank has staked its credibility. And today there are reasonable doubts as to whether in a context of strong domestic economic activity, demand pressures will be generated, making it difficult to meet this target, especially given the downward rigidity of both core inflation and medium-term inflation expectations.

These factors could place the Banco de México in a dilemma, as to whether to continue implementing a restrictive monetary policy, which could end up affecting economic growth as such, or to accept that given high real interest rates and the strength of the peso, monetary conditions are already sufficiently restrictive and that monetary policy has already played its part. Although all this remains to be seen, given that recent announcements indicate that the Banco de México wants to reinforce the anchor of price stability.

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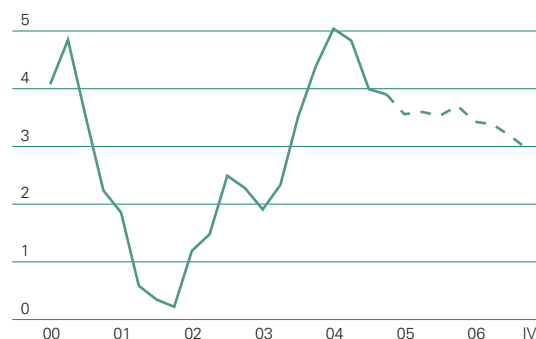
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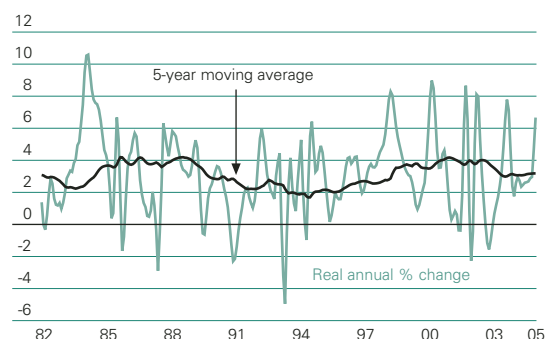
U.S. GDP

Annual % change



Note: Estimated through first quarter 2005
Source: BBVA Bancomer with BEA data

U.S.: Disposable Income



Source: BBVA Bancomer BEA data

U.S. Wealth / Disposable Income

%



Source: BBVA Bancomer with Federal Reserve data

In 2005-06, economic expansion will approach its potential

Dynamic private consumption and the strong stimulus of investment will continue to drive economic expansion in 2005-06, a period in which economic growth will come close to its potential, although at a lower pace than in 2004. One of the bases for this expectation is that private consumption, which has remained high both during and after the recession, will remain strong. Four factors suggest that the growing trend in family spending will continue during the next two years.

First, productivity growth will be more moderate with regard to its long-term trend, (2%-2.5%). These growth rates will enable maintaining important gains in families' real income. Second, relatively low interest rates will continue to drive spending on durable goods. Third, the increase in stock prices, and mainly higher housing values will allow significant growth in families' wealth, which will spur consumption. In fact, the ratio between wealth and disposable income has been growing significantly in recent years and currently stands at an annual 5.4%, higher than its long-term trend of 4.8%. Finally, recovery in the job market is gaining strength and will be an additional support factor. During January and February an average of almost 200,000 new jobs were created, compared to 190,000 in fourth quarter 2004 and 137,000 in third quarter 2004, confirming companies' confidence in the sustainability of the recovery.

Investment, which stepped up notably in 2004, following a sharp drop after the recession in 2001, will continue to spur economic growth. Companies' solid financial situation, the low cost of capital and growth in demand will help keep investment strong, although at a more moderate pace than in 2004.

Companies will continue to benefit from internal restructuring—adjustment of over-capacity and over-hiring—as well as from technological change and low interest rates. This will allow them to maintain strong cash flows, even higher than during the nineties. Despite the foreseeable rise in interest rates and the business risk premium, we don't expect a significant impact on companies' expansion plans. Moreover, the favorable performance of corporate earnings will enable companies to finance a large share of their capital requirements with their own funds, without excessive dependence on bank loans or access to the capital markets. Finally, demand will continue to support investment, an expectation already evident in the recent increase in inventories.

Inflation will remain low

Although the economic cycle has advanced, inflation will tend to remain relatively low and stable, thanks to the high credibility of the Federal Reserve, which has permitted anchoring inflation expectations, ensuring less volatility in the price formation process in line with the implicit goals of the central bank. In addition, the prices of some industrial products will continue to be low, insofar as production processes continue to benefit from globalization, mainly through low-cost imports from China.

At the same time, the flexibility of the domestic markets, particularly the labor market, ensures that possible negative shocks will have a transitory and less costly effect. Finally, high corporate margins and earnings, as well as idle capacity, will continue to allow companies to absorb higher costs without totally transferring this increase to final prices.

Nevertheless, the risks of higher inflation in 2005 have risen in recent months. This is due to price increases in raw materials, energy sources and the prices of imports, and a weakened dollar. Together with the above, lower growth in productivity and higher labor costs could generate additional inflationary pressures if companies are forced to transfer higher production costs to final prices. In fact, data are beginning to appear that give evidence of a greater price setting capacity by the business sector. Should this pressure continue, it would be difficult for inflation to drop from its current levels of 3%.

Domestic imbalances will be corrected gradually

One factor that is causing considerable concern is the expansion of domestic imbalances. The budget deficit could tend to decrease in the coming years as a result of continued economic recovery and possible lower spending needs for defense and national security. Despite this, the deficit will not drop significantly in 2005 (it will be 3.4% of GDP) and doubts will persist regarding its future performance if military spending continues to rise and tax reductions are made permanent. Overall, however, if the appropriate steps are taken, the outlook might not be so negative within a context in which the cyclical fiscal balance component has been corrected and the deterioration of the structural balance has been halted. The coming months will be key in evaluating the commitment of the administration with the announced goal of reducing the budget deficit in the coming years.

The current account deficit will rise in 2005 and will only begin to drop moderately in 2006. This will be due to solid economic growth in the U.S., higher than that of its main trading partners (and to the high marginal propensity to consume—and to import—of U.S. consumers compared to the consumers of its main trading partners, such as China) as well as to high energy and raw material prices.

U.S.: Earnings of Non-Financial Firms

% of business sector output, after taxes



Source: BBVA Bancomer with BEA data

U.S.: Financing Gap*

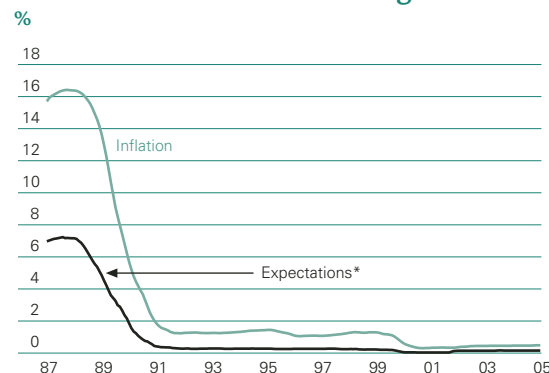
US\$ billions



* Spending on capital less funds generated internally and adjustment due to inventory valuation

Source: BBVA Bancomer with Federal Reserve data

U.S.: Inflation Variance During 10 Years



* Inflation expectations 12 months ahead

Source: BBVA Bancomer with BLS data

Social Security in the United States: Challenges and Outlook

The social security system in the United States provides benefits to 48 million individuals through two basic programs: Old Age and Survivors Insurance (OASI), which covers retired workers and family members and surviving spouses of deceased workers, and accounts for 85% of the system's total expenditures; and Disability Insurance (DI), which represents the remaining 15% and attends to the disabled below retirement age and their dependents.

Recent Statistics on Social Security, 2004

Workers covered by Social Security	157 million
Beneficiaries	
Retired workers and their dependents	33 million
Disabled workers and their dependents	8 million
Surviving family members of deceased workers	7 million
Total number of beneficiaries	48 million
Benefits paid in the year	493 billion
Revenue received	658 billion
Total assets in the trust	1.7 trillion
Tax rate	12.4%
Income limit subject to tax (2005)	90,000 USD

Source: SSA, CBO

The system is based on pay as you go, that is, it is financed through a distribution schema and administered by the public sector. The system's revenue is obtained from a payroll tax of 12.4% paid equitably by employees and management.

Ratio of Active to Retired Workers

Figures in millions of people except last column

	Workers	Population ¹	Growth ²	Gwth. pop. ³	Wkrs./pers. ⁴
1980	113.6	26.1	20.6	5.2	4.3
1990	133.7	32.0	20.0	5.9	4.2
2000	153.7	35.5	20.0	3.5	4.3
2010	165.4	39.5	11.8	4.0	4.2
2020	172.8	53.2	7.4	13.7	3.3
2030	178.1	69.4	5.3	16.3	2.6
2050	189.8	78.3	5.4	3.1	2.4

- 1 Population over 65 years of age
- 2 Expected growth in number of workers
- 3 Expected growth in the population over 65 years of age
- 4 Workers/persons over 65 years of age

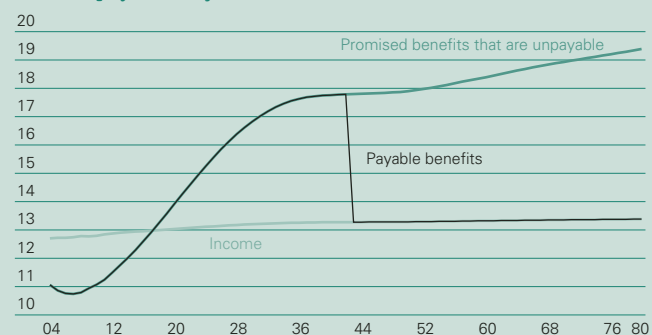
Source: CBO

The high ratio of active workers to pensioners has allowed the system to remain solvent. Nevertheless, this ratio is tending to diminish due to a higher life expectancy and a decline in the birth rate. This process will be accentuated with the retirement of the "baby boomers"

and it is felt that the ratio will be 2.6 active workers for each retiree in 2030 and 2.4 in 2050, significantly below the levels of past decades (4.3 in 1980 and 4.2 in 1990). This will translate into important costs in the public sector accounts.

Projections on Income and Benefits

% of the payroll subject to taxes



Source: SSA

In the next 75 years, the current cost of expenditures for future benefits under the current legislation will exceed revenue from the payroll tax plus the value of the trust by US\$4.0 trillion dollars. As of 2078, the deficit will increase by US\$7.1 trillion over an infinite time horizon, which results in a total of US\$11.1 trillion. Although in the short term, the system is financially healthy, as is the case in other countries, maintaining the current situation poses serious sustainability problems for public finances in the medium and long term.

The Bush administration currently seems to unofficially favor a proposal (model 2 of the Presidential Commission) that includes allocating 4% of the payroll tax to individual accounts with an initial maximum limit of US\$1,000; consider indexing benefits to inflation instead of wage growth; and guaranteeing protection for those with lower income levels. The transition cost for this program is estimated at between US\$0.9 trillion and US\$2 trillion.

Since wages tend to increase more than inflation, indexing benefits to the growth in prices would allow reducing the gap between benefits and social security system fees.¹ This, coupled with the individual accounts, ensures the system's solvency. In addition, President Bush has played with the idea of increasing the maximum level of income subject to

1 Recently a more moderate version of the proposal entitled "progressive indexing" is being debated. It excludes low-income workers from the measure.

the payroll tax (currently set at US\$90,000 annually), which would result in even greater solvency for the system.

Presidential Commission to Strengthen Social Security, 2001

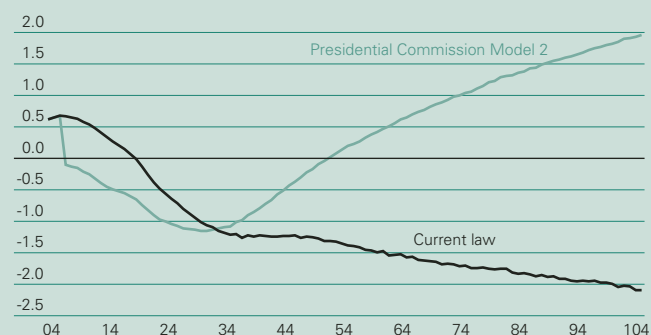
Model 2

- Personal accounts without change in income or benefits
- 4% payroll tax contribution with maximum limit of US\$1,000
- Real 2% yield on contributions to compensate benefits paid
- Payment of benefits assured at 120% above the poverty line for workers who receive minimum wage with at least 30 years of job experience
- Benefits will be indexed to inflation in 2009
- In 2052, the benefits for a low-income worker will be 27% greater in real terms than the current levels
- It will not be necessary to increase taxes
- Need to transfer resources between 2025 and 2054 to pay transition
- Positive flow after 75 years for all levels of participation

Source: The President's Commission to Strengthen Social Security

OASIDI Revenue - Expenditures

% of GDP



Fuente: CBO

According to the Congressional Budget Office, a reform along such lines would affect the economy mainly through family expectations. The reduction in benefits would lead to a decrease in private consumer spending and an increase in family savings. In addition, the reform would allow national wealth to increase between 10% and 12% by 2080 compared to current levels.

At the same time, the fiscal deficit would increase during the first few years. However, over time, expenditures will decrease, resulting in a decline in the public deficit in the long term.

The effects on the labor market are uncertain, since, on the one hand, the reduction in benefits will lead to some workers leaving the job market or retiring at a younger

age. On the other hand, the incentive for others will be to work more to compensate for the decrease in benefits. The effect on the availability of jobs is considered to be minor, with a difference between 1% and 1.5% with regard to simulations without the reform.

With regard to the GDP, the impact would depend on what the government decides to do with the growing surplus, that is, to reduce taxes or increase benefits. Nevertheless, in any event, the results indicate that the growth in GDP will be greater with a reform than without it.

Will this reform be implemented? Bush must seek support within his party, since although most Republican members of Congress favor including individual accounts, they differ considerably on the question of reducing benefits, raising taxes, and increasing the public debt. The Democrats are very much united against some of the possible lines of reforming the system.

On the whole, the future situation of the social security system worries Democrats and Republicans and therefore we feel it is very likely that a reform proposal will be approved that consists in assuring the system's solvency during the next 75 years. However, this could be less ambitious than the proposal outlined by President Bush.

To cover the costs of the transition, the government will resort to both indebtedness and cutbacks in other expenditure items, which would prevent the deficit from rising significantly. The approval of a reform proposal would send a positive signal to the markets, improving confidence in the outlook for public finances.

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U.S.: Non-Farm Business Sector Productivity and Unit Labor Costs

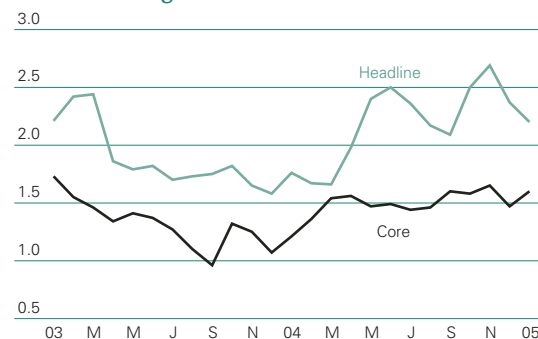
Annual % change



Source: BBVA Bancomer with BLS data

U.S.: Price Index of Personal Consumer Expenditures

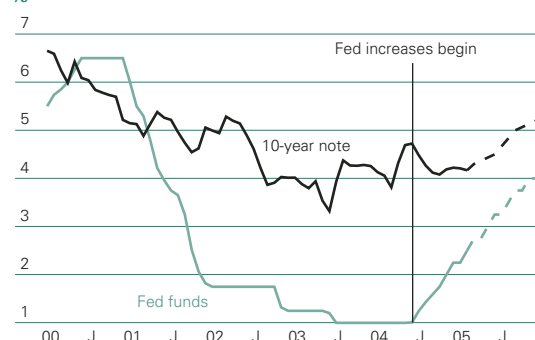
Annual % change



Source: BBVA Bancomer with BEA data

U.S.: Interest Rates

%



Source: BBVA

Financial environment

The dynamics of the Federal Reserve of increasing its reference rate 25 basis points at each of its meetings held since June 2004 will continue until interest rates approach levels of 3%, possibly at the May 3rd. meeting. After that, there will be greater uncertainty with regard to the pace at which the monetary authority will implement the next increases, since nominal interest rates will already be at the limit of the area considered "neutral" (between 3% and 5%). This could lead the monetary authority to base subsequent interest rate increases more on the available economic information, reducing the certainty with which monetary policy has moved in recent months. Overall, however, we believe that interest rate increases will continue to rise, to then close at 4% at the end of 2005.

As we had anticipated, the U.S. economy continues to post high growth rates for the fourth consecutive year, despite the increases in oil prices. This could indicate that there are fewer idle funds in the economy, which together with moderate productivity growth, higher production and import prices and the depreciation of the dollar, could lead the Federal Reserve to modify the inflation trend upward.

Within this context of greater uncertainty regarding monetary policy and a possible rising trend in inflation, U.S. long-term interest rates, which are at very low levels, could be expected to increase gradually until they stand at 5.2% by the end of the year, surely in an environment of greater volatility, given the doubts regarding the pace of federal funds rate increases starting in June. This would occur within a context of a gradual adjustment on the financial markets, in which the dollar in its exchange rate with the euro would end at levels close to \$1.35 per euro. In face of the expansion of the profitability spreads between the U.S. and Europe, which could favor the dollar, the U.S. currency would be negatively affected due to the country's high budget and current deficits. This rise in interest rates could lead to the beginning of a correction in the search process for profitability, which has led both corporate debt spreads and emerging countries debt spreads to very low levels. This adjustment will be limited, since we don't expect a scenario of marked volatility in the industrialized countries' profitability.

There are two risk scenarios. The first is that the Federal Reserve would make a pause in its interest-rate increases and that maintaining high monetary growth would lead to the accumulation of greater risks as regards an inflation rise. In this situation, the adjustment of the financial variables would probably be more abrupt, with significant increases in interest rates in the long term of the debt curve and a greater depreciation of the dollar. The second risk scenario is related to the low savings levels of families and their high level of indebtedness. A negative shock in confidence could cause a decrease in activity, without strong in-depth pressures on inflation, which would put a halt to interest rate increases during the whole of 2005 at levels close to the current ones.

Are Long-Term Interest Rates in the United States Too Low?

Several factors would indicate that long-term U.S. interest rates should be above their current levels. First, short-term rates have risen 150 basis points (bp) and the expectations for increases have been growing. Second, economic growth in 2005 has begun on solid ground. Third, potential inflationary pressures have been accumulating, in response to the growth in production and import costs, attributable both to higher oil prices and to the depreciation of the dollar.

Why are rates not rising more? In the first place, one could argue that companies are not displaying a strong demand for credit for new investment projects. Although U.S. savings levels are low, this is not the case on a world level. Thus, other countries' demand for U.S. assets has allowed long-term interest rates to remain low in the United States.

In the second place, insurance companies and pension funds are increasing the demand for long-term assets, partly because they can be affected by regulatory changes and partly because during the past few years they have maintained portfolios with low maturity assets. This situation could continue while they balance their portfolios, but its impact on the 10-year yield will depend on changes in debt supply, especially for the terms that are being issued.

In the third place, one might think (as in 2004) that U.S. rates remain low because, even though that country's economy has entered its fourth consecutive year of expansion, inflation expectations also remain low. In 2004, these inflationary expectations discounted in indexed bonds reached a minimum of 2.3% in September, and since then have posted maximum levels. At present, the accumulation of upward inflation risks seems to support greater increases in long-term rates.

In the fourth place, it is often argued that the temporary risk premium for 10-year securities has decreased in a context of confidence given the monetary policy announced by the Fed. However, this is not the case. The discounted risk premium in forward rates remains stable and close to 20 bp.¹

Finally, the long-term rates can encompass expectations of lower future growth, which translates into real rates below their equilibrium level (2.5% to 3%).² But once again, in a context of high liquidity, the risk that rate levels are being underestimated is high. If it is admitted that

productivity-based earnings will remain the same, it is difficult to think that the real rates are low.

U.S.: Inflationary Expectations Discounted in Indexed Bonds • %



Source: BBVA with Federal Reserve Data

What is the equilibrium level estimated to be for long term rates? If we consider that long term rates encompass medium term inflationary expectations (2.5%), the real interest rate compatible with stable inflation (from 2.5% to 3%), and the temporary risk premium (20 bp), it is possible to estimate that the equilibrium level is close to 5.5%.

U.S.: Contributions of Variables in the 10-year Rate Model in 2005 • Quarterly average

	3-month rate	Inflation	ISM*	Budget balance	10-year model
1st. quarter	1.6	2.5	0.0	0.1	4.3
2nd. quarter	1.8	2.8	0.0	0.1	4.7
3rd. quarter	2.1	2.5	-0.1	0.1	4.8
4th. quarter	2.3	2.7	-0.1	0.1	5.2

* Business confidence

Source: BBVA with Federal Reserve data

The econometric models that explain the performance of the 10-year rate in the United States³ estimate that it will reach 5.2% at the end of 2005. The increase in short-term interest rates will be the main determining factor in the performance of the long end of the yield curve.

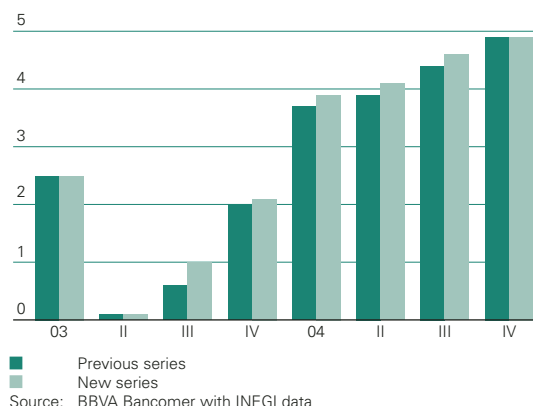
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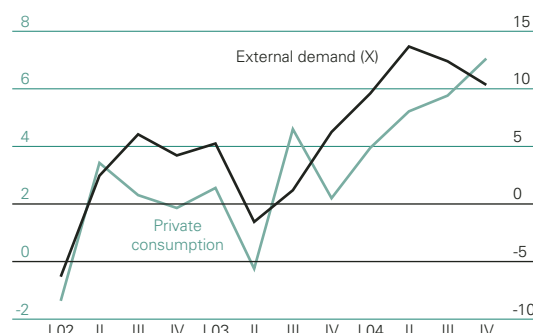
- 1 See BIS (2005): "Decomposing long-term yields", BIS Quarterly Review, March
- 2 See J. D. Amato (2005): "The role of the natural rate of interest in monetary policy", BIS working paper no. 171
- 3 The specified model is a mechanism for correcting errors with a 3-month interest rate and a long-term inflation rate and the dynamic incorporates changes in expectations on business activity (ISM), the 3-month rate, the inflation rate, and the budget balance.

Mexico: Upward Correction of Growth Projections for 2005: from 3.8% to 4.2%

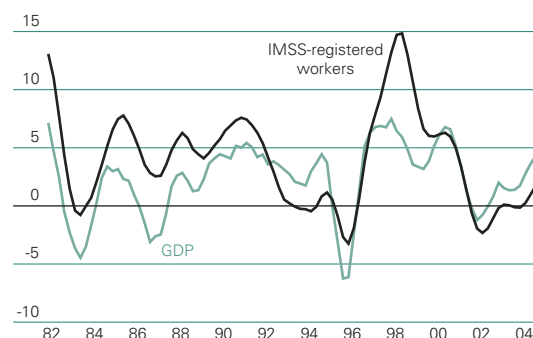
GDP Mexico Annual % change



Aggregate Demand Main components, annual % change



GDP & Formal Private Sector Employment Annual % change



In 2004, the Mexican economy grew an annual 4.4%, achieving its best performance in the past four years. This result, slightly above expectations, can be attributed, in part, to a review of growth figures for previous quarters and in part to a better performance in the final months of the year, especially due to strong domestic demand.

It has been a long road to achieve this growth. The moderate recession in recent years and the economic recovery confirmed by 2004 figures, is due, first of all, to the absence of a financial crisis in the latest recessive period. In contrast with other periods of contraction in which external shocks, the loss of confidence, or domestic imbalances led to abrupt adjustments in production, the reduced economic activity in the last recessive period has not been affected by any financial crisis. This has led to a more solid starting point in consolidating recovery.

Moreover, the recent period of economic growth has followed a classic pattern of industrialized and open economies, in which recovery has been spurred by a high degree of synchronization with the U.S. economy and has been consolidated due to the recovery of domestic demand. This process has led to an upward trend in Mexico's GDP since 2Q03, with the economy closing the last quarter of 2004 with an annual growth rate of 4.9%.

Without a doubt, 2004 confirms the end of the recession and the beginning of a new growth cycle. But it will be difficult to post increases that surpass those achieved in 2004. The lower growth expected in external demand (U.S. GDP is projected to increase slightly less than 4%), a more restrictive monetary policy, slightly lower oil prices, and the uncertainties caused by the electoral process, will generate some pressures on production trends. However, Mexico will continue to enjoy renewed momentum in growth resulting from domestic demand.

The expansion of foreign demand, particularly in the United States, spurred exports at the beginning of the expansive cycle in Mexico. In the past few quarters, increases in real wages and in employment have had a favorable impact on total wages and together with strong growth in credit, have bolstered the recovery of consumption. Looking forward, in addition to credit, one of the driving forces of activity in 2005 will be employment.

Employment, motivating factor for domestic demand

In the absence of structural reforms, employment usually experiences a delayed reaction in relation to GDP. The expansion of the productive plant occurs when the permanence of demand is confirmed and in light of good expectations for economic growth. It should come as no surprise, therefore, that in 2004, the number of registered workers in the Mexican Social Security Institute, which is used as an indicator of formal employment, increased 2.8%, while GDP posted greater growth, of 4.4%.

Formal urban employment has posted 19 consecutive months of growth, which in February 2005 led this indicator to surpass its historic high of November 2000. Nevertheless, job creation has been slower than in previous cycles. Two factors seem to influence this behavior: the lag and

the slow recovery of the U.S. manufacturing sector (which has experienced an intense and long process of loss of jobs) and the presence of new competitors in the domestic and international market, which has changed the structure of production and of Mexican exports.

These elements explain the different performance of employment by sector of activity and market orientation. Between 2001 and 2003, non-oil exports fell 2.5% and employment in the industrial sector declined 13.7%, equivalent to 755,000 jobs, a more than proportional adjustment, which can be attributed to restructuring of sectors and the need to be more productive in a highly competitive environment. Thus, despite the moderate recent recovery in employment between 2001 and 2004, some 671,000 industrial jobs were lost. The contraction in employment took place in both the maquiladora and non-maquiladora (domestic manufacturing industry) sectors, with a greater impact on the latter, as shown in the corresponding graph. At the same time, domestic demand was sufficiently strong to generate jobs and offset the drop in manufacturing industry employment. In this period, 647,000 jobs were created in the services sector and 34,000 in agriculture.

In 2004, conditions were more favorable and marked the beginning of the creation of jobs. In the domestic manufacturing industry, the contraction was marginal, and four of its sectors posted growth as was the case in most of the maquiladora branches, with the exception of footwear and leather, light plastics, toys, and sports articles. The corresponding chart illustrates the greatest changes in industry employment. These trends will continue in 2005. Internationally, U.S. industrial production will practically maintain its strength, consolidating its recovery. This will have a positive impact on employment in the sector, especially if the maquiladoras are able to gain market share in the process of plant relocations that could continue in U.S. industry.

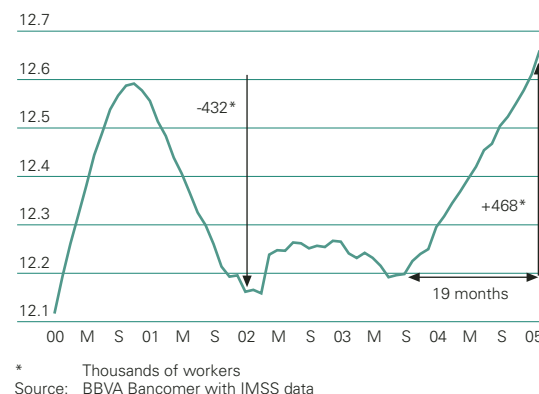
Overall, the creation of new jobs in 2005 will exceed last year's results. We expect an increase of more than 500,000 formal jobs. The accumulated results up until the first two weeks of March (122,900, the highest increase in the past five years) point in this direction. There is no doubt that this dynamism will support the strength of domestic demand, which we expect to continue.

The economy in 2005-2006: favorable outlook with a mild slowdown

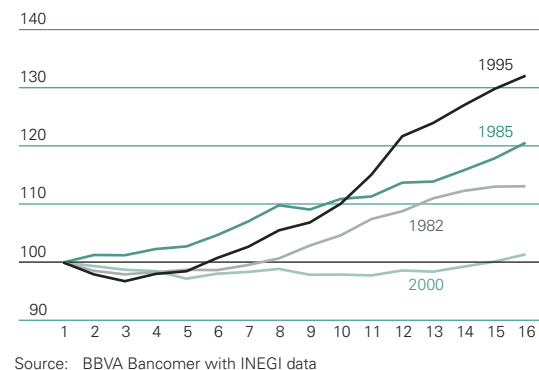
On the whole, in 2005, GDP is expected to grow somewhat more than what we originally projected, 4.2% compared with our previous estimate of 3.8%, even though we maintain expectations of a moderately downward trend, which will continue in 2006. As has been the case in previous years, consumption will be more dynamic than GDP.

The slowdown in the U.S. economy in 2005 will have a moderate impact on growth in Mexico. U.S. industrial production will maintain its strength at about 4%, which will continue to support Mexican growth, given the strong linkage between the industrial cycles of the two economies. On the domestic front, demand will continue to be strong, supported by greater job creation, by improvement in real wages, and an increased supply of credit. Consumption will maintain its dynamism due to gains in total wages and investment as a result of the rise in demand (domestic and foreign) and given the reduction of idle capacity in some economic branches.

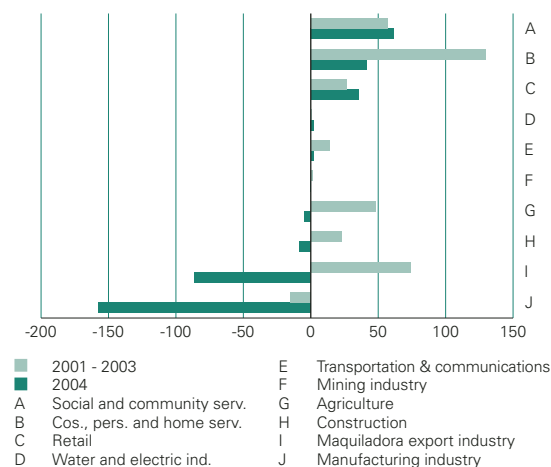
Formal Employment in the Private Sector Millions of urban IMSS-registered workers



Performance of Employment in Different Cycles • Base 100 = "ceiling" quarter of activity



Evolution of Employment by Activity Yearly average, thousands of workers

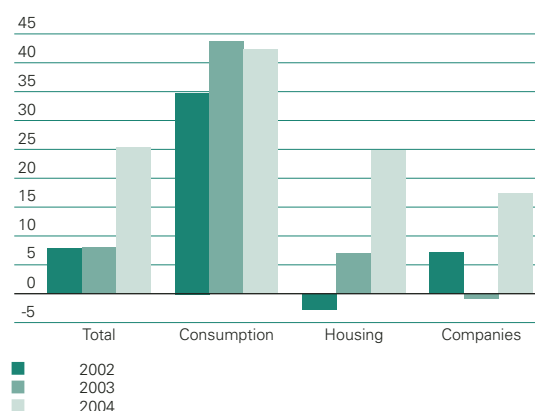


Manufacturing Industry • Main changes in formal private employment between 2000 and 2004, change

	Workers*		% change	
	01-03	2004	01-03	2004
Manufacturing industry				
Total	-201.3	-9.1	-13.7	-0.7
Met, mach. & equip. prod.	-98.1	3.5	-23.5	1.1
Textiles, apparel & leather	-45.7	-8.7	-24.1	-6.1
Chemicals and rubber	-28.3	-3.0	-11.9	-1.4
Non-metallic minerals	-7.2	0.5	-9.8	0.7
Paper, printing & publishing	-5.8	-0.4	-6.5	-0.4
Maquiladora export industry				
Total	-259.8	74.4	-19.8	7.1
Electric & electronic mat.	-108.6	8.6	-31.6	3.7
Textiles	-93.4	6.2	-32.3	3.2
Services	-13.8	9.8	-27.9	27.6
Furniture, wood & metal	-11.7	2.8	-18.8	5.6
Electric & electronic mach.	-7.9	9.1	-7.7	9.6

* Thousands
Source: BBVA Bancomer with INEGI data

Performing Loans to the Private Sector Real annual % change



Meanwhile, performing loans to the private sector, which have already shown greater strength since 1995, will continue to increase at high rates. Consumer credit will maintain its expansion of the past few years and post a real increase of more than 40%, while housing loans and company financing will consolidate their growth with variations of around 20%. More specifically, home construction will continue to benefit from the availability of financing, legal changes that promote growth in the sector, government programs, and increased demand. Despite the recent high growth rates of credit in Mexico, its growth trend will continue because its balance is low compared to GDP.

The electoral process will also boost productive activity in 2005 and 2006. In these two years, 47% of Mexican states (accounting for 58% of GDP) will be renewing their administrations. This is generally associated with the conclusion of public work projects and the resulting spillover in the economy, in addition to electoral expenses and political party expenditures. Among the states that stand out in this category due to their relative importance are the Federal District, the State of Mexico, and Jalisco.

We are not exempt from risks

The main risks and uncertainties are related to the strength of U.S. industrial activity (greater inflation and the sustainability of the fiscal and current account deficits, which could lead to higher interest rates and lower economic activity) and in the possibility of a relocation of industrial plants that might not benefit Mexico. In addition, it will be necessary to pay attention to inflationary pressures that the very dynamism of domestic demand could generate, which could translate into additional interest rate increases by the Banco de México (the central bank). We anticipate that the uncertainty generated by the political environment will not have important repercussions on the country's macroeconomic variables during the current pre-electoral year, although it is never advisable to lower one's guard on this front. There is still a long way to go before the selection of the presidential candidates and the definition of the incoming government's programs.

Macroeconomic Chart of Mexico Annual % change

	Registered					Projected						Contrib. to growth (pp)		
	2000	2001	2002	2003	2004	2005	2006	1T05	2T05	3T05	4T05	2004	2005	2006
GDP	6.6	-0.2	0.8	1.4	4.4	4.2	4.0	4.4	4.3	4.2	3.8	4.4	4.2	4.0
Total demand	10.4	-0.6	1.0	1.2	6.0	5.9	6.0	5.2	5.7	6.3	6.3	8.2	8.2	8.4
Domestic	8.5	0.6	0.8	0.7	4.1	4.9	4.3	4.5	4.5	5.2	5.4	4.2	5.0	4.5
Consumption	7.4	1.9	1.4	2.1	4.7	5.3	4.5	5.5	5.1	5.5	5.2	3.9	4.3	3.8
Private	8.2	2.5	1.6	2.3	5.5	5.7	4.8	5.9	5.3	5.8	5.6	4.0	4.1	3.5
Public	2.4	-2.0	-0.3	0.8	-1.2	2.5	2.6	2.9	3.0	2.0	2.1	-0.1	0.2	0.2
Investment	11.4	-5.6	-0.6	0.4	7.5	5.9	4.8	8.3	7.1	4.6	4.0	1.4	1.2	1.0
Private	9.0	-5.9	-4.1	-1.5	8.5	6.7	5.6	9.3	8.0	5.2	4.3	1.3	1.1	0.9
Public	25.2	-4.2	17.0	8.5	3.6	2.7	2.9	2.6	2.5	1.8	3.3	0.1	0.1	0.1
Chge. inventories*												-1.1	-0.5	-0.3
Net external												0.2	-0.8	-0.5
Gross external	16.4	-3.8	1.6	2.7	11.5	8.7	10.3	7.4	9.1	9.2	9.0	4.0	3.2	4.0
Imports (goods & serv.)	21.5	-1.6	1.5	0.7	10.2	10.3	10.7	7.7	9.4	11.3	12.3	-3.8	-4.0	-4.4

* The annual rates are not presented because they are not representative
Source: BBVA Bancomer with INEGI data

Employment and Economic Activity: Okun's Law in Mexico

Okun's Law postulates the existence of a quantitative relation between unemployment and economic activity. The underlying argument is simple. In a period of recession, given reduced demand, the productive sector generally lays off workers or, at least does not hire additional employees. On the other side of the equation, in a period of expansion, companies respond by hiring workers, which leads to a reduction in the open unemployment rate (OUR). A common way of formulating Okun's law is to correlate the output gap (the difference between registered and potential GDP) to changes in the OUR through an inverse, lineal, and relatively stable ratio.¹

In the United States, the ratio tends to be 1 to -1/2, that is, for each one point change in the output gap, the OUR moves 0.5 percentage points (pp) in the opposite direction. This quantification is subject to restrictions. For example, the unemployment rate has a lower limit equal to the natural jobless rate and cannot register negative numbers. Therefore, this ratio should be expressed within a certain numerical range.

Mexico: Output Gap and OUR, 1994-2004



Source: BBVA Bancomer with INEGI data

There are other specific difficulties in measuring this ratio in countries such as Mexico. In the developed countries, the estimate of potential GDP and therefore the output gap is more reliable than in the emerging economies. The volatility of the economy, the availability of long-term statistical data, structural changes, and external shocks, among other variables, can increase the uncertainty associated with calculating potential GDP. But it is worthwhile to consider not only the relation between output gap

and changes in employment, but also, whether there is a stable relation between the two and what the necessary economic dynamism is to create jobs.

In Mexico, the correlation between output gap and changes in the OUR is in line with expectations. It is negative and lineal but with a ratio between them of -0.25. This means that for each percentage point change in the output gap, the OUR will move on average 0.25 pp in the opposite direction. The difference between the elasticity of the OUR in Mexico and the U.S. could be explained by the relatively low levels of unemployment in Mexico, the large informal sector that acts as a shock absorber, and problems in estimating the output gap.

To resolve this latter problem, a direct ratio between economic activity and employment (or the OUR) could be formulated. Based on monthly data from 1994 to 2004, we see that economic activity (the IGAE index) is decisive in the performance of employment (the number of IMSS-registered workers) and changes in the OUR. In the first case, there is an acceptable correlation and the adjustment would imply that minimum growth of 1.6% is required to begin to create jobs. In the second scenario, the correlation is less but more significant and implies that it is necessary to post growth of at least 3% to begin to diminish the OUR. Therefore, the results confirm that economic activity is a decisive factor in job creation.

Results of some correlations between employment and economic activity (1994-2004)

PpcOUR	=	-0.2538 Output gap (-8.4)	R ² =0.62
%CIMSS(t+2)	=	0.83 %CIGAE (14.6)	-1.40 (-3.8) R ² =0.76
PpcOUR	=	-0.22*%CIGAE (-14.5)	+0.66 (8.6) R ² =0.62

In which:

PpcOUR = Annual change in percentage points of the OUR

Output gap = Spread between potential and registered GDP

%CIMSS(t+2) = Annual % change in the number of IMSS-registered workers with a lag on two periods

%CIGAE = Annual % change in the IGAE

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References:

Rafael Doménech, Víctor Gómez, "Estimating Potential Output, Core Inflation and the NAIRU as Latent Variables"

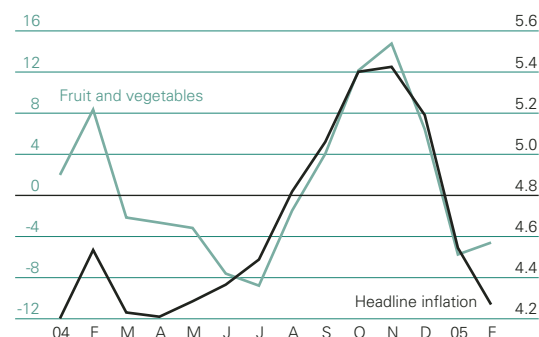
Ferguson Roger W, "Interpreting Labor Market Statistics in the Context of Monetary Policy"

Arias Jaxiel, Muñoz Carlos, "Desempleo en México, un problema de todos"

¹ The relation proposed by Okun can be broken or invalidated due to the empirical evidence with short-term data, result, for example, of changes in the active population structure.

Good Expectations for Inflation, Although Continues to Depend on Volatile Prices

NCPI and Fruit and Vegetables Annual % change



Source: BBVA Bancomer with Banco de México data

Govt'-Managed and Regulated Prices

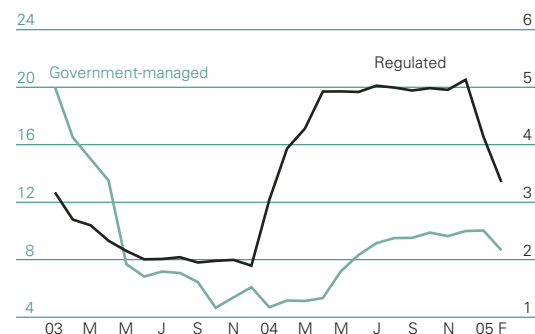
	Weight	Annual % chge.	
		Dec'04	Feb'05
Managed and regulated	17.0	7.5	5.9
Managed	7.6	10.0	8.7
Household gas	1.8	18.3	18.0
Electricity	2.4	9.2	6.6
Gasoline	3.3	5.8	4.8
Regulated	9.4	5.1	3.4
Public transportation	4.3	10.0	6.8
Rates and others*	0.6	1.7	1.9
Services**	4.4	1.4	1.1

* Licenses, car ownership tax, highways, parking

** Water, property taxes, telephone

Source: BBVA Bancomer with Banco de México data

Govt'-Managed and Regulated Prices Annual % change



Based on potential growth of around 4% and the estimated increase in 2005 GDP within a range of 4% to 4.2%, the model illustrates how core inflation will remain near its current levels for the rest of the year. In accordance with this projection, the recovery in demand will have a moderate impact on core inflation. However, the possibility of approaching the central bank's inflation target in 2005 seems complicated. The lowest growth rate that core inflation could register in some of the quarters would be 3.5%; and on the whole, in 2005, it could be closer to 4% than to 3.5%.

What is the balance for inflation?

With an agricultural year marked by low prices, the government's commitment to maintain the increase in government-managed and regulated prices within a range of 3% to 5%, and a moderate transmission of the rise in oil prices to energy costs (the impact would be basically through household gas), volatile prices will not be cause for concern in terms of inflation during 2005. Core inflation is another story, however, as it is at risk of increasing due to the process of recovery of economic activity. Although historically in Mexico there is no evidence of a stable and permanent correlation between a greater output gap and higher inflation, there are symptoms that indicate the need for caution. Indeed, the recovery in demand can make it easier for companies to transfer the increases in costs of the past two years to final prices and there is a possibility that an eventual depreciation of the peso could also lead to higher prices. In conclusion, for this inflationary component, the risks are greater.

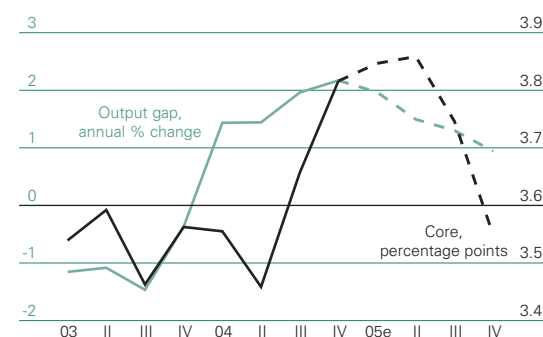
Since the range of volatility in overall inflation is up to a third over that of core inflation (see the chart on inflation volatility), and considering that our estimate for core inflation remains at 3.7% for the close of the year, the NCPI can easily fluctuate within a wide range, depending on the performance of its most volatile components. Our estimate for general inflation, of 4% at the close of 2005, is within this range, with a similar behavior projected for 2006.

The results of the analysis presented allow us to formulate some final considerations. First, core inflation is more relevant for long-term analysis than general inflation, since it better approximates the process of price formation in the economy. Second, the volatility of inflation in Mexico is intrinsic to its price index, because it reflects family income and consumer habits. In this sense, and given the composition of non-core inflation, overall growth in prices will be marked by a broader range of variability. Finally, in the absence of pressures from volatile prices, 2005 will reflect the difficulty faced by the economy in achieving a permanent reduction in core inflation, in a context of a recovery in internal demand.

- 2 The proposed estimate was $\pi_t = \alpha_0 + \alpha_1(Y - Y')_{t-3} + \alpha_2 w_{t-4} + \varepsilon_t$ where π , $(Y - Y')$ and w correspond to core inflation, output gap and wages, all in growth rates. The results of parameters α_0 , α_1 and α_2 were 2.43, 0.27 and 0.20 respectively, all significant and with a high kind adjustment ($R^2=0.96$).

In relation to the period covered in the sample, it should be noted that the concurrence of economic crisis and periods of high inflation between 1975 and 2000 make it difficult to identify a stable and significant correlation between the two variables in these years. Incorporating information starting from 2001 results in achieving a better evaluation of the impact of the economic cycle because some of the factors that had an effect on inflation in previous years are eliminated, such as expectations, salary adjustments, and the strong depreciations of the country's currency.

Output Gap* and Core Inflation: Phillips Model



* With estimated GDP growth of 4.2% in 2005

e estimated

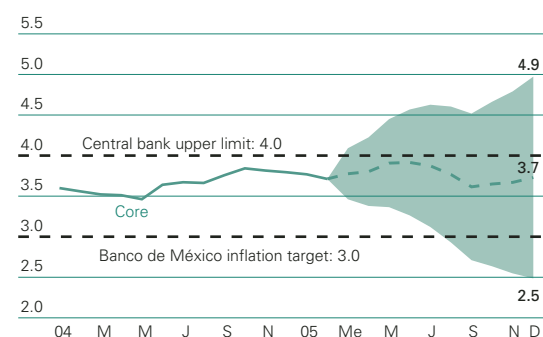
Source: BBVA Bancomer with INEGI and Banco de México data

GDP and Inflation: Phillips Model

	GDP, annual % chge.	Inflation, pp
2005		
1st. quarter	4.7	3.8
2nd. quarter	4.2	3.9
3rd. quarter	4.1	3.7
4th. quarter	3.7	3.5

Source: BBVA Bancomer with INEGI and Banco de México data

Variability Range in Headline Inflation Annual % change



e estimated as of March 2005

Source: BBVA Bancomer with Banco de México data

Inflation Volatility in Mexico

One of the most notable transformations in the Mexican economy as of the second half of the 1990s is the downward trend in inflation. After reaching inflation rates of over 50% in 1995, by 2000, growth in prices had fallen to 9% and moved toward a range of 4% to 5% between 2001 and 2004. Inflation control has been the result of different structural changes. First, fiscal discipline, with legal limits to public indebtedness and restrictions on its monetization; second, the autonomy of the central bank, which has allowed the country to gradually advance toward an inflation model based on objectives, with explicit targets; third, the trade opening, which has led to more competitive markets and a more efficient allocation of resources and; fourth, the flexibilization of the exchange rate, which prevents risks of accumulating financing pressures in Mexico's foreign accounts.

At the present time, the Banco de México has established a tolerance range in its inflation target (3%) of up to one percentage point, which it terms the "variability range." This 33% tolerance range in relation to the central bank's inflation target is not especially different from the ranges accepted by other central banks. Its function is to accommodate temporary price shocks, in such a way that it prevents the need for monetary policy to have to respond to them, unless they are perceived as permanent. It is possible that in Mexico, volatility in inflation is especially high, more as the result of the very composition of the price index than due to the strength of the temporary shocks.

The structure of the National Consumer Price Index (NCPI), which reflects family preferences and spending patterns, allows us to identify the main sources of volatility in inflation in Mexico. First of all, the weight of basic goods and services in the total index is considerably greater than in countries such as the United States, a reflection of family preferences and lower income. Of particular importance is the case of food, particularly non-processed food, which in Mexico represents up to 8.1% of the NCPI, while in the United States the corresponding figure is only 3.3%.

Second, special note should be made of the large number of services—with a high weight—for which prices are considered volatile in Mexico, among them transportation, telephone, water for household use, and education. This could reflect the not very competitive conditions of these markets. In addition, the share of the NCPI corresponding to this series of services is 8.4 percentage points higher in Mexico than in the United States.

The weight of all the volatile components of the Mexican NCPI is 30.4%, while for the U.S. the figure for the same categories totals 17.1%. The impact of this on headline inflation is evident: for the 2000-2004 period, when inflation in Mexico was 6%, on average, the non-core components contributed more than two percentage points to this rate, equivalent to one third of the total. In the U.S., average headline inflation in the same period was 2.5%, and the volatile components added one percentage point (39%).

Inflation: Volatile Components % share in the headline NCPI

	Mexico	U.S.	Diff.*
Core	69.6	82.9	-13.3
Non-core	30.4	17.1	13.3
Non processed foods	8.1	3.3	4.7
Meat and eggs	4.8	2.3	2.5
Fruit and vegetables	3.3	1.0	2.2
Transportation	4.7	0.8	4.0
Urban public transportation	3.8	0.3	3.5
Overland public transportation	0.6	0.1	0.5
Licenses and related fees	0.3	0.4	0.0
Education	5.2	2.3	2.9
Other goods and services	4.4	3.0	1.5
Telephone**	3.5	2.3	1.2
Water for household use	0.7	0.7	0.1
Property taxes	0.2	—	—
Energy and fuel	7.9	7.7	0.2
Household gas	1.8	1.3	0.6
Motor fuels	0.1	0.0	0.1
Gasoline	3.7	3.8	-0.1
Electricity	2.3	2.6	-0.4

* Difference in percentage points

** Excludes mobile telephones

Source: Banco de México and U.S. Bureau of Labor Statistics

Given this behavior of volatile prices, the expected performance of inflation based on the latest data can be projected, with core inflation of 3.7% for Mexico and 2.1% for the U.S., while headline inflation in the two countries could fluctuate between 2.5% and 4.9% and 1.3% and 2.9%, respectively. The difference with respect to core inflation could be greater in Mexico due to a higher percentage of volatile prices and a higher comparison base.

In conclusion, Mexico has greater volatility in inflation than other countries, such as the U.S.. This is intrinsic to the structure of the country's price index, which responds to consumption habits, family income and preferences, and the degree of competition in the domestic market.

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Approaching Highs in Short-Term Interest Rates

With the aim of reverting the rallying trend in inflation, the central bank (Banco de México) has been increasing the “short” in the last year by raising it at the rate of almost once a month (12 times from May 2004 through March 2005), at the same time maintaining the synchrony with U.S. monetary policy, which has implied a continuous rise in interest rates. In particular, the bank funding rate rose over 325 bps during this period, reflecting a more restrictive monetary policy and within a context of increases in U.S. long-term interest rates that were transferred, without expanding, to the long end of the curve in Mexico. Thus, the slope of the yield curve dropped significantly: The spread between the 10-year rate (M10) and the one-month rate went from 327 to only 88 bp in this same period (May 2004 to March 2005).

Base scenario: slight additional interest rate increases in 2005, remaining high in 2006, with greater risks upward rather than downward

Following the monetary restriction already applied by the central bank, we might expect the end of interest-rate increases to be nearing. Levels close to 10% could be established as the maximum point of this rallying cycle, although interest rates will remain at high levels, even after the beginning of 2006. The fact that we might not be far from the maximum levels in short-term rates is based on three aspects: first, the improvement in the price-risk balance due both to a reduction in observed inflation¹ and in expected short-term inflation. Second, the recent signals sent by the central bank could be interpreted in this sense. Among these signals, particularly significant is the fact that following a long series of increases in the “short” of amounts between P\$4 million and P\$6 million, the most recent increases (February 25 and March 22) were of only P\$2 million, the lowest in three years. This allowed the central bank to confirm its commitment of maintaining the monetary restriction and send the message that the situation does not require such large increases in interest rates as in the past. Third, recent communications and statements by the Governor of Banco de México and other members of the Board of Governors have underscored the progress made in terms of inflation and the outlook that it will be below 4% this year.

We are still far from seeing decreases: the inflation situation in Mexico still displays elements that are incompatible with the central bank’s inflation target, and these could extend into 2006. In the first place, both observed and expected inflation are far from the central bank target of 3% annual inflation. Second, core inflation—the best indicator for evaluating in-depth pressures on inflation—is anchored at levels slightly below 4%. Third, within a context of great strength in domestic demand, the pressures on services inflation could be more severe. Finally, despite the increases in short-term interest rates, which have driven real interest rates to levels of 7.0%, the degree of monetary restriction is far from the levels seen in previous years (see box: Monetary Conditions Index).

Recent Performance of the “Short” and Synchrony with U.S. Monetary Policy Millions of pesos

	Daily balance	Daily change	Synchrony*
Jan 10, 2003	20	3	No
Feb 7, 2003	22	3	No
Mar 28, 2003	25	3	No
Feb 20, 2004	29	4	No
Mar 12, 2004	33	4	No
Apr 27, 2004	37	4	Yes
Jul 23, 2004	41	4	Yes
Aug 27, 2004	45	4	Yes
Sep 24, 2004	51	6	Yes
Oct 22, 2004	57	6	Yes
Nov 26, 2004	63	6	Yes
Dec 10, 2004	69	6	Yes
Jan 28, 2005	75	6	Yes
Feb 25, 2005	77	2	Yes
Mar 22, 2005	79	2	Yes

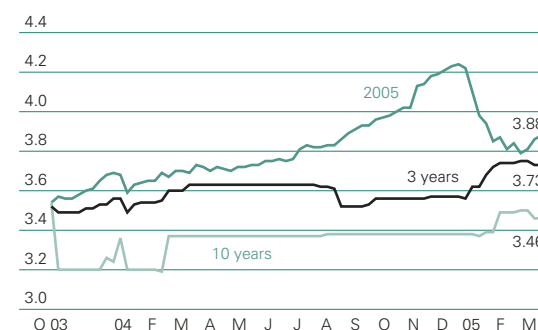
* Synchrony with Federal Reserve increases
Source: BBVA Bancomer with Banco de México data

Flows to Emerging Markets in the Money Market US\$ millions, 4-week moving average



Source: BBVA Bancomer with Bloomberg data

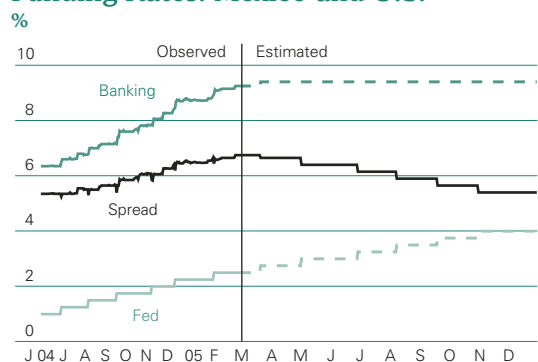
Inflation Expectations



Source: Infosal survey

¹ For greater details, see page 12.

Funding Rates: Mexico and U.S.



Source: BBVA Bancomer with Banco de México and Federal Reserve data

2005 Bank Funding Forecast

End of period, %

	Downward risk*	Base	Upward risk**
First quarter	9.50	9.50	9.50
Second quarter	9.50	10.00	10.00
Third quarter	9.00	10.00	10.45
Fourth quarter	8.50	10.00	10.75

* "Emerging countries idyl"

** Corresponds to an abrupt adjustment with a rally in inflation

Source: BBVA Bancomer

Interest Rate Exercises

in Terms of the Taylor Rule and

Inflation and Exchange Rate Scenarios

28-day Cetes, %, end of period, 2005

Exch. rate	Inflation scenario				
11.85 (eop)	3.00	3.50	3.75	4.00	4.25

1st. quarter	9.17	9.28	9.34	9.40	9.46
2nd. quarter	9.03	9.25	9.37	9.48	9.59
3rd. quarter	8.74	9.10	9.28	9.46	9.64
4th. quarter	8.19	8.83	9.15	9.47	9.79

Exch. rate	Inflation scenario				
11.60 (eop)	3.00	3.50	3.75	4.00	4.25

1st. quarter	9.02	9.13	9.19	9.25	9.31
2nd. quarter	8.72	8.95	9.06	9.17	9.28
3rd. quarter	8.41	8.77	8.95	9.13	9.30
4th. quarter	7.85	8.49	8.81	9.13	9.45

Source: BBVA Bancomer

For these reasons, we believe the central bank could opt to maintain interest rates at high levels in 2005 and 2006, until the uncertainty regarding high core inflation dissipates, particularly due to the start of a more vigorous cycle in domestic demand and uncertainty regarding a potential depreciation of the peso as the year progresses. Given the expectation of lower inflation in 2005 and 2006 (4% and 3.9%, respectively), maintaining high interest rates would imply that Banco de México could be increasing real interest rates gradually, with the aim of approaching inflation expectations in the medium term of 3%.

This scenario implies that at some point in time in the second semester, domestic interest rates will be disengaged from the rises in the Federal Reserve rate, which we expect will end 2005 at 4.0%. This would mean that the short-term interest rate spread between Mexico and the U.S. would return to levels close to those existing prior to the start of interest rate increases in Mexico in May 2004.

In the coming months, the risks in the performance of short-term interest rates in Mexico are trending upward

If Banco de México were to detect greater uncertainty regarding the outlook for inflation in the medium term, it could opt for a more forceful monetary stance in an attempt to reach its central target of 3% (which would allow it to have a greater margin for adapting price deviations) interest rates could continue rising to levels higher than 10.75%. Even though this would imply even higher real rates, the central bank would have leeway to do it, given the current degree of monetary restriction and under the perception of a lower cost in terms of economic growth, due to the low credit level in the economy (which limits this transfer channel of monetary policy). This stance could be justified due to its goal of consolidating—through higher interest rates—its monetary policy as an “anchor” of financial stability, in view of the possibility that the electoral process could adversely influence the foreign exchange market (particularly in 2006). Finally, greater inflationary pressure from high oil prices (which could have an impact both directly and through higher prices of products in the U.S.) and a greater monetary restriction in the U.S. than that which we are considering, could exert additional upward pressure on short-term interest rates in Mexico. To sum up, the risk today is one of greater increases in interest rates.

Possibilities of a drop in interest rates, only with positive “surprises” with regard to core inflation

Although there is a low probability, we cannot completely rule out a scenario of better data on core inflation in Mexico, with improved inflation expectations for the medium term and with a lower risk of inflation being transferred to wages. This could lead to moderate decreases in short-term interest rates, starting as soon as the second half of the year, in particular if the peso continues strong. Estimates of the performance of the central bank based on the Taylor Rule would be consistent with short-term interest rate levels of 9% if inflation stands at around 3.5% or if the exchange rate stands closer to current exchange rate levels than to our forecast for the end of 2005 of 11.8 pesos per dollar.

Long-term rates are anchored, but will rise slightly more in 2005 and 2006

As regards longer-term paper, the M10 rate will continue to be linked to that of the U.S. However, the increases in Mexican interest rates could be lower than those of the U.S., to the extent that inflation expectations decline. Thus, we estimate that the M10 rate will close 2005 and 2006 at 10.8% and 11.1%, respectively (taking into account the closing at 5.2% and 6.0% in 10-year bonds in the U.S.) This scenario will be reinforced with short-term rates of over 10.00% given that this would make lower medium-term inflation expectations more probable.

If the rises in U.S. interest rates were more moderate (up to 4.5% at year-end for the 10-year bond this year), it could continue to supply capital flows to emerging economies, which would favor the sovereign spread in Mexico and could also encourage the purchase of these bonds by domestic institutional investors, such as the Afores. In this scenario, the 10-year bond yield in Mexico could clearly stand below 10%, thereby causing a greater leveling off of the curve, which could persist through next year should these conditions prevail.

As mentioned previously, the risk is centered more in the other direction, given greater inflationary pressure in the U.S. Overall, this scenario could fall short in case of inflationary risks in the U.S., or abrupt adjustments of the financial variables given the imbalances in that country, which would lead to significantly higher interest rates than the 5.2% that we are considering (see section "Financial environment in the U.S.").

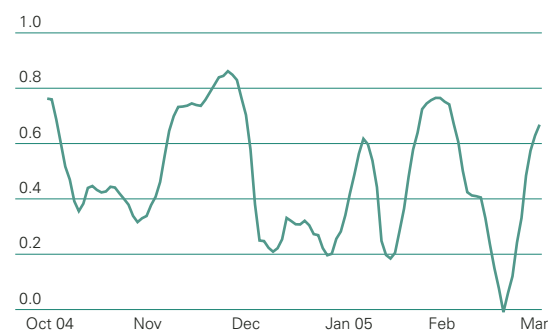
To sum up, the rate of increases in U.S. interest rates and the performance of observed and expected inflation in Mexico are fundamental in determining the course of domestic interest rates in 2005, since they will have an impact on the country's real interest rates and on the degree of international flows to emerging economies. Overall, there is a greater probability of our base scenario of a gradual upward adjustment in interest rates in the U.S. and a downward trend in domestic inflation, which would take interest rates close to 10.00% in the short end (bank funding) and to 10.80% in the long end (M10). At the same time, we believe there is less probability of an abrupt adjustment in the U.S. as well as of higher domestic inflation that is compatible with interest rates higher than 10.8% in the short end of the yield curve and higher than 11.4% in the longer end. Finally, although with a lower probability, we do not rule out that lower interest rates could be seen in both the short and long terms. Despite this, in view of the uncertainty regarding the adjustment speed of both variables, there could be periods of volatility on the financial markets.

10-year Bonds



Source: BBVA Bancomer with Banco de México and Federal Reserve data

Correlation Mexico-U.S. 10-year Bonds 30 days



Source: BBVA Bancomer with Banco de México and Federal Reserve data

2005 Interest Rate Scenarios End of period, %

	Downward risk*	Base	Upward risk**
Bank funding	8.5	10.0	10.8
28-day Cetes	8.6	10.1	10.8
28-day TIIE	8.9	10.5	11.1
10-year bonds	9.5	10.8	11.6
Federal Funds	3.0	4.0	4.5
10-year Treasury Notes	4.5	5.2	6.0

* "Emerging countries idyl"

** Corresponds to an abrupt adjustment with a rally in inflation

Source: BBVA Bancomer

Monetary Conditions Index (MCI): Application in Mexico

Determining the monetary conditions in an economy is a useful tool for evaluating the economic outlook. More restrictive or more relaxed conditions tend to generate lower or higher growth rates for economic activity and inflation. In other countries, it is common to develop and use a Monetary Conditions Index (MCI) as a variable that approaches the degree of restriction of a nation's monetary policy and functions as a leading indicator of inflation. For example, in Canada, New Zealand, and Norway, the MCI has been used not only as a monetary policy instrument but as an explicit goal or as a communication mechanism.

The MCI seeks to compile—in a single indicator—the impact of monetary conditions in monetary policy activity. In open economies, the MCI is commonly determined on a certain date (t) as the weighted sum of real interest rates (be they short- or long-term, or a combination of both), (r_t) and the real exchange rate (RER_t). These variables represent the main channels of transmission of monetary policy.

Although this indicator does not quantify—as such—the level of restriction, it does indicate the direction that the monetary policy approach in the economy is taking by comparing it to the conditions prevailing on a specific reference date (with r^* and RER^*).

$$MCI_t = [\delta \times (r_t - r^*) + (RER_t - RER^*)] \times 100 + 100$$

In which, δ is the weighted sum of real interest rates that represents their relative importance (in times) with regard to the real exchange rate channel (dollars per peso).

Specification based on Dennis (1997), Reserve Bank of New Zealand

Thus, a higher real interest rate or a real appreciation of the peso reflects more restrictive monetary conditions (higher MCI) by potentially generating lower economic activity, which tends to diminish inflationary pressures.

Scope and limitations

The main difficulty in determining the MCI consists in selecting the relevant variables in the formula and their relative importance. The δ coefficient implicitly determines the importance of the transmission of each variable (credit via interest or exchange rates) in monetary policy actions, and through them, in inflation. In the case of Mexico, the estimate of the parameters is

very sensitive to the specification of the model and the period under consideration. Different estimates generate different index levels, and therefore different measures of monetary restriction or relaxation. However, in these types of indicators, what is most important is their variation and trend in a specific period, which is illustrated in the model that is developed.

Application of the MCI to Mexico

Following the methodology used in New Zealand, the δ coefficient calculated for Mexico between the short term real interest rate and the exchange rate is 1.3 times, which is higher than that of New Zealand and Norway (2 times); Canada and France (3 times), and Germany (4 times). According to these estimates, a 1 pp increase in real interest rates in Mexico has an effect on the country's economic activity similar to a 1.3 pp appreciation of the real exchange rate.

Historically, δ could even be lower for Mexico given the major importance of foreign trade in economic activity and the relatively reduced penetration of the financial system, which diminishes the efficiency of the credit channel. However, the greater importance of domestic demand and the growing role of credit, will make δ increase in the future.

Estimate of δ in Mexico

$$\begin{aligned} \text{GapMx}_t = & -0.087\Delta r_{t-4} - 0.067\Delta \ln RER_{t-2} - 0.002\Delta \pi_{t-2} - 0.001\Delta \pi_{t-3} \\ & (-2.64) \quad (-2.34) \quad (-2.02) \quad (1.91) \\ & + 0.589\text{GapUSA}_{t-1} - 0.483\text{GapUSA}_{t-2} + 0.782\text{GapMx}_{t-1} \\ & (3.42) \quad (-2.38) \quad (8.41) \end{aligned}$$

$$R^2 = 0.93, DW = 1.5$$

Period: first quarter 1997 to third quarter 2004

In which, GapMx is the output gap (excess demand registered minus potential demand); r is the real 28-day interest rate; RER is the real exchange rate; π is inflation; and GapUSA is the U.S. output gap.

$$\delta \text{ in MCI is } 1.30 = -0.087 / -0.067$$

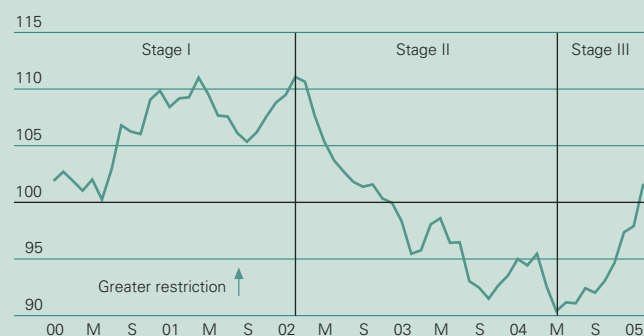
Since 2000, the MCI has experienced three stages in its evolution (with a duration of 26 months in the first two), using the average of the real exchange rate index (based on 2000 figures) and the real 28-day interest rate

for the 2002-2005 period as a reference. The first stage ranges from January 2000 to February 2002, and the MCI reflected a greater hardening of monetary conditions derived from high real interest rates (average 5.1%) and a real appreciation of the peso (annual average 5.8%). In this period, annual inflation diminished from 11% to 4.8% (with an average of 7.7%), while growth declined from 6.6% in 2000 to 0.7% in 2002.

In the second stage (March 2002 to May 2004), the MCI posted a decrease as a result of lower real interest rates (average 1.76%) and the real 5.5% annual depreciation of the peso. In this period, inflation stabilized at around 4.7% (with a minimum level of 3.97% in December 2003). At the same time, activity increased given that GDP went from zero growth to 4.4% in 2004.

Monetary Conditions Index (MCI) in Mexico

$\delta = 1.3$, base average: 2002-2003



Stage I MCI rise; π : 7.7%; r : 5.1%; RER: +5.8%, averages
 Stage II MCI decline; π : 4.7%; r : 1.8%; RER: -5.5%, averages
 Stage III MCI rise; π : 4.9%; r : 3.0%; RER: +0.6% (February data)
 Source: BBVA Bancomer with Banco de México data

In the final stage (June 2004 to date) the beginning of a restrictive phase in monetary policy took place, in which real interest rates rose from 2.2% to 5.15% in February (average of 3%). This has been accompanied by a real 0.6% appreciation of the peso, which can have an effect on moderating activity.

Conclusions

Beyond the limitations of this type of exercise, two important conclusions flow from the previous analysis. The first is that the MCI currently points to a hardening of monetary policy in relation to the conditions prevailing at mid-year 2004. Nevertheless, its level is still far from the degree of restriction registered at the beginning of 2002. The second conclusion is that the exchange rate channel is more important in Mexico than in developed economies, possibly as a result of the high level of the trade opening, the low level of credit activity, and the use (in the past) of the exchange rate as an important reference for price formation.

These considerations pose important challenges for monetary policy in Mexico, given that the variable that the central bank really controls is short-term interest rates. That is, indirectly, this exercise is compatible with the vision that increases in real interest rates should be relatively strong in Mexico in order to control inflation, especially in scenarios of low growth in domestic demand with expectations of a depreciation of the peso.

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Moderate Depreciation of the Peso and Gradual Increase of the EMBI+ Mexico

Selected Financial Variables Quarterly averages

	Fix ¹	Flows ²	EMBI+ ³	Spread rates ⁴	
				1-month	10-year
1st qtr 03	10.83	76.15	311	7.6	6.1
2nd qtr 03	10.45	112.25	240	5.0	5.2
3rd qtr 03	10.73	0.43	224	3.6	4.3
4th qtr 03	11.19	49.89	205	4.5	3.9
1st qtr 04	10.99	107.20	189	4.7	4.4
2nd qtr 04	11.40	-80.89	204	5.5	5.1
3rd qtr 04	11.45	20.14	194	5.8	5.9
4th qtr 04	11.32	103.28	174	6.3	5.8
1st qtr 05	11.16	250.24	160	6.7	5.5

1 Pesos per dollar

2 Flows to emerging markets, US\$ millions

3 Basis points

4 Mexico - U.S., percentage points

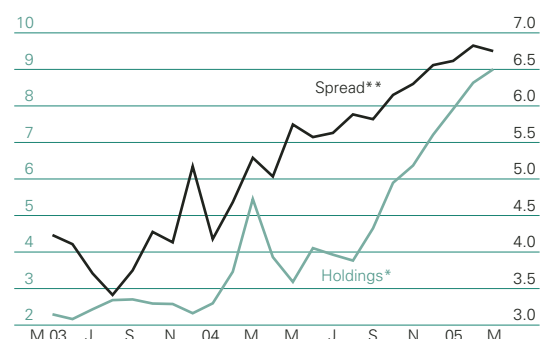
Source: BBVA Bancomer with Banco de México & Federal Reserve data

Foreign Participation in the Money Market and Exchange Rate



Source: BBVA Bancomer with Banco de México data

Foreign Participation in the Money Market and Interest Rate Spread



* % of total

** One-month interest rates Mexico - U.S., percentage points

Source: BBVA Bancomer with Banco de México and Federal Reserve data

Starting in September 2004, the peso began to appreciate against the dollar, a process that intensified at the start of 2005. The cumulative gain in the last six months was 1.7%, reaching a minimum level of 10.98 pesos per dollar (ppd) in February of this year (vs. an average of 11.31 pppd in the last quarter of 2004). Despite this, its level remains 1.5% higher than the average in the first quarter of last year. Similarly, the sovereign risk (measured through the EMBI+) posted an important decline in said period, reaching historic minimum levels in February 2005 (146 bp vs. 255 bp in May 2004). However, both trends are beginning to change.

Monetary conditions in the U.S. explain to a large extent the recent performance of the peso and the sovereign risk

The change in peso-dollar parity in the last six months can be attributed—first of all—to differences in the monetary conditions between Mexico and the U.S. The one-month yield gap with the U.S. rose gradually as of April 2004 (an average of 495 bp) after the start of the restrictive monetary cycle in Mexico, until it reached highs of 700 bp in January 2005. While in the long end of the curve, the performance showed the same trend (a rise in the 10-year spread of 458 bp on average in April to 560 bp in December 2004), this gap has stabilized in the first three months of this year. In terms of the U.S. Treasury note, it began to include the expected rises of the Federal Reserve.

Low U.S. long-term interest rates drove international investors to search for greater profitability, which—together with a low sovereign risk perception—led to a greater availability of funds for emerging economies. In fact, international flows to debt markets have remained at maximum levels. In Mexico's case, the reduction in the sovereign risk and interest rate spreads favoring our country boosted foreign demand for assets denominated in pesos. For example, holdings of government paper by foreigners rose from 3.7% on average in April 2004 to 9.2% in March of this year, with a high trend toward investment in the long term of the yield curve, in bonds commonly known as M's, with foreign investment in the Mexican money market surpassing US\$8.5 billion.

From a structural standpoint, the exchange rate was favored by economic growth in Mexico superior to that of the U.S. during more than one year, and by a lower current account deficit (-1.3% of GDP supported by high oil prices and the entry of remittances), which was totally covered by foreign direct investment (see graph). The above factors contributed to maintaining a low country risk perception and, together with sharp rises in short-term interest rates, restrained the expectations of a peso depreciation due to the rise in inflation in 2004.

Base scenario: the peso will depreciate moderately in 2005 and 2006

Throughout the rest of 2005 and especially in 2006, the previous financial conditions will be reverted partially, to the extent that the Federal Reserve toughens monetary conditions in the U.S. even more, and interest rates rise in that country more than in Mexico. Given that we expect that the rate of adjustment in U.S. interest rates will be gradual, the exchange rate will converge in its long-term trend determined by the inflation spread between both economies. Within this context, we estimate that the peso-dollar exchange rate close 2005 and 2006 at 11.8 and 12.2 pesos per dollar, respectively (an annual depreciation of 4% at the end of the periods).

Independently of possible periods of volatility in 2005 and 2006 associated with the electoral process, we estimate that the devaluation of the peso will tend to be gradual due to the following factors. First, the gap in economic growth will continue to favor Mexico this year when GDP will expand an annual 4.2% (vs. 3.6% in the U.S.). Second, the reduction of domestic inflation (together with possible inflationary pressure in the U.S. due to economic activity and oil prices) implies that in the long term, the extent of the peso depreciation will be low (in 2004, inflation in Mexico was 1.9 pp higher than in the U.S. and, in 2005, we estimate that it will be 1.3 pp). Third, the reduction in short-term rate spreads between Mexico and the U.S. will not be abrupt. Fourth, foreign accounts will not have problems in their financing, insofar as high oil prices tend to decrease the trade deficit and foreign direct investment flows and remittances to the country remain. Finally, the Mexican peso has achieved greater strength on the international markets as a diversification mechanism and hedge against foreign-exchange risk, which provides it with greater stability and liquidity for investors.

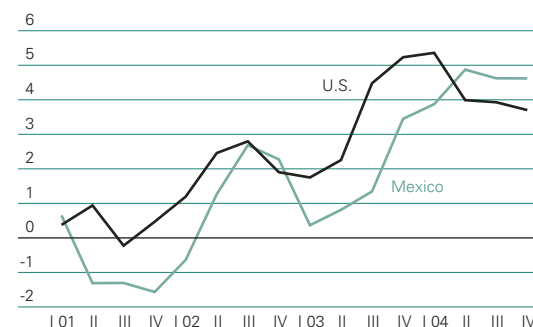
In this context, Mexico's sovereign risk will tend to increase during 2005 and 2006, a trend produced by the lower international liquidity conditions that we are anticipating for this period. Although, as with the expected performance of the exchange rate, we cannot rule out periods of greater volatility in Mexico's EMBI+ due to political events (in particular in 2006). We believe that, for the moment, these will be temporary in nature, as long as the economic fundamentals remain solid and the management of fiscal and monetary policies is prudent.

Greater depreciation if interest rates rise significantly and/or there is an important contraction in the flows

In the event that U.S. interest rates are adjusted upward more abruptly, there would be an adjustment in disposable funds for the emerging economies and, thus, a probable departure of foreign investors in securities denominated in pesos. Should this scenario materialize, the short-term consequence would be a greater depreciation of the peso versus the dollar, in which case, the exchange rate would end the year at 12.4 ppp and the peso would continue

GDP Growth

Annualized quarterly % change, 3-quarter moving ave.



Source: BBVA Bancomer with INEGI and Federal Reserve data

Balance of Payments

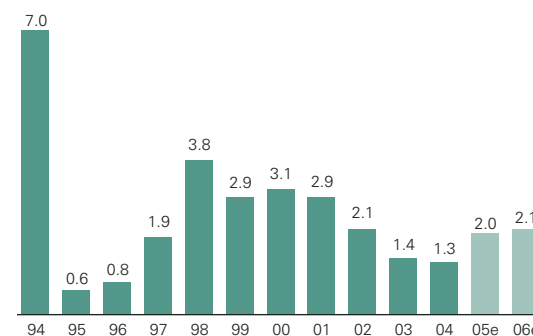
US\$ billions

	2004	2005
Current account	-8.7	-13.4
Trade balance	-8.5	-10.7
Interest	-9.4	-13.4
Tourism	3.9	4.3
Non-financial services	-8.4	-12.0
Remittances	17.0	18.4
Capital account	13.7	12.5
Foreign direct investment	16.6	13.0

Source: BBVA Bancomer with Banco de México data

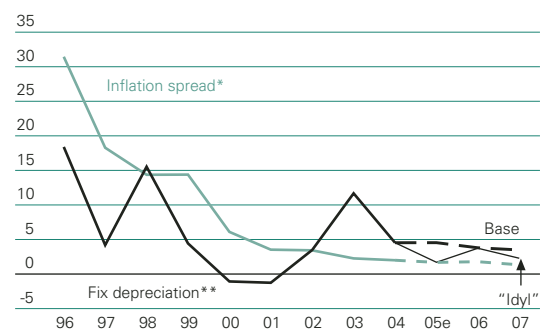
Current Account

% of GDP



Source: BBVA Bancomer with Banco de México data

Inflation Spread and Exchange Rate



* Mexico - U.S., percentage points

** Annual % change

Source: BBVA Bancomer with Banco de México and Federal Reserve data

Fix Exchange Rate Scenarios

End of period, probability

	2004	2005e	2006e
Base	11.3	11.8	12.2
"Emerging countries idyl"	11.3	11.5	11.9
Abrupt adjustment U.S.	11.3	12.4	13.2

e estimated

Source: BBVA Bancomer with Banco de México data

to depreciate throughout 2006 (13.2 ppd). In the medium and long terms, the peso could remain depreciated in case of contamination of inflation in Mexico, from higher prices in tradable goods and/or pressure from domestic demand.

Alternative scenario: greater strength in 2005

Our alternative scenario is based on the possibility of the peso continuing strong in the first half of 2005. This scenario of greater strength (a lower depreciation of the peso compared to the central scenario) would materialize in 2005 if the rate of increases in U.S. interest rates were to be more gradual than what is discounted by the market, whether due to low inflation in the U.S. or due to the Fed seeking to extend the U.S. current monetary boost a little more. Nevertheless, due to political factors, it will be difficult to have a persistently strong peso in 2006.

Within this context, interest rate spreads between Mexico and the U.S. could prevail longer, which would continue to favor the demand for assets denominated in pesos by foreign and domestic investors. Similarly, higher economic growth in Mexico than in the U.S., the coverage of the financing requirements of foreign accounts and the potential reduction of domestic inflation in Mexico would allow "anchoring", in this scenario, the country risk at relatively low levels and would mitigate the effects of political uncertainty.

To summarize, the course of the peso in 2005 and 2006 will be one of depreciation against the dollar at a rate that will be determined by the speed in the rise of U.S. interest rates. In the scenario in which these increases are gradual (the scenario we believe to be more probable), we estimate that the exchange rate could end the year at 11.8 ppd. At the same time, the range that we are considering for the exchange rate for the end of the year is 11.5 and 12.4 ppd, according to the rate of the increases in U.S. interest rates. In the absence of contamination of the economy and the financial markets due to political factors, our estimates for the exchange rate with greater probability are those of low range.

A View of Latin American Currencies

Latin American currencies, on the crest of a rally

In the past year, Latin American currencies have benefited from significant inflows of portfolio investment into the region in a context of low interest rates in the industrialized countries and the search for higher profitability in investments. The moderate recovery of foreign direct investment (FDI) has also helped exchange rates in Latin America. Another supporting factor has been the positive change in the terms of trade, mainly for countries that export raw materials.

Exchange Rates in Latin America

Currency/dollar		% change in 12 months*		
		NER/dollar	RER/dollar	REERI
Argentina	2.92	1.8%	-5.4%	1.1%
Brasil	2.76	-5.1%	-15.1%	-13.0%
Chile	592	-2.9%	-1.4%	1.9%
Colombia	2,385	-10.8%	-15.9%	-14.9%
México	11.22	2.2%	-0.6%	0.0%
Perú	3.26	-5.8%	-5.5%	-2.8%
Venezuela**	2,147	12.0%	-1.6%	5.4%

NER Nominal exchange rate

RER Real exchange rate

* Through February. An increase means a depreciation

** For calculating the NER and the REERI, a 12% devaluation (March 3) has been assumed for February

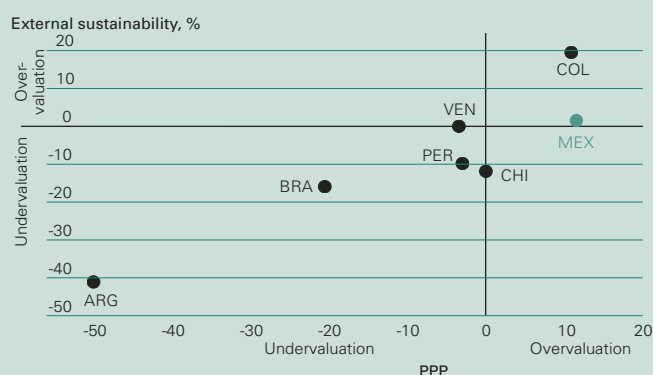
Source: Bloomberg y BBVA

How far away are from their equilibrium level?

To anticipate the performance of currencies in the medium term, it is useful to analyze the position they occupy in relation to their long term or equilibrium level. However, this level is difficult to estimate. A first approximation can be obtained by using the Purchasing Power Parity (PPP), that is, the idea that over prolonged periods of time, the performance of exchange rates can be estimated by the relative prices of baskets of similar goods. To do so, an equation has been calculated for the exchange rate with the dollar for each country based on the inflation spreads, in which the estimated constant represents the real equilibrium exchange rate. A second approximation is based on focusing on the balance of payments or external sustainability, an approach with particular importance in the 1990s for the emerging economies. For the exercise, a simple model¹ will be used that is based on two concepts: (i) an exchange rate that guarantees that a “sustainable” balance of payments will be obtained and (ii) that the dollarization of foreign liabilities will prevent the real equilibrium exchange rate from being infinitely depreciated to promote the external sector. That is, the model

incorporates the effect of a “negative balance sheet” that generates a real depreciation. The results of both focuses are illustrated in the following graph.

Differential of Latin American Currencies in relation to their Long Term Equilibrium Level



Source: BBVA

Based on these models, it can be inferred that there are no significant inconsistencies between the two methodologies. In general, the currencies of Venezuela, Peru, and Chile seem to be more or less in equilibrium, while Brazil and Argentina have undervalued currencies² and the Colombian currency is estimated to be overvalued by approximately 20%. In the case of Mexico, the overvaluation provided by the PPP model, in contrast with the balance of payments focus, could be explained by the country's structural changes of the past few years in relation to the “better quality” financing of its external deficit. Mexico's foreign deficit is being financed completely with FDI. In addition, remittances from migrants, flows characterized by their relative stability, represent 2.5% of GDP. All in all, this structural change of the Mexican external sector would indicate that the country could enjoy a real equilibrium exchange rate that is more appreciated than what the PPP would indicate. Nevertheless, the background message remains: the Mexican peso will depreciate, supported by a gradual rebound in U.S. interest rates that will contribute to gradually exhausting the emerging rally, removing appreciation pressures on the currencies.

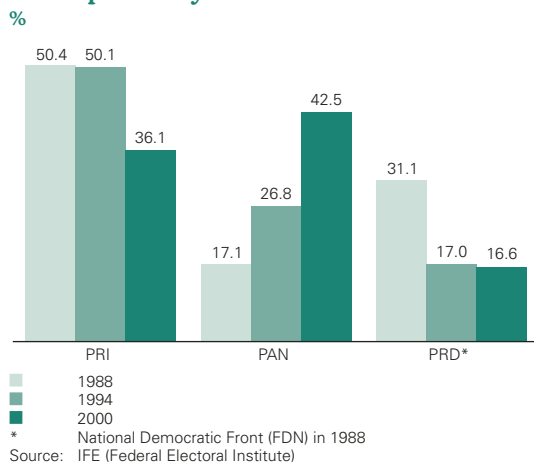
Luciana Taft

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1 For details on the model, see “La sostenibilidad de la deuda externa en economías emergentes”, J. Blázquez and L. Taft, July 2003, *Hacienda Pública Española/Revista de Economía Pública*; pp. 157-183. For the assumptions used in the exercise and the estimate of the relevant parameters, see Latinwatch, March 2005, Servicio de Estudios Económicos BBVA.

2 Both methodologies result in an overvaluation of more than 30% for the Argentine peso.

Presidential Elections: Votes per Party



Election of Federal Deputies: Votes per Party

%

	PRI	PAN	PRD*	Others
1988	56.8	15.8	25.6	1.8
1991	61.4	17.7	8.3	12.6
1994	51.1	25.7	15.2	7.8
1997	39.1	26.6	25.7	8.5
2000	36.9	38.2	18.6	6.1
2003	36.9	32.8	18.7	11.5

* National Democratic Front (FDN) in 1988
Source: IFE

Election of Federal Senators: Votes per Party

%

	PRI	PAN	PRD*	Others
1988	50.8	18.0	29.7	1.5
1991	61.5	17.7	8.4	12.4
1994	50.2	25.7	16.8	7.2
1997	38.4	26.9	25.8	8.9
2000	36.7	38.1	18.8	6.4

* National Democratic Front (FDN) in 1988
Source: IFE

Taking Stock of the Electoral Processes in Mexico since 1997

Now that the main political parties are readying themselves for what promises to be one of the hardest-fought presidential contests in recent times, it is worth taking stock of the electoral processes held since 1997. In that year, the current electoral legislation came into force, a system designed to decouple the Executive Power from organizing elections and ensure the appropriate representation of the parties. This reform also made possible the direct election of the mayor of Mexico City. The 2006 federal elections will be the fourth consecutive one's to be held under these rules. It should be mentioned that each of the five electoral processes held between 1985 and 1997 took place under different rules.

As a result of the above-mentioned electoral reform, the uncertainty and mistrust that usually accompanied the voting process was dissipated. Today, as in any democracy, it is not the voting process itself that can generate uncertainty and mistrust, since the majority of the population believe that their vote will be respected. The consolidation of autonomous electoral bodies, the development of a highly competitive party regime, along with the forming of political alliances at a local and national level, have led voters to focus on the quality of the candidates and their proposals.

The electoral map has undergone significant changes in the past ten years. The contest for all public offices has intensified. As recently as 1976, the PRI presidential candidate obtained 93.9% of the votes. In the decade of the eighties, the PRI candidates for the governorship of 14 of the 31 states also managed to achieve support levels of over 90%. In the presidential races of 1988 and 1994, the PRI faced greater competition: almost half of the voters backed the candidates of other parties. In 2000, for the first time since it was founded in 1929, the PRI lost the Presidency.

The 2000 election marked a milestone in Mexico's modern history: there had never before been a peaceful transfer of power from one party to another. Compared to the 1994 elections, the PRI lost 14 percentage points in voter preference, while the PAN won almost 16 additional points. Both in 1994 and in 2000, the PRD candidate was far from matching his feat of 1988, when he commanded close to one-third of the votes. The result in 2000 indicated that an alliance between the two main opposition parties, the PAN and the PRD, was not necessary to defeat the PRI in a presidential election.

Even though it no longer heads the Executive Power, the PRI is still the main party in Congress. It has a majority in the Senate and is the party with the most seats in the Chamber of Deputies. The voting percentage obtained by the PRI in the elections for federal deputies dropped from 56.8% in 1988 to 36.9% in 2000, a level that it maintained in the 2003 elections. The PAN has been the second force in the lower chamber after the elections held in 2000 and 2003, but the PRD surpassed it in seats after the 1997 elections, the year in which it matched the percentage of votes won by the National Democratic Front in 1988.

The changes in the balance of power in the Chamber of Deputies from 1997 on has made it difficult for the current Executive to build legislative majorities in favor of structural reforms of great significance. The legislative elections of 1985 was the last time that a party, the PRI, won a two-thirds majority in the lower chamber, which is necessary to approve any constitutional reform (also required is the backing of two-thirds of the Senate and half plus one of the state congresses). Starting in 1997, the PRI did not have a simple majority in the Chamber of Deputies either.

In contrast to previous electoral laws, those of 1994 and 1997 made it impossible for a party with the majority in the Chamber of Deputies to have the votes to amend the Constitution without the backing of another party. The legislation in force limits the number of total seats that a party can win to 300 (that is, 60% of the lower chamber), regardless of what its voting percentage might have been. In brief, no party will have the parliamentary predominance that the PRI enjoyed up to 1988. A President with a legislative majority has to negotiate with the other parties if he intends to drive constitutional reforms forward.

Since 1989 when the PAN became the first opposition party to win a governorship from the PRI, the elections in the states have been increasingly hard-fought. Alternation in the government has been the standard in 18 of the 32 federal states. Even in the 14 states where the PRI had never been defeated, the support for other options has strengthened. In the last two years, the PRI has defeated the PAN by a slim margin in the election for governor in the states of Veracruz (35.8% vs. 34.8%), Sonora (46.4% vs. 45.4%), Sinaloa (47.6% vs. 46.3%), Campeche (41.9% vs. 40%) and Oaxaca (49.4% vs. 46%).

At the end of 1997, the PRI governed 25 federal states, the PAN six and the PRD one. Currently, the PRI heads 16 states, the PAN 10 and the PRD six. The most important locality in the hands of the PRD is Mexico City, whose mayors prior to the 1997 reform were appointed by the President. The mayor now enjoys great political prominence, partly due to the fact that Mexico City concentrates 21.9% of the country's GDP and 8.5% of the total population, in addition to being the seat of government of the three powers of the Union. In the elections of 1997 and 2000, the PRD won with 48.1% and 34.8% of the vote, respectively.

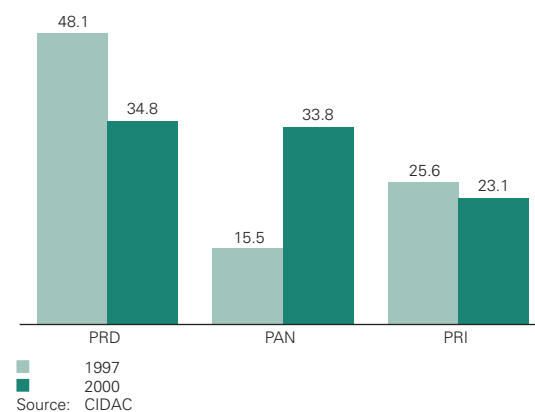
The sign of the times is the intense electoral competition that enriches and provides solidity to the multi-party system. However, the vitality of a democracy is also measured by its capacity to promote economic reforms. In this sense, the lack of progress in terms of structural change since 1997 cannot be ignored. In the past, reforms were implemented to resolve crises. Now, Mexico must aspire to higher growth goals and consolidate stability. It is necessary to take advantage of the macroeconomic environment in order to advance in achieving an agenda of reform and not remain behind compared to the rest of the world: additional delay might be too late and too costly.

Number of Governorships per Party End of year

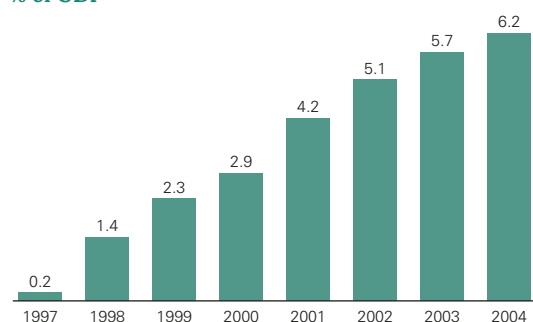
	PRI	PAN	PRD
1997	25	6	1
1998	23	6	3
1999	21	7	4
2000	19	8	5
2001	17	9	6
2002	17	9	6
2003	17	9	6
2004	17	10	5
2005*	16	10	6

* Through March 2005
Source: State Electoral Institutes

Election of Mexico City Mayor: Votes per Party %



Graph 1: Balance of Retirement Savings Funds Managed by Afores % of GDP



Source: BBVA Bancomer with Consar and INEGI data

Challenges for the Pension Systems in Mexico

One of the most important precautions that a person can take is that of ensuring sufficient funds for his retirement. A financial mechanism that allows reaching this objective is a pension.

The Pension Supply in Mexico

The pension supply in Mexico is organized based on public and private agencies authorized to receive contributions from workers while they are active to then pay them back as benefits once the workers have retired. Due to the extent of their coverage, the public agencies are the most important. Included among them are the federal institutions of social security such as the Mexican Institute of Social Security (IMSS) and the Institute of Security and Social Services of State Workers (ISSSTE)—agencies with the highest number of affiliates and rightful claimants—, state governments, state-owned firms and other organizations such as development banks and universities.

In the public agencies, two pension plans can be identified according to the manner in which they grant benefits and receive contributions: definite benefit (DB) and defined contribution (DC).¹ In the DB plans (the ISSSTE and most of the public agencies) a pension is defined at the start of the plan as a percentage of the worker's salary (replacement rate). In order to obtain it, workers must comply with the minimum requirements of age and time that they contribute. The plan finances the pensions with the contributions of active workers.

At the same time, in the DC plans, the workers make definite contributions to an individual capitalization account that accrues interest. It is the balance in that account that at the moment of retirement determines the pension in the form of programmed withdrawals or allowing the purchase of a lifetime annuity with an insurance company. The IMSS, for example, operates a mixed plan that established a DC plan, but also provides for a minimum pension equivalent to a minimum DB.

In the pension plans of the various government agencies, the requirements and the benefits are quite heterogeneous in terms of contributions, length of payment time, retirement age and replacement rates. Nevertheless, common characteristics of most of the pension plans operated with DB plans are: non-individualized contributions, low contribution rates and high replacement rates. However, in those with DC plans, the contributions are individualized and there is a balance between contributions and benefits. What the worker will receive depends directly on his contributions to an individual account (see chart 1).

The IMSS DC plan has two advantages over the DB: 1) workers can constantly increase their retirement income with their contributions, even after the legal retirement age, and; 2) it is possible for a worker to retire prematurely if he has accumulated sufficient savings. The

¹ For greater details on pension plans in Latin America see Angel Melguizo, "Hacia el sistema de pensiones del futuro, una comparación internacional", Latinwatch, Economic Studies Service, BBVA, Madrid, Second Quarter 2005.

IMSS has operated this plan as of July 1997, once a reform to the Social Security Law in 1995 allowed closing its previous DB plan.

With the reform to the IMSS pension plan, the retirement, disability and old age insurance operations were separated from the administration of its financing. The operation remained in the hands of the IMSS, although management was entrusted to agencies with private capital known as Retirement Fund Management Companies (Afores). As of their creation, the system with private administrators has been operating successfully: between 1997 and 2004, and the cumulative balance in the individual accounts grew from 0.2% to 6.2% of GDP (see graph 1).

Chart 1: Characteristics of the Main Pension Plans in Mexico

	Afores	Transition IMSS	IMSS-RJP	ISSSTE	ISSFAM	Pemex	CFE	L&F
Administration	Private	Public	Public	Public	Public	Public	Public	Public
Type of system	Mixed	Defined benefit	Defined benefit	Defined benefit	Defined benefit	Defined benefit	Defined benefit	Defined benefit
Contribution rates (% of the contribution base)	Worker: 1.125% Employer: 10.15% State: 0.0225% + 5.5% of MW	Worker: 0.75% Employer: 9.1% State: 0.015%	Worker: 3% Employer: residual cost of the plan	Worker: 3.5% Employer: 3.5% + contributions SAR92	Worker: None Employer: Assumes the entire cost of the plan	Worker: None Employer: Assumes the entire cost of the plan	Worker: None Employer: Assumes the entire cost of the plan	Worker: None Employer: Assumes the entire cost of the plan
Replacement rate (% of the contribution base)	Old age: depends on individual account balance Incapacity: 35% of the average contribution base in the last 500 weeks	Old age: 35% + 1.25% for each year beyond MW Incapacity: 70%	Old age: +100% Incapacity: na	Old age: 50% - 100% Incapacity: 50% - 100%	Old age: 60% - 100% Incapacity: 60% - 100%	Old age: 80% - 100% Incapacity: 60% - 100%	Old age: na Incapacity: na	Old age: na Incapacity: na
Requirements	Old age: 65 years and a min. of 1,250 weeks of contributions Incapacity: a min. of 250 weeks of contributions	Old age: 65 years and 500 weeks of contributions Incapacity: a min. of 150 weeks of contributions	Old age: 60 years and a min. of 10 years of service Incapacity: a min. of 150 weeks of contributions	Old age: 55 years and a min. of 15 years of service Incapacity: a min. of 15 years of service	Old age: a min. of 20 years of service Incapacity: a min. of 20 years of service	Old age: 55 years and a min. of 20 years of service Incapacity: a min. of 16 years of service	Old age: na Incapacity: na	Old age: na Incapacity: na
Base benefit	Cumulative balance in individual savings account	Average integrated salary of last 250 weeks	Last integrated salary	Average base salary of the last year	Last integrated salary	Last base salary	na	na
Base contribution	Integrated salary (max. 25 MW)	Integrated salary (max. 10 MW)	Integrated salary	Base salary	Integrated salary	Base salary	na	na
Number of registered workers 2004 (millions)	12.4	12.4	0.3	2.4	0.2	0.1	0.08	0.04
Num. of rightful claimants 2004 (millions)	42.6	42.6	1.2	10.3	na	na	na	na

MW Minimum Wage

na not available

* Pensions plans for workers of the private sector registered in the Mexican Institute of Social Security (IMSS)

Afores Compulsory plan for new IMSS-registered workers as of July 1997. The pension for the retirement insurance, loss of job and old age are operated by the IMSS and the contributions to that insurance by the Retirement Funds Managers (Afores)

Transition IMSS Plan for pensioners at the time of the reform and for workers that during the transition period do not want to retire under the Afores plan

IMSS-RJP IMSS, as employer, pensioner and retire plan

ISSSTE ISSSTE pension plan

ISSFAM Mexican Armed Forces Social Security Institute pension plan

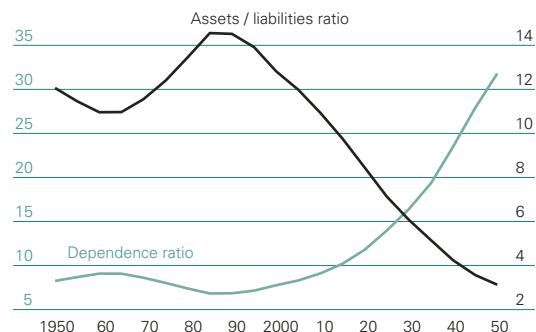
Pemex State-owned Petróleos Mexicanos (Pemex) pension plan

CFE Federal Electricity Commission (CFE) pension plan

L&F Light and Power Company (Luz y Fuerza) pension plan

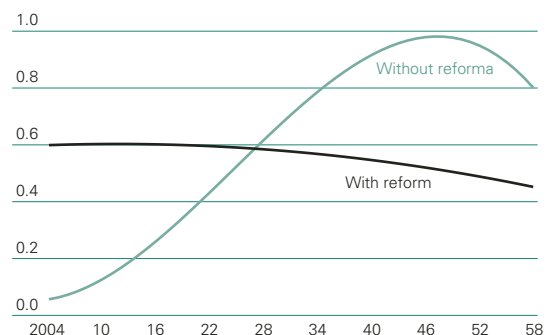
Source: International Monetary Fund, "The Financial Soundness of Mexico's Public Pension System" Mexico: selected issues", IMF Country report No. 02/238, National Finance Ministry Convention 2004, IMSS and INEGI

Graph 2: Population Dynamics in Mexico 1950-2050



Notes:
Dependence ratio = adults over 65 years of age as a percentage of the population between 15 and 65 years of age
Assets / liabilities ratio = persons between 15 and 65 years of age for each person over 65 years of age
Source: UN

Graph 3: IMSS Pensions
Annual fiscal cost, % of GDP, 2004-2058



Source: BBVA Bancomer with Consar data

Main challenges

a) To extend the definite contribution programs in government agencies

To improve the retirement conditions of workers it is necessary to extend the DC plans to all the public agencies, because if the DB plan continues to operate in them, in time there would have to be an adjustment against the well-being of the workers, due to the serious imbalance that they present between contributions and benefits. Moreover, demographic factors already underway will worsen their structural imbalance. The aging of the population and the lower birth rate will reduce the number of active workers for each retired person, while increases in life expectancy will extend the span of pensions compared to the payment time of workers contributing into the system (see graph 2).

The experience of the IMSS insurance program pertaining to disability, old age, elderly-worker employment termination and death (IVCM for the Spanish initials), in force until June 1997, explains the financial non-viability to which the agencies with DB plans are vulnerable (see graph 3). The stagnation of contributions to the plan—constant at 6% of the base salary for computing social security dues and benefits (SBC, Spanish initials for *salario base de cotización*) for 45 years, then gradually increasing to 8.5% in 1996— and the increase in benefits—the minimum pension rose from 40% to 100% of the minimum wage—created a serious structural imbalance between income and expenses that worsened with the rise in the life expectancy. Also, the IMSS paid on average a pension for 30 years when the average terms for paying into the system was 20 years.²

In all the public agencies with DB plans, the previous phenomenon is present to a greater or lesser degree. For example, in the ISSSTE, the

² See Fernando Solís S. and F. Alejandro Villagómez A. (1999), "Las Pensiones", La Seguridad Social en México. Fondo de Cultura Económica, Reading Series No. 88, Mexico City.

Chart 2: Composition of Administered Funds, June 2004
Percentage in relation to total fund

	Total (millions of dollars)	Government debt	Financial institutions	Non-financial institutions	Shares	Mutual and investment funds	Foreign issuers	Other
Mexico	37,930	85.6	4.3	10.1				
El Salvador	1,819	84.2	10.2	5.3	0.3			
Costa Rica	378	74.1	10.8	9.4		1.5		4.2
Argentina	16,222	68.1	4.5	2.1	10.4	2.9	9.4	2.5
Bolivia	1,617	64.9	6.5	18.2	7.9		1.6	0.9
Uruguay	1,323	55.5	37.7	5.4				1.4
Chile	48,992	21.2	28.3	7.1	13.3	2.5	27.5	0.1
Peru	6,699	21.2	16.2	11.0	36.9	1.6	9.5	3.5

Fuente: AIOS

contributions to the plan have not changed in almost 44 years and its benefits have increased, being that the average retirement age was gradually reduced from 61.9 years in 1975 to 55 in 2004. Also, as a result of demographic development, the number of active workers for each retired worker dropped from 20.9 in 1980 to 4.5 in 2004, while the average pension time span rose from 2.5 to 21.2 years.

The financial non-viability of the DB plans is a serious threat to the future well-being of workers, although also for budgetary stability and economic growth in Mexico, given that the gap between income and expenses in these plans must be covered with higher fiscal resources which could otherwise be allotted to social spending. For example, federal resources used to solve the ISSSTE annual imbalance reached a cumulative amount of 1.6% of GDP between 1990 and 2003, but should the decline in the number of active workers for each retired worker and the ratio between contributions and benefits remain unchanged, the annual deficit officially estimated could be 3% of GDP in the year 2053. Those annual deficits added and adjusted to present value would represent a liability equivalent to 45% of GDP in the case of ISSSTE, but of more than 100%, considering the overall total of government agencies (see graph 4).

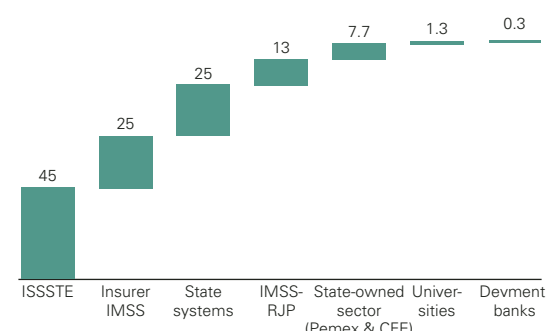
b) To increase the profitability in the individual accounts

In the IMSS, the substitution of the DB plan for another mixed one represented a great step forward on the road to establishing viable pension systems and long-term savings mechanisms in Mexico. Now, the challenge lies in perfecting the operation of the new system and in establishing the conditions that will make possible the highest accumulation of resources in the individual accounts.

In this sense, the balance of the individual account will be greater the higher the profitability of the instruments in which workers' resources are invested, the longer his contribution period is, and the higher the contributions into the system through the effect of the capitalization mechanism. Graph 5 shows that for a worker with a career salary of one minimum wage, the replacement rate at the time of retirement is higher in line with the longer time he pays into the system, but, particularly, the higher the real net interest rate of management expenditures is that his funds obtain.³

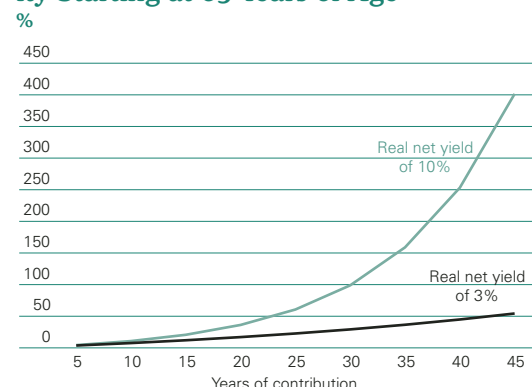
In Mexico, there are ample areas of opportunity for increasing the profitability in the retirement funds. As can be seen in graph 6, the Latin American experience with DC plans indicates that it is possible to obtain even higher real yields. Important progress in that direction has been made recently in Mexico by modifying the investment system for the savings funds for workers' affiliated to the IMSS. Specifically, as of December 2004, those funds can be allocated to new investment instruments (international securities and protected capital notes linked to stock indices) and placed in either of the two investment funds: one of fixed-income securities and the other of fixed- and variable-income securities in substitution of the old basic fund that operated only with fixed-income and concentrated most of the portfolio in government securities.

Graph 4: Pension Liabilities in Mexico*
% of GDP, 2003



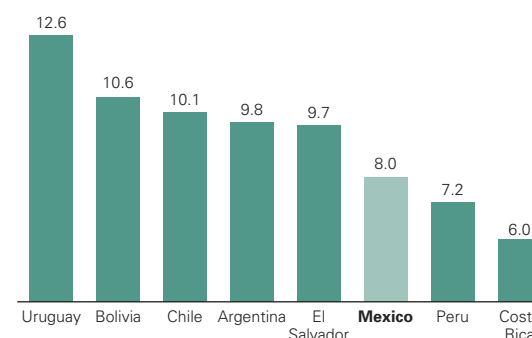
* The figures are indicative: they cannot be added due to differences in the calculation methodology
Source: ISSSTE, SHCP and CNH 2004

Graph 5: Replacement Rate with Annuity Starting at 65 Years of Age*



* Assumes a salary career of one minimum wage
Source: Espinosa-Vega and Sinha (2000)

Graph 6: Real Gross Profitability of the Pension Funds
Historic to June 2004, annual %

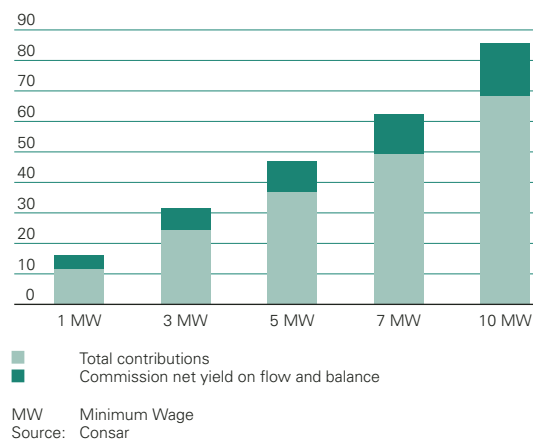


Source: AIOS

3 See Marco A. Espinosa-Vega and Tapen Sinha (2000), "A Primer and Assessment on Social Security in Mexico", Economic Review, Federal Reserve Bank of Atlanta, Atlanta.

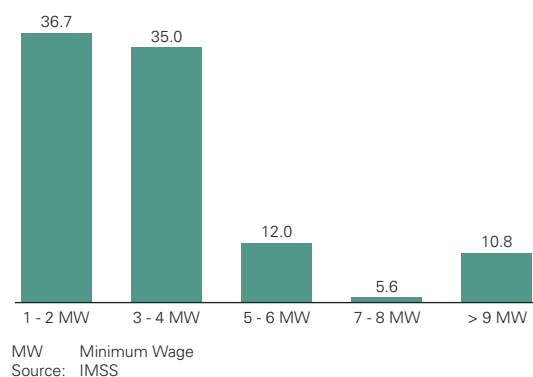
Graph 7: Composition of the Balance by Salary Level

Thousands of pesos, August 2004



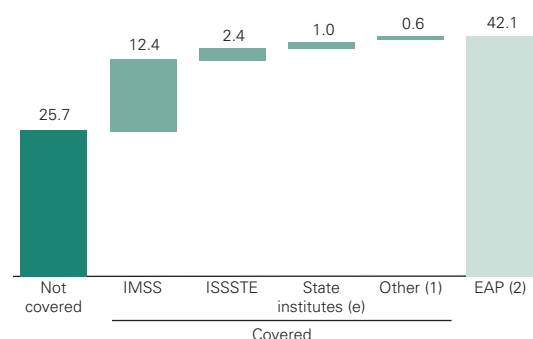
Graph 8: IMSS-registered Workers by Minimum Wage Range

% of the total, December 2004



Graph 9: Coverage of the Public Pension Plans in Mexico, 2004

Millions of workers



Undoubtedly, previous progress will allow improving the yields of the retirement funds and expanding the real yield options for the worker. Nevertheless, the existence of the 20% limits for investment in international securities and of 15% for those in variable-income make the Mexican investment system remain quite conservative compared to that of Latin American countries with high yields such as Chile and Uruguay, which are more flexible in their investment portfolios (see chart 2).

c) To increase the voluntary contributions to the capitalization systems

The advantages offered by capitalization are greater for those who make higher contributions to the system and who pay in longer. In this sense, another important challenge that the DC plans face is to have high contributions made into the system on a regular basis.

Although the obligatory contributions rates to individual accounts in Mexico are similar to those of other countries, the balance in the accounts for most IMSS-registered workers is relatively low, even with the capitalization mechanisms, since slightly more than 70% of the workers register base salaries for IMSS purposes lower than four times the minimum wage (see graphs 7 and 8). Thus, the options for complementary and voluntary contributions offer an important mechanism for additional savings. For example, in Japan, the United Kingdom and Canada these contributions represent between 20% and 50% of the pension. However, in Mexico, as a percentage of the total, excluding housing contributions, it represented 0.5% on average of the total between 1998 and 2004⁴. In addition to the above, a problem that the capitalization system in Mexico is facing is the relatively low number of active individual accounts. For example, in 2003, the number of registered workers who actually made contributions to the system represented 39.3% of the total, while in Uruguay, Chile and el Salvador, the percentages were 52.7, 51.9 and 46.3, in the same order.

d) To expand the coverage of the pension systems to independent workers and other pension funds

In order for workers to be able to ensure an appropriate level of well-being at the time of retirement, it is important for them to have access to the pensions. However, the formal pension system covers less than 50% of the employed economically-active population (see graph 9). Even though it is clear that an important challenge lies in expanding coverage, it is not so clear that this goal can be reached through the public systems. On the one side, public agencies do not have financially viable pension plans that they can offer to the public, and, on the other, it would not be desirable to attain greater coverage through increases in the size of the bureaucracy. Thus, the important alternatives for extending the coverage lie more in incorporating a greater number of workers to the formal economy and increasing the potential of the Afores in order to manage the independent workers' savings accounts and the firms' savings funds.

4 In 2004, the cumulative balance of voluntary contributions as a percentage of GDP was 0.03%, while that of compulsory contributions for retirement, worker employment termination and old age was 6.14%.

United States Indicators and Forecasts

	II'04	III'04	IV'04	I'05	II'05	III'05	IV'05	I'06	2004	2005	2006
Economic Activity											
GDP (real annual % change)	4.8	4.0	3.9	3.5	3.6	3.5	3.7	3.4	4.4	3.6	3.2
Personal consumption expenditures	3.6	3.6	3.7	3.5	3.7	3.3	3.2	3.2	3.8	3.4	3.2
Gross fixed investment	11.6	9.4	9.2	8.9	7.3	6.1	5.7	5.4	10.3	7.0	5.0
Non-residential	10.8	10.1	11.0	10.9	9.8	8.0	7.0	6.5	10.6	8.9	5.6
Structures	1.3	1.3	0.0	1.3	1.0	0.8	0.6	0.4	1.4	0.9	0.5
Equipment and software	13.9	12.9	14.5	12.3	10.9	8.5	7.1	7.8	13.6	9.6	6.7
Residential	13.2	8.0	6.5	5.7	3.3	2.9	3.4	3.0	9.7	3.8	3.6
Total exports	10.8	9.4	5.9	3.7	3.9	4.8	6.9	5.5	8.6	4.9	4.5
Total imports	10.7	11.1	9.8	7.8	6.0	5.4	4.3	4.7	9.9	5.9	4.5
Government consumption	1.6	1.8	1.6	2.8	2.8	2.8	2.8	2.3	1.9	2.8	2.3
Contribution to Growth (pp)											
Personal consumption expenditures	2.5	2.5	2.6	2.5	2.6	2.3	2.3	2.3	2.7	2.4	2.2
Private investment	2.6	1.9	1.9	1.4	1.0	1.1	0.9	0.9	2.1	1.1	0.9
Net exports	-0.5	-0.7	-0.9	-0.8	-0.5	-0.3	0.0	-0.2	-0.6	-0.4	-0.3
Government consumption	0.3	0.3	0.3	0.5	0.5	0.5	0.5	0.4	0.4	0.5	0.4
Prices and Costs (annual % change, average)											
CPI	2.9	2.7	3.3	2.9	2.7	2.6	2.5	2.5	2.7	2.7	2.6
Core	1.8	1.8	2.1	2.3	2.3	2.2	2.2	2.2	1.8	2.3	2.1
PCE	2.3	2.2	2.5	2.4	2.2	2.1	2.0	2.0	2.2	2.2	2.1
Core	1.5	1.5	1.6	1.6	1.6	1.7	1.7	1.6	1.5	1.7	1.6
GDP deflator	2.2	2.2	2.4	2.3	2.3	2.4	2.4	2.5	2.1	2.4	2.5
Productivity	2.9	2.0	3.7	2.4	2.3	2.2	2.0	2.1	3.2	2.2	2.0
Real compensation per hour	0.8	4.1	0.9	1.7	1.8	1.9	2.0	1.7	1.3	1.9	1.5
Unit labor cost	0.4	4.3	-0.4	1.7	1.9	2.2	2.4	2.1	0.5	2.1	2.0
Other Indicators											
Industrial production (real annual % change)	4.9	4.6	4.2	3.9	3.8	4.1	4.1	4.0	4.1	4.0	3.5
Capacity utilization (%)	77.9	78.2	78.8	79.2	79.0	79.0	79.4	79.7	78.1	79.1	79.6
Light weight vehicle sales (millions, annualized)	16.6	17.1	17.2	16.3	16.3	16.3	16.3	16.2	16.8	16.3	16.3
Housing starts (thousands, annualized)	1,920	1,969	1,975	2,022	1,809	1,824	1,852	1,787	1,952	1,877	1,727
Nonfarm payrolls (thousands of new jobs, average)	135	161	183	162	161	152	154	182	183	157	183
Unemployment rate (average, %)	5.6	5.4	5.4	5.3	5.4	5.3	5.3	5.2	5.5	5.3	5.1
Personal savings rate	1.3	0.7	1.6	1.3	1.5	1.6	2.1	2.1	1.2	1.6	2.3
Trade balance (US\$ billions)	-151	-156	-172	-175	-174	-169	-170	-173	-617	-688	-684
Current account balance (US\$ billions)	-165	-166	-188	-192	-191	-180	-175	-191	-666	-738	-739
% of GDP	-5.7	-5.6	-6.3	-6.3	-6.2	-5.7	-5.5	-5.9	-5.7	-5.9	-5.6
Fiscal balance (US\$ billions, fiscal year)	—	—	—	—	—	—	—	—	-412	-427	-377
% of GDP	—	—	—	—	—	—	—	—	-3.6	-3.4	-2.9
WTI (dollars per barrel, average)	38.4	44.1	47.1	49.9	44.5	42.7	41.0	39.3	41.2	44.3	38.5
Financial Markets (eop)											
Fed Funds (%)	1.25	1.75	2.25	2.75	3.25	3.75	4.00	4.25	2.25	4.00	5.00
3-month Libor (%)	1.61	2.02	2.56	3.12	3.50	4.00	4.25	4.50	2.56	4.25	5.25
10-year Treasury Note (%)	4.72	4.19	4.24	4.48	4.50	5.00	5.20	5.50	4.24	5.20	6.00
Dollar/euro	1.21	1.24	1.35	1.30	1.30	1.33	1.35	1.34	1.35	1.35	1.30

eop end of period
CPI Consumer price index
PCE Personal consumption expenditures index

Mexico Indicators and Forecasts

	2000	2001	2002	2003	2004	2005*	2006*	I'05	II'05	III'05	IV'05
Economic Activity											
GDP											
Real annual % change	6.6	-0.2	0.8	1.4	4.4	4.2	4.0	4.4	4.3	4.2	3.9
Per inhabitant (US dollars)**	5,920	6,279	6,432	6,235	6,454	6,719	6,900	6,751	6,687	6,656	6,771
US\$ billions	581	622	649	639	676	712	738	704	717	688	737
Inflation (eop, %)											
Headline	9.0	4.4	5.7	4.0	5.2	4.0	3.9	4.3	4.7	4.2	4.0
Core	7.5	5.1	3.8	3.7	3.8	3.7	3.7	3.8	3.9	3.8	3.7
Financial Markets											
Interest rates (eop, %)											
Bank funding	18.6	8.1	8.3	6.1	8.8	10.00	10.00	9.50	10.00	10.00	10.00
28-day Cetes	17.6	6.8	7.0	6.0	8.6	10.1	10.3	9.6	10.0	10.2	10.1
28-day TIE	18.4	7.9	8.5	6.3	9.0	10.5	10.7	10.0	10.3	10.6	10.5
10-year Bond	—	10.3	10.1	8.3	9.7	10.8	11.1	10.5	10.6	10.8	10.8
Exchange rate											
Pesos per dollar, eop	9.6	9.1	10.3	11.2	11.3	11.8	12.2	11.3	11.4	11.7	11.8
Public Finances											
Fiscal balance (% of GDP)	-1.1	-0.7	-0.6	-0.6	-0.3	-0.1	-0.2	na	na	na	na
Financial Require. of the Public Sector (% GDP)	-3.3	-3.0	-2.6	-3.0	-2.7	-2.1	-1.9	na	na	na	na
External Sector***											
Trade balance (US\$ billions)	-8.0	-10.0	-7.9	-5.6	-6.1	-10.7	-12.6	-6.8	-7.9	-9.2	-10.7
Current account (US\$ billions)	-23.7	-23.9	-13.8	-8.9	-8.0	-13.4	-16.4	-9.4	-10.7	-12.1	-13.4
Current account (% of GDP)	-4.1	-3.8	-2.1	-1.4	-1.2	-2.0	-2.1	-1.4	-1.6	-1.8	-2.0
Oil (Mexican mix, dollars per barrel, eop)	18.8	14.4	24.7	25.7	33.4	28.8	27.6	38.7	31.5	30.1	28.8
Monetary Aggreg. & Banking Act. (ann. % chge.)											
Core bank deposits	-13.9	2.2	-5.5	7.4	6.2	5.1	4.1	3.6	5.8	4.0	5.1
Commercial banks performing loans****	2.6	0.8	7.9	8.1	25.3	16.9	14.4	29.2	26.8	24.5	16.9
Aggregate Demand (annual % change)											
Total	10.4	-0.6	1.0	1.2	6.0	5.9	6.0	5.2	5.7	6.3	6.3
Domestic demand	8.5	0.6	0.8	0.7	4.1	4.8	4.5	4.3	4.5	5.2	5.4
Consumption	7.4	1.9	1.4	2.1	4.7	5.3	5.5	5.5	5.1	5.5	5.2
Private	8.2	2.5	1.6	2.3	5.5	5.7	5.8	5.8	5.3	5.8	5.6
Public	2.4	-2.0	-0.3	0.8	-1.2	2.5	2.5	2.9	3.0	2.0	2.1
Investment	11.4	-5.6	-0.6	0.4	7.5	5.9	4.5	8.3	7.1	4.6	4.0
Private	9.0	-5.9	-4.1	-1.5	8.5	6.7	4.5	9.3	8.0	5.2	4.3
Public	25.2	-4.2	17.0	8.5	3.6	2.7	4.6	2.6	2.5	1.8	3.3
External demand	16.4	-3.8	1.6	2.7	11.5	8.9	9.7	8.0	9.1	9.2	9.0
GDP by sectors (annual % change)											
Agriculture	0.6	3.5	0.1	3.5	4.0	2.3	1.9	3.8	-1.6	4.3	3.0
Industrial	6.1	-3.5	-0.1	-0.2	3.8	3.9	3.6	3.7	4.3	3.6	4.0
Mining	3.8	1.5	0.4	3.7	2.5	3.0	3.1	1.7	2.8	3.4	4.2
Manufactures	6.9	-3.8	-0.7	-1.3	3.8	3.8	3.5	3.6	4.2	3.4	3.8
Construction	4.2	-5.7	2.1	3.3	5.3	5.4	6.5	5.2	5.9	5.2	5.2
Electricity, gas and water	3.0	2.3	1.0	1.6	2.3	2.7	3.1	1.7	2.7	2.7	3.6
Services	7.3	1.2	1.6	2.1	4.8	4.4	4.4	4.7	4.8	4.4	3.8
Retail, restaurants and hotels	12.2	-1.2	0.0	1.6	4.9	4.8	4.1	5.9	5.5	4.7	3.2
Transportation and communications	9.1	3.8	1.8	5.0	9.7	7.5	8.2	6.8	8.1	6.9	8.3
Financial, insurance and real-estate	5.5	4.5	4.2	3.9	4.6	4.4	5.1	4.7	4.3	4.7	4.0
Community and personal	2.9	-0.3	0.9	-0.6	1.7	2.0	1.6	2.1	2.4	2.0	1.5

eop end of period
 * Forecasts in **bold**
 ** Seasonally-adjusted series for quarterly data
 *** Accumulated, last 12 months
 **** To the private sector
 na not available

Economic Research Department Presentations

Title	Institution - Client	Place and date
Caracas www.provincial.com		
Claves Macroeconómicas para 2005	Provincial Foundation	Caracas Jan. '05
Perspectivas Financieras 2005-2007	Corporate Banking	Caracas Jan. '05
Claves Macroeconómicas y Financieras	Global Banking	Caracas Feb. '05
Claves Macroeconómicas y Financieras	Global Banking	Caracas Feb. '05
Claves Macroeconómicas y Financieras	Global Banking	Caracas Mar. '05
Claves Macroeconómicas y Financieras	Global Banking	Caracas Mar. '05
Lima www.bbvaibancocontinental.com		
Perú: Perspectivas Económicas 2005	BBVA Seminar	Lima, Dec. '04
Perspectivas para el 2005	Continental Bolsa	Lima, Jan. '05
Tendencias Macroeconómicas	World Bank Mission	Lima, Jan. '05
Situación Económica	Global Banking	Lima, Feb. '05
Perspectivas Económicas: 2005-2006	Global Banking Clients	Lima, Feb. '05
Perspectivas Económicas: 2005-2006	Global Banking	Lima, Mar. '05
Perspectivas Económicas: 2005-2006	Global Banking Clients	Lima, Mar. '05
Madrid www.bbva.com		
Retos de corto y largo plazo de la economía brasileña	University of Deusto	Bilbao, Mar. '05
El Urbanismo en España.	Mexican Bankers Association	Mexico City, Mar. '05
América Latina: la economía política de lo posible	IADB	Washington, Feb. '05
Situación del Mercado Inmobiliario e Hipotecario	Association for Managing Progress	Barcelona, Feb. '05
¿Son sostenibles los niveles actuales de tipos de interés?	University of Oviedo	Oviedo, Feb. '05
Brasil: una mirada estructural	ESADE	Barcelona, Feb. '05
¿Están las estrellas alineadas?	IESE, Lazard Freres	Madrid, Jan. '05
Unlocking Credit:¿ El vaso medio lleno o medio vacío?	IADB-BBVA Seminar	Madrid, Jan. '05
Anjo o Demônio para América Latina	BBVA Brazil	Sao Paulo, Dec. '04
La incógnita del dólar	Central Bank	Lima, Dec. '04
Las claves del escenario macroeconómico y financiero	BBVA Continental	Lima, Dec. '04
Presentación Nuevas Publicaciones SEE	BBVA Uruguay	Montevideo, Dec. '04
Economía Brasileña: doble reto	BBVA Chile	Santiago de Chile, Dec. '04
Mexico and United States www.bancomer.com		
¿Hacia dónde se dirigen las variables financieras en México?	Corporate Clients	Mexico City, Jan - Mar '05
Mexico: outlook and challenges	Bear Sterns, Barclays, Bank of Tokyo	Mexico City, Jan. '05
Perspectivas económicas y financieras de México	Private Banking Clients	Mexico City, Jan. '05
La economía y los mercados en el 2005	Regional Councils, Asset Managment	DF, Monterrey, Gdl., Feb.'05
El potencial de la banca en México	2nd. University Congress, ABM-ITESM	DF, Monterrey, Gdl., Feb.'05
Economic and financial outlook in Mexico	IMF Annual Visit	Mexico City, Mar. '05
¿Es China una amenaza para la economía mexicana?	Capem - Oxford Econometric Forecasting	Mexico City, Mar. '05
La estructura del mercado de suelo para vivienda	Mexican Bankers Association	Mexico City, Mar. '05
EUA: mirada estructural	U.S. Retail Banking	Houston, Mar. '05
Integración económica México-EUA y más allá	U.S. Retail Banking	Houston, Mar. '05
Santiago de Chile www.bhif.cl		
De la recuperación al crecimiento	BBVA Clients	Viña del Mar, Mar. '05
Perspectivas Económicas 2005-06	PROVIDA Board of Directors	Santa Cruz, Mar. '05
Chile: Perspectivas y riesgos	Banco de España	Santiago, Mar. '05
Agenda Interna y los TLC	CAF - OAS Workshop	Cartagena, Col., Feb. '05
Recuperación en medio de turbulencias	BBVA clients by region	Puerto Varas, Nov. '04
Panorama Económico Mensual	BBVA Corporate Banking	Santiago, Nov. '04
Panorama Económico 2004-2005	BBVA Retail Banking	Santa Cruz, Nov. '04
Perspectivas Económicas 2004-2005	Gardilic Constructors	Santiago, Oct. '04
Panorama Económico Mensual	BBVA Corporate Banking	Santiago, Oct. '04
Instituciones y Crecimiento Económico	BBVA Seminar	Madrid, Oct. '04

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Other publications



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