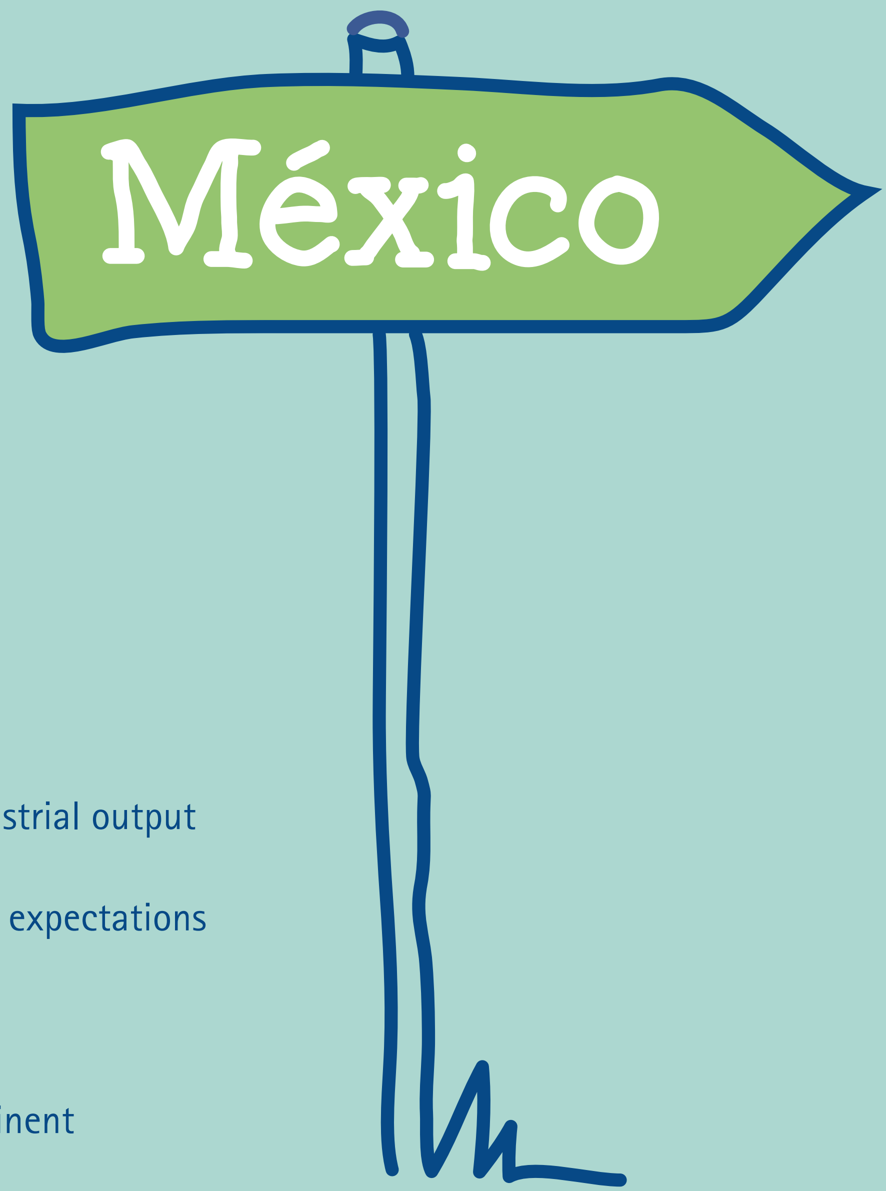
BBVA Bancomer

Situación

Economic Research Department

First Quarter 2006



U.S.: less growth, but higher industrial output

Mexico: growth of around 3%

Inflation: facing the challenge of expectations

Toward monetary neutrality

A strong peso: the entire year?...

Competitiveness: Achilles' heel

Plagued by elections on the continent

Mexico: Editorial

In 2005, inflation in Mexico continued to converge toward the target set by Banco de México: 3%, plus or minus a one-percentage point margin. This achievement, especially important in the case of core inflation, should be framed within a long-term horizon in which the country, after experiencing the destructive effect of inflation on numerous occasions, has opted for a series of measures clearly aimed at reducing and controlling price increases. Among the most important of these measures are a cautious fiscal policy (both in terms of managing public spending as well as in setting rates and prices for public goods and services), the existence of an autonomous central bank focused on price stability, and trade opening policies that have allowed Mexico to benefit from the advantages of globalization, particularly from the reduction of prices on a world level.

Although this process has been successful, it would not be advisable to let our guard down. The first step, convergence toward the inflation target, has been accomplished. But a difficult stage remains, namely, its stabilization. Only when price increases have been stabilized around the inflation target over a long period of time, will an inflationary risk premium no longer be incorporated into the inflation expectations of the economic agents and in the negotiation processes of prices and wages. This, in turn, will facilitate maintaining the inflation target in the medium and long term.

Although there will necessarily be a waiting period before knowing what will occur in the long term, we will soon see what could be a first sign in determining whether the improvement in inflation has changed the dynamics of price formation on the part of economic agents. Given the expected upturn in headline inflation in the first few months of 2006 due to seasonal effects, atypical bases of comparison, and increases in some agricultural prices—elements that are impossible to control at the level of monetary policy without generating an unnecessary cost in terms of growth—we will have to see whether expectations, especially medium and long-term projections, do not rise on a par with headline inflation, and if price formation and wage negotiations are not affected. Let us hope that this will be the case.

Although it might be unnecessary today to highlight the advantages of low and stable inflation given the unanimity of opinions in this regard, it should be emphasized that its benefits are distributed among all the layers of society and in all sectors. Not only does reduced inflation benefit those who have less (clearly inflation is an especially onerous tax for those in the lowest income strata), but control over price growth allows for a decrease in interest rates in all their terms, expanding the possibilities to finance consumption and investment.

As we have already commented on other occasions, this stability is a necessary, although insufficient, condition for Mexico to achieve further growth. Just as it would be senseless to believe that greater growth can be obtained with higher inflation, it is unreasonable to believe that low inflation, and in general greater macroeconomic stability, can, in and of itself, boost the economy's growth potential. To achieve this, there are few shortcuts, and it is necessary to move forward with measures that increase productivity. The question that we will have to answer is… when?

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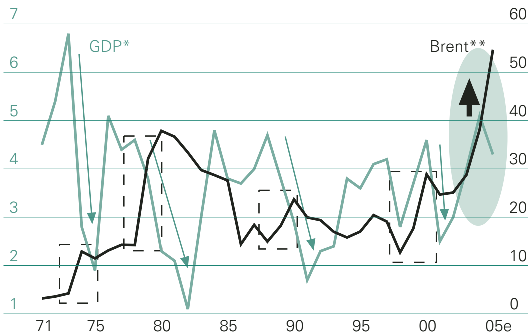
This publication was prepared by:

Jorge Sicilia j.sicilia@bbva.bancomer.com
Adolfo Albo a.albo@bbva.bancomer.com
Javier Amador j.amador@bbva.bancomer.com
David Aylett dp.aylett@bbva.bancomer.com
Giovanni Di Placido giovanni_diplacido@provincial.com
Fernando González f.gonzalez8@bbva.bancomer.com
Octavio Gutiérrez o.gutierrez3@bbva.bancomer.com
Ociel Hernández o.hernandez@bbva.bancomer.com
Nathaniel Karp n.karp@bbva.bancomer.com
Mayte Ledo teresa.ledo@grupobbva.com
Fernando Tamayo fernando.tamayo@bbva.bancomer.com
Eduardo Torres e.torres@bbva.bancomer.com
Nicolás Trillo nicolas.trillo@grupobbva.com

World Growth and Oil Prices



* Real annual world % change
** Dollars per barrel
e estimated
Source: BBVA with IMF and Bloomberg data

Unit Labor Costs
Annual average growth rate, %

Source: BBVA with National Statistics data

A Different World

One of the main characteristics of 2005 has been the positive balance in economic growth despite the rise in oil prices. The coincidence in the timing of both of these factors could respond to the increase in world demand that could be translating into a significant growth of trade flows and an increase in the prices of raw materials, mainly energy products and metals. Therefore, the shock that would be taking place would not be due to rising crude oil prices, but would be derived from the growing trade participation and activity of new countries, such as China and India, which account for almost half of the world population.

In terms of supply, the relative growth of the work force has led to lower growth in wages that would partially offset the rise in oil prices and that presumes the existence of a global contention factor on inflationary pressures. This has allowed the central banks to maintain high liquidity in times of high economic growth, without a rebound in the outlook for higher prices in the medium term. Only in those countries with more advanced cyclical phases have inflation expectations experienced a rallying trend, fearing the appearance of "second round" effects derived from higher energy prices. Despite this, long-term interest rates remain low, a reflection of the credibility surrounding inflation control by the monetary authorities, and of the growing importance of the flows.

Continuity of solid growth in the United States

In 2006, overall economic growth will be similar to that of the previous year, but with a somewhat different composition. In the United States we expect a slowdown in growth, from 3.6% in 2005 to rates closer to 3% in 2006. This performance will be mainly the result of moderation in private consumption growth, within a context of a negative savings rate.

Its evolution would be conditioned by various factors. First, there is lower growth in real disposable income due to the convergence of productivity with its long-term trend (2-2.5%), a process that could have already started and that would moderate the growth of real wages. Second, consumption will be affected by more moderate job creation in view of greater caution on the part of companies and a lower generation of new jobs in the real-estate sector, which has strongly boosted the creation of private employment in the last three years. In fact, the gradual cooling off of the real-estate sector (wealth effect) that is beginning to be reflected clearly in some leading indicators will help moderate consumption when it reduces mortgage refinancing.

As a result of this lower rate of expansion in consumption, the rise in the cost of financing and the moderation in the expansion of cash flow and business profits, private investment will tend to moderate, particularly the residential. The cash flow trend suggests lower private investment going forward. Also, even though profits remain at historically high levels, we expect that their growth rate will continue with a moderation trend, affected by a lower rate of increase in sales, higher labor costs and interest rates, and price power, which although higher, is still limited by high competition and globalization. As a whole, the above aspects will affect business expectations and optimism; this greater uncertainty will add to the caution of the companies, moderately limiting non-residential private investment.

Lower growth in consumption and investment will lead to lower expansion in consumer goods and capital imports. Thus, reduced demand will imply lower growth in imports than in exports, by which the current account deficit will be reduced as a percentage of GDP in 2006 and 2007. In contrast, we expect the fiscal deficit to GDP ratio to rise in 2006, mainly due to reconstruction costs of the areas affected by the hurricanes. In 2007, the reduction of the additional appropriations relative to the war in Iraq and the fight against terrorism, mainly, and greater economic growth, which will boost tax collection, will allow reducing this ratio.

In other areas, such as the Economic and Monetary Union (EMU), the economic outlook has improved. Confidence has begun to rally significantly, particularly in Germany, which allows expecting a recovery of activity toward rates of 2.0% of GDP in 2006, after 1.3% growth the previous year. Nevertheless, the uncertainty regarding European growth has not dissipated completely. The Asian Southeast, and in particular China, which has just revised the value of its aggregate production upward, will continue to show rates close to the high average of recent years. Nevertheless it will continue strongly biased toward notable growth in investment, consistent with an expansion model seeking the development of exporting platforms and a moderate pause in family consumption. In turn, in 2006 Japan could incorporate the positive impact of growth in the area, recovering GDP growth rates close to their potential. Finally, other regions like the Middle East will continue to benefit from the shock in the exchange terms, derived from the rise in the prices of raw materials that they export and will maintain growth rates at around 5%.

Gradual adjustment of the monetary policies

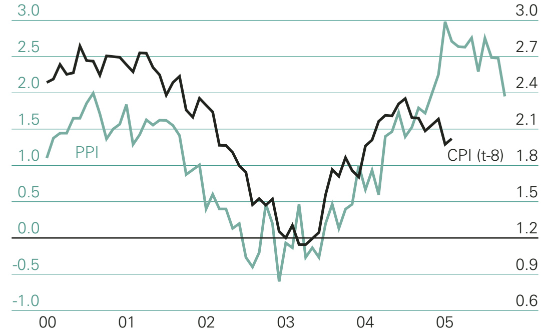
Within the previous context, in which the global growth rate will remain high in 2006, it is foreseeable that the central banks will adopt a less expansive policy. However, given that the priority of the monetary authorities is the control of price expectations, and these in general terms remain moderate, the adjustment in interest rates will be gradual, ruling out a scenario of a strong adjustment in the economies.

In the United States, core inflation will maintain a moderate upward trend during 2006 (2.5% on average), as a result of the delayed transmission of higher production costs to final prices. The position of the economy in the current expansion cycle, with the labor market strengthening and lower idle capacity, imposes upward risks, although the notable growth in productivity, market flexibility, high competition, low external prices, absorption of greater costs in view of high margins and mainly, anchored inflation expectations, will all

U.S.: Non-Agricultural Productivity and Real Disposable Income
Annual % change

Source: BBVA with BLS & BEA data

Production and Consumption Prices
Core, annual % change



Source: BBVA and BLS data

delimit these increases. Under these parameters, and with expected headline inflation at 2.8% for 2006, in view of the expected drop in oil prices, we foresee that the Federal Reserve will place official interest rates at levels of 4.75% in the first quarter of 2006, levels of greater monetary neutrality in which it could halt the process of increases begun in June 2004.

In the EMU, although the European central bank began an upward cycle in interest rates in December 2005, justified by monetary growth and the fear of a deterioration in inflation expectations, it does not seem likely that significant increases will be produced. In face of the doubts and uncertainty regarding the future growth of the area, we expect official interest rates to stand at 2.75% by the end of 2006. In Japan, the forecasts are less aggressive, and the first increase in rates could even be delayed more than what the market discounts, placing it in mid 2006. The route is limited, since a premature rise in interest rates could have a negative impact on the exit of the deflationary process.

Globalization and financial diversification support the anchoring of long-term rates.

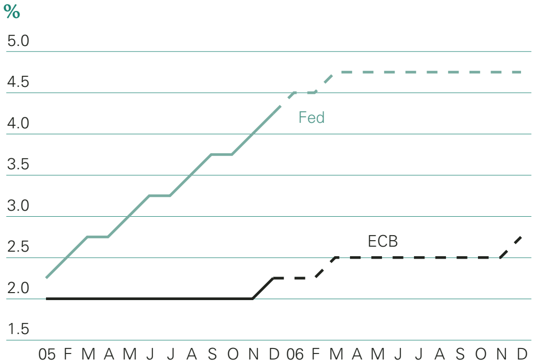
The leveling seen in interest rate curves in a generalized context of less expansive monetary policies would respond to the confluence of two factors. The first would be the deepening of the capital flows, in whose expansion of recent years the increase in the bond volumes operated has been significant. Behind this evolution would be the uncertainty in the world economy, high savings in Europe and Japan due to the life cycle, regulatory issues that mainly affect insurance companies or pension funds, and the development of the European corporate market or of the emerging bond markets in local currencies.

The second factor would be the diversification in the capital flows, since a higher number of agents and countries actively participate in the financial market. Thus, the dispersion of the current account balances not only has not diminished, but has risen in recent years. The current account deficit of the United States is rising and among the economies showing a surplus, not only do those of Southeast Asia and Japan stand out but also the oil-exporting countries.

This deepening and diversification of the capital flows could be assuming, among other estimates, almost one percentage point less in the 10-year bond rates. Given than an inflection in both trends is not expected and there are no elements to consider an increase in the nominal and real volatility of the economies, long-term interest rates can be expected to remain at low levels.

In particular, the debt curve in the United States could remain practically flat, with 10-year rates ending 2006 at levels of 4.8%, which could advance toward 5.1% in 2007, minus one percentage point over their level in December 2005. In the EMU, the 10-year rate could stand at 4.0% and at 4.3% at the end of 2006 and 2007, respectively.

United States and EMU: Interest Rates



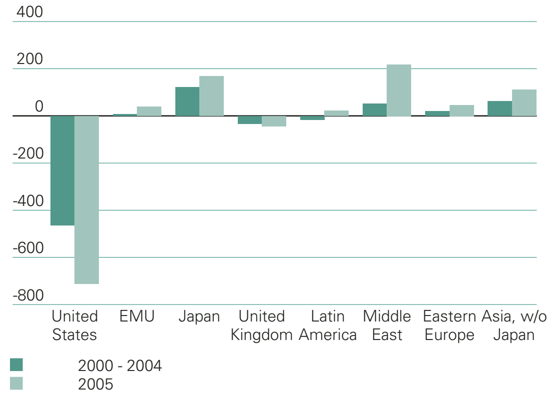
Note: Estimated as of January 2006
Source: BBVA with Bloomberg data

Risks of the central scenario

Among the global risk factors for 2006, the slowdown of some of the most dynamic economies of the world should be mentioned, especially China and the United States. In the case of China, its current dynamism and the absence of signals of clear reheating lead us to assign low probability to a scenario of an abrupt slowdown. In the case of the U.S., the signs of moderation in the real-estate sector warn of the risks derived from an adjustment in the price of assets, which, should it occur, could slow down consumption and investment and lead to a reduction in interest rates in all the terms of the yield curve. The probability that such an adjustment might occur is limited, since there are factors that could offset the negative effect on the wealth of families: financial conditions, productivity levels and, especially, the performance of the labor market.

Another risk element lies in a possible rise in oil prices, relative to the difficult geo-political situation in some of the main oil-producing countries. Were this to derive in the price remaining higher than our current forecast of a slight moderation in 2006, not only would growth tend to moderate but also the pressure on inflation would lead to rises in the short-term rates.

Current Account Balance by Region
Billions of dollars



Source: BBVA with IMF data

Oil: Calm after the Storm?

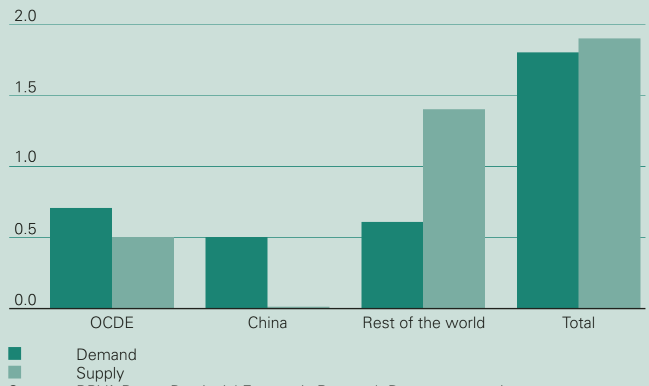
After a year of strong rises in oil prices (along the order of 60%) up to September 2005, at the beginning of 2006 the market seemed to be entering a period of calm. To begin with, the factors that boosted the rise in energy prices were a perception of a weak equilibrium in the market, a period of sustained growth in demand, the fear that an important producer would halt sales (although only on a temporary or transitory basis) in a market with a limited capacity to offset such an eventuality, and a more intense hurricane season than is normally the case. The latter had a significant impact in the Gulf of Mexico, the area in which the greater share of U.S. crude oil and hydrocarbon products are produced, refined, and imported. It would seem that at the end of 2005, there was a return to a period of calm. In the fourth quarter of 2005, oil prices fell 11%, to close the year at an average of US$54.48 for the Brent and US$42.72 for the Mexican mix. The big question is whether the trend will continue or if, on the contrary, prices will once again increase.

The pessimists (high prices) believe that the strong growth of the world economy and of demand will be maintained. This behavior, given the low additional production capacity that is available and the persistence of production losses due to the hurricanes, together with a greater geopolitical risk associated with the situation in the Middle East, could explain a sustained rise in prices, as has occurred in the past few weeks. This could bring the Brent to US$63 per barrel, as estimated by the U.S. federal government's Energy Information Administration (EIA) and would maintain prices in real terms at such levels over the next few years.

The optimists (low prices) base their projections on lower growth of the world economy and demand, which in turn, reflects the effect of the impact of high prices, accompanied by a greater recovery in inventories, higher growth capacity of supply, and lower geopolitical risk. From this perspective, the correction in prices will be much faster than expected and average oil prices would be close to or below US$50 dollars per barrel for the Brent and US$38.50 for the Mexican mix.

In the short term, the pessimists have the advantage. The current year began with a conflict between Russia and Ukraine, with Moscow fulfilling its threat to cut off the supply of natural gas to Kiev after the latter definitively rejected the price increase decreed by Russia. *Gazprom* (the Russian public gas corporation) began to lower the pressure in the gas pipeline that carries the fuel to Ukraine, reducing supplies by about 120 million cubic meters daily and affecting the rest of Europe, which receives 85% of the supply that passes through Ukraine. This boosts prices due to a possible impact on demand for such products, mainly as a result of the lower temperatures on the European continent at the beginning of the year. Beyond representing a precise and short-term element, this is coupled with a number of potential risk factors that loom in the future.

Increase in Supply and Demand in 2006



Source: BBVA Banco Provincial Economic Research Department estimates

The other element, perhaps of greater importance, is the increase in the geopolitical risks in the Middle East associated with the renewed conflict over Iran's nuclear intentions and the possible impact that such a development would have on the region's stability.

What to expect in 2006?...

The behavior of the market in 2006 will be halfway between the position of the optimists and the pessimists. This will be a year of solid growth of the world economy, with an average increase in demand that is 1.8% above 2005 levels, but with a similar or slightly higher improvement in terms of supply. In relation to oil supply, at current price levels, the reaction of the producer countries is not insensitive, since a stable price of US$60 dpb (dollars per barrel) in real terms incorporates a 40% increase in supply from non-OPEC countries over the next five years, by activating 85% of these nations' reserves and making such efforts viable from an economic standpoint. On the other hand, in a scenario of US$20 dpb, 70% of those reserves would not be developed, and in a situation in which prices fall to US$40 dpb, 55% of the reserves would not be. In this price cycle, the non-OPEC countries will once again play a central role in the growth of supply.

In fact, the OPEC's announcement that for the second quarter of 2006 it will be necessary to cut back production by at least a million barrels, since producers will be undergoing a year of building up inventories, has begun to reflect this greater strength on the supply side. Following up on the OPEC's behavior and reaction will be key, although it should be pointed out that the OPEC is caught in the dilemma that sustained levels of real prices at US$60 dpb could imply a loss in market share in the medium term, similar to what occurred with the expansion generated by the North Sea operations. Therefore, it is likely that such developments will favor a medium-term target price somewhere in the neighborhood of US$40 to US$45 dpb rather than the current levels

A more detailed review on the demand side indicates that despite having low elasticity, the improvement in efficiency is allowing the greater requirements associated with growth and improvement in living conditions in the developing countries to be absorbed without an explosive growth in demand, although a sustained increase can be projected.

These structural changes that would accompany a rather optimist vision would face geopolitical factors in the short term that are indeed intensifying at the beginning of the year and which will incorporate greater uncertainty. Of particular importance in this regard is the case of Iran, which is the greatest risk factor for 2006, together with a break in the possibility of a negotiated solution to the Israeli-Palestinian conflict.

Given our vision of a greater strength in market fundamentals than those contemplated by the pessimists and a more intensified geopolitical risk than that advanced by the optimists, the scenario for 2006 involves an intermediate outlook between the two approaches, which will be reflected in an average price of US$54.6 for the Brent and US$42 dbp for the Mexican mix, similar to the levels registered in 2005.

Giovanni Di Placido giovanni_diplacido@provincial.com

In 2006, We Will Have a Year of Similar Growth

2005 below expectations, mediocre growth

We estimate that, save for revisions to the series, in 2005 the Mexican economy grew at an annual rate of 3%. This growth is lower than that of 2004 (4.4%) and is below expectations for its performance at the beginning of the year (3.8%) At that time, the external and internal conditions forecast a traditional recovery cycle for the Mexican economy. The initial driving force was to come from external conditions, with growth in the United States surpassing its potential, which provided a good incentive for growth of Mexico's exports and a boost for investment that would allow consolidating the incipient recovery of domestic demand. This performance, as a whole, would lead to a recovery process that would provide feedback and would be sustained. The high growth figures of the fourth quarter of 2004, symptoms of formal job generation and the reactivation of bank credit guaranteed these expectations. In addition, there were very high foreign currency flows[1]: oil revenue over the budget, remittances at record high historical levels, a renewed boost to foreign investment on the financial markets not seen since the decade of the nineties and acceptable levels of foreign direct Investment. Nevertheless, despite these favorable conditions, growth was very low, so much so that it could be qualified as mediocre.

What happened? An unfortunate coincidence of circumstances which became worse due to structural deficiencies that Mexico is facing. The economy registered a slowdown in the first quarter and a moderate recovery in the second. GDP fell from an annual rate of 4.9% in the 4Q04 (fourth quarter of 2004) to less than half in the 2Q05, 2.0%, and to 3.3% in the 3Q05 (growth in seasonally-adjusted series), with growth for the fourth quarter estimated at around 3%. Although, in general, all the sectors reflected these trends, their performance varied (see chart 2).

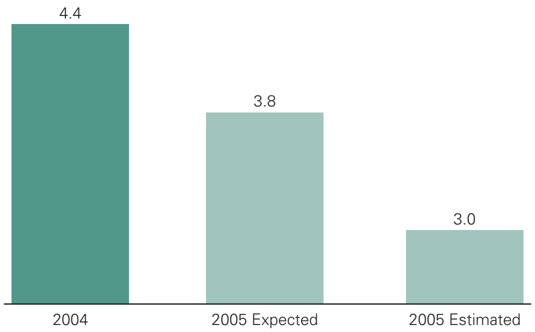
The source of the problem can be found in the performance of industry. Industrial production has maintained a descending trend during four consecutive quarters, with a significant loss of strength. In agriculture, which by nature is a volatile sector, the fluctuations were abnormally high. It was services that supported growth, since they expanded above the average for the economy and accounted for a high share in the value of production (almost 70% of GDP).

The problems facing industry are competitiveness, restructuring and adapting to changes in consumer preferences

In the industrial sector, the change in its growth rate has been associated mainly with manufacturing performance and has been concentrated in a few branches of activity. In the first half of the year, the activities that contributed the most to the unfavorable change were electronic articles, auto parts, vehicles, iron and steel, and glass. Particularly outstanding in the later trend toward recovery were vehicles, machinery and electrical equipment, pharmaceuticals,

1 It is estimated that these flows were approximately US$70 billion, equivalent to 9.1% of GDP: oil 2.1%, remittances 2.7% and FDI 4.3%.

GDP Mexico
Annual % change



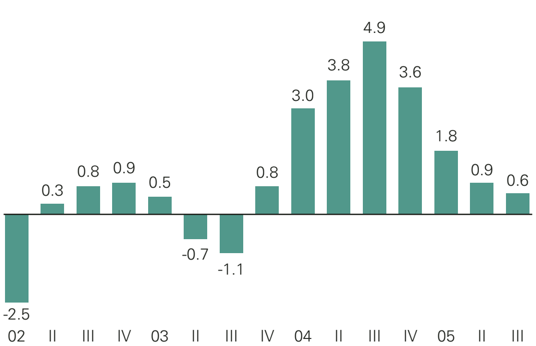
Source: BBVA Bancomer with INEGI data

GEAI
January - November, seasonally-adjusted series

	Annual av. % change		Contribution to growth	
	2004	2005	2004	2005
Total	**4.4**	**3.3**	**100.0**	**100.0**
Agriculture	3.4	2.6	3.9	3.9
Industry	3.8	1.4	26.1	12.6
Services	4.7	4.2	70.0	83.5

Source: BBVA Bancomer with INEGI data

Industrial GDP
Annual % change, seasonally-adjusted



Source: BBBVA Bancomer with INEGI data

printing and auto parts. A favorable example of what occurred in industry can be found in the automobile sector, the lead player in the slowdown during the first quarter of 2005 and also in its recovery in the second quarter. Its problem was linked to the restructuring now taking place in the sector, derived from the process of incorporation of new models for the foreign market in order to adapt to the change in consumer preferences. This sector represents 14% of production and 18% of manufacturing exports.

Generally speaking, it can be said that there was a combination of two essential factors coming together: on the one hand, Mexican industry is showing signs of erosion in its competitiveness and, on the other, U.S. industry underwent an important restructuring that did not favor it. Thus, during the year, Mexican exports were displaced from their main markets, such as the United States, where competition intensified with other suppliers from China and the rest of Asia.

The construction industry also began the year with slow growth as a result of increases in steel prices and some changes in housing construction standards. In this activity, there is also a recent trend toward improvement, boosted by credit growth, stability and the closing of public works in the last year of the current administration.

Nevertheless, domestic demand has kept up its pace.

Domestic demand maintains a good expansion rate according to the latest available figures: 5.7% in the third quarter, thanks to the strength of gross fixed investment and private consumption. The performance in industry was reflected in the moderation of investment, although it remained as the most dynamic within aggregate demand, well over the average for the economy.

In investment, the higher growth rates are seen in machinery and equipment, with 11.6% annual change. These trends can be considered an indicator of confidence in the economy and of a favorable outlook for manufacturing production and exports. This could be interpreted as a gradual trend toward "normalization" in the export markets, and would not necessarily be completed this year. The construction data do not reflect the boost to housing, so that an improvement is expected in the coming months.

Consumption is also showing a favorable performance with rates higher than the average for the economy. The three components of consumption grew at relatively high rates with durable goods as the most dynamic (6.3% in the first nine months of the year), followed by non-durable goods (5.9%) and services with 4.6%. In general, consumption increased due to the improvement in total wages (employment and wages) and credit growth, and to economic stability, which encourages the purchase of durable goods.

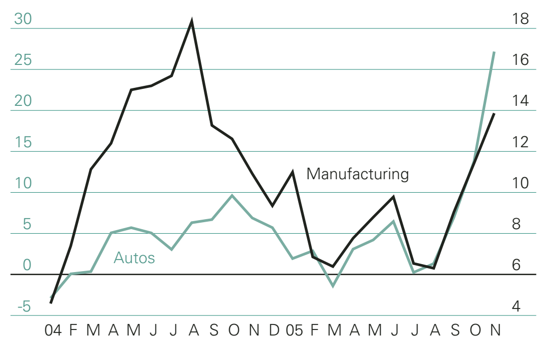
In aggregate demand, it should be underscored that the most dynamic performance is in the imported component. In consumption of domestic and imported goods, that of domestic goods is more stable, although with growth of barely 4% on average in this year.

Manufacturing Production
Annual % change

	2004	2005			Contrib. %
		1 sem.	2 sem*	Jan-Oct	
Total	**3.8**	**1.4**	**1.1**	**1.3**	**100.0**
Highest contributions					
Non-electrical mach. & equip.	6.3	14.6	3.0	10.0	16.6
Beer	4.5	9.2	8.7	9.0	16.4
Auto parts	9.9	2.6	3.7	3.0	15.2
Non-met. min.	2.8	4.8	4.7	4.7	14.7
Soft drinks	1.3	7.3	2.6	5.4	13.8
Greatest losses					
Synth. resins & chem. fibers	3.7	-2.1	-10.0	-5.2	-5.4
Soft fibers	-0.8	-6.7	-5.6	-6.3	-6.0
Pharmaceuticals	-2.3	-4.9	0.6	-2.7	-6.0
Apparel	0.6	-1.1	-7.0	-3.5	-7.4
Electronic eq.	9.0	-11.9	-22.0	-15.9	-58.1

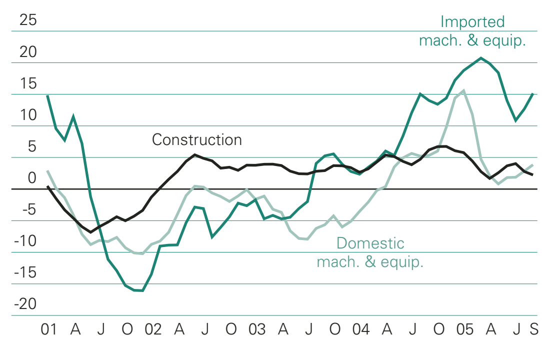
* July - October
Source: BBVA Bancomer with INEGI data

Exports
Annual % change, 3-month moving average



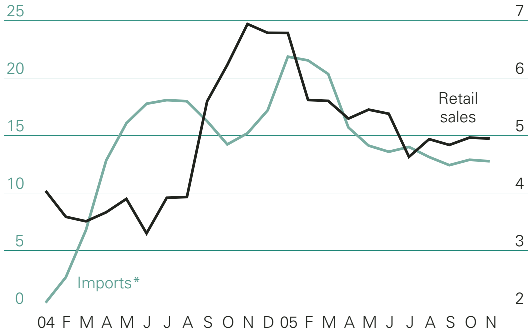
Source: BBVA Bancomer with Banco de Mexico data

Gross Fixed Investment
Annual % change



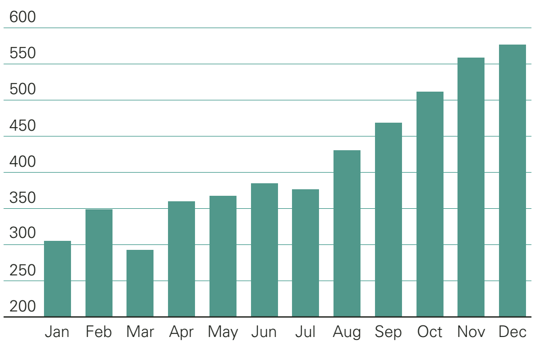
Source: BBVA Bancomer with INEGI data

Imports and Sales
Annual % change, season.-adjusted, 3-month mov. av.



* Imports of consumer goods, excludes gasoline
Source: BBVA Bancomer with Banco de Mexico and INEGI data

New Jobs
IMSS, thousands, 12 months



Source: BBVA Bancomer with STPS data

Mexico: Macroeconomic Chart
Annual % change, seasonally-adjusted

	2004	2005e	2006e
GDP	**4.4**	**3.0**	**3.2**
Total demand	**5.9**	**4.4**	**4.5**
Domestic	5.3	5.2	4.5
Consumption	4.7	4.7	4.1
Private	5.5	5.3	4.3
Public	-1.2	0.1	1.9
Investment	7.5	7.1	6.0
Private	7.5	6.8	5.6
Public	3.5	10.4	7.7
Foreign	11.5	5.8	6.7
Goods & services imports	**10.2**	**8.1**	**7.5**

e estimated
Source: BBVA Bancomer with INEGI data

However, consumption of imported goods has reached 22%. Although the share of purchases abroad is relatively low in the total (7.7%), its strength reduces the boost to domestic production of goods. In investment in machinery and equipment, the situation is similar: 3.3% vs. 16.1% for domestic and imported machinery and equipment, respectively.

Outlook: heading toward similar growth, the first quarter will be more dynamic.

The macro outlook for 2006 will be framed within the force of external demand due to U.S. GDP growth of around 3%, but with a recovery in industry, which should lead to a favorable demand for exports. Also, capital flows to the emerging markets will be maintained, both due to the oil market and remittances (See chart "Capital flows to Latin America in 2006"). Domestically, there will be driving factors: a trend toward recovery by the close of 2006, employment expansion, growth of bank credit at high rates, the allocation to spending this year of funds pending from the constitutional controversy and the oil revenue surplus of the immediate previous year, which could be repeated in the same magnitude for a second consecutive year and greater public investment.

Within this context, the boost provided by growth will be mainly domestic. Our scenario for 2006 considers annual GDP growth of 3.2%, with a better performance in the first half of the year. We expect a moderate slowdown for private consumption and private investment, although with good growth levels. In production, the forecasts point to a recovery in industry, particularly in manufacturing; that is, a less negative contribution of the external sector, with performance in services similar to that of 2005. In brief, moderate growth with a good start for the year in the industrial sector.

Perhaps some of the main risks for this forecast can be found externally, in the performance of the U.S. economy, given high oil prices and the related risk for the real estate market in that country (See section on International Environment). On the domestic side, one would have to be attentive to the possible uncertainty associated with the new circumstances and characteristics of the political process, which could cause lower growth in investment and consumption decisions.

Inflation: Facing the Challenge of Expectations

At the close of 2005, inflation declined to its lowest level in more than 35 years, and even clocked in at 2.91% in November, below the target set by the Banco de México. A decade after the last macroeconomic crisis, it can be said that the country's monetary policy achieved its long-term target of 3% inflation, which the central bank had been seeking since the 1990s and explicitly so since 2000. Now the challenge is to consolidate these levels over time, which has allowed making progress in the process of nominal convergence with U.S. inflation rates that began following the trade integration resulting from the North American Free Trade Agreement (NAFTA). In achieving these results, different structural transformations of the Mexican economy had an impact, such as the flexibilization of the exchange rate, the trade opening, the deregulation of economic activity, and fiscal discipline. Some important advances in monetary policy, such as the autonomy of the central bank and setting explicit inflation targets, also contributed.

At the same time, although these elements have represented long-term support in the downward trend in inflation, the favorable results in 2005, in which inflation decreased by almost two percentage points compared to the previous year (3.3% vs. 5.4%, at the close of both periods), can largely be attributed to cyclical or temporary conditions. For the first time in eight years, government managed and regulated prices (electricity, gas, gasoline, mass transit, among others) have been brought into line with the inflation target. Price increases on such goods and services declined from 7.4% to 4.8% between 2004 and 2005 (December), in the process contributing 0.5 percentage points to the reduction in inflation. The downward cycle in agricultural prices played an even more important role, with the agricultural subindex declining from 10.1% to -2%, contributing one percentage point, half of the drop in inflation. Together, agricultural prices and public rates and prices accounted for almost 75% of the reduction in inflation in 2005.

The drop in core inflation was supported by the strength of the peso (appreciation of 4.7% in the year, at the end of the period) and the downturn in the economy, in addition to a favorable impact in food prices due to a downward trend in the cost of inputs for their production. Core inflation in the period under consideration fell from 3.8% to 3.1%.

Therefore, although in 2005 the best results were achieved in the road toward price stability, it should be noted that the success is still partial and is not fully guaranteed. It still remains to be seen whether inflation will be able to remain at around 3% for an extended period of time or if it will continue to be subject to cyclical or temporary conditions.

Thus, the question that arises in relation to inflation is whether in 2006 the same conditions that allowed the growth in prices to decline in 2005 will remain in effect or in other terms, if the inflation levels achieved can be sustained or even improved, up to what point and for how long, and on what factors such a situation would depend. This is what will be analyzed in this section.

Upward pressure at the beginning of the year, seasonal upsurge, and basis of comparison

The seasonal adjustments in prices at the beginning of the year, characteristic among the components of core inflation and some

Registered Inflation vs. Target

Annual % change, year-end

	Headline	Core	Official target	Range[1]	Fulf.[2]
1995	52.0	52.8	19.0		NO
1996	27.7	25.6	20.5		NO
1997	15.7	15.9	15.0		NO
1998	18.6	17.7	12.0		NO
1999	12.3	14.2	13.0		SÍ
2000	9.0	7.5	10.0		SÍ
2001	4.4	5.1	6.5		SÍ
2002	5.7	3.8	4.5		NO
2003	4.0	3.7	3.0	+/- 1	SÍ
2004	5.2	3.8	3.0	+/- 1	NO
2005	3.3	3.1	3.0	+/- 1	SÍ

1 Variability range, percentage points
2 Fulfilled
Source: BBVA Bancomer with Banco de México data

Contribution to the Decline in Inflation, 2005

	Weig.[1]	2004	2005	Diff.[2]	Cont.[3]
Total	**100.0**	**5.2**	**3.3**	**-1.9**	**100.0**
Core	**69.6**	**3.8**	**3.1**	**-0.5**	**25.1**
Merchandise	37.0	3.9	2.8	-0.4	20.8
Food	14.7	7.0	3.7	-0.5	26.5
Services	32.5	3.7	3.5	-0.1	4.5
Housing	17.9	3.7	2.6	-0.2	11.0
Non-core	**30.4**	**8.2**	**3.8**	**-1.4**	**72.7**
Agriculture	8.1	10.1	-0.2	-0.8	44.7
Fruits & vegetables	3.3	6.4	-1.9	-0.3	14.6
Meat & eggs	4.8	12.7	0.9	-0.6	30.4
Mged. & regulated	17.2	7.5	4.8	-0.5	25.3
Managed	7.8	10.0	7.1	-0.2	12.1
Regulated	9.4	5.1	2.4	-0.3	13.7
Education	5.2	7.5	6.6	0.0	2.4

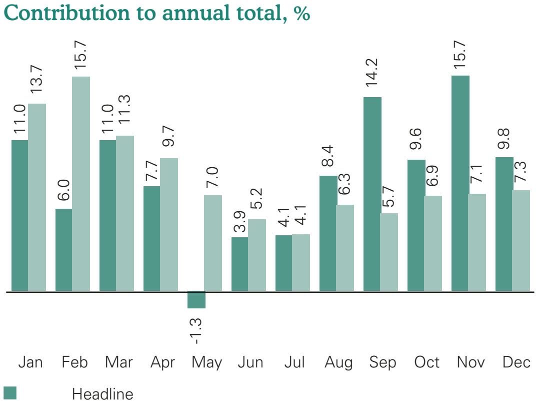
1 Weight, %
2 Difference, percentage points
3 Contribution, %
Source: BBVA Bancomer with Banco de México data

2005: Breaking the Seasonal Factor
% of monthly inflation

	Registered	Seasonal factors 3%	Seasonal factors 4%
January	**0.00**	**0.39**	**0.52**
February	0.33	0.15	0.20
March	0.45	0.31	0.41
April	0.36	0.21	0.28
May	-0.25	0.00	0.00
June	**-0.10**	**0.16**	**0.21**
July	**0.39**	**0.07**	**0.10**
August	0.12	0.28	0.37
September	0.40	0.43	0.57
October	0.25	0.30	0.39
November	0.72	0.43	0.57
December	0.61	0.24	0.31

Source: BBVA Bancomer with Banco de México data

Seasonal Pattern of Inflation*
Contribution to annual total, %



* Based on 2000 - 2005 figures
Source: BBVA Bancomer with Banco de México data

items in non-core inflation, such as energy and education, as well as the effects of the basis of comparison (January, May and June 2005, with negative or zero variations in the NCPI) will lead to an arithmetic upsurge in the annual inflation rate (headline and core) during the first few months of 2006, until it reaches levels of between 3.7% and 3.8% before the end of the first six months of 2006.

For example, according to the trends observed in the past few years (2000-2005) close to 30% of annual inflation is accumulated in the first quarter of the year. For core inflation, this trend is more pronounced (because it is subject to less volatility) and in the first quarter, 40% of the year's inflation of the year is accumulated, with 60% corresponding to the first six months.

Public prices will continue to be aligned...

In non-core inflation, public prices will be aligned for the second consecutive year with the inflation target. In terms of energy, as a result of a presidential decree issued in September 2005 and ratified in the Revenue Law, during 2006, electricity rates for household consumption will not increase more than 4% in the course of the year. The same increase is authorized for LP gas and a maximum price is set for natural gas, with a 28% subsidy for gas earmarked for domestic consumption. In the case of gasoline, a policy is anticipated that is similar to what was applied in 2005, based on fixed monthly increases until prices reach a maximum growth rate of 4%. In addition, the projection of a gradual decline in oil prices (average of US$42 dollars per barrel vs. US$43 in 2005) strengthens the expectation of moderate increases in the cost of this fuel. Finally, in the case of regulated prices, in which public transportation has the greatest weight, price growth in line with the inflation target is expected, in accordance with the Banco de México.[1]

There will be no surprises in the education sub-index. Its growth, although greater than that of the NCPI, has been gradually on the decline and it will maintain this trend in 2006, supported by the good results of 2005. In any event, its contribution to headline inflation will be limited, average growth of 6.5% annually would contribute 0.3 points to inflation for the year.

... although the risks could come from agricultural prices and core inflation

In agricultural prices, the outlook is less optimistic. Following the trend observed in the past few years, marked by growing volatility and alternating between high and low growth rates, a cycle of small harvests or high prices can be anticipated (see box). International beef and pork prices are posting a moderate upward trend in the futures market for 2006. In the case of chicken, the Asian poultry flu could have a negative impact on prices. The risk is that what occurred in 2004 could be repeated, namely, that an increase in domestic prices for fruits and vegetables could be combined with a rise in also high international meat prices. In any event, agricultural prices, mainly for fruits and vegetables, will be the main factor in inflation volatility during 2006.

For core inflation, despite its convergence during 2005, its two main components, goods and services, began to present a diverging trend toward the final part of the year. Price increases for goods declined in response to the strength of the peso and the reduced pressure on

1 Report on July-September 2005 inflation.

prices of raw materials used in the production of food. Meanwhile, prices for services rose due to the recovery of domestic demand.

Although the growth of the economy in 2005, at an estimated 3%, was lower than its potential growth, and the expectation for 2006 is that it will maintain a similar rate, private consumer spending is increasing more rapidly, supported by the expansion of credit, the strength of the peso, as well as job creation and wage increases. Demand, the exchange rate, and wages contributed to a large extent to the variations in core inflation in the past few years.[2] Thus, the main risk factors for core inflation would be the expansion in consumption, wage hikes above the target set by the Banco de México (4.5% in December 2005) in response to the effect on inflation expectations due to the seasonal upsurge at the beginning of the year, as well as the end of the cycle of the appreciation of the peso.

Convergence of expectations, an important challenge

In Mexico, inflation expectations, even medium and long-term projections, are highly sensitive to the volatile components. This reflects a weak rationality[3], which points to the need to further increase the credibility of the central bank. Given that wage negotiations and annual adjustments in prices of goods and services are based on such expectations, in the final analysis, without a convergence of long-term inflationary projections, the minimum inflation level could be permanently above the target set by the Banco de México. A key factor to anchor such expectations is the commitment on the part of the central bank to meet the inflation target on a permanent basis. This can only be achieved with core inflation anchored at around 3% over a prolonged period of time, which allows the indicator to absorb temporary supply pressures.

Inflation scenarios

In our base scenario, core inflation will remain relatively stable in a range of 3.1% to 3.4% over the year, with pressures of a seasonal nature in the first six months, and a level of 3.2% at the end of 2006. In this scenario, demand pressures will remain limited by relatively low economic growth, while exchange rate volatility will be moderate. The risks of a rise in inflation would be associated with a higher than projected expansion of consumption (4.5% in annual terms), the transmission—and persistence—of the pressures from agricultural prices on food, whose relative weight in core inflation is 20%, as well as downward rigidity in wage negotiations and some degree of transmission of the exchange rate to prices (see box on the exchange rate). In this context, core inflation could conclude the year at levels above 3.5%. Finally, we are assigning a lower probability to a scenario based on a strong economic downturn, which would begin in the external sector (recession in the United States), in which demand pressures would be reversed and core inflation would close the year below 3%. For headline inflation, the previously described scenarios would point toward levels of 3.6%, higher than 4%, and close to 3% respectively. In synthesis, we expect a contained inflation in comparison with the previous year.

2 This series of variables, plus seasonal factors, help explain up to 96% of the evolution of inflation in the 2000-2005 period:

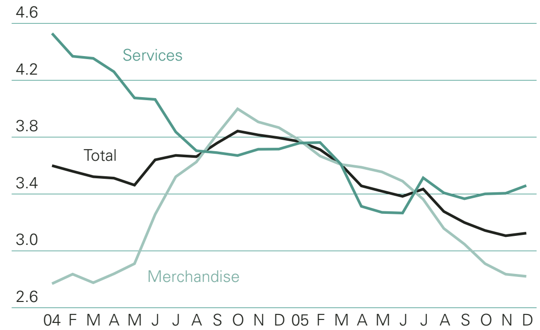
$$Core_t = \underset{(0.00)}{0.22 \cdot Core_{t-12}} + \underset{(0.00)}{0.07 \cdot OutputGap_{t-4}} + \underset{(0.00)}{0.16 \cdot exchange_{t-2}} + \underset{(0.00)}{0.15 \cdot nominalwage_{t-3}} + \underset{(0.03)}{0.02 \cdot retailsales_{t-12}}$$

$R^2 = 0.96$; DW = 1.63

In which the values in parenthesis represent results of statistic-t

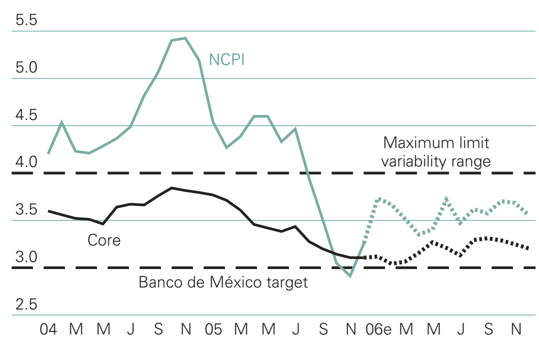
3 Review Situación México, First Quarter 2005

Core Inflation
Annual % change



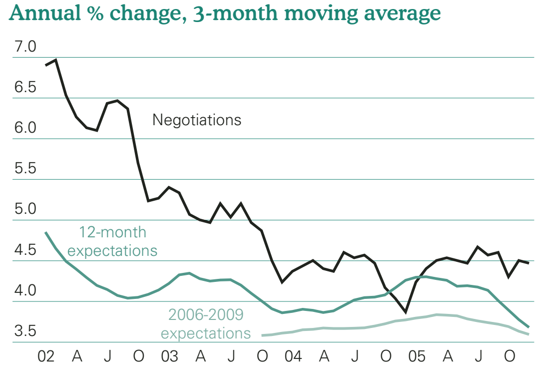
Source: BBVA Bancomer with Banco de México data

Inflation
Annual % change



Source: BBVA Bancomer with Banco de México data

Wage Negotiations and Inflation Expectations
Annual % change, 3-month moving average



Source: BBVA Bancomer with Banco de México data

Inflation: Dancing to the Rhythm of the "Salsa"?

To the extent that advances have been made in reducing inflation, its volatile components have taken on greater relative importance, especially in countries like Mexico where the weight of such items in the NCPI is comparatively greater compared to other nations. For example, while in the United States, non-processed foods represent 3.3% of the NCPI, in Mexico the corresponding figure is 8%. The reasons are due to income levels and consumer habits and preferences.

What is the outlook for the volatile components of inflation in 2006? In terms of energy, the signs indicate that pressures will remain contained as long as the transfer of oil and gas prices to other products continues to be cushioned. At the same time, a high degree of uncertainty prevails in the agricultural sector in relation to the performance of prices after they registered a declining trend in 2005. Even though their weight in the NCPI is relatively low, given their high fluctuation they could play a key role in inflation volatility during the year.

In recent years, the contribution of the fruits and vegetables subindex to headline inflation has been rising and the prices of these products have shown sharp rises and falls. Some characteristics of the subindex help to explain this behavior. First of all, it is highly concentrated, since the 15 most important products (of 35) represent 75% of the total.

Main Agricultural Products in the NCPI

	Weight in the NCPI (pp)	Accummulated % share
1. Tomato	0.50	15.03
2. Beans	0.32	24.61
3. Potato	0.23	31.72
4. Apple	0.21	38.03
5. Banana	0.18	43.42
6. Orange	0.14	47.73
7. Onion	0.14	51.86
8. Avocado	0.13	55.82
9. Other vegetables	0.12	59.35
10. Green tomato	0.11	62.65
11. Mango	0.09	65.40
12. Papaya	0.09	68.07
13. Zucchini	0.08	70.45
14. Key lime	0.08	72.82
15. Serrano chili	0.07	74.86
16. Others	0.83	25.14
Total	**3.30**	**100.00**

Source: BBVA Bancomer with Banco de México data

Second, the variation in prices—and their volatility—is more pronounced in the case of vegetables than in fruits. Indeed, in the past 15 years (1991 to 2005), only on two occasions has the pattern of high and low vegetable prices been interrupted between one year and the next. Meanwhile, in the case of fruits, there has been a more uniform development, especially in the past decade. Finally, vegetables have a greater relative weight than fruits, 60% vs. 40% respectively.

Thus the trend in agricultural prices can be determined, generally speaking, on the basis of a reduced series of products, particularly vegetables. Seven such products are the most important, namely tomatoes, green tomatoes, onions, Serrano chili peppers, beans, potatoes and zucchini. Together, these products represent 70% of the vegetable subgroup total.

What factors determine the agricultural cycle?

Once the products that could represent the trend in agricultural prices are identified, it is interesting to explore the main elements that affect such prices, or put more simply, to determine if it is possible to characterize the agricultural cycle. Among the factors that affect agricultural prices are the surface area under cultivation, the production or yield per hectare planted, international prices, the degree of availability of water and, in general, climatic conditions, as well as meteorological phenomena.

Based on this information, an initial analysis of the agricultural cycle was undertaken through a panel model that allows data to be analyzed not only over time but also permits different observations to be considered for each point in time, that is, in the form of cross sections. The model includes the four most representative vegetables—tomatoes, potatoes, zucchini, and onions—with annual data for the 1981-2003 period, in variation rates and using the prices of agricultural products, prices in the United States[1], and the relationship between production volume and cultivated land area as explanatory variables, since in integrating such data a measurement of land productivity is obtained that at the same time considers the range of divergences associated with climatic contingencies. The equation was codified as:

1 For the agricultural products under consideration, Mexican producers do not have the capacity to affect prices in the U.S. market. At the same time, changes in supply or demand in the United States affect the decisions of Mexican producers. Therefore, there should be no problems in formulating estimates due to the existence of causality considerations.

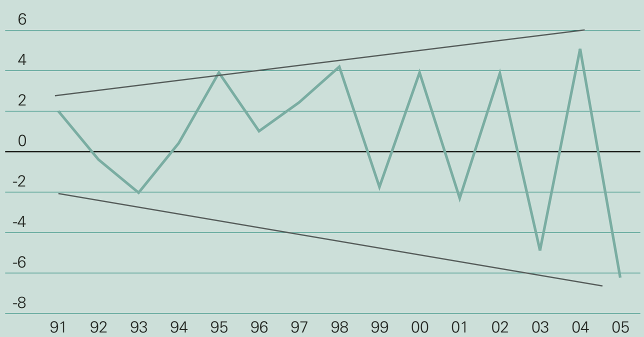
$$Prices_t = 0.21 * Prices_{t-1} + 0.51 * USPrices_t - 0.59 \left(\frac{Production}{Surface}\right)_t$$

$R^2 = 0.31$; $DW = 2.2$

All the parameters were statistically significant (95% reliable) and their signs were consistent with what was expected, namely, high prices alternating with low prices, prices varying inversely with land productivity (yield per hectare) and directly with prices in the United States. However, it is necessary to carry out new estimates that allow for a better specification of the "dummy" variable included in the model, in order to separate the effects of production and surface area on prices independently.

Contribution of Agricultural Products to Inflation

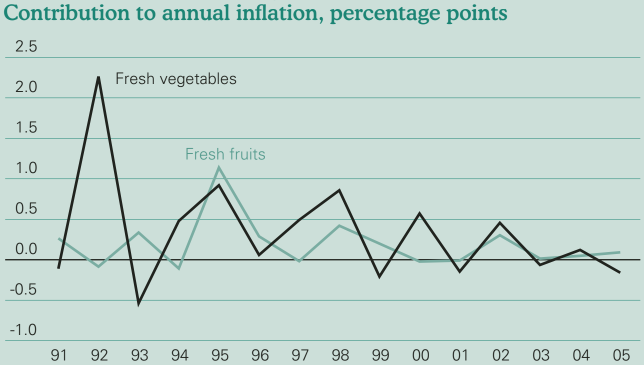
%



Source: BBVA Bancomer with Banco de México data

Prices: Fruits and Vegetables

Contribution to annual inflation, percentage points



Source: BBVA Bancomer with Banco de México data

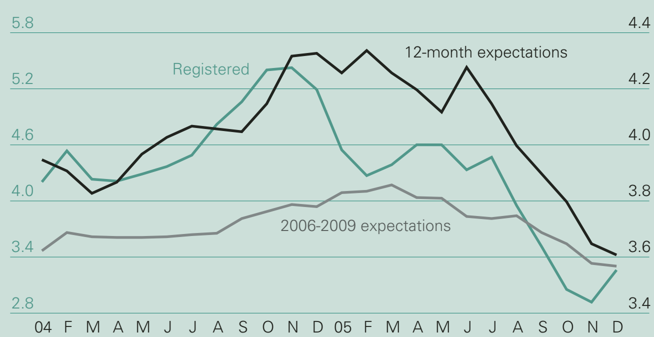
Due to their nature, prices of agricultural products can experience significant variations even in different regions. For example, a year of drought in a region known for tomato production can, at the same time, be a period marked by abundant rains in areas where chili is grown. Furthermore, the fall in prices associated with a year of good harvests can be offset, at least partially, by high prices in the foreign market. These difficulties become clear with the model's low capacity for prediction. In the final analysis, it means that although it is possible to identify the main elements that determine agricultural prices, anticipating their performance is much more complicated.

What can we expect for 2006?

The volatility of agricultural prices, and in general, of inflation, is associated with a reduced series of products, among the most important of which are tomato, chili pepper, and onion, the ingredients of a typical Mexican hot sauce. According to the trends of the past decade, their volatility will not only not diminish in 2006, but in fact will be an important element in the general determination of prices, or at least, of the non-core component. To cushion the impact of this volatility, "anchoring" expectations—centered more on core inflation—and the credibility of the country's monetary policy are key factors. Given that the economic agents base their decisions on savings, investment, salary negotiation, etc., on what they expect in terms of future inflation, to the extent that these expectations incorporate long-term inflation trends more and not just their short-term performance, the economy will be able to move toward price stability.

Inflation: Registered and Expectations

%



Source: BBVA Bancomer with Banco de México data

In this context, one of the challenges of the central bank lies in the need to consolidate its credibility to influence the more stable formation of expectations more clearly, anchored in the inflation target. If this does not occur, inflation will always be dancing to the rhythm of the "salsa", as occurred in 2004.

Eduardo Torres e.torres@bbva.bancomer.com

Declines in Bank Funding Rates to Continue in 2006

Mexico: Calendar of Important Monetary Announcements in 2006

	Policy announcements[1]	Inflation report	Inflation report[2] 1st half	Prev. mth.
Jan.	27	31	24	9
Feb.	24		23	8
March	24		23	8
April	21	26	24	6
May	26		24	9
June	23		22	8
July	28	31	24	6
Aug.	25		24	8
Sept.	22		22	7
Oct.	27	31	24	6
Nov.	24		23	8
Dec.	8		21	7

1 Monetary policy announcements and press releases. Released to the market at 9:00 a.m. Mexico City time
2 Released to the market at 2.30 p.m. Mexico City time
Note: The 2006 Monetary Program was announced on Jan. 31, 2006
Source: Banco de México

United States: Calendar of Important Monetary Announcements in 2006

	FOMC meeting	Report to Congress
January	31	
February		X
March	28	
April		
May	10	
June	28 / 29	
July		X
August	8	
September	20	
October	24	
November		
December	12	

Source: Federal Reserve

The reduction of inflation to levels of 3%, the strength of the peso in response to high international liquidity, and the outlook for economic growth close to its potential framed the beginning of the downward cycle in bank funding rates. Thus, as of August 25, 2005, such rates dropped 150 points to close the year at 8.25%. At the same time, the previously mentioned factors also came together to define a downward trend in long-term bond rates. In the final quarter of the year, the yield on the 10-year bond (M10) fell from 10.51% to 8.2%.

For 2006, it is likely that the behavior of the financial markets will continue to be influenced by the outlook for contained inflation, growth of economic activity close to its potential, and high international liquidity, which would support the strength of the peso. This would result in a continuation of the declining trend in Mexican interest rates throughout 2006. However, at present, the main doubts involve determining the levels to which bank funding rates could drop, the speed in their adjustment during the year, and the response of the curve throughout 2006, which is a year that will be marked by greater political uncertainty. In the following section we will describe our vision of the financial markets for 2006 as well as the probable monetary response on the part of the central bank.

The bank funding rate will tend toward a "neutral" rate in 2006

The estimated performance of inflation, economic growth, and international liquidity for 2006 make it possible for Banco de México to allow funding rates to diminish toward their theoretical level of monetary neutrality. In terms of the domestic factors, our estimates indicate that price growth in 2006 will be contained within the tolerance range established by the central bank so that the average increase in headline inflation could be an annual 3.6% for the year, with core inflation stabilizing at an average of 3.2%. In addition, economic growth close to the potential (BBVA Bancomer estimates a real 3.2% increase) limits demand pressures on prices and reduces the possibility that potential supply pressures (via agricultural or energy prices) will negatively affect price formation and wages in the economy.

In this framework, the internal conditions are being established so that the Banco de México can continue to move away from its restrictive monetary policy and allow real short-term interest rates to reflect the real expansion of the economy gradually. At the present time, real interest rates are at an annual 4.5% for the year (vs. an average 2.5% in 2003 when inflation finished the year within the central bank target), which implies a spread of more than 3 pp with regard to the potential expansion of the economy and, therefore, a still restrictive approach to monetary policy. In this context, the "neutral" interest rate consistent with the demand for liquidity resulting from the discounted increase in prices and economic activity for 2006, could reach around 7% in nominal terms (see box for further details regarding calculation).

Although we project upturns for both inflation and, to a lesser extent, economic activity during the first half of the year, we feel that these movements will be temporary and will not have an impact on medium- and long-term inflation expectations. For this reason, we believe that the trend in the country's monetary policy will not diverge from its annual downward trend toward "neutral" levels.

In terms of international factors, high international liquidity could continue during 2006, which will tend to be reflected in reduced risk premiums for emerging economies and, therefore, in a strengthened exchange-rate parity. Among the most important reasons behind the greater international liquidity in 2006 are: (1) the surpluses of financial resources of the central banks in Asian countries, given their high trade surplus with the rest of the world; (2) the additional revenue in oil-producing countries; and (3) the possibility that U.S. monetary authorities will not impose greater increases in their benchmark rates when federal fund rates reach 4.75%. In fact, the reduced premium for liquidity can be observed in the yield curve of U.S. interest rates, which was inverted for the first time in five years at the beginning of 2006 in the two- and 10-year terms.

The outlook for high international liquidity tends to increase the availability of resources for the economy, strengthen the peso in relation to the dollar, and allow, therefore, lower domestic rates. In response, the international environment —together with the domestic conditions of inflation and growth— favors the adoption of a monetary policy of lower interest rates in 2006. In addition, the continuation of international flows will tend to compensate potential increases in domestic sources of risk such as the country's electoral process.

Considering the previously mentioned internal and external factors, bank funding rates could diminish by at least 50 basis points in the first half of the year (closing at 7.5%). This would represent a pause in the downward trend in funding rates in order not to incorporate greater volatility in the financial markets prior to the June 2006 presidential elections. Subsequently, and if the electoral process is orderly, funding rates could continue their decline to levels of 7% at the close of the year.

The main risks in 2006 are defined and limited

At present, the most probable trend in monetary policy points to funding rates converging more rapidly with the "neutral" interest rate (7% at the close of the first half of the year). This scenario would materialize in the event of: first, an increase in international flows, which would lead to an even greater appreciation of the peso, given reduced interest rate spreads between Mexico and the United States; second, less internal political risk; and third, lower economic growth.

The contrary scenario in relation to a prompt pause in the downward cycle in funding rates is not very probable at the moment and could only materialize in the event of a considerable weakening of the peso versus the dollar (either due to greater domestic political risk and/or

Monetary Conditions Index
Average base 2002-2003

Note: Rises in the index indicate relative strengthening of domestic monetary conditions
Source: BBVA Bancomer with Banco de México data

Financial Forecasts
%, end of period

	Bank funding	M10
1st quarter 2006	8.00	8.40
2nd quarter 2006	7.75	8.30
3rd quarter 2006	7.50	8.30
4th quarter 2006	7.00	7.90
2005 average	**9.30**	**9.40**
2006 average	**7.60**	**8.10**

M10 10-year bond
Source: BBVA Bancomer estimates

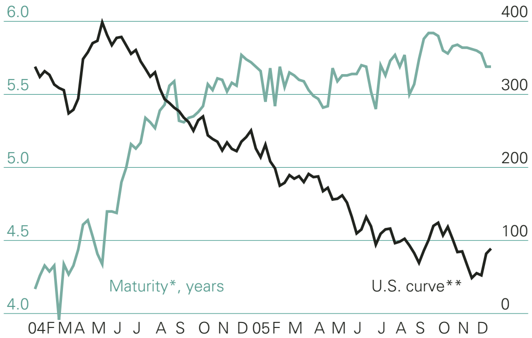
resulting from an interruption in the international flows) or an upturn in inflation (registered and projected) either attributable to greater economic activity, high wage hikes, or increases in international prices due to supply shocks (for example, oil) as well as the transfer of such eventualities to expectations.

The yield curve will continue to be flat in 2006

During 2005, interest rates on long-term bonds were determined by the reduction of inflationary expectations in the country and the low aversion to risk on the part of international investors, which favored the abundance of financial resources available for emerging markets. This abundance was spurred by a less attractive financial return in developed economies, which allowed foreign-investor bond holdings in Mexico to increase from 16% of the total amount in circulation to 20% by the middle of the year (vs. 3.8% at the beginning of 2004). As a result, the average term of foreign investor portfolios rose to a maximum of 5.9 years in 2005 (vs. 4.3 years on May 13, 2004, when the slope of the curve began to diminish in the United States, a liquidity proxy).

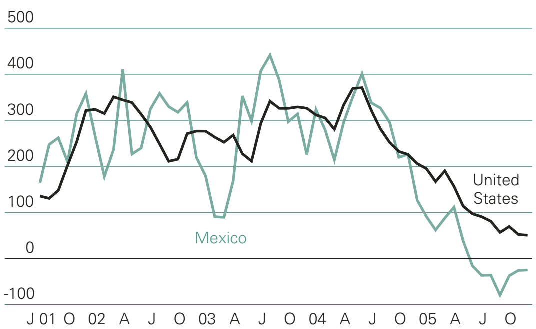
For the current year, basically the same factors that determined the long-term rates in the country will continue to prevail (contained inflation and high financial flows). However, a slight increase in the risk premium is likely in the second half of the year in view of the federal elections. Based on such considerations, we estimate that the yield paid on the 10-year bond (M10) will reach around 7.9% at the end of the year. The most probable trend is that, in the context of an international scenario marked by greater liquidity, the potential increase in political risk will be mitigated during the year and we will see even lower yields on the M10 (up to 7.5% at the close of 2006).

Maturity and International Liquidity



* Foreign bond holders, average maturity
** 10 year bond - Fed, basis points
Source: BBVA Bancomer with Banco de México & Federal Reserve data

Curve Slope
10-year Bond - O/N, basis points



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

Long-term Equilibrium Interest Rate in Mexico

In August 2005, Banco de México allowed a relaxation in domestic monetary conditions, with which the downward cycle in interest rates began. This monetary approach can be attributed to the recent drop in domestic inflation accompanied by a greater slowdown in economic activity. This has led to speculation regarding the level that short-term interest rates could reach and how long this process could take. In this sense, determining a real long-term equilibrium rate for Mexico—together with inflation and projected growth—provides us with evidence as to how distant rates are with regard to the theoretical equilibrium level and, therefore, the possible performance of monetary policy in 2006.

Natural interest rate as a monetary policy indicator: definition and considerations

The real long-term equilibrium interest rate—or natural rate—can be interpreted and calculated in different ways. For example, the natural rate can be understood as the rate that establishes liquidity conditions consistent with a predetermined level of inflation (that authorities wish to sustain) and economic growth close to the potential. In this sense, the calculation of the long-term equilibrium rate takes on importance as a reference point for the "neutral" rate—which does not incorporate distortions in price determination in the economy— and toward which monetary policy will tend to be directed.

At the same time, the "natural" rate can also be understood as the rate that reflects marginal productivity attributable to capital. In practice, and in accordance with assumptions on the production structure and flexibility in the markets, potential growth tends to be used as an approximation of real profitability in the economy. Based on this specification, the ideal conditions of the economy—in the absence of market rigidities—could be characterized by the real "natural" rate plus the inflation target.

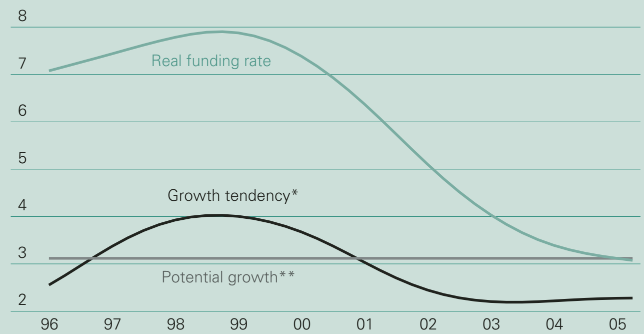
Nevertheless, the real long-term equilibrium interest rate is not observable and involves difficulties in terms of its calculation that have to be considered in order to interpret it. First of all, this rate can fluctuate due to nominal rigidities (for example, contractual wages and degree of market competition). Secondly, the natural interest rate in the economy varies due to real factors such as the savings rate, the marginal productivity of capital (even the level of capital assets), and the exogenous variations in government spending that could alter economic growth. In this sense, the natural rate is sensitive to structural changes in the economy (for example, reforms) or the adoption of a new fiscal policy. Thirdly, uncertainty exists in relation to the true level of potential growth.

Currently, what is the natural interest rate?

One way of estimating the level of real equilibrium interest rates in Mexico is by calculating the potential growth of the economy, so that when adding the Banco de México inflation target (3%), the result would be the nominal short-term "neutral" interest rate for 2006. Thus, considering the lineal trend in quarterly GDP since 1994, the estimated potential growth is 3.2%. If the inflation target is 3% (+ / - 1 pp), the nominal rate should tend to be in a range between 5.2% and 7.2%. These levels are below the current bank funding rate of 8.25%.

Real Rate and Potential Growth

Annual %, average



* According to the Hodrick-Prescott filter ** Lineal trend
Source: Own calculations with Bloomberg data

Nevertheless, we should be cautious with these "neutral" interest rate levels, since there is the risk that the same nominal changes that have allowed for a reduction in inflation (for example, volatile prices) could be reversed in 2006. In view of this uncertainty, if we add a risk premium of between 0.8% and 1.3% (calculated as the difference between the long-term trend of the real rate and tendential growth in accordance with the Hodrick-Prescott filter) the resulting nominal interest rate for 2006 could be up to 7.5% (even below the current 8.25%).

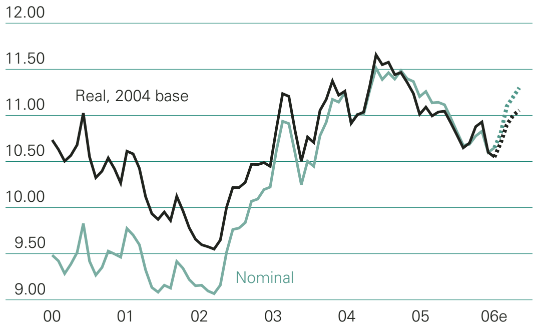
Although different calculations of the equilibrium rate indicate a trend toward monetary relaxation in 2006, the presence of risks due to nominal pressures suggests (independently of other considerations, such as the strength of the peso) that the convergence will be gradual until the behavior of volatile prices in the economy (for example, agricultural products) can be observed.

Octavio Gutiérrez o.gutierrez3@bbva.bancomer.com

1 Based on D'Amato (2005) "*The role of the natural rate of interest in monetary policy*". BIS Working Papers No. 171.

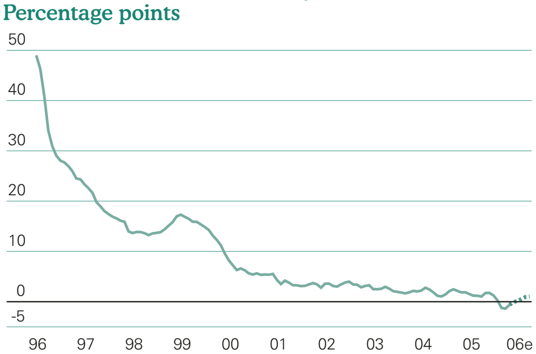
Conditions Prevail for Strength of the Peso

Exchange Rate
Pesos per dollar



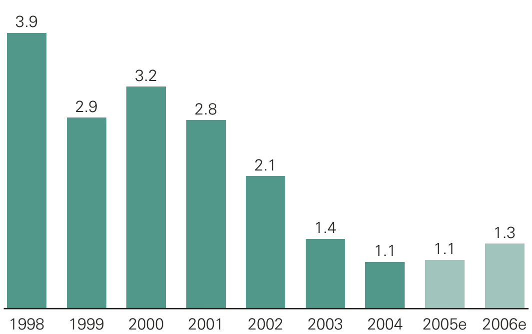
e estimated
Source: BBVA Bancomer with Banco de México data

Mexico-U.S. Inflationary Spread
Percentage points



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

Current Account
% of GDP



e estimated
Source: BBVA Bancomer with Banco de México data

Despite the reduction of the interest rate spread between Mexico and the United States, in the last part of 2005, the exchange rate maintained the appreciation trend it had started in mid 2004. Thus, in real terms, the peso reached the levels it had in February 2001.

The question is whether these levels of strength in nominal and real terms will prevail in 2006, or if there will be a breakdown at some point. To revert the real exchange-rate trend of the last 19 months completely, the peso would have to depreciate 10%, which, given expected inflation for this year, would imply an adjustment of more than 12% from the nominal exchange rate, which would mean an exchange rate of close to 11.92 ppd at the end of this year. Even though this should be the trend of the peso, given the expected reduction of the spread between Mexican and U.S. interest rates and the lag in productivity, in our base scenario, we believe that high liquidity in the international environment will tend to dominate changes in parity, with the peso fluctuating within a range of strength. An exchange rate of 11.3 ppd at the end of this year would be in line with the expected scenario of the various determinants of the currency.

The fundamentals and excess capital flows will provide support for an orderly adjustment of the peso

Mexico's inflationary convergence with the U.S. accelerated in 2005, reducing pressure on the exchange rate and leading to its stability. This momentum will continue in 2006. Despite seasonal risks and supply factors that lead us to anticipate a rebound of inflation in Mexico, it will be moderate and will not be accompanied by substantial pressures on core inflation. At the same time, the growth differential could be reduced this year, since moderate growth is expected for both Mexico and the U.S. (of around 3% in both countries).

Moreover, we believe that the flows from remittances and oil exports will be maintained. This will undoubtedly allow over-financing the current account deficit, which, as a percentage of GDP, will remain at reduced levels in 2006. However, given that crude oil prices are quite volatile, we should be cautious with regard to this outlook.

The peso will also be supported by the situation in the country's public accounts, which independently of the financial benefits obtained from the public debt policy of the current administration (of lengthening credit terms, replacing foreign currency liabilities with pesos, and financing at fixed interest rates), "financial armor plating", its greatest contribution will come from signals sent by the market and their positive effects on sovereign risk, giving rise to a more favorable environment in the foreign exchange market. Within this context, the early refinancing of public debt maturities for 2006 and 2007 is particularly significant, as is the goal of maintaining public finances balanced, with an economic deficit of 0.0%.

Finally, capital will continue to enter the emerging markets[1] as a result of lower international volatility in growth and inflation (which in addition is much lower), which justifies reducing the risk premium

1 Review box: "Capital Flows to Latin America in 2006"

demanded by investors. Also, high world liquidity (mostly the outcome of the long period of low rates in industrialized countries and the flows from Asian and oil-producing countries) supports a process in search of productivity that makes this movement possible and, after resulting in very reduced rates (and slopes) in the world, it has moved on to loan risks and to emerging markets such as Mexico, where, in addition, there is a profitability spread that investors consider sufficient to offset the risk.

Nevertheless, monetary policy will play a predominant role in the peso fluctuations.

Although the funding rate will continue to decline in 2006, given that the rallying cycle of U.S. monetary policy is approaching its end, the interest rate spread between the two countries will not decline at the same speed as in the last months of 2005. Therefore, the exchange rate should react to this reduction at a more measured and balanced rate, modulated by the abundance of liquidity and aversion to risk.

Regarding expectations in the funding rate, its reduction by 50 bp on December 9th indicates, as a minimum, the greater maneuvering room of monetary policy, in view of the strength of the peso and perhaps the intent to revert the pressures on monetary conditions, which are still restrictive. In our judgment, this decision shores up a scenario of acceleration of the downward cycle, in view of the possibility that the flows will last longer, which could maintain the strength of the peso with lower spreads between U.S. and Mexico rates (reducing the risk premium), and give rise to a favorable outlook for core inflation. This places the exchange rate within the context where the dynamics between the interest rate spread and foreign exchange parity will be what will gradually determine the balances in the financial markets in 2006.

In brief, from the standpoint of the contribution to the variability of the exchange rate in 2006, changes in the spread between interest rates and other factors such as liquidity and risk will have a greater relevance in the dynamics of the peso (31% and 50%, respectively). As opposed to recent years, the role that economic growth and inflation will play will be delimited, which is why, should our scenario materialize, these two elements will only affect foreign-exchange volatility by 19%.

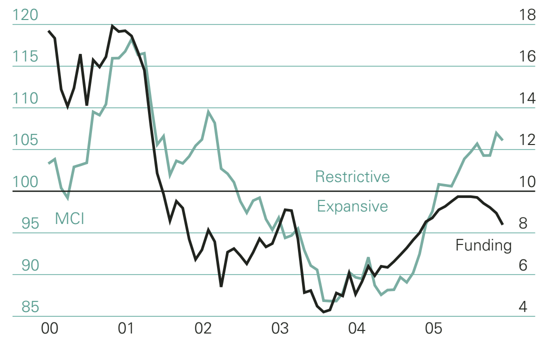
Thus, we believe that an exchange rate of 11.3 ppd will result from the equilibrium among all the determinants toward the end of 2006. Given the fierce search for profitability in an international environment of high liquidity, we maintain a bias of greater strength of the peso, which would reflect the optimism in the international markets (10.80 ppd, also toward the end of this year) and would also be supported if oil prices rise in 2006. One last source of pressure on the exchange rate is that related to the loss of competitiveness of the exporting sector, which cannot be completely ruled out as a risk element, particularly in the medium term. Only an unsuspected shock, such as a radical change in the perception of the political risk —or a flight to quality— derived from a greater aversion to risk, would be a warning sign for the exchange rate.

Exchange Rate Projection
Pesos per dollar, end of period

	Base	Strength trend
1st quarter 2006	10.80	10.60
2nd quarter 2006	11.10	10.90
3rd quarter 2006	11.20	10.80
4th quarter 2006	11.30	10.80

Source: BBVA Bancomer

Monetary Conditions Index (MCI) and Bank Funding Rate



Source: BBVA Bancomer with Banco de México data

Share in the Variability of the Exchange Rate

	Economic activity	Inflationary spread	Interest rate spread	Other
Jan 2001-Jun 2005	17%	**18%**	24%	**41%**
In 2006, the dynamics of interest rates, as well as other factors (risk, liquidity, etc.) will have greater relevance on the variability in the peso				
2006	10%	**9%**	31%	**50%**

Source: BBVA Bancomer

Peso Determinants in 2006
Contribution to annual change, pesos per dollar

	Strength trend	Base
Mexico-U.S. inflationary spread	0.13	0.13
Mexico-U.S. production spread	-0.01	-0.01
Productivity	0.10	0.10
Mexico curve slope	-0.40	-0.25
Interest-rate spread	0.29	0.60
Fiscal deficit and current account	-0.02	-0.02
Risk factor	0.06	0.10
Total	**0.15**	**0.65**
Fix (2005 close + total)	**10.80**	**11.30**

Source: BBVA Bancomer

What Elements Could Intensify the Pass-through from the Exchange Rate to Prices, Placing Inflationary Stability At Risk?

Transmission of the exchange rate to prices within a context of low inflation

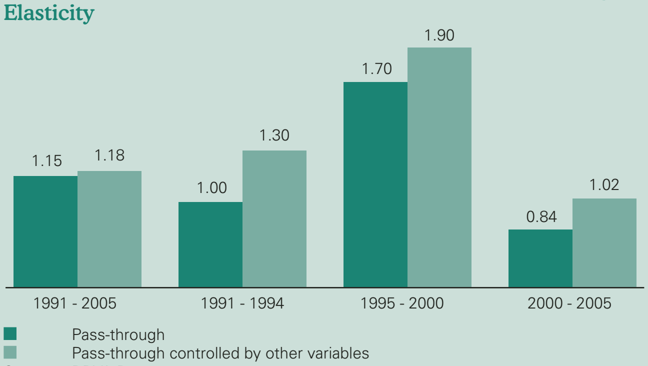
The Mexican economy has not been exempt from the worldwide decline in inflation. In November, inflation was below the target set by Banco de México (3%). At the same time, the intensity of the transmission of the exchange rate to prices seemed to have subsided. Among the main causes that have curbed growth in prices and limited the pass-through are globalization and greater international competition, macroeconomic stability, a better management of monetary policy, and the development of the financial markets.[1]

However, certain doubts persist regarding the sustainability of the current inflation rate in a context of recovery of the economic cycle and given the risk of a greater transfer of movements in the exchange rate to prices, in view of the uncertainty surrounding this year's presidential elections, as well as due to the possible reduction in international liquidity.

To evaluate inflation resulting from variations in the peso/dollar parity, it should be kept in mind that in the past few years the pass-through has not only been contained, but the influence of prices on the exchange rate has also increased. If, in estimating the elasticity between prices and the exchange rate, we take into account that parity levels also adjust to the performance of inflation and productivity, the result is that the long-term effect of the peso on prices increases (see graph). This means that although the pass-through has been contained, it is still important.

Evolution of the Importance of the Pass-through

Elasticity



Source: BBVA Bancomer

A factor that characterizes periods of greater transmission is high volatility in the exchange rate. In fact, it is this factor that leads us to conclude that the greater variability in peso-dollar parity is an important determinant of the strength of the transfer effect from the exchange rate to prices. To summarize, the pass-through can be hidden (or contained) as a result of the greater importance acquired by other components in the recent evolution of inflation.

At what level of the exchange rate would inflation be destabilized?

In order to "awaken" the intensity of the pass-through, and in the process place inflationary stability at risk, certain elements must coincide. First, the changes in the exchange rate must occur more abruptly and should be variations of such significance that they have an impact on inflation expectations and wage negotiations. Secondly, the effect that globalization has had on world inflation should not overly compensate future depreciations of the peso. Given that we expect growth higher than the potential, the pressure of the exchange rate on prices would not be magnified. By way of example, if we consider these elements, and assume that volatility will increase 100% (the difference between current levels and those registered in 2002-2003), with average variations in the peso that would change the trend in the real exchange rate (persistent modifications that would take the peso to a level of 12.6 to the dollar in one year), in the course of this period the depreciation would add 0.9 percentage points (pp) to inflation. An exchange rate of 11.3 pesos per dollar in one year could increase inflation by 0.3 pp, provided this movement occurs under the conditions mentioned above.

Potential Effects on Inflation According with the Magnitude & Duration of the Exchange Rate Adjustment

Inflation percentage points

Duration	Exhange rate (magnitude, ppd)									
(months)	10.90	11.00	11.20	11.30	11.60	11.80	12.00	12.20	12.40	12.60
1	0.00	0.02	0.04	0.07	0.09	0.11	0.13	0.16	0.18	0.20
3	0.014	0.03	0.07	0.10	0.13	0.17	0.20	0.23	0.27	0.30
6	0.015	0.06	0.11	0.17	0.22	0.28	0.33	0.39	0.44	0.50
9	0.016	0.09	0.18	0.27	0.36	0.44	0.53	0.62	0.71	0.80
12	0.018	0.10	0.20	**0.30**	0.40	0.50	0.60	0.70	0.80	**0.90**

Source: BBVA Bancomer

In conclusion, the intensity of the transmission could be "hidden" at this time and could become evident with the emergence and persistence of greater volatility of the exchange rate.

Ociel Hernández o.hernandez@bbva.bancomer.com

1 See "PesoWatch" of November 18, 2005, which presents a detailed analysis.

Capital Flows to Latin America in 2006

The year 2005 was characterized by high capital flows to the emerging markets, both for foreign direct investment (FDI) as well as portfolio investment. These flows have been favored by a context of high liquidity on an international level, low risk aversion, sustained increases in the prices of raw materials, and a more than acceptable economic growth. By regions, Asia continues to outperform Latin America in this regard, although in the latter case, this was the first year of positive portfolio investment flows since 2000. In particular, inflows from fixed income securities have led to a considerable decline in the premiums paid by Latin American countries for their bonds (the EMBI+ spread is below 300 bp). In variable income securities, the Latin American market indexes have averaged earnings of more than 60% (in dollars). This situation, raises the question as to what extent such inflows, both FDI as well as portfolio investment, are sustainable in 2006.

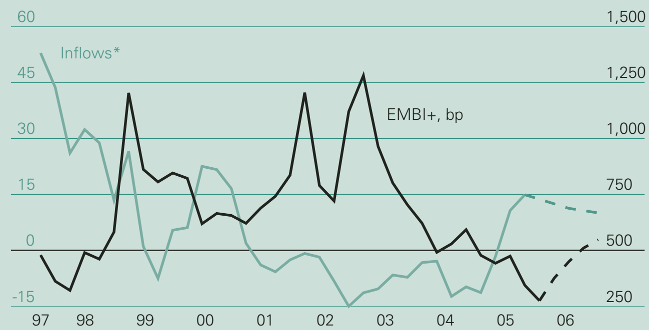
Those elements considered as push factors (high global liquidity, low volatility, favorable feeling on the part of institutional investors, high prices of raw materials, and world growth) configured a very favorable 2005 for portfolio investment flows to Latin America. However, we expect a somewhat lower level of such flows for 2006, since we anticipate a moderation in international liquidity, a limited turnaround in volatility, and commodity prices that are somewhat more moderate than they are at present, although they still will remain high. In addition, world growth is expected to slow down.

At the same time, those considered to be pull factors (carry trade, gains in stock market indexes, improvements in credit quality, regional growth, and monetary policy decisions adopted by the respective central banks, among which the most important involve the accumulation of reserves) have also supported portfolio investment flows to Latin America. For 2006, we expect a somewhat less favorable scenario, especially since carry trade operations will have less room for maneuvering and because it will be an election year in many countries of the region.

Combining all of these factors together, our base scenario indicates portfolio investment slightly below the levels registered in 2005. With these investment inflows, the EMBI+ spread would rebound around 50 bp on average for the year, which would represent considerable stability, and above all, levels below the historical averages. This could translate into flows of close to U$10 billion, down from the US$15 billion registered in 2005.

What are the risks? On the whole, the risks are clearly on the decline. In relation to the factors analyzed here, it should be noted that the performance of capital investment flows and the EMBI+ is especially sensitive to volatility. Thus, in a scenario in which volatility were to rebound to levels similar to those seen at the beginning of 2003 (tied to an international recession), this would lead to an increase in the EMBI+ spread of about 250 bp on average during the year, in relation to the base scenario. If to this we add interest rate increases, bringing them up to as much as 5.75% in the United States, the EMBI+ spread could rise an additional 75 bp, with important outflows from the region (-US$10 billion).

Latin America: EMBI+ and Net Inflows



* Net inflows in portfolio investment, billions of dollars
Source: BBVA with IFS and Datastream data

In the past few years and concretely in 2005, a series of factors have been accumulating that tend to have a delayed reaction on FDI and that lead us to be optimistic for 2006. Among these aspects, we can mention the growing size of the market, the greater trade opening, some contained labor costs, renewed productivity, and a lower political risk. Therefore, except for certain volatility that could be generated by the elections scheduled in the region, we project FDI inflows at levels higher than those registered in 2005, this is, from US$62 billion to as much as US$75 billion (see article in LatinWatch from 1Q06).

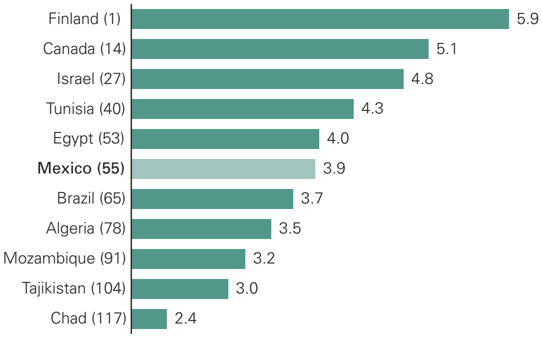
In conclusion, maintaining the flows

Our base scenario estimates for 2006 involve FDI inflows higher than those of last year and somewhat lower portfolio investment inflows, leading to a net result in which capital flows to the Latin American region will be similar to those of 2005 or even slightly higher, although with a change in their composition. This undoubtedly is good news for the region. Furthermore, the risk scenario involves a reduction of flows that could lead to a rapid and significant correction in risk premiums.

Nicolás Trillo nicolas.trillo@grupobbva.com

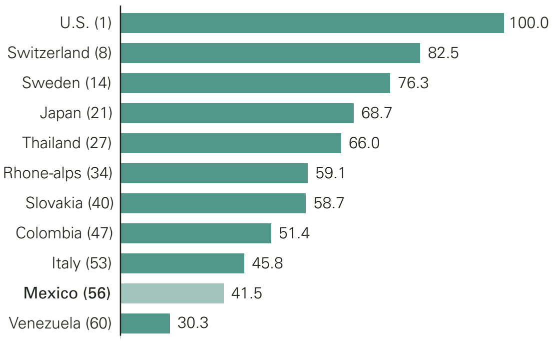
Fernando González f.gonzalez8@bbva.bancomer.com

Growth Competitiveness 2005
Relative position and value of the index



Source: BBVA Bancomer with World Economic Forum (WEC) data

World Competitiveness 2005
Relative position and value of the index



Source: BBVA Bancomer with International Institute for Management Development data

Main Competitiveness Indices

Source	World Economic Forum (WEF)	International Institute for Management Development (IIMD)
Index	Growth Competitivenss (GCI)	World Competitiveness Index (WCI)
Index beginning	1989	1979
Repre-senting	117 countries	60 economies
Criteria	Economy Institutions Technology	Economy Government Business Infrastructure
Surveys	80,000	4,000

* 51 countries 9 national economic regions
Source: BBVA Bancomer and WEF and IMD data

International competitiveness: an indicator of economic growth potential[1]

The differences in the levels of well-being among nations or regions are mainly related to production factors and their productivity, which in turn, determine the return rate on investment and together with population growth, the capacity of the economy to grow in the medium and long term.

Among others, the World Economic Forum (WEF), and the International Institute for Management Development (IMD), have dealt with the factors related to the capacity for sustained growth. The WEF is a private non-profit institution founded in 1971 and focuses on the discussion of growth-related topics. It publishes "The Global Competitiveness Report" annually. The IMD is one of most important business schools in the world and publishes its studies on competitiveness in its "IMD World Competitiveness Yearbook".

This article analyzes competitiveness[2] from the standpoint of both institutions, in which this concept is defined as the series of factors, policies and institutions that determine the level of productivity of a county's economy.

Methodology

Both the WEF and the IMD have developed competitiveness indices to quantify the relative position of the countries in relation to their capacity for growth. These indices are based on the weighting of a wide number of indicators, taking into account published statistical data and opinions derived from their surveys, and also consider macroeconomic, technological, public institutions and infrastructure aspects.

The WEF structures and publishes the Growth Competitiveness Index (GCI) based on three sub-indices: technology, institutions and macroeconomic environment. The indicator assigns different weights, according to the technological situation. The number of countries analyzed has increased from 16 in 1979 to 117 in 2005 and their opinion surveys total 80,000. In 2005, the index values fluctuated between 5.94 and 2.37 points for the economies of the countries with greater or lesser competitiveness, respectively. For a better understanding of the growth processes, this institution designed a new indicator, the Global Competitiveness Index. This new index, which will be published starting in 2006, involves nine criteria and a new weighting structure. Moreover, it also generates an indicator on the competitiveness of businesses.

1 Maximum GDP level that can be maintained with a given technology and without generating inflation. In the absence of other changes, it would be determined by growth in the work force and by the accumulation of capital and technological progress. .

2 The competitiveness of a country is closely related to its participation in the world markets and is linked to relative prices; productivity under conditions for sustained growth, and it depends on the amount produced per unit of production factor.

The IMD analyzes the competitive position of 60 economies: 51 countries and 9 local or regional economies through the World Competitiveness Index. (WCI): This index uses 241 criteria of the 314 that are available; of these 2/3 involve statistical data and 1/3 are indicators of 4000 surveys conducted by the Institute. The information is grouped into four categories: macroeconomy, public sector, business and infrastructure, each one with equal weighting. This indicator assigns a value of 100 to the most competitive economy and generates a descending scale for the rest.

The comparison of results between the two sources—the WEF and the IMD—has some limitations. For example, the number of economies analyzed is different: 60 vs. 117 in 2005 and has changed over time. Also, its standardization (at 100) has restrictions, since they are not random samples. Therefore, the numbers are important within each index for each additional year, more than in its performance over time and as a relative indicator, than as an absolute datum. Due to these characteristics, the countries in the first places are in both lists and tend to coincide, while those in the last places do not.

Results

In this context, and with any of the competitiveness indicators, there are consistent results: the United States or Finland take the first places. China surpasses Mexico, and, among the Latin American countries, Chile has a clear advantage over the rest. Mexico, Argentina and Brazil compete for an intermediate place in the WEF index or for the last places in the IMD indicator. Although Mexico's relative position in the GCI (55 of 117) is better than that of Argentina and Brazil, the latter country surpasses Mexico in the WCI (51 vs. 56 among 60 countries). For Latin America, the coverage of these indices is partial: 21 countries in the first and seven in the second. In the first of these indices, only two countries surpass Mexico: Chile and Uruguay. But in the second, three of them do: Chile Colombia and Brazil. This is due to the weighting value of the different variables.

In each index there are general factors and sub indices which do not always coincide among themselves in the ranking of the countries. For example, the United States ranks first in technology, but 23rd in macroeconomic environment. In any case, these indices allow approaching the weaknesses and strengths of each country. These results raise two questions: How has Mexico's relative position evolved over time? Why does Mexico hold a relatively low competitive position?

Mexico's competitiveness among the average and with no progress in recent years

According to the GCI, between 2003 and 2005, Mexico's competitive position fell from 47^{th} to 55^{th} place, while the number of countries analyzed rose from 101 to 117. Therefore, it cannot be said that the relative competitive position of the country deteriorated, since the introduction of new countries has no retroactive effect. In fact, when the information is standardized at 100 participants, the competitive position remains at 47, with a marginal advance in 2004 that was

Competitiveness According to the Index
Place in a list of selected countries

	Growth competitiveness	World competitiveness
United States	2	1
Finland	1	6
Hong Kong	28	2
Chile	23	19
Spain	29	38
China	49	31
Mexico	**55**	**56**
Argentina	65	58
Brazil	72	51
Total countries	**117**	**60**

Source: BBVA Bancomer with Global Competitiveness Report 2005-2006, WEF, IMD World Competitiveness Yearbook, 2005 and IMD data

Components of the Growth Competitiveness Index
Place in a list of selected countries

	Total	Technology	Institutions	Macro environ.
Finland	1	2	5	4
United States	2	1	18	23
Hong Kong	28	26	23	8
Chile	23	35	22	15
Spain	29	27	36	24
China	49	64	56	33
Mexico	**55**	**57**	**71**	**43**
Argentina	65	59	74	86
Brazil	72	50	70	79
Total countries	**117**	**117**	**117**	**117**

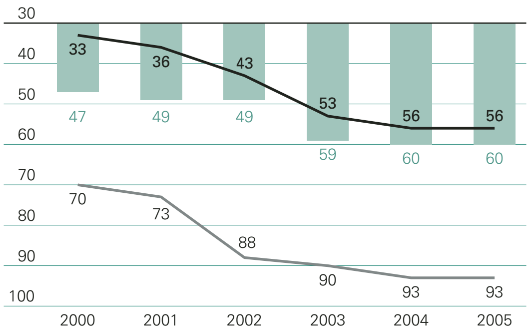
Source: BBVA Bancomer with Global Competitiveness Report 2005-2006, WEF data

Changes in the Growth Competitiveness Index
Place in a list of selected countries

	2003	2004	2005	2003 - 2005
Finland	1	1	1	0
United States	2	2	2	0
Hong Kong	24	21	28	-4
Chile	28	22	23	5
Spain	23	23	29	-6
China	44	46	49	-5
Mexico	**47**	**48**	**55**	**-8**
Argentina	78	74	72	6
Brazil	54	57	65	-11
Total countries	**101**	**104**	**117**	

Source: BBVA Bancomer with Global Competitiveness Report 2005-2006, WEF data

Mexico: Competitiveness According to the World Competitiveness Index
No. of economies analyzed & Mexico's relative position



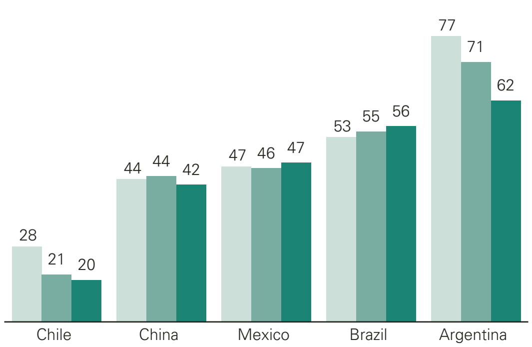
Number of economies
Competitiveness
Standardized at 100 countries
Source: BBVA Bancomer with IMD data

International Competitiveness of Latin America According to Different Indices
Standardized index at 100 countries

	Growth competitiveness	World competitiveness
Quartile 1	Chile (20)	
Quartile 2	Uruguay (47)	Chile (32)
	Mexico (47)	
	El Salvador (48)	
	Colombia (49)	
Quartile 3	Trinidad y Tobago (52)	Sao Paulo (72)
	Costa Rica (55)	Colombia (78)
	Brazil (56)	
	Peru (59)	
	Jamaica (60)	
	Argentina (62)	
	Panama (63)	
Quartile 4	Venezuela (77)	Brazil (85)
	Honduras (80)	Mexico (93)
	Guatemala (84)	Argentina (97)
	Nicaragua (85)	Venezuela (100)
	Bolivia (87)	
	Dominican Rep. (88)	
	Ecuador (89)	
	Paraguay (97)	
	Sao Paulo (99)	

Source: BBVA Bancomer with WEF and IMD data

Growth Competitiveness Index
Standardized relative position at 100 observations



2003 2004 2005
Source: BBVA Bancomer with WEF data

lost in 2005. Last year there was an improvement in the evaluation of the macroeconomic framework, but due to deterioration in the other two indicators and in the net, one echelon was lost, thereby returning to 47th place.

If competitiveness is analyzed within the WCI, Mexico fell from 33rd to 56th place between 2000 and 2005. However, this data must be interpreted with caution. If we consider the change in the relative position, we would be talking about a deterioration of the country's competitiveness of 23 points or places, which would be an error of magnitude, although not of direction. Two fundamental factors must be taken into account: the number of economies analyzed grew from 47 to 60, and of the new entities included, nine are regions of nations that were already participating in the comparison and the remaining ones are not randomly selected countries. The regional economies that are included belong to countries with a better classification than Mexico; if the area is better than the country of which it is a part, this displaces that country and Mexico to a lower position. The number of countries can be standardized at 100, but the discretion shown in their inclusion cannot be neutralized: this explains approximately half of the deterioration; the rest is of its own merit.

Mexico is at a disadvantage compared to its main competitors

The adjoining table analyzes Mexico's relative position as well as that of the Latin America countries in 2005 by using the indices presented in this document. To facilitate the comparison, all of the countries have been classified in quartiles and the information is standardized at 100.

The table shows the following: 1) The GCI includes a greater number of Latin American countries than the WCI; 2) The WCI classifies most of the economies of the region negatively. In this index the developed countries are predominant and, therefore, the countries of the region are at a disadvantage and are concentrated in the last quartile; 3) Chile is the best positioned country in both indices and at a relatively long distance compared with the rest of the countries; 4) Mexico is in an intermediate position: in the GCI index, it is in the middle of the general table (in 47th place) and over that of the economies of the region. In the WCI index, Mexico is surpassed by Chile, Sao Paulo, Colombia and Brazil, but, in turn, ranks higher than Argentina and Venezuela. The comparison of Sao Paulo with the rest of the countries is debatable, since each country could include its best economic zone to compete, and some regions in Mexico would obviously surpass the relative position of the country.

Based on the different indices, a brief analysis can be made of the strengths and weaknesses of the countries. For example, in 2005 and in a series standardized at 100 observations, Mexico ranked 49th in the GCI total, although 37th in macroeconomic variables, 49th in technology and 61st in Public Institutions (table on the following page). China surpassed Mexico in the first and third of these sub-indices and Chile in all of them. Although the three countries show their greater strength in the economic variables, Chile adds to these its institutional framework and also managed to advance in two of its indices. However, China lost ground in its macroeconomic indicators and Mexico in those of technology and institutions.

The competitive position has concrete expressions in tangible variables. Competitiveness is a reflection of productivity, and the latter of production costs and the quality of goods and services of the economy. Bureaucracy, quality in the allocation of public spending, deficiencies in the rule of Law, a lag in education, limitation in health, lack of infrastructure, little competition due to monopolistic or oligopolistic public or private activities, the absence of true and timely information or weakness in public finances, among other variables, have a bearing on production costs and lower the profitability of companies, penalize the well-being of the population and reduce the potential for growth in the economy in the medium and long term.

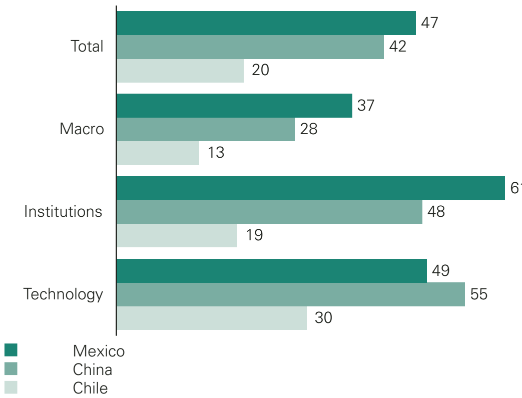
Consequently, Mexico should progress in all the aspects, although particularly in those where its relative position is worse: the institutional framework. In this last aspect, the following criteria, among others, are taken into account: independence of the judicial system, the rule of Law, corruption and the costs of insecurity. But this is not isolated from the rest of the variables, for example, education. Therefore, the emphasis should be on the greatest lags, although progress should be generalized. It is not enough to have stability and/or growth; it is also necessary to do it better than other countries and also to have modern and competitive public institutions and with access to and the application of cutting-edge technology. That is, competitiveness is a combination of multiple factors, not only of one.

Conclusions: the surest way to increase growth is through productivity

Notwithstanding some limitations in the competitiveness indices, these are valuable instruments for understanding the determining factors of economic growth, the inter-relation of such variables and their performance over time. The relative position of the competitiveness of a country in a specific list depends on the methodology, the number of cases analyzed and the type of countries included in each index. Consequently, their analysis and conclusions must be done cautiously. For example, Mexico is classified in the fifth ten percent section in one index and in the tenth in the other. For each country, the most relevant comparison is with its main competitors; also, the reference to other similar developing countries could be useful to see what can be accomplished when the proper steps are taken. In Mexico, the recent evaluation suggests that the progress made in economic stability was not sufficient to improve the total competitive position of the country and that Mexico tends to lag in relation to the progress made by its main competitors. The challenge now, once macro stability has been reached, is to advance in productivity as the most solid and permanent route by which to increase the potential growth of the economy.

Competitiveness 2005

Relative position, standardized series at 100



Source: BBVA Bancomer with WEF data

Growth Competitiveness Sub Indices of Selected Countries

Standardized position at 100 observations

	Total	Technology	Institutions	Macro environ.
Chile				
2004	21	31	19	26
2005	20	30	19	13
Change	**1**	**1**	**0**	**13**
China				
2004	44	60	53	23
2005	42	55	48	28
Change	**2**	**5**	**5**	**-5**
Mexico				
2004	46	46	57	47
2005	47	49	61	37
Change	**-1**	**-3**	**-4**	**10**

Source: BBVA Bancomer with WEF data

Investment Environment and Business Climate

An important factor for economic growth is the environment that companies face in any country of the world. The increase in investment leads to greater growth and therefore to better employment and a decline in poverty. Decisions regarding new investments, the expansion of existing projects, or the selection of new countries or regions to expand productive activities depend on multiple factors, among them the business climate or environment. This refers to the ease or difficulties that investors encounter to initiate, maintain, or simply conclude activities when they have to do so.

To expand the available knowledge on these issues, the World Bank (WB) is working on a series of indicators, specifically: 1) Investment Climate Surveys and 2) the Doing Business Project. With this effort, the World Bank seeks to further expand the knowledge and dissemination of the variables related to these issues, which are of interest to investors, authorities, and academicians, who are all concerned with promoting economic development through international transparency.

The surveys on the business environment seek to identify and quantify the difficulties or restrictions that companies face and relate them to the business profile, growth, and investment. This project began in 2001 and covers 53 countries through random surveys applied to 26,000 companies of different sizes in diverse regions of each nation. The surveys are conducted by qualified personnel and cover 82 aspects of the business environment and the corresponding companies with quantitative and qualitative variables.

As of 2003, the Doing Business Project analyzes the existing regulations in 130 countries in five areas: opening a business, bankruptcies, compliance with contracts, labor regulations, and access to credit. For these regulations, aspects such as the number of paperwork procedures, the time required, and the cost of each of them are quantified. The research is conducted through a panel of experts in the main city of each country and in the cases of large nations, in more than one city.

The adjoining chart presents some indicators on dynamism, the business climate, and the development profile for a group of selected nations. The first block includes countries by income level, the second contains some developed nations and/or those posting high growth, while the third presents the main Latin American countries. Although the list is short, it should be noted that vigorous growth and economic development are associated with better conditions for business.

Based on these indicators, Mexico occupies a relatively better position in Latin America than other countries, except for Chile. But among the more developed or industrialized countries, Mexico lags seriously behind. Given this panorama, the country's potential for improvement is great.

Fernando González f.gonzalez8@bbva.bancomer.com

Indicators on Investment Environment

	GDP[1]	Opening a business		Ownership registration		Local competition[2]	Gov't transparency[2]	Literacy[3]	Exports	
		Number of days	Number of procedures	Number of days	Number of procedures				Manufacturing[4]	Techno.[5]
Countries according to income										
High income	2.5	27	7	60	5	5.4	4.7	—	82	23
Middle income	3.3	50	11	80	7	4.6	3.5	90	60	18
Low income	4.7	66	11	100	7	4.2	3.6	61	47	4
United States	3.2	5	5	12	4	5.9	4.9	—	81	32
Korea	5.5	22	12	11	7	5.3	4.4	—	92	32
Ireland	7.6	24	4	38	5	5.2	4.2	—	88	41
China	9.5	41	12	32	3	5.3	4.2	91	90	23
Chile	5.6	28	10	31	9	5.6	4.5	96	18	3
India	5.8	89	11	67	6	5.6	4.1	61	75	5
Mexico	3.0	58	8	74	5	4.9	3.7	91	84	21
Peru	3.9	98	10	31	5	5.5	3.7	85	21	2
Colombia	2.3	43	14	23	7	4.6	4.0	92	38	7
Argentina	2.3	32	15	44	5	4.4	2.0	97	31	7
Brazil	2.6	152	17	42	14	5.2	3.6	86	54	19
Venezuela	0.5	116	13	34	8	3.8	2.1	93	13	3

1 Annual average % change 1990-2003
2 World Economic Forum (WEF) Index
5 High technology, % of manufactured goods
3 % of the population, 15 years and older
4 % of total
Source: BBVA Bancomer with World Development Report 2005, World Bank data

Mexico and the Latin American Electoral Process

David Aylett david.aylett@bbva.bancomer.com

For Mexico and Latin America, 2006 will be a year of intensive electoral activity. Together with Mexico, fifteen countries of Central and South America and of the Caribbean will hold presidential and/or legislative elections, including Brazil, Colombia and Venezuela. The current electoral cycle started at the end of 2005 with voting in Chile, Bolivia, Honduras, Argentina and Venezuela. Despite the disenchantment with the electoral process that some sectors of the Latin American population have expressed, there are no conclusive signs that democracy in the region has lost its strength and vitality; on the contrary, it could be argued that party activities are in full swing, undoubtedly fuelled by political players' expectation of securing victory at the ballot box. The above serves to prove that Latin American democracy has become entrenched, and orderly transfer of power is now a reality.

The Elections in Mexico and Brazil Will Attract the Most Attention

Some countries of the region will experience hard-fought electoral contests, others not as much. For example, in Chile, the candidate of the government coalition in the elections of last December 11th, had to go to a second round face-off with her closest competitor before ensuring victory. In contrast, Bolivia, characterized in the past by fragmentation of the vote between several presidential hopefuls, threw up a clear winner, with over 50% support, in its recent election (December 18). Electoral uncertainty in Latin America is not synonymous of disorder and government breakdown, but rather a key ingredient of democracy. While democracy means much more than simply being able to vote, this system of government would be inconceivable without disputes between those competing for public office, which are intrinsic to the process.

The renewal of executive and legislative power in Mexico and Brazil —whose economies are the largest in the region— will monopolize the attention of analysts in 2006. Following its successful experiment of political alternation in 2000, Mexico is now facing, this coming July 2nd, an unprecedented electoral process, since the polls show that any one of the three main parties could win the Presidency of the Republic (although hardly an absolute majority in the two legislative chambers). Should the current Chief Executive of Brazil, "Lula" da Silva, seek re-election, this outcome seems less certain than a year ago. The scandal in which some officials of his government were involved in 2005 has undermined "Lula" 's popularity, leaving him in a potentially vulnerable situation. Nevertheless, the elections, set to be held in October, are no cause for concern, unlike four years ago.

Of the elections to be held in the first half of 2006, those in Peru (April 9) and Colombia (May 28) are worth noting. While in the former, a candidate of the left, Ollanta Humala, has made steady gains in the polls, in the latter, President Alvaro Uribe is seeking to remain in his post after Congress approved a reform allowing immediate re-election. In theory, the good performance of the Peruvian economy —GDP registered a growth rate of nearly 6% in 2005— should favor the government candidate, although for some electors, the recent victory of the candidate of the left in Bolivia is a source of inspiration. For his part, the Colombian President's handling of national security is a valuable electoral asset.

Electoral Calendar for the American Continent 2005-2007

	Country	Type of Election
Oct. 23, 2005	Argentina	Legislative
Nov. 27	Honduras	Presidential/Legislative
Dec. 4	Venezuela	Legislative
Dec. 11	Chile	Presidential/Legislative
Dec. 18	Bolivia	Presidential/Legislative
Jan. 15, 2006	Chile	2nd. round presidential
Jan. 23	Canada	Parliamentary
Feb. 5	Costa Rica	Presidential/Legislative
Feb. 7	Haiti	Presidential
March	Guyana	Presidential/Legislative
March 12	Colombia	Legislative
March 12	El Salvador	Legislative
March 19	Haiti	Possible 2nd. round presidential
April 2	Costa Rica	Possible 2nd. round presidential
April 9	Peru	Presidential/Legislative
May 16	Domin. Rep.	Legislative
May 28	Colombia	Presidential
July 2	Mexico	Presidential/Legislative
Oct. 1	Brazil	Presidential/Legislative
Oct. 15	Ecuador	Presidential/Legislative
Oct. 29	Brazil	Possible 2nd. round presidential
Nov. 5	Nicaragua	Presidential/Legislative
Nov. 7	United States	Legislative
Nov. 26	Ecuador	Possible 2nd. round presidential
Dec.	Trin. y Tob.	Presidential/Parliamentary
Dec.	St. Lucia	Legislative
Dec. 3	Venezuela	Presidential
Dec. 7	St. Vincent	Parliamentary
Oct. 28, 2007	Argentina	Presidential
Nov.	Guatemala	Presidential

Source: Political Data Base for the Americas, Univ. of Georgetown, Washington D.C.

Latin America: Presidential Term, Re-election and Second Round

	Presidential term	Potential Re-election	2nd. Round
Chile	4 years	Yes*	Yes
Peru	5 years	Yes*	Yes
Colombia	4 years	Yes	Yes
Mexico	6 years	No	No
Brazil	4 years	Yes	Yes
Venezuela	6 years	Yes	No
Argentina	4 years	Yes	Yes

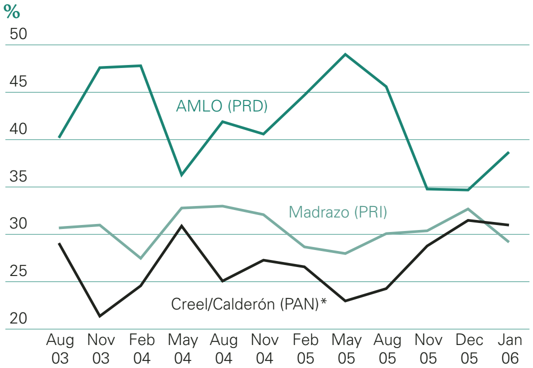
* Only possible after conclusion of the next presidential term
Source: Political Data Base for the Americas, Univ. of Georgetown, Washington D.C.

Mexico: Popularity of the Presidential Candidates
%

	AMLO (PRD)	Calderón (PAN)	Madrazo (PRI)	Difference 1st & 2nd
Covarrubias	39.0	27.0	22.0	12.0
Reforma	40.0	30.0	26.0	10.0
Mitofsky	39.0	31.0	29.0	8.0
IPSOS-Bimsa	40.0	33.0	26.0	7.0
Milenio	37.0	31.0	30.0	6.0
Average	**39.0**	**30.4**	**26.6**	**8.6**

Source: National polls by respective firms, January 2006

Mexico: Support for Presidential Candidates
%



* Until August 2005, it was measured with Creel. As of November with Calderon
Source: National polls by Consulta Mitofsky, 2003-2006

Re-Election and the Second Round in Latin America

One characteristic of the electoral process in Mexico that sets it apart from the majority of Latin American countries is that the re-election of the President is not permitted nor is there a second round election if the winner secures less than 50% of the vote. While Latin American legislation is notoriously inclined to re-election, there are significant variations in the rules. In five nations (Argentina, Brazil, the Dominican Republic, Venezuela and now Colombia) re-election is permitted, in nine it is only possible after at least one other presidential period has elapsed (Bolivia, Costa Rica, Chile, Ecuador, El Salvador, Nicaragua, Panama, Peru and Uruguay). The only other countries besides Mexico that prohibit it altogether are Guatemala, Honduras and Paraguay.

Regarding the second round, in 1979, only two Latin American countries (Costa Rica and Ecuador) had this electoral system. In later decades, 12 countries adopted it, including Argentina, Brazil, Chile, Uruguay, Colombia and Peru. According to an analysis of 39 elections with a second round system held between 1979 and May 2002, only in seven cases did a "reversion of the initial result", as the political scientist Anibal Perez-Liñan called it, occur. This happens when a majority of the electorate shares a "negative consensus" against the first round winner.[1] A review of the 21 cases in which a second round took place indicates that if the candidate in the lead has a significant advantage, the runner-up is unable to win. In cases where a "reversion of the initial result" was registered, the advantage in points was minimum. The most extreme case of "reversion" was the victory of Jorge Batlle, who was seven percentage points behind Tabare Vazquez (31.3% vs. 38.5%) in the first round of voting in Uruguay (1999). In the second round, Batlle won with a seven-point advantage: 51.5% vs. 44%.

Assessment

In Mexico, much has been said about the advisability of allowing the second round election. The re-election of the Chief Executive faces historic resistance and, for the moment, is not a topic for discussion. For its part, the argument that is frequently used in favor of the second round is that it confers greater legitimacy to the winning candidate. However, if a country has trustworthy electoral rules and a solid institutional framework that guarantees the transparency of the voting process, the legitimacy of the winner is self-evident. The experience of some South American countries (Ecuador, Peru) with the second round election has not spared them from political crises. When all is said and done, strengthening democracy in Mexico and Latin America depends on the quality of institutions, the maturity of the citizenry and a vigorous civic culture. Elections are the axis of a democratic system. However, active participation in the political process, the open discussion of proposals and programs, the protection of basic liberties and rights, respect for the Law, the acceptance of dissent and transparency in the conduct of public affairs are elements that also contribute to the good functioning of a democracy and that to a greater or lesser degree are present in Mexico, or are at least in the process of consolidation.

1 Pérez-Liñán, Aníbal: "*The reversion of the result in the second round election. An institutional assessment of the voting.*" Paper presented at the First Latin American Congress of Political Science, University of Salamanca, 2002.

United States Indicators and Forecasts

	IV'04	I'05	II'05	III'05	IV'05	I'06	II'06	III'06	2004	2005	2006
Economic Activity											
GDP (real annual % change)	3.8	3.6	3.6	3.6	**3.4**	**3.2**	**3.1**	**2.5**	4.2	**3.6**	**2.8**
Personal consumption expenditures	3.8	3.5	3.9	3.8	**3.3**	**3.1**	**2.6**	**1.7**	3.9	**3.6**	**2.4**
Gross fixed investment	9.4	9.4	8.0	7.9	**7.0**	**6.1**	**4.4**	**3.8**	9.7	**8.1**	**4.3**
Non-residential	10.9	10.3	9.2	8.3	**8.0**	**8.2**	**7.5**	**7.3**	9.4	**8.9**	**7.3**
Structures	2.8	3.1	1.7	1.9	**1.3**	**2.0**	**0.4**	**0.6**	2.2	**2.0**	**0.8**
Equipment and software	13.8	12.8	11.8	10.6	**8.5**	**8.3**	**7.7**	**7.2**	11.9	**10.8**	**7.7**
Residential	6.6	7.7	6.1	7.2	**5.9**	**2.6**	**-1.0**	**-2.7**	10.3	**6.7**	**-1.2**
Total exports	6.1	6.7	7.7	6.9	**7.2**	**6.1**	**5.4**	**5.6**	8.4	**7.1**	**5.5**
Total imports	10.6	9.4	5.7	5.1	**4.2**	**3.4**	**3.3**	**2.9**	10.7	**6.1**	**3.0**
Government consumption	2.1	1.7	1.8	2.0	**1.5**	**2.2**	**2.2**	**2.2**	2.2	**1.7**	**2.2**
Contribution to Growth (pp)											
Personal consumption expenditures	2.7	2.5	2.7	2.7	**2.4**	**2.2**	**1.9**	**1.2**	2.7	**2.6**	**1.7**
Private investment	1.7	1.6	0.7	0.7	**0.8**	**0.6**	**0.8**	**0.8**	1.9	**1.0**	**0.7**
Net exports	-1.0	-0.8	-0.1	-0.1	**0.1**	**0.1**	**0.0**	**0.1**	-0.8	**-0.2**	**0.1**
Government consumption	0.4	0.3	0.3	0.4	**0.3**	**0.4**	**0.4**	**0.4**	0.4	**0.3**	**0.4**
Prices and Costs (annual % change, average)											
CPI	3.4	3.0	2.9	3.8	3.7	**3.5**	**3.1**	**2.4**	2.7	3.4	**2.8**
Core	2.1	2.3	2.2	2.1	2.1	**2.2**	**2.5**	**2.7**	1.8	2.2	**2.5**
PCE	3.1	2.7	2.5	3.1	**2.9**	**2.8**	**2.5**	**1.9**	2.6	**2.8**	**2.3**
Core	2.2	2.2	2.0	1.9	**1.8**	**1.9**	**2.1**	**2.3**	2.0	**2.0**	**2.2**
GDP deflator	2.9	2.8	2.5	2.9	**3.1**	**3.0**	**2.8**	**2.6**	2.6	**2.8**	**2.7**
Productivity	2.6	2.8	2.3	3.1	**2.4**	**2.4**	**2.4**	**2.2**	3.4	**2.7**	**2.3**
Real compensation per hour	2.4	3.2	2.6	1.2	**1.7**	**1.7**	**1.7**	**1.6**	1.8	**2.2**	**1.6**
Unit labor cost	3.3	3.4	3.2	1.8	**3.2**	**1.8**	**1.4**	**0.5**	1.1	**2.9**	**1.5**
Other Indicators											
Industrial production (real annual % change)	4.3	3.9	3.0	2.8	2.7	**2.6**	**2.9**	**3.1**	4.1	3.1	**3.0**
Capacity utilization (%)	79.4	79.9	79.9	79.9	80.3	**80.7**	**81.3**	**79.9**	78.6	80.0	**80.3**
Light weight vehicle sales (millions, annualized)	17.3	16.4	17.2	18.0	15.9	**15.8**	**15.9**	**15.8**	16.9	16.9	**15.8**
Housing starts (thousands, annualized)	1,973	2,083	2,044	2,101	2,035	**1,896**	**1,902**	**1,930**	1,950	2,066	**1,921**
Nonfarm payrolls (thousands of new jobs, average)	190	182	198	147	146	**124**	**157**	**170**	183	168	**144**
Unemployment rate (average, %)	5.4	5.2	5.1	5.0	4.9	**5.1**	**5.2**	**5.2**	5.5	5.1	**5.2**
Personal savings rate	2.3	0.5	-0.2	-1.5	**-0.5**	**-0.5**	**-0.1**	**0.9**	1.7	**-0.4**	**0.2**
Trade balance (US$ billions)	-188	-199	-198	-196	**-192**	**-199**	**-194**	**-192**	-617	**-712**	**-711**
Current account balance (US$ billions)	-753	-795	-791	-783	**-767**	**-798**	**-775**	**-767**	-666	**-784**	**-769**
% of GDP	-6.3	-6.5	-6.4	-6.2	**-6.0**	**-6.2**	**-5.9**	**-5.8**	-5.7	**-6.3**	**-5.8**
Fiscal balance (US$ billions, fiscal year)	—	—	—	—	—	—	—	—	-412	-331	**-415**
% of GDP	—	—	—	—	—	—	—	—	-3.6	-2.6	**-3.1**
Brent (dollars per barrel, average)	48.5	52.9	53.9	65.5	61.1	**57.7**	**55.0**	**52.4**	41.9	58.3	**53.8**
Financial Markets (eop)											
Fed Funds (%)	2.25	2.75	3.25	3.75	4.25	**4.75**	**4.75**	**4.75**	2.25	4.25	**4.75**
3-month Libor (%)	2.56	3.12	3.52	4.07	4.54	**5.12**	**5.12**	**5.12**	2.56	4.54	**5.12**
10-year Treasury Note (%)	4.22	4.48	3.91	4.32	4.39	**4.85**	**4.90**	**4.90**	4.22	4.39	**4.90**
Dollar/euro	1.36	1.30	1.21	1.20	1.18	**1.20**	**1.20**	**1.22**	1.36	1.18	**1.22**

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

Mexico Indicators and Forecasts

	2002	2003	2004	2005	2006	I'05	II'05	III'05	IV'05	I'06	II'06	III'06	IV'06
Economic Activity													
GDP (seasonally-adjusted series)													
Real annual % change	0.8	1.4	4.4	**3.0**	**3.2**	3.6	2.0	3.3	**3.1**	**3.6**	**4.5**	**2.7**	**2.0**
Per inhabitant (US dollars)*	6,431	6,235	6,453	**7,047**	**7,184**	6,836	6,945	7,191	**7,218**	**7,258**	**7,141**	**7,086**	**7,250**
US$ billions	649	639	676	**755**	**798**	707	750	748	**816**	**797**	**809**	**765**	**819**
Inflation (eop, %)													
Headline	5.7	4.0	5.2	3.3	**3.6**	4.4	4.3	3.5	3.3	**3.7**	**3.9**	**3.8**	**3.6**
Core	3.8	3.7	3.8	3.1	**3.2**	3.6	3.4	3.2	3.1	**3.1**	**3.2**	**3.3**	**3.2**
Financial Markets													
Interest rates (eop, %)													
Bank funding	—	6.1	8.8	8.3	**7.0**	9.5	9.8	9.3	8.3	**7.8**	**7.5**	**7.3**	**7.0**
28-day Cetes	7.0	6.0	8.6	8.0	**7.1**	9.6	9.6	9.0	8.0	**7.8**	**7.6**	**7.3**	**7.1**
28-day TIIE	8.5	6.3	9.0	8.6	**7.4**	9.9	10.0	9.5	8.6	**8.0**	**7.8**	**7.5**	**7.4**
10-year Bond	10.1	8.3	9.7	8.5	**7.9**	10.5	9.6	8.5	8.5	**8.3**	**8.2**	**8.3**	**7.9**
Exchange rate													
Pesos per dollar, eop	10.3	11.2	11.3	10.7	**11.3**	11.3	10.8	10.8	10.7	**10.8**	**11.1**	**11.2**	**11.3**
Public Finances													
Fiscal balance (% of GDP)	-1.2	-0.6	-0.3	**-0.1**	**0.0**	nd	nd	nd	**-0.1**	**nd**	**nd**	**nd**	**0.0**
FRPS (% GDP)	3.3	3.1	2.7	**2.1**	**1.5**	nd	nd	nd	**2.1**	**nd**	**nd**	**nd**	**1.5**
External Sector**													
Trade balance (US$ billions)	-7.6	-5.8	-8.8	**-9.3**	**-10.7**	-10.2	-9.7	-9.5	**-9.3**	**-8.0**	**-8.1**	**-9.2**	**-10.7**
Current account (US$ billions)	-13.5	-8.6	-7.3	**-8.4**	**-10.1**	-9.0	-8.7	-9.8	**-8.4**	**-7.6**	**-9.5**	**-9.6**	**-10.1**
Current account (% of GDP)	-2.1	-1.3	-1.1	**-1.1**	**-1.3**	-1.3	-1.2	-1.3	**-1.1**	**-1.0**	**-1.2**	**-1.2**	**-1.3**
Oil (Mexican mix, dpb, eop)	24.7	25.0	32.4	48.5	**38.8**	33.7	40.1	50.7	48.5	**43.7**	**42.6**	**40.7**	**38.8**
Monetary Agreggates & Banking Activity (ann. % chge.)													
Core bank deposits	-5.5	7.5	6.3	**6.9**	**4.8**	3.1	2.3	6.4	**6.9**	**6.8**	**3.7**	**4.1**	**4.8**
Commer. banks performing loans***	8.5	8.6	26.1	**25.6**	**21.4**	29.6	30.0	30.4	**25.6**	**25.9**	**25.4**	**23.4**	**21.4**
Agreggate Demand (ann. % chge., seasonally-adjusted)													
Total	1.0	1.2	5.9	**4.4**	**4.5**	5.4	3.4	4.8	**4.2**	**4.5**	**5.4**	**4.3**	**3.6**
Domestic demand	0.9	1.8	5.3	**5.2**	**4.5**	5.9	4.2	5.7	**5.0**	**5.0**	**4.8**	**4.2**	**4.0**
Consumption	1.3	2.1	4.7	**4.7**	**4.1**	5.8	3.1	5.4	**4.7**	**4.2**	**4.2**	**4.0**	**3.9**
Private	1.5	2.3	5.5	**5.3**	**4.3**	6.5	3.5	6.1	**5.1**	**4.5**	**4.4**	**4.3**	**4.2**
Public	-0.1	1.0	-1.2	**0.1**	**1.9**	-0.2	-0.5	-0.3	**1.3**	**2.1**	**2.8**	**1.3**	**1.3**
Investment	-0.7	0.4	7.5	**7.1**	**6.0**	6.5	8.8	7.0	**6.3**	**8.2**	**6.9**	**5.0**	**4.2**
Private	-4.0	-1.2	7.5	**6.8**	**5.6**	8.3	7.6	6.4	**7.4**	**7.3**	**6.2**	**4.8**	**4.3**
Public	13.7	9.4	3.5	**10.4**	**7.7**	15.1	13.1	9.5	**9.0**	**11.5**	**9.5**	**5.8**	**4.1**
External demand	1.5	2.8	11.5	**5.8**	**6.8**	7.2	3.9	5.0	**7.1**	**9.4**	**7.3**	**6.2**	**4.4**
Imports	1.4	0.7	10.2	**8.1**	**7.6**	9.9	7.2	8.5	**6.8**	**6.8**	**7.7**	**8.3**	**7.5**
GDP by sectors (annual % change)													
Agriculture	0.1	3.5	4.0	**-0.4**	**1.1**	-0.1	-3.1	5.6	**2.4**	**3.4**	**6.5**	**-0.9**	**-6.9**
Industrial	-0.1	-0.2	3.8	**1.5**	**3.3**	1.4	0.8	1.2	**1.6**	**3.3**	**4.7**	**3.0**	**2.5**
Mining	0.4	3.7	2.5	**1.4**	**2.1**	-0.3	1.6	1.8	**1.7**	**2.0**	**2.2**	**1.9**	**3.4**
Manufactures	-0.7	-1.3	3.8	**1.3**	**3.4**	1.3	0.4	1.1	**1.4**	**3.5**	**5.0**	**3.0**	**2.6**
Construction	2.1	3.3	5.3	**3.0**	**3.5**	2.9	2.7	1.7	**3.2**	**3.1**	**5.3**	**3.2**	**2.2**
Electricity, gas and water	1.0	1.6	2.3	**0.5**	**2.0**	-2.0	2.7	1.9	**1.6**	**2.9**	**0.3**	**2.6**	**2.5**
Services	1.6	2.1	4.8	**4.1**	**3.8**	4.9	3.4	4.3	**3.6**	**3.8**	**4.7**	**3.4**	**3.4**
Retail, restaurants and hotels	0.0	1.6	4.9	**3.3**	**3.3**	4.9	2.3	3.2	**2.5**	**3.2**	**4.7**	**2.7**	**3.5**
Transportation and communications	1.8	5.0	9.7	**6.7**	**6.6**	8.3	6.6	6.6	**5.6**	**6.3**	**7.6**	**6.7**	**6.3**
Financial, insurance and real-estate	4.2	3.9	4.6	**5.7**	**5.2**	5.4	5.2	6.2	**5.8**	**5.5**	**5.8**	**4.7**	**4.8**
Community and personal	0.9	-0.6	1.7	**1.7**	**1.0**	1.7	1.3	2.1	**1.7**	**1.5**	**1.3**	**0.4**	**0.3**

eop end of period
dpb dollars per barrel
* Seasonally-adjusted series for quarterly data
** Accummulated, last 12 months
*** To the private sector
FRPS Financial Requirements of the Public Sector, % of GDP
na not available
Note: **Bold** figures are forecast

Economic Research Department Presentations

Title	Institution - Client	Place and date
Bogota www.bbva.com.co		
Perspectivas Económicas 2005 - 2006	Fogafín	Bogota, October 2005
Coyuntura y Perspectivas Macro	Fitch	Bogota, October 2005
Entorno Macroeconómico	Real-estate clients	Bogota, November 2005
Coyuntura Macroeconómica y Financiera	Treasury & Investment Banking clients	Bogota, December 2005
Panorama Económico Colombiano	Investor Relations	Bogota, December 2005
Perspectivas Económicas 2006	Corfivalle & Communication Media Forum	Bogota, December 2005
Buenos Aires www.bancofrances.com.ar		
Tipo de Cambio Real en Argentina	Natnl. Institute of Agric. Technology Seminar	Buenos Aires, November 2005
Panorama Macroeconómico de Argentina 2005-2006	CTI Argentina	Buenos Aires, December 2005
Panorama Macroeconómico de Argentina	Institute of Investment Funds clients	Buenos Aires, December 2005
Caracas www.provincial.com		
Perspectivas Mercado Petrolero	Venezuela-Spain Chamber of Ind. & Commerce	Caracas, October 2005
Perspectivas Macro 2005-2007 y su impacto en el Estado Zulia	Reunion with clients	Maracaibo, October 2005
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Persp. Eco. 2005-2006 y su Impacto en la Región Centro-Occidental	Reunion with clients	Barquisimeto, November 2005
Lima www.bbvabancocontinental.com		
Situación Económica	PRAXAIR	Lima, November 2005
Perú: Escenario Económico	Cajamarquilla, BBVA, CAFAE, Edelnor	Lima, December 2005
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Financial Markets in Emerging Countries: Does Politics Matter?	IIF	Frankfurt, October 2005
¿Una Nueva Agenda o un Nuevo Paradigma para el Desarrollo?	Cumbre Iberoamericana	Salamanca, October 2005
Economic Outlook for Latin America	BBVA clients	New York, October 2005
Entorno Económico Mundial	Venezuelan Congress of Financial Executives	Caracas, October 2005
FDI: Competing Destinations (LAC, Asia, Eastern Europe)	Banco de España	Madrid, October 2005
Perspectivas Económicas entre China y América Latina	BBVA clients	Santiago de Chile, Nov. 2005
Sector Eléctrico Español: Balance Regulatorio	Congreso Iberoamericano de Regulación Eco.	Santiago de Chile, Nov. 2005
Mexico www.bancomer.com		
Escenario Económico y Financiero de México	Corporate & Government clients	Mexico City, Oct.-Dec. 2005
Escenario Político	Foreign Institutional Investors	Mexico City, Oct.-Dec. 2005
Escenario Económico y Financiero de México: 2005-2008	Business Areas Planning Journals	Mexico City, October 2005
La Economía Mexicana ante el Proceso Electoral 2006	Corporate and Private Banking	N.L./S.L.P./Jalisco, Oct. 2005
Ante el Reto de Elevar el Crecimiento de la Economía	Regional Council Presidents	Mexico City, October 2005
Mercado Hipotecario en México	IMEF University Forum	Puebla, October 2005
Potencial de la Vivienda en México	Private Banking clients	Mexico City, November 2005
México y sus Indicadores	National Defense School	Mexico City, November 2005
BBVA USA www.bancomer.com		
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Entorno Macroeconómico de Estados Unidos	Treasury Committee	Mexico City, October 2005
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For further information please contact:

Economic Research Department | Av. Universidad 1200 | Col. Xoco | 03339 México D.F. | Tel. (52) (55) 5621 5994 | Fax (52) (55) 5621 3297 | www.bancomer.com

Economic Research Department BBVA Group

Chief Economist
José Luis Escrivá

Deputy Chief Economist
David Taguas

Unit Heads
North America: Jorge Sicilia
Mexico: Adolfo Albo
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Sector Analysis: Carmen Hernansanz

Financial Scenarios: Mayte Ledo
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North America Economic Research Dept.

Jorge Sicilia j.sicilia@bbva.bancomer.com

Adolfo Albo a.albo@bbva.bancomer.com
David Aylett david.aylett@bbva.bancomer.com
Fernando González f.gonzalez8@bbva.bancomer.com
Octavio Gutiérrez o.gutierrez3@bbva.bancomer.com
Ociel Hernández o.hernandez@bbva.bancomer.com
Carlos Herrera carlos.herrera@bbva.bancomer.com
Alma Martínez alma.martinez@bbva.bancomer.com
Eduardo Millán e.millan@bbva.bancomer.com
Javier Morales francisco.morales@bbva.bancomer.com
Eduardo Torres e.torres@bbva.bancomer.com

Nathaniel Karp n.karp@bbva.bancomer.com
Javier Amador j.amador@bbva.bancomer.com
Marcial Nava jm.nava@bbva.bancomer.com

Fernando Tamayo fernando.tamayo@bbva.bancomer.com
Elisa Sánchez elisa.sanchez@bbva.bancomer.com

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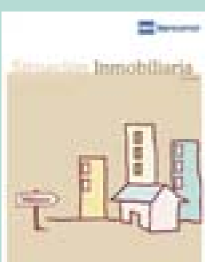


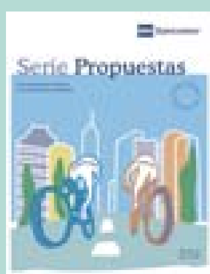



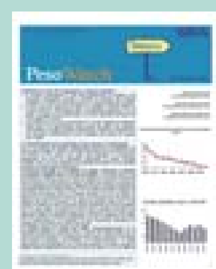



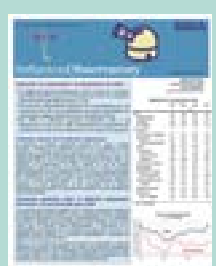


Situación:

- Argentina
- Chile
- Colombia
- Peru
- Spain
- Venezuela