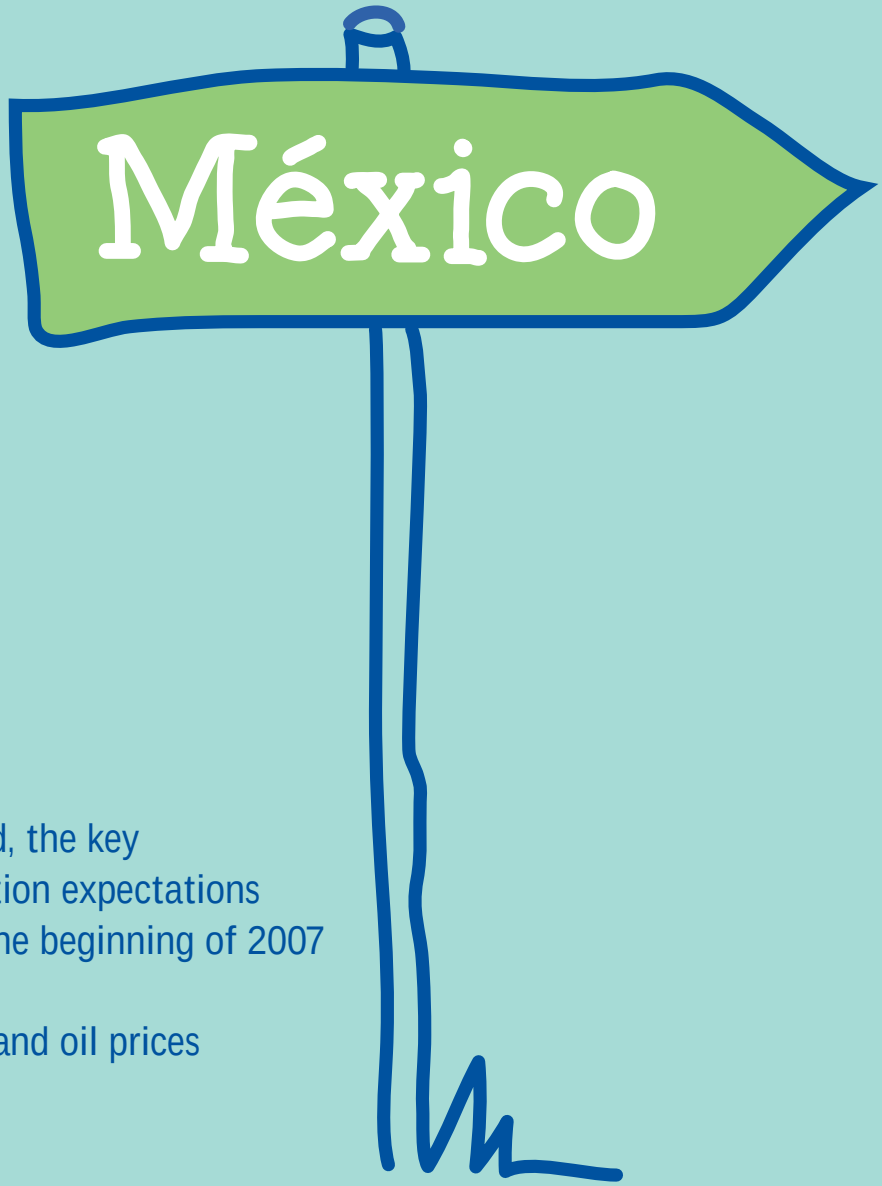
BBVA Bancomer

Situación

Economic Research Department

Fourth Quarter 2006



Soft slowdown; domestic demand, the key
Banxico: more credibility in inflation expectations
Monetary "pause" at least until the beginning of 2007
The peso will remain strong
The risks: sudden U.S. slowdown and oil prices

Mexico: Editorial

The year 2006 had been favorable for the Mexican economy. The two elements of uncertainty that were present in the first half of the year have dissipated. Externally, the slowdown in the U.S. economy will be less pronounced than some analysts had anticipated, while internally, the electoral process, despite the close results and ultimate resolution through the courts, has begun to open (albeit slowly) spaces for reconciliation and political agreements.

Growth expectations for 2006 have been increasing throughout the year. While at the beginning of the year, they were in a range close to 3.5%, now they are above 4.5%, the highest growth rate since 2000. Alongside the reactivation of the economy, employment has also posted renewed growth, with a projected million jobs created, a figure not seen in more than a decade. Key to these results has been the recovery of the auto industry. Of particular importance is this industry's capacity to adapt to changes in consumer preferences and to the strong global competition. We report on this performance in an article that emphasizes that to achieve these results, a process of investment maturity has been necessary. In terms of inflation, what has been most noteworthy is the progress made in anchoring expectations, which seem to react less strongly than in the past to transitory conditions and short-term volatility, intrinsic to the NCPI. In its task of assuring price stability and inflation control, Banco de México has managed to move forward on the level of communication and the implementation of monetary policy, achieving greater effectiveness.

On the financial level, although volatility was pronounced toward the middle of the year, it was also a passing phenomenon. The financial markets maintain, in general, symptoms of strength that could continue over the next few months. Meanwhile, the peso has registered a nominal appreciation of 0.5% in the first nine months of the year compared to the same period in 2005, within an environment marked by a lower risk aversion toward emerging markets. Something similar is occurring on the long part of the curve and in the country risk indicators. In this favorable context, of particular importance was the placement of a 30-year government bond. In just seven years it was possible to expand the government bond yield curve from one to 30 years, and indeed, few countries can boast of such rapid process, in the final analysis, reflected in stability.

The risks approaching 2007 continue to be present and are still centered on external conditions, namely a downturn in the U.S. economy that is stronger than anticipated and that, on the one hand, reduces capital flows toward emerging markets, and on the other, could cause a drastic fall in the prices of raw materials, such as oil. This could put the synchronization and linkage between the production cycles of the two economies to the test. In the experience of the past few years, in an economic decline, the response in Mexico has been faster than in the United States, and slower in its recovery. From this flows the importance of strengthening internal demand, which cushions these impacts and that on a more structural level, allows progress to be made on the pending issues, on the need to boost potential growth. A new presidential administration, a new congress, and a civil society more aware of the challenge could point, this time, toward the road in which there are no shortcuts, toward productivity as a mechanism to increase per capita income and reduce poverty levels.

Contents

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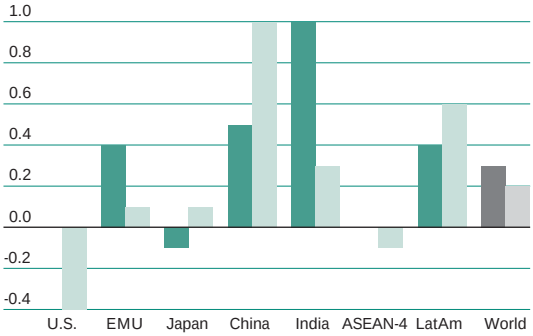
IMF Revision of Growth Projection for April to September 2006

Percentage points



Source: BBVA with IMF data

Economic expansion continues and diversifies geographically

The world economy continues to expand at a rate that has remained at about 5%. Also, and in contrast with other cycles, current growth is supported by an increasingly more extensive geographic base. Together with the strength shown by the recovery in Europe, the division of the main emerging markets continues to surprise favorably, which is leading to positive reviews of expected growth for the end of 2006. BBVA has modified its projections upward for the second half of the year, for China, the European area and Latin America by 1.4, 0.5 and 0.3 points, respectively. The only exception is the United States, for which we have maintained our GDP growth estimate at 3.3%. In general, as also shown by the IMF forecasts (see the attached graph), growth worldwide in the coming quarters is visualized as more solid than was expected at the beginning of 2006.

With this broad geographic base backing global growth, we find ourselves facing the most expansive phase worldwide since the decade of the seventies. Factors such as technological development and globalization of the world economy, the markets and the financial systems favor the current environment. In this cycle, inflationary risks have been delimited, despite the fact that the rise in the price of raw materials has co-existed with extraordinarily low interest rates. For these reasons, if we were to place on a scale both the apparent reversion of an inflationary rallying trend and the shift in the OECD monetary policy from expansive to neutral interest rates, the risk of inflation rises would be maintained relatively under control.

However, to continue on the global growth path would depend, to a large extent, on whether growth in the more dynamic regions would be relatively immune to the moderate slowdown that is already evident in the U.S. In fact, and as we specify below, it is in this country where we observe the most uncertainty during the coming months.

Uncertainties in the world economy are changing ...

One of the most significant events since the end of the third quarter has been the generalized price drop in raw materials, which, among others, has affected gas, copper, aluminum, zinc, nickel and oil. If we concentrate on this last good, we will be able to appreciate the important changes that have taken place in some of the factors that in recent months have led to their revaluation.

On the one hand, the relatively benign hurricane season in the Gulf of Mexico has eliminated the possibility of risks in the supply of oil in that zone, as opposed to what happened in 2005. On the other, lower geopolitical risks have given oil prices a breather, which is particularly important both for the diplomatic progress in Middle East tensions and because we suppose that the recent events in North Korea will not have an impact on the market. In September, Israel ended its troop withdrawal from Lebanon, in observance of the main UN resolution aimed at resolving the conflict. Another political risk that

BBVA: Oil Scenarios

Brent, dollars per barrel

Source: BBVA

has had a bearing on the expectations of oil prices is that the dispute being faced by the U.S. and Iran with respect to nuclear energy also seems to be easing, although the Korean nuclear test could make the negotiations become more expensive.

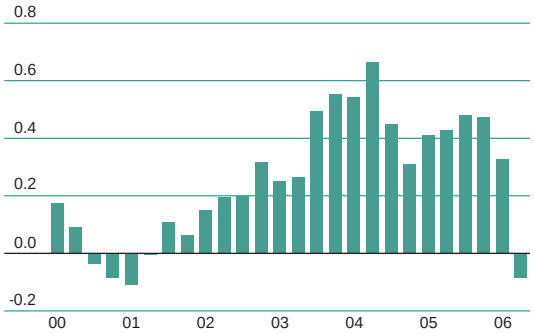
In this case, even though we are far from an arbitrated solution such as the one that brought to an end the confrontation between Lebanon and Israel, it seems that Washington is increasingly tending toward rejecting a military solution to the conflict. With oil prices at about US$60, the risk for the global economy derived from a price shock is, today, considerably lower than a few months ago. Therefore, there is a greater probability for the base scenario that would imply an average price of almost 65.5 dollars per barrel (dpb) in 2006 and 58.2 dpb for the Brent in 2007, equivalent to 56.2 dpb and 51.9 dpb for the Mexican mix. This performance would find backing in a scenario of lower strength in world growth. In brief, our base scenario considers oil price stability close to the levels reached at the end of September.

This scenario does not imply the absence of risks for the world economy, since other factors of uncertainty have acquired a predominant role recently. Among these, the adjustment of the real estate sector in the U.S. is undoubtedly the most important. The base scenario presumes that the U.S. economy will slowly moderate its growth rate. Thereby, housing investment will have a negative contribution for the first time since 1995 and consumption will moderate slowly, at the same time that it has less support derived from earnings in income and wealth, which has represented the price rise in housing in recent years, all of which should lead to a slight moderation in the ratio of consumption to GDP.

However, the U.S. economy could continue to grow very close to its potential level, reaching a rate of about 2.8% in 2007. On the one hand, the expansion in the rest of the world and the accumulated dollar depreciation are allowing net exports to make a positive contribution to growth for the first time since 1995. On the other, non-housing growth is maintaining a positive tone, supported by high business earnings, high liquidity levels and low interest payments in an environment where the global financing conditions continue to be quite favorable.

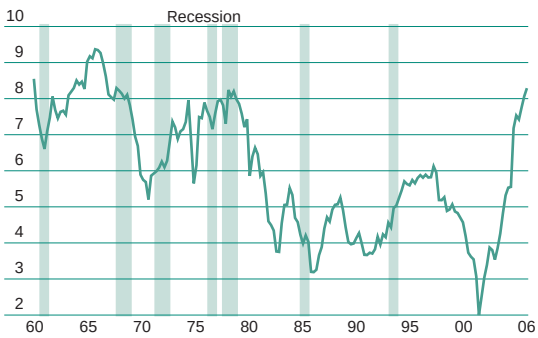
The most probable response from the monetary authorities to this economic situation will be maintaining the official interest rates at the current 5.25% levels for a prolonged period. There are several reasons for this. In the first place, inflation will moderate, although it will continue to be close to the high end of the range desired by the Federal Reserve. In the second place, moderation in activity will be limited—the economy has the internal and external support with which to face a slowdown in housing investment—and to the extent that it is moderate, it will be viewed by the Federal Reserve as favorable to containing inflation and perhaps to increasing the private savings rate and reducing the foreign imbalance. In the third place, following a period of notable liquidity in the whole world, generated by a very lax monetary policy in recent years, the central banks will be very cautious when reducing their official interest rates.

United States: Contribution of Housing Investment to GDP
Percentage points



Source: BBVA with National Statistics data

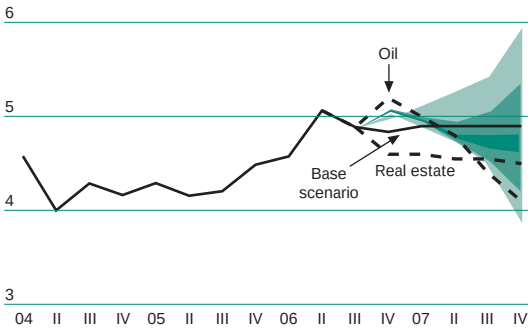
Business Benefits
% of GDP



Source: BBVA with National Statistics data

U.S.: 10-year Interest Rates

%



Source: BBVA

Monetary conditions in the U.S. are not in a restrictive zone and consumers' and businessmen's expectations seem to be relatively anchored. Within this context, long-term interest rates have a limited run, with a margin for increase of up to 5% for the 10-year bond. In this scenario, we believe that this figure is one of reference in view of the current market expectation of a reduction in interest rates in 2007. In turn, capital flows continue to show notable strength and buyers' interest for U.S. assets has reactivated, both by the central banks and private agents, which also limits the rise in the long-term interest rates.

... but the probability of this remains contained

The risk scenario being faced by the Federal Reserve corresponds to a greater adjustment in housing investment and private consumption, which would lead to a slowdown in growth to levels of between 1% and 1.5% in the coming two years. In any case, the probability of this scenario is limited. Recent adjustment experiences of the housing sector in countries such as the United Kingdom or Australia are showing that the impact on the overall economy is not high, as the structural reduction in interest rates justifies, to a large extent, that housing price levels are high and that they do not undergo prolonged adjustments. Now, if this scenario materializes, the Federal Reserve could "purchase an insurance policy" in face of low growth, reducing their official interest rates to 4.5% in 2007, which would take the 10-year rates to levels close to 4.3%.

In addition to circumstances that could limit the effects of the real estate adjustment on the rest of the U.S. economy, there are also doubts regarding their significance for the world economy. The current globalization process in some cases has led to a redirection of the trade flows. In Asia's case, a trend is evident toward more endogenous growth, intensifying the intra-regional trade links and to the detriment of the peso with regard to the U.S. in terms of Asian exports. On the other hand, the macroeconomic situation of the emerging markets is very satisfactory in general, with several countries in a surplus situation in their current accounts and accumulation of reserves that lead to a macroeconomic position much less vulnerable than the characteristic one of financial crises of the past decade.

Europe, for its part, would achieve growth of 2.5% in 2006, higher that the expectations that existed with respect to this area. The recovery of internal demand should be underscored, backed by a good business situation and the recovery of business and consumer confidence. Within this context, official interest rates would reach 4% in this region towards mid-2007, while the euro would maintain its relative strength against the dollar, at figures close to the current ones, that is, close to 1.30.

Central Scenario:
GDP Growth by Region

%

	2005	2006	2007p
United States	3.5	3.3	2.8
EMU	1.4	2.5	2.2
China	9.9	10.0	9.5
Latin America	4.4	4.7	4.0
World	**4.9**	**4.9**	**4.6**

p projection
Source: BBVA

The Weight of Fundamentals in the Oil Market

Analysts' appreciation of the reality of the oil market tends to be dichotomic. There is always a group who thinks that the price of oil will reach levels higher than 100 dollars a barrel, and others, among them our analysts, who defend the idea that the equilibrium market price will be below 50 dollars.

The "Malthusian" focus

The first of these views (the most popular) is based on the structural imbalance in supply and demand. The economies with the highest demand for oil are the emerging markets, led by China. This has been the cause of a true structural change in the energy market, since in the past 20 years it has quadrupled its consumption of oil, tripled that of natural gas, and quintupled demand for electricity. China, together with other emerging markets such as India, has accounted for more than half of the growth in world demand for oil in recent years.

On the supply side of the equation, there is considerable pessimism. The following question seems legitimate: how long can a nonrenewable resource such as oil last? The obvious answer is that sooner or later supplies of oil will run out. This well-founded view is accompanied by other short-term evidence. Many analysts affirm that since 1980, no new important oil fields have been discovered, giving rise to the suspicion that there is not much more to discover. That is, the maximum level of production has been reached and net output will begin to decline, with the greater growth in demand over supply being structural. The obvious result of this scenario is, of course, an explosive wave of price increases. This also implies a "Malthusian" view of the oil market.

A more optimistic approach

The second opinion recognizes a good part of the arguments advanced by the first viewpoint, but with extenuating factors, both on the demand as well as the supply side, similar to those contained in "An essay on the principle of population" by Thomas Malthus (1798).

On the demand side, the elasticity of oil consumption to GDP is greater in the developed countries given the high current price levels in response to technological advances that allow for saving energy. In terms of the emerging markets, they are beginning to absorb part of the price increases with gains in efficiency, as can be seen in economies such as China and India.

On the supply side, it is not completely true that no new oil reserves and production have entered the market since 1980. The fall in prices since that year up until the latest cycle of increases, with the exception of periods of geopolitical conflict, was a factor that inhibited exploration and launching production in more complex oil fields.

Projects previously were valued at prices below 18 dollars a barrel, with only 20% of potential new reserves being economically exploitable. However, these projects are currently valued at 40 dollars, with almost the entirety of projects that were not previously considered feasible now activated. We are beginning to see the concrete result with Canada's launching of operations involving an important oil deposit on the coast of Alberta, which signified a 14% increase in the world's proven reserves, similar to what occurred at one point in the North Sea.

A similar situation can be observed in the Caspian Sea, the Orinoco Oil Belt in Venezuela, and the previously mentioned North Sea, without considering the "marginal" reserves of the rest of the OPEC countries. The apocalyptic vision that the end of oil is near is far from incorporating these elements, both on the demand as well as the supply side of the equation. The idea of a convergence of prices to an equilibrium level below 50 dollars incorporates these elements, and the short-term de-alignment with regard to this price is based on geopolitical risk factors and the expectations corresponding to the predominance of the first of the above-mentioned views.

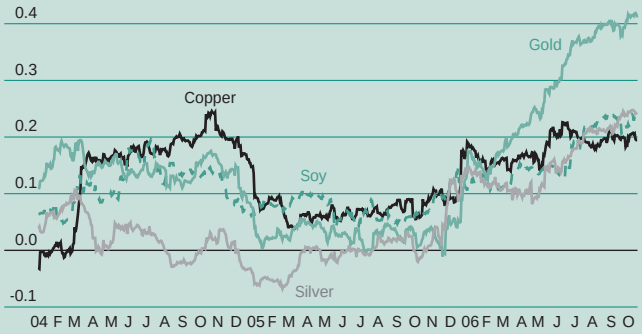
Interpreting the market...

What has occurred in the past three months is a reflection of the second viewpoint. The downward adjustment in prices has exceeded 25%, as a result of a) reduced expectations of adverse supply shocks following the end of a benevolent hurricane season, in line with estimates at the close of the first quarter, b) the possible opening of negotiations with Iran, c) the conclusion of the conflict in Lebanon and, finally, d) potential lower "speculative" investment following what occurred with the strong losses in the Amaranth hedge fund in the gas market, a development that shifted attention away from investments in this type of raw material during the past month. It should be added that North Korea's recent nuclear test is not expected to have a significant impact on the market, although it could make the negotiation with Iran somewhat more expensive.

Some analysts affirm that the recent movement in oil prices is based more on a greater weakness of the global economy, whose scope has still not been fully felt, mainly because the changes in price are synchronized with those of the rest of the raw materials. Even though, in fact, there is a perception of lower dynamism, it is, from our point of view, modest, with the projected growth of the U.S. economy near its potential level in 2007.

The performance of the past quarter could be indicating that the speculative component in the raw materials market is more important than expected. In fact, about 60 billion dollars have been channeled toward these markets. The volume of these speculative investments has a clear effect in that it generates an additional and fictitious demand for raw materials that upwardly pressures futures prices.

12-month Correlation of Daily Changes Between Oil Prices and Other Raw Materials



Source: BBVA

This element could be a key factor that explains the combined movement of raw material prices in this cycle and explains, for example, why copper is at more than double its equilibrium price, divorced from its fundamentals. In addition to Chinese demand, the speculative component is playing a key role. One hypothesis could be that raw material prices as a whole are following the behavior of oil even though they are in dissimilar markets, with part of this relationship indeed attributable to speculative investments.

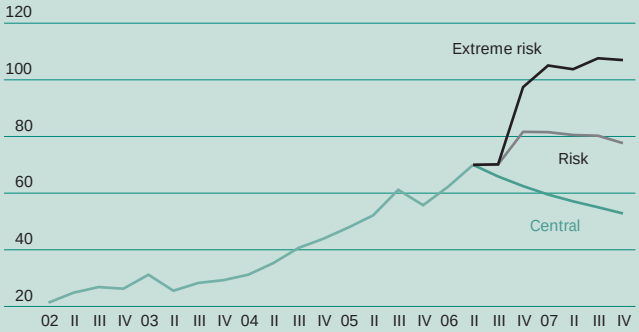
Output Cut in the OPEC quota

OPEC, which currently produces almost 1.5 million barrels daily above its quota, has announced a possible cut in output of 1 million bpd, with the aim of halting the fall in prices registered in the past few weeks. The perception of excess supply in the market is reflected in the behavior of U.S. inventories, which are above their maximum level of the past five years, even if adjusted by demand.

The countries that most promoted these cuts within the OPEC are those whose output is below the current quota, and therefore a reduction would not imply abandoning production, while the rest of the nations, if such cutbacks were introduced, would be sacrificing heavy crude. What remains to be seen in terms of evaluating the viability of realizing this proposal involves the behavior of the countries allied with the United States within the OPEC, given the proximity of Congressional elections in that nation.

Oil Scenarios

Brent, dollars per barrel



Source: BBVA

An additional element to be evaluated is that as of 2002, to the extent that supply improves and U.S. inventories increase, oil prices will react by rising. Up until that point, there was a clear negative and strong correlation between oil prices and reserve stocks. It should be taken into account that a key variable is price expectations associated with additional production capacity. To the extent that this capacity is greater, it is perceived that the market is better prepared to face the geopolitical risk factors resulting from an eventual reduction of a member country's production.

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How Will Mexico Face the Slowdown in the U.S.? ...

The strength in domestic demand will remain in 2006

After arousing doubts among some analysts as to whether the uncertainty regarding the electoral process would generate a momentary postponement in consumption and investment decisions of agents, the performance of the macro variables so far this year indicates that the electoral effect on economic activity was practically nil. In contrast, the first six months of this year were surprising because of their strength, leading us to expect that the slowdown in Mexico will be soft as of the second half of the year, and will bring GDP growth to 4.6% in 2006 and 3.6% in 2007, in line with the slowdown in the U.S.

The high growth in the first half of the year was due to the important contribution of both internal and external demand. Internal demand grew 7.2% in the first half of the year, the highest rate since 2002. In consumption, growth extended to durables, non-durables and services. In investment, imported machinery and equipment was significant, while the construction sector was also favorable.

Foreign demand continued to play an important role in the current cycle in its two components: oil and non-oil exports. Total exports grew 21.6% in the first half of the year (in dollar terms), while non-oil exports grew 17.9%, the highest growth rate in six years. It should be noted, however, that exports are highly concentrated: five export products (not including oil) account for almost 60% of exports; in this last year, growth in the automobile sector is particularly outstanding.

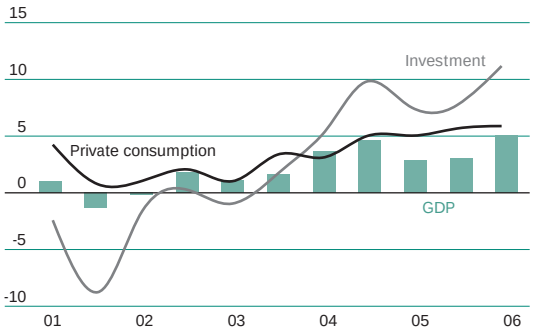
Oil exports grew at an annual rate of 44.2% in the first half of the year. It is significant that oil prices had a bearing in generating a high value of these exports: while in 2005, 1,818 barrels were exported daily (on average), in the first six months of 2006, the daily average was 1,908 barrels, almost 5% more. However, the price per barrel was 25% higher (it rose from US$43 in 2005 to US$53 in the first half of 2006).

In terms of supply, the first half of the year was characterized by the good results in the three large GDP components: industry, services and agriculture showed very similar growth (5.4%, 5.3% and 4.8%, respectively, semester vs. semester in seasonally-adjusted series), with which GDP as a whole grew 5.1% compared to the first half of 2005.

In services, the positive strength was affected by factors such as spending in the media relative to the electoral process, the expansion in telecommunication services, the recovery in consumption and investment in hotel areas of southeastern Mexico as a result of the Wilma and Stan hurricanes in October of last year. Likewise, the improvement in sectors such as manufacturing, as well as consumption and the boom in construction was reflected in more banking, leasing, and financial intermediation services.

GDP and Domestic Demand

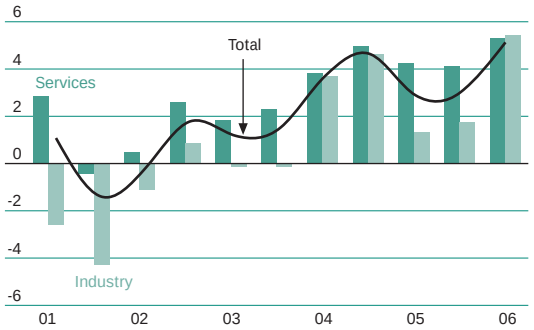
Real annual % change



Source: BBVA Bancomer with INEGI data

Gross Domestic Product

Annual % change



Source: BBVA Bancomer with INEGI data

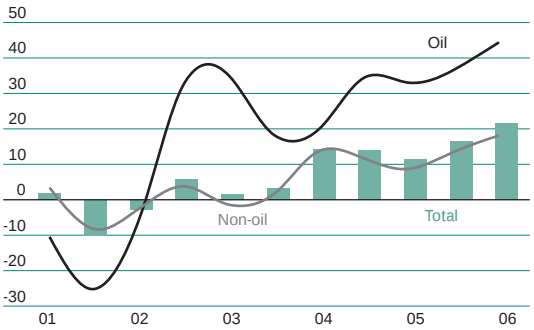
Manufacturing Industry

Annual % change, seasonally-adjusted

	1Q05	2Q05	3Q05	4Q05	1Q06	2Q06
Total	**2.7**	**0.6**	**0.6**	**2.5**	**4.3**	**6.3**
Food, bev. & tob.	5.4	2.2	2.3	0.1	1.0	3.0
Textiles and apparel	0.5	-4.1	-2.9	-2.4	-2.8	1.1
Wood industry	0.1	-1.4	-0.3	4.7	3.5	1.5
Paper & publishing	1.2	0.9	2.2	0.5	1.5	2.6
Chemical subs.	3.5	2.8	0.8	0.2	-1.1	2.1
Non-metallic min.	3.9	3.7	2.8	2.3	4.5	6.5
Basic metals	1.6	1.8	-2.5	2.2	4.4	1.3
Metal,mach.& equip.	0.5	-1.5	-0.1	7.4	**12.6**	**14.8**
Other manufactures	5.6	-3.2	-1.3	1.0	3.7	2.6

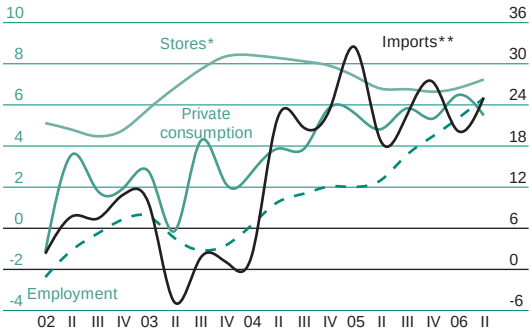
Source: BBVA Bancomer with INEGI data

Exports
Annual % change



Source: BBVA Bancomer with INEGI data

Private Consumption Indicators
Annual % change, seasonally-adjusted



* Self-service and department stores
** Imports of consumer goods
Source: BBVA Bancomer with INEGI data

IMSS-Affiliated Workers
January-August, annual change, thousands of workers

Source: BBVA Bancomer with IMSS data

Industry, despite notable recovery in the last three years, is focused on some production branches, in particular metallic products, machinery and equipment. In this branch, products linked to foreign demand were outstanding: the automobile and auto parts industry, and also some others such as machinery and electrical and electronic products, metal furniture and optical and medical devices (see "The recovery of Exports in the U.S. Market" chart). In contrast, industries such as textiles, publishing and chemicals, have shown unfavorable trends in recent quarters.

It should be considered that the favorable performance of the economy in the first part of the year was favored by non-recurrent factors such as the acceleration of production in the automobile industry, high oil prices, and the conclusion of public works at the end of the administration, as well as high revenues due to family remittances from abroad.

Outlook: 2006 is still a good year; for 2007 the key will be services

The global economy is experiencing the highest and longest-lasting growth in several decades: Europe and Asia are maintaining high expansion rates and have even raised their expectations upward, inflation at a global level is more stable, and there is less volatility on the financial markets than a decade ago.

In the midst of this relative global bonanza, the U.S. has entered a slowdown phase that unquestionably will have an effect on Mexico's economy. Today, the greatest risk that could limit growth in the following months and in 2007 is related to the magnitude of the U.S. slowdown. In the base scenario, U.S. GDP will grow this year at a 3.3% rate and at 2.8% in 2007, a half point less. Industrial production will drop, from 3.7% this year to 3.4% in 2007, 0.3 pp less. Within this context, it is important to know to what point domestic demand will be prepared to cushion the impact of lower external demand (see article on Mexico-U.S. synchronization).

As mentioned previously, the components of internal demand have stood out due to their strength in the first part of 2006. We are optimistic about the future and expect the relative strength of internal demand to continue through the remaining months of 2006.

Private consumption indicators reinforce the outlook that 2006 will continue to be a good year for consumption, with gradually lower growth rates: both imports of consumer goods and the retail sales index maintain high annual changes compared to the start of the recovery. Elements supporting the solid nature of consumption will be the inflow of remittances, consumer credit and job creation. As regards remittances, through August they have totaled over US$15.5 billion, and for the entire year, could surpass US$21 billion, with which the total amount of remittances has grown five-fold in the last ten years. Growth in consumer credit is increasing, in real terms, 45% annually. Finally, the job creation rate is particularly significant, with positive growth in recent periods: the highest job creation rate has been achieved (in terms of affiliates to the Mexican Social Security Institute, IMSS) since 1998, with more than 900,000 jobs created from August 2005 to August 2006. This trend will tend to moderate due to the seasonal effect toward the end of the year.

In the coming months and in 2007, the trend of the external sector will have repercussions on industry: its effects have already started to transmit with moderation on the manufacturing component that has had nil or slightly negative growth in recent months. The five products that account for 72% of manufacturing exports, have started to moderate their growth; (machinery and electrical material, mineral fuels, land vehicles, mechanical apparatuses, boilers and instruments and optical and medical devices). In the coming months, we will see the continuation of this moderation, to which we will have to add the statistical effect in the early quarters of 2007, derived from a larger comparative base.

In this sense, it should be noted that the strength observed in imports and exports seems to announce an imbalance that will continue into 2007, with imports slowing down at a lower rate than exports, while the contribution of net external demand will be negative and will expand.

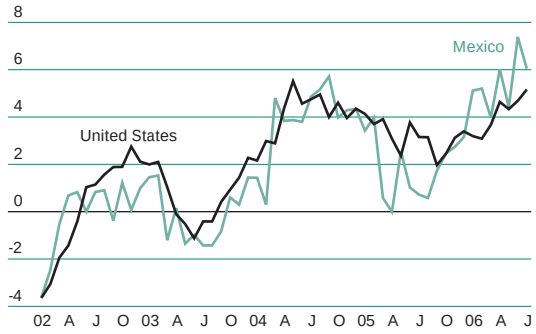
The key component in 2007 will be services, which contribute close to 70% of GDP. The moderation in industry will tend to diminish the growth in the services component. The services sector, much more stable than industry and which was the support for growth in supply in 2001 and the early months of 2002, will also restrain moderation in 2007. Historically, the relation between industry and services is narrow[1], variations in industry imply effects in services that are seen in the same period and with a lagging effect of up to four quarters. We estimate the elasticity of the services component in view of variations in industry at between 0.15 and 0.35, which is why we believe the services component will continue to expand in 2007, although at a lower rate than this year. Variables that will have to be monitored in the coming months are the job component in services (a sector that contributes close to 45% of IMSS affiliates) as well as tourist services.

The risk scenario, to which we assign a low probability, considers a more pronounced slowdown in the U.S. than currently anticipated. In this case, in addition to having effects on the real economy, the moderation would imply "second-round effects" on financial markets, derived from the foreseeable greater risk-aversion of investors, which could translate into the reassignment of capital flows to emerging economies such as Mexico, as well as the impact on foreign and fiscal accounts of lower raw material prices.

Finally, the favorable effects on agents' perception relative to the approval of structural reforms should not be ruled out, even if they are partial in the early years of the next administration, which undoubtedly will have en effect on Mexico's productive activities, both in terms of greater confidence and greater investment, which would be transferred to lower interest rates and a higher appreciation of the peso.

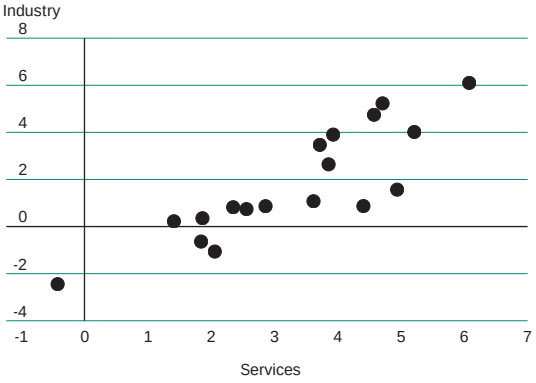
1 Coefficient of correlation between 2002 and 2006: 0.86.

Industrial Production
Real annual % change



Source: BBVA Bancomer with INEGI and U.S. Department of Commerce data

Industry and Services GDP
Annual % change, 1Q02-2Q06



Source: BBVA Bancomer with INEGI data

Macroeconomic Chart of Mexico
Annual % change, seasonally-adjusted series

	2004	2005	2006e	2007e
GDP	**4.2**	**3.0**	**4.6**	**3.6**
Total demand	6.2	4.6	7.1	5.6
Domestic	4.3	5.4	6.7	5.5
Consumption	3.6	4.8	6.0	4.9
Private	4.1	5.4	6.0	5.0
Public	-0.4	0.3	6.5	4.0
Investment	7.5	7.6	9.7	8.0
Private	8.8	9.6	9.7	7.9
Public	2.5	-0.4	9.3	8.5
Foreign	11.7	6.8	11.5	7.5
Goods & servs. imports	11.6	8.6	13.0	10.0

e estimated
Source: BBVA Bancomer with INEGI data

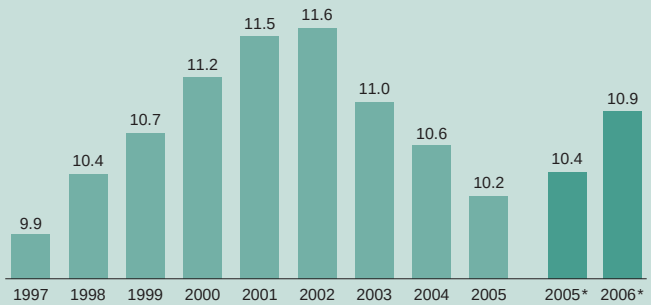
The Recovery of Exports in the U.S. Market: A Long-Lasting Phenomenon?

China's entry into the WTO

In December 2001, China entered the World Trade Organization (WTO) and in doing so achieved the elimination of a good part of the existing trade barriers. In just four years, the country's progress was significant: in 2005 China accounted for slightly more than 7% of world exports, more than 3 pp than four years previously.[1] In this same period, Mexico not only did not advance, but rather lost slightly more than half a percentage point of its share of world exports. In 2005, Mexico accounted for 2% of global exports.

The incorporation of one of the largest economies in the world into global trade meant a trend change in Mexico's exports to its main trade partner, the United States. After the North American Free Trade Agreement (NAFTA) entered into effect, trade between Mexico and the United States intensified, reaching historical levels. Mexican exports to the United States tripled in the first 10 years of NAFTA, placing Mexico as the U.S.' second largest trade partner, after Canada, and representing 11.6% of U.S. imports. As of 2003, Mexican exports rapidly began to decline in terms of their share of the U.S. total, dropping 1.4 pp between 2002 and 2005.

Share of Mexican Exports in the U.S. Market
%



* January-June
Source: BBVA Bancomer with INEGI data

Incipient reversal in 2006

In the final months of 2005 and more concretely in 2006, a modest 0.5 pp improvement has been posted in the share of Mexican exports in the U.S. market, still far from the historical record highs. Of this gain, 0.19 pp corresponds to durable goods, 0.37 pp to non-manufactured goods (mainly oil), while there was a 0.06 pp drop in manufactured non-durable goods. It should be emphasized that during the first half of 2006 compared to the same period the year before, only three of the 15 main exporters to the United States (that account for 75% of that country's total imports) increased their market share. These countries were Mexico with a 0.50 pp gain, China with 0.40 pp, and Saudi Arabia with 0.23 pp. In the case of Mexico and Saudi Arabia, high international oil prices played a very important role. However Mexico, contrary to Saudi Arabia, also improved its market share in manufactured goods.[2]

Share of U.S. Imports
Annual % change, first half of 2006

	Total	Manufacturing		Non-manufacturing
		Durable	Non-durable	
Mexico	0.50	0.19	-0.06	0.37
China	0.40	0.58	-0.21	0.03
Saudi Arabia	0.23	0.00	-0.04	0.27

Source: BBVA Bancomer with data from the U.S. Office of Trade and Industry

After oil, Mexico's gain in market share is mainly attributable to manufactured durable goods. In this category, most of the gain is concentrated in four industries: transportation equipment and vehicles (in which automobiles stand out), computers, and computer equipment, electrical equipment and components, and non-electrical machinery. These branches account for more than 70% of Mexican exports of manufactured goods to the United States.

Special mention should be made in the case of the auto industry, which posted an extraordinary recovery in its exports beginning in the second half of last year. In this industry, the commercial restructuring in the United States has encouraged greater investments for launching

1 In exports of manufactured goods, the gain in market share is higher, at 3.6 pp, with 8.2% of overseas sales of manufactured goods worldwide.

2 The countries gaining in imports of non-durable goods (ordered according to the volume of their imports in the U.S. market) have been the United Kingdom with a 0.36 pp increase, the Netherlands with 0.55 pp, the Russian Federation with 0.52 pp, and Venezuela with 0.25 pp.

new models that have gained acceptance in international markets, mainly in North America (see article "Restructuring of the U.S. Auto Industry").

Mexican Products in the U.S.*
% share, January-June

	2005	2006	Difference
Total	**10.4**	**10.9**	**0.50**
Non-manufactured goods	2.2	2.6	0.37
Oil	11.0	12.2	1.20
Manufactured goods	8.2	8.3	0.13
Durable	6.8	7.0	0.19
Transportation equipment	15.0	16.8	1.75
Vehicles	12.4	14.9	2.41
Electrical equip. & components	24.5	25.9	1.38
Non-electrical machinery	7.2	7.7	0.47
Computers and equipment	12.8	13.0	0.22
Non-durable	1.4	1.3	-0.06
Clothing and textiles	9.0	7.9	-1.06
Plastics	7.1	7.1	-0.08

* For the large components of manufactured goods and the total of non-manufactured goods, % of total imports; % in each branch of the components
Source: BBVA Bancomer with data from the U.S. Office of Trade and Industry

Among the main industries that have lost market share and, in fact, have been characterized by their decline in their share of U.S. imports are the textile industry, furniture and plastics, and medical equipment.

The recovery, an individual effort

The recent recovery in the U.S. market should be evaluated as an individual effort in which the industries involved have known how to benefit from comparative advantages in relation to the rest of the players, and not as a generalized increase in the country's competitiveness. There are signs that the lack of structural reforms in Mexico has undercut the country's competitiveness in relation to other economies. Indeed, of the 50 countries with the most exports to the United States, 80% posted better annual growth than Mexico in their sales to the U.S. market in 2003 and 62% in 2005. The market share of U.S. imports of many of those countries grew in the same years, with half of the economies with the greatest share gaining ground in 2003 and 44% in 2005. In both years Mexico lost market share.

In qualitative terms, Mexico has lost ground in relation to other economies in areas such as regulatory quality, the rule of law, public security, anti-corruption control, and government effectiveness. It is clear that as long as structural factors that include alleviating basic social necessities in addition to making the markets more flexible in a context of strengthening institutions and raising productivity and competitiveness are not resolved, it will be difficult to keep up with the struggle for global trade.[3]

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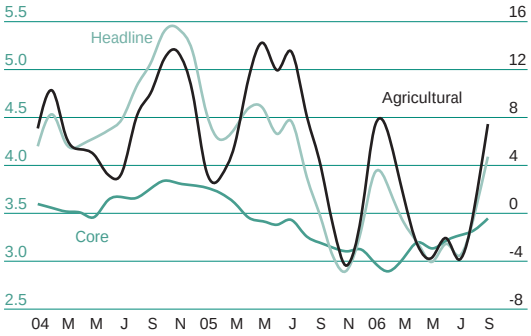
3 See "Proposal Series"; number 33, January 2006: "Ten Measures to Boost Productivity and Well-being", which analyzes second-generation reforms that could raise the potential growth of the economy.

With the Rebound in Inflation, Expectations should be Watched

Inflation
Annual % change



Source: BBVA Bancomer with Banco de México data

2005-2006 Inflation

	Annual % chge.		Differ.*	Share*
	Dec'05	Sep'06		
NCPI	**3.3**	**4.1**	**0.8**	**0.8**
Core	3.1	3.4	0.3	0.2
Commodities	2.8	2.9	0.1	0.0
Services	3.5	4.0	0.6	0.2
Non-core	3.8	5.4	1.7	0.5
Agricultural	-0.2	7.5	7.6	0.6
Regul. & negotiated	4.8	4.3	-0.4	-0.1
Education	6.6	5.7	-0.9	0.0

* Percentage points
Source: BBVA Bancomer with Banco de México data

Pass-through of U.S. Inflation to Mexico: Cyclical Component
% change and share in percentage points

Source: BBVA Bancomer with Banco de México and BLS data

This article analyzes the evolution of the main components of inflation throughout the current year, the impact of the volatile components on it, and the outlook for growth in prices.

In general, a comparative balance of inflation for the year to date shows favorable results, because beyond short-term volatility, the different sub-indexes that comprise the National Consumer Price Index (NCPI) have remained within a narrow variation range and, for the second consecutive year, within the target range set by Banco de México. This occurred despite the rebound in economic activity, especially the internal components of consumer demand and investment (with growth rates of 6.5% and 11.5% in the first half of the year, the highest rate since 2000). Contrary to other expansion cycles, this time around pressures on demand have been contained. The result is also important because it occurs in a context of rising inflationary pressures in regions with which Mexico maintains strong trade ties (for example, core inflation in the United States, which rose from 2.2% in December to 2.8% in August).

Among the factors that explain the stability of inflation in 2006 are the alignment in public utility rates (contribution of 0.1 points to the decline in inflation in September vs. the close of 2005, with rates from 4.8% to 4.3%); reductions in agricultural prices during the first half of the year (% average monthly change of -0.5% in the January-June period); globalization or the "China effect" (the sub-index of commodities excluding food, at rates between 1.5% and 2% since 2002, vs. an average of 3.6% for core inflation); and the strength of the peso (average of 10.9 pesos to the dollar in the January-September period, a nominal appreciation of 0.5% vs. 2005).

Starting as of the third quarter of 2006, a rebound in volatile prices (to a certain extent anticipated) led the NCPI to levels above the upper limit of the inflation target range set by Banxico (4.4% through the first two weeks of October). Furthermore, we can expect inflation to remain high through the first half of 2007 due to different factors, among them.

First, an arithmetic effect resulting from seasonal factors and the comparative base, among them the withdrawal of subsidies to electricity consumption in October and November; the Christmas season; the review of prices in the private sector at the end of the year and public rates at the beginning of every year, and the rise in the services sub-indexes in the first months of the year (50% of inflation in services is accumulated in the January-April period). Second, the impact of the hurricanes in September that affected the Pacific Coast states, which are important agricultural producers. Third, still high raw material prices; the increase in prices of construction materials was the factor that most pressured core inflation in the first six months of the year. Finally, the downward rigidity in the components comprising core inflation that have posted renewed increases in recent months and which partially reflect the delayed effects of U.S. inflation (the evidence suggests that inflation in that country anticipates some components of core inflation in Mexico by up to four months).

Outlook for stability in core inflation

Discounting the previous effects, the risks for core inflation toward the close of 2006 and during 2007 are limited. On the one hand,

the growth of economic activity has not translated into significant inflationary pressures. This can be explained, as pointed out in the Banco de México's September 2006 report on monetary policy, first of all, by "balanced" growth, spurred both by exports as well as the domestic market; secondly, due to the country's excess production capacity (the volume of manufacturing production barely reached 2000 levels by the middle of the current year), and finally, a sustained recovery in investment starting in 2004.

In any case, there will not be time to wait to confirm if demand pressures end up materializing, because apparently the economic cycle has already reached its maximum level and the signs of a downturn have begun to be noticed both in Mexico and the United States. After a first half year marked by average growth of close to 5% in Mexico, the country's economy will gradually moderate its growth in the second six months, to average growth of approximately 4.6% for 2006. For 2007, growth could be around 3.6%. An important part of this downturn will be associated with the performance of the U.S. economy, whose growth we estimate will decline from 3.3% in 2006 to 2.8% in 2007.

The downturn in the United States will imply less pressure on prices. Core inflation could decline from this year's average of 2.5% to 2.3% in 2007. Expectations call for the exchange rate to remain stable (in nominal terms), at 11 pesos per dollar on average during 2007. These two factors delimit the risks both of transferring variations in the exchange rate to prices as well as of "imported inflation."

Finally, raw material prices began to subside, and along with them, pressures on some components of core inflation, particularly housing services, strongly tied to the prices of construction materials.

In this scenario, we expect that core inflation will decline from levels of 3.4% at the close of 2006 to 3.2% at the end of 2007. For headline inflation, we anticipate levels of 3.8% and 3.5% respectively, with certain pressures in the first half of the year.

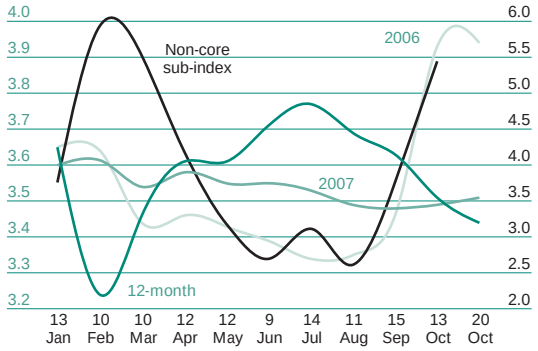
Expectations, key factor

Among the risks for the convergence of inflation toward 3% is a repetition of an experience such as that of 2004, when short-term volatility (agricultural prices) was transferred to medium-term expectations, which was coupled with some imported inflation. The experience in 2006 seems to be different, since this time the increase in agricultural prices during the third quarter has only had an impact on short-term expectations. At the same time, while in 2004, the component of imported inflation could reflect a demand shock linked to the economic cycle in the United States (impact on food and clothes), in 2006 this component reflected the rise in raw material prices (steel and other construction materials) with a transitory and similar impact in both countries.

In synthesis, even though inflation will remain close to the upper limit of the Banco de México target until mid-2007, the risk of a rapid growth in core inflation is limited. The outlook is that this is what will contribute to the convergence of inflation toward the end of the following year.

Inflationary Expectations* and Volatile Prices

Annual %

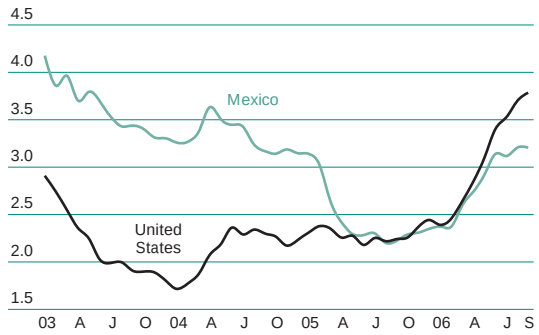


* Infosel survey

Source: BBVA Bancomer with Banco de México data

Housing Sub-Index*

Measurement units

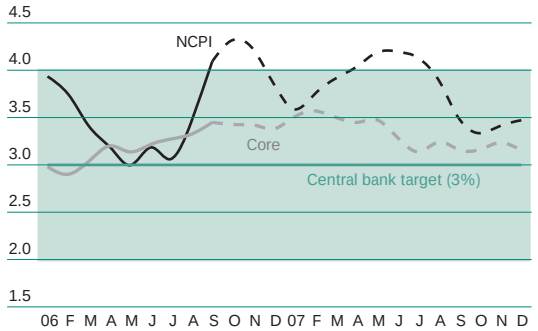


* Housing rental, assigned housing rent, and products for home maintenance

Source: BBVA Bancomer with Banco de México and BLS data

Inflation

Annual % change



Source: BBVA Bancomer with Banco de México data

Mexico - U.S. Inflation: Common Shocks or Pass-through?

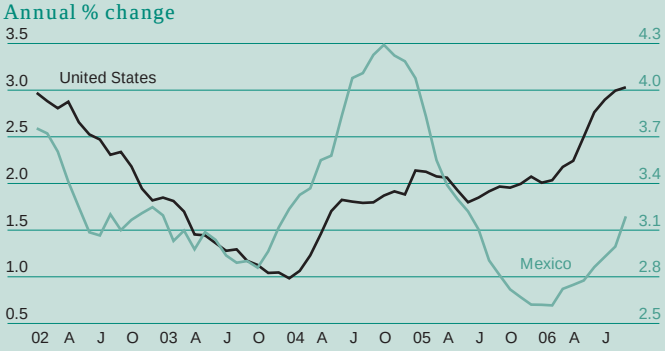
In the process toward price stability in Mexico, the opening of the economy has played a preponderant role in transferring declines in international prices to domestic prices. This article analyzes the sources for such links between Mexican and U.S. prices, with estimates on the scale and speed with which they interact.

Trade opening, the first link

Inflation control has not only been a product of the trade opening, but has also been influenced by fiscal discipline, the autonomy of the central bank, the liberalization of the exchange rate, and the deregulation of markets. However, following the adoption of the North American Free Trade Agreement (NAFTA), productive integration and the elimination of tariff barriers have had a major impact on the process of price formation in Mexico.

Compound Core Inflation Index*

Annual % change



* Prepared with sub-indexes of comparable prices in foods, transportation, apparel, and housing; represents 43% of the NCPI in Mexico

Source: BBVA Bancomer with Banco de México data

In breaking down the NCPI in Mexico into its main components, it can be seen that up to 50% of inflation (70% of core inflation) has a potential linkage with international prices and its evolution continues, in general, along the same lines as in the United States. The linkage mainly occurs in food, apparel, automobiles, housing services (due to the high weight that rent and construction materials have in both countries, as an approximation of building costs), and different items such as electrical and electronic appliances, among others. Statistical analysis supports the idea that in some cases the variations in U.S. prices can be seen as an early indicator of inflation in Mexico, with a maximum delay of four months. The Granger causation test shows that, for the 2001-2006 period, U.S. price increases preceded those in Mexico by one month for food and housing, and by up to four months for apparel. In the case of automobiles, the price movements could be simultaneous.

Granger Causation Test*

		Mexico			
		Food	Clothing	Transportation	Housing
United States	Food (t-1)	15.87 (0.00)			
	Clothing (t-4)		7.28 (0.00)		
	Transportation (t)			5.57 (0.01)	
	Housing (t-1)				7.72 (0.01)

* Ratios denote the value of statistic-t on zero hypothesis (United States does not affect Mexico); value in parenthesis denotes 95% confidence probability

Source: BBVA Bancomer

Pass-through or globalization?

There can be two reasons for the linkage between prices in Mexico and those of the United States. The first would be to consider that Mexico is becoming integrated into the U.S. economy and, because it is small in relative terms, its prices are on the receiving end of any variations, in addition to the linkage of prices due to intra-industrial trade. The second reason involves the linkage due to conditions common to both countries, namely the intensification of globalization and the reduction in technology prices, as well as the entry of Chinese and, in some cases, Indian products (apparel and textiles), in addition to the common shocks in raw materials (steel and other construction materials) that have had a similar impact on both countries (see the graph on housing prices in Mexico vs. the United States in the corresponding article).

Conclusions: so near and so far

With the commercial integration with the United States and its own opening of the economy, inflationary shocks in Mexico, and in general, international prices are increasingly important for the country. The entry of new participants in world trade and the drop in prices of technology and other products have been favorable shocks for inflation, although this point also helps us remember that Mexico still has a long way to go in relation to competitiveness and the flexibility of the markets, which are necessary to better and more rapidly reflect the changes on this level, which of course includes the external context. An example is the case of electronics (computers, televisions, and video equipment), where prices in Mexico barely reflect the pronounced declining trend that this sector has registered on a world level. Indeed, in the United States, such prices have fallen 14% on average during 2004-2006, while in Mexico the reduction has been 3.5%.

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Financial Markets: Between Monetary Pauses and Low Financial Volatility

Prior to the last increase in the federal funding rate in the U.S. (5.25% on June 29), doubts regarding the country's economic growth and the persistence of inflationary pressures have led to greater uncertainty regarding the course that U.S. monetary policy would take. As a consequence, global financial volatility rose significantly from May to June, global capital markets increased their risk to double that registered since 2004, and the main currencies in the world showed increased volatility. Within this context and together with the internal electoral process, the performance of the markets in Mexico was similar: rises in the risk premiums in May and June led to losses in the capital markets of up to 19.4% compared to the maximum seen in the first four months of the year and in a peso depreciation against the dollar of up to 10% in that period.

However, the story reverted as new information (relative to prices and activity) shored up the outlook of an eventual monetary pause in the U.S. This outlook, together with the possibility of a reduction in the federal funding rate in 2007, put a brake on the period of financial volatility, leading it to converge once again toward minimum levels.

A context of low global volatility. Will it continue?

In an environment of solid economic fundamentals, short-term inflationary pressures have had a reduced impact on the markets, compared with the doubts regarding monetary policy actions by the Fed. In 2007, the attention of the markets in Mexico will continue to concentrate on the U.S. and, particularly, on the availability of international flows.

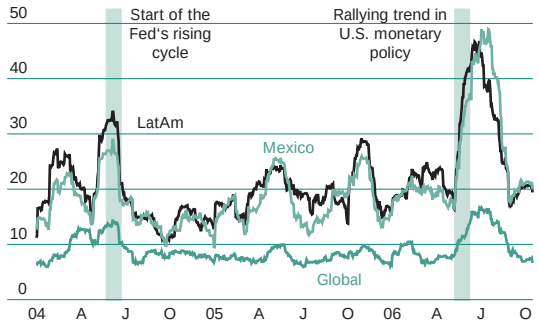
To the extent that the U.S. monetary cycle (beginning in 2004 and through June 2006) was discounted by the market, annualized volatility of the global capital markets (MSCI[1]) remained at an average of 8%, while the same index for capital markets in Latin America and Mexico both averaged 20%. However, during May and June, global volatility doubled when it registered 16% (Latin America and Mexico, 45% and 50%, respectively) due to greater uncertainty regarding the next monetary positions of the Fed. Once the monetary pause became a reality (June 2006), the variability of the global index of the MSCI, returned to levels lower than 8% (the lowest in ten years). Similarly, the capital markets in Latin America reduced their variability after the pause had started (see Graph).

In the foreign-exchange markets, the situation has been similar. However, in this area, the performance of the Mexican peso stands out when its variability in recent weeks was lower than that of the high-liquidity currencies (euro, pound, yen and franc) It is important to note that in Mexico, volatility in the financial markets as a whole has reached minimum levels in the last two years (General Index of Financial Volatility of Mexico, see Graph).[2]

1 Morgan Stanley Capital International Index
2 Mexico's general volatility index is calculated considering the variability in the foreign-exchange market, the capital market (MSCI), swap spreads and sovereign spreads. Increases (decreases) in their levels indicate greater (lower) volatility in the markets as a whole.

MSCI: Annualized Volatility

%



Source: BBVA Bancomer with Bloomberg data

Foreign-Exchange Volatility

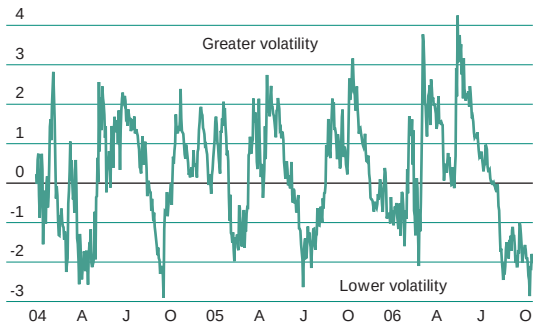
Currency vs. dollar, 3 months, averages

	Current	2006	2005	2004
Mexican peso	7.0	8.5	7.3	9.0
Euro	6.9	8.3	9.0	10.5
Pound sterling	6.8	7.9	8.2	9.5
Japanese yen	7.5	8.7	8.5	9.5
Brazilian real	10.7	15.1	14.3	12.8
Canadian dollar	7.4	7.7	8.4	8.7
Swiss franc	7.8	9.1	9.8	11.1

Source: BBVA Bancomer

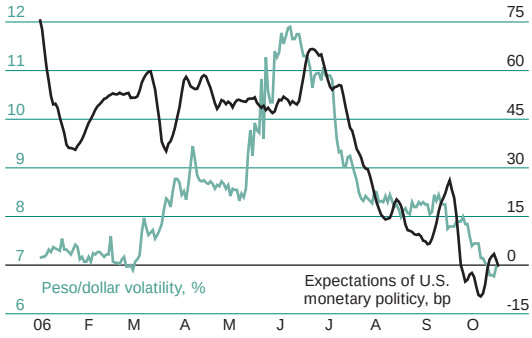
Mexico: Financial Volatility Index

%



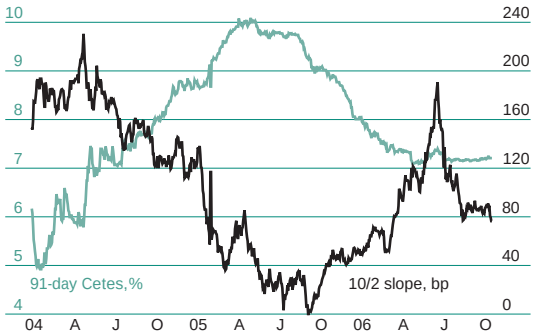
Source: BBVA Bancomer with Banco de México data

Annualized Volatility of the Peso Expectations of U.S. Monetary Policy



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

Mexican Curve Slope



Source: BBVA Bancomer with Banco de México data

Real 3-month Rate*
U.S., EMU and Japan, %

* Weighted average according to the size of each economy
Source: BBVA Bancomer with Bloomberg data

Our outlook is that the Fed will maintain its reference rate at 5.25% during 2006 and 2007 in view of a scenario of moderate slowdown—due to low housing investment and lower real-estate wealth—that would serve to contain inflationary pressures in the U.S. When this dissipates, the Fed rate would drop 75 basis points in 2008. Thus, it is foreseeable that financial volatility will continue to be contained until more pronounced reductions start to be discounted from the federal funds rate toward the end of 2007. The above contributes to Banco de México enjoying the elements of international liquidity that will provide it with sufficient room to maintain its current monetary position awaiting valuation of the course that domestic inflation will take.

Only an alternative scenario of early drops by the Fed during 2007—induced by a U.S. economy with a greater slowdown—would lead to phases of greater volatility (and, therefore, of higher risk premiums), although not higher than those of May and June of this year.

Banco de México (the central bank) vigilant in 2006 and part of 2007: base scenario

Regarding monetary policy, Banco de México is maintaining bank funding at 7% in April 2006. The intention of the central bank is to extend the monetary position until there is evidence that headline inflation begins to converge with the target (3%), which could occur toward mid-2007. The elements that indicate that we will not observe a slackening in the monetary conditions in the coming months can be identified in the communiqués of the central bank's Board of Directors.

The Board increases its headline inflation range foreseen for 2006 up to 4% (vs. 3.5% estimated previously) in view of the supply pressures observed in some markets such as that of tomato, chicken, sugar and tortilla. As regards core inflation, it places it between 3.0% and 3.5% this year. Also, it expects that by the end of 2007, headline and core inflation could stand at 3.5% and 3.0%, respectively. That is, Banco de México foresees that the supply pressures will be temporary, but it is cautious when it incorporates agricultural and livestock prices in its risk balance on inflation together with high services inflation and inflationary expectations that are distant from the target. Within this context, the Board of Directors eliminates from its communiqué the phrase "there is no space available for a slackening" and replaces it with "it (the central bank) reiterates its intention of propitiating the convergence of inflation with its target". This change provides greater flexibility for a future movement in the monetary policy and does not in itself imply an indication of an impending monetary action.

Even though the outlook for a moderation of the economy will tend to alleviate inflationary pressures in the country,[3] the slackening of the monetary conditions will only be produced when there is clear evidence that core inflation converges toward 3%, which will be a low pass-through of the temporary supply shocks to the formation of prices in the economy.

3 Our base estimates for the real sector of the economy are: growth of 4.6% and 3.6% for 2006 and 2007, with inflation at the close of 3.8% and 3.5%, respectively.

In this sense, we believe there could be the opportunity of gradual decreases in the funding rate through mid-2007, so that it could close that year at 6.5%. Factors contributing to this drop are an expected inflation that will be maintained controlled and a downward trend in economic activity. This could be supported by the potential development of structural reforms.

Economic context in 2006-07: similar to 2004-05?

One of the main risks for this scenario consists in returning to the inflationary dynamics of 2004, when agricultural and livestock price increases had a bearing on core inflation, in an environment of foreign-exchange depreciation and greater-than-expected growth in domestic demand. On this occasion, not only is the activity being moderated within a context of a strong peso, which will limit the pass-through to core inflation, but also, long-term inflationary expectations are contained, the monetary policy is in a neutral range and federal funds will enter into a long phase of stability.

Due to all of this, we believe that the risks on inflation are currently lower compared to the past rallying episode in core inflation, which favors a greater anchoring with expectations and the handling of basic communications (see chart). If in this rallying period of the more volatile components core inflation and expectations are maintained under control, the door will open to a lower rate, to the extent that a real lower rate will be necessary to contain possible inflationary outbreaks.

Yield curve and parity, good news?

Within a global context of reduced volatility in view of the monetary pause in the U.S., liquidity has not decreased significantly on the international markets. This circumstance, together with the monetary pause of Mexico's central bank, made the Mexican financial market perform in a relatively stable manner. Mexico's EMBI+ has been reduced from 140 bp (end of 2Q06) to 100 bp. This performance has been relatively generalized on the emerging markets due to the relative stability of financial flows. For this reason, and to maintain the federal funding rate at 5.25%, it is reasonable to assume that international liquidity and sovereign-risk premiums for Latin America will be similar to the current ones.

Also, since the beginning of 3Q06, the long-term rate (M10) has decreased by approximately 80 bp, to stand close to 8.0%, thanks to an important domestic appetite for long-term investments and the maintenance of foreign-investor positions. Within the current international and monetary context, it is foreseeable for the M10 to close at 8% and 7.5% in 2006 and 2007.

Finally, in foreign-exchange matters, in the last three months the most important currencies have suffered an average depreciation of 2.7% compared to the dollar, while the Mexican peso only depreciated 0.3%. In a still favorable external environment in terms of flows and a positive domestic framework, which has allowed maintaining delimited risk premiums, we estimate, as a base scenario, relative strength in the peso for the end of this year (10.9 ppd) and the beginning of 2007, which would reflect maintaining the interest rate spread between Mexico and the U.S. By mid-2007, there could be

EMBI+ Mexico and BAA Corporate Spread in the United States

Basis points

Source: BBVA Bancomer with Bloomberg data

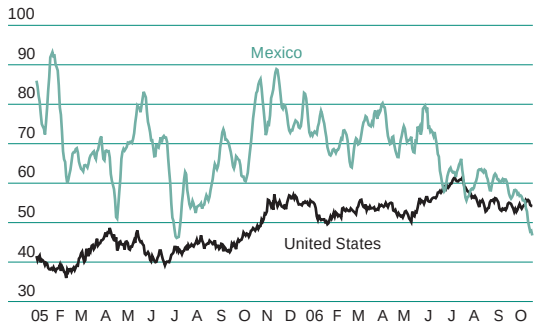
10-year USA-Mexico Spread Expected by the Market seen in 1 year

Basis points, 2006

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

10-Year Swap Spread

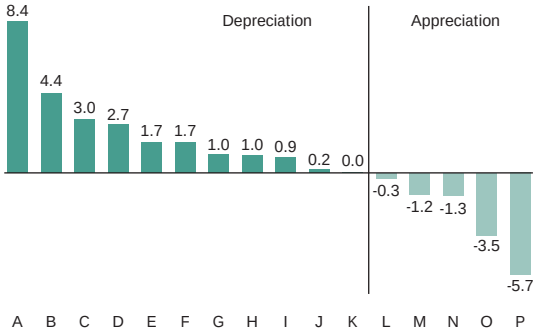
Basis points



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

Currency Appreciation / Depreciation Versus the Dollar

In 3 months, %



A NOK
B ZAR
C CHF
D JPY
E TWD
F SEK
G EUR
H DKK
I CAD
J KRW
K AUD
L SGD
M GBP
N MXN
O BRL
P NZD

Source: BBVA Bancomer with Bloomberg data

Financial Markets

End of period

	Base	Slowdown in the U.S.	Renewal of flows
	Exchange rate, pesos per dollar		
2006	10.9 (10.9)	11.1	10.8
2007	11.3 (11.0)	11.7	10.6
	Bank funding, %		
2006	7.0 (7.1)	7.0	7.0
2007	6.5 (6.8)	6.0	6.5
	M10 Bond, %		
2006	8.0 (8.4)	8.0	8.0
2007	7.5 (7.7)	7.3	7.0
	EMBI+ LatAm, bp		
2006	225	225	225
2007	250	300	225

Note: Annual average in parenthesis
Source: BBVA Bancomer

Signal for 2007

No abrupt and permanent adjustments are foreseen for the financial variables under any of our possible scenarios (base, optimistic, pessimistic). The year 2007, in general, is taking shape as a relatively stable year, with periods of moderate increases in volatility toward the second half, derived from a 50 bp reduction of the bank funding rate and of the moderation of favorable international factors for the Mexican financial market

episodes of volatility prior to the reduction of funding: nevertheless, we foresee that this will be temporary and reduced, given that the reduction in the funding rate would be due to a relatively positive environment in terms of inflation. Therefore, in the second half of 2007, the exchange rate could return to levels higher than 11 ppd and would close the year at 11.3 ppd.

Alternative scenarios: the bad and the good

Currently, the main risk for the Mexican financial markets is the extent of the slowdown in the U.S. Even though, for the moment we observe a gradual adjustment in its growth, a greater adjustment in the real-estate sector could cause a greater aversion to risk among investors, which could be reflected in lower levels of international liquidity and greater volatility on the markets.

In this scenario (of low probability), we estimate that the U.S. economy would moderate to about 1.5% in 2007, with an average inflation of 1.5% and some federal funds ending at 4.5%. In this case, bank funding would close the year at 6%. In this scenario, it is foreseeable that the yield curve will increase in such a way that the possibility of reductions in the M10 rate would be limited. As for the performance of the peso, we would observe a higher depreciation when greater risk premiums are incorporated (2007 close of 12.1 ppd).

Another alternative scenario that could increase its probability in the coming months would be that of a renewal of flows toward the Mexican economy. These higher capital flows would be attracted by greater confidence, in view of the possibility of progress in structural reforms and in view of a U.S. economy growing close to its potential. A higher sovereign-risk rating could even be considered, given the proper management of the public debt and the outlook for progress in Mexico's GDP potential, if tax collection efficiency is increased. In this panorama, bank funding would diminish due to expansions in the economy's potential supply, rather than from the drop in aggregate demand, as would be the case in base and pessimistic scenarios, although the margin of the drop will depend on the scope of the reforms. In this environment of higher potential supply, the M10 rate and the exchange rate would incorporate lower risk premiums so that these could close 2007 at 7% and 10.6 ppd, respectively.

Banco de México Communication and the Financial Market

After 10 years of the Banco de México's autonomy, periods can be seen in which the monetary authorities have emphasized the use of specific policy instruments such as the "short", regulation deposits, and communiqués on monetary conditions. These instruments have been interpreted by market participants in different ways and evaluated in accordance with the clarity of the messages, the duration of the movements (i.e. frequency of the monetary cycle), and the effects on expected inflation.

At the beginning, the Banco de México's emphasis centered on increasing its creditor position within the financial system by establishing "shorts" or shortfalls in the balances of the banks' current accounts—supplemented with other instruments such as obligatory deposits with the central bank—in order to affect liquidity conditions in the economy and thus allow the market to determine the short-term "equilibrium" interest rate consistent with the state of the economy. Under this scheme, the communication strategy consisted mainly of biweekly announcements on monetary policy (the amount of the "short") and an extensive monthly press release on Banco de México's view of the situation. Those opposing this process argued that the effects of the "short" on interest rates tended to rapidly dissipate as the monetary base kept expanding, and that the asymmetries in the market's reading of the central bank's monetary intentions (given the absence of a defined position) generated greater uncertainty—and therefore higher volatility—in relation to determining the short-term rates. Thus, the efficiency of the mechanism designed to influence expectations could turn out to be limited.

As of March 26, 2004, discreet increases and decreases in the bank funding rate could be observed that—in addition to reducing volatility—have reflected a direct signal from Banco de México on the direction that the "internal monetary situation" should follow in accordance with its inflation target. This indication was introduced, together with a succinct balance sheet of inflationary risks with clear targets, in the monthly communiqués in which Banxico explicitly outlined not only the direction of the monetary adjustment, but also its scope and perspectives (i.e. to link monetary conditions to movements of the Fed, to indicate the maximum scale of monetary slackening, and to indicate whether there is room for subsequent declines in rates).[1] Given this, it is worthwhile exploring the way in which this transmission of monetary targets has been processed and assimilated by the market and what possible implications this could have on the development of expectations in the country.

Is March 2004 a dividing line in the implementation of monetary policy?

If we consider that the market forms its expectations on the upcoming direction of the authorities' monetary policy by analyzing communiqués issued by Banxico, but also using as a reference instruments such as, for example, rules of behavior (such as the Taylor Rule) and processing information on Monetary Conditions Indices to appraise the degree of restriction prevalent in a given moment, then we could evaluate whether after March 2004, the market's ability to predict monetary trends with these instruments has increased. If this is the case, it could imply advances in communication in terms of its influence on the formation of expectations in the financial market and, with it, suggest possible gains in improving the central bank's reputation.

To evaluate this, we estimated the probability of some monetary development occurring in month *t*, m_t, given the *a priori* change in direction in the Taylor Rule selected, R_{t-1}, and a Monetary Conditions Index, MCI_{t-1}.[2] Thus, m_t takes the value of 1 if we note some development (hardening and/or slackening of monetary conditions) and 0 in the contrary case (it should be noted that this value is independent of whether these signals are carried out with the "short" or a guided movement in monetary conditions).

$$P(m_t = 1 \mid X_{t-1}, \beta) = 1 - \Theta(-\beta' X_{t-1})$$

$$R_t = \alpha_0 + \alpha_1 \pi_1^{gap} + \alpha_2 \gamma_{t-1}^{gap} + \alpha_3 \xi_{t-1}^{gap} + \rho R_{t-1} + \upsilon_t;$$

$$MCI_t = \kappa_1 r_t + \kappa_2 \xi_1^{real}$$

P(•) is the probability of occurrence of development *m* given the previously described exogenous variables: Θ is the accumulated normal distribution function, β the Probit, and *X* the vector of exogenous variables (ΔR_{t-1}, MCI_{t-1}). Where π^{gap} is the differential between registered inflation minus the central bank target, γ^{gap} is the production gap (actual growth minus potential growth), ξ^{real} is the real appreciation of the peso and r is the real interest rate.

PROBIT Estimates

Coefficients	Mov. tow. restriction		Mov. tow. relaxation	
	A	B	A	B
C	2.15 ns	17.00 *	-12.55*	-103.81**
	(2.24)	(5.87)	(3.57)	(55.93)
ΔR_{t-1}	0.60 **	2.64 **	-1.19 *	1.02 ns
	(0.33)	(1.41)	(0.42)	(3.44)
ICM_{t-1}	-0.02 ns	-0.18 *	0.11 *	1.01 **
	(0.02)	(0.06)	(0.03)	(0.54)
Avg. Log-Likelihood	-0.583	-0.264	-0.353	-0.128
McFadden R^2	0.07	0.61	0.37	0.79
Obs. Total	57	30	57	30
Obs. *m*=1	18	12	14	9

A March 1999 to March 2004 B March 2004 to August 2006
Notes: Significance of parameters * at 99%, ** at 95%, and *** at 90%. Standard errors ( )
Interpretation of results:
In all of the estimates subsequent to March 2004, a greater "Cuasi R2" was registered and fewer errors in the adjustment of the equation. In the case of restrictive movements, an increased reliability of those making the estimates was noted, which is not the case for announcements of a slackening. The high significance of the parameters in the slackening model before March 2004 could reflect the nature of the transitory effects of the "short" on interest rates.
Source: BBVA Bancomer

The evidence provided by the model is suggestive of the positive effects of communication on analysts' expectations. Before direct indications on funding rates (sample from July 1999 to March 2004) were seen, 109 monetary policy announcements were registered. The result is that in 57 months, 18 such announcements involved greater monetary restriction (increasing the "short") and 14 a slackening of such conditions. Subsequently, 51 meetings were held in 30 months, with 12 resulting in a monetary restriction (either the "short" or a signaling of the internal monetary conditions) and 9 with a slackening. Based on the binary model and considering those developments whose occurrence probability was greater than 50% (level of the previously selected "cut-off", which does not affect the results), we noted that, after March 2004, a greater number of such developments were predicted by the instruments mentioned previously (Taylor and MCI, see figure). Some 91.7% of the developments involving a restriction were correct (vs. 16.7% before March) as was the case with 88.9% of announcements slackening monetary conditions (vs. 50% previously), and 85.7% of the occurrence of any monetary news (vs. 75% beforehand).

Monetary Direction According to Signals Contained in the Taylor Rule and the MCI

Frequency of predictions (cut-off, c = 0.5)

Developments	Signal			
	Restriction	Slackening	Some mov.	No mov.
From 1988 to March 2004				
Total	18	14	32	25
Forecasts	3	7	24	10
% correct	16.7	50.0	75.0	40.0
After March 2004				
Total	12	9	21	9
Forecasts	11	8	18	1
% correct	91.7	88.9	85.7	11.1
From 1988 to date				
Total	29	23	52	34
Forecasts	16	11	49	4
% correct	55.2	47.8	94.2	11.8

Source: BBVA Bancomer

Conclusions

Although it is advisable to have a larger sample, the evidence gathered suggests that subsequent to the introduction of direct signals on monetary conditions—together with a succinct balance sheet on inflationary risks—market participants have been in a position of having greater precision on the evaluation of internal monetary conditions as well as the central bank's future intentions. This can be the result not only of a clearer transmission of monetary intention, but also of a learning process by the market in reading these messages. Independently of all this, the adoption of a communication strategy that translates into a clearer and more rapid orientation of the direction of bank funding rates can contribute to Banco de México's greater influence on conjectures within the financial market. If this is the case, this could reflect an advance in the credibility in monetary policy that would place it in a favorable position to influence longer-term interest rates, as has been emphasized in studies focused on other central banks.

Simultaneously, the results also point out the importance for the central bank to continue advancing in terms of clarity in the use of its instruments and in communicating its intentions (i.e. the circulation of minutes of meetings of the Governing Board). This would consolidate the advances in terms of credibility and would allow the central bank to have a more efficient influence on the mechanisms for transmitting expectations on monetary policy. This is particularly important in strengthening its target-based policy on inflation.

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1 It should be clarified that the Banco de México is keeping other instruments on hold (i.e. "short" and obligatory deposits), which can be reactivated in the future.

2 Different specifications of the Taylor Rule and the MCI were considered in which the qualitative results of the binary probability are maintained. It is important to note that the coefficient of the Taylor Rule for inflation remains relatively constant for sub-samples of the period.

Mexico and the U.S.: Macroeconomic Synchronization in this Cycle

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The main risk factor: the United States

One of the main risks facing the Mexican economy is an abrupt downturn in U.S. economic growth. A severe adjustment, in addition to having effects on the real sector of the economy, could have "second-round" implications related to lower capital investment flows to emerging economies as a result of a greater risk aversion on the part of investors and could possibly reduce the demand for raw materials, and along with it, could lead to lower prices for such products. In this context, this article will analyze the possible intensity and speed of pass-through of variations in the U.S. economy on Mexico through the trade channel in relation to the country's GDP and its components in terms of demand, namely consumption, investment and exports.

To analyze this synchronization, annual data were used since 1930, and as of 1993 quarterly statistics. Correlations of the annual growth rates of the variables were employed along with different filters to extract the cyclical component from the data.[1]

This article will first offer a brief historical overview based on comparisons of lineal correlation in variations in GDP of both economies. In the second section, the correlation will be analyzed in the period following the adoption of the North American Free Trade Agreement (NAFTA). The third section will discuss the scope and speed of transmission in that period as well as the transmission channels in terms of demand. The final section will provide some conclusions.

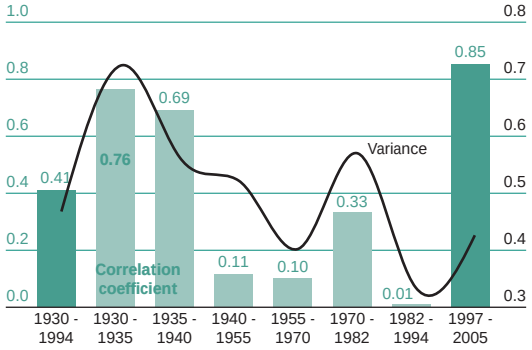
Correlated transmission but without causation

Throughout most of the 20th century, the economies of Mexico and the United States experienced some stages of growth similar in scope and direction. However, these stages were, in general, short-lived and not always associated with a clear causal relationship. The scope of the co-movements between both economies changed as of Mexico's opening to foreign trade at the end of the 1980s and especially after NAFTA came into force. In this sense, it is as of the adoption of this agreement that both economies have presented a relatively stable and high lineal correlation. In addition, in this stage, contrary to previous periods, there is clear evidence of a unidirectional causation of the cyclical component of U.S. GDP to that of Mexico, that is, variations in the United States precede and spur changes in Mexico and not the other way around.[2]

Between 1930 and 2005, the lineal correlation in annual growth rates was 0.40. In dividing the sample (before NAFTA) in periods related to economic policy in Mexico, the lineal correlation of growth rates fluctuated at around 0.76 between 1930 and 1935 and up to 0.01 between 1982 and 1994; the variance of this lineal correlation is, in general, high, although with a declining trend. As of 1997, the cor-

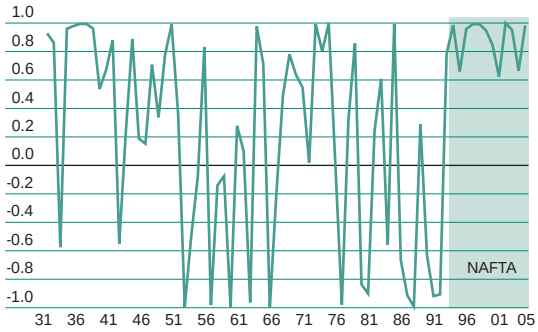
1 Holdrick-Prescott and Baxter-King filters varying the assumptions on the length of the cycle.
2 In previous periods, the evidence is not conclusive, since it is not thorough in relation to different disparities.

Correlation in Growth and its Variance
Mexico - United States



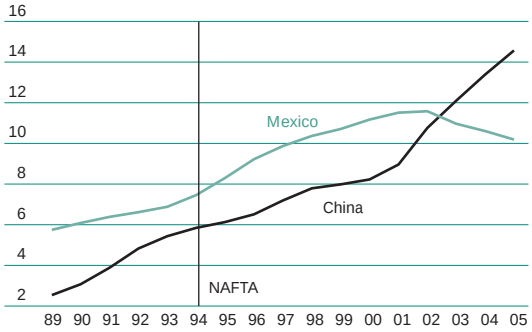
Source: BBVA Bancomer

GDP, Cyclical Component
Moving correlation, 3 years



Source: BBVA Bancomer with INEGI data

U.S. Imports
% of total



Source: BBVA Bancomer with INEGI and U.S. Dept. of Commerce data

GDP
Moving correlation, 2 years

Source: BBVA Bancomer with INEGI data

relation is not only considerably higher than before (0.85) but also has relatively little variance.[3]

The low correlation prior to the trade opening is directly related to the direction of Mexican economic policy between 1940 and the end of the 1970's, where first through the so-called "import substitution model" and then with "stabilizing development", protectionist policies were implemented, aimed at developing the domestic market. In 1986, Mexico signed the General Agreement on Tariffs and Trade (GATT, today known as the World Trade Organization) and unilaterally opened up to commerce, which induced export flows and greater and more diversified investment.

In the 1980s, despite the trade opening that the GATT represented, the accumulated internal imbalances and the structure of the agreement limited its scope. Specifically, the situation in which the Mexican economy had been practically closed to trade distorted the performance of the national productive apparatus and limited its productivity, in addition to creating inefficiencies. Thus, the true change in the country's trade structure was experienced when NAFTA entered into effect in 1994.

Post-NAFTA period: a clear and high causal relation

The NAFTA had an extraordinary impact on Mexico's commercial structure. The analysis of NAFTA's effect on Mexican trade with the United States and Canada is a widely discussed topic and without seeking to delve further into it, it is pertinent only to comment on some general aspects. Specifically, Mexican exports to the United States quadrupled between 1993 and 2005 and imports from the U.S. to Mexico doubled. In this period, Mexican exports to the United States reached a record level in 2000, when the U.S. was receiving 88.7% of Mexico's overseas sales. As of that year, Mexico has been exporting relatively less to the United States and has been displaced by Chinese products. Thus, through July 2006, the United States received 84.5% of total Mexican exports.

Between 1997 and the second quarter of 2006, in an analysis of two-year moving correlations between the annual growth rates of the two countries, of particular importance is the very high correlation, on the one hand, between the time NAFTA entered into effect and 1998, related to a development strategy based on the external sector, and subsequently, between 2002 and 2004, following the recovery from the negative effect attributable to the contagion from the Russian and Brazilian crises. On the other hand, there were two periods with lower and in fact declining correlations, the first between 1998 and 2000 when the United States maintained a growth rate of close to 5% while Mexico entered a downturn, resulting in a negative correlation. In the post-NAFTA period, the time of greatest integration measured in terms of lineal correlation occurred at the end of 2002.

With variables from 2001 to the second quarter of the present year, practically a complete cycle can be identified in both Mexico as well as in the United States, so that from the analysis of the duration and breadth of the cycles it can be concluded that the extent is similar

3 For a graphic analysis, see the chart on sub-periods prior to NAFTA coming into force.

in both countries. However, fluctuations in Mexican GDP are more pronounced and the periods of contraction tend to be more severe than in the United States. Several years after NAFTA came into force, an economic downturn was experienced that for Mexico began at the beginning of 2000 and extended until the third quarter of 2001. At the same time, the U.S. contraction was not so pronounced, and in that country the growth rate of the period prior to the beginning of the recession[4] was resumed six quarters later. Meanwhile, in the case of Mexico, a similar rate was reached only 16 months later, in the final quarter of 2004.

Scope and speed of transmission

With the aim of analyzing the scope and speed with which internal variations coming from the United States influence Mexico's economic growth, a regression analysis was made for moving periods involving 40 observations with two exercises, for the total (GDP) from 1930 to 2005 with annual data and for components from 1997 up to 2Q06.[5]

Data indicate that in the final decades of the 20th century and the first few years of the current century, the scope of the impact of U.S. economic shocks on the Mexican economy was significantly greater than in previous periods. The speed of transmission measured in terms of the time necessary for U.S. economic crashes to reach and have an impact in Mexico has changed drastically, from a practically non-existent effect up until 1994, to a positive and significant elasticity in subsequent periods and dates.[6]

An analysis of the post-NAFTA period (with quarterly data) shows that since 1997, both the intensity and the persistence of internal shocks have declined, from a maximum elasticity of 1.3 between 3Q97 and 3Q02 to an almost zero effect from 2001 until the present.

In terms of the effect of variations in U.S. economic growth, together with the higher correlation in the early years of NAFTA, in the 2002 to 2004 period and since the middle of last year, there has been a greater speed of transmission of the shocks.[7] The greater effect is being experienced in the current cycle (1Q01-2Q06) with an elasticity of between 0.80 and 1.4. In other words, in response to a one percentage point increase in U.S. growth in a quarter, the pass-through to the Mexican economy implies, on average, an increase of close to one percentage point three months later. The intensity of the effect can depend on the cyclical stage that the economy is going through, since in a context of moderate or even negative growth, the effect can be more pronounced than during stages of major growth and expansion. This effect partially explains why even though the length

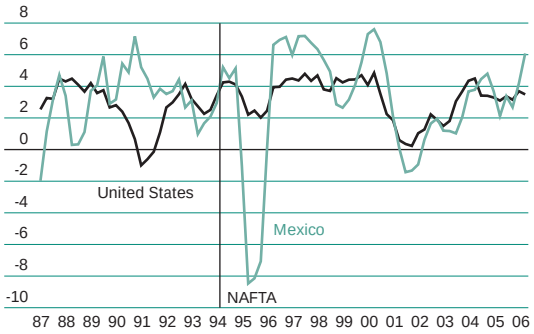
4 The official beginning of the recession was dated by the NBER as the first quarter of 2001.

5 The equations are as follows: $\Delta X_{it} = \alpha_i + \sum_{i=1}^{5}\beta_i \Delta X_{it-1} + \sum_{i=0}^{5}\gamma_i \Delta US_{it-1}$ in which ΔX is the annual change in the Mexican GDP and ΔUS in the one from U.S.

6 The mobile regression coefficients of the historical graph are those obtained for a confidence level of 80%, which was chosen for illustrative purposes. For a confidence level of 95%, only the last two periods are statistically significant.

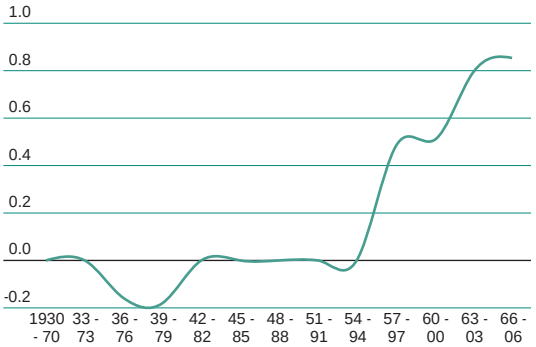
7 It should be pointed out that in the exercise that has been presented, variations in U.S. GDP were only considered as an independent variable and even though the specification tests were successfully contrasted, the inclusion of other variables could modify the scope of the elasticity, and therefore these results should be interpreted cautiously.

GDP
Annual % change



Source: BBVA Bancomer with INEGI data

Contemporary Effect of Changes in the U.S. Economy on Mexico



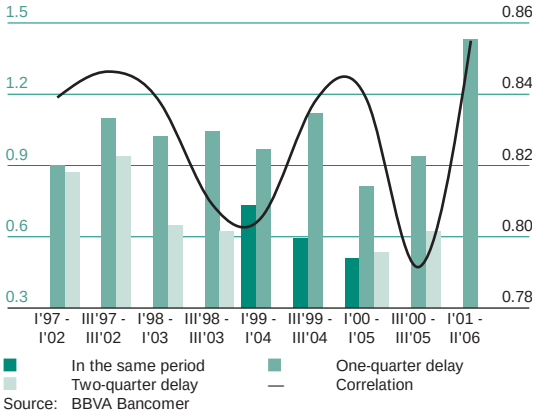
Source: BBVA Bancomer

Correlation Coefficients with U.S. GDP

Mexico	GDP	Exports	Investm.	Consump.
1Q94-3Q98	0.92	-0.78	0.90	0.91
4Q98-4Q00	-0.05	-0.25	-0.18	-0.20
1Q01-2Q03	0.89	0.90	0.82	0.40
3Q03-1Q06	0.71	0.65	0.69	0.45
1997-2006	**0.81**	**0.84**	**0.77**	**0.57**

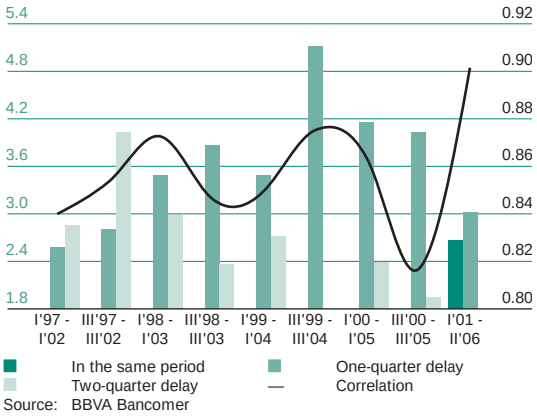
Source: BBVA Bancomer

Effect of Variations in U.S. Economic Growth on Mexican GDP



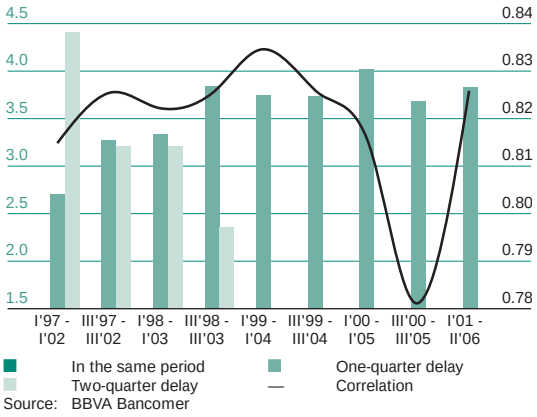
Source: BBVA Bancomer

Effect of Variations in U.S. Economic Growth on Mexican Exports



Source: BBVA Bancomer

Effect of Variations in U.S. Economic Growth on Mexican Capital Formation



Source: BBVA Bancomer

of the cycles is similar in both countries, in Mexico the fluctuations tend to be more pronounced, with a recovery from a downturn taking more time to extend to the productive sectors.

Transmission channels

A similar exercise in moving regressions was conducted with data starting from 1997 based on the components of GDP on the demand side, in order to quantify the effect that variations in U.S. GDP have on each component. The transmission channel of the variations takes place, in the first instance, through trade (exports) and subsequently in the two main components of internal demand, namely, investment and private consumption.

This exercise shows that in all the components of GDP on the demand side, the effect of changes in U.S. GDP shows, on average, a three-month delay in transferring to Mexico. In the case of Mexican GDP and investment, changes in U.S. GDP take a quarter for their effects to be transferred to Mexico, while for exports and private consumption, variations in U.S. GDP have an impact on these variables in the same time period.

In the case of exports, in the current cycle (starting from 1Q01) the effect is no longer delayed but occurs in the same time period. With a quarterly delay, Mexican exports reflect a 2.5 pp change for each percentage point change in U.S. GDP.

Greater or lesser activity is reflected in variations in the growth of new investments, where the effect takes place a quarter after the change in U.S. GDP and the variation is on a larger scale (3.8 pp). It should be mentioned that the correlation between U.S. GDP and fixed investment in Mexico is high in the post-NAFTA period (1997-2006), 0.73, and concentrated in the tradable goods segment through investment in machinery and equipment (correlation coefficient of 0.81), and not in construction (correlation coefficient of 0.27). This high correlation and elasticity in relation to variations in U.S. GDP were intensified with NAFTA due to the greater financial relationship and the opening of the country's capital account, with financial conditions in the United States affecting Mexican subsidiaries in addition to possible effects in the stock market.

The strong effect of variations in U.S. GDP on investment in Mexico suggests the presence of an important financial transmission channel, which would take on greater importance in response to the possible second-round effects in the case of a risk scenario in which the downturn in the U.S. economy were greater than expected.

On the consumption side, the correlation with U.S. GDP is considerably less (0.47 since 1997). Within consumption, services stand out in relation to goods, with a very stable correlation of 0.62 in the entire period. At the same time, the correlation between the consumption of both durable as well as non-durable goods in Mexico in relation to variations in U.S. GDP are low (0.13 and 0.30, respectively). This low correlation in goods suggests that this type of consumption responds for the most part to idiosyncratic shocks in the Mexican economy, while, in contrast, the services component is related to those variables tied to foreign trade (freight, leasing, insurance, etc.).

Conclusions

After NAFTA came into force and specifically following Mexico's balance of payments crisis in 1995, the economies of Mexico and the United States are more synchronized. This has occurred despite the idiosyncratic shocks that have affected Mexico, such as the contagion effect from the Asian and Brazilian crises and China's entry into the WTO. As of 1997, the intensity and duration of the cycles in Mexico and the United States are similar although the fluctuations in Mexican GDP are more pronounced.

In the post-NAFTA period, the scope and persistence of the effect of U.S. economic shocks on Mexico are greater than before. The effect of variations in U.S. GDP is transmitted in the same period and with one or two quarters delay in reaching Mexico. In the current cycle (beginning in 2001), the impact of U.S. variations is greater in intensity and shorter in delay time than was previously the case, with the effect being immediate in foreign trade and with a quarterly lag in GDP. Furthermore, the intensity of the effect has remained close to one and even slightly higher in the current cycle.

The transmission channels are mainly through foreign trade and specifically through exports of manufactured goods. The variation in trade flows also translates into different allocations of resources for private investment and finally, these lower flows influence private consumption due to the real different income and the change in foreign trade.

In response to a downturn in the U.S. economy, the repercussion in Mexico will be, in the first instance, on the real economy. In a scenario in which the adjustment is not gradual, there would also be financial effects through lower capital investment flows to emerging economies, resulting from a greater risk aversion. Furthermore, it would be necessary to consider negative effects derived from the lower prices of raw materials resulting from the reduced demand for such items generated in the United States.

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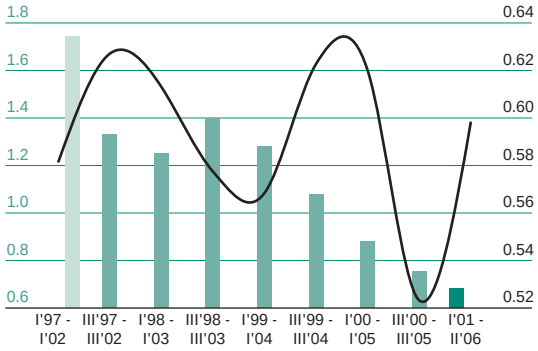
Effect of Variations in U.S. Economic Growth on Mexican Private Consumption



Source: BBVA Bancomer

Effect of Variations in U.S. GDP on Changes in the Components of Mexican Demand

Annual chge.	GDP	Exports	Investm.	Consump.
Correlation*	0.86	0.90	0.83	0.60
Regression coefficient 1Q01 - 2Q06				
ΔUSY		2.66		0.68
ΔUSY(-1)	1.43	3.02	3.83	
ΔUSY(-2)				
ΔUSY(-3)				0.88
R^2	0.81	0.92	0.74	0.63

* Correlation coefficient in relation to annual variations in U.S. GDP
Note: Only coefficients that are statistically significant are reported
Source: BBVA Bancomer

Mexico and the United States Synchronization: Historic Outlook

The periods in which the total movement between Mexico and United States GDP is analyzed are:

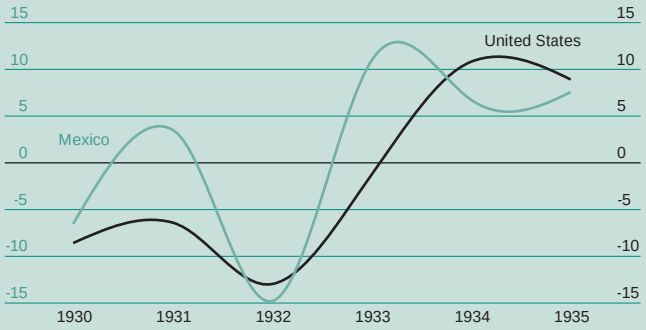
Mexico - United States Macro Relation

	Growth correlation	Average growth		Correlation variance
		Mexico	U.S.	
1930 - 2005	0.40	4.52	3.55	0.48
1930 - 1993	0.42	4.70	3.53	0.46
1930 - 1935	0.76	1.23	-1.60	0.72
1935 - 1940	0.69	4.54	6.74	0.56
1940 - 1955	0.11	5.73	5.69	0.52
1955 - 1970	0.10	6.51	3.86	0.40
1970 - 1982	0.33	6.28	2.53	0.57
1982 - 1994	0.01	1.92	3.09	0.33
1997 - 2005	0.85	3.48	3.29	0.43

Note: Graphs refer to the annual % change of GDP for both countries

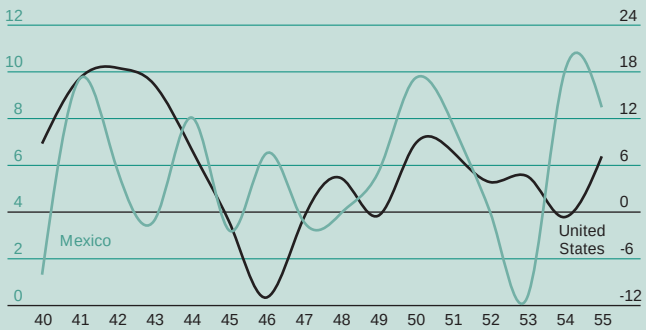
Stage Following the Great Depression

1930-1935: Period between the World Wars characterized by expansive policies



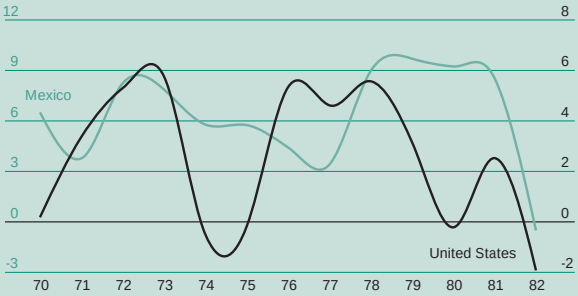
Beginning of the Import Substitution Model

1940-1955: Industrial reorganization, infrastructure works promoted by the government. Support for the domestic market



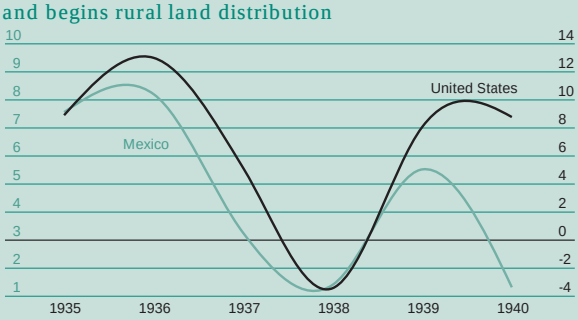
Imbalances Accumulate: foreign debt crisis

1970-1982: Monetized, high public spending, hyperinflation with frequent devaluations. High GDP growth



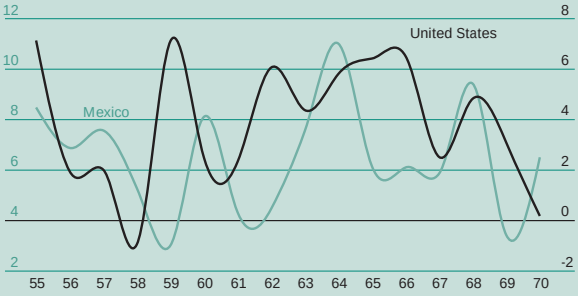
Lazaro Cardenas Era (LC)

1935-1940: LC initiates reforms: nationalizes oil and railways and begins rural land distribution



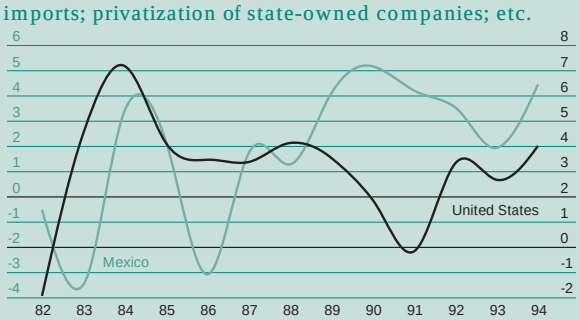
Stabilizing Development

1955-1970: High growth with low inflation but structural weaknesses accumulate



Stabilization Programs

1982-1994: Oil boom and trade opening begins; drop in tariffs on imports; privatization of state-owned companies; etc.



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Restructuring of the U.S. Automotive Industry; Implications for Mexico

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Global Trends in the Industry

In the last two decades, the automotive industry throughout the world has undergone several transformations among which the following are noteworthy: the regionalization of the production networks directed by the large corporations, the organization toward the production of assembly modules in auto manufacturing, the sub-contracting of increasingly broader segments of the manufacturing process (outsourcing), and the launching of vehicles propelled by hybrid engines.

These changes have had repercussions in Mexico, which is more than ever assuming a more relevant role in automobile manufacturing in the North America region. At present, the Mexican automotive industry is comprised of slightly more than 1,000 establishments, of which 14 are engaged in assembling vehicles and, the rest, in the production of auto parts. The latter includes close to 300 establishments in the in-bond manufacturing industry and, of the total, more than 600 companies have foreign direct investment (FDI). The Mexican automotive industry employs slightly more than 500,000 persons, 10% of which are in the terminal automobile area and the rest in auto parts. In addition, it has an important share (24%) in total manufacturing exports and in manufacturing production (17.4%).

Mexico's automotive industry shows a strong dominion of the "Three Great" assembly companies in North America, although it has also diversified. As of 1994 and up to now, the Mexican complex is an important part of the whole in North America, which is formed by hundreds of plants that are producing the most diverse components in a wide range of lines and models aimed at meeting the enormous and sophisticated demand of the U.S. market. The North America Free Trade Agreement (NAFTA) area produced 24.4% of the total of light vehicles worldwide in 2005.

The U.S. auto assembly companies continue to suffer in their own market

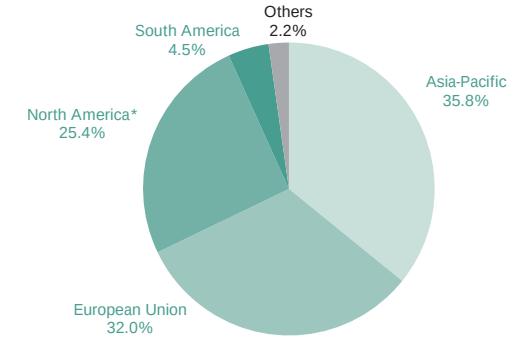
Both GM and Ford continue to battle to survive through intense restructuring programs that will prevent them from losing a greater market share, without having succeeded to date. Through 3Q06, total light vehicle sales (automobiles and light trucks) in the U.S. fell 3.7%, of which Ford and GM lost 10.2%, while the Asian manufacturers gained 5%. For the former, this represents a market share loss of over 2.2 pp compared to 2005, which was capitalized by the Asian manufacturers.

As the Ford and GM market share has been diminishing, labor costs have been growing more rapidly (voluntary severance settlements, pension funds and medical insurance) as well as operating expenses (plant shutdowns and elimination of models). Meanwhile, foreign manufacturers based in the U.S. do not face high expenses in health and retirement, since they have a younger labor force and few pensions to pay in the medium term, giving them a great advantage in terms of costs.

As regards U.S. auto part manufacturers, the restructuring now being undertaken by Ford and GM has caused a great impact of which the most significant effects are the net and operating results, with losses for the most important companies and, for others, declarations

World Light Vehicle Production by Region

62.5 million units in 2005



Source: BBVA Bancomer with csmauto.com data

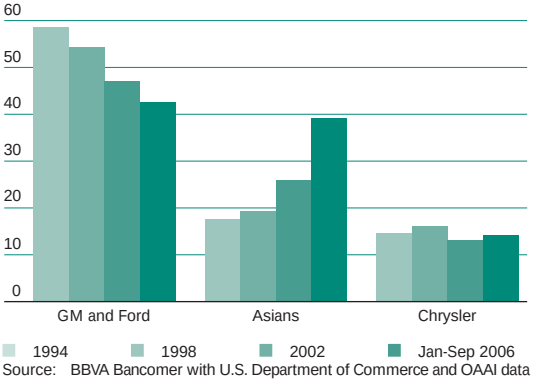
Main Trends in the World Automobile Industry

Concentration of assembly plants in the world. The structure of the world the automobile industry has experienced changes mainly through its consolidation. At present there are only nine participants (that produce around 50 million units annually) and that represent 82% of world production.
Relatively low growth in production in the North America zone. As per estimates by CSMauto, the emerging Asian markets will experience important increases. Also, it projects that China will increase its average production by 13.4% in 2005-2010. In contrast, the NAFTA zone will advance 1.4% on average in the same period.
Loss of market share of U.S. auto assembly companies. Ford and GM have lost 16 percentage points of market share in the U.S. between 1994-2006, while the Asian companies gained 21.6 percentage points in the same period. This is a problem for the auto part companies established in Mexico, which traditionally have been linked to the U.S. companies.
The growing responsibilities of suppliers. The greater negotiating power of the automobile assembly companies has been reflected in the greater responsibility of suppliers and the high pressure to reduce the prices of the components.

Source: BBVA Bancomer

Market Share by Company in the U.S.

Percentage



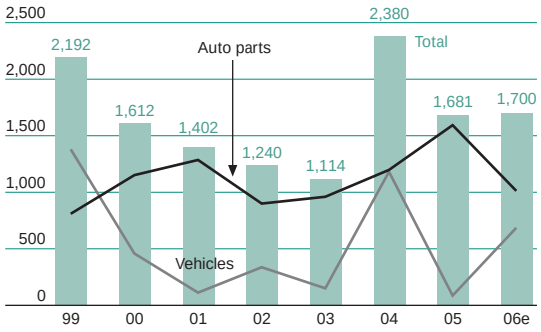
Source: BBVA Bancomer with U.S. Department of Commerce and OAAI data

Main U.S. Auto Part Manufacturers
Millions of US$

Company	2005			2004		
	TS	NE	NM	TS	NE	NM
Johnson Controls	28,020	909	3.2	26,434	819	3.1
Delphi	27,201	-6,369	-23.4	28,633		
Goodyear T&R	19,723	228	1.2	18,433	115	0.6
Lear Corp.	17,089	-1,382	-8.1	16,920	423	2.5
Visteon	16,976	-270	-1.6	18,655		
TRW Auto. Hold.	12,643	204	1.6	12,041	29	0.2
Navistar Interntl.	11,696	294	2.5	9,747	247	2.5
Dana	10,092	-1,379	-13.7	10,970	82	0.7
ArvinMeritor	9,816	12	0.1	9,089		
Federal-Mogul	6,286	-334	-5.3	6,163		
Autoliv	6,205	293	4.7	6,144	326	5.3
Tenneco	4,441	58	1.3	4,230	15	0.4
BorgWarner	4,294	240	5.6	3,520	218	6.2
Tower Automotive	3,444	-832	-24.2	3,189		
American A&M	3,387	56	1.7	3,603	160	4.4
Exide Tech.	2,691	1,282	47.6	2,492		
Fleetwood Ent.	2,624	-162	-6.2	2,598		
Thor Industries	2,558	122	4.8	2,186	106	4.9
Carlisle	2,551	106	4.2	2,453	79	3.2
Hayes Lemmerz	2,405	-131	-5.4	2,248		
Dura Auto. Sys.	2,344	2	0.1	2,494	13	0.5
Metaldyne	2,180	-21	-1.0	2,000		
Cooper T&R	2,155	-9	-0.4	3,918	180	4.6
Modine Manuf.	1,544	62	4.0	1,197	41	3.4
Total 2005	**202,365**	**-7,021**	**-3.5**	**199,353**		
Subtotal*	128,742	-196	-0.15	124,288	2,852	2.3

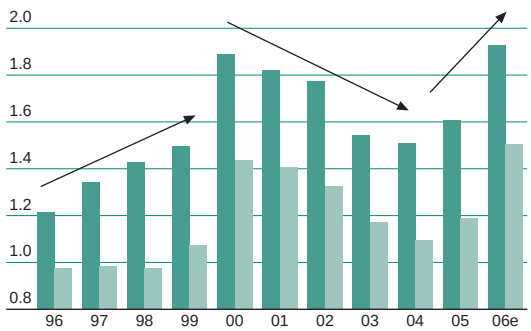
TS = Total Sales; NE = Net Earnings; NM = Net Margin, %
* Sub-Total of companies that reported 2004 net earnings
Source: BBVA Bancomer with Fortune 500 data

FDI in Mexico: Automobile Industry
Millions of US$



e estimated
Source: BBVA Bancomer with Economy Ministry data

Light Vehicle Production and Exports
Millions of units



e estimated
Source: BBVA Bancomer with AMIA data

of bankruptcy. In 2005, Visteon, Delphi and Lear Corp. accumulated losses worth US$8bn. It should be mentioned that the first two are the largest original suppliers of Ford and GM, respectively. Also, more than half of the most important U.S. auto parts manufacturers had losses, and the rest averaged a very small profit margin.

In an attempt to reverse the situation, auto parts manufacturers are following two main strategies. One is the relocation of production in low-cost countries, such as Mexico might be, notwithstanding the impact that this might have on the local economies. The second is a revision of their business practices, which includes products, its relationship with customers and attempts to integrate into the supplier networks of other assembling companies. The auto part companies have been overwhelmed by labor costs, which, in view of the lack of flexibility to reduce them in the U.S., the best alternative has been to move their plants to other countries. The countries of destination exhibit the following characteristics: they have an installed automobile industry, an economy linked to foreign trade, and advantages in the relative cost of labor, among others.

Flexibility and the capacity to adapt of Mexico's automobile industry

Currently, the automotive industry established in the country is going through a new phase of expansion after almost four years, in which the terminal automotive industry experienced sharp declines. The stage that it is starting and probably will consolidate in the coming years has been sustained by the maturing of investment projects of the automobile assembly companies established in the country. The projects have been characterized for promoting exclusive promotion for the world of new and more sophisticated models and with a higher content of auto parts. In Ford's case are the Fusion, Zephyr and Milan in the category of luxury medium-sized models. GM manufactures the HHR in this category and Chrysler has the Mega-Cab in the luxury pickup. VW participates with the Jetta A5/Bora in the medium compact segment, Toyota with the Tacoma luxury pickup, and Nissan with the Tiida/Versa compact. Also, the U.S. automobile assembly companies have made substantial investment so as to face the automotive restructuring, rationalization and integration in the NAFTA zone.

Investment flows are determinant factors for furthering progress in aspects such as the development of technology, machinery and equipment, process development and improvement, greater production capacity as well as the training of human resources. The automotive industry in the last six years has remained attractive as the main destination sector in manufacturing activity. Within the automotive industry, foreign direct investment has been aiming toward auto part production, while the assembly of light vehicles has shown more modest amounts, thereby reflecting, on the one hand, the search to modernize (flexible production) and optimize the existing installed production capacity of the terminal industry, and, on the other, the consolidation of the supply chain strategy in order to face the high costs that U.S. companies are contending with.

The new expansion phase of light vehicle production, strongly propelled by exports. In the current phase, the new models produced and investments made—in particular by Ford and VW—have propelled light vehicle production. In fact, it is estimated that in 2006

the industry will show its best performance in the last six years. The units assembled could reach a volume higher than that of 2000, when 1,889,000 units were produced. By company, the situation is similar, although GM, Ford and Toyota surpass their levels compared to 2000. This outlook is supported by the performance shown in their foreign sales, which, it is estimated, will achieve annual growth of 30%.

Growth in production and auto part exports is consolidating. The present trend to delegate to auto part producers the manufacture of complex components made up of multiple parts (assembly modules) has favored Mexico. The installation of auto parts manufacturers in the country has been reflected in the continuous rise in exports to the U.S. in the last five years. For other companies of Japanese origin established in the U.S., there has been progress is Mexico's supply of auto parts, although at modest levels. For example, in Toyota's case, its purchases from our country totaled US$800mn in 2002, a figure that could increase to US$1.4bn by 2006.

An opportunity for Mexico: to consolidate its position as an important regional producer

The maturing of investments for 2006 (US$37mn by Toyota, US$32mn by Honda, US$1bn by DaimlerChrysler and US$650mn by GM) has given rise to moderate optimism regarding the production of light vehicles and auto parts for 2007. Also, given the similar labor productivity between Mexico and the U.S., substantially lower labor costs in Mexico (US$3.5 an hour vs. US$27 in the U.S.), an experienced labor force with a long tradition in vehicle production and supply to the U.S. market are significant advantages for producers to consider Mexico as an option to bring costs down and face the competition seen by U.S. companies around the world. An additional advantage is that Mexico is also favored by its geographic location.

In this sense, the PriceWaterhouseCoopers (PwC) previsions regarding global installed production capacity underscore the following aspects: the North America zone will remain with a capacity for 18.8 million units through 2010. By country, although the U.S. is the one that will experience the greatest adjustment due to the plant shutdowns announced by Ford and GM, this zone will be moderate due mainly to production capacity increases of the Japanese and Korean plants. Mexico will be the only one that will increase its production capacity by 25%, reinforcing the positive outlook for investment and production in the medium term.

As for the auto part industry, a trend toward consolidation and relocation of suppliers is feasible. Also, that its benefits are limited due to the demand from vehicle manufacturers to increasingly reduce the price of auto parts within a context of rising prices of raw materials. This situation opens up a window of opportunity for Mexico.

In short, the situation now being experienced by the automotive industry in the world, in particular that of the U.S., offers Mexico the opportunity to consolidate its position as an exporting power in the North America zone. Nevertheless, for the country to capitalize on this will require greater progress in productivity, since it is facing a world automotive industry with enormous challenges. In other words, Mexico can successfully face competition in a global environment if it makes the necessary structural changes.

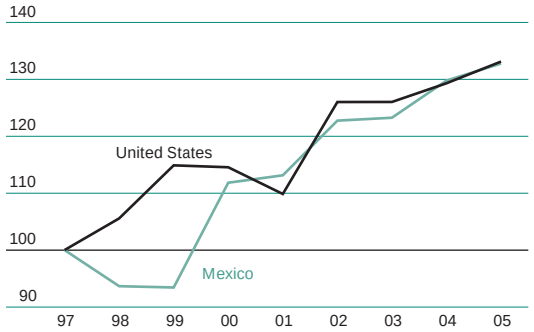
Auto Parts Production and Exports*

Annual % change

* Mexican Exports to the U.S.
e estimated
Source: BBVA Bancomer with Bloomberg data

Labor Productivity

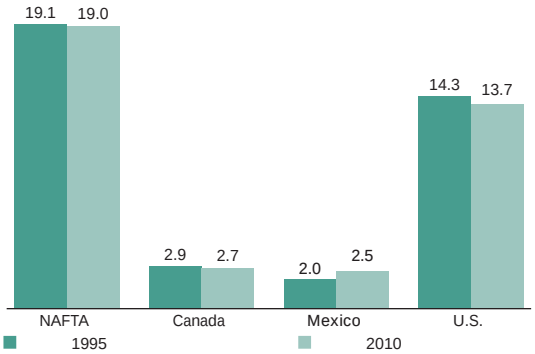
Index 1997 = 100



Source: BBVA Bancomer

North America Production Capacity

Annual units



Source: PWC Global Automotive Outlook 2006, 4Q Release

Automobile Industry in Mexico

Numbers

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	
Supply											
Economic importance, % of GDP	2.5	2.7	2.8	3.1	3.0	3.0	2.8	2.8	2.9	3.4	est
Terminal	1.3	1.4	1.4	1.7	1.6	1.7	1.5	1.5	1.6	2.0	est
Auto Parts	1.2	1.3	1.4	1.4	1.3	1.3	1.3	1.3	1.3	1.4	est
Employed personnel, thousands	369	410	434	473	448	438	433	437	463	503	jul
Terminal	49	54	57	60	57	52	46	43	46	52	jul
Auto parts	320	356	377	414	390	386	388	394	418	451	jul
Production, volume index (1993= 100)											
Terminal	135.5	147.6	162.0	202.8	196.1	206.3	190.7	194.1	185.1	254.1	jul
Real annual % change		8.9	9.8	25.2	-3.3	5.2	-7.6	1.8	-2.8	37.3	jul
Auto Parts	133.5	148.3	162.3	179.5	165.9	162.2	159.9	174.8	176.8	189.7	jul
Real annual % change		11.1	9.5	10.6	-7.6	-2.2	-1.4	9.3	2.6	7.3	jul
Terminal automobile prod., th. of units	1,363	1,465	1,551	1,936	1,856	1,823	1,589	1,570	1,673	1,542	sep
Automobiles and light trucks	1,339	1,428	1,494	1,889	1,818	1,774	1,541	1,507	1,606	1,475	sep
Heavy trucks[2]	24	38	57	46	38	48	48	63	67	67	sep
Demand											
Domestic market prod., th. of units											
Automobiles and light trucks	354	449	416	456	435	455	370	406	414	315	sep
Heavy trucks	18	23	24	29	27	25	23	25	29	31	sep
Domestic market sales[3], th. of units											
Automobiles and light trucks	482	643	667	854	919	978	978	1,096	1,132	800	sep
Heavy trucks	18	24	26	35	30	26	25	28	35	35	sep
Export production, thousands of units											
Automobiles and light trucks	984	979	1,077	1,433	1,382	1,319	1,170	1,102	1,186	876	sep
Export sales, thousands of units											
Automobiles and light trucks	983	972	1,074	1,434	1,404	1,326	1,170	1,094	1,186	1,138	sep
Heavy trucks	5	14	34	17	11	24	25	38	37	37	sep
Export specialty[4]											
Automobiles and light trucks	73.5%	68.6%	72.1%	75.8%	76.0%	74.4%	76.0%	73.1%	74.3%	78.7%	sep
Heavy trucks	23.0%	38.5%	58.7%	36.5%	29.0%	48.9%	51.7%	59.9%	56.6%	55.0%	sep
Automobile exports, millions of dollars	744,598	23,094	28,300	32,744	32,045	33,026	32,665	36,132	40,066	31,600	ago
Terminal	14,033	15,178	18,863	22,065	21,885	21,498	20,362	20,845	22,622	18,459	ago
Automobiles and light trucks	9,888	11,148	12,587	16,649	15,171	13,828	12,329	11,616	13,191	11,222	ago
Heavy trucks	4,145	4,029	6,276	5,416	6,714	7,671	8,033	9,229	9,432	7,237	ago
Auto parts	730,565	7,917	9,437	10,679	10,161	11,527	12,304	15,287	17,443	13,141	ago
Manufacture	4,009	4,804	5,633	6,109	5,972	6,713	7,160	8,717	10,226	7,543	ago
In-bond	726,556	3,113	3,803	4,570	4,189	4,815	5,143	6,570	7,217	5,598	ago
Automobile exports, % of manuf. exports	22.2	21.9	23.3	22.6	22.8	23.3	23.2	22.4	22.9	23.9	ago
Terminal	14.9	14.4	15.5	15.2	15.5	15.2	14.5	13.2	12.9	14.0	ago
Automobiles and light trucks	10.5	10.6	10.4	11.5	10.8	9.8	8.8	7.4	7.5	8.5	ago
Heavy trucks	4.4	3.8	5.2	3.7	4.8	5.4	5.7	5.9	5.4	5.5	ago
Auto parts	7.3	7.5	7.8	7.4	7.2	8.1	8.7	9.2	10.0	10.0	ago
Manufacture	4.3	4.6	4.6	4.2	4.2	4.7	5.1	5.5	5.8	5.7	ago
In-bond	3.0	3.0	3.1	3.2	3.0	3.4	3.7	4.2	4.1	4.2	ago
Auto. imports from U.S., US$ millions	25,424	27,670	32,556	39,665	39,482	40,972	40,436	42,172	42,708	32,137	ago
Terminal	12,110	13,190	15,788	21,002	21,302	20,903	19,397	19,068	18,777	15,194	ago
Auto parts[5]	13,314	14,480	16,768	18,663	18,180	20,069	21,039	23,104	23,931	16,943	ago
Auto.exports to U.S./Manuf. exports, %	nd	nd	34.6	37.6	32.5	28.3	28.0	29.2	30.4	25.7	ago

1 Automobile industry GDP /Total GDP to basic values at constant prices
2 Includes chassises and excludes AMIA production
3 Includes imports
4 Exports / production (units)
5 Includes exports of other industries such as the glass, fabrics, electrical and electronic parts
Source: BBVA Bancomer with INEGI, Banco de Mexico, AMIA, ANPACT and U.S. Census Bureau data

United States Indicators and Forecasts

	I'06	II'06	III'06	IV'06	I'07	II'07	III'07	IV'07	2005	2006	2007
Economic Activity											
GDP (real annual % change)	3.7	3.5	2.9	**3.1**	**2.6**	**2.7**	**3.0**	**3.0**	3.2	**3.3**	**2.8**
Personal consumption expenditures	3.4	3.0	2.8	**3.2**	**2.6**	**2.6**	**2.3**	**2.3**	3.5	**3.1**	**2.5**
Gross fixed investment	6.9	3.9	1.9	**2.0**	**0.9**	**2.3**	**3.5**	**3.6**	7.5	**3.6**	**2.6**
Non-residential	7.4	7.2	7.9	**7.7**	**6.0**	**6.4**	**5.6**	**5.6**	6.8	**7.6**	**5.9**
Structures	2.6	8.0	13.7	**12.4**	**11.6**	**7.9**	**4.9**	**2.6**	1.1	**9.2**	**6.6**
Equipment and software	9.2	6.8	5.7	**5.1**	**3.0**	**5.0**	**5.0**	**6.4**	8.9	**6.7**	**4.9**
Residential	6.1	-1.5	-7.7	**-8.0**	**-8.4**	**-6.1**	**-1.8**	**-1.2**	8.6	**-2.9**	**-4.5**
Total exports	9.0	8.2	9.0	**8.9**	**7.3**	**7.5**	**7.4**	**6.7**	6.8	**8.8**	**7.2**
Total imports	6.4	6.4	7.8	**5.0**	**3.3**	**3.3**	**1.7**	**1.5**	6.1	**6.4**	**2.5**
Government consumption	2.0	2.0	1.6	**2.0**	**1.8**	**1.8**	**1.8**	**1.8**	0.9	**1.9**	**1.8**
Contribution to Growth (pp)											
Personal consumption expenditures	2.4	2.1	2.0	**2.3**	**1.9**	**1.8**	**1.7**	**1.6**	2.5	**2.2**	**1.7**
Private investment	1.0	1.2	0.9	**0.3**	**0.2**	**0.3**	**0.5**	**0.6**	0.9	**0.9**	**0.4**
Net exports	-0.1	-0.2	-0.3	**0.1**	**0.3**	**0.3**	**0.6**	**0.5**	-0.3	**-0.1**	**0.4**
Government consumption	0.4	0.4	0.3	**0.3**	**0.3**	**0.3**	**0.3**	**0.3**	0.2	**0.3**	**0.3**
Prices and Costs (annual % change, average)											
CPI	3.6	4.0	3.3	**2.2**	**2.4**	**1.7**	**1.7**	**2.5**	3.4	**3.3**	**2.1**
Core	2.1	2.5	2.8	**2.8**	**2.7**	**2.3**	**2.1**	**2.1**	2.2	**2.5**	**2.3**
PCE	3.0	3.3	2.9	**2.1**	**2.1**	**1.5**	**1.4**	**1.9**	2.9	**2.8**	**1.7**
Core	2.0	2.2	2.4	**2.3**	**2.3**	**2.1**	**2.0**	**1.9**	2.1	**2.3**	**2.1**
GDP deflactor	3.1	3.3	2.9	**2.3**	**2.2**	**2.2**	**2.2**	**2.0**	3.0	**2.9**	**2.1**
Productivity	2.8	2.5	1.3	**2.2**	**2.0**	**2.0**	**2.0**	**2.0**	2.3	**2.2**	**2.0**
Real compensation per hour	2.6	3.5	3.2	**3.2**	**2.6**	**2.6**	**2.6**	**2.6**	1.0	**3.1**	**2.6**
Unit labor cost	3.6	5.1	5.2	**3.2**	**2.7**	**2.7**	**2.7**	**2.7**	2.0	**4.3**	**2.7**
Other Indicators											
Industrial production (real annual % change)	3.3	4.6	5.1	**3.9**	**4.0**	**3.1**	**2.3**	**3.1**	3.2	**4.2**	**3.1**
Capacity utilization (%)	81.1	82.0	82.3	**82.5**	**82.6**	**82.8**	**83.0**	**83.1**	80.1	**82.0**	**82.9**
Light weight vehicle sales (millions, annualized)	16.9	16.4	16.6	**16.4**	**16.6**	**16.6**	**16.5**	**16.6**	16.9	**16.6**	**16.5**
Housing starts (thousands, annualized)	2,123	1,873	1,735	**1,742**	**1,723**	**1,681**	**1,662**	**1,657**	2,073	**1,868**	**1,681**
Nonfarm payrolls (thousands of new jobs, average)	176	115	121	**160**	**140**	**140**	**140**	**140**	165	**143**	**140**
Unemployment rate (average, %)	4.7	4.6	4.7	**4.6**	**4.7**	**4.7**	**4.8**	**4.8**	5.1	**4.7**	**4.7**
Personal savings rate	-1.4	-1.3	-1.4	**-1.3**	**-0.6**	**-0.4**	**-0.1**	**0.2**	-0.5	**-1.3**	**-0.2**
Trade balance (US$ billions)	-213	-218.4	-215.0	**-214**	**-210**	**-209**	**-194**	**-194**	-724	**-789**	**-749**
Current account balance (US$ billions)	-849	-871.8	**-860**	**-856**	**-840**	**-837**	**-777**	**-775**	-805	**-859**	**-807**
% of GDP	-6.5	-6.6	**-6.5**	**-6.4**	**-6.2**	**-6.1**	**-5.6**	**-5.5**	-6.4	**-6.5**	**-5.9**
Fiscal balance (US$ billions, fiscal year)	—	—	—	**-260**	—	—	—	**-286**	-318	**-275**	**-301**
% of GDP	—	—	—	**-2.1**	—	—	—	**-2.2**	-2.6	**-2.1**	**-2.2**
Brent (dollars per barrel, average)	66.4	74.6	72.0	**59.5**	**58.1**	**57.2**	**56.3**	**55.1**	58.3	**68.1**	**56.7**
Financial Markets (eop)											
Fed Funds (%)	4.75	5.25	5.25	**5.25**	**5.25**	**5.25**	**5.25**	**5.25**	4.25	**5.25**	**5.25**
3-month Libor (%)	5.00	5.48	5.37	**5.33**	**5.27**	**5.22**	**5.17**	**5.12**	4.54	**5.33**	**5.12**
10-year Treasury Note (%)	4.85	5.14	4.63	**4.84**	**4.90**	**4.90**	**4.90**	**4.90**	4.39	**4.84**	**4.90**
Dollar/euro	1.21	1.28	1.27	**1.27**	**1.28**	**1.29**	**1.29**	**1.30**	1.18	**1.27**	**1.30**

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

Mexico Indicators and Forecasts

	2003	2004	2005	2006	2007	I'06	II'06	III'06	IV'06	I'07	II'07	III'07	IV'07
Economic Activity													
GDP (seasonally-adjusted series)													
Real annual % change	1.4	4.2	3.0	**4.6**	**3.6**	4.2	6.1	**4.5**	**3.8**	**2.9**	**2.9**	**3.5**	**4.9**
Per inhabitant (US dollars)*	6,356	6,729	7,497	**8,138**	**8,604**	6,990	7,420	**7,435**	**8,168**	**7,995**	**8,074**	**7,701**	**8,389**
US$ billions	639	683	769	**843**	**900**	832	849	**812**	**879**	**863**	**931**	**868**	**937**
Inflation (eop, %)													
Headline	4.0	5.2	3.3	**3.8**	**3.5**	4.4	3.2	4.1	**3.8**	**3.9**	**4.2**	**3.5**	**3.5**
Core	3.7	3.8	3.1	**3.4**	**3.2**	3.6	3.2	3.4	**3.4**	**3.5**	**3.3**	**3.2**	**3.2**
Financial Markets													
Interest rates (eop, %)													
Bank funding	6.1	8.8	8.3	**7.0**	**6.5**	7.3	7.0	7.0	**7.0**	**7.0**	**7.0**	**6.8**	**6.5**
28-day Cetes	6.0	8.6	8.0	**7.0**	**6.5**	7.3	7.0	7.1	**7.0**	**7.2**	**6.8**	**6.5**	**6.5**
28-day TIIE	6.3	9.0	8.6	**7.3**	**6.7**	7.6	7.3	7.3	**7.3**	**7.3**	**7.1**	**6.7**	**6.7**
10-year Bond	8.3	9.7	8.5	**8.0**	**7.5**	8.7	9.7	8.2	**8.0**	**7.8**	**7.7**	**7.7**	**7.5**
Exchange rate													
Pesos per dollar, eop	11.2	11.3	10.7	**10.9**	**11.3**	11.0	11.4	11.0	**10.9**	**10.8**	**10.9**	**11.1**	**11.3**
Public Finances													
Fiscal balance (% of GDP)	-0.6	-0.2	-0.1	**0.2**	**0.0**	na	na	**na**	**0.2**	**na**	**na**	**na**	**0.0**
FRPS (% GDP)	3.0	2.7	2.1	**1.5**	**1.4**	na	na	**na**	**1.5**	**na**	**na**	**na**	**1.4**
External Sector**													
Trade balance (US$ billions)	-5.8	-8.8	-7.6	**-5.1**	**-11.6**	-5.0	-4.5	**-5.3**	**-5.1**	**-6.4**	**-7.9**	**-8.4**	**-11.6**
Current account (US$ billions)	-8.6	-6.6	-4.6	**-3.8**	**-11.1**	-1.1	-0.6	**-2.7**	**-3.8**	**-7.1**	**-10.3**	**-10.1**	**-11.1**
Current account (% of GDP)	-1.4	-1.0	-0.6	**-0.3**	**-1.3**	-0.1	-0.1	**-0.1**	**-0.3**	**-0.7**	**-1.1**	**-1.3**	**-1.3**
Oil (Mexican mix, dpb, eop)	25.7	28.6	44.9	**57.6**	**49.4**	51.4	55.5	**60.5**	**57.6**	**54.4**	**52.3**	**51.5**	**49.4**
Monetary Agreggates & Banking Activity (ann. % chge.)													
Core bank deposits	6.9	3.1	3.2	**7.4**	**6.0**	6.7	6.8	**6.4**	**7.4**	**6.1**	**7.1**	**6.1**	**6.0**
Commer. banks performing loans***	5.5	27.7	26.6	**21.7**	**17.5**	27.9	28.4	**26.5**	**21.7**	**20.0**	**16.1**	**15.7**	**17.5**
Agreggate Demand (ann. % chge., seasonally-adjusted)													
Total	1.2	6.2	4.6	**7.1**	**4.7**	7.7	8.1	**6.9**	**5.8**	**4.3**	**4.1**	**4.7**	**5.9**
Domestic demand	1.8	4.3	5.4	**6.7**	**4.7**	7.8	6.6	**6.2**	**6.4**	**5.0**	**5.0**	**4.3**	**4.6**
Consumption	2.1	3.6	4.8	**6.0**	**4.4**	6.6	5.8	**5.6**	**6.0**	**4.6**	**4.6**	**3.9**	**4.3**
Private	2.2	4.1	5.4	**6.0**	**4.8**	6.5	5.5	**5.7**	**6.1**	**5.2**	**5.2**	**4.2**	**4.6**
Public	1.0	-0.4	0.3	**6.5**	**0.7**	7.3	8.7	**5.0**	**5.1**	**0.0**	**0.0**	**1.0**	**1.8**
Investment	0.4	7.5	7.6	**9.7**	**6.1**	12.9	9.6	**8.7**	**7.6**	**6.2**	**6.3**	**6.0**	**5.9**
Private	-1.6	8.8	9.6	**9.7**	**6.1**	11.1	11.9	**8.5**	**7.4**	**6.2**	**6.3**	**6.0**	**5.9**
Public	8.5	2.5	-0.4	**9.3**	**6.2**	22.1	-1.6	**9.6**	**8.5**	**6.3**	**6.4**	**6.1**	**6.0**
External demand	2.7	11.7	6.8	**11.5**	**8.2**	11.1	13.2	**12.1**	**9.6**	**7.5**	**7.3**	**8.4**	**9.7**
Imports	0.7	11.6	8.6	**13.0**	**7.4**	16.4	12.8	**12.5**	**10.5**	**7.5**	**6.8**	**7.2**	**8.0**
GDP by sectors (annual % change)													
Agriculture	3.1	3.5	-1.5	**4.9**	**5.5**	2.3	7.5	**4.1**	**5.4**	**1.4**	**1.0**	**8.8**	**9.9**
Industrial	-0.2	4.2	1.6	**5.1**	**3.4**	4.5	6.2	**5.4**	**3.3**	**2.7**	**2.5**	**2.9**	**4.3**
Mining	3.7	3.4	1.2	**2.9**	**2.3**	4.1	1.3	**3.9**	**3.2**	**0.2**	**3.6**	**3.0**	**2.4**
Manufactures	-1.3	4.0	1.2	**5.0**	**3.4**	4.6	6.2	**5.6**	**3.6**	**2.9**	**2.6**	**2.9**	**5.0**
Construction	3.3	6.1	3.3	**6.4**	**4.1**	6.2	7.2	**4.5**	**2.3**	**2.1**	**2.7**	**4.1**	**4.2**
Electricity, gas and water	1.5	2.8	1.4	**4.3**	**2.0**	3.0	4.1	**3.7**	**3.7**	**1.1**	**-0.7**	**1.5**	**2.5**
Services	2.1	4.4	4.2	**4.7**	**3.9**	4.8	5.5	**4.8**	**4.0**	**3.6**	**3.7**	**3.7**	**4.5**
Retail, restaurants and hotels	1.5	5.5	3.1	**4.1**	**3.6**	3.7	4.9	**4.8**	**3.3**	**2.9**	**3.9**	**3.2**	**3.4**
Transportation and communications	5.0	9.2	7.1	**8.4**	**6.4**	8.1	9.1	**8.6**	**7.2**	**6.4**	**6.1**	**5.8**	**6.4**
Financial, insurance and real-estate	3.9	3.9	5.8	**5.1**	**4.5**	5.7	5.5	**4.8**	**4.8**	**4.7**	**4.2**	**4.5**	**4.5**
Community and personal	-0.6	0.6	2.1	**2.5**	**2.0**	2.7	3.4	**2.4**	**1.5**	**1.5**	**1.1**	**1.6**	**3.2**

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		
Coyuntura Macroeconómica y Financiera	Sun Brokers	Bogota, July 2006
Coyuntura Macroeconómica y Financiera	Cemex	Bogota, August 2006
Coyuntura Macroeconómica y Financiera	Secretaría de Hacienda Distrital	Bogota, September 2006
Buenos Aires www.bancofrances.com.ar		
Perspectivas Económicas 2006-2007	Foreign Trade Sector Clients	Mar del Plata, July 2006
Perspectivas Económicas 2006-2007	Foreign Trade Sector Clients	Buenos Aires, August 2006
Perspectivas Económicas 2006-2007	PSA Citroën Peugeot	Buenos Aires, August 2006
Persp. Macroeconómicas y Sec. Construc. e Inmobiliario 2006-2008	Real estate investors	Buenos Aires, September 2006
Caracas www.provincial.com		
Previsiones Macroeconómicas 2007	Good Year	Valencia, August 2006
Coyuntura y Previsiones Macro 2007	Kimberly Clark	Caracas, August 2006
Previsiones 2007 y Análisis Sector Alimentos	Kraft	Caracas, August 2006
Lima www.bbvabancocontinental.com		
Cinco Preguntas para el Próximo Quinquenio	Short-term Meeting - BBVA Clients	Lima, July 2006
FDI: 5 Aspectos que Pueden Ayudar	Bloomberg	Lima, July 2006
Peru: Economic Outlook	Wells Fargo	Lima, August 2006
Peru: Situación Económica	IFC	Lima, August 2006
Los Primeros 30 Días	Short-term Meeting - BBVA Clients	Lima, September 2006
Contexto Económico y Mercado Laboral	Universidad Católica del Perú	Lima, September 2006
Madrid www.bbva.com		
Situación y Perspectivas de la Economía Española	Universidad Internacional Menéndez Pelayo	Santander, July 2006
Presentación Situación Inmobiliaria	Press	Madrid, July 2006
Perspectiva para la Economía Global	Press	Barcelona, July 2006
Presentación EuropaWatch y Situación España	Press	Madrid, July 2006
China: Tendencias, Claves y Soluciones	Bolsa de Valencia	Valencia, September 2006
Mexico www.bancomer.com		
Método de Componentes Principales para Análisis Regional	INEGI	Mexico City, August 2006
Estimación del PIB a Nivel Estatal	Asoc. Mex. de Secretarios de Desarrollo Eco.	Mazatlán, Sin., August 2006
Escenarios Macroeconómicos después de las Elecciones	Corporate Banking - Kellog´s	Querétaro, Qro., July 2006
México: Fortaleza Económica en la Coyuntura Política	Corporate Banking -Novo-Nordik	Mexico City, July 2006
La Economía Mexicana en el Primer Semestre de 2006	Patrimonial Banking - ASPA	Mexico City, July 2006
Panorama Económico para el Cuarto Trimestre de 2006	South Metropolitan Regional Council	Mexico City, September 2006
La Economía al Cierre de 2006	North Metropolitan Regional Council	Mexico City, September 2006
México a Dos Meses de las Elecciones	Monterrey Regional Council	Monterrey N.L., Sept. 2006
¿Se Mantendrá el Crecimiento Económico en los Próximos Meses?	Guadalajara Regional Council	Guadalajara, Jal., Sept. 2006
México: Se Modera el Crecimiento en el Segundo Semestre	Patrimonial Banking - South Metro Clients	Mexico City, September 2006
Papel de la Banca en el Bienestar y el Crecimiento Económico	Universidad Iberoamericana	Mexico City, September 2006
¿Estamos en Camino de un Aumento de la Calificación Soberana?	Treasury and Markets	Mexico City, September 2006
Una mirada a México en el 2007	Government and Business Banking	Mexico City, October 2006
Construyendo una agenda eco. mínima para los próximos 6 años	El Semanario	Mexico City, October 2006
¿Cómo actuará Banxico ante el repunte infla. y la desacele. en EUA?	National Council of Regional Presidents	Mexico City, November 2006
BBVA USA www.lnb.com		
Economic Slowdown and Inflationary Risks	Board of Directors BBVA USA	Houston, July 2006
The Economy is in Transition	Board of Directors LNB	Laredo, August 2006
US & Mexico: Economic Trends & Perspectives	LNB Commercial Banking Clients	Laredo, September 2006
US-Mexico Trade Relations	Western Hemispheric Trade Center	Laredo, September 2006
El Mercado Inmobiliario en Estados Unidos	Global and Distribution Markets	Sumiya, September 2006
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