BBVA Bancomer

Mexico Watch

Economic Research Department

Second Quarter 2009

A global crisis that shows signs of stabilization

Mexico: recession and recovery in hand with external factors

The peso, undervalued but with a outlook toward its appreciation

The challenge of reinforcing the performance margin of fiscal policy

Contents

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Editorial and Executive Summary

The Mexican economy is experiencing the most rapid and intense adjustment of the past 15 years, with declines in activity in the first half of 2009 comparable to the levels posted in 1995. For the year as a whole, this implies a decline in GDP comparable to what occurred back in 1995. However, contrary to what occurred on previous occasions, it has not been domestic factors that sparked the adjustment. Mexico faces an external crisis due to the impact of restricted liquidity conditions and the drop in global demand. However, the conditions of the Mexican economy, some of its strong points that have been built up over the past few years, are serving, to some degree, as support factors that are contributing to mitigate the impact of the crisis, although not as intensely as required.

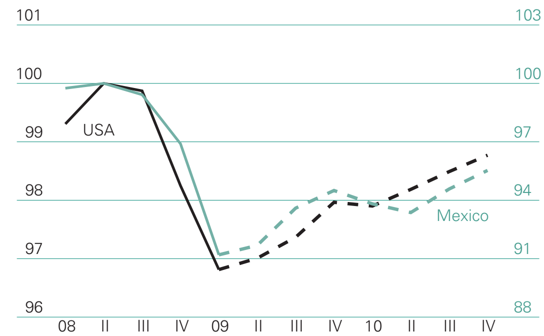
The Mexican economy is more open to external factors than before and is especially close to the nucleus of the current crisis, the United States, which explains the intensity of the adjustment that it faces. But this proximity and the opening to the U.S. economy, which will likely recover before other countries, combined with the impact of the performance margin of the monetary and fiscal policies implemented in the past few months, will also facilitate the Mexican economy's ability to overcome its current difficulties.

However, overcoming the crisis will not be as rapid as was the case in 1995. First of all because global demand is not growing at the same rhythm as in 1995, nor can it be expected that the recovery of the U.S. economy and of other developed nations will allow for a return to growth rates as high as those of the second half of the 1990s. Secondly, the high degree of indebtedness of U.S. families will lead to increases in the savings rate and a per capita reduction in the consumption of durable goods. Finally, although the depreciation of the peso is helping the margin, it will not do so to the same extent as in the 1995 crisis, fortunately, given the harmful effect of the devaluation of the country's currency on inflation and real wages.

In this situation, we should ask ourselves whether, in the event that an additional anti-cyclical boost from economic policy is needed, there is maneuvering room for this. And the answer is that in this regard perhaps the performance limits are being put to the test. The monetary policy implemented by the Banco de México is taking advantage of the margin provided by the improvement of the global financial environment to reduce interest rates, nominal and real, to their minimum historical levels, coherent with the anchoring of the inflationary outlook and the intensity of the recession in economic activity. In addition to this, there is the performance of long-term interest rates and the improvement in the global financial environment, with lower risk aversion levels in the emerging markets.

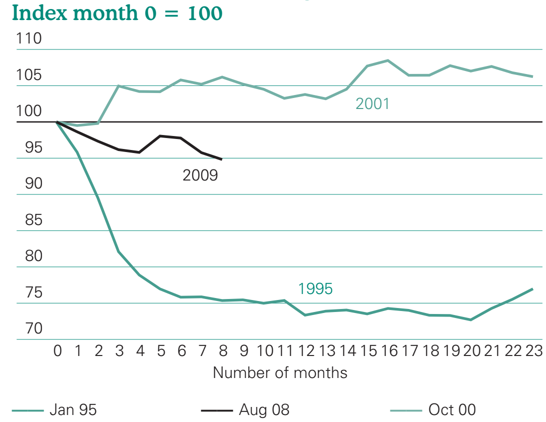
The stability of the financial markets in Mexico is also a dividend of the experience accumulated in the satisfactory handling of economic policy, which makes the country structurally solid. This has allowed for a greater potential availability of abundant and cheap liquidity in dollars through the Flexible Credit Line approved by the IMF. This, coupled with the credit line in dollars with the Fed equals the central bank's dollar reserves, which lessens the possibility of problems in

Gross Domestic Product
June 2008 Index = 100



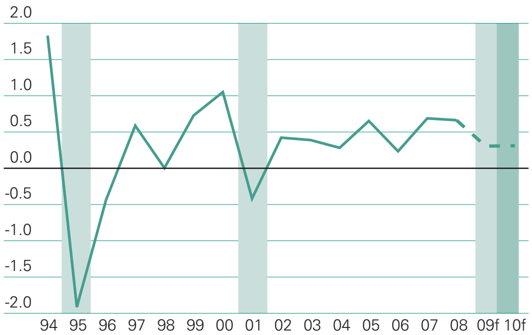
Source: BBVA Bancomer with INEGI and Federal Reserve data

Mexico: Real Total Wages
Index month 0 = 100



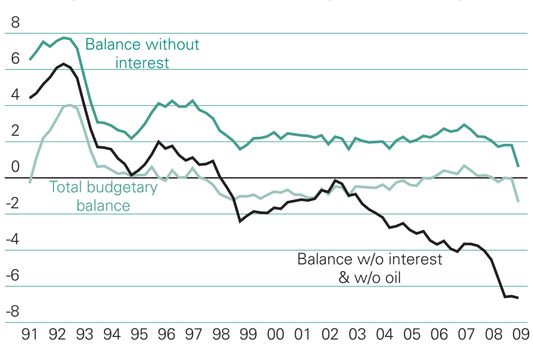
Source: BBVA Bancomer with INEGI data

Mexico: Public Spending in Consumption and Investment
Contribution to growth, percentage points



Note: Recessive period shaded
Source: BBVA Bancomer

Mexico: Public Balance
% PIB, prom. móvil 4 trimestres, positivo = superávit



Source: BBVA Bancomer con datos de INEGI y SHCP

financing the balance of payments. Due to lower economic growth, the gap between imports and exports of goods and services tends to close, and the level and structure of maturities of Mexican public and private debt limits the anticipated increase in the interest payment deficit.

As regards fiscal policy, for the first time in its history, Mexico is able to implement an anti-cyclical strategy, partially mitigating the impact of the crisis basically with increases in spending in public investment and, in addition, with transfers of resources implemented through price regulations or policies supporting corporate liquidity through development bank guarantees. But with all these measures, the program implemented only represents the equivalent of barely more than 1% of GDP, which in the final analysis could imply a boost to growth of about half that level.

If it were necessary to increase discretionary measures to boost demand or to support the available income of companies and families, it is not possible to go beyond what has already been approved without reaching the limits established in the Federal Budget Responsibility Law. This is not a specific problem of the limits—although it would be worthwhile to consider the possibility of setting goals for the public deficit and surplus consistent with the cycle—but of the structure of public revenue and expenditures.

As we explain in Mexico Watch, the control of the public deficit in the past few years has been supported by a growing contribution of the positive balance between oil-related revenue and expenditures. Without the contribution from oil revenue the public balance is strongly in the red, which keeping in mind the medium-term outlook for the exploitation of this resource, implies a structural vulnerability of public accounts, in addition to introducing elements of uncertainty in the short term due to the evolution of prices. In this situation, and also given the limited nature of the non-oil tax collection base, control of the budget balance depends on public spending, which prevents public expenditures from adequately fulfilling their role of ensuring cyclical stabilization and the provision of public goods such as health care, education, or security. This definitely prevents fiscal policy from contributing as much as it can to promoting the long term growth of the economy and increasing the population's well-being.

A Global Crisis that is Stabilizing

In the second quarter of 2009 the economic panorama improved with reduced tensions in the financial markets and an apparent lower rhythm in the weakening of real activity

From a global perspective, the evolution of the economy since the beginning of 2009 continued to be marked by high levels of pressure in the financial markets, which have been lessening as the year goes on. Thus, in May, U.S. bank credit default swaps (CDS)[1] dropped to their lowest level since the Lehman Brothers bankruptcy, while European CDS have plummeted to their lowest point since November 2008. At the same time, important adjustments are also being posted in the interbank markets, with the three-month Overnight Index Swap (OIS) spread[2] in the United States and in the European Monetary Union at its lowest levels since the beginning of 2008. However, in both cases there are still significant levels of tension, both in comparison with those registered in the first phases of the crisis as well as in those prevailing in the period prior to it.

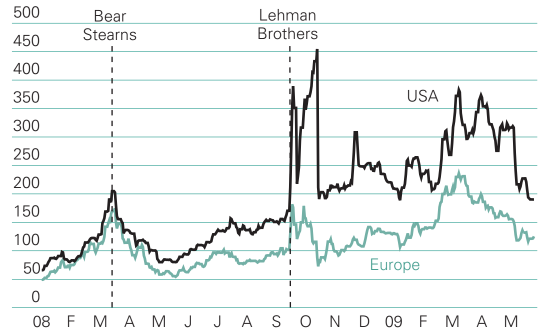
The continuity and intensification of the contraction of the global economy in the early months of the year were a fundamental element in maintaining high risk aversion levels. Thus, data from the first quarter of 2009 continued to show strong declines in U.S. economic activity (-1.6% in quarterly terms), with a declining rhythm similar to the decreases posted in the fourth quarter. In Europe, the indicators maintained an exceptionally negative tone, with a 2.5% drop in GDP in the first quarter compared to the final quarter of 2008, higher than the 1.6% decline posted in the fourth quarter. Nevertheless, the general tone of the period's indicators based on the data available to date and in relation to April and May is, on the whole, less negative. Based on this change, it could be assumed that the rhythm of contraction in economic activity could be tapering off, although declines will still probably occur in the short term. The markets reacted positively to this possible improvement in the period under consideration, but the continuity of this trend will continue to be subject to the uncertainty surrounding how long the crisis will indeed last.

Public policy measures to stabilize the financial system, more intense in the United States

In response to the continuation of the financial tensions and the contraction of the global economy, the governments concerned have increased measures to face the global financial crisis. The U.S. economy continues to show the greatest progress in the adoption of such policies, especially after the new administration launched a new program of measures designed to stabilize the financial system. A key element within this program involved "stress tests", designed to measure the resistance of the balance sheets of the main financial institutions to adverse economic scenarios, with the objective of knowing and disclosing their capital requirements, eliminating the existing uncertainty in this regard. The results of the test indicated that 10 of the 19 main U.S. financial institutions need US$75 billion dollars in additional capital, which they must obtain in

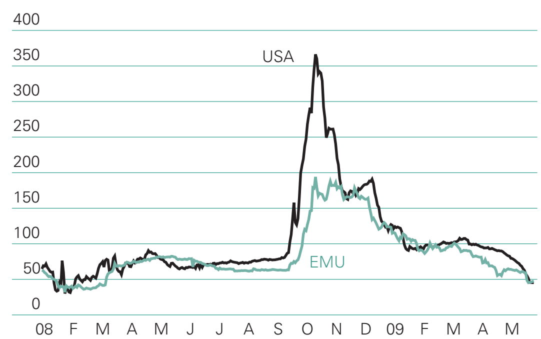
1 *Credit Default Swap* is a loan derivative used to hedge credit risk.
2 The interbank rate spread with the Overnight Index Swap, is based, therefore, on the degree of risk assigned to interbank loans.

Banks: 5 Year Senior CDS
Basis Points



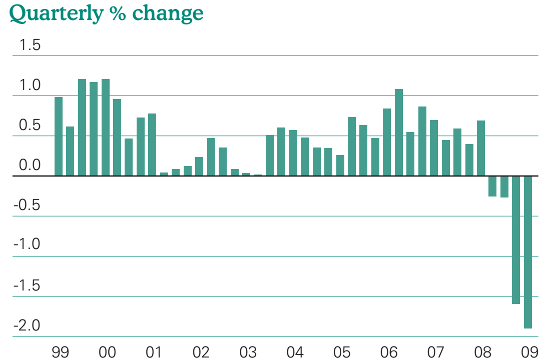
Source: BBVA Bancomer with Bloomberg data

Interbank Markets: Three Month OIS Spread
Three month Libor – three month OIS



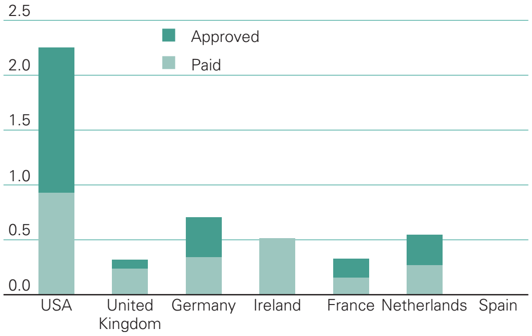
Source: BBVA Bancomer with Bloomberg data

EMU: GDP Growth
Quarterly % change



Source: BBVA with Datastream data

Bank Capitalization Programs
% of total bank assets

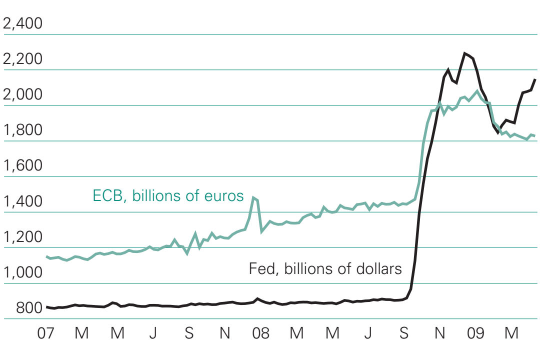


Source: BBVA Bancomer with Datastream data

Average 30-Year Mortgage Loan Interest Rate in USA
%

Source: BBVA with Bloomberg data

Central Banks: Total Assets



Source: BBVA with Datastream data

six months. These results were well received in the market, favoring the recent reduction of financial tensions. In addition, several financial institutions undertook rapid and successful actions to increase their own resources. A second important element in the effort to stabilize the financial system is to facilitate placing bank balance sheets on a sound footing, reduce the numbers in the red and the risk assumed. To achieve this objective, the Public-Private Investment Program was launched, with the aim of attracting private investors to buy structured assets—non-liquid assets and assets whose valuation based on market criteria would be difficult— from banks through funds in which capital will be contributed jointly by the private and public sector, with a very significant degree of leverage. Finally, the new U.S. presidential administration has launched a plan designed to improve access to housing and avoid foreclosures.

The BBVA Economic Studies Services appraisal of the U.S. bank stabilization strategy is positive, since it has a global focus on the question —the assets and liabilities of the banks' balance sheets— with credible stress scenarios and with a view toward involving the private sector in seeking a solution to the problem. All in all, the implementation of the approved plans presents major complexities, and if these elements are not correctly brought together or the potential synergies between the different programs are not taken advantage of, their impact could turn out to be limited.

Meanwhile, the Federal Reserve has been a key participant in the financial stabilization process and the fight against deflationary risk. Thus, the Federal Reserve has launched a program to purchase 1.25 billion dollars in mortgage bonds from Freddie Mac and Fannie Mae, with the aim of reducing the financing cost of mortgages for Americans. Another key step was the announcement of purchases of public debt for up to 300 billion dollars. In addition, the Federal Reserve will participate in the financing of the Public-Private Investment Program, which could end up reaching a figure of close to 1 trillion dollars.

In Europe, the financial stabilization efforts have continued to be centered basically on the national level, with very different initiatives depending on the country. Thus, Germany and Ireland are putting the final touches on a "bad bank", an institution that would buy the banks' highest risk assets. Meanwhile, the European Central Bank (ECB) continued its policy of reducing the official interest rate, which at the time this report was written was set at 1%. The European monetary authority has decided to continue conducting weekly liquidity auctions through the fixed rate system, covering the full allotment during the period of time necessary and in any event even after the end of 2009, while the term of the loans made by the ECB has been extended up to 12 months. Meanwhile, in May, the acquisition of 60 billion Euros in bank certificates was announced.

The adoption of these monetary policy measures is justified, since in the short term the main risk is that the persistence of a very weak economic environment could lead to maintaining negative inflation rates for too long a period of time. In addition, although the balance sheets of the central banks continue to indicate a strong expansion (especially in the case of the Federal Reserve), the central banks should not face difficulties in rapidly reducing liquidity when the time comes to do so.

The emerging economies reflect the global situation, but they are receiving important support

The emerging economies have also been affected by the global financial crisis and the strong decline in international trade, and it is likely that many of them will experience recessions in 2009. However, the main emerging economy, China, launched support programs based on a massive taxl stimulus and an exceptional relaxation of bank credit. With these measures, the Chinese economy —which slowed substantially in the fourth quarter of 2008— in the first quarter of 2009 began to justify the expectation that it could reach 8% growth in the year as a whole. At the same time, it should be noted that the impact of the global environment thus far has been limited to real economic activity, without financial crises having yet erupted in important countries. However, it is true that some regions are especially vulnerable. This is particularly the case of the Eastern European countries, which present high risks , given the characteristics of their financial systems —with reduced availability of domestic liquidity and the burden of credit in foreign currency— dominated by the financing of some European banks, pressured, in turn, due to their exposure to the global crisis.

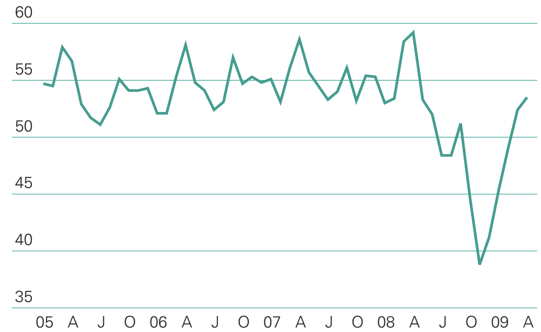
In terms of the financial variables, toward the end of the first quarter, the negative feeling in the markets, predominant at the beginning of the year, was reversed. Especially important for the emerging markets was the G-20 summit on April 2 in London. During the summit, the leaders of the main economies of the world decided to increase the resources of the International Monetary Fund (IMF) by 750 billion dollars and allow for an additional 250 billion dollars to be issued in Special Drawing Rights (SDRs). This increase in IMF resources allows financing the Flexible Credit Line, a new IMF program aimed at helping those countries with solid fundamentals that are experiencing temporary financing problems. For the time being, Mexico, Poland, and Colombia have obtained credit lines through this program. Subsequently, the emerging economies benefitted from a greater appetite for risk observed on a global level in the financial markets. Thus, financial inflows began to be seen in Asian and Latin American countries.

Despite the stabilization registered and the measures adopted, the recovery continues to be determined by its intensity and an uncertain beginning

The effectiveness of the policies to place the financial systems on a sound footing, on the one hand, and the fiscal policies to stimulate demand on the other, will be the center of attention in the next few months. Their final impact will determine the starting time for economic recovery, its rhythm, and the geographical areas in which it will be consolidated.

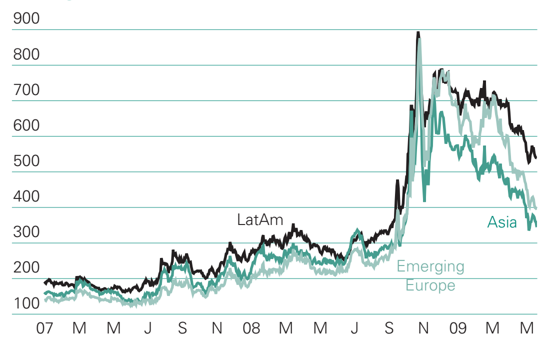
Even though the above-mentioned measures are having a favorable impact on the economy in 2009, the elements of a possible recovery toward the end of 2009 and the beginning of 2010 are still uncertain. The recent data seem to suggest that the rhythm of economic decline has been halted. Nevertheless, the end of the recession could occur, in any event, with growth rates that are very moderate and below their potential. In addition, it is likely that the recovery will occur later on in Europe, given the greater slowness in the adoption of financial stabilization and monetary policy measures. These uncertainties will force the central banks to maintain low official interest rates for a long period of time.

China: PMI Indicator



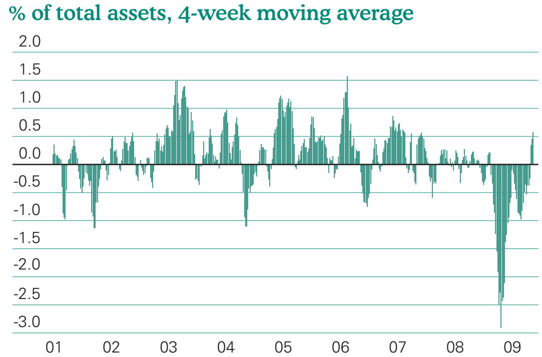
Source: BBVA with Bloomberg data

EMBI Spreads
Basis points



Source: BBVA with Datastream and JP Morgan data

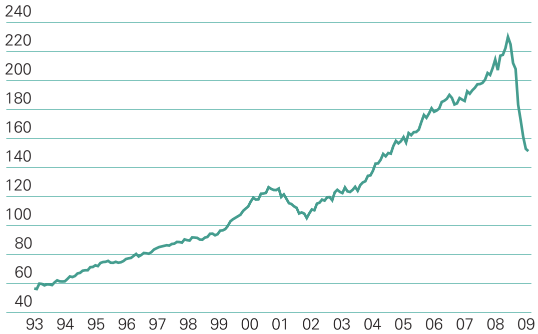
Emerging Markets: Inflows of Fixed Income Retail Funds
% of total assets, 4-week moving average



Source: BBVA with Bloomberg data

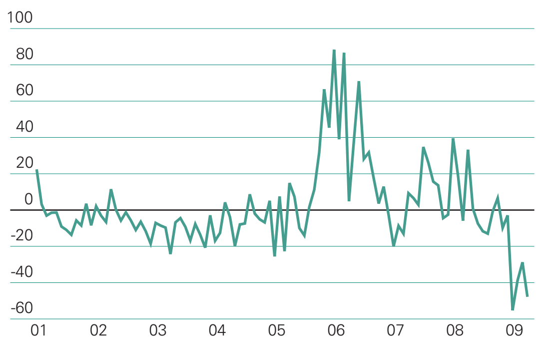
Mexico: Recession and Recovery Hand in Hand with External Factors

USA: Imports of Goods and Services
Billions of dollars



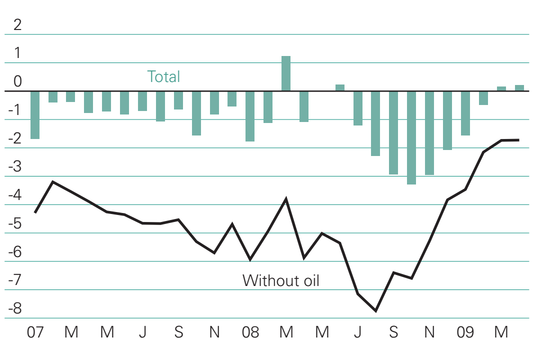
Source: BBVA Bancomer with Federal Reserve data

Automobile Production for Export
Annual % change



Source: BBVA Bancomer with AMIA data.

Trade Balance
Billions of dollars



Source: BBVA Bancomer with INEGI data

The collapse in demand from the U.S., Mexico's number one customer

In mid-2008, the tensioning of financial conditions in the world had a marked impact on external demand, in particular from the United States, the receiving country of 81% of Mexican exports. Total U.S. imports underwent one of the most important drops in its history, falling 34% in the nine months that elapsed since their record high in July 2008, which in March 2009 are currently at the nominal level of October 2004.

Mexican manufacturing exports to the U.S. underwent a 22.7% decline through March 2009 (measured in dollar terms), while those directed to the rest of the world fell 34.7%. Some of the most affected manufacturing exports were in the automobile branch (-34.6%), machines and electrical material (-20.3%) and mechanical apparatuses (-13.1%). In the first of these cases, the decrease is accompanied by what will be one of the most important industrial restructuring in recent years. Thus, the value of non-oil exports has dropped slightly more than US$5.174 billion from April 2008 to 2009, which is equivalent to an annual 24.6% decrease.

Moreover, oil exports did not mitigate the performance described for the rest of Mexican sales abroad, but rather accentuated it. In the first four months of the year, there was a recovery in the price of oil of US$13—from US$33.3 per barrel (dpb) on average last December, to US$46.4 dpb In April—. However, the export platform is in a downward trend process, which has implied on average 151,000 barrels less in daily exports in the same period. Thus, the value of oil exports is 57% lower in April than a year ago.

On the other hand, import volumes, a variable closely linked to exports (72% of imports are intermediate goods) have moderated significantly, and their volume in terms of dollars, the same as that of exports, is comparable to the level in May 2005. The speedier moderation in imports than in exports has closed the result in the balance of trade in recent months, by which the balance is showing a slight surplus of US$209 million in April of this year ((-) US$1.726 billion, excluding oil exports).

Activity is adjusting downward; employment is down and is affecting domestic spending

Together with external demand, industrial production has fallen sharply in recent months, intensifying a deterioration that began more than a year ago. Due to its importance in exports, particularly significant in manufacturing activity is the deterioration in the automotive branch (80% of automobile production is earmarked for export) of which the loss in the aggregate value at the end of 2006 and the 1Q09 is equivalent to 30% (-38% compared to the same period of the previous year) Jointly, the most intense drops have taken place in activities more closely linked to the U.S. cycle, although the most dependent on the domestic market are also registering an intense although more recent adjustment, as sharp as those most exposed to external demand.

The tertiary sector of the economy experienced a setback in the first quarter of the year, comparable only to that observed in the second quarter of 1995. Thus, in the 1Q09, the value of services was almost 8% less than that of the previous year and 17% lower than that of trade activities, which represent 22% of services. Also, in the first quarter, in addition to the setback in trade, the drop was generalized in other services, so that 10 of the 14 branches comprising the tertiary sector fell compared to the previous year. It should be mentioned that branches in services that did grow can be related to the dynamics of the public sector, which, as we will see, is mitigating the impact of the crisis. This is the case in educational services (0.7% y/y) or in the value of government activities (1.9% y/y).

The channel through which this rapid transmission of the drastic contraction is produced in external demand in the total of Mexican activity is the drop in employment and of available revenue, which reduces the capacity of aggregate spending of households and companies.

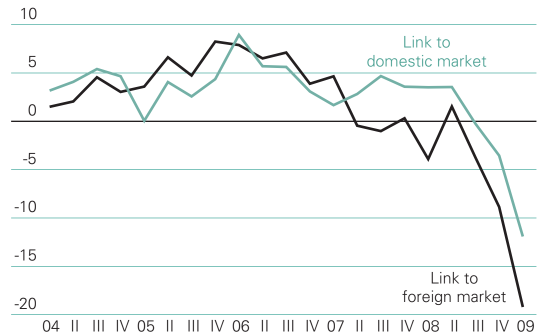
Labor market adjustment in perspective

Through April 2009, the Mexican economy had lost slightly more than 500,000 jobs compared to the same month the previous year, or 534,000 when the reference is the maximum employment observed throughout 2008. The slowdown in job creation was gradual in 2007; it intensified in the first six months of 2008; and, deepened at the end of that year to attenuate its deterioration rate in the most recent months. The contraction in employment was surprising in its intensity, although not unexpected, since it goes hand in hand with the global recession that reduces external demand, especially in the automotive industry. These factors especially have an impact on an economy such as the Mexican, open to the exterior, concentrated on relatively few markets and products, and with limited maneuvering margins of economic policy to mitigate the impact of the crisis.

Ninety per cent of the jobs lost in recent months are among social security affiliated workers, with the rest pertaining to temporary jobs. This is not unusual given that, of the total affiliated workers, most (88%) are permanent, who, in addition, register an annual contraction rate slightly higher (an annual 3.6%) than that of temporary workers (2.5%).

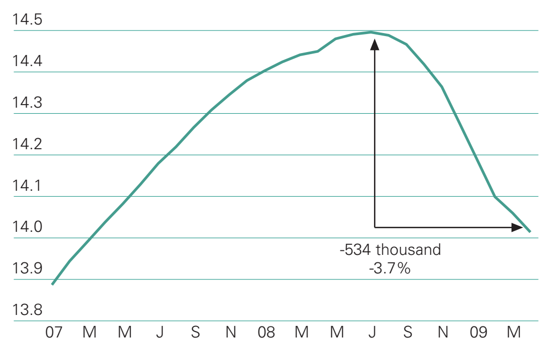
The monthly evolution of employment during a slowdown in the economy shows some difference compared to the current performance. A simple characterization, as of the time in which the contraction began, indicates the following: in 2008-09, the adjustment in employment began by being less intense than in 2001, to later gain depth gradually, although not coming close to the deterioration rate of 1995. These differences in the performance of employment in the three phases of adjustment of activity registered by the Mexican economy reflect specific peculiarities of those periods.

Non-Automotive Manufactures*
Annual % change



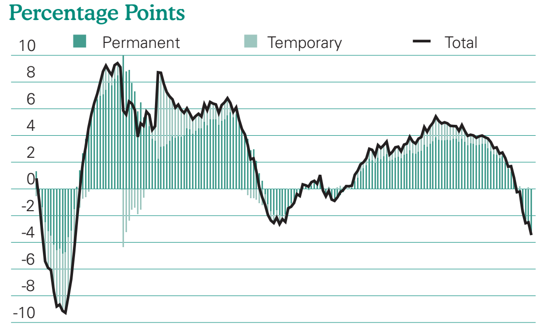
* Link to foreign market, considered are the branches whose correlation co-efficient with the U.S. manufacturing cycle is higher than 0.6 between 2004 and 2008.
Source: BBVA Bancomer with INEGI data.

Formal Private Employment
Millions, seasonally-adjusted, 3-month moving average



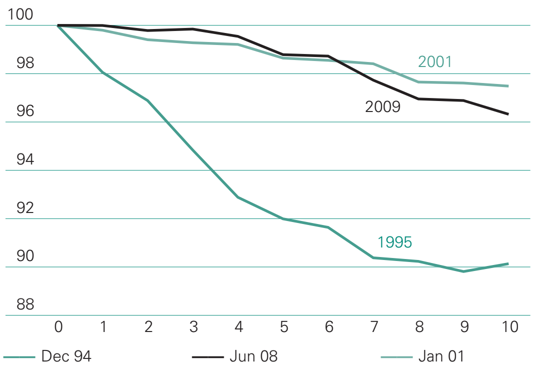
Source: BBVA Bancomer with IMSS and STPS data

Formal Private Employment Contribution to Growth
Percentage Points



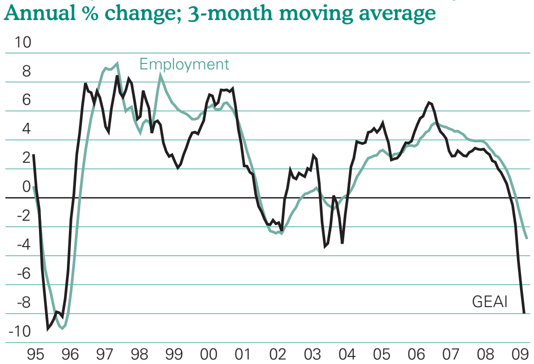
Source: BBVA Bancomer with IMSS and STPS data

Formal Private Employment
Maximum level = 100



Source: BBVA Bancomer with IMSS and STPS data

Activity and Formal Private Employment
Annual % change; 3-month moving average



Source: BBVA Bancomer with IMSS and STPS data

Annual Evolution of Employment
Affiliated workers in the IMMS, net creation, April 2009

	Level	Annual change	
	Millions	Thousands	%
Total	**13,849.8**	**-484.9**	**-3.4**
Agriculture	**348.6**	**-5.3**	**-1.5**
Industry	**4,857.4**	**-526.1**	**-9.8**
Extraction	96.7	4.6	4.9
Manufacturing	3,486.9	-423.1	-10.8
Construction	1,101.3	-114.3	-9.4
Electrical	172.5	6.8	4.1
Services	**8,643.8**	**46.5**	**0.5**
Trade	2,831.3	-3.7	-0.1
Transportation	748.2	-21.1	-2.7
For companies and persons	3,319.1	13.9	0.4
Social	1,745.2	57.3	3.4

Source: BBVA Bancomer with INEGI data

The loss of jobs was much greater in relative terms in 1995, but it is also true that the recovery showed elements of momentum that are not going to appear today, at least not as intensely. In 1995, there was a domestic financial crisis, but in a globally favorable external environment shored up by the entry into force of NAFTA (the North America Free Trade Agreement signed in December of 2003 and in force as of 1994) and a growing external demand. Specifically, in the financial crisis of 1995, the NAFTA and the cheapening of the cost of labor in dollars boosted manufacturing exports in nominal dollars and especially among these, the most labor intensive, such as textile products. However, in 2001, the presence of China in the U.S. market increased, both due to its competitive capability and to the status of Normal Permanent Trade Relationship that the U.S. granted the Popular Republic of China in May 2000, and its incorporation in the World Trade Organization (WTO) in December 2001. All of this accelerated the drop in Mexican manufacturing exports in 2001 and its near stagnation in 2002 and 2003. This structural shock for Mexico led to the brake in the labor market through 2004.

At the present time, support for the nominal stability of the economy—the perspectives of low and stable inflation and a need for manageable exterior financing— is combined with a much less favorable external environment, one that is weaker. But also certainly, there is an impact on activity branches that are more capital- rather than labor-intensive, which explains the existing imbalance between the adjustment of activity and that of employment. Finally, the current situation points to a very gradual recovery of activity and employment in the coming months.

Manufacturing and Construction are the sectors with a greater negative impact

Similar to productive activity, the evolution of employment is quite heterogeneous, between the activity sector and the geographic regions, or between the States in the country, and is defined in general terms by the impact of the crisis in each sector of activity and by the productive capabilities of each geographic zone. In this context, the contraction in employment is concentrated in the industrial sector with 526,000 jobs closed, while that of services increased a little, with 46,000 jobs, although with a declining trend. In turn, the agricultural sector is playing a marginal role with a contraction of 5,000 jobs in the general evolution, because it is relatively small and volatile.

Therefore, the net decline in employment is practically concentrated in a single sector, and, taking into account the relative size of Industrial employment, which represents 35% of formal private employment, the impact of the recession is more significant. In the industrial sector, there was a contraction in the manufacturing industry (-10.8% this year and -1% the year before) and in construction (-9.4%), which means that one in eight manufacturing jobs have been closed or vacated, and one in ten jobs in construction. In contrast, in the electric and extractive industries, the evolution was favorable. In services, the performance is also differentiated by branch, with two sectors growing and two in contraction: social services (+3.4%), services for companies and households (0.4%), trade (-0.1) and transportation (-2.7%). For the total of the services sector, growth in April (+0.5%) is the lowest in the last nine months and the trend seems to project negative rates in the coming months, in part due to the impact of the influenza emergency. While employment in the industrial sector is associated with the decrease in external demand, in services the main determinant is the domestic market.

Border States and industrial areas are the territories most vulnerable to the current adjustment

The evolution of employment in the various states reflects their productive capability and their trade relationship abroad, but, in general, all show an unfavorable evolution in recent months, although with a strong difference among them. The border and the main industrial cities in the country are necessarily the most affected by the current economic situation, but the areas that depend the most on agriculture, on domestic trade and on the relative weight of the public sector in its economy have been able to increase their labor population. Thus, through April, while in Chihuahua or Baja California, there were 14% and 10% drops, respectively, in Chiapas and Oaxaca there was growth between 4% and 6%. .

The slowdown or contraction in employment is also differential over time. In Baja California and Chihuahua, the first negative rates occurred in March and April of 2008, respectively (of course, this implies that the employment levels on those dates are lower than those of 2007; therefore, the problem has been occurring during some time) but in Oaxaca, the first quarter of 2008 is better than that of the previous year.

Total wages show a contraction for the first time in the last ten years, despite support from the anchoring of inflation perspectives

The deterioration in employment and an evolution of nominal wages below inflation combined for a contraction in March of 4% annually of total wages. Following the recovery after the 1995 crisis, the current situation is the first occasion in which total wages are in the red, which is important due to the possible impact on domestic demand. The negative rates of total wages began to be seen since the end of 2008, and a return to positive rates in the short term is not likely, despite the favorable expectations regarding inflation. Nevertheless, the situation is significantly more favorable than that of 1995. The anchoring of inflationary perspectives in historically very low figures and an exchange rate submitted to the scrutiny of the markets do not forecast sharp and sudden losses in purchasing power like those of that time. The adjustment between income and purchasing power will derive fundamentally from the brake in employment, not from real wages.

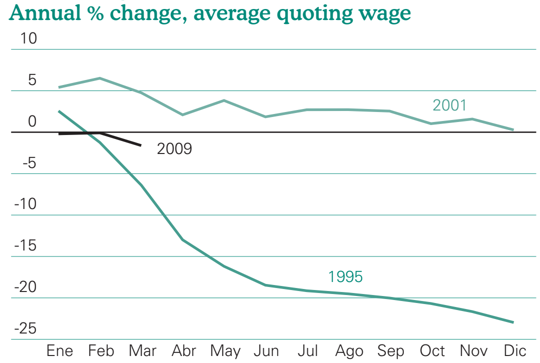
Mexico will recover its growth in line with that of the U.S.

Although there is still no data on the aggregate value of production in demand components for the first quarter of 2009, it is reasonable to

Evolution of Employment
States according to their annual change, April 2009

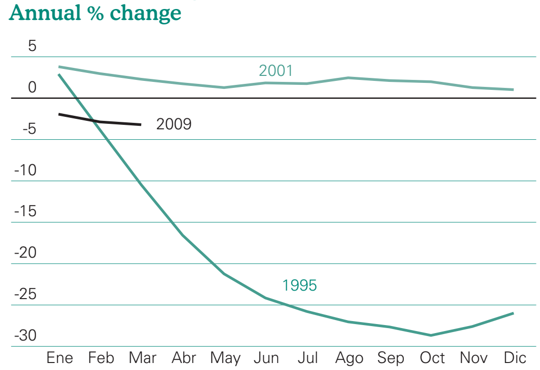
Source: BBVA Bancomer with IMSS data

Real Wages
Annual % change, average quoting wage



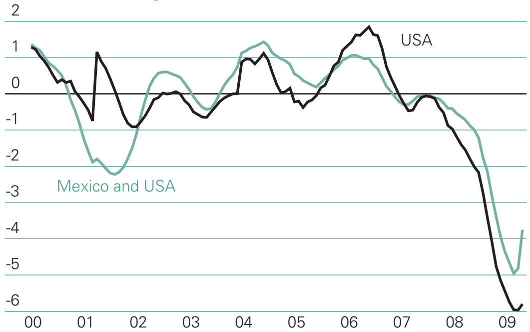
Source: BBVA Bancomer with INEGI data

Real Total Wages
Annual % change



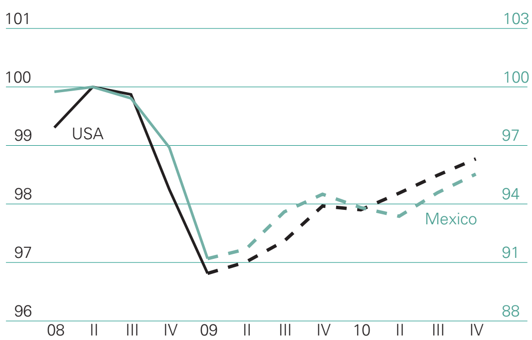
Source: BBVA Bancomer with INEGI data

Leading Synthetic Indicator
Annual % change, standardized



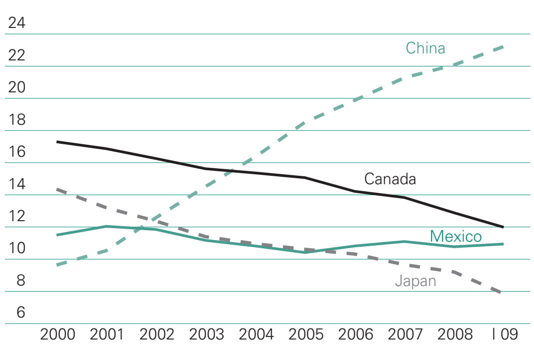
Source: BBVA Bancomer with INEGI and Federal Reserve data

Gross Domestic Product
June 2008 Index



Source: BBVA Bancomer with INEGI and Federal Reserve data

USA: Manufacturing Imports by Origin
% of total



Source: BBVA Bancomer with USA Department of Commerce data

assume that consumption and ´private investment have undergone one of the most significant contractions in recent years, when the impact of the shock of lower external demand has conjugated its rapid transmission to domestic demand through employment and some conditions of less abundant and more costly financing.

The change in the performance of the above-mentioned factors will support the recovery of the Mexican economy. Some symptoms of improvement in recovery began to be seen between March and April in timely indicators such as consumer confidence, producer confidence or in the monthly indicator of formal affiliated workers in social security that could predict a lower contraction rate in the Mexican economy from some contingent reactivation in private consumption. However, this profile of incipient recovery will be modulated by the short-term economic impact, centered, in particular, on some activities of the influenza epidemic (see inset: "Balance of risks of the precautions and the flu"). For the coming quarters, the outlook for recovery will depend to a great extent on the intensity and continuity of the recovery of external demand, which will have a marked influence on the rally in the domestic market. In this sense, the profile of Mexican economic growth for the coming quarters assumes a response to the incentives forthcoming from its number one trading and financial partner, the United States. The course foreseen for Mexican growth is not beyond the reasonable, taking into account what has been integrated by both economies (see attached graph). Recovery will be gradual and more intense toward 2010, a year in which clearly positive growth rates are expected in both countries, although not achieving levels close to their potential. The Mexican economy has managed to maintain its participating share in the U.S. market in a very competitive global environment, as reflected by the stable weight of imports from Mexico in total purchases of goods by the U.S. Once the impact derived from the entry of China as a global competitor at the beginning of this decade has been absorbed, Mexico continues to maintain, since 2003, a share in total imports by the U.S. of 11% in the 2005-08 period. This is a high and stable share, as opposed to what occurs to other important trading partners of the U.S., such as Canada and Japan. Only China maintains a growing share of the U.S. import market.

Beyond the more or less favorable current situations, foreign direct investment to Mexico from the U.S. maintains high levels, representing close to 40% of the total that comes into the country. These investment flows are particularly linked to the development of the sectors such as the automotive industry—to nourish its domestic market—and of trade distribution for the Mexican domestic market. Direct Investment flows, in a global and competitive environment, allow improvements in the endowment of capital in the economy that lead to earnings in productivity and greater contributions to long-term economic growth.

Still, the growth profile of the coming quarters will be relatively soft when it is compared with previous recovery cycles, and the improvement in the conditions of the global economy will be moderate and gradual as well. By this, we estimate 12.7% in growth in 2010 in Mexico following the 6.3% decrease in 2009.

In addition to the support of the global environment, the impact of the crisis and the following recovery will be mitigated and boosted, respectively, by public demand, fundamentally implemented through greater expense in investment. For the first time in Mexico an anti-cyclical fiscal policy is applied discretionally, capable of contributing with a greater demand to the lack of activity and spending in the private sector. Up to now, the public sector, in times of a decline in activity, acted in the same sense as the cycle, cutting back on spending so as to reduce the recourse of savings--in particular, external--. Placing public finances on a sound footing and gaining credibility in achieving budgetary goals have allowed applying a program of discretional increase in productive public spending, that which is earmarked for investment. However, as this publication analyzes, without additional reforms, the margin of fiscal policy to meet its cyclical stabilization role, contribute to improving the endowment of physical and human capital through education and improve the distribution of revenues is limited.

Notwithstanding the anti-cyclical policies, the adjustment of the current recessive episode will continue to fall on families' and companies' expenditures as per the expected evolution of its fundamentals, available family income, the expectation of benefits and the cost and availability of financing. In fact, in terms of contributions to growth, consumption and private Investment will subtract from growth in a magnitude comparable only to 1995.

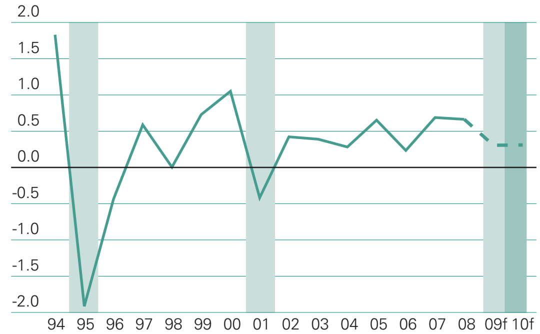
The exchange rate in terms of global financial factors and domestic events

Financial events of a global nature, external to the Mexican economy and which affected investors' perception of risk as well as the availability of liquidity on the international markets, have been the main determinig factors of the performance of the Mexican peso. Since September 2008, when the Lehman Brothers bankruptcy extended the financial crisis to a global level, the dynamics of the peso has undergone two phases. Thus, after having depreciated 27% against the dollar between September 2008 and March 2009, the peso has shown an appreciation in its parity with the dollar of around 11% through May. As can be observed in the graph, between March and May, the exchange rate depreciated despite a considerable decrease in the levels of global aversion to risk, which had played a determining role in the fluctuations in the exchange rate in the previousquarters. In turn, domestic financial factors, such as the demand for dollars linked to corporations, also contributed to the evolution of the peso.

From a long-term perspective, the peso showed an over-evaluation in its theoretical equilibrium level since 2005 (see chart on the over-valuation of the peso) as a result of the capital flows to emerging markets due to the low interest rates in the developed countries, a period of abundant liquidity, a high rate of appetite for risk and the perception of stability and solid fundamentals in those economies. However, because of the credit crunch and the sudden drop in the appetite for risk, a net capital outflow from emerging countries to instruments free from risk occurred, which resulted in an under-valuation of the peso, considerably below its theoretical levels (See graph).

Mexico: Public Spending in Consumption and Investment

Contribution to growth, percentage points



f (p) forecasts as of 2009
Note: Recessive period shaded
Source: BBVA Bancomer

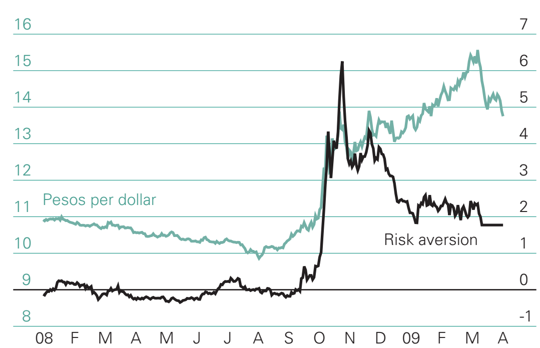
GDP: Demand Components

Annual % change

	2007	2008	2009	2010
GDP	3.3	1.4	**-6.3**	**1.7**
Consumption	3.6	1.5	**-3.2**	**1.1**
Private	3.9	1.6	**-3.6**	**1.1**
Public	2.1	0.6	**0.0**	**1.4**
Investment	6.7	4.2	**-12.9**	**5.4**
Private	5.8	2.0	**-18.2**	**6.4**
Public	12.9	13.3	**7.3**	**2.8**
Exports	5.6	1.6	**-14.7**	**-1.6**
Imports	7.0	4.6	**-11.0**	**-0.1**

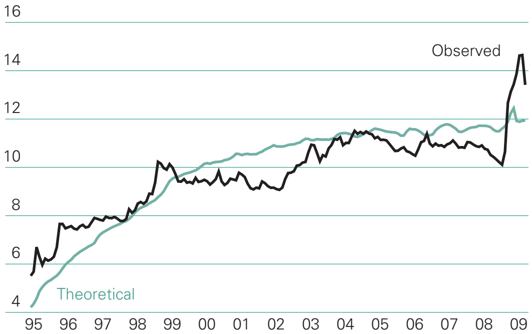
Source: BBVA Bancomer

Risk Aversion Index and Exchange Rate



Source: BBVA Bancomer with Bloomberg data

Theoretical and Observed Exchange Rate
Pesos per dollar

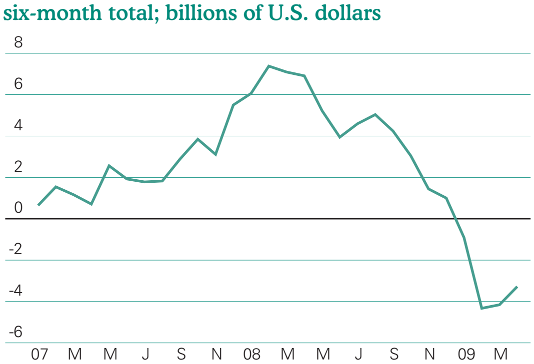


Source: BBVA Bancomer with Banco de Mexico data

Mexico: Foreign Flows on the Stock Market
Six-month total; billions of U.S. dollars

Source: BBVA Bancomer with Bloomberg data

Mexico: Foreign Flows on the Bond Market
six-month total; billions of U.S. dollars



Source: BBVA Bancomer with Banco de Mexico data

Given this dynamic, BBVA Bancomer Economic Studies Service believes that, as soon as those global and financial factors are diluted, which have had an influence on the depreciation of the peso since the financial crisis acquired a global dimension, the Mexican currency should tend towards its theoretical equilibrium level. In fact, the aversion to global risk levels has started to decrease significantly since the end of 2008 to date, although the peso did not gain any ground against the dollar until March. In part, this was due to the fact that some factors continued to maintain certain pressure on the peso, as occurred at the beginning of 2008,[1] which was reflected through fluctuations in capital flows toward Mexico.

Evolution of capital flows to the emerging economies

With data from the Global Fund Flows & Allocation Data Base (FFADB)), the generalized outflow of funds, from the Mexican capital markets, which started in June 2008 and intensified in the following months, reached a cumulative maximum of US$2.5 billion in November 2008 in a 6-month period (See graph). In turn, the stronger outflow of capital on the Mexican debt market was observed in February of this year with a six-month cumulative figure along the order of US$4.3 billion (See graph). Also, the high levels of volatility and aversion to risk completely eliminated opportunities for carry-trade,[2] which, in turn, fed back the net outflow of capital flows, thereby accentuating the generalized depreciation of the emerging currencies (see graph). Specifically, the peso fell to levels of up to 15.6 pesos per dollar in March 2009.

This capital outflow took place mainly due to two reasons. In the first place, as a consequence of the lack of liquidity on the debt markets, in view of which investors had to liquidate their positions in the emerging markets in order to be able to cover their "margin calls"[3] independently of the fundamentals of those economies. In the second place, due to the considerable increase in the aversion to risk and a marked preference on the part of international investors to place their capital flows in assets with no risk, although of low yield, mainly U.S. Treasury bonds.

This situation has persisted throughout these months, considerably appreciating the dollar and the yen compared to other high-yield currencies in developed countries like the Australian dollar, for example, but in particular, compared to currencies of emerging economies even those with solid fundamentals like Mexico.

In this respect, the dynamics of 5-year CDs and EMBI+s reflected in this period the little appetite for risk. As can be observed in the graphs, 5-year CDs reached record levels last March in light of the fear that the environment of financial crisis would lead to a situation that would impede meeting their financing commitments. Also, in

1 Then a sudden increase in the demand for dollars was produced byf some corporations in face of their losses in derivative positions when the exchange rate surpassed P$12 per dollar.
2 It is the yield (if it is positive) or the cost (if it is negative) that an asset provides while it is held until an investor sells a currency that has a relatively low interest rate to invest in another that pays a higher rate.
3 "Margin calls" are made by a stock broker for an investor so he will deposit the financial resources or additional securities as collateral to keep the margin at a required minimum level.

view of expectations of the imminent drop in the expected yields of sovereing bonds in Mexico and other emerging economies, the EMBI+s reached never before seen levels last October, importantly affecting the value of the peso versus the dollar.

It was not until November 2008 when the outflow of funds started to attenuate in the debt market and, until February 2009 when this outflow reverted in the capital market. Although, so far this year, foreign capital began to return to Mexico and other emerging markets, this has been a gradual process.

Under this global environment, a series of measures adopted by the local authorities to increase the supply of dollars in the market, including the availability of additional liquidity lines in dollars, helped to reduce the uncertainty surrounding the financing of the current account. In the first place, the Foreign Exchange Commission established a mechanism to guarantee that part of the international reserves accumulated during 2009 would be sold on the foreign exchange market, auctioning US$100 million daily as of the 9th of March and until the 8th of June[4]. Second, a Flexible Credit Line (FCL) was activated with the International Monetary Fund (IMF) for US$47 billion and a temporary foreign exchange mechanism known as a swap line waslestablished with the United States Federal Reserve for US$30 billion.[5] These two mechanisms made available more than US$70 billion without compromising the reserves, thereby guaranteeing sufficient liquidity in foreign currency in face of unexpected problems of the Mexican economy for its financing in dollars.

Perspectives for the exchange rate in terms of the evolution of the global financial crisis and reforms in the domestic economy

It is expected that, even though levels of aversion to risk don´t continue to drop, they will at least not deteriorate more, particularly now that the main leading indicators of the U.S. suggest the beginning of a recovery in economic activity in that country, which although incipient, at least implicates a less intense deterioration. To the extent that the levels of global aversion to risk and liquidity return to more sustainable levels. the dynamics of the peso should slowly show an important correction toward its equilibrium levels (See graph). In this scenario, a recovery would be produced of the capital flows to emerging countries, including Mexico.

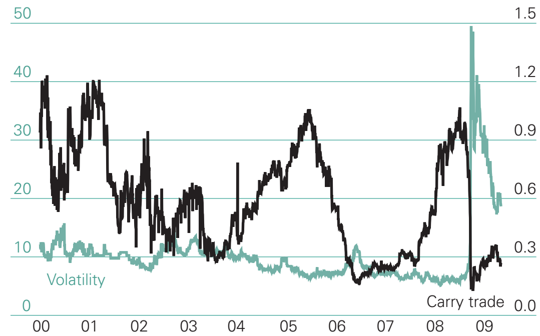
In the concrete case of the Mexican economy, it is possible that international investors will still be more cautious as long as there are no clear indications of the economic effects of the breakout of the A-H1N1 flu of April, as well as of the change In outlook from stable to negative by Standard & Poor's of the credit rating of Mexican debt, given certain vulnerabilities in its public accounts[6].

4 Last May 29th, the Foreign Exchange Commission announced that as oft June 9th and through September 9th, the ordinary sale on the foreign exchange market is reduced to US$50 million dollars, and the one made in case of a 2% depreciation compared to the day before, goes from US$300 million to US$ 250 million.dollars

5 In particular, last April 21, 2009, the first auction of US$4 billion took place. The resources placed were ultimately US$3.2 billion, suggesting lower demand on the part of corporations as of those dates, as well as the stability at that time of the financial variables.

6 See chart on the impact of the changes in the rating, in the financial variables, and Section IV of the publication for an analysis of the outlook for fiscal policy.

Mexico: Carry Trade Indicator and Implicit Volatility of the Exchange Rate

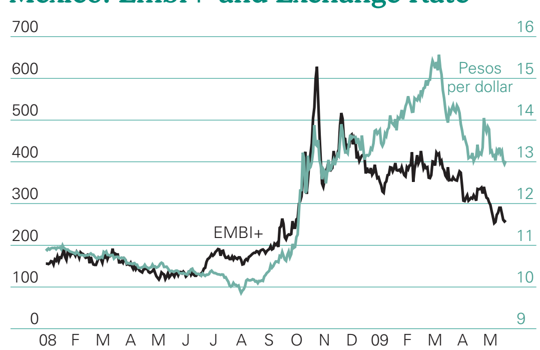


Source: BBVA Bancomer with Bloomberg data

Five-Year CDS
January 1st 2009 Index = 100

Source: BBVA Bancomer with Bloomberg data

Mexico: Embi+ and Exchange Rate

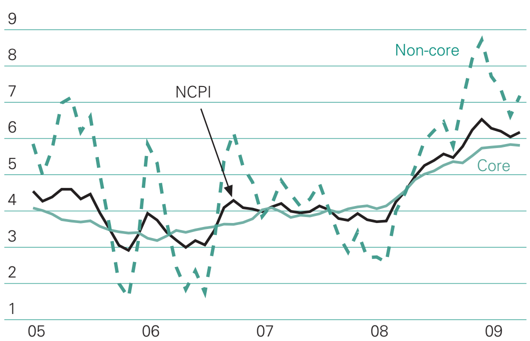


Source: BBVA Bancomer with Bloomberg data

Exchange Rate Observed and Theoretical with Forecasts
Pesos per dollar

Source: BBVA Bancomer with Bloomberg data

Mexico: Inflation
Annual %



Source: BBVA Bancomer with Banco de Mexico data

Banco de México: History of Modifications on Estimated Inflation
Annual %, quarterly average

	3Q07	1Q08	2Q08	4Q08	1Q09
4Q07	3.50-4.00	3.81	3.81	3.81	3.81
1Q08	3.75-4.25	3.89	3.89	3.89	3.89
2Q08	4.00-4.50	4.50-5.00	4.92	4.92	4.92
3Q08	4.00-4.50	4.50-5.00	5.25-5.75	5.48	5.48
4Q08	3.75-4.25	4.25-4.75	5.50-6.00	6.18	6.18
1Q09	3.50-4.00	3.75-4.25	5.25-5.75	5.75-6.25	6.18
2Q09	3.50-4.00	3.50-4.00	4.50-5.00	5.25-5.75	5.50-6.00
3Q09	3.00-3.50	3.00-3.50	3.75-4.25	4.50-5.00	4.75-5.25
4Q09	nd	3.00-3.50	3.50-4.00	3.75-4.25	4.00-4.50
1Q10	nd	3.00-3.50	3.50-4.00	3.75-4.25	3.75-4.25
2Q10	nd	nd	3.25-3.75	3.25-3.75	3.25-3.75
3Q10	nd	nd	nd	3.25-3.75	3.25-3.75
4Q10	nd	nd	nd	3.00-3.50	3.00-3.50
1Q11	nd	nd	nd	nd	3.00-3.50

Source: BBVA Bancomer with Banco de Mexico data

At the same time, downward short-term interest rates are expected in view of the current policy of monetary easing, as well as a lower spread between funding rates, although these are still at relatively high levels (of around 500 bp at the end of May). In this respect, it would be expected that these high spreads and an environment of lower aversion to risk favor the peso.

Inflation: a history of continued pressure since 2006

In recent years, the Mexican economy has been exposed to an environment of increases in production costs which, in a scenario of relative expansion of demand, has translated into a continuous rise in annual inflation. In its core index, inflation has risen from a 3.5% annual average in 2007, 4.9% in 2008 and 5.8% in the first five months of 2009. These increases were explained in the beginning by the international rise in prices of industrial raw materials (i.e. steel), later, of food inputs (i.e. grains), energy inputs (i.e. fuels) and, more recently, by marked rises in foreign exchange costs.

These successive supply shocks were gradually transferred to the consumer in the core headings such as processed foods, housing services, and other services (i.e. tourism) and, lastly, in rises of tradable goods other than food. The transfer of greater costs to the final prices to consumers can be understood by GDP growth (2006-08) close to its potential, so that the expansion in demand allowed producers to lodge said increases.

To the above was added the adverse dynamics in volatile non-core prices such as agricultural and livestock (affected by climate factors and fodder inputs), regulated prices (such as gasoline, electricity, etc.) and government-managed (such as transportation affected by energy products). This implied that annual headline inflation passed from historic minimums in the last months of 2005 (2.91%, slightly below the target of Banco de Mexico) to maximum levels of the last seven years (6.53% at the end of 2008).

The continuation of supply shocks in an environment of still favorable economic growth and the persistence of inflation (time lapse by which a disturbance is totally transferred to the final prices) led the central bank to make known, as of the third quarter of 2007, an estimated course for inflation that implied convergence with its target for the end of 2009 and that contributed to provide more transparency to the market with regard to its inflationary risk balance. The persistence of a pressured and uncertain environment gave rise for the Banco de México to modify, on four occasions, its inflation projection base and extend the convergence term toward the end of 2010.

...that is yielding in 2009

Despite the continuous rises in inflation in recent years (for which the origin is found in external factors, although the structure of the Mexican economy does not help) and the high dependence of its dynamic on volatile factors that generate greater price uncertainty (25.2% of the basket of prices correspond to the generic, not to the core), medium- (3 years) and long-terms (10 years) inflationary expectations have remained at relatively low levels of 3.5% annually. Although these expectations remain deviated from the central bank's target (3%), it is notorious that they have not been contaminated to a greater extemt by the sharp inflationary rises registered in recent months.

The above is favorable since it might indicate that the short-term price disturbances are being perceived as transitory and have not permanently contaminated price formation in the economy. In part, this is manifested in wage increases contained in contractual negotiations, which have fluctuated below an annual 5% since 2004[7].

As opposed to the 2006-08 period, prevailing economic conditions in 2009 point to a greater probability of a reduction in headline and core inflation. Even though, in recent dates (4Q08 and 1Q09), a high depreciation was observed, as well as a rise in foreign exchange volatility, it is probable that the magnitude of the economic adjustment in motion will contribute to mitigate the size of the transfer of foreign-exchange costs to final prices and to shorten the persistence of said rises in inflation. In fact, it is foreseeable that the greater part of said transfer of foreign-exchange costs has occurred in the first five months of this year and that it has concentrated on the index of "other merchandises" which includes a good number of marketable goods.

It should be noted that headline inflation has decreased by 0.35 percentage points (pp) in the first four months of the year (from an annual 6.53% to 6.17%) which is explained not only by a correction downward in non-core prices (from 8.72% to 7.18%), but also by a decrease in components that are sensitive to the rhythm of economic activity such as services (with annual Inflation dropping from 5.07% to 4.55%) Recently, the negative shock in domestic demand due to the recent health contingency (the A/H1N1 flu virus) could marginally have contributed to the reduction of annual inflation.

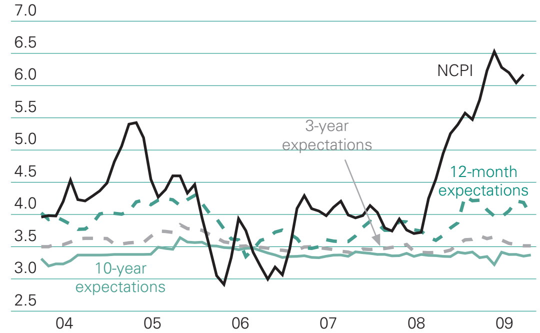
Estimates and inflationary risk balance for 2009 and 2010

Our scenario for economic growth for 2009 implies an expansion of the production gap in the economy, which translates into lower use of productive resources; that is, in an economic structure that leads to low inflation. The main questions arise regarding the magnitude of said drop in inflation and the main risks prevailing in the environment.

Regarding the magnitude of the drop in inflation and, contrary to the market consensus, we estimate that annual inflation could close the year at close to 3.8% (vs. 4.4% according to a central bank survey in May) which would mean a downward correction of 2.75 pp compared to annual inflation at the end of 2008, and which could be the highest adjustment downward since the last recession in 2001. For the moment, we cannot rule out that, to

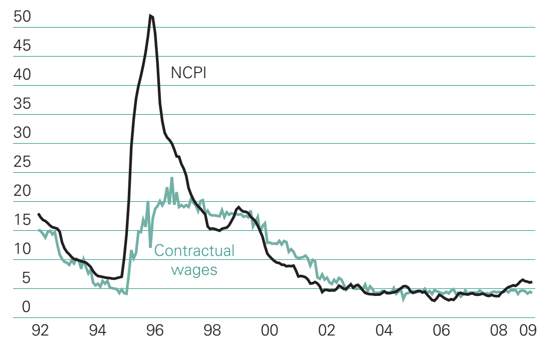
7 Said increase tends to incorporate both the anchored perspectives for medium-term inflation as well as the economic growth cycle and gains in productivity.

Mexico: NCPI and Expectations
Annual %



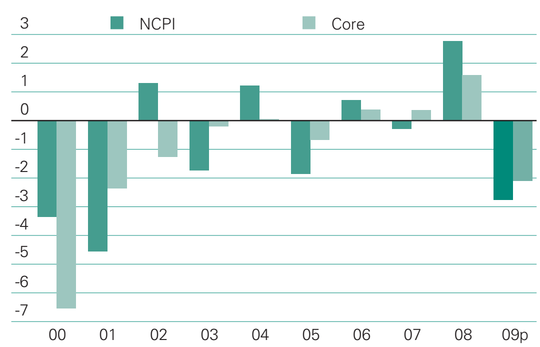
Source: BBVA Bancomer with Banco de Mexico data

Inflation and Wages
Annual % change



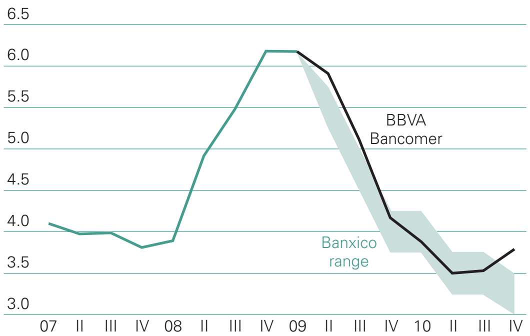
Source: BBVA Bancomer with Banco de Mexico data

Inflationary Adjustment: Difference Between Annual Inflation at the End of Each Year
December vs. december previous year, pp



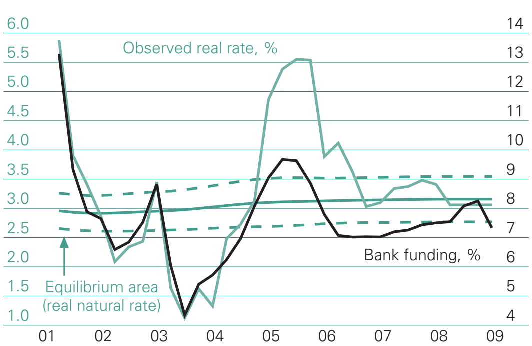
Source: BBVA Bancomer with Banco de Mexico data

Mexico: Inflation Forecasts
Annual % change; quarterly average



Note: Forecasts as of the second quarter of 2009
Source: BBVA Bancomer with Banco de Mexico data.

Estimated Range, Real Natural Rate and Real Observed Rate
Ex-post, %



Source: BBVA Bancomer

the extent that the recession continues in the country, a bias of lower inflation will be defined.

Even though, inflationary trend projections point to between 4.4% and 4.6% at the end of the year, we believe it is feasible to maintain our current estimate (3.8%) below the market estimate and in a lower range of the inflationary course announced by the central bank for 4Q09, due to the cycle of very low economic growth, the government's price policy in energy products (electricity, gasoline and domestic gas), which will contrast, as per what was announced, with the strong rises in these generics at the end of 2008, and the dilution of the foreign-exchange shocks registered at the end of last year.

Similarly, an adjustment downward in core inflation is foreseeable, however, at a lower magnitude to that estimated by the NCPI (the National Consumer Price Index). Given the levels reached by core prices at the beginning of the year, it cannot be ruled out that annual core inflation would be slightly above the NCPI. Although, usually this is not the case in times of inflationary adjustment, it would not be surprising to observe this situation.

Among the risks that could have a bearing on higher inflation than we estimate for 2009, of note are: (1) renewed episodes of depreciation and high foreign-exchange volatility that pressure costs upward; (2) adverse climate factors that imply higher prices in agricultural and livestock products (volatile); (3) international prices of raw materials; and (4) rigidity in the domestic markets that is associated with a lower rate of inflation decrease (i.e. little competitive structures in markets).

For 2010, we estimate that headline inflation could continue on its adjustment trend downward and be close to an annual 3.4% rate in the first part of the year; however, the same economic recovery process (domestic and international) could contribute to discreet rallies for the last third of the year and close at slightly under 4%.

The negative economic environment and the outlook for anchored inflation allowed the consolidation of the cycle of monetary easing

In 2008, Banco de Mexico raised the bank funding rate by 75 bp, after having raised it 50bp in 2007. Nevertheless, we believe that this strategy cannot be catalogued as the implementation of a restrictive monetary policy, since the central bank tried to maintain constant the changes in real interest rates[8] in accordance with the evolution of inflation and in terms of economic growth that fluctuated around its potential.

8 In the document, "The Natural Rate in Mexico: An important parameter for monetary policy strategy". BBVA WP 0806, we argue that this ranking represents the real natural interest rate, which coincides with the average level seen in recent years. When real interest rates are higher than this ranking, it could be said that the policy is restrictive, whereas if they are below, this infers that an expansive policy exists. This suggests that the central bank managed, in recent years, a monetary policy that would produce interest rates close to this equilibrium or toward a neutral monetary position.

Even though Banco de México maintained interest rates high in the third and fourth quarters of 2008, the Governing Board gradually raised the intensity of the topics linked to the risks in economic growth in its communiqués on monetary policy. This allowed a more detailed integration of the evolution of the central bank's risk balance in a monetary scheme in which the ultimate goal is maintaining inflation at 3.0% (+/- 1% variability range). In this way and together with the publication of medium-term forecasts, the communication strategy of the monetary authorities provided for space to initiate a policy of monetary easing consistent with the risk balance and in line with meeting the inflation target in the times projected.

Toward the end of the cycle of monetary easing.

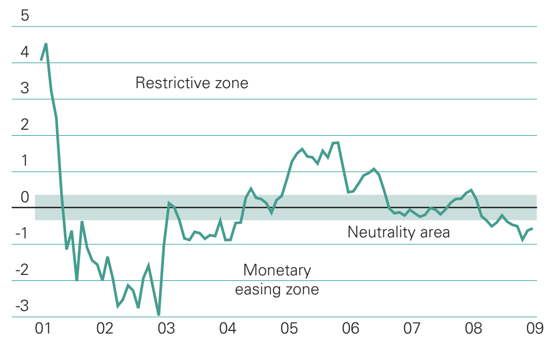
Banco de Mexico began to reduce the funding rate in January 2009 by 50bp. This movement, as well as the communiqué published generated expectations that the central bank would implement a marked cycle of interest rate reduction. The economic context justified this expectation.

Despite the correction of the different indicators of aversion to risk at the beginning of 2009, the depreciation of the exchange rate became acute, mainly in February. which led the Governing Board to place an alert regarding the materialization of the foreign exchange cost on the price of some products. This risk, as well as the fear that the additional reductions in the funding rate could contribute to financial volatility, led to a reduction in the monetary easing rate and an explicit message in which the reduction rate was subjected to diminishing this volatility. The gradual consolidation of the stability of the global markets and, consequently, the stability and appreciation of the peso in the subsequent months have allowed Banco de México to maintain a marked reduction rate in the funding rate as of March, reducing it by 225 bp since then (at the close of this publication in the first week of June, it stands at 5.25%).

Given the sharp contraction of the economy in the last two quarters, as well as uncertainty regarding the economic impact of the outbreak of the AH1n1 influenza, we believe that the risk balance will continue to lean toward that of lower economic growth (see pages 14 - 16 for comments on inflationary perspectives).

In this context, the central bank will maintain the cycle of monetary easing, although with less intensity and with a relatively close end. The Banco de México is being clear regarding its future actions: the funding rate will continue to drop, but at a lower magnitude--" future actions will probably be of a lower magnitude"--. We believe that the central bank will reduce the bank funding rate toward levels of 4.5% in the summer of 2009. Nevertheless, given that the exchange rate dynamic has proven not be linked to monetary actions, but rather to the environment of global aversion and, In view of the possibility that Inflation will converge In a more accelerated manner toward the end of the year, the easing period could be extended. It is expected that the monetary pause will be maintained during 2010.

Monetary Conditions Index



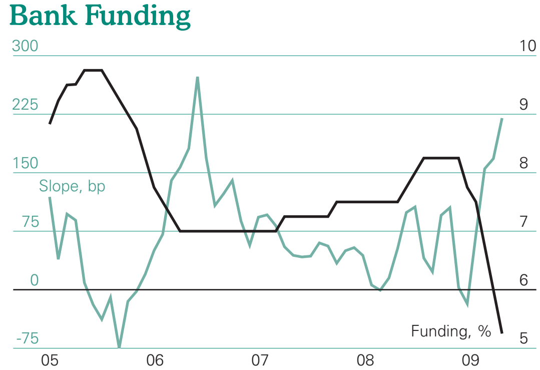
Note: Weighted index between interest rate level and real exchange rate
Source: BBVA Bancomer

Monetary Policy: Bank Funding

%

Note: Forecasts as of June 2009
Source: BBVA Bancomer

Yield Curve Slope and Bank Funding



Source: BBVA Bancomer with Bloomberg data

Implicit Risk Premium
Long-Term Rates

Note: 10-year interest-rate spread (Mex.-USA) lower expectations for the pesos per dollar exchange rate (one year view)
Source: BBVA Bancomer

Implicit Inflation Expectation in Long-Term Interest Rate
%

Source: BBVA Bancomer with Bloomberg data

Liquidity Premium
on the Yield Curve*
Basis points

* Estimate of 10-year non-observable factor, in terms of inflation, industrial activity and implicit expectation of interest rates in a swap curve
Source: BBVA Bancomer

Interest rate structure: the high slope is here to stay

As was commented, the sharp foreign exchange depreciation reduced the rhythm of monetary easing in February. This strategy, together with financial uncertainty, interrupted the flattening out of the yield curve (which was even inverted from mid-December 2008 to mid-January 2009). The current growth of the yield curve differed markedly from the previous cycle of monetary easing implemented in 2005. In that year, it remained inverted and, in general, less steep for a longer time. The global context of risk aversion and the inflationary trend explain these differences.

In the graph, an implicit risk estimate is presented of domestic long-term interest rates on the international markets. The premium collected by investors upon the start of the financial crisis, and still in the early months of the year rose exponentially. This means that the volatility of the peso, in addition to generating doubts regarding the rhythm of reduction of the monetary policy rate throughout the yield curve, placed an addition premium to acquiring domestic bonds, as reflected by lower bond holdings by foreigners.

It should be pointed out that, even though the financial markets do not discount an inflationary convergence toward an implicit 3.0% in the bonds real rate, they do incorporate a lower inflation level than the average registered in 2008, and these instruments currently operate assuming an implicit inflation of 3.91%..

Another indicator from which it can be deduced that the curve yield reflected a greater risk premium (than inflationary uncertainty) in the last few months, is shown on the graph of the liquidity premium. This series reflects the additional basis points to economic risk factors such as inflation, economic activity and short-term rates. The liquidity premium alien to these factors has increased considerably as of the end of 2008[9].

In brief, the curve did not maintain a relatively flat slope for a longer time, due to the implicit risks in an environment of financial volatility and, once these risks are delimited, the monetary easing cycle is approaching its end, which is why the weight of the premium associated with expectations of future interest rates have begun to dominate the curve structure.

When considering that a large part of the monetary easing course is already given (we expect bank funding to close at 4.5%), we foresee that the curve slope will continue to present limits downward. That is, long-term rates should decrease, although only in terms of the implemented monetary strategy, adjusting to a lower extent than short-term rates. We believe that the current slant (around 300 bp), although it does reflect, in part, the phase of the monetary cycle that we are in, is high given that we expect a convergence of inflation toward levels lower than 4.0% at the end of this year; also, we foresee that the stability of the

9 To this were added the restrictions that some funds have faced to invest in these instruments for being in the VaR limits. Longer term bonds at a fixed rate present a greater interest rate risk; thus, institutional investors face restrictions to increase their holding when the risk limits of their portfolios are at their allowed maximums.

international financial markets will consolidate as 2009 advances, which should contribute to lowering the pressure in the long part of the curve. We estimate the M10 at levels close to 6.4% at the end of 2009 with a bias that this level could fluctuate between 7.0% and 6.4%. For 2010, we believe the curve slant will remain high, which would imply a yield in the M10 of close to 7.2% by the end of the year. In any case, lower levels than those that are quoted today on the markets.

Balance of payments for 2009-10, orderly adjustment and without financing problems

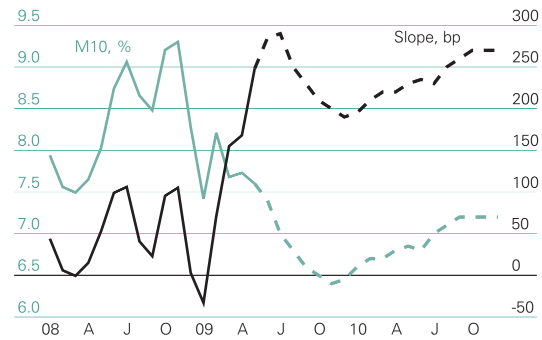
A multiplicity of recent factors have altered the dynamics of the current account in a diametrically opposed way and generated certain uneasiness regarding the availability of foreign resources to finance the potential course of current transactions abroad during the coming years. In part, the process of "un-savings" of the private sector in recent dates, together with a weaker fiscal position by the government in the current recessive cycle (low tax revenues and difficulties to reduce spending) led Standard & Poor´s to give Mexico's sovereign rating a negative perspective.

Even though, for the moment it is estimated that the economic slowdown cycle, more accentuated in Mexico than in the U.S., will imply a less accentuated trade deficit than last year (ergo: lower financing pressure), it is advisable to place greater emphasis on the analysis of those elements that could implicate risks for the balance of payments and greater challenges for the economy. In brief and considering the evidence published in the first quarter of the year, the large balances in the current account point to the next dynamic for 2009: (1) a lower deficit in the trade balance in terms of dollars; (2) outflows due to contained factorial services (i.e. interest): (3) a higher deficit in non-factorial services (i.e. tourism, and freight); and (4) lower inflow from transfers from the rest of the world. (i.e. remittances).

Thus, we estimate that the current account deficit could rise during all of 2009 by P$-16.3 billion compared to US$-15.7 billion of last year. In terms of GDP, this deficit would expand from -1.4% to -1.9% in 2009. It should be noted that as opposed to the recessive cycles, on this occasion we can rule out a crisis in the balance of payments, which in the past—to correct the external lack of equilibrium—ended up leading to strong adjustments in prices in the economy (especially, foreign-exchange parity), which accentuated and prolonged the economic crisis.

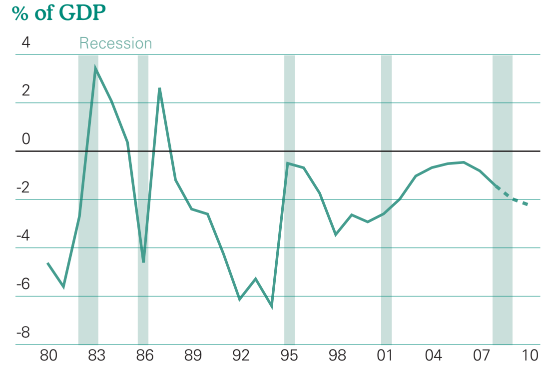
On this occasion an orderly adjustment is feasible in the balance of the external accounts, thanks to: (i) the free-float foreign exchange regime; (ii) the prudent management of public finances, which implied a reduction in the government's external liabilities and the extension of amortization terms; and (iii) containing inflation at prudent levels, which brings with it lower nominal distortions on the local markets (that is, the prices in the economy reflect more efficiently the relative scarcity of goods and services). Furthermore, even in a scenario of lower growth, a gradual reduction in the current account deficit could be foreseeable, and, thus, lower external financing needs. This acquires importance in

M|10 and Curve Slope



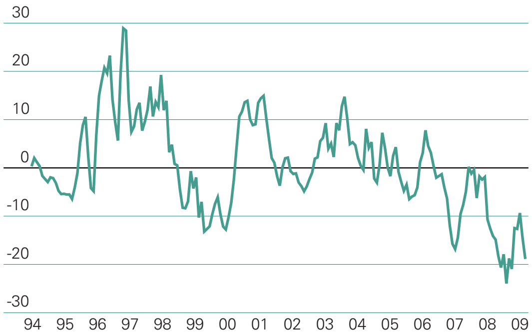
Source: BBVA Bancomer

Mexico: Current Account Balance
% of GDP



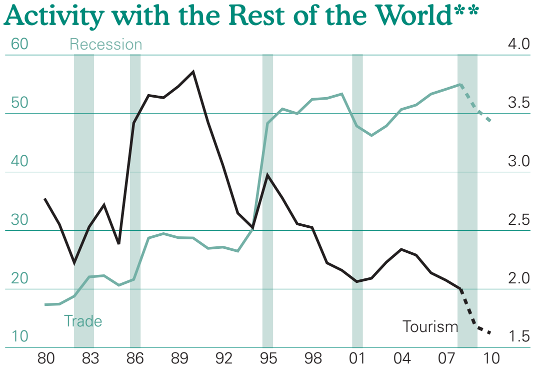
Note: Forecasts as of 2009
Source: BBVA Bancomer with Banco de Mexico and INEGI data

Mexico: Oil Exports Volume
Annual % change in thousands of barrels daily, 3-month moving average



Source: BBVA Bancomer with Banco de Mexico data

Mexico: Indicator of the Depth of International Trade* and of Tourist Activity with the Rest of the World**



* Exports plus imports share of GDP
** Inflow plus outflow of resources from tourism on GDP
Source: BBVA Bancomer with Banco de Mexico data

the current environment, since the relative stability of the external accounts—in the final analysis—translates into greater certainty for investors with regard to the lack of foreign resources in the economy.

Although delimited, the following describes the challenges faced by Mexico in its external balances for 2009.

Trade balance: lower inflows from net oil exports but a trend toward reduction of the non-oil deficit

The perspective for inflows of oil export revenue is not too encouraging for the coming years, and this is one of the immediate challenges for the economy (both fiscal and trade). Although oil prices are far from the levels reached in 2008 (47.14 dpb so far this year vs. a 2008 average of 84.4), they recently stabilized and could undergo a gradual increase in their cost, in line with the recovery of the world economy. The challenge is centered on the loss of production capacity and lower oil-barrel exports, which have posted annual decreases since mid-2006. This brings with it a lower inflow of export resources, but also gradual increases in imports of energy products (I.e. refined products and natural gas). This point implies continued drops in the positive oil balance, which we estimate at US$9.1 billion for this year (vs. US$14.4 billion in 2008).

For the non-oil trade balance, we estimate a lower deficit with the rest of the world this year (US$-25.4 billion vs. US$-31.2 billion in 2008) because the lower economic growth in Mexico, compared to our main trading partners, would imply a lower relative demand of imports. It is important to point out that the slowdown in the automobile industry—which could contract over 40% this year—would explain part of this exporting and importing of inputs dynamics.

Similarly, it is important to note that, to the extent in which the slowdown is more accentuated in the country, this deficit will tend to correct itself, which would imply lower pressure from foreign savings to finance purchases abroad. But also of note is the fact that Mexico's total trade transactions (measured as the sum of exports and imports with relation to GDP) could show their lowest level since 2001, without ruling out that they are the lowest since the trade opening. This pro-cyclical trend of the extent of the foreign trade opening of the economy already happened in the 2001 recession, the first without a brusque adjustment of the exchange rate. This is relevant for activities and services linked to the external sector (insurance, transportation, etc.).

Balance of non-factorial services: tourist activity will begin to weaken (travelers) and there will be lower international trade (freight)

We foresee a slight increase in the deficit of this balance (from US$-7.0 to US$-7.7 billion in this year) spurred by a latent decrease in international travelers to Mexico and lower activity in services linked to trade (freight). Despite this, the deficit in non-factorial services will be moderate due to fewer departures abroad by Mexican tourists, which is related to low economic growth and the loss in the value of the peso against other currencies. Despite this, tourist activity as a whole (departures plus arrivals with relation to GDP) could continue with their decreasing trend since 2004 and reach historic minimums due to the factors described above.

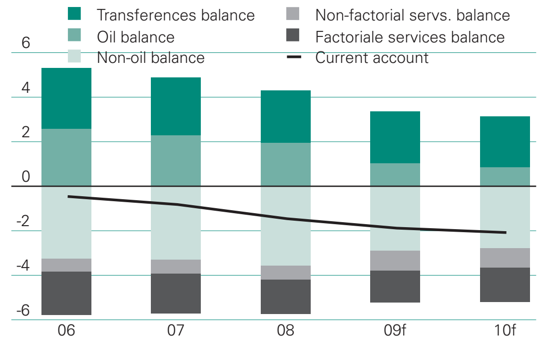
Balance of factorial services (interest) a decrease in the deficit in the short term, but pressure going forward due to indebtedness

Even though this item presents higher levels of uncertainty to project, there are elements that lead us to believe that the deficit will remain contained throughout 2009 (US$-13.2 billion vs. - US$16.8 billion in 2008). Among the elements that point to this is the financial cost of the foreign debt of the public sector that was budgeted for 2009 and the amortization calendar (capital and interest) of the private sector, which rose in the previous quarter to US$88.billion for 2009 (and US$6.6 billion for 2010). Nevertheless, we do not rule out a potential deviation of the deficit of the factorial services balance (toward US$-17.0 billion), which will depend on the terms of new debt transactions (public and private), the renegotiation of existing liabilities, and international financial conditions. Despite this, we do not think that this implies a greater risk over a year's time.

Balance of transfers: pillar for the inflow of resources in the current account

The dynamics of transfers is dominated by the evolution of family remittances. In this case and considering the recession in the U.S., which has had an impact on employment of the immigrant population, a contraction in family transfers to Mexico in 2009 is foreseeable as is a discreet expansion in 2010, as the U.S. economy recovers.. Even though the contraction of these remittances was moderate in the first four months of this year (an annual -8.5%), we do not rule out that the adjustment downward will be a little more intense in what is left of this year, so that the remainder of this balance could drop from US$25.5 billion in 2008 to US$20.4 billion in 2009. We do not discard a positive bias in this item (based on the recovery in the U.S. and the growth spread with Mexico); however, we maintain this level of inflows from remittances in order to be prudent in the dimension of foreign financing needs. Given the outlook for the exchange rate, the adjustment in pesos derived from remittance inflows will be less intense, at least in 2009, which will also reduce the impact on available income and the spending capacity of families.

Current Account Composition
% of GDP



f (p) forecast as of 2009
Source: BBVA Bancomer with Banco de Mexico and INEGI data

Mexico: Current Account

	2008	1Q09	2Q09	3Q09	4Q09	2009	2010
			Billions of U.S. dollars				
Current Account	**-15.7**	**-1.1**	**-6.1**	**-5.7**	**-3.5**	**-16.3**	**-19.8**
B. Trade	-17.3	-1.9	-0.3	-8.8	-5.3	-16.2	-18.5
B. Non-Factorial Serv.	-7.1	-0.7	-2.4	-1.7	-2.9	-7.7	-8.6
B. Factorial Serv.	-16.8	-4.0	-4.5	-1.2	-3.0	-12.7	-14.8
B. Transfers	25.5	5.5	1.0	6.1	7.8	20.4	22.0
			% of GDP				
Current Account	**-1.4%**	**-0.5%**	**-2.8%**	**-2.6%**	**-1.6%**	**-1.9%**	**-2.1%**
B. Trade	-1.6%	-0.9%	-0.1%	-4.0%	-2.4%	-1.9%	-1.9%
B. Non-factorial serv.	-0.6%	-0.3%	-1.1%	-0.8%	-1.3%	-0.9%	-0.9%
B. Factorial serv.	-1.5%	-1.8%	-2.1%	-0.6%	-1.4%	-1.5%	-1.5%
B. Transfers	2.3%	2.5%	0.5%	2.8%	3.6%	2.3%	2.3%

Note : Estimates as of second quarter of 2009
Source : BBVA Bancomer with Banco de Mexico data

Financing of foreign accounts

If to the current account deficit that we foresee for 2009 (US$16.3 billion) we add the potential outflows of the capital account due to amortization of the private sector (US$27.7 million according to Finance Ministry declarations) the foreseeable liquidity needs for the whole year would be approximately 5% of GDP. For the time being, the availability of current resources of the economy. together with foreseeable inflows for the economy, allow us to project that Mexico will have sufficient resources to meet its financing needs in the year: to this we add the international reserves (US$75.6 billion), the inflows in the balance of payments due to oil (US$10.9 billion), and a modest foreign investment flow US$11 billion), which implies an availability of resources of 11.1% of GDP (almost 2.2 times the needs of the balance of payments).

If to the above we add the availability of the government of credit lines with the International Monetary Fund, with the Flexible Credit Line (US$47 billion) and the Swap Line with the Federal Reserve (US$30 billion), the total availability of sure resources for the economy would be 19.9% of GDP (4 times the need of the balance of payments).

For 2010, we estimate a slight rally of the current account deficit (US$-19.8 billion or -2.1% of the GDP) inherent to the expected recovery cycle, which does not imply a risk for the balance of payments under the expected cycle of modest international expansion.

Nevertheless, it is always prudent to monitor the risks going forward, which we consider are delimited and not probable for 2009 and 2010. Among the elements to be monitored —under stress situations—the following are significant: (1) an outflow of portfolio foreign investment together with an abrupt loss of confidence; (2) a higher trade deficit induced by variables such as a loss of competitiveness in Mexico; (3) a greater drop in oil production; and, (4) exponential growth of government liabilities that brings with it a greater effort for redeeming said obligations in the long term.

Coverage of Financing Needs in Mexico for 2009

	Billions	% of GDP
Liquidity requirements for 2009		
Current account deficit	16.3	-1.9
Private sector amortizations in capital account*	27.7	-3.2
Total	**44.0**	**-5.0**
Coverage Capacity of 2009 Requirements		
International reserves	75.6	-8.6
Foreign direct investment**	11.0	-1.3
Inflows in BP from oil coverage	10.9	-1.2
IMF-FCL	47.0	-5.4
FED-SWAP	30.0	-3.4
Total	**174.5**	**-19.9**

* Own estimates based on SHCP and Banco de Mexico declarations
** Own estimate assuming a modest evolution in FDI
Note: The calculation of the figures is prudent as to coverage of requirements, since it does not incorporate possible indebtedness of the private sector.
Source: BBVA Bancomer with Banco de Mexico data.

Risk Balance in Forecasts and Influenza: Impact Uncertain, but Limited and Short Term

The global environment, decisive in the Mexican economy's risk balance

The global environment in which the Mexican economy is immersed will be gradually improving in the next few quarters, as the effects are noted of the positive impact of the policies implemented to stabilize the financial system and promote demand. The United States is one of the developed economies in which the economic adjustment has been most intense, but also earlier, and where a broader series of measures has been implemented to overcome this situation. Thus, it is reasonable to believe that the recovery will occur before and more intensely in the Mexican economy's number one trade partner and investor. This support from the global scenario for an economy so open to the international environment and particularly to the United States, as is the Mexican economy, is the basis for expecting its recovery. Meanwhile, as long as the recovery of U.S. demand provides better than expected upside surprises, a rise in Mexican economic growth could also occur.

The economic impact of the influenza epidemic: uncertain but limited in intensity and duration

In terms of more domestic factors that could affect the uncertainty surrounding the rhythm and the timeframe for the beginning of the recovery of the Mexican economy, the AH1N1 influenza epidemic is particularly important.

Flu Epidemics

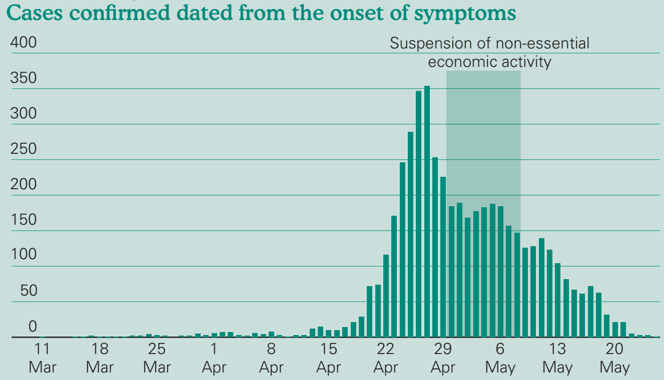
	SARS, 2003 Worldwide	Type A, 2009 Worldwide	Type A, 2009 Mexico
Contagion			
Number of confirmed ill	5,410	19,273	5,563
In relation to population (X per 100,000)	0.1	0.3	5.1
Number of countries affected	29	66	—
Mortality rate (% of cases)	9.6	0.6	1.7

SARS: infection five weeks after the health alert, mortality for the entire period of the epidemic
Type A: data through June 3, 2009
Source: BBVA Bancomer with data from official sources, WHO

The health emergency was launched on April 23 following the detection of an outbreak of non-seasonal flu, of a different virus, that was causing an unusual number of infections and a certain number of deaths. As can be seen in the following chart, in the weeks that transpired since the health alert, almost 20,000 people have contracted the illness worldwide —15,000 of whom live in the United States and Mexico—, which implies an infection rate triple what was registered in 2003 with the SARS (Severe Acute Respiratory Syndrome). The mortality rate among those infected is considerably below that of 2003, both worldwide as well as in Mexico.

The relatively benign nature of the epidemic, based on the information available up until now, has not prevented an economic impact from emerging, as a result of the combination of two effects. First of all, the direct impact both from the suspension of activities designed to mitigate the spread of the epidemic as well as from workplace absenteeism due to the epidemic itself or the need to take care of family members. Secondly, the effect of lower demand in the areas affected due to fear of infection. The lower demand for leisure-related activities affected the services sector in fields such as retail distribution and especially tourism activities as a whole. The quantitative estimate of the final impact of this type of development is very uncertain, and especially so in these moments, in which the available up-to-date information for the month of May is very sketchy.

Mexico: Type A Influenza
Cases confirmed dated from the onset of symptoms

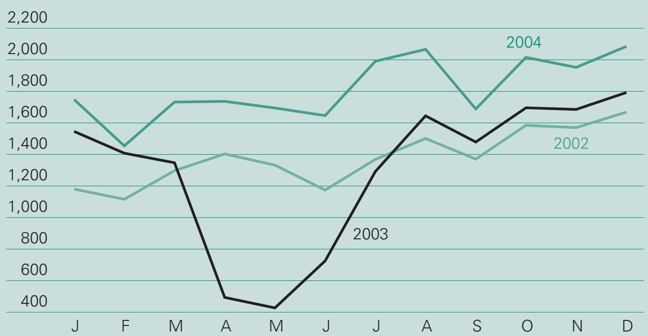


Source: BBVA Bancomer with Ministry of Health data

The government decreed the suspension of educational activities, which with different dates for resuming classes was not fully renewed in the State of Mexico and the Federal District until May 11. In addition, in that period it was also decided to close restaurants, museums, and in general all types of entertainment and sporting events in the area with the greatest incidence of the epidemic, Mexico City,. The cancellation of activities became more intense between May 1 and 5, when the Federal Government announced that all non-essential activities of the federal public administration were to be suspended. In the case of the private sector of the economy, basic transportation and telecommunication services, retail distribution, manufacturing production, and banking activities continued, although taking into account the health authorities' recommendations to minimize the risk of infection.

With the information available, it can be stated that the direct impact will be limited quantitatively, due to the time period involved being temporary and the activities affected by the decision to suspend them being geographically defined. In terms of workplace absenteeism due to the illness, the benign nature of the outbreak in terms of the seriousness of the symptomatology led to a very reduced impact.

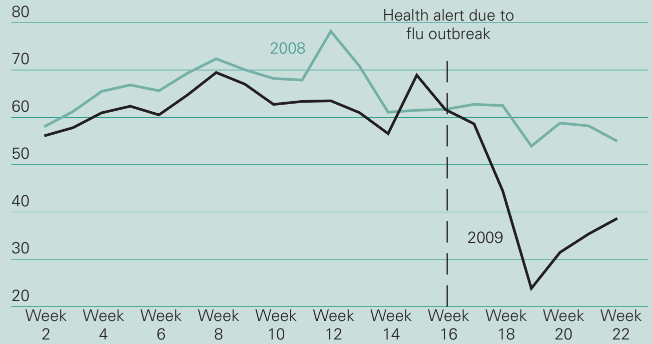
Hong Kong: Tourist Inflow
Thousands of persons



Source: BBVA Bancomer with data from the Hong Kong government

In terms of the fear of contagion, the available evidence indicates that if this negative impact burst upon the scene suddenly, it also dissipated with relative speed. Using as a reference point what occurred in Hong Kong in 2003 with the SARS, which was the last comparable epidemic and for which the information available is more complete, in turns out, as can be seen in the corresponding graph, that the decline in tourist arrivals in 2003, while intense, did not last. Two months after the health alert was decreed, the inflow of tourists began to recover its habitual levels and in five months these returned to normal.

Mexico: Tourist Demand
Hotel occupancy rates, %, weekly evolution



Source: BBVA Bancomer with Ministry of Tourism data

In this sense, the information for the period of the Mexican tourism industry also points in the direction of a recovery in the weeks following the beginning of the health emergency. As can be seen in the corresponding graph, in the last period for which information is available, the last week of May, the hotel occupancy rate was, on average, close to 40%, 15 points lower than the previous year, but 15 points above the levels registered in the first week of May, when the occupancy rate was the lowest during the peak of the health emergency. The recovery is more intense in destinations where most of the tourism is domestic in origin than in areas with a greater share of foreign tourism, but in both the trend is toward a gradual improvement.

In summary, it is reasonable to feel that the impact on economic activity from the influenza outbreak will be very limited in terms of activities that were suspended in order to minimize the contagion. As regards the effect of lower spending in the services sector, the data that point to a gradual return to normal, such as in similar outbreaks in other countries, are encouraging.

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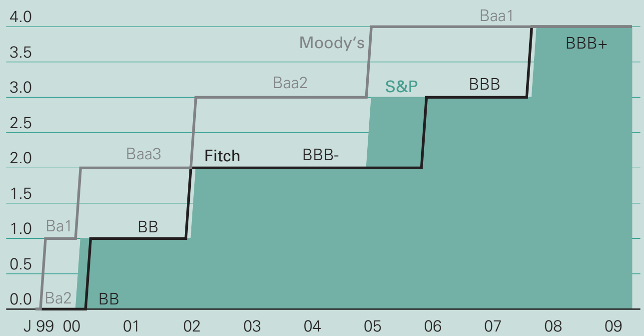
Changes in Rating, Reactive Adjustments in Response to Market Movements

This past May 11, the Standard & Poor´s (S&P) rating agency downgraded its outlook on Mexico's sovereign debt from stable to negative, maintaining the ratings for long-term placements in foreign currency at BBB+ and short-term placements at A-2. In local currency, the long-term placement was maintained at A+ and the short-term at A-1. This change in outlook in the end may or may not be followed by a real downgrading of ratings.

Ratings on Long-Term Debt in Foreign Currency

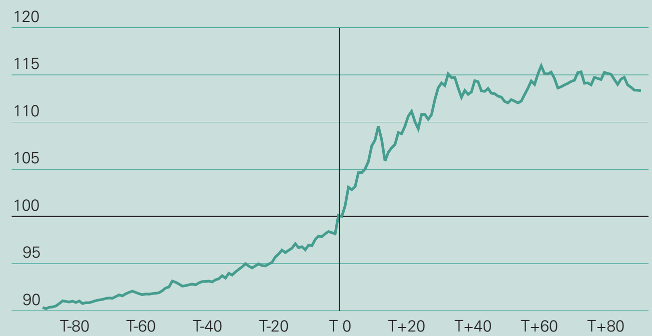


Source: BBVA Bancomer with Bloomberg data

The evidence suggests that the impact of a real downgrading of the ratings on a country's sovereign debt by the rating agencies[1] on variables such as the exchange rate or the EMBI+ spread is difficult to separate from other factors that simultaneously could be affecting its value. In addition, these adjustments in the credit ratings are usually pro-cyclical or reactive. That is, the empirical evidence suggests that the adjustments in the financial variables usually occur prior to the announcement of the change in rating. This indicates that the downgrading in credit ratings, more than anticipating the movements in the financial variables, tend to validate the information already discounted previously in the financial markets.

In general, a downgrading of a credit rating usually occurs in an environment of economic decline in the debt issuer's home country. For example, the graph shows an average exchange rate index for a sample of emerging economies (Argentina, Brazil, Colombia, Peru, and Russia) that had their credit rating from S&P downgraded in the past few years. There is a 90-day window before and after the date on which their rating was changed. As can be seen, this adjustment in the rating occurred within a context of a significant currency depreciation. Thus, in the 90 days prior to the downgrading, the average exchange rate for the countries in the sample had already depreciated by around 7%. The average depreciation registered in this index 90 days after the change in ratings was 12%. Even though the depreciation in the latter window was nearly twice as much as in the previous window, the movement was less durable, and it is not possible to say that the change in rating has been the decisive factor in the dynamics of the exchange rate as of that moment.

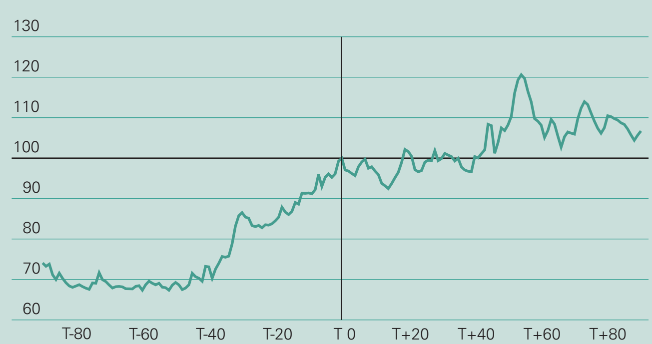
Average Exchange Rate Index



Source: BBVA Bancomer with Bloomberg data

Meanwhile, the following graph shows a similar trend in the case of the EMBI+ spread for the same sample of emerging economies. As in the case of the exchange rate, the effect of an adjustment in the rating granted by S&P does not appear to significantly alter the previous trends. Concretely, the average EMBIs+ spread for the countries of the sample had increased by 30% as a whole for the 90 days prior to the adjustment in ratings and only 4% for the 90 days following the downgrade.

JP Morgan EMBI+ Spread



Source: BBVA Bancomer with Bloomberg data

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1 The evidence shows that the rating agencies tend to adjust their ratings as part of a chain reaction. That is, when one agency changes the rating it has granted, the others tend to do so as well.

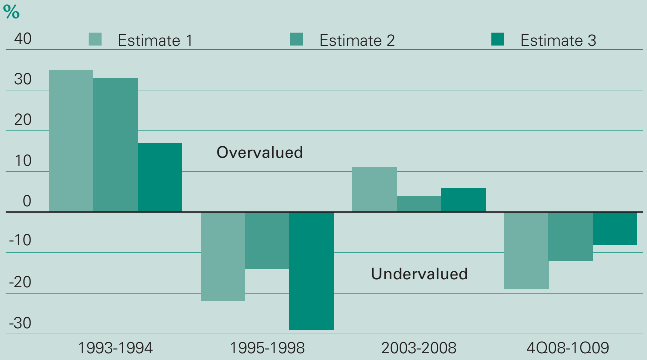
How Undervalued is the Peso?

In general terms, there are different ways of estimating whether a country's currency is overvalued or undervalued in relation to another foreign currency, in fact, as many as there are ways of calculating its theoretical or equilibrium value. One of the methods most used is by employing the concept of Purchasing Power Parity (PPP). Based on this concept, the equilibrium exchange rate would be the method for measuring in equivalent prices the purchasing power of different currencies for a specific basket of goods and services[1] . However, the difficulty of finding baskets of goods and services that are perfectly comparable makes the calculation of this index imperfect.

In order to have a reference point for the peso/dollar exchange rate, BBVA Bancomer has prepared an index based on the equilibrium, benchmark, and theoretical exchange rates, the BBVA Bancomer Index, which averages out the following three indicators: 1) the PPP index; 2) the estimate derived from a CHEERS model, which incorporates an error correction model between PPP, short and long-term interest spreads, manufacturing productivity in both countries, and the exchange rate; and 3) the previous estimate plus the effect on the long-term relation between the U.S. and the Mexican current account balance. The co-integration method (Vector Error Correction Model) is used, except for PPP. The equilibrium exchange rate is derived from the long-term relationship between these variables.

1 Under/Overvalued Peso for Periods with Different Estimates

%



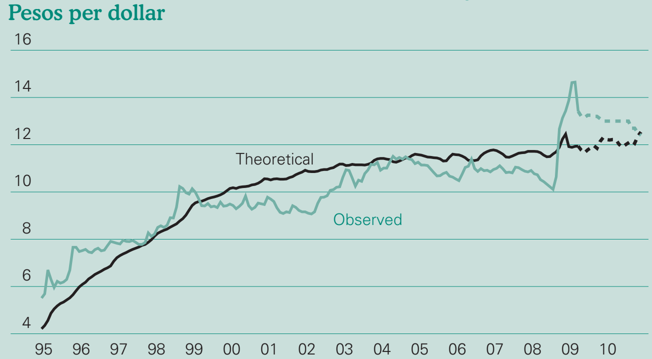
Source: BBVA Bancomer with Banco de México data

1 This index was originally developed by Gustav Cassel in 1920 and is based on the law of a single price. That is, if the markets are efficient, identical goods will have the same price. The PPP, in one of its more complete specifications, takes into account the differences in productivity between the different countries, which is reflected in the price levels of non-tradable goods and services, which are generally lower in economies with low income levels (or which are less productive).

Thus, this method for calculating the equilibrium exchange rate includes three of the indicators most used for such purposes, even though all of them belong to the same family of models, and for representing an average, cushions the possible bias inherent in some of them. As a result, any deviation from the observed exchange rate in relation to the average of these three theoretical ratios can be interpreted as the degree of the currency being under or overvalued with regard to its theoretical value.

2 Exchange Rate
Observed and Theoretical with Projections

Pesos per dollar



Source: BBVA Bancomer with Banco de México data

Graph 1 illustrates the average under or overvaluation of these three estimates for different periods up to the 1Q09 (last available data). As can be seen, the three estimates point in the same direction in the different stages of the peso's parity cycle. In turn, graph 2 shows that the peso's exchange rate with regard to the dollar strayed exponentially in relation to the estimated theoretical level (BBVA Bancomer index) but according to our projections, it is expected that it will tend to reach its equilibrium level at the end of 2010. Meanwhile, graph 3 indicates the dynamics of this under/overvalued level and the corresponding projections for 2009 and 2010, when the peso's estimated undervalued level should dissipate.

According to this index, in September 2008 the peso was undervalued by around 10%. This trend of the strengthening of the peso began in 2005 and intensified in 2007 and 2008. However, the liquidity crisis and the worsening of global risk aversion beginning in September 2008 put an end to this period of the relative strength of the peso. Thus, the strong depreciation registered since September 2008 implies that the peso is undervalued by around 19%, but this trend has started to reverse itself in the past few months.

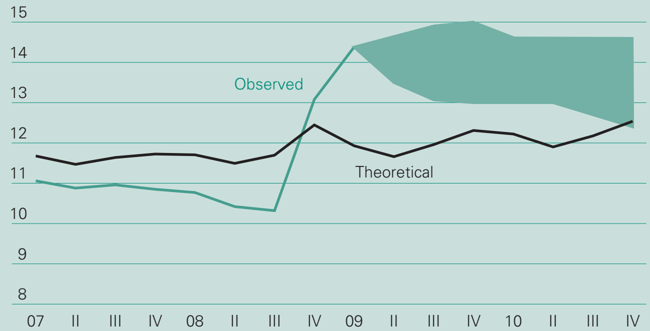
3 Under/Overvalued Peso and Projections

%

Source: BBVA Bancomer with Banco de México data

4 Observed and Theoretical Exchange Rate

Pesos per dollar



Source: BBVA Bancomer with Banco de México data

It should be mentioned that in the crisis of 1994-1995, when the Mexican peso went from being overvalued by 18%-20% in December 1994 to being undervalued by around 30% in May 1995, the drop was about 50 percentage points. Although the depreciation of the peso was much more severe in that financial crisis, which makes sense given that the exchange rate was fixed before 1995, the speed with which the currency depreciated in the current crisis in relation to the equilibrium level was undoubtedly very similar.

Projected level of the peso/dollar exchange rate

The exchange rate has an important appreciation margin, given the relative stability of the available estimates at around 12.3 pesos per dollar. This level is only an approximation, since the degree of uncertainty in the calculations is considerable. Nevertheless, the BBVA Bancomer index for the theoretical exchange rate throughout the sample has, in fact, served as a conceptual point of comparison, and it has allowed us to significantly relate the degree to which the peso is under or overvalued with the dynamism of other economic variables such as inflation or interest rates.

Based on our projections for this year, we expect the exchange rate to close 2009 at levels of close to 13 pesos per dollar (see graph 4), with all the uncertainty inherent to these estimates.

All in all, what seems clear is that the Mexican peso has changed its fluctuation level, this being understood as its oscillating around a more or less stable value. Since abrupt depreciations of a currency generally lead to a change in its fluctuation level, as can be seen in graph 5, it would be difficult for the peso to return to an exchange rate under 11.0 pesos per dollar in the short and medium term. Unless a structural change materializes in the next two years, be it domestic or international (in terms of inflation, economic growth, gains in productivity, etc.), it would appear that the exchange rate will be at ranges of around the 13 pesos per dollar at the end of 2009 and at around 12.4 ppd at the end of 2010.

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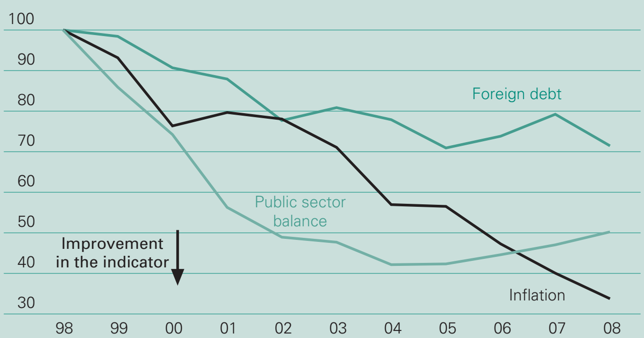
Indicator of Macroeconomic Risk for the Exchange Rate

In the short term, the determining factors and risks in relation to the exchange rate resemble those of simply another financial asset. That is, their fluctuations will depend on the currency's yield expectation. Different indicators have been elaborated to measure these expectations based on the behavior of financial risk aversion implicit in the markets.

Nevertheless, the determining factors of the exchange rate in the medium and long term are more associated with the evolution of macroeconomic variables, mainly those related to the financing structure of an economy. A relatively favorable financial position in relation to the international dynamic translates into lower depreciation pressures on the exchange rate.

1 Macro Variables of Emerging Economies

1998 Index = 100



Source: BBVA Bancomer based on averages of each variable and IIF data

It should be emphasized that a great majority of emerging economies have implemented structural reforms since the 1990s that have improved their macroeconomic performance and, therefore, reduced their associated foreign exchange risk (see example in graph 1). However, the relative behavior by region has been different, which is why the preparation of an indicator measuring the relative position of medium term foreign exchange pressures has been proposed.

2 Indicator of Macroeconomic Risk for the Exchange Rate by Region

(excluding Africa and the Middle East)

Source: BBVA Bancomer

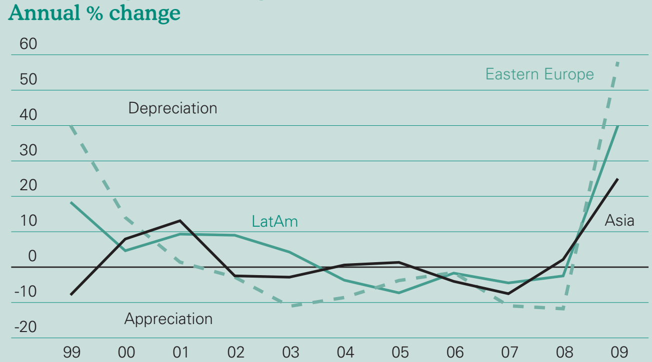
Thus, we have prepared an Indicator of Macroeconomic Risk for the Exchange Rate (RMTDC for its Spanish initials) for 40 emerging economies, based on the macroeconomic fundamentals linked to foreign exchange pressures.

Using a sample of 40 countries and seven economic variables[1], we obtained the relative position, according to an ordinal value, for each of these variables and each economy for the 1990-2009 period[2]. That is, for each year we averaged the hierarchical values of all the variables, which indicate the relative average position of foreign exchange risk compared with other emerging economies. In other words, it is a dynamic indicator for each country of the macroeconomic reflection of foreign exchange risks compared with other emerging economies. The indicator should show the potential capital investment outflows compared with other countries.

Thus, it should be emphasized that the indicator that we have constructed will not show a macroeconomic risk lower than the exchange rate unless it represents a relative improvement in relation to other countries.

3 Average Exchange Rate

Annual % change



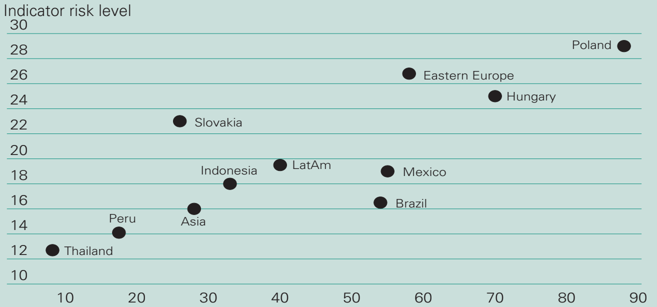
Source: BBVA Bancomer; the Latin America data were adjusted in 2002 to minimize the effect of Argentina

1 The variables used are: 1) current account in relation to GDP, 2) international reserves in relation to imports, 3) total foreign debt in relation to GDP, 4) service of short-term debt in relation to the total, 5) total debt service in relation to exports, 6) annual inflation, and 7) current account in relation to foreign direct investment. The idea is to calculate the economic pressures on the exchange rate from different angles. It is not only enough to incorporate the size of the current account with relation to its financing sources, but also the amount of total debt (not only public) based on the strength of the economy, including inflationary pressures, and its revenue sources from exports. In general, these variables are part of the series of factors monitored by the rating agencies. The Economist published an article on February 26, 2009 concerning the macroeconomic risks in emerging economies, using an indicator with three variables.

2 Annual data from the Institute of International Finance (IIF). The data for 2009 represent an IIF estimate.

Graphs 2 and 3 illustrate the evolution of the indicator by regions. Although gradually, Latin America has implemented reforms that have allowed it to improve its foreign-exchange risk levels as measured by the Indicator of Macroeconomic Risk for the Exchange Rate (RMTDC). Only recently, the emerging Asian economies have presented, on average, a positive correction in terms of future foreign exchange pressures. The Asian crisis of the 1990s led to the implementation of measures to minimize this risk.

4 Relation between Depreciation in the Current Financial Crisis and the Indicator Level



Depreciation measured using the minimum level reached in 2009 vs. the minimum level between August and December 2008

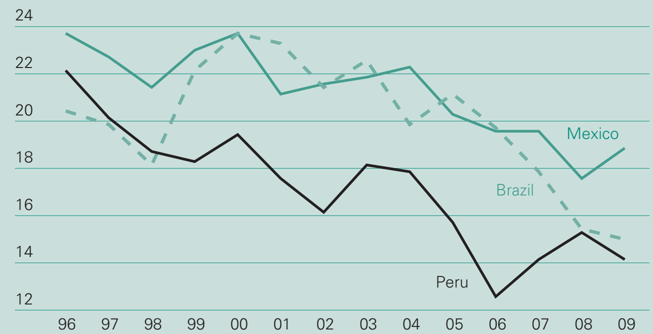
Source: BBVA Bancomer

In terms of the indicator by region, and the behavior of the exchange rate (domestic currency in relation to the dollar), two conclusions can be drawn. First, the scale of the currency appreciation by region observed during the sample is not linked to the evolution of the Indicator of Macroeconomic Risk for the Exchange Rate. In Eastern Europe the risks were higher, while its currencies appreciated by an even greater degree than in the case of Asia and Latin America. Second, the Indicator of Macroeconomic Risk for the Exchange Rate is associated with the degree to which the currencies of the different emerging economies depreciated on average in this latest financial crisis (graph 4). For example, the Eastern European region presented higher risks associated with its macroeconomic characteristics, which were reflected in a greater depreciation of its currencies (the macro imbalances were greater in these countries). The indicator for Latin America was the second in terms of these risks, and the reaction of its currencies was, on average, less severe than in the case of Eastern Europe, but greater than in Asia (this latter region with lower risk according to the Indicator of Macroeconomic Risk for the Exchange Rate).

3 The case of Chile is interesting, because it reflects the spirit of the indicator. Its macroeconomic situation is favorable and it is among the best positioned countries, although it is very vulnerable on the level of foreign trade. However, it has not shown such a pronounced relative improvement as the case of these three countries (Peru, Brazil, and Mexico).

Furthermore, within the Latin American region (graphs 5 and 6), the three economies that have shown the most progress in relative terms have been Peru, Brazil, and Mexico[3]. Among them, Peru has been the most outstanding in this regard, with a less vulnerable foreign exchange market. The recent explosion of the financial crisis hardest hit the currencies whose indicator reflected a less favorable foreign exchange situation, as was Mexico's case, than the currencies of those nations with a better Indicator of Macroeconomic Risk for the Exchange Rate (Peru and Brazil). This link between the magnitude of the currency depreciation and the level of the Indicator of Macroeconomic Risk for the Exchange Rate can be seen, on average, among the different countries of the sample.

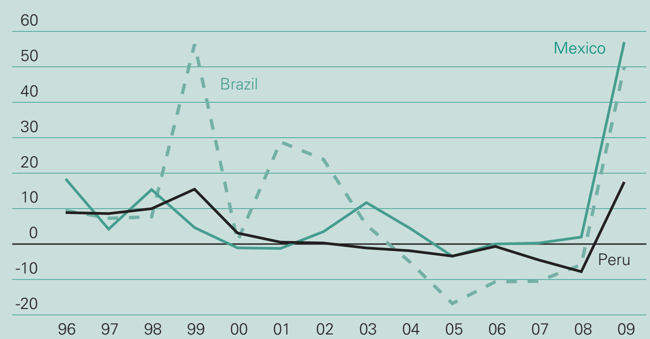
5 Indicator of Macroeconomic Risk for the Exchange Rate



Source: BBVA Bancomer

6 Average Exchange Rate

Annual % change



Source: BBVA Bancomer

In conclusion, the level of the Indicator of Macroeconomic Risk for the Exchange Rate vs. that of other economies, provides data as to the relative magnitude of possible pressures on the exchange rate in a context of financial crisis. It is an early warning of the relative macroeconomic risks compared with other emerging economies.

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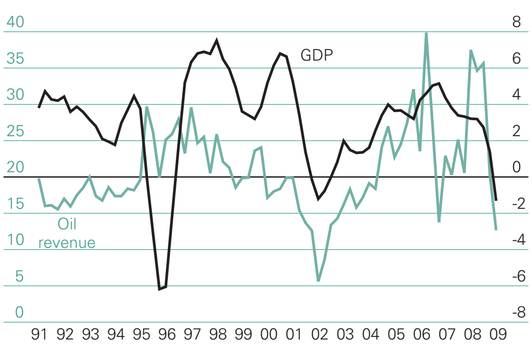
Fiscal Measures Announced for 2009
% of GDP

Fiscal package		Taxes*	Current spending	Capex	Total
Oct. 8 & 20 2008	Counter-cyclical plan	—	—	0.50%	0.50%
Jan. 7, 2009	Counter-cyclical plan	—	0.30%	0.20%	0.50%
May 5, 2009	Support for flu emergency	0.12%	0.002%	—	0.13%
May 28, 2009	Savings measures	—	-0.30%	—	-0.30%
	Total	**0.12%**	**0.00%**	**0.70%**	**0.83%**

* Taxes imply lower expected tax collection
Source: BBVA-Bancomer estimates based on SHCP communications. Figures may differ from official statistics, since an estimate is made of the part that will be implemented, which is actually additional.

Economic Growth and Fiscal Oil Revenue
Annual % and % of total



Source: BBVA Bancomer with INEGI and SHCP data

The first counter-cyclical fiscal policy in history…

In response to the country's sharp economic contraction cycle, the fiscal authorities have announced three packages involving increased spending (social and capital) with the aim of mitigating the effects of the recession on employment, business financing, and investment. The total amount contemplated by the measures that are related directly to aggregate demand is close to 1% of GDP[1] in 2009. However, it is estimated that the real boost to growth this year could be close to 0.6 pp of GDP, since part of the additional spending could be diluted due to imports and furthermore, delays in carrying out the programs, particularly public work projects, cannot be ruled out.

In breaking down the public deficit in its structural and cyclical components[2], we can see that the discretionary deficit that the government has induced to face the economic downturn is about 0.5% of GDP for the year.

… thanks to the prudent management of public finances…

The measures announced were adjusted in terms of their content and represent, in practice, the first fiscal program involving increased spending in economic downturn cycles in Mexico. This counter-cyclical program was possible thanks to: (i) the prudent management of public spending since the end of the 1990´s; (ii) the gradual reduction of the public sector's levels of indebtedness, which increased the availability of resources for the federal government; (iii) the adjustment in the debt accounting rules of some government-owned enterprises, which allow them to reduce the financial cost (v.gr. pidiregas (long-term productive investment projects with a deferred impact on spending) in Pemex); and (iv) the creation of stabilization funds based on non-recurrent surplus revenue (v.gr. oil), which through March 31, 2009 totaled 148 billion pesos (1.3% of GDP). In addition to this, the Federal Budget Responsibility Law (March-06) provides greater certainty by forcing a contained and stable management of the public deficit.

… but, the scope of the economic recession exposed vulnerabilities and the need for a new reform

Previous budgetary efforts were expressed in greater fiscal flexibility to cope with a phase of economic contraction that might have been relatively benign. However, when the recession intensified at the beginning of this year and when uncertainty increased with regard to its duration, more questions were raised regarding budgetary stability under conditions of stress with relation to future revenue and expenditures.

In terms of revenue, the high degree of dependence on oil revenue (which represents 32% of budgetary revenue) was again placed in the public limelight. Its dynamic is consistent with the rhythm of economic

1 This figure does not include support measures and credit guarantees offered by the development banks or discounts in public prices such as gasoline.
2 Both components are associated respectively with discretionary decisions by the government and with the exogenous impact of the economic cycle. Different methods exist to provide such a breakdown; for further details, see information in the attached box inset.

activity, with decreases in revenue from the state oil company are in line with declines in economic activity. Thus, the government's future capacity to carry out policies involving increased spending—in order to contribute to cyclical stabilization—continues to be very limited and conditioned on the generation of prior oil savings (v.gr. stabilization funds). Otherwise, the government would have to incur high public deficits and potential debt problems, which would tend to increase sovereign risk (as S&P warned when revising Mexico's rating outlook) and in the end would turn out to be counterproductive by raising the economy's financing cost.

Another source of vulnerability is the meager collection levels for consumption taxes (VAT) and income taxes (ISR/IETU), which compare extremely unfavorably with tax collection levels on an international level (see graph). The reasons for the low efficiency in collection efforts are related to: (i) the design of the taxl system, which allows differentiated tax treatments (v.gr. VAT rates); (ii) the reduced taxpayer base and people's high incentive to remain in the informal economy (and not pay taxes) given a not very favorable evaluation of public services (health, security, education, public works, etc); (iii) the complexity of meeting one's tax obligations; and (iv) opportunities to avoid paying taxes and tax evasion.

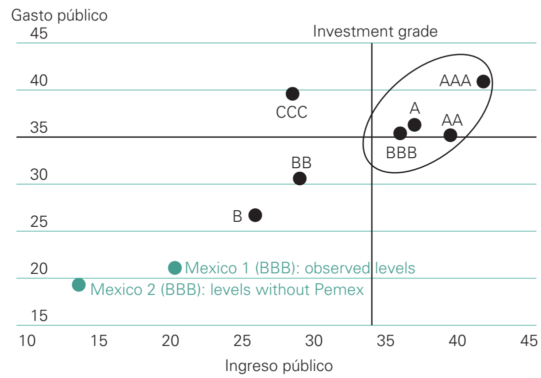
The recent tax reform approved in October 2007 was positive due to its introducing taxes designed to tighten tax controls (the IETU, the flat rate corporate tax) aimed at reducing forms of tax evasion (for example, tax consolidation) and making income tax (ISR) payments more efficient for active taxpayers. Nevertheless, according to the Finance Ministry (SHCP) itself, the reform was partial and required subsequent changes that would allow for increasing tax revenue and, at the same time, spreading the tax burden more equally among the population. In an environment of modest growth, the above-mentioned reform provided certain breathing room for public finances and postponed the need for deeper fiscal changes. However, the intensified contraction in GDP in 4Q08 (-1.6% in annual terms) and 1Q09 (-8.6%) once again exposed the weak tax structure and shortened the time span for carrying out a new tax reform (which, in the eyes of S&P should occur this year).

With the decline in GDP, tax collection levels on income and consumption contracted -8.8% and -11.3% in annual terms, respectively, in the first quarter of the year. This trend could continue given the weakness in domestic demand and as a result of the impact of the interruptions in economic activity following the flu emergency.

Without reform, the viability of public finances would be compromised

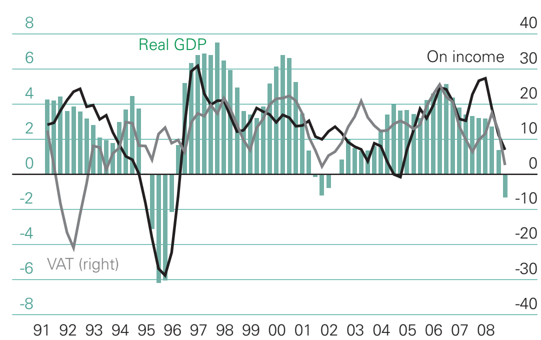
In the absence of a reform that would strengthen tax revenue, the high dependence on oil revenue, coupled with the volatility of oil prices on the international markets and the outlook for lower hydrocarbon production, could imply that—by design—public finances would be considered as "endogenous" to economic activity and even as an element that tends to accentuate the economic cycles (given the legal need to contain the public deficit).

Fiscal Revenue and Expenditures
% of GDP, 2008, avge., according to level of S&P rating



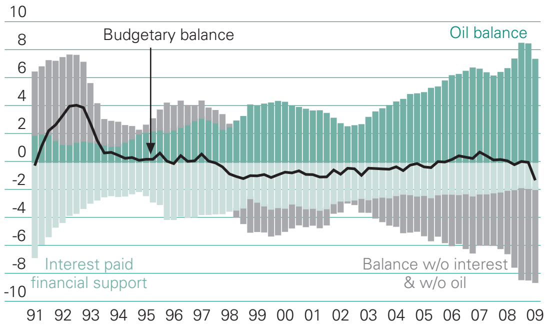
Source: S&P (2008)

Economic Activity and Tax Collection Levels
Annual %



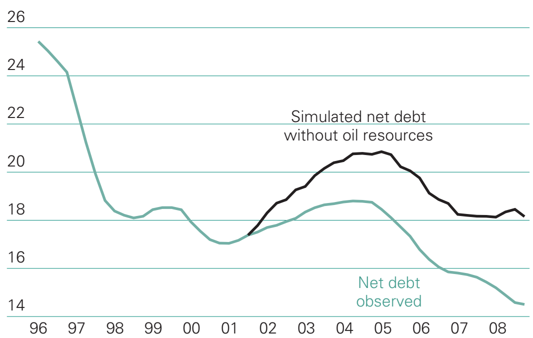
Source: BBVA Bancomer with INEGI and SHCP data

Breakdown of the Budgetary Balance
% of GDP, negative = deficit



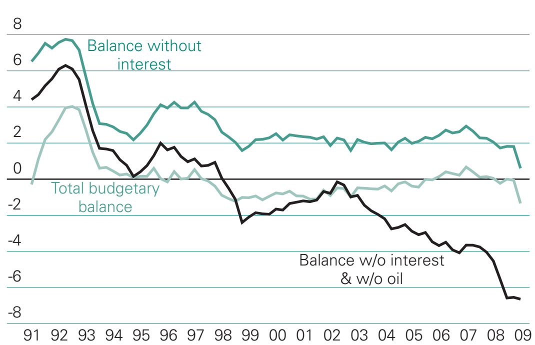
Source: BBVA Bancomer with INEGI and SHCP data

Total Net Debt Observed and Simulated without Oil Resources
% of 2008 GDP, 4-quarter moving average



Note: Total net public debt based on Banco de México methodology. Simulated debt assumes the same interest payment profile and without the contribution of fiscal oil revenue; the shortfall in resources to maintain budgetary spending is assumed to be compensated with greater debt.
Source: BBVA Bancomer with INEGI and SHCP data

Public Deficit
% of GDP, 4-quarter moving average. positive = surplus



Source: BBVA Bancomer with INEGI and SHCP data

If we analyze different definitions of the public balance sheet, the problem previously alluded to becomes clear (see graph). On the one hand, the primary budgetary balance has registered a stable evolution since 1998 and has allowed savings to be generated to redeem obligations and improve the profile of public debt (the improvements in the sovereign risk perception depends to a large extent on this). On the other hand, emphasis should be placed on the recent decrease of the traditional balance sheet (with and without interest) that is linked to the temporary increase in spending announced as of 4Q09 by the government and the strong contraction in GDP.

Nevertheless, if we were to exclude items such as revenue and government spending attributable to the oil industry, the government's operating balance (without tax payments) would be close to -6.6% of GDP. It should be emphasized that the public deficit without oil revenue has been continually weakening in the past few decades and that the government's budgetary balance sheet is increasingly dependent on oil-related resources generated in Mexico. Therefore, the outlook is negative if the forecast of Mexico having a lower oil production capacity is considered.

In an extreme scenario, if public finances did not have these nonrenewable resources, the result of the government's operation would not generate sufficient surpluses to redeem credit obligations, which would imply strong adjustments in spending or the unsustainable growth of the public debt. For example, based on the assumption of a lack of Pemex revenues and expenditures and the assumption that government spending will be following the same pattern as it has since 2002, the government's total net debt (estimated by the central bank) would today be close to 20.8% of GDP instead of the current figure of 17.2%. As a result of this, there is an urgent need for reform of the country's tax system.

… even in the short term, the challenges are considerable

The current economic situation imposes complex fiscal challenges. On the one hand, the federal government has undertaken an additional spending program to alleviate the effects of the recession and, on the other, the declinel in public sector revenue demands that expenditures be contained in order to avoid accumulating a high public deficit that would increase the country's risk perception.

In the short term, the pressures on the government's budget deficit can be attributed to the decline in tax revenue (oil and non-oil) that could partially be compensated by interest income (and the use of stabilization funds) that together with the allocation of further spending in its counter-cyclical programs (1% of GDP) imply additional fiscal pressures. Therefore, to achieve its objective of a traditional deficit for 2009 (1.8% of GDP), the authorities announced (28-May-09) austerity measures of 35 billion pesos (0.3% GDP), which would be earmarked to reducing the government's operating expenditures. In this sense it is positive that these measures do not affect (as in past recessive cycles) capital and social spending items.

The availability of government assets (stabilization funds) facilitates attaining the goal of a traditional fiscal deficit for 2009. However, the possibility of low tax collection levels for 2010 (either due to the lack of a reform or economic growth below the potential) would imply the need for additional austerity measures for next year that could account for as much as 1% of GDP in order to maintain the same deficit levels.

The previous figures would imply that the public sector's financial requirements (broad definition of fiscal deficit) could be close to 3% of GDP (vs. 2% in 2008). Nevertheless, "authorized" detours cannot be ruled out in the broad deficit in public finances, which could stem from the reform of the State Employees' Social Security and Services Institute (ISSSTE) and could account for up to 0.7% of GDP in an extreme case scenario.

To summarize, the scale and intensity of the recession in Mexico as well as the possibility of economic growth below the potential, have exposed the structural vulnerabilities of public finances and the need for a rapid tax reform. In our opinion, this tax reform should, as a minimum, address the following points and focus on the need to: (i) avoid differentiated tax treatments and regressive taxes (that is, that accentuate the levels of income inequality); (ii) expand the taxpayer base to reduce the individual tax burden; (iii) reduce administrative complexity in complying with tax obligations; and (iv) improve the quality of public services that are financed by taxes, and in general, raise the efficiency of public spending.

Alternative Adjustments in Budgetary Balance

% of GDP, traditional deficit

	Base scenario			Stress scenario in pub. finances		
	Balance goal	Negative factors	Positive factors	Balance goal	Negative factors	Positive factors
2008 total	**-1.8**			**-1.8**		
a. Lower oil exports		-1.3			-1.4	
b. Lower tax revenue		-0.7			-0.9	
c. Hedges			1.2			1.2
d. Balance oil stabilization fund			1.3			1.3
e. Non-recurring revenue			0.6			0.6
f. Fiscal loss after flu epid.		-0.2			-0.2	
g. Austerity measures (May 28)			0.3			0.3
h. Net savings in stabilization funds		**-1.2**			**-0.9**	
2009total	**-1.8**			**-1.8**		
i. Lower oil exports		-1.0			-1.2	
j. Lower tax revenue		-0.5			-0.7	
k. Use of stabilization funds (k=h)			1.2			0.9
l. Austerity measures for 2010 equilib.			**0.3**			**1.0**
2010total	**-1.8**			**-1.8**		

Note: Stabilization funds accounted for 1.3% of GDP at March 31, 2009. This does not include Pension Restructuring Support Fund (FARP) resources for 64 billion pesos (0.5% of GDP). Benefits of a potential tax reform are not incorporated
Source: BBVA-Bancomer calculations with SHCP data

Calculating the Structural Public Balance in Mexico as a Tool to Evaluate Fiscal Policy Efforts during the Course of the Economic Cycle

In Mexico fiscal revenue and spending have been dominated by a rigid expenditure structure (v.gr. high weight of spending on wages, multi-annual commitments of investment spending, etc) and a particularly uncertain evolution of public revenue (v.gr. considerable importance of non-recurrent and oil revenues). This made it impossible for the government to implement counter-cyclical fiscal policies that would reduce the effects of a recession, without incurring increasing risks of unsustainable debt.

Specifically, the budget deficit's high degree of dependence on volatile energy prices which are determined on the international markets has meant that public finances tend to be endogenous to the economic cycle and to even accentuate recessive phases. Due to this, it was impossible to speak of "automatic stabilizers" of spending (v.gr. unemployment compensation) that would imply greater fiscal expenditures in stages of low growth and vice versa with higher growth.

This situation has radically changed following years of prudent management of public accounts. This has allowed limiting the extent and duration of government debt and in 2009 opened the door for implementing the first counter-cyclical fiscal policy in Mexico's recent history.

Given this new panorama, it has become necessary to develop instruments that would allow evaluating and quantifying fiscal policy efforts based on the state of the economy (expansive or recessive). Specifically, to have a simple methodology that would separate the components of the budgetary balance that fluctuate in accordance with the cycle (for example, income taxes) from those that due to their not being tied to the automatic effect of the economic cycle can thus be attributed to the government's discretionary spending.

The calculation and breakdown of the fiscal deficit in cyclical and structural components are important in the current period, since following up on their trends could be a key element in a future fiscal reform in Mexico, which would go from being based on targets involving sustainability in public finances, reflected in a budgetary balance goal from year to year, to one based on multi-annual goals that would take into account the fluctuations of the economic cycle.

Estimate of the structural public deficit

The observable public balance to GDP (SP_t) can be considered as the sum of a structural component (SPE_t) and a cyclical component (SPC_t), so that:

$$SP_t = SPE_t + SPC_t = SPE_t + \beta \Upsilon gap_t\,; \qquad [1]$$

in which the cyclical component is a function of the "output gap" (Υgap = difference between observed GDP and trend) with a response elasticity β_t [1]. At the same time, the structural component (SPE_t) is what would be observed when the economy is along the road of trend growth. Both definitions of deficit contain different economic implications; while the cyclical balance would be associated with transitory fluctuations, the structural balance assumes tax burdens on future generations, and therefore, its discretionary level implies an intertemporal distribution of revenue within an economy.

For the direct estimate of the budgetary balance the following steps and adjustments were followed[2].

First, the output gap was estimated as the difference between observed GDP and the Hodrick-Prescott filter for determining GDP (with $\lambda = 1600$)

Second, the cyclical component is weighed in equation [1] with the relative weight of government spending in the economy (G_t / PIB_t) in order to gauge the magnitude of the cycle (see equation [2])

Third, equation [3] is formulated, in which the structural public balance, SPE_t, is a non-observable component of the total balance, SP_t, in equation [2] and is based on its own past, SPE_{t-1}

$$SP_t = SPE_t + \beta_t \left[\frac{G_t}{PIB_t} \right] \Upsilon gap_t + \upsilon_t\,; \qquad [2]$$

$$SPE_t = \theta \cdot SPE_{t-1} + \varpi_t\,; \qquad [3]$$

In which υ and ω are random variables.

1 The elasticity of the budgetary balance to the economic cycle, β, can be understood as the elasticity of public revenue minus the elasticity of public spending to the cycle.

2 Following the methodology of Corrals, F., Varela, J, and Doménech, R. (2002). "Los saldos presupuestarios cíclico y estructural de la economía española" ("Cyclical and Structural budget balances of the Spanish economy"). Hacienda Pública Española, No. 162-(3/2002). IEF.

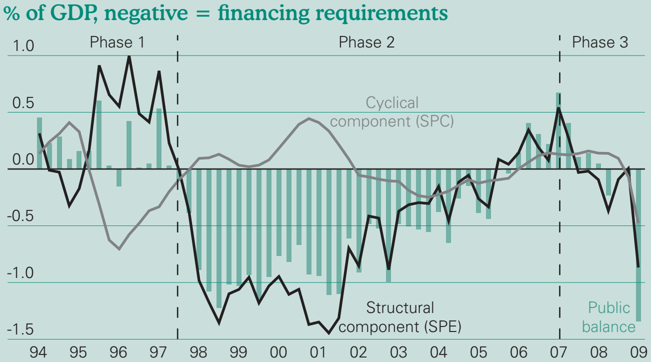
Fourth, the results are obtained by means of maximum probability for the period from the 1Q94 to the 1Q09 through the use of the Kalman filter of the observable equation [2], the transition equation [3] and of the state variable, SPE_t

Based on this approach, an elasticity of the cyclical balance to the output gap is estimated for Mexico of $\beta = 0.58$, relatively high[3]. The relatively high elasticity of the budgetary balance to the cycle reflects the high dependence of fiscal revenue on the cycle (for example, oil prices) and the rigidity of spending mentioned at the beginning of this article. In addition, the estimated parameter θ is 0.93[4].

Interpretation of results

The following graph shows the observed public balance with the breakdown of the structural factor (as an indicator of a discretionary fiscal decision) and the cyclical component. The results are suggestive. In a first stage, a fiscal behavior marked by greater spending was registered, which when coupled with the 1994-95 recession did not allow for mitigating the scope of the economic recession (positive structural component) and that, in addition, displayed erratic budgetary deficits (see bars in the graph). The generation of the positive structural surplus contributed to the decrease in the government's net debt from levels of 35.6% of GDP in 1995 to 23.6% in 1997.

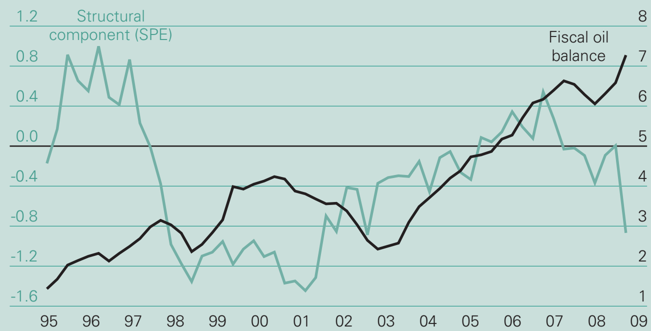
Components of the Public Balance in Mexico
% of GDP, negative = financing requirements



Source: BBVA Bancomer with SHCP and INEGI data

In a second stage, a high structural fiscal deficit is observed, which has been gradually corrected since 2001 to produce a general structural surplus by mid-2005. In addition to the government's fiscal efforts remaining pro-cyclical, the continued correction of the deficit occurred thanks to a constant improvement in the fiscal oil balance sheet (fiscal oil revenue minus Pemex expenditures) since 1998, which allowed reducing public debt to levels of 17.5% of GDP.

Structural Deficit and Fiscal Oil Balance
% of GDP



Source: BBVA Bancomer with SHCP and INEGI data

Finally, in a third stage of fiscal effort we can see that the advances in public savings and debt reduction undertaken in the past few decades, made it possible for both the structural component as well as the cyclical deficit to be negative, that is, counter-cyclical and —contrary to the past—they contributed to mitigating the latest recession (see the 1Q09 in the graph).

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3 For example, for the case of the Spanish economy, the calculated value is between 0.41 and 0.48. See "Situación España BBVA", October 2006, pp. 17 and 18. Available on line: http://serviciodeestudios.bbva.com/KETD/ketd/esp/nav/geograficas/europa/espana/historico/afondo/revistas/index.jsp

4 Equation [3] allows for non-seasonality of SPE in which θ=1 and based on our estimates, the hypothesis of random behavior of the non-observable variable cannot be rejected. For the estimate it was felt that the initial value of SPE is unknown

United States Indicators and Forecasts

	2007	2008	2009	I'08	II'08	III'08	IV'08	I'09	II'09	III'09	IV'09
Economic Activity											
GDP (US$ billions)	13,808	14,265	**14,242**	14,151	14,295	14,413	14,200	14,090	**14,112**	**14,224**	**14,541**
Nominal growth (%)	4.8	3.3	**-0.2**	4.7	4.1	3.3	1.2	-0.4	**-1.3**	**-1.3**	**2.4**
Real growth (%)	2.0	1.1	**-2.0**	2.5	2.1	0.7	-0.8	-2.5	**-3.1**	**-2.4**	**-0.1**
GDP deflactor	2.7	2.4	**1.8**	2.6	2.3	2.0	2.6	2.0	**2.1**	**1.8**	**1.1**
Personal consumption (real % change)	2.8	0.2	**-0.5**	1.5	1.3	-0.2	-1.5	-1.4	**-1.4**	**-0.3**	**1.1**
Government consumption (real % change)	2.1	2.9	**3.5**	2.6	2.6	3.1	3.2	1.8	**3.1**	**3.7**	**5.4**
Gross fixed investment (real % change)	-5.3	-6.7	**-20.4**	-2.3	-6.6	-7.3	-10.4	-23.3	**-21.7**	**-21.1**	**-15.5**
Construction[1]	-17.9	-20.7	**-21.4**	-21.3	-21.6	-20.6	-19.4	-23.4	**-24.8**	**-21.4**	**-15.8**
Industrial production (real annual % change)	1.5	-2.2	**-10.0**	1.4	-0.4	-3.2	-6.7	-11.6	**-12.4**	**-10.1**	**-5.7**
External Sector (constant US$ billions)											
External balance	-547	-390	**-324**	-462	-381	-353	-365	-303	**-332**	**-332**	**-329**
Total exports	1,426	1,514	**1,208**	1,501	1,545	1,556	1,455	1,337	**1,223**	**1,159**	**1,114**
Total imports	1,972	1,904	**1,532**	1,963	1,926	1,909	1,819	1,640	**1,555**	**1,491**	**1,443**
Current account balance (% of GDP)	-5.3	-4.7	**-2.9**	-5.0	-5.1	-4.9	-3.6	-2.1	**-3.6**	**-3.4**	**-2.6**
Prices (annual % change)											
Final annual inflation	4.1	0.1	**2.0**	4.0	5.0	4.9	0.1	-0.4	**-1.0**	**-1.5**	**2.0**
Average annual inflation	2.9	3.8	**-0.4**	4.1	4.4	5.3	1.6	0.0	**-0.7**	**-1.6**	**0.8**
Other Indicators											
Primary fiscal balance[2] (% of GDP)	-1.2	-3.2	**-12.7**	—	—	—	-3.2	—	**—**	**—**	**-12.7**

1 Residential investment
2 Fiscal Balance (% of GDP)
Note: forecasts in **bold**

Mexico Indicators and Forecasts

	2006	2007	2008	2009	2010	I'08	II'08	III'08	IV'08	I'09	II'09	III'09	IV'09
GDP (seasonally-adjusted series)													
Real annual % change	5.1	3.3	1.4	**-6.3**	**1.7**	3.3	2.5	1.5	-1.7	-8.6	**-8.3**	**-5.9**	**-2.5**
Per inhabitant (US dollars)	9,046	9,667	10,176	**7,854**	**8,616**	10,262	10,850	11,216	8,376	7,157	**7,852**	**8,066**	**8,338**
US$ billions	949	1,023	1,086	**845**	**934**	1,095	1,157	1,197	894	770	**845**	**868**	**897**
Inflation (average, %)													
Headline	4.1	3.8	6.5	**3.8**	**3.9**	4.2	5.3	5.5	6.5	6.0	**5.7**	**5.0**	**3.8**
Core[1]	3.8	4.1	5.7	**4.0**	**3.7**	4.3	5.0	5.4	5.7	5.8	**5.4**	**4.7**	**4.0**
Financial Markets (eop, %)													
Interest rates													
Bank funding	7.00	7.50	8.25	**4.50**	**4.50**	7.50	7.75	8.25	8.25	6.75	**4.75**	**4.50**	**4.50**
28-day Cetes	7.02	7.44	7.94	**4.47**	**5.02**	7.48	7.78	7.61	7.94	6.75	**4.60**	**4.47**	**4.47**
28-day TIIE	7.37	7.93	8.68	**4.83**	**4.87**	7.93	8.19	8.66	8.68	7.57	**5.40**	**4.83**	**4.83**
10-year Bond (average)	7.57	8.04	8.28	**6.40**	**7.20**	7.49	8.74	8.48	8.28	8.30	**7.60**	**6.80**	**6.40**
Exchange rate (average)													
Pesos per dollar	10.88	10.86	13.67	**13.00**	**12.40**	10.64	10.31	10.94	13.67	14.00	**13.18**	**13.20**	**13.00**
Public Finances*													
Fiscal balance (% of GDP)	0.1	0.0	-0.1	**-1.8**	**-1.8**	nd	nd	nd	-0.1	nd	**nd**	**nd**	**-1.8**
FRPS (% of GDP)	-0.8	-1.1	-2.1	**-2.8**	**-2.8**	nd	nd	nd	-2.1	nd	**nd**	**nd**	**-2.8**
External Sector[2]													
Trade balance (US$ billions)	-6.1	-10.1	-17.3	**-16.2**	**-18.5**	-1.6	-0.9	-6.4	-8.3	-1.9	**-0.3**	**-8.8**	**-5.3**
Current account (US$ billions)	-4.4	-8.3	-15.7	**-16.3**	**-19.8**	-2.6	-2.1	-4.5	-6.6	-1.1	**-6.1**	**-5.7**	**-3.5**
Current account (% of GDP)	-0.5	-0.8	-1.4	**-1.9**	**-2.1**	-0.9	-0.8	-1.6	-2.4	-0.5	**-2.8**	**-2.6**	**-1.6**
Oil (Mexican mix, dpb, eop)	53.1	61.7	84.4	**34.7**	**34.5**	83.6	104.4	104.2	45.3	39.2	**31.5**	**34.0**	**34.1**
Aggregate Demand[4] (ann. % chge., seasonally-adjusted)													
Total	6.9	4.2	2.1	**-7.6**	**1.2**	5.0	3.9	3.0	-3.1	**-9.6**	**-9.1**	**-7.8**	**-3.6**
Domestic demand	6.2	4.3	2.0	**-5.4**	**2.0**	2.9	3.4	3.1	-1.2	**-7.5**	**-7.0**	**-5.7**	**-1.1**
Consumption	5.2	3.6	1.5	**-3.2**	**1.1**	2.8	2.1	1.8	-0.9	**-5.2**	**-4.4**	**-3.0**	**-0.1**
Private	5.7	3.9	1.6	**-3.6**	**1.1**	3.1	2.2	2.0	-1.1	**-6.2**	**-5.4**	**-3.1**	**0.2**
Public	1.7	2.1	0.6	**0.0**	**1.4**	1.1	1.1	0.2	0.0	**2.0**	**2.0**	**-2.0**	**-2.0**
Investment	10.4	6.7	4.2	**-12.9**	**5.4**	3.2	8.0	7.9	-2.2	**-16.0**	**-15.7**	**-15.2**	**-4.9**
Private	13.0	5.8	2.0	**-18.2**	**6.4**	3.1	9.6	5.5	-10.1	**-25.0**	**-25.0**	**-18.1**	**-4.7**
Public	-1.6	12.9	13.3	**7.3**	**2.8**	3.9	2.4	16.5	30.2	**20.0**	**20.0**	**-5.5**	**-5.5**
External demand	11.0	5.6	1.6	**-14.7**	**-1.6**	7.8	5.0	2.3	-8.5	**-17.2**	**-16.6**	**-15.1**	**-10.0**
Imports	12.7	7.0	4.6	**-11.0**	**-0.1**	10.1	8.2	7.2	-7.0	**-12.7**	**-11.2**	**-13.1**	**-7.0**
GDP by sectors (ann. % chge., seasonally-adjusted)													
Primary	6.0	2.1	3.2	**3.7**	**0.5**	0.3	5.4	3.8	3.3	2.3	**3.1**	**5.0**	**4.3**
Secondary	5.8	2.5	-0.6	**-9.6**	**3.5**	2.5	0.4	-1.2	-4.2	-11.1	**-11.6**	**-10.8**	**-6.2**
Mining	1.4	-0.6	-2.3	**-1.2**	**-1.7**	-1.0	-4.3	-2.3	-1.7	-2.1	**-0.2**	**-1.6**	**-1.9**
Electricity	12.1	3.7	2.3	**-4.9**	**1.0**	7.3	4.5	0.5	-2.9	-3.2	**-7.4**	**-5.1**	**-4.1**
Construction	7.6	4.4	-0.6	**-7.2**	**1.8**	2.4	0.4	-0.6	-4.5	-9.4	**-8.8**	**-7.4**	**-5.0**
Manufactures	5.9	2.6	-0.4	**-13.2**	**6.0**	3.1	1.7	-1.3	-5.0	-14.8	**-16.0**	**-15.2**	**-8.0**
Tertiary	5.2	4.0	2.1	**-5.3**	**1.4**	4.2	3.2	2.3	-1.0	-7.8	**-7.6**	**-4.3**	**-1.7**
Retail, restaurants and hotels	6.5	4.6	2.9	**-10.0**	**0.7**	6.3	5.0	5.2	-4.9	-17.0	**-15.2**	**-5.8**	**-2.2**
Transportation, mail and warehouse	5.6	3.7	0.9	**-9.1**	**2.5**	4.0	1.9	0.6	-2.9	-10.2	**-13.8**	**-10.1**	**-2.3**
Masive media information	10.6	10.0	8.0	**2.4**	**3.3**	8.0	11.0	7.0	6.2	4.2	**0.7**	**2.4**	**3.2**
Financial and insurance	16.7	11.2	-1.2	**-2.9**	**1.5**	4.5	2.0	-4.8	-5.9	-4.4	**-5.4**	**-1.8**	**0.3**
Real-estate and rent	4.1	3.0	3.2	**-5.5**	**1.0**	4.1	3.5	3.1	2.1	-10.2	**-2.7**	**-5.9**	**-3.3**
Prof., cientific and technical servs.	3.0	3.1	2.3	**-1.4**	**3.0**	1.5	1.8	4.3	1.5	-2.2	**0.8**	**-1.5**	**-2.1**
Company and corporate management	19.7	-2.9	4.3	**1.2**	**2.5**	3.9	2.9	2.1	8.3	4.3	**1.5**	**1.8**	**-2.5**
Business support services	3.7	3.1	1.5	**1.0**	**1.4**	3.3	1.8	1.2	-0.3	-1.5	**2.7**	**1.1**	**1.6**
Education	0.1	2.1	0.9	**-0.8**	**2.1**	1.4	1.6	0.7	0.0	0.0	**-0.1**	**-1.5**	**-2.2**
Health and social security	7.8	-0.5	1.1	**-0.5**	**0.7**	-1.0	0.4	2.0	3.0	-1.4	**3.6**	**-1.7**	**-2.5**
Cultural and sport	2.2	3.5	1.7	**-4.2**	**4.3**	2.1	-0.3	3.9	1.2	-3.4	**-10.1**	**-4.3**	**1.1**
Temporary stay	1.6	2.5	0.9	**-16.6**	**6.7**	3.5	2.0	1.6	-3.3	-7.1	**-42.2**	**-11.9**	**-4.7**
Other services exc. government	3.3	3.9	1.8	**-2.0**	**0.2**	3.2	2.4	1.0	0.7	-1.9	**-3.0**	**-2.0**	**-1.4**
Government activities	-0.3	1.2	0.0	**1.0**	**1.0**	0.9	0.6	-0.3	-1.1	3.0	**1.5**	**0.3**	**0.4**

eop end of period
dpb dollars per barrel
FRPS Financial Requirements of the Public Sector
na not available
Note: **Bold** figures are forecast

1 Core index that does not include education
2 Accumulated, last 12 months
3 Banco de México data
4 Base 1993=100; GDP by sectors base 2003=100. The observed data of the primary, secondary and tertiary sectors are seasonally-adjusted by INEGI, the rest are own seasonally-adjusted
* As of 2009 the Fiscal Balance definition changes, therefore data is not comparable

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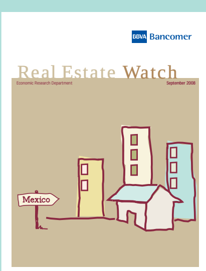
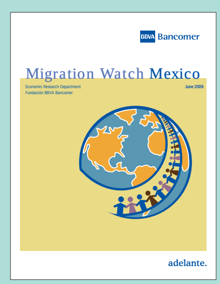
Other publications





Country Watch:

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