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Situación

Economic Research Department

Second Quarter 2007

Activity: weak 1st semester, some improvement in the 2nd

Inflation: has the turbulence in raw material prices passed?

Will the monetary pause continue?

A strong peso with low risk aversion will be maintained

Progress expected in fiscal and energy policy reforms

Contents

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Editorial Board:
Adolfo Albo, Jorge Sicilia

This publication was prepared by:
Editor: Jorge Sicilia j.sicilia@bbva.bancomer.com
Editor: Adolfo Albo a.albo@bbva.bancomer.com
Octavio Gutiérrez o.gutierrez3@bbva.bancomer.com
Ociel Hernández o.hernandez@bbva.bancomer.com
Cecilia Posadas c.posadas@bbva.bancomer.com
Eduardo Torres e.torres@bbva.bancomer.com
Design: Fernando Tamayo fernando.tamayo@bbva.bancomer.com

Mexico: Editorial

The Mexican economy has entered a slowdown that will lead it this year to post a growth rate below its potential. Given the cyclical synchronization of the Mexican economy, the downturn is the result of lower external demand in the United States, and its effects can mainly be seen in industry and to a lesser extent, in domestic demand. Employment generation will exceed the average levels of the past few years, with around 600,000 new jobs in the formal sector. In comparing the current situation with the last cyclical slowdown that Mexico faced due to lower U.S. economic growth in 2000, internal demand is displaying greater strength, and this is reflected in the performance of variables such as construction, credit to the private sector, and employment. Furthermore, the causes of the downturn in the U.S. economy are different, and they currently can be attributed to the real estate market, which has less impact on external demand. The outlook for the U.S. economy only involves a tempering of growth and not a recession, and lower growth will be noted in the first part of the year, with a probable upturn toward 2008.

As to inflation, the balance of risks has worsened. The rising trend in inflation can be attributed to the accumulation of different supply shocks. Many of these derive from conditions in the international raw material market: the rise in energy prices, in the costs of construction materials and agricultural products, particularly corn and sugar. The conditions for more moderate growth in inflation toward the end of the year are present, such as the incipient weakening of these supply shocks, reduced economic activity, the strength of the peso, wage revisions in line with the inflation target and, contrary to 2005, anchored expectations of inflation. However, risks persist in the event of new supply shocks or a greater contamination to other prices.

Given this panorama, in April, Mexico's central bank chose to restrict its monetary policy, qualifying its measures as preventive and subsequently, in May, the central bank decided to put its actions on hold. Without modifying its estimated inflation target, the motivations for such an approach can be found in the uncertainty and weakening of the balance of risks. Although it could be felt that the Banco de México might take advantage of the slowdown in the economy so as to try to strengthen the anchoring of inflation expectations toward 3%, which would lead the central bank to be more restrictive. We believe that it will choose to maintain the same monetary policy with a message indicating greater restriction until inflation clearly converges toward its target. The risks are undoubtedly that in the next few months an isolated rise in interest rates could occur. In any case, at the end of the year or the beginning of 2008, room for a reduction in interest rates is the most probable scenario.

A final note, of great importance, has been the progress in structural reforms, the first of which involves the ISSSTE. In the next few months the following reform will involve fiscal policy, given higher spending in the short term, and subsequently, energy policies, with greater amounts of budgetary resources involved. These are the first steps in an agenda full of issues in which the country cannot wait any longer to raise its competitiveness and to achieve a higher growth potential that would allow for greater job creation. We are confident that the maturity of the forces involved will prevail, with a view toward benefiting the country, and that progress will continue to be seen in this window of opportunity that is viewed on the horizon.

International Outlook

Expansion continues at a global level

During 2007, economic activity will maintain its notable strength, although its growth will be slightly moderated. Currently, the world economy is immersed in its greatest cyclical expansion since the oil crisis of the seventies, expanding for the fifth consecutive year at rates higher than 4.0%. However, what is most characteristic of this cycle is the vast geographic base that is backing global growth. Thus, the main driving force for growth will continue to be the developing countries, with Asia, and particularly China, as the leading actors. As for the developed countries, the euro zone continues to accumulate positive surprises in activity, and our growth expectations, which already surpass the potential, indicate GDP growth of 2.5%. Japan, the second largest economy of the world, is consolidating its economic recovery, after a decade of having been submerged in deflation.

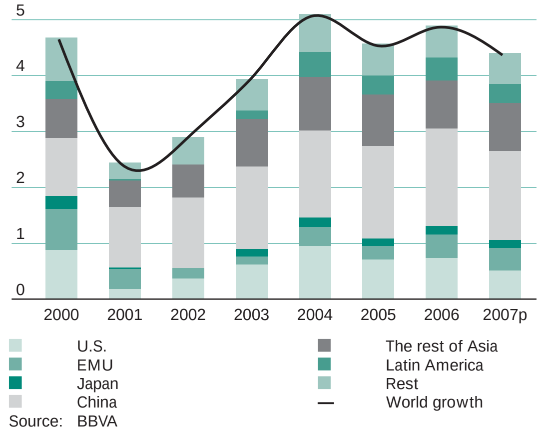
However, it is the United States, one of the main reference points at a global level, where the greatest uncertainties fall. In addition to the concern regarding the adjustment of the real-estate sector, made more acute by uncertainties forthcoming from the sub-prime market (the riskiest segment of the mortgage market), is the transitory weakness of non-residential investment. Nevertheless, taking into account the strength of the fundamentals of the entrepreneurial sector that sustain investment, as well as the solidity of employment and consumption, the economy will recover its strength in the second half of the year. Despite this, risks, derived from a deeper adjustment of the non-residential investment or of the real-estate sector in the U.S., continue to take on a major role, together with the impact that the geopolitical risk could have on the oil risk, the main risks at a global level.

The U.S.: the main source of uncertainties

Until several months ago, the main factors of uncertainty came mainly from the war conflict with Iran, which eventually could lead to an escalation in oil prices and to a strong slowdown of the U.S. economy, as a result of an abrupt adjustment of its real estate sector. Both factors continue to be in force, although the second one with new elements. On the one hand, surging strongly is the concern surrounding the problems which certain of the riskier segments of the mortgage market are going through, the so-called sub-prime segment, and its potential impact on private consumption and contagion of the financial market in general (credit crunch) that could end up having a very negative impact on the real economy. Nevertheless, the little relative importance of the sub-prime on the mortgage loan market (7%), the growing diversification of the risks and the growth of the revenues which contribute to maintaining family solvency, delimit the risk of contagion throughout the rest of the economy.

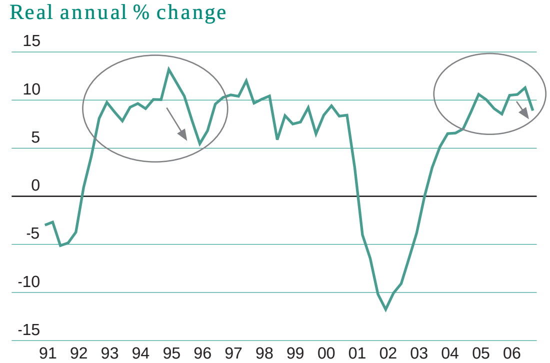
On the other hand, the most important risk now would be the slowdown of non-residential investment in the U.S. economy that started to materialize at the end of 2006, which if long-lasting, would cause a strong setback to activity, in view of a greater weakness in employment and a marked slowdown in consumption, currently the main supports of the U.S. economy. However, given the strength of the fundamentals of the entrepreneurial sector that sustain investment

Growth and Contribution by Areas
Percentages



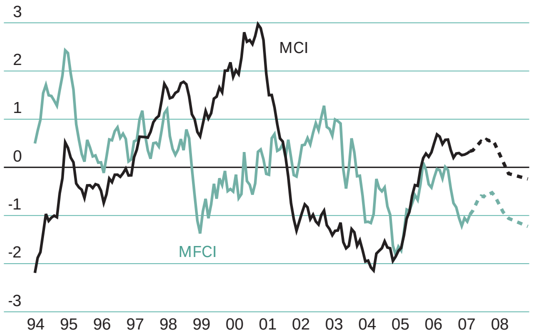
Source: BBVA

Non-Residential Investment
Real annual % change



Source: BBVA

U.S.: MFCI and MCI



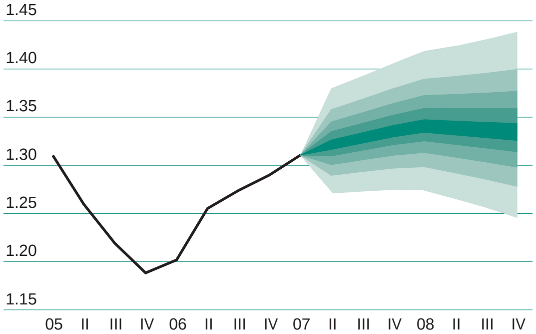
* Using core inflation
Note: Forecasts as of April 2007
Source: BBVA

Financial Forecasts
End of year

	2005	2006	2007f
Official rates			
U.S.	4.25	5.25	**5.25**
EMU	2.25	3.50	**4.25**
10-year rates			
U.S.	4.5	4.7	**4.8**
EMU	3.4	3.9	**4.3**
Dollar/euro	1.19	1.32	**1.33**

f forecast
Source: BBVA

Dollar / Euro
End of period



Note: Forecasts as of 2nd. Quarter 2007
Source: BBVA

and the positive outlook for entrepreneurial investment, everything indicates that the most recent performance can be qualified as a soft-patch, a readjustment in mid cycle. Therefore, our forecasts indicate that the economy will recover its strength in the second half of the year, although with a lower growth than what initially was expected for this year (from 2.8% to 2.3%), which later will lean toward its potential in 2008 (2.8%).

De-coupling of Monetary Policies

In the current situation of a divergent cyclical position of the economies, the various routes to be followed by the central banks are understandable. In the U.S., the Fed will maintain official interest rates stable at the current 5.25% for a prolonged period of time, since joining them are, on the one hand, core inflation that is moderating although close to the upper part of the Fed's tolerance range, and, on the other, a transitory weakness of activity and still lax financial conditions. In fact, these conditions, which incorporate the performance of the stock market and of the currency, as well as of short-term rates and long-term bonds, are currently in a more relaxed zone than when rates were at 1% in the middle of 2003.

The above contrasts with areas such as Japan and Europe, where the monetary policy continues to normalize. In the former, the official rates will stand at around 1% at the end of the year, even though the movements will come about very gradually and in terms of the performance of activity and of inflation. In the latter, the Central European Bank (CEB) will increase the "refi" rate up to 4.25%, supported by the strength of European growth and by inflationary risks that continue to rise. Even though the monetary tone in the main economies will continue to be restrictive, it is foreseeable that low market volatility and high liquidity will continue, sustained by the fact that the accumulation of reserves on the part of the developing economies and the limitations of long-term rates will continue to be seen in this cycle, all of it supported by stock market valuations and solid profit expectations. Within this context, a slight rally in long-term bonds is expected, although more limited in the U.S. due to strong demand for U.S. debt by foreign investors. Thus, our forecast for the ten-year rates is of 4.3% for Europe and of 4.8% for the U.S.

The dollar, in turn, continues to weaken against the euro since the end of 2006. Structural factors have been operating against the currency, such as mergers and acquisitions of companies and the recent news on the diversification of reserves. With respect to this, worth mentioning is the creation in China of a state agency of reserves for their management. Relatively similar plans in Japan and Russia will follow. Nevertheless, the recent weakness of the currency seems to be exacerbated, which is due to the fact that the market ponders a less benign scenario for the U.S. economy. Thus, in the same measure in which the market adjusts its outlook in line with our base scenario, the dollar should return to more appreciated levels, at about 1.32-1.33$/€.

In any case, as has been mentioned, the balance of risks inherent to the world economy ponders more concentrated impacts on the U.S. economy, setting a clearly depreciating bias on the dollar, at the same time that it affects long-term bonds downward.

The Pass-Through of the Slowdown in Internal Demand will be a Key Factor

Revision of 2007 projections

The slowdown of the most important economy in the world has begun and with it, the effects on its main trading partners were not long in coming. The recent performance of the U.S. economy indicates that the moderation expected for 2007 will lead to lower growth than originally anticipated in that country (2.8% initially estimated; 2.3% new projection). Mexico's close commercial ties with the United States indicate that this lower growth will translate into more moderate growth in Mexico than was originally estimated. Consequently we have modified our GDP growth projections for this year from 3.6% to 3.2%.

It is important to keep in mind that although lower growth than in 2006 is expected in economic activity, an abrupt reduction in the country's production dynamics is not anticipated. In this period of economic slowdown, the economy's growth rate will be slightly below its potential level.[1] At the same time, it should be considered that 2006 was extraordinary in various senses, with factors such as high international oil prices, non-recurring expenditures related to the election campaigns, and the allocation of resources for spending that were left pending due to constitutional challenges, all of which spurred growth, contributing to making last year a period with the greatest and most balanced growth in the past six years.

Pass-Through: via exports and investment

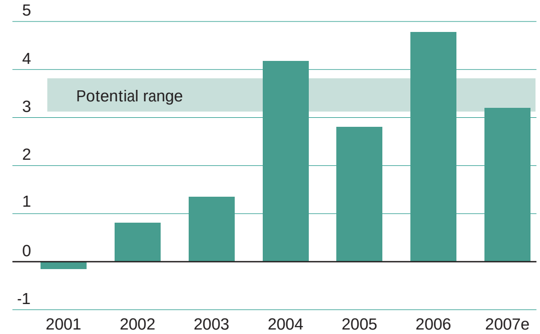
Up until now, the moderation in U.S. economic growth has been confined to the real estate sector. The fact that the import component of this sector is reduced has helped to moderate the effect on other economies. The pass-through of the moderation in activity in the U.S. market will be transmitted to other countries via demand channels, through fewer exports to the United States. In this sense, blocks of countries that have gained a share in the U.S. market and that have not explored alternative destinations, especially emerging economies, could be among the most vulnerable in the face of reduced U.S. demand for imports.[2] Reduced activity in the housing sector will imply moderation in manufacturing divisions related with construction (metal products, glass, wood, furniture etc.), which will diminish that country's industrial dynamism.

It is clear that following the adoption of the North American Free Trade Agreement (NAFTA), the synchronization between the Mexican and the U.S. economies has intensified, particularly in their manufacturing sectors, where inter-industrial relations have been strengthened; therefore it would be advisable to follow the industrial dynamics cautiously. In this sense, the effect of the reduced strength of the manufacturing sector related to real estate activity has been coupled with a particularly important factor in the case of Mexican exports, namely, the auto industry. As has been previously reported, the rise

1 BBVA analysis ("Determining factors and characteristics of the economic cycles in Mexico", to be published) places the potential growth of the economy at a rate between 3.5% and 3.9%.

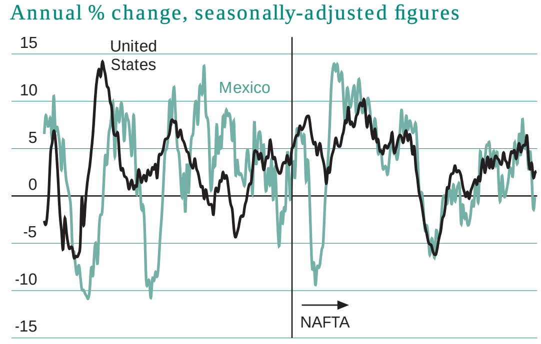
2 The U.S. market share of manufactured goods coming from the China-Brazil-India block and Russia rose from 10.9% between 1995 and 2000 to 18.3% between 2001 and 2006. In the case of Mexico, the corresponding figures are from 9.7% to 10.8% in the same periods.

Gross Domestic Product
Real annual % change



e estimated
Source: BBVA Bancomer with INEGI data

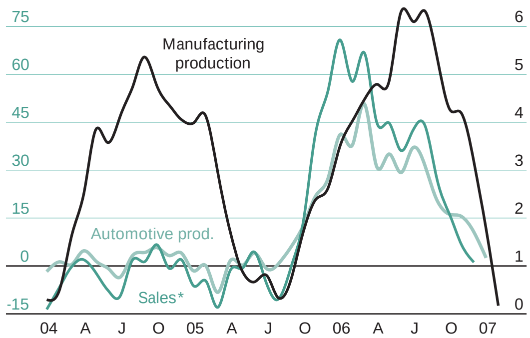
Manufacturing Production
Annual % change, seasonally-adjusted figures



Source: BBVA Bancomer with INEGI and Federal Reserve data

Automotive Sector

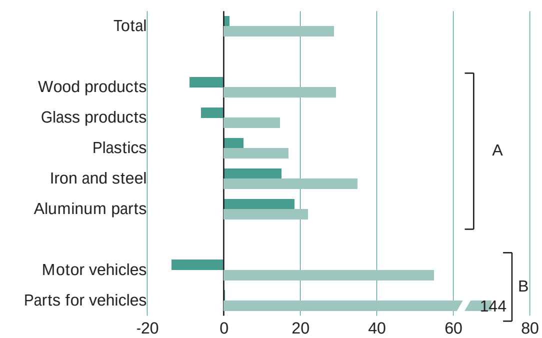
Annual % change, three-month moving average



* Foreign motor vehicle sales, var. in units
Source: BBVA Bancomer with INEGI data

Export Categories

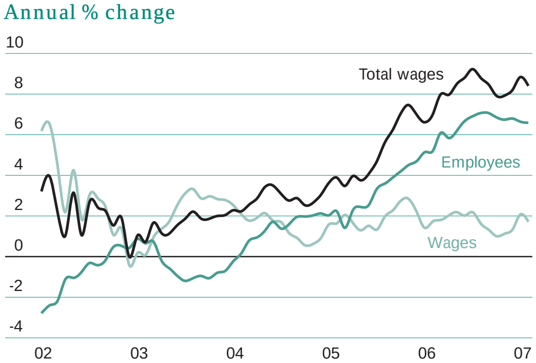
Annual % change in dollars, January-February average



2007
2006
A Related to construction industry
B Automotive sector
Source: BBVA Bancomer with INEGI data

Total Wages

Annual % change



Source: BBVA Bancomer with INEGI data

in the manufacturing sector registered since mid-2005 can largely be attributed to the restructuring of the U.S. auto industry and the change in North American consumer preferences, directed toward lower cost vehicles, many of which are produced in Mexico, and this implied an extraordinary dynamism in the export segment. Due to the importance of this branch within total manufacturing production (close to 21.5%), it had a strong impact on industrial output.[3] By mid-June of last year, automobile exports reached a maximum level of close to 160,000 units a month (compared to 98,000 a year before). In the following months, the sector's exports, although they remained at high levels, in terms of annual variations and given a very high basis of comparison, posted a pronounced moderation in growth.

The latest data on industrial production show that the slowdown intensified as of December of last year, with declines that averaged 3.6% in the final quarter of 2006 to only 0.6% in annual terms in the first three months of 2007. The linkage between the reduced strength of U.S. manufacturing activity and Mexican production has already translated into considerably lower and even negative growth in items related to the auto sector. The average growth in exports related to motor vehicles has declined from 53% in the first quarter of the year to -8.5% in the first three months of 2007. Exports of manufactured goods have grown (in dollar terms) by 6% in the first quarter of the year (21% in the same period of 2006). At the same time, the construction industry displayed a weak start at the beginning of the year, with quarterly growth of 2%, significantly below the level registered in the same period of 2006 (8.9%). The reason for the reduced strength can be attributed to a slow beginning of the year in public construction projects and possible minor episodes of oversupply in the entry level housing segment, which should be reversed over the course of the year.

In terms of oil exports, an important factor to consider in 2007 is the lower expected price and export level. According to the General Criteria on Economic Policy (issued by the Finance Ministry), it is estimated that the average price for exported crude oil will be around 42.8 dollars per barrel, almost 10 dollars less than the price registered in 2006. Meanwhile, it is estimated that the export platform could decline from 1.810 million barrels daily (mbd) in 2006 to 1.628 mbd this year. The net effect implies fewer resources corresponding to oil revenue, along the order of 11.40 billion dollars.

Based on these considerations, the scope and duration of the moderation in growth will depend to a large degree on the extent of the reduction in U.S. economic growth. However, internal demand will play a crucial role in how soft the cycle is. It will allow a reasonable growth dynamics to be maintained, particularly until the second half of the year, once the worst part of the U.S. economic slowdown has occurred, which would enable a new boost in Mexican economic activity. Up to now, factors related to internal demand have shown resistance to the slowdown, in particular when comparing them with the most recent period in moderate economic growth tied to the external market.

3 Here the following divisions are included: automobile production and assembly (about 15%; motors and parts 3%; accessories 1.2%; and others such as production and assembly of chassis, brakes, and transmissions).

Factors spurring internal growth still strong

Although sectors tied to the domestic market (consumption and services) have slowed their expansion in the final part of the year, they have maintained solid growth rates. At the same time, retail sales have remained relatively stable in the past few months, with an annual variation of 1.6% in the first two months of the year compared to 2.4% in the fourth quarter of 2006.

Key elements to watch closely in the next few months will be performance of employment and real wages. Also important will be the continued strength of credit and inflows of foreign currencies in family remittances. In terms of employment and wages (total remunerations), it should be pointed out that job creation in the current slowdown cycle compares very favorably with the upcoming slowdown cycle that has begun in the external sector (See box on "Employment and construction: key variables for internal demand in the current cycle").[4] In particular, in this period of deceleration, the creation of formal jobs has continued to increase; moreover, and in contrast to what occurred last year, it is permanent workers, more than part-time laborers, who are joining the workforce. The comparison with the previous cycle shows a substantial difference in downside resistance, which can even be verified in the case of workers in the manufacturing industry.

In terms of remittances, there is a possible risk factor that should be taken into account, namely, that an important percentage (close to 28%) of Mexican nationals (men) who work in the United States are employed in the construction sector.[5] The link between the strength of this sector (measured as new home starts) and remittances is significant, and therefore, we cannot rule out an additional negative effect on the amount of remittances sent to Mexico, which totaled more than 23 billion dollars in 2006 and that for 2007 could reach similar levels.

The risks

As has been mentioned in the past, the most important risk facing the Mexican economy consists of a scenario of a more pronounced slowdown in the United States. In this case, Mexico could enter a prolonged period of moderate growth that would become generalized on the level of internal demand. The negative impact of this could be magnified by effects related to greater volatility in the financial sector. Up to now, however, this risk has been contained and the likelihood of it occurring is low. In the domestic market, the risks are related to the beginning of a prolonged period of high inflation that can lead to additional restrictions in monetary policy and at the same time, to the possible perception of slowness in the process of approving reform measures.

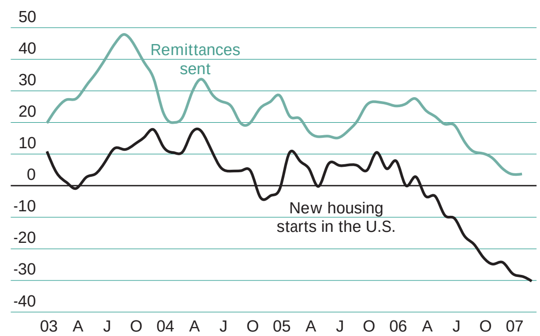
4 As is mentioned in the box, the beginning of the slowdown in this cycle is comparable to that of 2001 in the first few months in the sense that both had their origin in the slowdown in the U.S. industrial sector. The big difference is that in 2001 the performance of economic activity led to less generalized activity, which was coupled with adverse factors such as the terrorist attacks in New York, which set off a severe recession. In the current scenario, this possibility is considered to be highly unlikely.

5 Conapo: Mexican migration and the U.S. labor market. Figure for 2005 for the male population born in Mexico.

Total Employment
Index 100 = month in which the slowdown began

Source: BBVA Bancomer with INEGI data

U.S. Real Estate Market and Remittances
Annual % change, three-month moving average



Source: BBVA Bancomer with Banco de México and Dept. of Commerce data

Macroeconomic Chart for Mexico
Annual % change, seasonally-adjusted figures

	2004	2005	2006e	2007e
GDP	**4.2**	**2.8**	**4.8**	**3.2**
Total demand	6.2	4.4	7.0	5.3
Domestic	4.3	5.2	6.1	4.3
Consumption	3.6	4.6	5.1	3.7
Public	4.1	5.1	5.0	4.2
Private	-0.3	0.3	6.0	-0.1
Investment	7.5	7.6	10.0	6.4
Foreign	11.7	7.0	11.2	6.9
Goods & servs. imports	11.6	8.5	12.3	8.5

e estimated
Source: BBVA Bancomer with INEGI data

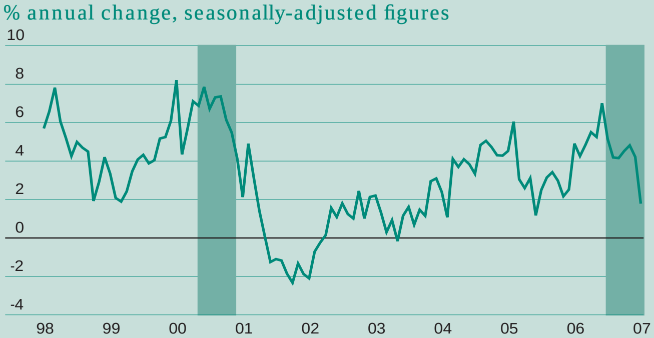
Employment and Construction: Key Variables for Internal Demand in this Cycle

Comparison of cycles with similar detonating factors

To put the economic slowdown in context, it is appropriate to carry out an exercise based on a historical comparison of the extent to which key variables have moderated their behavior in this cycle in relation to a period with similar characteristics. In particular, the dynamics of the first nine months of the slowdown of this and the previous cycle will be compared; the first in the post-NAFTA era.

In both cases, the moderation of economic growth began as a result of the reduced strength of the U.S. economy. In 2000, the slowdown began in the second half of the year as a result of an important contraction in sectors of industry linked to high technology. In the current cycle, the moderation in economic growth has its origin in the real estate sector, but also in a recent cycle of the tempering of growth in industrial production. Two notable differences make the comparison between the two cycles of moderation possible only in their respective first few months. To begin with, the global character of high technology industry contrasts with the predominantly internal nature of the construction sector, a characteristic that could have magnified the effect in the first case. Secondly, the moderation in economic growth was exacerbated by the September 11 terrorist attacks, which intensified the risks of an economy that was already slowing down. The reduced strength in industrial sectors linked to foreign trade in high technology was coupled with the negative effect on tourism and transportation, and as a result, growth in that year (2001) was negative and recessive, a situation that is not contemplated in the current scenario.

General Economic Activity Index
% annual change, seasonally-adjusted figures

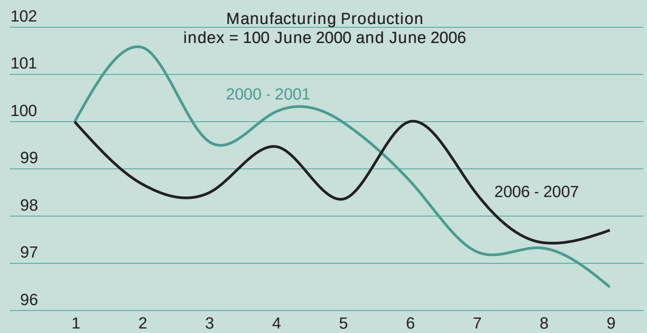


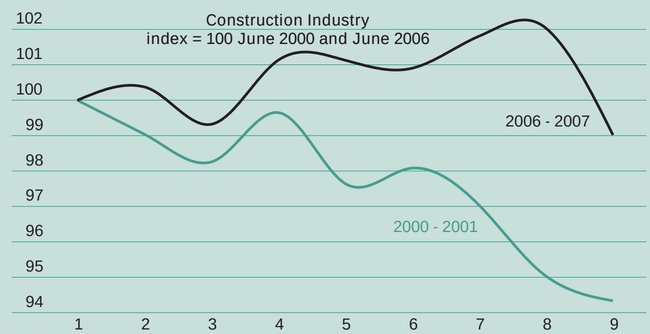
Source: BBVA Bancomer with INEGI data

In the comparisons that are described in the following section, the moderation in growth is shown in relation to the crest of the cycle. This point is the month of June 2000 and 2006, respectively.

In production:

Manufacturing production with strong tempering of growth; in contrast, construction with relative strength

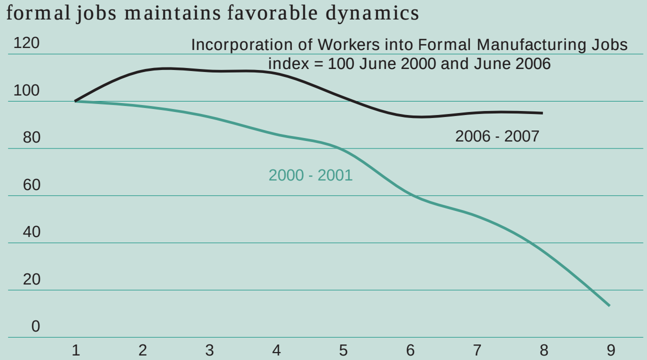


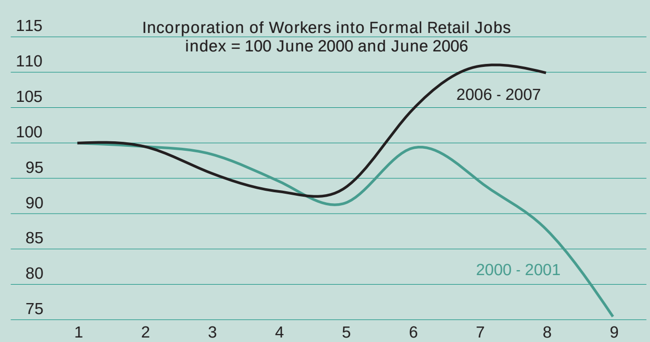


Source: BBVA Bancomer with INEGI data

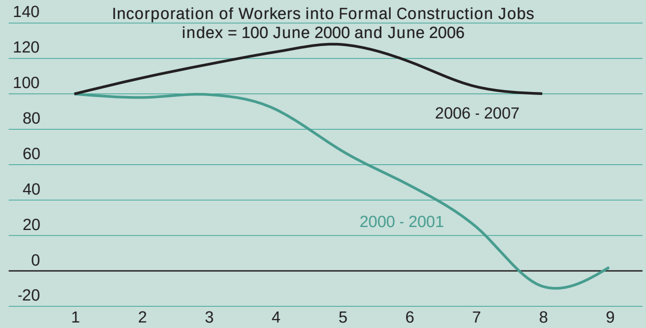
In employment:

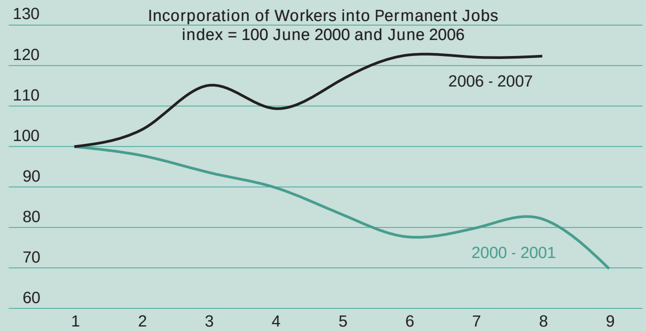
Compared to the previous cycle, the incorporation of workers into formal jobs maintains favorable dynamics





Source: BBVA Bancomer with INEGI data

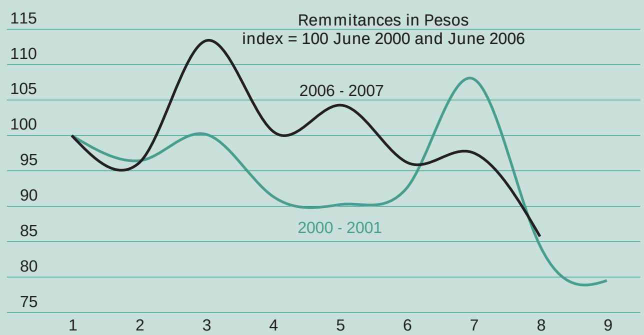


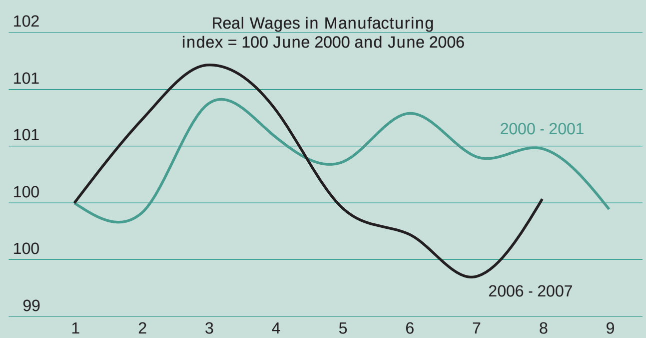


Source: BBVA Bancomer with INEGI data

Factors to keep an eye on:

Remittances and real wages are important variables to keep an eye on due to their relevance in internal demand





Source: BBVA Bancomer with INEGI data

The similarities

In terms of production, the most important similarity is in the behavior of manufacturing output. In the previous cycle, as is the case with the current cycle, the manufacturing industry and particularly the sector tied to exports strongly felt the effect the U.S. economic slowdown. From the June-August quarter to the December-January period of the past cycle, an almost seven percentage point decline in growth in manufacturing was posted. The current cycle is 6 pp behind.[1]

The differences

In the productive sector, an important difference can be found in construction. While in the previous period, the industry's growth was considerably lower in all the quarters considered, in the current cycle, the construction sector has maintained its relative strength.

The other difference that should be highlighted, and that will be key in the next few months, is the behavior of employment. The incorporation of workers into the sectors that account for the highest percentage of employment is very positive and the slowdown in some industries (construction and, notably manufacturing) can barely be perceived, while in others such as retail, an important expansion has even been registered in the past six months. It should be emphasized that in terms of type of employment, the comparison is also positive. Both the employment of permanent as well as part-time workers compares favorably with the previous cycle. Finally, in this cycle, credit will continue to be a factor that provides strength to the domestic market.

Issues to keep an eye on

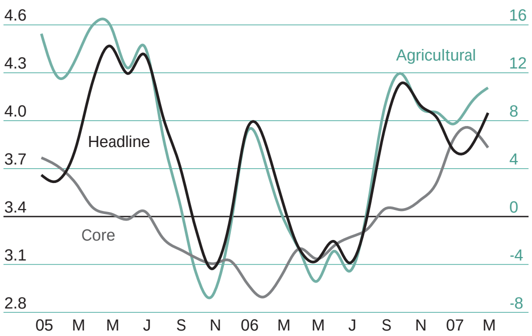
Issues to keep an eye on due to their importance as factors boosting domestic demand are remittances and real wages. In the first case, the possible impact of the slowdown in the U.S. real estate sector on the amount of remittances sent to Mexico should not be underestimated. In terms of the second factor, real wages (both in manufacturing as well the figure based on the daily average base salary calculated for paying fees to the Mexican Social Security Institute (IMSS)) show a relative stagnation. The positive dynamics of formal employment have contributed to maintaining the growth of total wages at high levels[2], and therefore the performance of employment in the next few months will be key in analyzing whether the moderation in economic growth in Mexico will be light and transitory, as we expect.

Cecilia Posadas c.posadas@bbva.bancomer.com

1 Average growth in manufacturing, June-Sept. 2000: 7.4%, Dec.-Feb. 2001: 0.4; June-Sept. 2006: 6.3%, Dec.-Feb. 2007: 0.2%.
2 Eight percent in last quarter of the year compared to 8.6% on average in the two previous quarters.

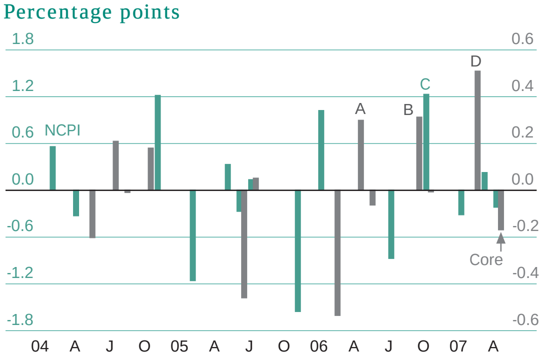
Inflation: Is the Storm Over?

Inflation
Annual % change



Source: BBVA Bancomer with Banco de México data.

Inflation: Cumulative Changes
Percentage points



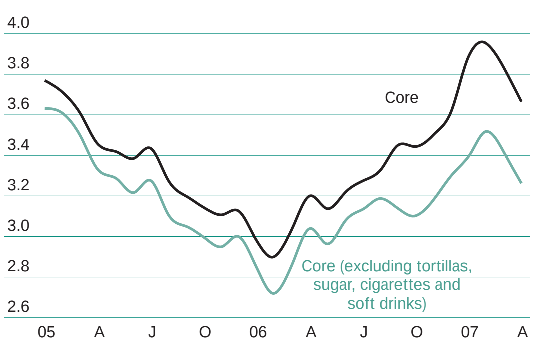
A Steel, April - May 2006
B Tortilla-sugar, June - September 2006
C Tomato, July - October 2006
D Tortilla, cigarettes, soft drinks, October 2006 - February 2007
Source: BBVA Bancomer with Banco de México data

Supply Shocks 2006 - 2007

Period	Products	Impact, pp
Core		
Apr. - May 2006	Steel	0.3
June - Sept. 2006	Tortilla, sugar	0.3
Oct. 2006 - Feb. 2007	Tortilla, soft drinks, cigarettes	0.5
NCPI		
Jul. - Oct. 2006	Tomato	0.5

Source: BBVA Bancomer with Banco de México data

Core Inflation
Annual %



Source: BBVA Bancomer with Banco de México data

In the early months of 2007, inflation in Mexico was reflecting the effect of several supply shocks accumulated throughout the year. Even though the vulnerability of the general price index to fluctuations in volatile prices is known, the difference compared to previous episodes, for example in 2005, has been the impact on core inflation. At the same time, supply episodes seen in the last year mostly originated on the international markets, where volatility is on the rise, and consequently, the uncertainty regarding the futures prices of some foods and raw materials that has been transferred to the upturn of some components in the core sub-index. In the end, this implies a deterioration in the balance of inflationary risks, since even though elements do exist that mitigate the pressures (peso stability, economic slowdown), the risk remains of the appearance of new shocks and of the contamination of agricultural prices on other prices, which could have an impact on inflation expectations.

A chronology of the recent shocks

The year 2006 was characterized by the recurrence of episodes of supply shocks that had a bearing on inflation through diverse components. First, there was the rise in raw materials (oil, steel, and other metals), associated with strong growth in the world economy and, particularly, in some developing countries (China, India, among others). The transfer to domestic prices was mainly reflected in the component of housing services of the core sub-index; the latter increased 0.3 percentage points, from 2.9% to 3.2% in the second quarter due to said effect.

Between June and September, a second shock occurred, this time stemming from the international grain market (greater demand for corn for the production of ethanol in the U.S.). The impact on core inflation, derived from the tortilla and sugar, was once again a rise of 0.30 percentage points on the annual rate. One would have to add that, in this period, climatic contingencies generated considerable damage in important agricultural regions (Michoacan, Sinaloa) and, in particular, on crops with a high weighting on the consumer price index, such as tomatoes. Due to this last effect, headline inflation rose 0.5 percentage points between August and October.

Toward the end of 2006 and the beginning of 2007, an additional increase in the tortilla price attributable to the rally in international corn prices, in soft drinks due to rises in sugar and corn syrup, and also in cigarettes due to higher taxes, has led to a new increase in core inflation of 0.5 percentage points.

Thus, the rising course in core inflation, from its minimum historic level in February 2006, 2.9%, to its maximum in February 2007, 3.95%, can be explained by the sharp rises in a reduced number of products. In fact, it should be noted that, with the exception of food, the components of core inflation maintained relative stability in 2006. During 2007, their annual rates have shown a moderate decrease. Moreover, if tortillas, sugar, soft drinks and cigarettes are eliminated, the annual rate of the core sub-index would have reached maximums at 3.5%.

An important difference in the shocks observed in the recent period compared to those of previous years is the anchorage of inflation expectations. At the same time that inflation has managed to converge on the central bank's long-term target (with its variability range of +/- one percentage point) and the main source of volatility lies in the agricultural component, inflation expectations have gradually incorporated the supply shocks by this sector as transitory phenomena. In 2006 and 2007, the transfer of short-term volatility on inflation expectations is lower than in the previous years.

Have the shocks finally run out?

Within a context of an economic slowdown and the expectation of peso stability (supported to a great extent by international liquidity), the question in terms of the future evolution of inflation is linked to supply shocks and their impact on core inflation, particularly on food products. Regarding the latter, it is difficult to predict that there will not be new rises in the international prices of grains or of domestic agricultural products, nor can full compliance of the agreements be guaranteed so as to maintain stability in the price of the tortilla.

What can we expect for the remainder of 2007?

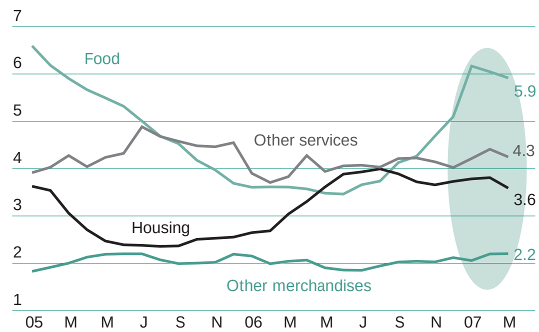
A gradual moderation in the annual rate of the components of core inflation during 2007, as well as signals from the futures markets of the exhaustion of the upward pressures on grains, and on construction materials (steel and other metals), allows for certain optimism as to the future performance of inflation.

Going forward, two possibilities can be identified. The first, conforming our base scenario, stems from the gradual dilution of the agricultural shock, within a context of lower economic strength (worldwide and domestically), financial stability (particularly in the exchange rate) and anchored expectations. In this scenario, headline and core inflation would begin to show clear signs of moderation in the second half of the year, with year-end levels of 3.7% and 3.5%, respectively.

The second scenario considers the possibility of an extension of the supply shocks. A second round of increases in processed foods cannot be ruled out totally if the prices of grains on the international markets continue to show rising signs. Similarly, significant rises in volatile prices (agricultural and livestock, government managed and regulated) could lead to a new rally in headline inflation, higher than 4.5%, a level already discounted in the forecasts for the second and third quarters simply for statistical effects. In this environment, an additional element of concern would be the deterioration of expectations, which would be transferred to wages and, in turn, would delay or moderate the downward course in core inflation. The outlook under this scenario would point to headline inflation levels toward the end of 2007 at ranges close to 4%, and for core inflation, at levels higher than 3.5%.

Core Inflation: Main Sub-Indexes

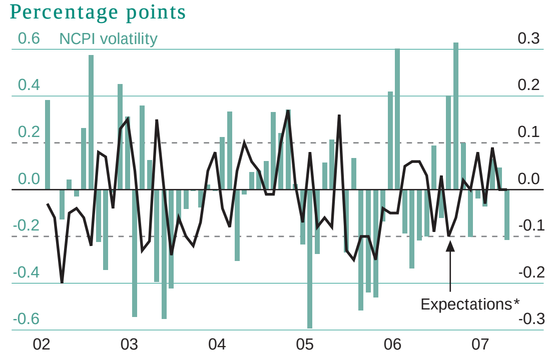
Annual % change



Source: BBVA Bancomer with Banco de México data

Inflation Volatility Observed vs. Expectations

Percentage points

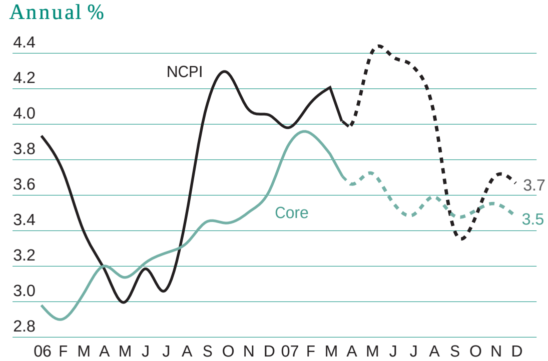


* Change in 12-month expectations with a one-month lag

Source: BBVA Bancomer with Banco de México data

Inflation 2006 - 2007

Annual %



Note: Forecasts as of May 2007

Source: BBVA Bancomer with Banco de México data

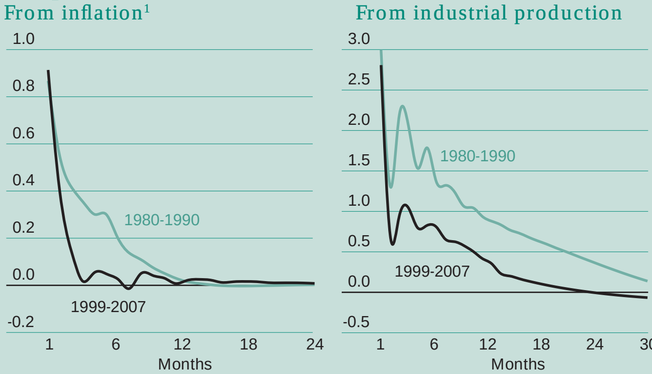
Comments on the Degree of Persistence of Inflation in Mexico

The speed with which changes in inflation revert to their medium and long-term trend defines its degree of persistence. This characteristic of inflationary dynamics is of vital importance in designing monetary policy, to the extent that, among other factors, it can be the very result of the efficiency in its implementation.

On an international level, a decline has been seen in this speed of adjustment, attributable to a greater credibility in the monetary authorities' capacity to counteract inflation, globalization, and international competition, as well as fewer flows and the reduced scope of the supply shocks (among others).[1]

Inflation in Mexico has experienced major changes in its dynamics, which also include the downward adjustment in the persistence of price growth, even to a greater extent than in the developed countries.[2] One way of appreciating this is by identifying the response of inflation to shocks simulated in different periods (innovations in inflation). However, since it is also probable that the scope of the shocks that affect prices is different, we shall consider the simulation with the standard deviation of inflation in the period.

Response to a 1 Standard Deviation Shock



1 Weighted by the standard deviation in inflation during the period

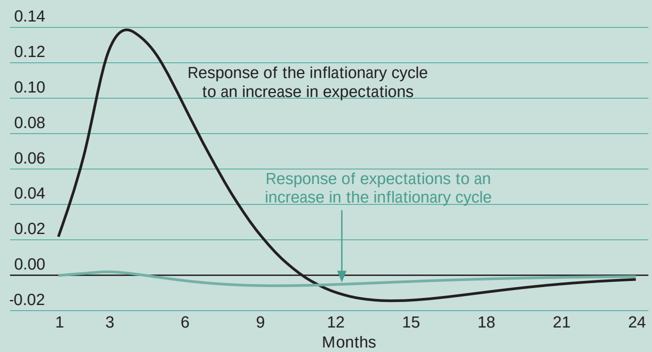
Note: SVAR that includes oil prices, industrial production, inflation, interest rates, monetary aggregate. Variables seasonally adjusted and in changes.

Source: BBVA Bancomer

The graph shows that the response of inflation to a shock involving a standard deviation is similar in the first period. However, during the following months, the convergence toward its trend in 1999-2007 is much greater than what was, on average, evident in the 1980-1990 period. This is independently of the difference in the strength of the turbulences that affected inflation. An alternative explanation is that the current economic stability has influenced the pattern of growth in prices. In the graph, it can be seen that the fluctuations in industrial production are also less persistent, but if we control them by the degree of variation, as was done in the case of inflation, both the scope as well as the persistence of economic activity is very similar. This suggests to us that all the factors that have transformed the characteristics of the fluctuations in Mexican economic growth could be behind the new strength of inflation, including the design and implementation of monetary policy.

Simulations in Shocks in the Inflationary Cycle and Expectations

1 standard deviation



Note: SVAR that includes oil prices, industrial production, inflation, inflation expectations, and interest rates. Variables seasonally adjusted and in changes. The result is sensitive to changes in order between inflation and expectations (2002-2007)

Source: BBVA Bancomer

The variability of the volatile component of inflation has not changed in the past six years, as was to be expected, but that of core inflation has diminished considerably, which clearly reflects the dominance of economic components, specifically of demand, on inflationary trends. It should be noted that medium term inflationary expectations are much more anchored to the official target, and that in the statistical relation between such projections and inflation, the effect of the expectations dominates the behavior of prices and not the other way around (see graph—other methodologies offer the same result). This indicates that in Mexico, the monetary authorities have played an important role in the current dynamics of inflation, although the road to anchoring expectations at 3.0% can be more complicated and requires a higher cost in terms of sacrificing growth (or a series of positive supply shocks that lead to inflation during a long period at those levels). For the time being, the convergence of inflation toward levels of 3.5% is good news.

Ociel Hernández o.hernandez@bbva.bancomer.com

1 Frédéric S. Mishkin (March 2007) summarizes, in his opinion, the relevant stylized data on the latest results on changes in the inflationary dynamics in some countries. Remarks at the Annual Macro Conference.

2 The central bank has expounded on some details of this phenomenon. See Banco de México's 2007-01 working paper.

Banxico Underscores its Commitment to Lower Inflation in an Uncertain Environment

The behavior of the financial markets in the year has been altered by both internal and external events. Outstanding among those having more bearing on investors are—externally—the fear of a greater slowdown in the U.S. in view of conditions on the real-estate market and of hydrocarbons; and—internally—the deterioration in the balance of inflation risks, the unexpected restriction of internal monetary conditions and the possibility of approval of structural reforms with a bearing on the outlook of sovereign risk.

Thus, financial volatility increased, with the 10-year fixed-rate bond fluctuating so far this year at between 7.4% and 8.1%; and the exchange rate between 10.77 and 11.21 pesos per dollar. The rallying episodes in volatility were concentrated in March after concerns increased regarding the degree of the slowdown in the U.S. and the end of April after the non-anticipated rise in the bank funding rate.

Although we anticipated increases in volatility during the first half of the year, it is advisable to value the events that have most contributed to this behavior and its outlook for the remainder of 2007. In general terms, we believe that, during the third quarter, the doubts regarding the balance of inflationary risk, the monetary position that the central bank adopts in the short term and the degree of the economic slowdown in the U.S. will continue.

For the end of this year and the beginning of 2008, we continue to see possibilities of gradual decreases in interest rates in all terms, with an exchange rate closing at levels close to 11 pesos per dollar. The following are the main factors upon which we based our previous estimates.

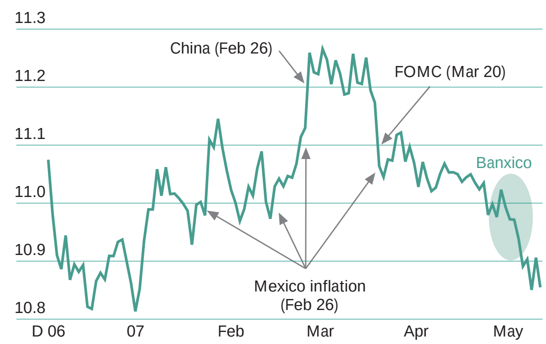
How do we value the rise in the bank funding rate?

In a decision not expected by the market, last April 27, the central bank decided to restrict internal monetary conditions so the bank funding rate went from 7% to 7.25%, and later, on May 25th, it chose to make a pause at this level. In our judgment, these measures represent important information to value, which concerns: (a) the factors that led to making that decision; and (b) the response on the foreign-exchange market and of long-terms bonds in face of this hardening.

Regarding the precedent for these measures, it was underscored that throughout the first quarter, the Banco de México chose to maintain its pause in the monetary cycle (bank funding at 7% since April 21, 2006). This decision was framed by an environment of an accumulation of supply shocks that affected prices in specific markets (i.e. sugar and corn-tortilla) and that led it —in a first instance—to warn about a possible hardening of monetary policy in case of a greater deterioration in the balance of risks. The inflation profile announced by the central bank was of a range between 4%-4.5% in the 3Q07 and between 3.5%-4% by the end of the year, for both headline and core inflation.

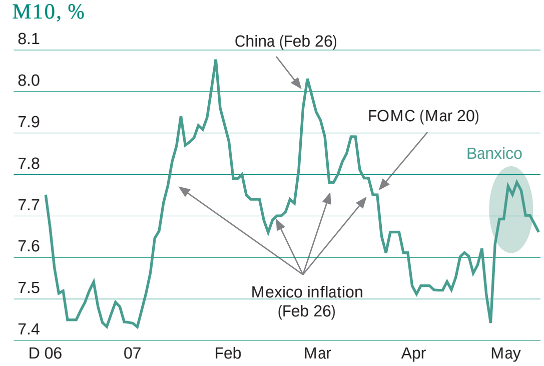
After announcing a reduction in prices of the first two weeks of April (due to factors typical for the tourist season and decisions in adminis-

Exchange Rate
Pesos per dollar



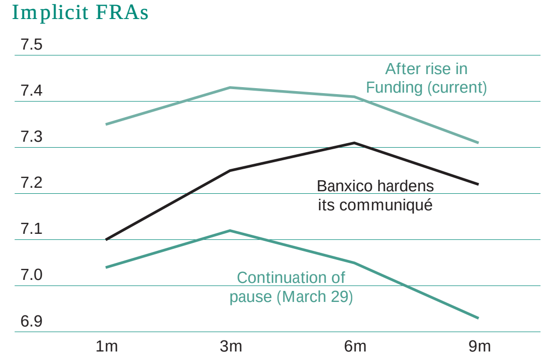
Source: BBVA Bancomer with Banco de México data

Long-Term Interest Rate
M10, %



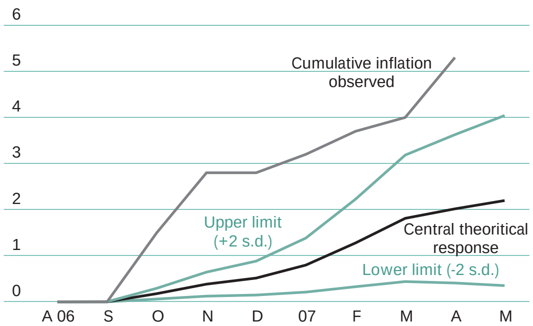
Source: BBVA Bancomer with Banco de México data

Outlook for Bank Funding
Implicit FRAs



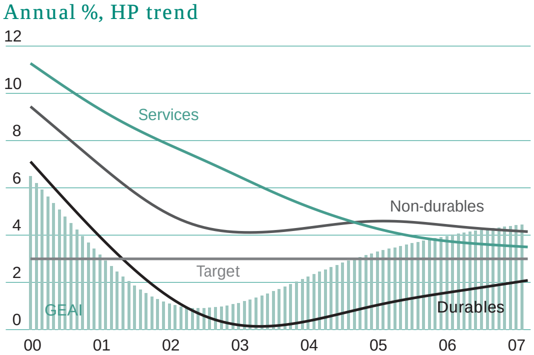
Source: BBVA Bancomer with Banco de México data

Cumulative Response in Livestock in View of Continuous Boosts in Corn
Inflation percentage points



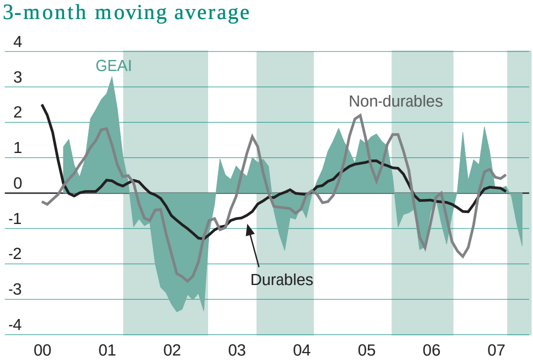
s.d. standard deviation
Source: BBVA Bancomer. Boost-Response controlled by activity and other prices, sample 1995-2007

Activity and Price Trend
Annual %, HP trend



Source: BBVA Bancomer

Prices and Activity: Cyclical Components
Cycle over trend in percentage points, HP, GEAI t+5, 3-month moving average



Source: BBVA Bancomer

tered prices), the central bank opted to harden monetary conditions on one occasion by 25 bp, in view of the fact that "the uncertainty associated with the determination of prices" had risen, particularly of the tortilla and other foods whose inputs are grains. Thus, it believed it to be "advisable to reinforce the monetary posture in a preventive manner" and with the intention of "underscoring" its commitment with the inflation target. Even though it introduced signs of greater uncertainty, the Banco de México maintained its inflation profile for 2007 and expects that the risk balance will improve this year. Also, it explicitly eliminated the warnings that it had been making on the conditions that would lead to a new rallying movement and limits itself to indicating that the purpose of the step is to reach a better balance of risks.

This communication, together with the fact that it maintains its inflation profile, leads the central bank to adopt a more restrictive monetary bias, which would be justified when (i) it defines the movement as preventive, (ii) it indicates that the slowdown of activity could contribute to mitigating the risks; and, (iii) it omits the explicit warning of a new restriction.

The panorama of an economic slowdown and stability in the exchange rate will be the elements that will support the Banco de México to maintain its rates at levels of 7.25% during the coming months. For this scenario to materialize, it will be necessary that core inflation show a downward trend—as we expected as of June—that new supply shocks will not appear again, and that medium-term inflationary expectations and wage negotiations will not deteriorate.

A second interpretation of the communiqué, which results from a partially different valuation than the previous one, consists in that the central bank could be visualizing additional pressures on inflation—derived from previous shocks in foods—which three months ago it had not registered when it began to communicate the deterioration in the balance of risks. The greatest uncertainty in determining some prices could refer to a reaction of certain prices to the rise in the price of grains beyond what has been experienced in previous disturbances.

In a closer monitoring of the performance of food prices following the rises in the price of corn, we identify that the prices of livestock and milk products have responded with greater sensitivity to what we would assume based on historic sensitivity. Due to which, should additional pressures materialize in these foods during May and/or June, an additional monetary restriction would not be ruled out with the aim of continuing to underscore its commitment to reduce inflation

Pondering both interpretations, we believe that the risks of contamination are currently important; however, we estimate that the economic slowdown and the strength of the peso will be factors that will tend to delimit the capacity of producers to transfer most of the costs to the final consumer and will therefore contribute to mitigating this risk. For this reason, we consider as our central scenario that the Banco de México will maintain its funding rate at 7.25% until the third quarter of this year and we have chosen to establish as a short-term bias, a rise to 7.5%, should food price rises be prolonged or if a certain contamination of expectations should materialize. In both cases, we maintain our outlook of diminishing headline and core inflation in the second half of the year. This would create opportunities in the last quarter of 2007 or the beginning of 2008 for the central bank to seek to initiate a more relaxed phase of the monetary conditions in synchrony with the cycle of the economy.

Our vision has not changed for the medium term. Independently of the monetary biases adopted in the short term, the outlook is of lower interest rates for 2008, given economic growth surrounding the potential and risk premiums at reduced levels, which favor an exchange rate without sufficient upsets to alter the inflationary course in said year.

How do we interpret the reaction of the financial markets following the monetary restriction?

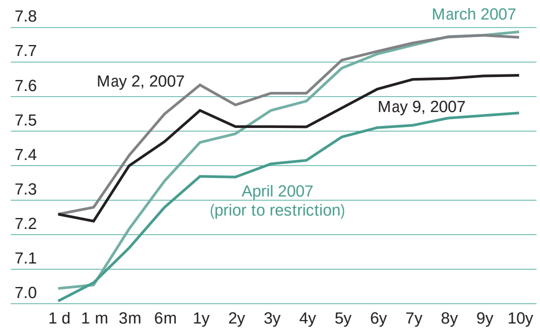
Prior to the announcement of the monetary policy of the Banco de México, the slope of the yield curve was displaying decreases, which accelerated after the announcement of the contraction of prices for the first two weeks of April and of May. By this, the slope went from 95 bp at the close of February to 35 bp days before the end of April, as the market assigned a greater probability of a monetary pause. Together with this, the average level of the yield curve went from 7.7% at the end of February to 7.3% before the monetary restriction. The unexpected announcement of monetary restriction had as a response a shifting toward a rise in the yield curve with a slight reduction of the slope, which stabilized at around 50 bp in the first week of May and led the average of the curve to stand at 7.6%.

The above-mentioned events led the course of long-term rates in Mexico to continue to lack synchronization with those of the U.S., even though the environment that explains it is different from prior episodes. In the first instance, increases in long-term bond yields in Mexico and drops in the U.S. at the end of February and the beginning of March were explained by the outlook for a slowdown in that economy which led to higher risks premiums for Mexican issues. In a second phase, in April, the drop in such rates in Mexico was guided by the favorable inflation data of the first two weeks of that month, the outlook for approval of structural reforms and the generalized feeling of a prolonged pause in monetary policy.

Lastly, the recent increases in bond rates in Mexico responds more to the boost seen in the short term than to a context of increases in the risk premiums and where international financial volatility has remained delimited. In fact, of particular significance is the fact that the upward course of the long-term rates has been slightly lower that the boost of 25 bp in the short sections of the curve. The above, in addition to discounting an unchanged risk environment, could reflect the fact that this monetary bias is being interpreted as transitory.

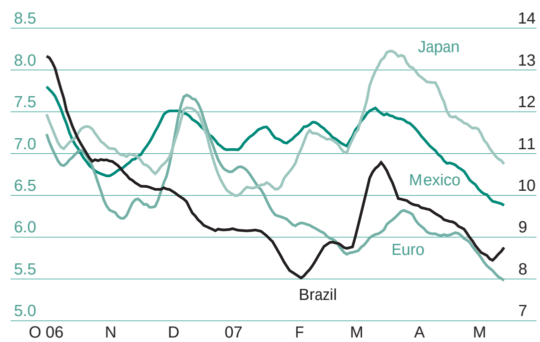
The increase induced by the Banco de México in the interest rate spread with the U.S. (from 220 to 255 bp in short sections)—together with an international environment of low volatility—made investment

Yield Curve
%



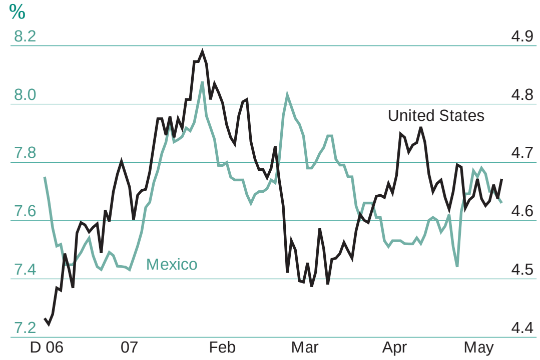
Source: BBVA Bancomer with Banco de México data

Exchange Rate Volatility
3-months implicit, contracts



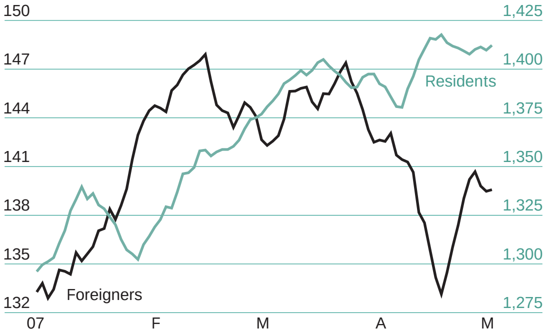
Source: BBVA Bancomer with Bloomberg data

10-Year Bond
%



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

Government Securities Holdings
Billions of pesos, 5-day moving average



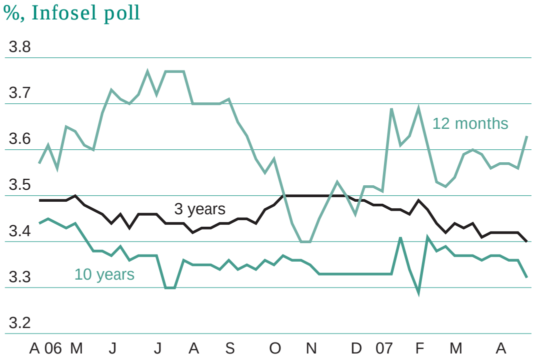
Source: BBVA Bancomer with Banco de México data

Financial Scenarios
End of period

	2007	2008
Base Scenario (60%)		
Bank Funding, %	6.75	6.50
10-Year Bond, %	7.3	7.2
Exchange Rate, pesos per dollar	11.0	11.2
Reform Scenario (35%)		
Bank Funding, %	6.75	5.75
10-Year Bond, %	7.0	6.1
Exchange Rate, pesos per dollar	10.6	10.8
Inflation Risk Scenario (5%)		
Bank Funding, %	8.00	7.25
10-Year Bond, %	8.4	7.6
Exchange Rate, pesos per dollar	10.9	11.0

Source: BBVA Bancomer

Inflation Expectations
%, Infosel poll



Source: BBVA Bancomer with Infosel data

in Mexican bonds more attractive and provided greater strength to the exchange rate with the peso standing at around 10.8 ppd (an appreciation of 1.3% and 3.1% compared to the average of March and April). Thus, foreign investment in government long-term securities expanded from 135.8 billion pesos from the day of the monetary announcement to 141.3 billion pesos for the first week of May. Similarly, the positions of the futures market in Chicago showed a greater appetite for the Mexican peso when the contracts registered a long net position of 3.2 billion dollars (the highest in the year).

Financial outlook for the second half of 2007 and 2008

The factors that have dominated market dynamics will continue to be important in their dynamics in the coming months. In matters of monetary policy, we can surmise a pause at 7.25% for the second and third quarters of the year, with a bias at which it could increase to 7.5%.

Nevertheless, we believe that, independently of the bias that the central bank might adopt in its immediate meetings, the behavior of the yield curve and the exchange rate suggest to us that both levels of bank funding are compatible with a more relaxed monetary period for the fourth quarter of the year or the beginning of 2008, at which the funding rate could reach 6.75% in said cycle. The above would take internal monetary conditions to levels consistent with economic growth below the potential that inflation—headline or core— would produce tending towards the central bank target and expectations of wage increases and medium/long term prices anchored at current levels.

In the short term, the monetary policy bias will depend to a large extent on the performance of the risk balance and, in particular, on the signals to the market that it wants to emphasize: (i) pause at 7.25% where greater weighting to the slowdown cycle would be given that would tend to mitigate inflationary pressures; or (ii) increase the funding rate to 7.5% in view of the need to authenticate even more its commitment in face of an expected medium- and long-term inflation that remains slightly off track from its target of 3%.

In this sense, we estimate that the recent strengthening of the peso, following the increase in bank funding, reduces the probability of a second hardening: to the extent that the origin of the slowdown lies in the external sector, greater peso appreciations following a second monetary restriction—in the absence of a rally in the sovereign risk—could prolong the economic slowdown phase. Similarly, a strengthened peso is consistent not only with the greater spread in rates with the U.S. in the short term, but also with the outlook of a delimited risk of inflation in Mexico for the medium term.

In short, taking into account the outlook for a moderate slowdown in the U.S.—with delimited increases in international risk premiums—and gradually declining local inflation in the second half of the year, we think that there is a margin for a drop in the long sections of the yield curve and fluctuations in the exchange rate in delimited ranges both for 2007 and 2008. Our estimates for the close of the 10-year bond (M10) and the exchange rate are 7.3 and 11.0 for 2007; and of 7.2 and 11.2 for 2008, respectively.

Alternate scenarios, though with low probability

Independently of the funding monetary bias (whose response on bonds and parity would be transitory), the main alternative scenarios could derive in an optimistic feeling on Mexico should the new structural reforms be approved (assigned probability of 35%). In this case, there would be a margin for greater bank funding drops toward 2008—assuming that the reforms could gradually increase the potential growth—the long-term rates with greater space downward and a slightly more appreciated peso than our central forecast (see table).

A negative scenario (with a 5% probability) could break out should a significant inflationary deterioration be registered that would divert the medium-term expectations from the 3% target. In such case, the hardening cycle could be prolonged this year with slight drops in the funding until the end of 2008. Thus, long-term rates would remain pressured upward for a longer period of time and the exchange rate would stand close to 11 ppd given the greater rate spreads with the U.S.

The Exchange Rate in Mexico in Relation to Dollar-Euro Movements

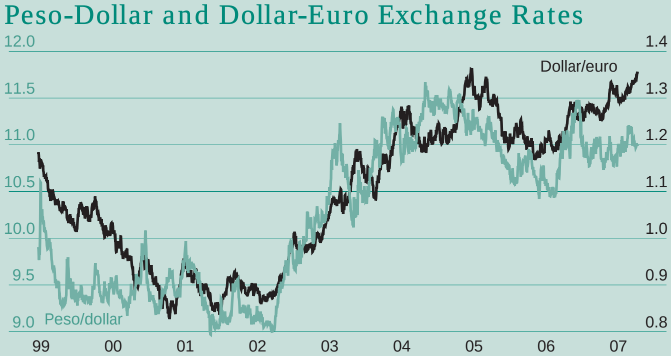
Synchronization of exchange rates?

Since the peso-dollar exchange rate reached its maximum level at the beginning of 1999 following the "tequila crisis", it has maintained a close relationship with movements between the dollar and the euro (in general, with the exchange rate between the dollar and another foreign currency). In fact, both exchange rates are co-integrated, which means that they sustain a stable long-term relation (positive in this case).

This long term linkage would suggest that both currencies could be structurally interrelated. The constant increase in the integration, both commercial and financial, between the United States and Mexico, and the intensified correlation of their respective economic cycles are, among other reasons, what is behind this relationship. Furthermore, the correlation between the core inflation of both countries has become greater in recent years, the result of the synchronization of cycles that are increasingly less pronounced.

When the depreciation (appreciation) of the dollar is persistent, this undoubtedly affects the peso-dollar exchange rate, with a depreciation (appreciation) of the peso in relation to the dollar. It should be pointed out that in the medium term, this relation of the dollar-euro vs. peso-dollar is respected independently of the dynamics of the spread in interest rates. In the very short term, changes in the interest rate spread does, in fact, temporarily break this elasticity, but it is important to emphasize that it only does so transitorily.

Peso-Dollar and Dollar-Euro Exchange Rates



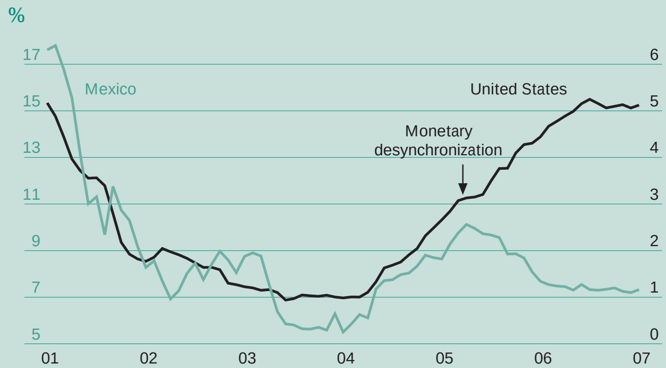
Source: BBVA Bancomer with Banco de México data

Synchronization of interest rates?

With regard to the behavior of interest rates between Mexico and the United States and the dynamism of the exchange rate, there are two elements to consider. First, interest rates are also highly synchronized in the medium term. While economic cycles continue to be very integrated and, as a result, inflation in both economies maintains a certain relationship, short-term interest rates will tend to strengthen this correlation.

Secondly, the direction of the movement in the interest rate spread is not the factor that dominates the behavior of the exchange rate, but rather it is the combination of the level of the spread, the risk aversion, and the phase in which the monetary policies of both economies are to be found. If in the two countries the direction of the monetary policy approach as well as the respective phase is similar, the interest rate spread will not be a relevant factor, such as is the case with the degree of international liquidity, risk aversion, and "carry" opportunities (financial margin).

Six-Month Interest Rates in Mexico and the U.S.



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

At this time, the last three factors mentioned above not only support the stability of the peso, but even its strength, to which it would be necessary to add that the monetary policy approach favors the local currency. The main element of risk in a depreciation of the peso in relation to the dollar centers on the possibility of a more severe adjustment of the dollar/euro parity and that, given the United States' economic and financial ties with Mexico, the peso would reverse its strengthening trend of the past few years. In other words, as long as a recession does not materialize in the United States and, therefore, in the Mexican economy, the peso will remain strong for some time.

Ociel Hernández o.hernandez@bbva.bancomer.com

United States Indicators and Forecasts

	2006	2007	2008	III'06	IV'06	I'07	II'07	III'07	IV'07	I'08	II'08
Economic Activity											
GDP (real annual % change)	3.3	**2.3**	**2.8**	3.0	3.1	2.1	**2.2**	**2.4**	**2.4**	**2.7**	**2.7**
Personal consumption expenditures	3.2	**3.2**	**2.6**	2.7	3.6	3.4	**3.5**	**3.3**	**2.8**	**2.5**	**2.5**
Gross fixed investment	2.9	**-2.6**	**3.3**	2.0	-1.1	-4.2	**-3.4**	**-2.8**	**0.2**	**2.4**	**3.0**
Non-residential	7.2	**2.7**	**4.2**	8.3	6.0	3.2	**3.0**	**1.5**	**3.3**	**3.9**	**4.1**
Structures	9.0	**3.2**	**3.6**	14.1	11.2	9.4	**2.9**	**0.1**	**0.9**	**1.4**	**4.1**
Equipment and software	6.5	**1.7**	**4.2**	6.0	4.0	0.8	**2.0**	**1.0**	**3.3**	**3.9**	**4.1**
Residential	-4.2	**-14.0**	**0.4**	-8.1	-12.8	-16.7	**-16.8**	**-13.4**	**-8.5**	**-3.7**	**0.0**
Total exports	8.9	**5.4**	**5.9**	9.1	9.4	5.5	**5.7**	**5.6**	**4.6**	**6.5**	**6.2**
Total imports	5.8	**2.3**	**3.1**	7.2	3.3	1.6	**2.3**	**1.9**	**3.5**	**3.7**	**3.4**
Government consumption	2.1	**1.9**	**2.2**	1.6	2.7	1.7	**2.0**	**2.0**	**2.0**	**2.2**	**2.2**
Contribution to Growth (pp)											
Personal consumption expenditures	2.3	**2.3**	**1.8**	1.9	2.6	2.4	**2.4**	**2.4**	**2.0**	**1.8**	**1.8**
Private investment	0.7	**-0.6**	**0.5**	1.0	-0.4	-1.0	**-0.9**	**-0.7**	**0.1**	**0.4**	**0.4**
Net exports	0.0	**0.2**	**0.2**	-0.2	0.5	0.3	**0.3**	**0.3**	**0.0**	**0.1**	**0.2**
Government consumption	0.4	**0.3**	**0.4**	0.3	0.5	0.3	**0.4**	**0.4**	**0.4**	**0.4**	**0.4**
Prices and Costs (annual % change, average)											
CPI	3.2	**2.4**	**2.2**	3.3	1.9	2.4	**2.4**	**1.9**	**2.8**	**2.4**	**1.8**
Core	2.5	**2.3**	**2.1**	2.8	2.6	2.6	**2.3**	**2.1**	**2.2**	**2.2**	**2.2**
PCE	2.7	**2.1**	**1.9**	2.8	1.9	2.2	**2.1**	**1.7**	**2.3**	**2.0**	**1.7**
Core	2.2	**2.1**	**2.0**	2.4	2.2	2.2	**2.0**	**2.0**	**2.0**	**2.0**	**2.0**
GDP deflactor	2.9	**2.4**	**1.9**	2.9	2.5	2.7	**2.2**	**2.1**	**2.5**	**1.6**	**1.8**
Productivity	1.6	**1.9**	**2.2**	0.9	1.6	1.2	**2.2**	**2.2**	**2.2**	**2.2**	**2.2**
Real compensation per hour	1.5	**1.1**	**1.4**	0.1	2.9	-0.1	**1.4**	**1.4**	**1.4**	**1.4**	**1.4**
Unit labor cost	3.2	**1.5**	**1.6**	2.6	3.4	1.3	**1.6**	**1.6**	**1.6**	**1.6**	**1.6**
Other Indicators											
Industrial production (real annual % change)	4.0	**2.4**	**3.2**	5.1	3.5	2.4	**2.4**	**2.4**	**2.4**	**2.9**	**3.3**
Capacity utilization (%)	81.7	**81.0**	**81.3**	82.3	81.5	81.3	**81.4**	**80.8**	**80.4**	**80.5**	**81.0**
Light weight vehicle sales (millions, annualized)	16.6	**16.5**	**16.1**	16.6	16.4	16.5	**16.5**	**16.5**	**16.6**	**16.4**	**16.1**
Housing starts (thousands, annualized)	1,812	**1,438**	**1,478**	1,704	1,555	1,460	**1,495**	**1,428**	**1,368**	**1,388**	**1,448**
Nonfarm payrolls (thousands of new jobs, average)	189	**112**	**100**	202	177	143	**109**	**100**	**95**	**90**	**90**
Unemployment rate (average, %)	4.6	**4.6**	**4.7**	4.7	4.5	4.5	**4.5**	**4.6**	**4.7**	**4.7**	**4.7**
Personal savings rate	-1.3	**-0.2**	**0.0**	-1.4	-1.3	-0.6	**-0.4**	**-0.1**	**0.2**	**-0.3**	**-0.2**
Trade balance (US$ billions)	-765	**-706**	**-706**	-201.4	-179	-178	**-182**	**-181**	**-165**	**-181**	**-183**
Current account balance (US$ billions)	-857	**-761**	**-765**	-229	-196	**-197**	**-199**	**-190**	**-175**	**-200**	**-203**
% of GDP	-6.5	**-5.5**	**-5.3**	-917.5	-783.2	**-787.7**	**-797.2**	**-758.6**	**-700.4**	**-800.7**	**-810.4**
Fiscal balance (US$ billions, fiscal year)	-248	**-177**	**-118**	—	-248	—	**—**	**—**	**-177**	**—**	**—**
% of GDP	-1.9	**-1.3**	**-0.8**	—	-1.9	—	**—**	**—**	**-1.3**	**—**	**—**
Brent (dollars per barrel, average)	69.1	**58.4**	**55.1**	72.0	63.4	65.0	**57.2**	**56.3**	**55.1**	**55.1**	**55.1**
Financial Markets (eop)											
Fed Funds (%)	5.25	**5.25**	**5.25**	5.25	5.25	5.25	**5.25**	**5.25**	**5.25**	**5.25**	**5.25**
3-month Libor (%)	5.36	**5.30**	**5.25**	5.37	5.36	5.35	**5.34**	**5.32**	**5.30**	**5.27**	**5.25**
10-year Treasury Note (%)	4.70	**4.80**	**4.90**	4.63	4.70	4.64	**4.73**	**4.76**	**4.80**	**4.83**	**4.85**
Dollar/euro	1.32	**1.33**	**1.32**	1.27	1.32	1.33	**1.34**	**1.34**	**1.33**	**1.34**	**1.33**

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

Mexico Indicators and Forecasts

	2004	2005	2006	2007	2008	I'06	II'06	III'06	IV'06	I'07	II'07	III'07	IV'07
Economic Activity													
GDP (seasonally-adjusted series)													
Real annual % change	4.2	2.8	4.8	**3.2**	**3.9**	4.2	6.2	4.5	4.3	2.6	**2.8**	**3.3**	**3.9**
Per inhabitant (US dollars)*	6,729	7,490	8,118	**8,723**	**8,993**	8,062	8,221	7,909	8,281	8,326	**9,094**	**8,555**	**8,916**
US$ billions	683	768	841	**912**	**949**	832	850	820	861	867	**950**	**896**	**935**
Inflation (eop, %)													
Headline	5.2	3.3	4.1	**3.7**	**3.5**	4.4	3.2	4.1	4.1	4.2	**4.4**	**3.4**	**3.7**
Core	3.8	3.1	3.6	**3.5**	**3.1**	3.6	3.2	3.4	3.6	3.8	**3.6**	**3.5**	**3.5**
Financial Markets													
Interest rates (eop, %)													
Bank funding	8.55	8.25	7.00	**6.75**	**6.50**	7.25	7.00	7.00	7.00	7.00	**7.25**	**7.25**	**6.75**
28-day Cetes	8.6	8.0	7.0	**6.8**	**6.5**	7.3	7.0	7.1	7.0	7.0	**7.3**	**7.3**	**6.8**
28-day TIIE	9.0	8.6	7.4	**7.1**	**6.8**	7.6	7.3	7.3	7.4	7.5	**7.6**	**7.5**	**7.1**
10-year Bond	9.7	8.5	7.6	**7.3**	**7.2**	8.7	9.7	8.2	7.6	7.8	**7.7**	**7.6**	**7.3**
Exchange rate													
Pesos per dollar, eop	11.3	10.7	10.9	**11.0**	**11.2**	11.0	11.4	11.0	10.9	11.1	**10.9**	**11.1**	**11.0**
Public Finances													
Fiscal balance (% of GDP)	-0.2	-0.1	0.2	**0.0**	**0.0**	nd	nd	nd	0.2	nd	nd	nd	**0.0**
FRPS (% GDP)	-2.5	-1.7	1.7	**1.6**	**1.3**	nd	nd	nd	1.7	nd	nd	nd	**1.3**
External Sector**													
Trade balance (US$ billions)	-8.8	-7.6	-6.1	**-14.3**	**-21.1**	-5.0	-4.5	-5.4	-6.1	-9.5	**-12.1**	**-14.5**	**-14.3**
Current account (US$ billions)	-6.7	-4.9	-1.5	**-14.7**	**-19.4**	-1.7	-0.7	-1.5	-1.5	**-6.2**	**-10.1**	**-13.8**	**-14.7**
Current account (% of GDP)	-1.0	-0.7	-0.2	**-1.6**	**-2.0**	-0.2	-0.1	-0.2	-0.2	**-0.7**	**-1.2**	**-1.5**	**-1.6**
Oil (Mexican mix, dpb, eop)	28.6	44.9	50.1	**53.1**	**43.9**	51.4	55.5	58.2	50.1	50.0	**52.2**	**52.1**	**53.1**
Monetary Agreggates & Banking Activity (ann. % chge.)													
Core bank deposits	3.1	3.2	1.0	**4.9**	**4.7**	6.7	6.2	3.3	1.0	6.1	**6.7**	**5.7**	**4.9**
Commer. banks performing loans***	27.7	26.6	25.0	**17.5**	**16.4**	27.8	28.5	26.8	25.0	23.3	**16.1**	**15.7**	**17.5**
Agreggate Demand (ann. % chge., seasonally-adjusted)													
Total	6.2	4.4	7.0	**4.8**	**6.3**	7.0	8.7	7.1	5.3	**3.8**	**4.3**	**5.1**	**6.1**
Domestic demand	4.3	5.2	6.1	**4.3**	**5.2**	6.4	8.0	6.0	4.0	**3.9**	**4.0**	**4.2**	**5.0**
Consumption	3.6	4.6	5.1	**3.7**	**4.1**	5.5	6.9	5.0	3.2	**3.4**	**3.7**	**3.6**	**4.2**
Private	4.1	5.1	5.0	**4.2**	**4.6**	5.3	6.7	5.0	3.2	**3.7**	**4.2**	**4.2**	**4.6**
Public	-0.3	0.3	6.0	**-0.1**	**-0.1**	7.0	8.6	5.2	3.3	**1.0**	**-0.8**	**-0.8**	**0.2**
Investment	7.5	7.6	10.0	**6.5**	**9.2**	10.3	12.5	10.1	7.3	**5.9**	**5.4**	**6.3**	**8.2**
Private	8.8	9.6	11.6	**6.3**	**9.0**	9.1	15.1	12.9	9.1	**7.5**	**5.3**	**5.7**	**6.6**
Public	2.5	-0.4	8.5	**7.5**	**10.0**	22.1	-1.6	9.6	6.0	**-1.9**	**5.9**	**9.7**	**14.1**
External demand	11.7	7.0	11.2	**7.0**	**9.6**	11.2	13.1	11.3	9.3	**4.0**	**6.0**	**8.1**	**9.7**
Imports	11.6	8.5	12.3	**8.6**	**11.2**	16.0	12.9	13.1	7.7	**6.5**	**7.7**	**9.0**	**11.0**
GDP by sectors (annual % change)													
Agriculture	3.5	-2.1	4.8	**2.6**	**1.6**	2.7	8.0	-2.3	9.8	0.2	**-0.5**	**6.3**	**4.6**
Industrial	4.2	1.7	5.0	**2.2**	**3.9**	7.1	3.9	5.4	3.6	0.6	**2.1**	**2.4**	**3.2**
Mining	3.4	2.1	2.2	**1.9**	**1.7**	6.1	-0.4	2.7	0.8	0.3	**0.2**	**3.2**	**2.0**
Manufactures	4.0	1.4	4.7	**2.1**	**3.5**	7.1	3.9	5.1	3.1	-0.1	**1.5**	**2.2**	**3.1**
Construction	6.1	3.3	6.9	**3.8**	**5.0**	8.8	5.3	7.8	5.9	2.1	**3.9**	**4.4**	**4.5**
Electricity, gas and water	2.8	1.7	5.0	**3.0**	**3.2**	4.1	4.5	5.9	5.4	5.3	**2.4**	**1.9**	**3.0**
Services	4.2	3.6	4.7	**3.8**	**4.5**	5.1	5.0	4.6	4.1	3.5	**3.4**	**3.6**	**4.5**
Retail, restaurants and hotels	5.5	2.7	3.7	**3.3**	**4.0**	5.1	4.0	3.2	2.8	1.6	**2.6**	**3.2**	**4.8**
Transportation and communications	9.2	7.1	9.1	**6.8**	**8.1**	8.4	9.2	9.3	9.3	7.6	**6.5**	**6.5**	**6.3**
Financial, insurance and real-estate	3.9	5.8	5.4	**4.3**	**4.7**	6.0	5.8	4.9	4.7	4.9	**4.1**	**4.2**	**4.7**
Community and personal	0.6	1.8	2.8	**1.6**	**2.1**	3.0	3.6	2.9	1.7	2.1	**1.0**	**1.9**	**2.0**

1 See page 21
eop end of period
dpb dollars per barrel
* Seasonally-adjusted series for quarterly data
** Accummulated, last 12 months
*** To the private sector
FRPS Financial Requirements of the Public Sector, % of GDP
na not available
Note: **Bold** figures are forecast

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75 años adelante.

For further information please contact:

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

Economic Research Department BBVA Group

Chief Economist
José Luis Escrivá

Unit Heads
North America: Jorge Sicilia
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Global Trends: Joaquín Vial

North America Economic Research Dept.

Jorge Sicilia   j.sicilia@bbva.bancomer.com

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

Estados Unidos
Nathaniel Karp   nathaniel.karp@bbvausa.com
Javier Amador   javier.amador@bbvausa.com
Marcial Nava   jm.nava@bbva.bancomer.com

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

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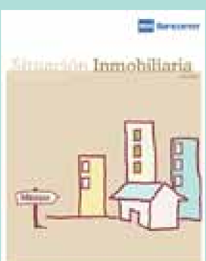


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- Argentina
- Chile
- Colombia
- Peru
- Spain
- Venezuela