



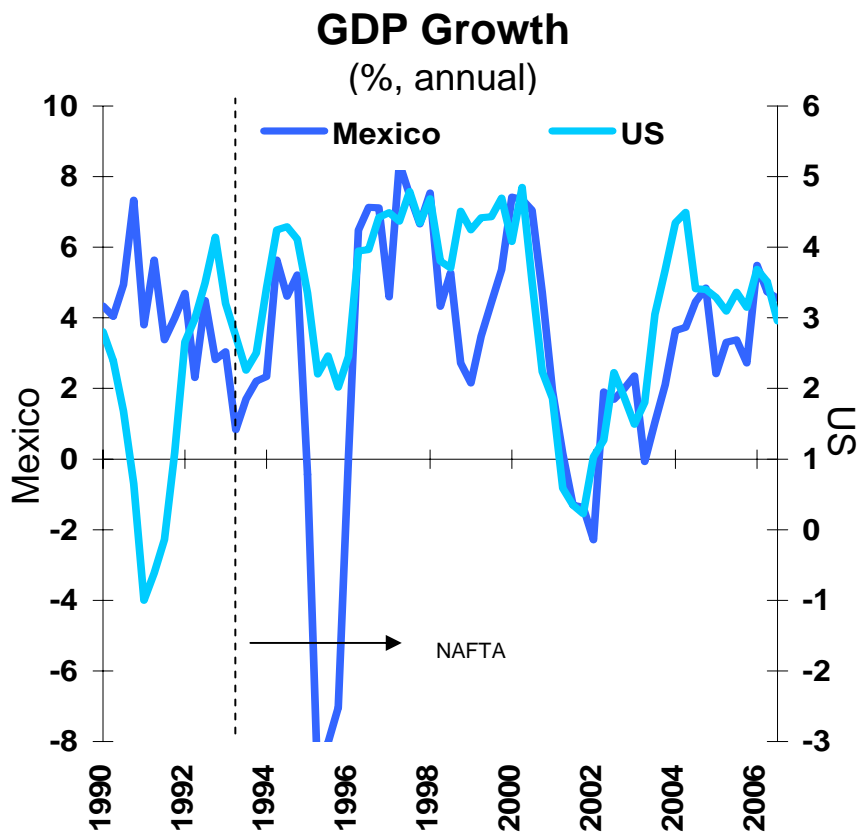
The Mexican Economy

February 2007

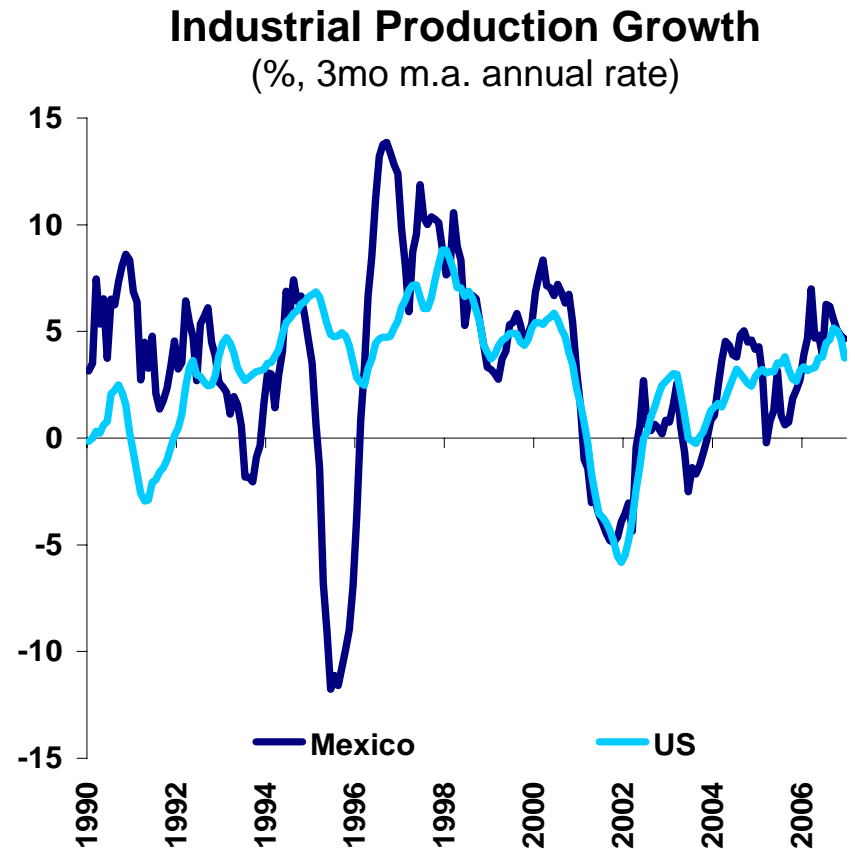
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Following NAFTA, exports became the main engine of growth in Mexico, linking fluctuations with those in the US primarily through manufacturing. This integration explains both the fast growth of the late 90s and the deceleration of 2001-2003.



Source: INEGI and BEA



Source: INEGI and FED

However, in the last few years the dynamics of economic growth in Mexico shifted towards domestic sources. Two factors account mainly for this shift:

- Macroeconomic stability
 - Lower inflation
 - Fiscal discipline
 - Floating exchange rate
 - No external imbalances

- Financial Development
 - Improved legal framework and regulation
 - Foreign investment in the sector
 - Public debt management

A series of reforms in the financial sector were implemented.

Reforms to the Law Regulating Financial Groups

Changes to the Credit Institutions Law

Popular Savings and Credit Law

Creation of the National Savings and

Financial Services bank (BANSEFI)

Law Regulating Credit Bureaus

Reform to the Securities Market Law

New Law for Investment Funds

Reform to the Law Regulating Credit Bureaus

Creation of the Fund to Foster Banking Card Terminals

Law for the Ordering and

Transparency of Financial Services

Reform to the Bank Secrecy Law

Reforms to the Popular Savings and Credit Law Risky Capital Investments

Reform to Real Estate and Infrastructure Trusts (FIBRAS)

Reform to the Law on the Protection and Defense of the Users of Financial Services

Lavado de dinero y financiamiento al terrorismo

Ley de Transparencia y Fomento al Crédito Garantizado

Banking Resolutions

Reform to the Law of the Federal Mortgage Loan Society (SHF)

Multiple Purpose Financial Institutions (SOFOMES)

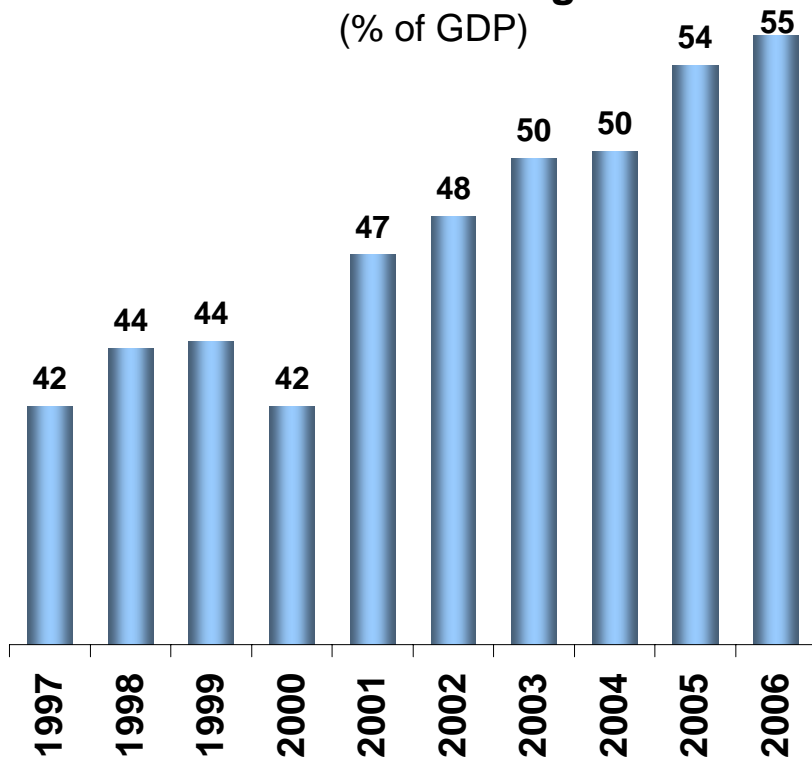
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SHCP

Macroeconomic stability and legal changes to the financial sector had a favorable impact on savings. Financial savings grew 42 to 54 percent of GDP between 2000 and 2006, propelled mainly by institutional investors (particularly, pension funds).

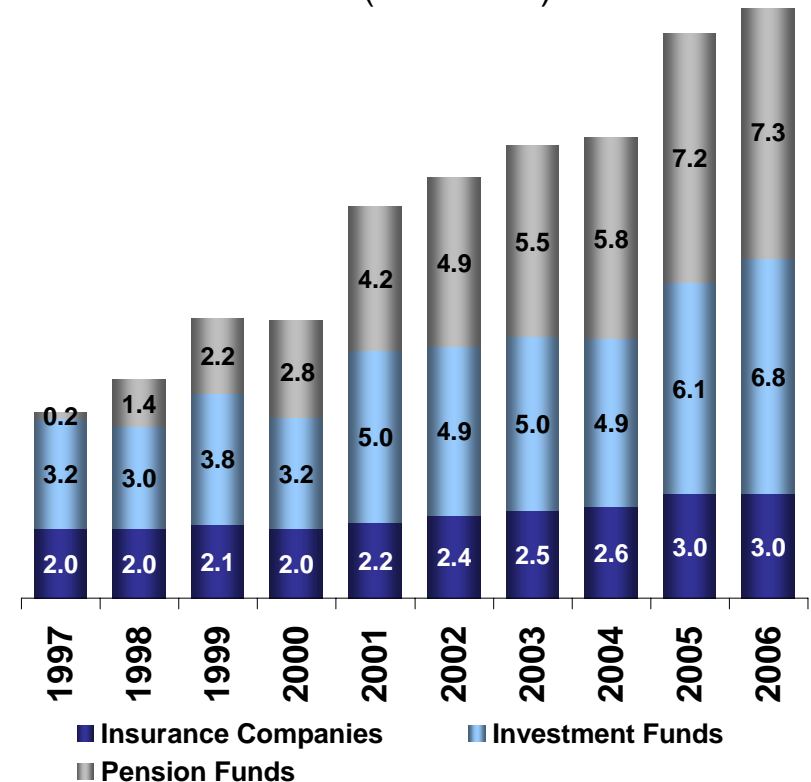
Financial Savings*/
(% of GDP)



*Measured as M3a minus currency

Source: Own calculations

Institutional Investors' Savings
(% of GDP)



Source: Banxico

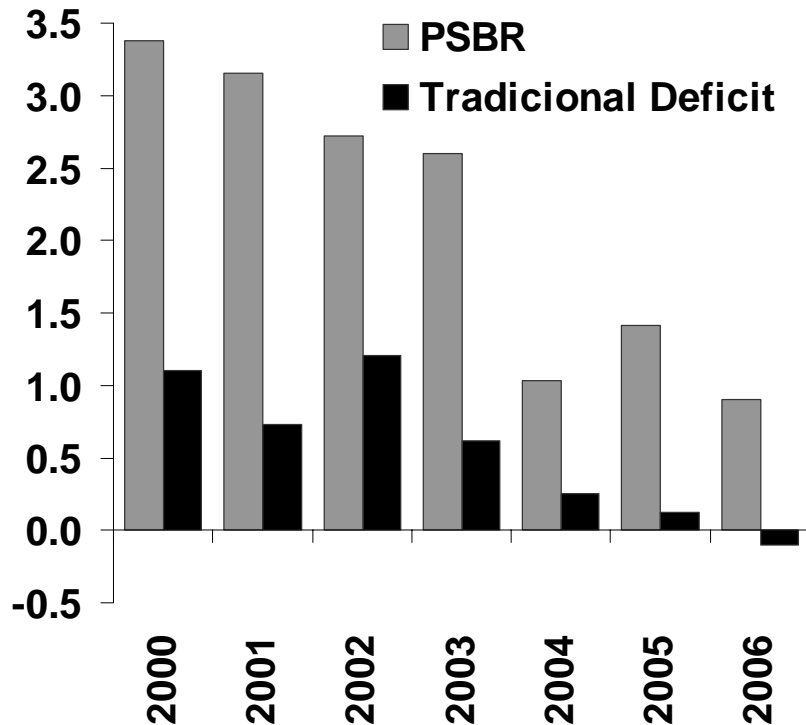
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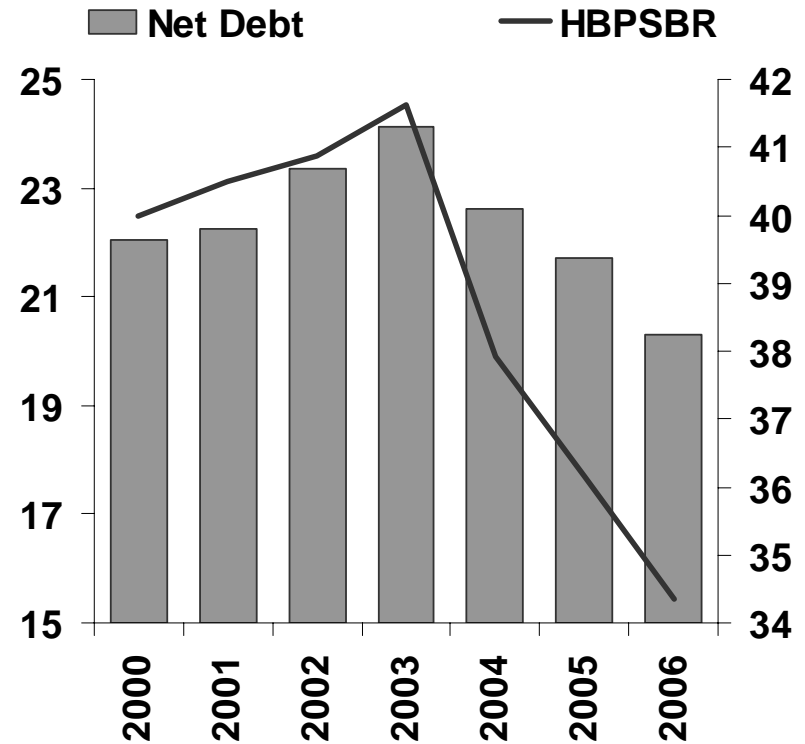
Mexico carried out an important effort to reduce fiscal imbalances and public debt as a proportion of GDP. Public finances were put on a sustainable path.

Public Deficit and PSBR (% of GDP)



Source: SHCP

Net Debt and HBPSBR (% of GDP)



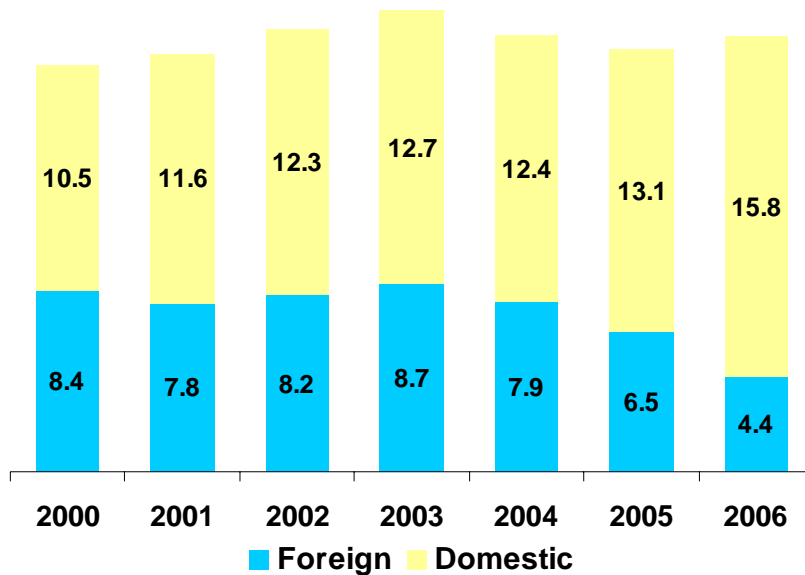
Source: SHCP

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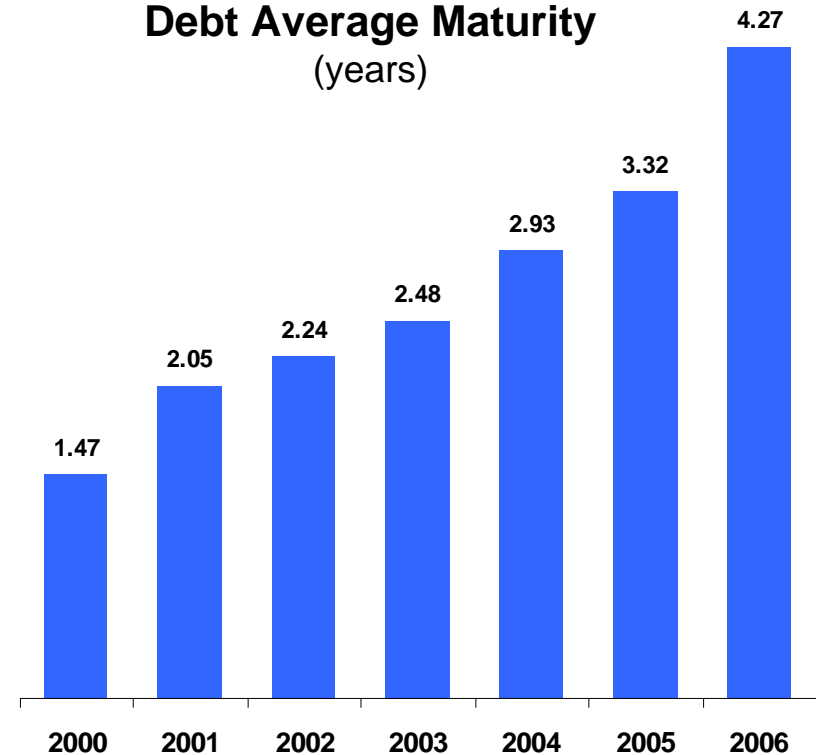
The composition of public debt was changed in favor of domestic sources of financing and the average maturity of liabilities was increased.

Federal Government Net Debt Composition (% of GDP)



Source: SHCP

Federal Government Net Debt Average Maturity (years)



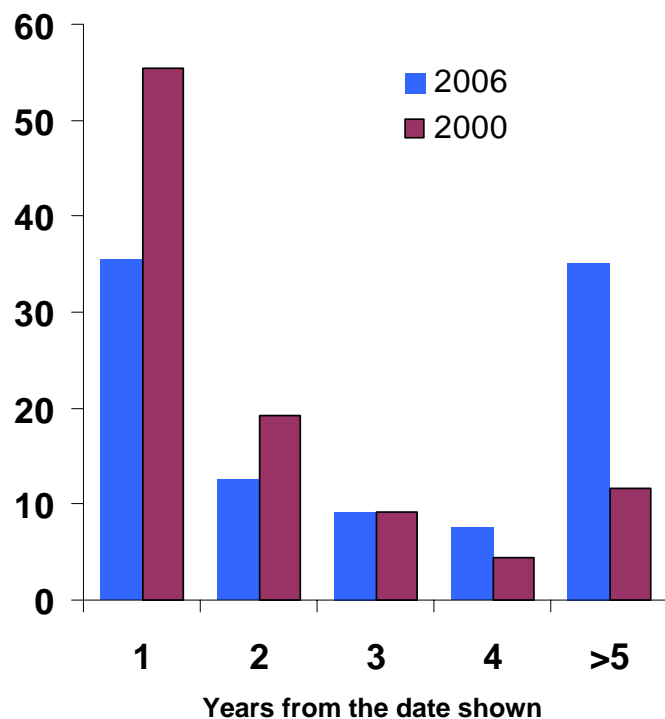
Source: SHCP

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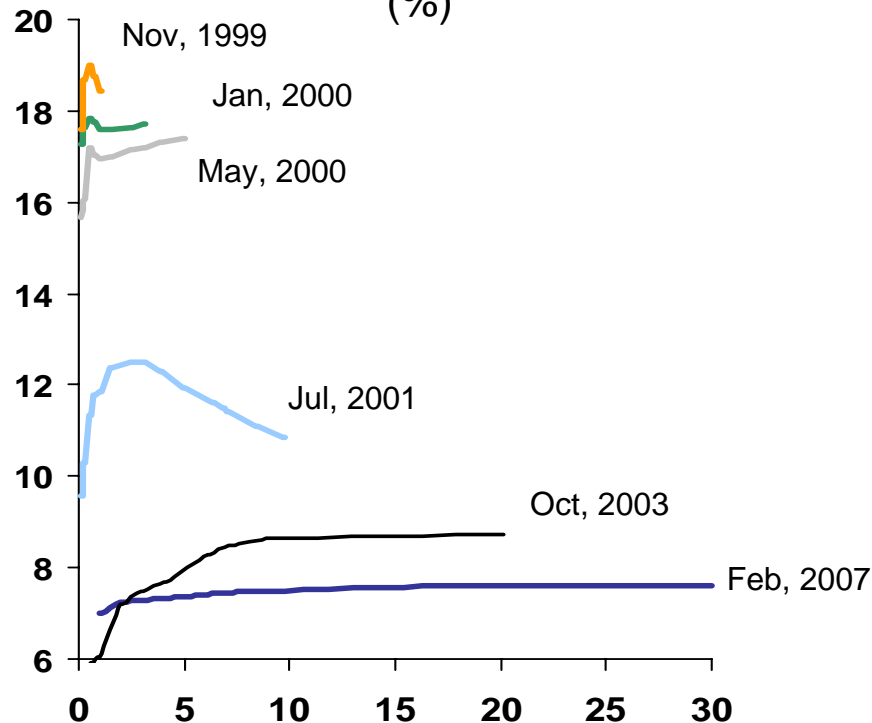


The debt amortization profile was improved, thus reducing refinancing risks and its macroeconomic implications. The public debt strategy made an additional contribution to financial development by extending the government securities yield curve.

Amortization Profile (% of outstanding balance)*



Yield Curve (%)



*Federal Government Domestic debt
Source: SHCP

Source: SHCP

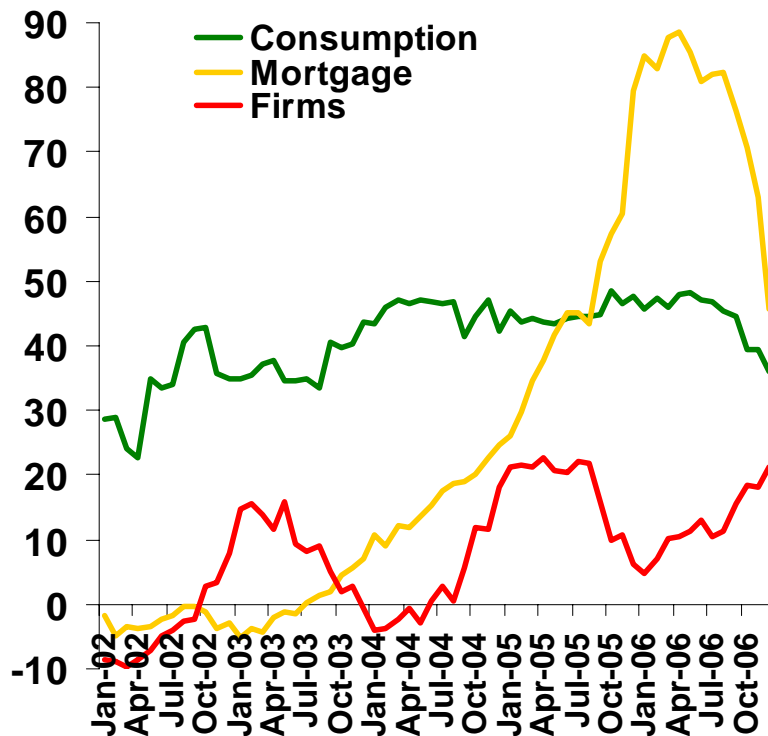
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Increased supply of financial resources and a lower absorption of the public sector translated into a fast expansion of credit activity. New credit explains an important share of private consumption growth.

Outstanding Direct Credit by Commercial Banks

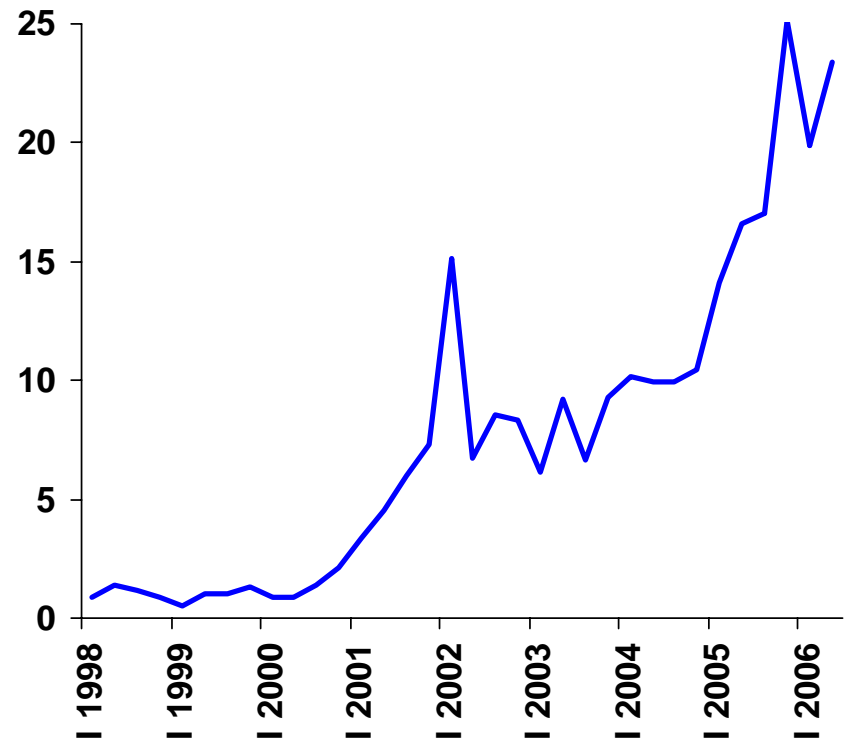
(real % annual change)



Source: Banxico

New Consumption Credit

(as % of change in consumption of durable goods)



Source: Banxico

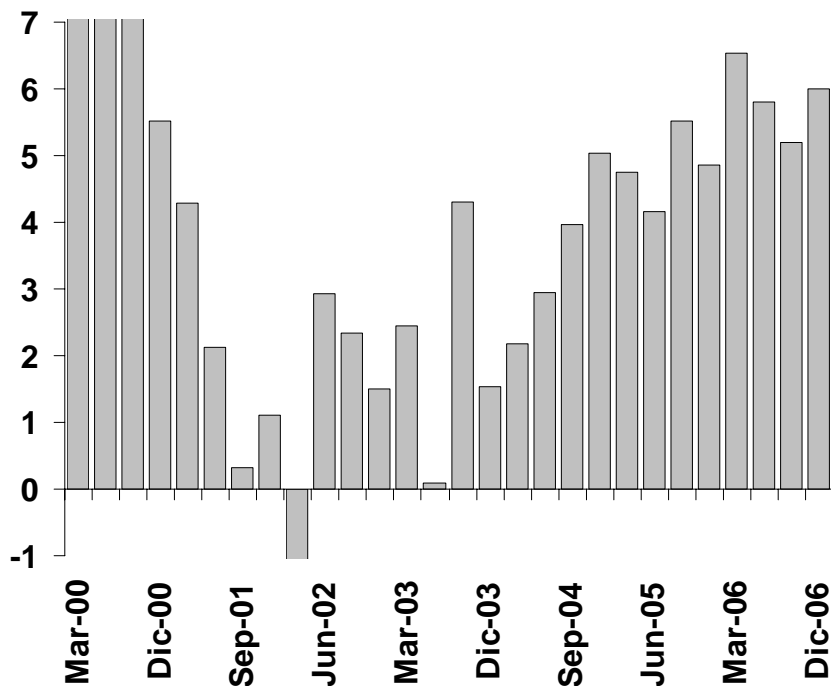
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Domestic demand sources displayed a strong dynamism in 2004-2006. Private consumption maintained high stable growth rates and investment expanded fast, even in items non directly correlated with housing.

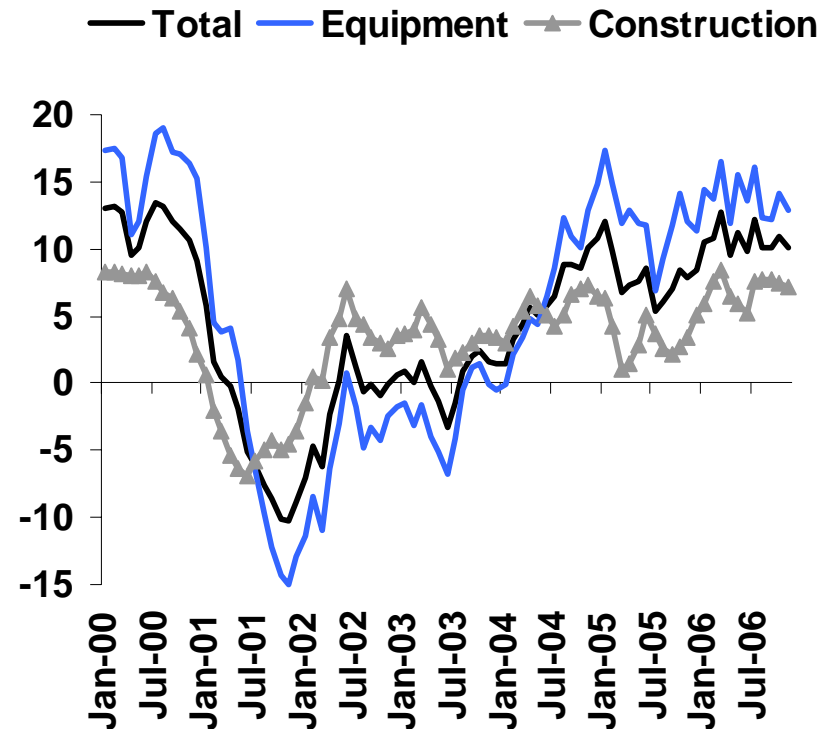
Consumption

(real annual variation, %)



Investment

(annual variation, %)



Source: INEGI

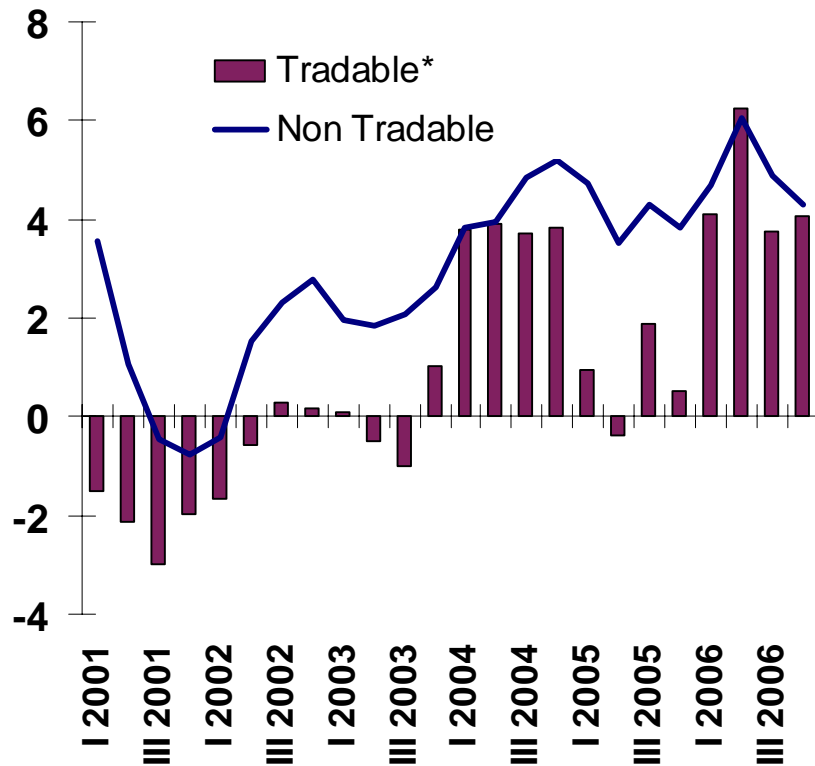
Source: INEGI

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Domestic aggregate demand became an important and stable source of growth. Non-tradable sectors stayed resilient in spite of fluctuations in external demand.

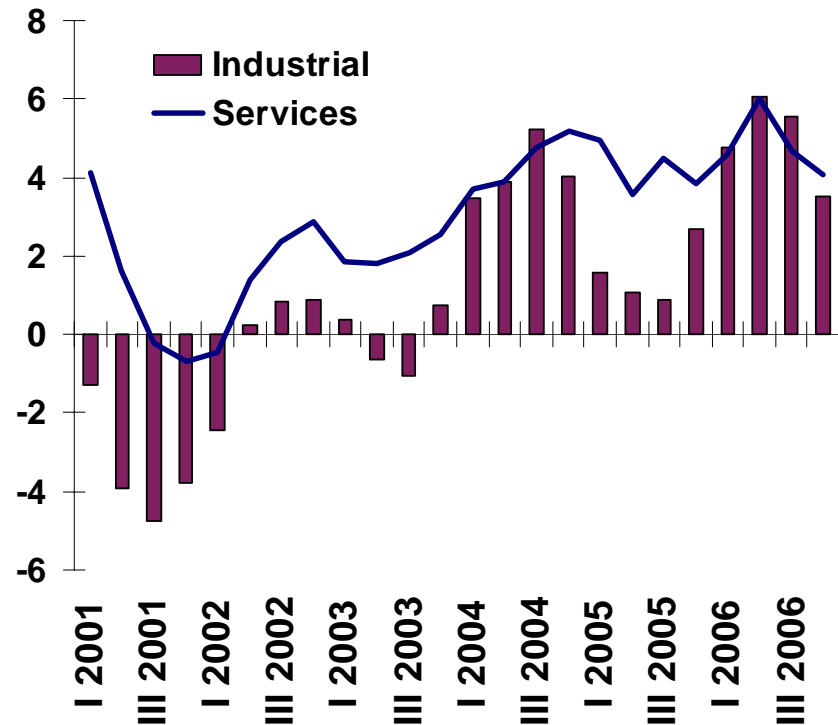
GDP Growth
(%, annual)



Source: INEGI

Tradables: Manufacturing, mining and farming. Non-tradables: Construction, energy (non-oil), and services.

GDP Growth
(%, annual)



Source: INEGI

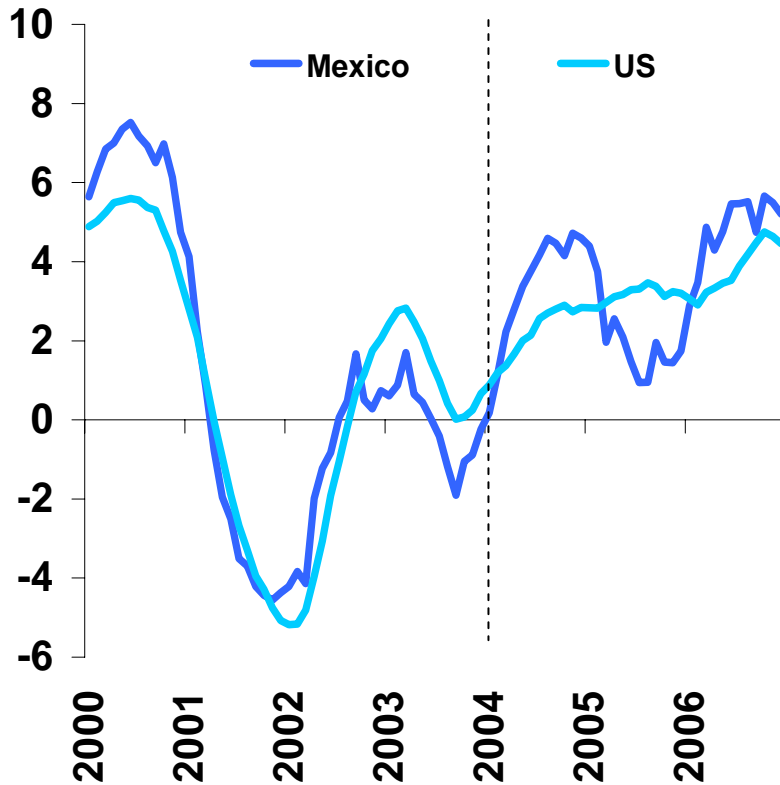
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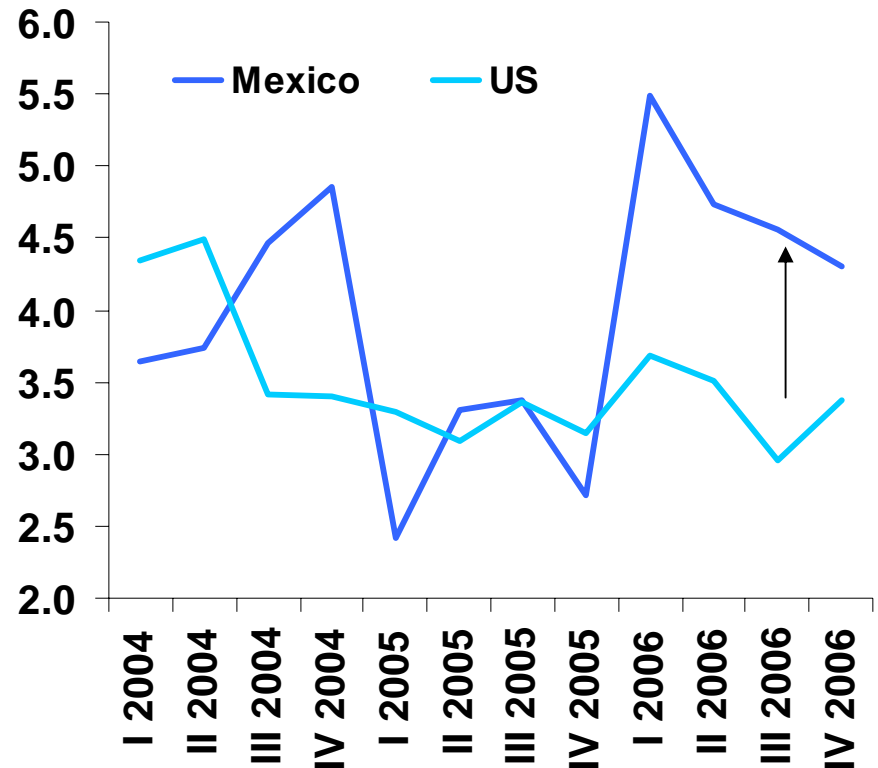
This may explain why the correlation of manufacturing activity in Mexico and the US has diminished slightly. Moreover, the correlation of overall economic activity in both countries has not affected Mexico as in the past.

Industrial Production Growth (%, annual)



Source: INEGI

GDP Growth (%, annual)



Source: INEGI

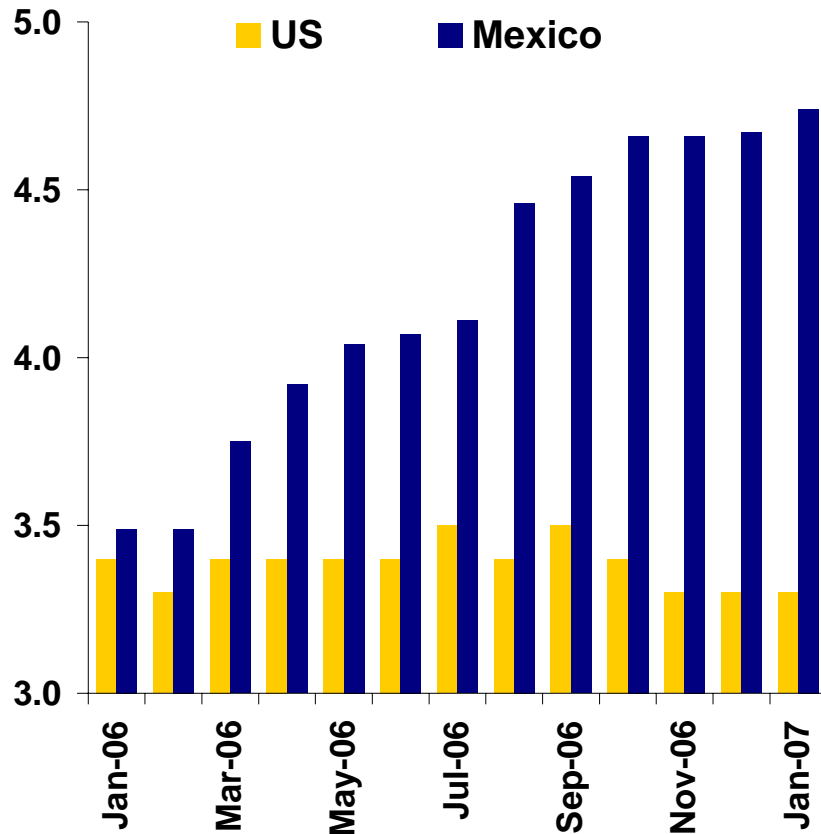
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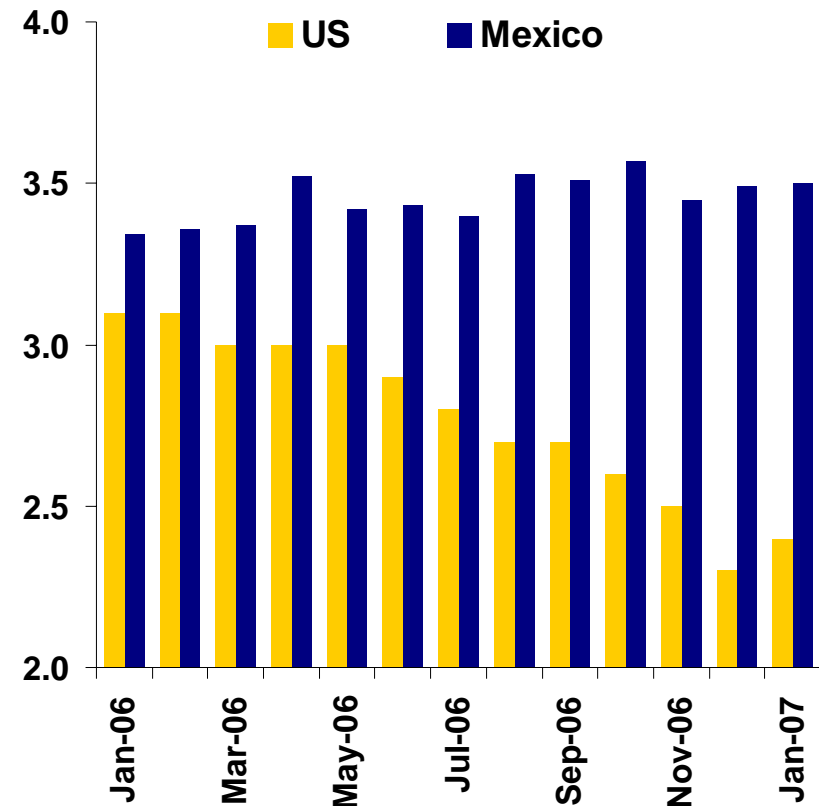
The diminished correlation of economic activity between Mexico and the US due to a stronger domestic demand has been incorporated into market expectations.

Expected 2006 Growth (%)



Source: Consensus Forecast and Banxico Survey

Expected 2007 Growth (%)



Source: Consensus Forecast and Banxico Survey



The Economic Program for 2007 is the first interaction between the current Administration and Congress on economic matters.

- **It is worth noting that the approval of the Economic Program was achieved with the consensus of almost all the political parties.**
- **This was a first step by the Executive branch towards setting a favorable environment to consolidate a more in depth fiscal reform with the support of all the political forces.**
- **It is a positive sign that all political parties understand the necessity to attain more sustainable sources of revenue to increase social and infrastructure spending.**

Macroeconomic Outlook, 2006 – 2007^{e/}

	2006		2007
	Economic Policy Guidelines*	Observed	Estimated
Gross Domestic Product (real annual change)	3.6	4.8	3.6
Inflation (Dec/Dec)	3.0	4.1	3.0
Interest Rates			
28-day Cetes (% , nominal average)	8.9	7.2	6.8
28-day Cetes (% , real average)	6.1	3.0	3.9
Public Balance (% of GDP)	0.0	0.2	0.0
Crude Oil Price (dollars per barrel)	36.5	53.1	42.8
Current Account Deficit (% of GDP)**	-2.2	-0.2	-2.3
Oil Export Platform (million barrels per day)	1,868.0	1,810.0	1,648.0

*/ Economic Program for 2006 approved by Congress.

**/ Expected

Some measures that contribute to fiscal simplification, foster voluntary compliance and facilitate the regularization of taxpayers, are:

- Increase the minimum level of income by which a personal income tax declaration is required.
- Create a stimulus for the correct compliance with monthly payments.
- Develop a focalized program for the reorganization of outstanding fiscal credits.
- Exclude un-complying taxpayers from subsidies.
- Prevent the inadequate use of fiscal losses and allow the revision of fiscal years when those losses originated.
- Allow the fiscal authority to correct, only once, any legal vices.
- Make consultations public and informative while maintaining the legal security of taxpayers acting in good faith.

The Federation's Expenditure's Budget for 2007 is characterized by the following features:

- An important restructuring of public spending that emphasizes spending on infrastructure, security, social spending and economic development.
- An effort to improve the allocation and design of the Government's programs.
- Special attention to transparency and accountability in public spending.
- An austerity agenda.

In case of a sustained decrease in oil prices, elements incorporated in the budget would be put to use in order to absorb part of this shock.

- The resources from the Oil Revenue Stabilization Fund can be used to cover the approved spending in the budget.
- The budget decree includes an item that accounts for 35 billion pesos of additional resources to the Fund that comes from the Right on Hydrocarbons for the Stabilization Fund.
- Excess revenues that are generated from other sources and do not have a specified allocation in the law, can be used to compensate a fall in oil revenue.



In order to propose a fiscal reform, some pre-requirements are needed:

- On the expenditures side:
 - Reinforcing transparency and accountability.
 - Guaranteeing a more efficient use of resources.
 - Allocating more resources to social and economic development spending.
- On the revenue side:
 - To attend the claim that not everybody pays taxes, promoting a fair tax burden and reducing fiscal evasion.

Some of these pre-requirements are included in the Economic Program for 2007.

Going further, the fiscal reform that we would like to implement should include the following elements:

- The diversification of the revenue structure that helps to reduce the vulnerability of public finances to oil price volatility and to possible future reductions in the oil production platform.
- The relation between the Federation and the Federal entities should be set on a more solid base.

In addition to the fiscal reform, a reform to the public sector workers' pensions is needed. It would allow:

- Guaranteeing the solvency of the system,
- Providing greater mobility between the public and private sectors,
- Fostering the development of the financial sector.



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