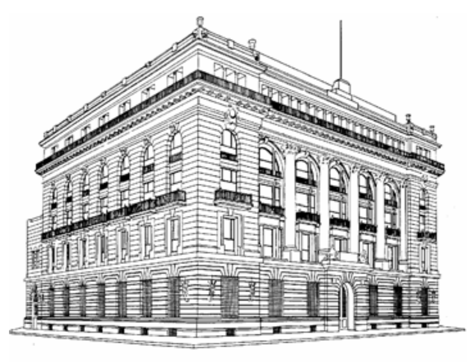
Annual Report Summary

2007



BANCO DE MEXICO

APRIL 2008

I. Introduction

The world economy exhibited robust growth during 2007, although economic activity in the U.S. was less vigorous than in 2006, particularly towards the last quarter of the year. World inflation rebounded, mainly as a result of increases in energy and food prices, while in some emerging economies inflation was also driven by the growth of domestic demand.

Liquidity conditions in international financial markets remained loose during the first half of 2007. Nonetheless, problems in the subprime sector of the U.S. mortgage market worsened during the second half of the year, generating a crisis in its financial markets, as well as in those of other advanced economies. Although the subprime mortgage market is relatively small, the crisis had a significant effect on institutions that were linked to it in some way, like commercial banks, bond insurers and credit rating agencies. These difficulties led to perceptions of greater global credit risk among investors as well. The crisis, therefore, brought about a tightening of general credit conditions, which affected even instruments not directly related to the mortgage problem.

In response to these events, advanced economies' central banks took different actions to reestablish order in financial markets. Such measures initially focused on supplying the markets with high amounts of liquidity and providing more flexible access to central bank financing. Once it became evident that these measures were not sufficient, additional actions were taken. Thus, in December, the U.S. Federal Reserve introduced a mechanism which supplied funds to the financial system through auctions in order to avoid some of the shortcomings of the discount window. The central banks of several industrialized economies also worked together to supply the markets with liquidity. Some of these banks, particularly the Federal Reserve, lowered their reference interest rates, while others left them on hold in an attempt to reduce the impact of tighter credit market conditions on the rest of the economy. Although this situation led to an increase in the spreads on sovereign debt instruments of emerging market economies during the second half of the year, such adjustment was smaller than that recorded during previous periods of financial turmoil.

Economic activity in Mexico grew at a slower rate in 2007 than in 2006. The Mexican economy expanded at a real annual rate of 3.3 percent in 2007, compared to 4.8 percent in 2006. Such result stemmed mainly from weaker external demand, although domestic spending also decelerated. The reduced growth of the total wage bill and lower revenues from workers' remittances contributed to the decline in private consumption. Investment also slowed, particularly private sector investment, although it still grew at a faster annual rate than GDP for the fourth consecutive year.

The development of inflation in Mexico during 2007 was influenced by increases in the international prices of various commodities, especially those used as inputs in the production of foodstuffs. Headline inflation fluctuated at around 4 percent during the first eight months of 2007 and then declined slightly during the last four months, ending the year at 3.76 percent. Notwithstanding the aforementioned, analysts' medium and long-term expectations for inflation remained relatively stable, above the 3 percent target.

In light of the above, the Board of Governors of Banco de México decided to tighten monetary conditions on two occasions in 2007. In April, Banco de Mexico's monetary policy stance was tightened as a preemptive measure in order to have a better balance in terms of inflationary risks and prevent price and wage determination processes from being contaminated by the growth in the international prices of different commodities. With this action, the overnight interbank rate rose from 7.00 to 7.25 percent. Later in October, in response to an upward revision in inflation expectations and deterioration in the corresponding balance of risks, monetary conditions were further restricted and the overnight interbank rate was raised to 7.50 percent. Such measure was designed to prevent contamination of price and wage formation processes on the one hand, and to moderate inflation expectations on the other.

II. External Conditions

In 2007, the world economy exhibited vigorous growth for the fourth consecutive year, despite the economic slowdown in the U.S. and the emergence of serious problems in the U.S. and other advanced economies' financial markets. Economic growth in the U.S. was slower than during 2006 mainly as a result of contraction in sectors related to housing construction. Economic activity also tended to slow in the Euro zone and Japan, although in a less pronounced way than in the U.S. Economic growth in emerging economies remained strong but also decelerated slightly towards the end of the year. Inflation rose in both emerging and industrialized economies during 2007. These developments mainly responded to rising energy and food prices as well as the vigorous growth of domestic demand in emerging countries. The deterioration of subprime mortgage-backed financial instruments in the U.S. led to higher risk aversion in credit markets during the second semester, which in turn caused a liquidity crisis and an increase in risk premia. The aforementioned events forced the central banks of those countries more affected to adopt diverse measures, which included supplying liquidity to the markets and, in some cases, changing their monetary policy stance. These problems resulted in higher sovereign risk spreads for emerging market economies, although such increases were smaller than during previous episodes of financial turbulence.

Prices of commodities, particularly oil and food, escalated during 2007 and became a significant source of world inflationary pressures. The price of oil surpassed previous historical maximums with the price of the West Texas Intermediate (WTI) briefly reaching 100 US dollars per barrel in November Oil prices were influenced by an increasing demand from emerging economies, political turmoil in the Middle East, the depreciation of the US dollar, and stagnation in oil supplies from OPEC member and non-member countries, among other factors. Increases in food prices mainly responded to greater consumption in high growth emerging economies, the demand for agricultural products for use in bio-fuel production, and adverse weather conditions.

Financial markets in the U.S. were subject to persistent turmoil during 2007. Since the beginning of the year concerns were voiced about rising delinquency rates on subprime mortgage loans, particularly the segment subject to adjustable interest rates. Subprime mortgage borrowers and the investors who bought such mortgages were most directly affected by the collapse of this market. However, despite the relatively small size of the subprime mortgage market, the influence of different factors caused that this crisis had a substantial impact on other financial markets.

Central banks affected by the subprime mortgage crisis responded in different ways during 2007. Such measures included injecting liquidity to financial markets, making the conditions of access to central bank financing more flexible, concerting actions among several of them and changing their monetary policy stance.

In the first phase, the measures adopted by central banks, including the Federal Reserve and the European Central Bank (ECB), focused on supplying considerable amounts of liquidity to financial markets. These measures were then supported by efforts in other areas. Thus, in the middle of August the U.S. Federal Reserve cut its discount rate by 50 basis points (thereby reducing the margin between this rate and the federal funds rate to half a percentage point) and increased the term of financing through the discount window. This measure also allowed banks to request resources from the Federal Reserve using a wider range of collateral than that required in open market operations. Later, in September, the Federal Open Market Committee reduced its target for the federal funds rate by 50 basis points.

These initial measures had a positive impact on the markets. Nevertheless, the announcement of considerable losses in commercial banks and bond insurers led to a new episode of turbulence at the end of 2007. Under such context, the Federal Reserve announced in December a new instrument to supply funds to the financial system known as Term Auction Facility (TAF), which had the objective of overcoming some limitations of the discount window. Additionally, the central banks of several advanced economies coordinated efforts to supply liquidity. As part of such measures, foreign exchange swap lines were established between the Federal Reserve, the European Central Bank, and the Swiss National Bank in order to ensure the availability of US dollar liquidity. Furthermore, some central banks, including the Federal Reserve, the Bank of England and the Bank of Canada, cut their reference interest rates, while the ECB and the Bank of Japan left theirs unchanged. The U.S. government also introduced a series of measures designed to prevent increases in moratorium interest rates and foreclosures on mortgage loans.

Although these measures once again calmed the markets and lowered risk premia, they did not provide a definite solution to the problem. Thus, the differential between interbank rates and yields on government bonds remained high towards the end of 2007. As a result, the difficulties in international financial markets significantly increased the risks of economic slowdown, particularly in the U.S.

In 2007, the Japanese and Euro economies grew at a vigorous pace, although at a slower rate than that registered during the previous year. Economic growth in the Euro area weakened towards the end of the year due to the difficulties in financial markets and the impact of high oil prices on real disposable income. GDP growth in Japan resulted from solid investment and strong exports, in a context of relatively weak consumption expenditure.

The difficulties in international financial markets during 2007 had a less significant impact on emerging economies than during previous episodes of turmoil. This is partly explained by improved economic fundamentals in such countries during recent years, as well as by the favorable trajectory of their terms of trade. Furthermore, in general, these economies' financial institutions are not significantly exposed to subprime mortgage-backed assets. Capital flows to emerging economies remained at high levels despite episodes of nervousness. Although these countries' stock markets suffered contagion from events in advanced economies, they still exhibited gains at the end of the year. For the first time in several years, sovereign risk spreads for emerging economies followed an upward trend during 2007 -after having reached historically lows in the middle of the year- as a result of increased global risk perceptions. Nonetheless, in historical terms sovereign risk spreads were still relatively low.

III. Developments in the Mexican Economy: General Overview

III.1. Economic Activity

In 2007, the performance of the Mexican economy was mainly characterized by the following:

a) Both domestic and external aggregate demand as well as GDP grew at a lower rate than in 2006.

b) Although the private consumption component of aggregate demand decreased, it continued to make the largest contribution to real GDP growth, followed by gross capital formation. The slower expansion of consumption expenditure responded to several factors among the most important of which were: although financing for consumption continued to grow at high annual rates, these were below those recorded in the previous year; the reduction in the real annual growth of the total wage bill; the significant slowdown in inflows from workers' remittances; and Mexico's business confidence and climate indicators weakened along with forecasts for economic growth. The latter might have had a negative impact on private expenditure.

c) Investment outpaced economic growth for the fourth consecutive year. The latter resulted from increases in both public and private investment expenditure. Imported capital goods registered the highest growth among the components of investment expenditure.

d) Total public expenditure was higher in 2007 than in the previous year mainly due to a significant increase in investment expenditure. This result was favored by increased public revenues, resulting from higher oil prices.

e) Exports of goods and services made the largest contribution to the decline in the annual growth of aggregate demand. Such result mainly reflected the deceleration of demand from the U.S.

f) Economic growth was higher in the non-tradable goods sector than in the tradable goods sector.

III.2. Employment, Earnings, and Productivity

The slowdown of economic growth in 2007 compared to that registered during 2006 led to a deceleration in the demand for labor, particularly in the formal sector.

The most relevant aspects of the labor market during the year were:

a) Although there was a significant rise in the number of workers insured by the IMSS, such increase was lower than that recorded in 2006.

b) Formal employment growth was more evident in temporary jobs than in permanent jobs in urban areas.

c) The number of workers insured by the IMSS increased more in the services sector than in the industrial sector.

d) The improvement of formal employment did not translate into a shortage of skilled labor.

e) The proportion of the population in informal employment and the underemployment rate remained high throughout the year.

f) The main indicators for earnings exhibited mixed growth. According to the results of the National Employment Survey (*Encuesta Nacional de Ocupación y Empleo*, ENOE), nominal earnings recorded lower average growth than during 2006, while the IMSS reference wage and contractual wages rebounded.

g) Average output per worker calculated using information from the ENOE and Mexico's National Accounts System grew at a lower rate than in 2006.

III.3. External Sector

The less vigorous growth of aggregate demand and GDP during 2007 translated into a modest deficit in the current account of the balance of payments, measured as a proportion of GDP. In 2007, the external sector was characterized by the following:

a) Non-oil exports grew significantly, although at a slower rate than during 2006. Such result reflected the deceleration of external demand from the U.S., which also affected automotive exports. Exports to other markets remained strong, leading them to increase their participation in total non-oil exports. These developments were influenced by the depreciation of the peso vis-à-vis non-US dollar main currencies.

b) The value of oil exports reached unprecedented levels in response to considerably higher crude oil prices which prevailed in international markets throughout most of the year. Nevertheless, the expansion of such exports was surpassed by the growth of oil imports, implying a reduction in the oil trade balance as compared with that observed in 2006.

c) A significant annual growth of merchandise imports but smaller than the one shown in 2006. This result responded to the deceleration of GDP and aggregate demand during the year.

d) Inflows of workers' remittances grew at a considerable slower rate, a slowdown experienced by several Mexican states.

e) Capital account surplus due to the net result of the following: significant inflows from foreign investment, external financing channeled to the private sector, and also to investment projects known as Pidiregas; outflows associated to public sector's payments of foreign debt; and, increases in Mexican assets held abroad.

f) The amount of foreign direct investment was the second highest in the Mexican economy's history, surpassed only by that recorded in 2001, which included a large acquisition in the banking sector.

g) Significant increase in net international reserves.

III.4. Public Finances

In line with its goal to maintain equilibrium in the fiscal balance, the public sector recorded an economic surplus equivalent to 0.01 percent of GDP in 2007. The fiscal balance was achieved with higher budgetary revenues and expenditures than those originally programmed, due to the fact that excess revenues led to a similar increase in public expenditure according to mechanisms defined in the Federal Budget and Fiscal Responsibility Law (*Ley Federal de Presupuesto y Responsabilidad Hacendaria*, LFPyRH) and the Federal Revenues Law (*Ley de Ingresos de la Federación*) for 2007 (LIF-2007).

In 2007, budgetary revenues equaled 25.5 percent of GDP (2,485.6 thousand million pesos). During 2007, higher non-oil revenues were attained, representing a change in the trend followed by public revenues in recent years.

In 2007, budgetary revenues were 247.2 thousand million pesos (2.5 percent of GDP) higher than those programmed in the 2007 Federal Revenues Law. As a result, in 2007, public expenditure surpassed its programmed level by 244.6 thousand million pesos (10.9 percent). Excess revenues and the rules governing their application meant that more programmable expenditures were channeled to capital expenditure than those observed during previous years.

In 2007, budgetary expenditures accounted for 25.4 percent of GDP (2,483.0 thousand million pesos). Public expenditure grew 5.9 percent in real terms compared to 2006 due to an increase in programmable expenditures (10.0 percent at constant prices), particularly on capital expenditures.

III.5. Monetary and Credit Aggregates

At the end of 2007, the monetary base was 494.7 thousand million pesos. During the same year, the monetary base grew, on average, 12.7 percent at an annual rate, figure below the 16.2 average percent growth observed in 2006. The decline in the expansion of monetary base responded to the economic slowdown and the dissipation of temporary factors which took place in 2006, such as the increased use of money that usually occurs during federal elections.

In 2007, net international assets rose by 10.931 billion US dollars; thus their stock at December 31, 2007 was 87.235 billion US dollars. The monetary base grew by 44,922 thousand million pesos during 2007. As a result, Banco de México's net domestic credit decreased by 73,562 million pesos during the year.

In 2007, in a context of economic slowdown, monetary aggregates expanded at lower rates than in 2006. The monetary aggregate M1 recorded a nominal annual average variation of 9.7 percent, figure 5.9 percentage points below previous year's figures. The slower growth rate of the narrow monetary aggregate was mirrored by all of its components. The monetary aggregate M2, which includes M1 and residents' financial savings, grew at a real annual average rate of 6.3 percent, 4.2 percentage points below 2006 figures. The monetary aggregate M4 registered a real average annual variation of 7.2 percent in 2007, compared to real average growth of 11.1 percent in 2006. The latter resulted from the abovementioned slower rate of growth in residents' financial savings (M2), which was partly offset by the stronger performance of foreigners' financial saving.

The expansion of financing to the private sector observed during recent years continued in 2007. In December 2007, total financing to the non-financial private sector accounted for 32.6 percent of GDP, two percentage points higher than in December 2006. After having grown at a real annual rate of 15.5 percent in 2006, such aggregate recorded an average annual variation of 9.6 percent in 2007.

Credit to households (both consumption and mortgage) was less vigorous than during previous years. Total financing to households grew 8.9 percent at a real annual rate and accounted for 14.7 percent of GDP, while financing to consumption recorded a real annual variation of 18.1 percent (28.9 percent in 2006) and represented 5.4 percent of GDP.

Total financing to firms registered a real annual variation of 10.2 percent and accounted for 18 percent of GDP in December 2007. Such growth can mainly be explained by the increase in domestic sources of funds, particularly credit granted by commercial banks. Thus, in 2007, domestic financing to non-financial private firms recorded a real annual variation of 16.4 percent, its highest growth in recent years. Commercial bank credit to firms grew 30.5 percent in real terms.

III.6. Inflation

At the end of 2007, annual headline inflation was 3.76 percent, 0.29 percentage points below the 4.05 percent observed in December 2006. In particular, average headline inflation was 4.05 percent during the first eight months of 2007, while in the last four months of the year it declined to 3.81 percent.

Throughout 2007, headline inflation was mainly influenced by three factors: first, growing processed food prices resulting from the global supply shocks which put upward pressure on prices of different commodities; second, non-core inflation remained high during the first eight months of the year and decreased in the last four months in response to the decline in agricultural prices as well as the freezing of several administered goods prices (low-octane gasoline, LP gas, and electricity); and, third, the gradual fading of supply shocks that had affected prices since the previous year, particularly the fall in the annual price variation of housing which responded to the slower rate of growth of prices of construction materials.

Annual core inflation reached 4.00 percent at the end of 2007, 0.39 percentage points above the 3.61 percent observed in 2006. The upward trajectory exhibited by core inflation throughout 2007 mainly responded to the development of the food product price subindex. However, increases in the latter index were partly offset by the lower growth rate of the services price subindex, especially the core group of housing-related services.

The decline in annual non-core inflation between December 2006 and December 2007 (from 4.96 to 3.27 percent) responded to the pattern followed by the prices of agricultural products and administered and regulated goods, which decreased throughout the year.

IV. Monetary and Exchange Policy

IV.1. Monetary Policy

The Board of Governors of Banco de México tightened monetary conditions on two occasions during 2007. The first of such restrictions took place in April, after the Board had kept monetary conditions unchanged from May 2006 to March 2007. With this action the overnight interbank interest rate rose from 7.00 percent to 7.25 percent at the end of April 2007. It continued at this rate until October, when the Board tightened monetary conditions once again by 25 basis points. On this occasion the overnight interbank interest rate rose to 7.50 percent, remaining at such level for the rest of the year.

In 2007, inflation in Mexico was adversely affected by several supply shocks that mainly originated from significant increases in the international prices of different food products. These shocks were persistent and of considerable magnitude and prompted a raise in both headline and core inflation due to their significant influence on CPI prices.

Banco de México follows a wide set of indicators and statistics to evaluate the current conditions that affect inflation and its outlook. From the results it can be inferred that supply shocks concentrated on the prices of certain items, that is, the rebound in food price inflation in 2007 apparently did not affect significantly the prices of other items. Supply shocks affected more short-term inflation expectations and less significantly the price determination process and medium and long-term inflation expectations.

The previous analysis reveals that monetary policy faced a complex situation during 2007. On the one hand, available information suggests that no generalized inflationary pressures from the demand-side existed. Long-term inflation expectations remained relatively stable and wage negotiations did not show signs of contamination. On the other hand, however, the persistence of the supply shocks affecting food inflation was a main cause of concern.

Under this context, in April, Banco de México's Board of Governors decided to tighten monetary conditions by 25 basis points as a preemptive measure. With this action, the overnight interbank rate rose to 7.25 percent at the end of April. This more restrictive monetary policy stance was adopted in order to accomplish a better balance of risks for inflation, in particular, to prevent the supply shocks that had taken place from affecting the price and wage determination process.

Later in the Inflation Report of July-September 2007, Banco de México revised upwards its forecasts for inflation for the following quarters. This revision was partly due to the prevision that inflation would reach high levels in some quarters in response to the effects of supply shocks on food prices. Additional upward pressures on inflation were expected as some firms might try to pass on to consumers the cost associated to the tax raises approved by Congress in 2007 and which would come into force in 2008. Nonetheless, such adjustments to overall price levels were expected to occur only once and their effect on inflation would, thus, be temporary. It is important to mention that previsions for inflation included in this report and in the future cover a two-year moving horizon (eight quarters).

In October 2007, after taking into consideration the upward revision in its forecasts for inflation and the corresponding risks, the Board of Governors of Banco de México decided to tighten monetary conditions by 25 basis points for the second time during the year. The aim of this restriction was to contribute, on the one hand, to prevent the process of price and wage determination from being contaminated and, on the other, to moderate inflation expectations.

The performance of the yield curve in Mexico was determined by both the effects of monetary policy actions and the conditions prevailing in international financial markets. On the one hand, the Board of Governors' decision to tighten monetary conditions by 25 basis points at the end of April and October led to an increase in short-term yields. On the other hand, in a context in which global risk appetite declined in response to problems in the U.S. mortgage market, medium and long-term interest rates increased during the second half of 2007. In particular, after the tightening of monetary conditions in April, the yield curve "flattened" during the second quarter of the year. The curve followed a similar pattern after the short-term rate was raised by 25 basis points in October. Nonetheless, the yield curve reverted and "steepened" during November and December in response to the increase in longer term interest rates mainly as a result of the decline in risk appetite in international markets.

The referred increase in interest rates in Mexico together with the reduction in interest rates for all terms in the U.S., contributed to raise significantly the interest rate differentials between both countries. Most of this increase took place during the second half of the year, when problems in the U.S. mortgage market worsened.

Given the reduction in appetite for risk in international financial markets during the last few months of 2007, domestic financial markets adjusted, in general, in an orderly fashion compared to other episodes of turmoil in international markets. This result is due to multiple factors, such as the improvement in the perception of sovereign risk, and the development and consequent deepening of the Mexican Exchange and Money markets.

IV.2. Exchange Policy

The favorable conditions prevailing in international financial markets during recent years continued in the first half of 2007. However, in the second half of the year there was a transition to an environment of greater volatility characterized by reduced appetite for risk among investors. This situation led to tighter credit market conditions which were reflected in an increase in emerging economies' sovereign debt spreads and in the differentials between these economies' interest rates and those of the U.S.

In an environment where international prices of different commodities rose and the differentials in interest rates increased as compared to the U.S., the exchange rates of several emerging economies with a significant share of commodities in their exports tended to appreciate during 2007. This was the case of Brazil, Colombia, and Chile. Unlike the aforementioned countries, Mexico's exchange rate depreciated during 2007 because it mainly exports manufactured goods.

V. Final Remarks

The world economy grew at a fast rate in 2007, although economic activity in the U.S. slowed significantly towards the end of the year. Worldwide inflationary pressures increased as a result of rising energy and food commodity prices in international markets. This situation was exacerbated in emerging economies by the high weight of foodstuffs in their consumption baskets and, in some cases, by the vigorous growth of domestic demand. The crisis in some advanced economies' financial markets during the second half of the year had less of an impact on emerging markets than in previous episodes of financial turmoil. The aforementioned partly resulted from more solid economic fundamentals, improvements in these countries' terms of trade, and their reduced exposure to problems in the U.S. subprime mortgage market.

In 2007, the Mexican economy grew at a slower pace than in 2006. Such performance mainly originated from the deceleration of external demand, although the growth of domestic expenditure also weakened. GDP grew 3.3 percent (4.8 percent in 2006) as a result of improvements in all three of its components, but particularly in the services sector. The industrial sector exhibited modest growth (1.4 percent), due to reduced expansion in the manufacturing industry which, in turn, responded to slower external demand. The slowdown in economic activity during 2007 reduced the demand for labor.

In 2007, inflation in Mexico was affected by the rise in world food inflation. The increase in international prices of grains and dairy products had a significant impact on the domestic prices of various food products that use them as raw materials. Inflationary pressure was partly offset by the fading of the supply shocks that occurred during 2006, particularly the disinflation of housing prices as prices of construction materials declined. Furthermore, the annual variation of the non-core index followed a lateral pattern during the first eight months of the year and decreased during following months. Thus, the relatively high level of inflation during 2007 did not significantly affect the economy's price and wage formation processes.

Under this context, Banco de México’s Board of Governors decided to tighten monetary conditions on two occasions during 2007. In April, the Board tightened its monetary policy stance as a preemptive measure in order to accomplish a better balance of risks for inflation and prevent the supply shocks that had taken place from affecting price and wage determination processes. In October, the monetary policy stance was tightened for a second time in response to upward revisions in the prospects for inflation and a deterioration in the balance of risks associated to these prospects. This measure was designed to prevent any possible contamination of the price and wage formation processes and to help moderate inflation expectations.