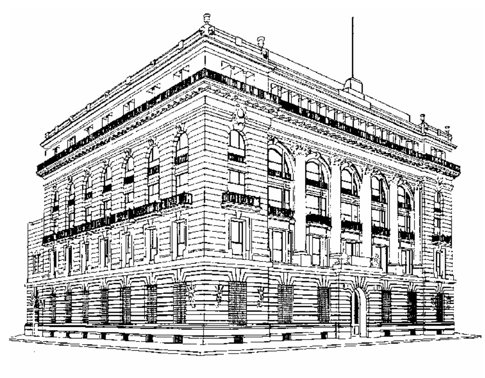
Inflation Report
October – December 2004
and
Monetary Program
for 2005



BANCO DE MEXICO

JANUARY 2005

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FOREWARNING

Unless otherwise stated, this document has been prepared using data available as of January 28, 2005. Figures are preliminary and subject to change.

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Inflation Report October-December 2004

I. Introduction

The world economy continued to grow at a favorable pace in 2004. Despite the fact that the global economy is expected to exhibit a slight reduction of its growth rate, forecasts for 2005 remain positive.

In particular, the U.S. economy is anticipated to grow closer to its potential rate. Despite the fact that aggregate demand is expected to grow at a slower rate than in the previous year, both consumption and investment are expected to follow favorable paths. Furthermore, U.S. industrial production continues to expand and is anticipated to grow at a higher rate than GDP. Headline CPI inflation is expected to decline, while core CPI inflation is expected to stabilize at nearly the same level observed at the end of 2004. Based on most recent information, no significant inflation pressures are foreseen in the short term.

In general terms, international financial markets exhibited reduced volatility, plenty liquidity, and a significant search for higher yields during 2004. This was based on a favorable growth scenario, reduced inflation pressures worldwide -except for price increases in several commodities, including the significant increase in crude oil prices- and the improvement in both U.S. corporate gains and in emerging markets' credit standing.

Such conditions prevailed despite the fact that by mid-year the Federal Reserve Board began its cycle of monetary policy actions to withdraw the monetary stimulus. Such decisions were due, among other factors, to the fact that U.S. core CPI inflation and its expectations have been relatively contained, which, therefore, has enabled U.S. monetary policy actions to be implemented at a moderate pace. In contrast with previous cycles, when the Federal Reserve has tightened its monetary policy stance, on this occasion, interest rates for longer terms have remained at relatively low levels.

Under such conditions, Mexico's economic activity grew at an annual rate of 4.7 percent during the fourth quarter of 2004. The strength of the demand for Mexican exports and the availability of resources that have promoted domestic expenditure deserve mention. Regarding the latter, the most significant have been oil revenues and workers' remittances, and the pace at which consumption and mortgage credit have been growing. Such environment has sustained the proper conditions that fostered the continued growth of consumption at a vigorous pace and the consolidation of the recovery of investment. Industrial and manufacturing production expanded, therefore contributing to job creation. Nonetheless, the rate of growth of employment eased during the fourth quarter of 2004.

The external environment affected the path of headline CPI inflation in Mexico. In particular, during 2004 the contribution of several Asian economies, especially the Chinese, to world GDP growth continued to increase. The expansion of such economies has been characterized by their intensive use of energy, metals and other raw materials, as well as a considerable increase in several food imports. Consequently, such commodity prices were subject to significant pressures in international markets, therefore affecting headline CPI inflation. Given their nature, the abovementioned supply shocks mostly affected CPI's non-core component and the food items of the core merchandise price subindex.

Furthermore, during the fourth quarter of 2004, different weather-related factors changed supply conditions of many fruits and vegetables in Mexico and the U.S. The hurricanes that hit the East Coast of the U.S. affected many fruits and vegetables' crops significantly. In particular, tomato prices were subject to considerable pressures, which began to ease in December.

As for the outlook for inflation in 2005, two issues must be underlined:

(a) First, commodity prices are expected to exhibit a more favorable behavior.

(b) Second, regarding inflation pressures from the demand side, given that the economy is currently at the upper phase of its growth cycle, idle productive capacity in different sectors continues to narrow. This could foster the conditions for a greater number of producers to raise their prices more easily. Furthermore, it is more likely that sequels to the supply shocks that affected inflation in 2004 appear under such environment. This is particularly relevant during the first months of the year, when the different price subindexes that make up the core consumer price index exhibit high seasonality because producers of many goods and services usually concentrate their price revisions at the beginning of the year.

Under such context, it is important to mention that despite the growth of different components of expenditure, no significant inflation pressures from the demand side are envisioned. Nonetheless, it is clear that the Central Bank will continue to face significant challenges regarding inflation in 2005: i) core CPI inflation apparently has stabilized, although at relatively high levels; ii) core services' inflation excluding housing has exhibited downward resistance; in fact, in recent months it has rebounded due to the price increases in food and crude oil; and iii) core CPI inflation and its expectations suggest that the long-term inflation target has not been incorporated yet into the price determination process in a widespread fashion.

Consequently, Banco de México will remain attentive so that no sequels to the significant rebound in inflation in 2004 arise. In particular, it will monitor inflation pressures that could originate from the demand side and from wage negotiations in order to foster monetary conditions that facilitate the convergence of inflation to its target.

II. Recent Developments and Main Determinants of Inflation October-December 2004

II.1. Recent Developments in Inflation

At the end of the fourth quarter of 2004, annual headline CPI inflation closed at 5.19 percent, 1.21 percentage points above that recorded at the end of the previous year. During the same comparison period, annual core CPI inflation and non-core CPI inflation rose by 0.14 and 3.54 percentage points, respectively.

The main inflation pressures observed during 2004 originated from commodity price increases in international markets. This was due mainly to the fact that during the current cyclical recovery of the world economy, certain economies, especially the Chinese, increased their share in world growth. The expansion of such economies has been characterized by their intensive use of energy, metals and other raw materials, as well as a considerable increase in several food imports. Given their nature, the abovementioned supply shocks mostly affected CPI's non-core component and the food items of the core merchandise price subindex. In this regard, the following deserves mention:

(a) The increase in international energy prices affected administered prices negatively: their annual growth rose from 6.11 percent at the end of 2003 to 10.02 percent in December 2004. Household-use gas prices exhibited a significant increase in their annual growth rate: from 7.75 to 18.27 percent during the referred period.[1]

(b) The annual growth rate of livestock good prices rose from 8.34 percent at the end of 2003 to 12.69 percent at December 2004. Such prices were affected by three factors: an increase in global demand for this type of goods; sanitary problems that led to a reduction in world beef production, which, in Mexico, was heightened by authorities' restrictions on beef imports; and higher production costs originated by the price increase in grain forage for cattle.

[1] CPI's item "household-use gas" is composed of liquid propane gas (95 percent) and natural gas (5 percent).

(c) Among other factors, price increases in both livestock products and several grains and cereals, which are used as raw materials for many processed foods, affected the latter's prices. This was reflected in a significant rise in processed food prices within the core merchandise subindex, which increased their annual growth from 4.70 percent in December 2003 to 7.04 percent at the end of 2004 (Table 1).

Table 1 **Consumer Price Subindexes**

Annual variation and contribution (percent)

	Dec-2003/ Dec-2002 Variation	Dec-2003/ Dec-2002 Contribution 3/	Dec-2004 Dec-2003 Variation	Dec-2004 Dec-2003 Contribution 3/	Contribution Difference 3/
CPI	**3.98**	**3.98**	**5.19**	**5.19**	**1.2140**
Core	**3.66**	**2.51**	**3.80**	**2.59**	**0.0818**
Merchandise	**2.62**	**0.95**	**3.87**	**1.38**	**0.4345**
Food	4.70	0.68	7.04	1.03	0.3463
Other	1.24	0.27	1.69	0.36	0.0882
Services	**4.84**	**1.56**	**3.72**	**1.21**	**-0.3527**
Housing	4.12	0.73	3.70	0.66	-0.0747
Other	5.72	0.83	3.74	0.55	-0.2780
Non-core	**4.66**	**1.47**	**8.20**	**2.60**	**1.1322**
Agriculture	**3.65**	**0.31**	**10.11**	**0.85**	**0.5436**
Fruits and vegetables	**-2.36**	**-0.09**	**6.43**	**0.22**	**0.3114**
Tomato	0.30	0.00	23.24	0.15	0.1509
Other 1/	-2.97	-0.09	2.51	0.07	0.1605
Livestock	**8.34**	**0.40**	**12.69**	**0.63**	**0.2322**
Beef	10.62	0.23	15.51	0.36	0.1280
Other 2/	6.42	0.17	10.22	0.27	0.1042
Administered and Regulated Prices	**3.91**	**0.69**	**7.51**	**1.32**	**0.6306**
Administered	**6.11**	**0.51**	**10.02**	**0.85**	**0.3429**
Low-octane gasoline 4/	4.74	0.14	5.42	0.17	0.0220
High-octane gasoline 4/	2.37	0.01	8.47	0.04	0.0277
Electricity	7.04	0.20	9.15	0.26	0.0669
Liquid propane gas	7.75	0.16	18.27	0.38	0.2264
Regulated	**1.90**	**0.18**	**5.13**	**0.46**	**0.2877**
Education	**8.59**	**0.47**	**7.50**	**0.43**	**-0.0419**

1/ Includes other fruits and vegetables.
2/ Includes fish, pork meat, and other meats.
3/ Partial figures may not add up due to rounding.
4/ Items High and Low Octane Gasoline include prices at border and non-border cities. In the former case, prices are determined according to the prices prevailing at the nearest city across the border. In the latter case, prices are adjusted every month according to a percentage predetermined at the beginning of the year.

(d) An increase in the subindex of regulated prices, due mainly to the rise in public transportation fares in Distrito Federal (Mexico City) and Estado de México.

(e) Price increases in several fruits and vegetables during the second half of 2004, stemming from the reduction in the supply of some of these products due to adverse weather conditions in Mexico and the U.S. (fruits and vegetables grew at an annual rate from –2.36 percent in December 2003 to 6.43 percent at the end of 2004). Tomato prices, which increased significantly, were subject to considerable pressures between August and November, which began to ease in December.

Summing up, during 2004, many supply pressures, mainly external, affected headline CPI inflation significantly.

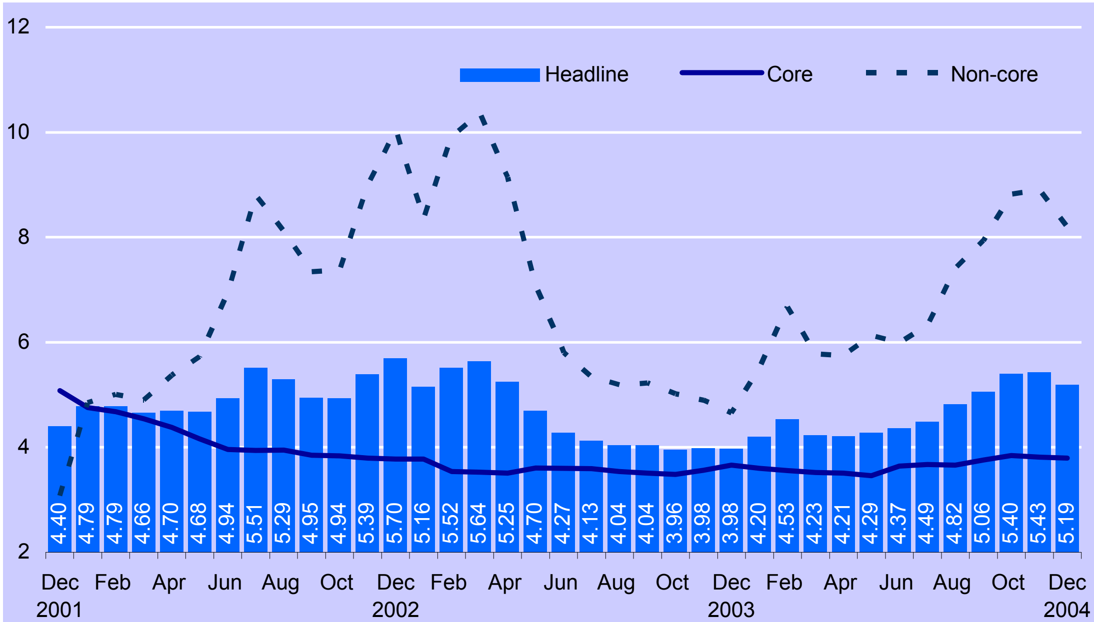
Annual core CPI inflation was 3.80 percent at the end of 2004, 0.14 percentage points above its previous year figures. This was due to differing trends within its components. The annual growth rate of the merchandise subindex increased 1.25 percent during the referred period, while that of the services' subindex partially offset such effect by falling 1.12 points. The increase in processed food prices (due mainly to the rise in the prices of many commodities that are used as inputs in food manufacturing) mostly accounted for the increase in merchandise price inflation. Regarding the services' subindex, prices of services excluding housing grew at a slower rate during the fourth quarter of 2004. Nonetheless, such rate rose in the last months of 2004.

II.2. Inflation Indicators

II.2.1. Annual Inflation

At the end of the fourth quarter of 2004, annual headline CPI inflation was 5.19 percent, 0.13 percentage points above its level at the end of September. During such period, the behavior of such indicator was influenced mainly by the increase in the annual growth rate of the non-core consumer price index (0.27 percentage points), given that annual core CPI inflation rose only 0.04 points (Graph 1).

Graph 1 **Headline, Core and Non-core Consumer Price Indexes**
Annual percentage change



II.2.1.1. Non-core Inflation

During the fourth quarter of 2004, additional supply shocks affected the non-core consumer price index. Such index was characterized by the following events:

(a) The higher annual growth rate exhibited by such indicator was driven by the increase in the prices of a small number of items, especially tomatoes and liquid propane gas (Table 2 and Box 1).

(b) The growth rate of electricity prices eased at the beginning of the quarter due to the adjustment in high consumption (unsubsidized) rates. This was due mainly to the reduction in natural gas prices during the third quarter of the year.

(c) Inflation pressures originated by the subindex of livestock good prices decreased. This was mainly due to the reduction in the annual growth rate of both egg prices (from 18.10 to 5.19 percent in the analyzed quarter) and beef prices (from 18.23 to 15.51 percent in the same period) [Graph 3].

Box 1
Contribution of the Price Variations of Tomato and Household-use Gas to Headline CPI Inflation

The increase in non-core inflation during the fourth quarter was attributed mainly to the upward movement in tomato and household-use gas prices. During such period, tomato prices grew from 12.44 to 23.24 percent at an annual rate, while household-use gas prices did so from 14.28 to 18.27 percent. The magnitude of such increments, together with the high weight of both items in the CPI (0.50 percent for tomato and 1.84 percent for household-use gas), affected headline CPI inflation significantly. In fact, the total contribution of both items was 0.16 points, higher than the increase exhibited by annual headline CPI inflation during the fourth quarter of 2004.

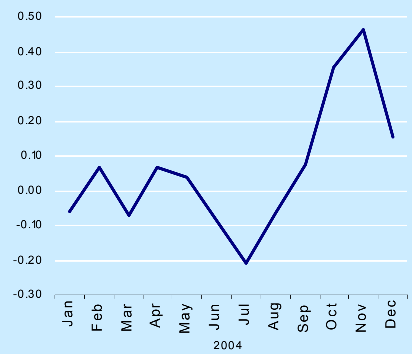
CPI's basket of weights is determined according to Mexican urban population's patterns of consumption, which are estimated based on the Survey of Household's Income and Expenditure Patterns, conducted periodically by INEGI. Even when the weight of tomato in the CPI's basket might seem high, compared with other world price indexes, Mexico's CPI basket is similar to that of other Latin American countries where the diet or income per capita is similar to that of Mexico (Table 1).

Table 1
Weight of Tomato in Different Price Indexes: International Comparison

Latin America	Weight	Rest of the World	Weight
Argentina	0.52	Germany	0.27
Brazil	0.43	Australia	0.13
Chile	0.48	Canada	0.12
Costa Rica	0.56	Spain	0.38
Mexico	0.50	United States	0.10
Nicaragua	0.52	Great Britain	0.08
Peru	0.51	Italy	0.39
Uruguay	0.49	Japan	0.08
		South Korea	0.02
		Malaysia	0.03

The upward movement in tomato prices was due to the sharp fall in its supply due to adverse weather conditions, both in Mexico and in the U.S. Such increase had a significant effect on the CPI's trajectory. The incidence of such variations reached 0.46 percentage points in November (Graph 1). In December, the supply of tomatoes began to normalize, bringing about a decline in its price. As a result, at the end of the year, such item reduced its contribution to annual headline CPI inflation by 0.15 points.

Graph 1
Incidence of Tomato Prices on Annual Headline CPI Inflation



In contrast with the sudden and short-lived effect of tomato prices on headline CPI inflation, household-use gas prices raised their contribution to headline CPI inflation throughout the year (Graph 2). The incidence of such item on annual headline CPI inflation peaked in December (0.38 percentage points). Thus, as long as household-use gas prices continue to exhibit positive monthly variations, their effect on headline CPI inflation could be long lived.

Graph 2
Incidence of Household-use Gas Prices on Annual Headline CPI Inflation

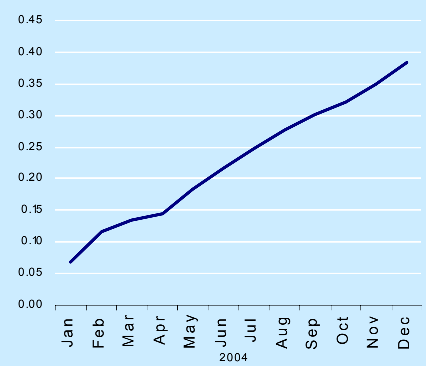


Table 2 **Consumer Price Subindexes**

Annual variation and contribution (percent)

	Sep-2004/ Sep-2003 Variation	Sep-2004/ Sep-2003 Contribution 3/	Dec-2004 Dec-2003 Variation	Dec-2004 Dec-2003 Contribution 3/	Contribution Difference3/
CPI	**5.06**	**5.06**	**5.19**	**5.19**	**0.1303**
Core	**3.76**	**2.59**	**3.80**	**2.59**	**0.0058**
Merchandise	**3.82**	**1.38**	**3.87**	**1.38**	**0.0073**
Food	6.98	1.02	7.04	1.03	0.0101
Other	1.68	0.36	1.69	0.36	-0.0028
Services	**3.69**	**1.21**	**3.72**	**1.21**	**-0.0015**
Housing	3.93	0.70	3.70	0.66	-0.0476
Other	3.40	0.51	3.74	0.55	0.0461
Non-core	**7.93**	**2.47**	**8.20**	**2.60**	**0.1245**
Agriculture	**9.99**	**0.82**	**10.11**	**0.85**	**0.0319**
Fruits and vegetables	**4.04**	**0.14**	**6.43**	**0.22**	**0.0875**
Tomato	12.44	0.07	23.24	0.15	0.0781
Other 1/	2.22	0.06	2.51	0.07	0.0094
Livestock	**14.14**	**0.68**	**12.69**	**0.63**	**-0.0555**
Beef	18.23	0.40	15.51	0.36	-0.0423
Eggs	18.10	0.11	5.19	0.03	-0.0781
Other 2/	8.44	0.17	11.93	0.23	0.0649
Administered and Regulated Prices	**7.09**	**1.22**	**7.51**	**1.32**	**0.1002**
Administered	**9.54**	**0.76**	**10.02**	**0.85**	**0.0892**
Low-octane gasoline 4/	4.24	0.13	5.42	0.17	0.0330
High-octane gasoline 4/	8.34	0.04	8.47	0.04	0.0001
Electricity	12.68	0.29	9.15	0.26	-0.0263
Liquid propane gas	14.28	0.30	18.27	0.38	0.0823
Regulated	**4.94**	**0.45**	**5.13**	**0.46**	**0.0111**
Education	**7.51**	**0.44**	**7.50**	**0.43**	**-0.0077**

1/ Includes other fruits and vegetables.
2/ Includes fish, pork meat, and other meats.
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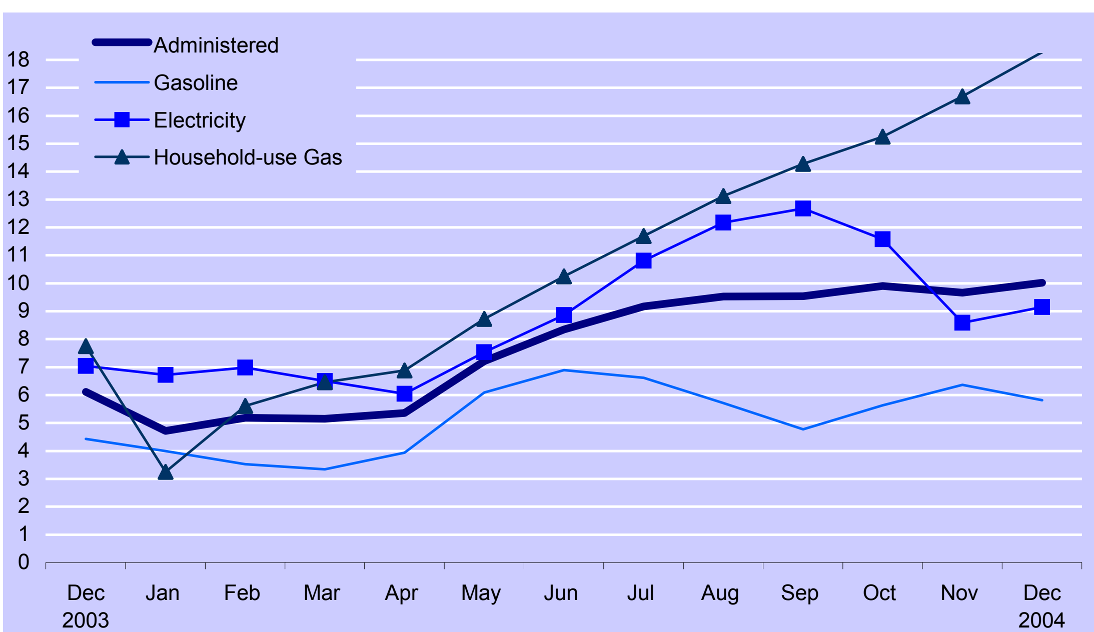
4/ Items High and Low Octane Gasoline include prices at border and non-border cities. In the former case, prices are determined according to the prices prevailing at the nearest city across the border. In the latter case, prices are adjusted every month according to a percentage predetermined at the beginning of the year.

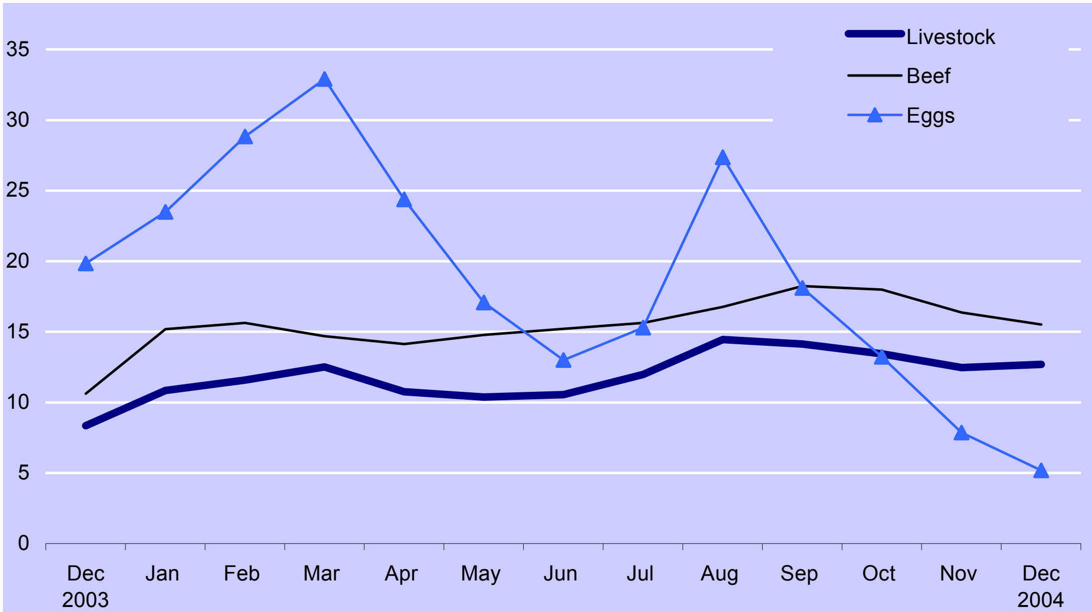
Graph 2 **Index of Administered Prices**

Annual percentage change



Graph 3 **Livestock Price Index**

Annual percentage change



II.2.1.2. Core Inflation

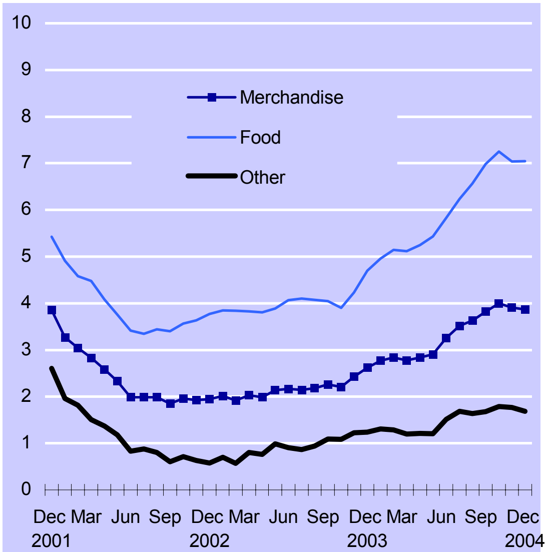
Annual core CPI inflation was 3.80 percent at December 2004, while at the end of September it was 3.76 percent. Such result was due mainly to a 0.05 percentage point increase in the annual growth rate of the merchandise subindex. The latter responded, to a great extent, to the persistent negative effects originated by the previous price increases of several commodities used as inputs in food manufacturing. Nonetheless, such effect began to dissipate in November and December, which, in turn, contributed to moderate the upward path followed by merchandise prices (Graph 4).

During the reference period, the annual growth rate of the services' price subindex rose 0.03 percentage points. As for its components, the housing subindex's annual variation fell, nearly offsetting the increase in the rest of the services' price subindex (Graph 5). The latter's annual growth rate rose from 3.40 percent in September to 3.74 percent in December. Such result was mainly attributed to the price increase in several commodities that are demanded by the suppliers of certain services included in this subindex. This is clearly reflected in the increase in air transportation fares, whose annual rate rose from 10.66 to 16.82 percent during the referred period, partially responding to the upward movement in the annual growth rate of jet fuel prices (from 18.78 to 33.25 percent in that period).

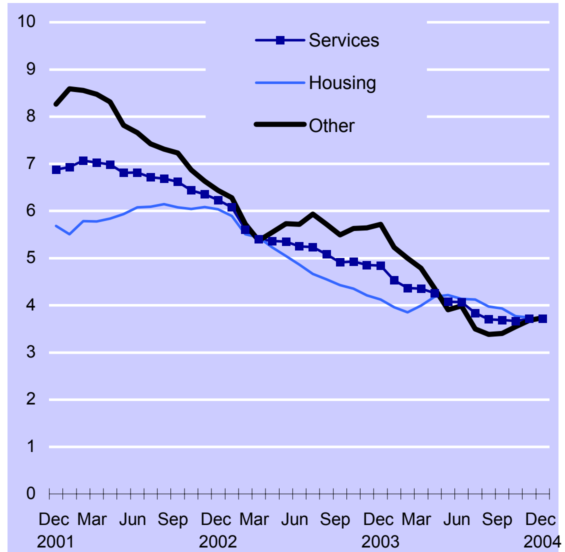
Graph 4 **Core Price Index (Merchandise and Services)**

Annual percentage change

a) Merchandise



b) Services

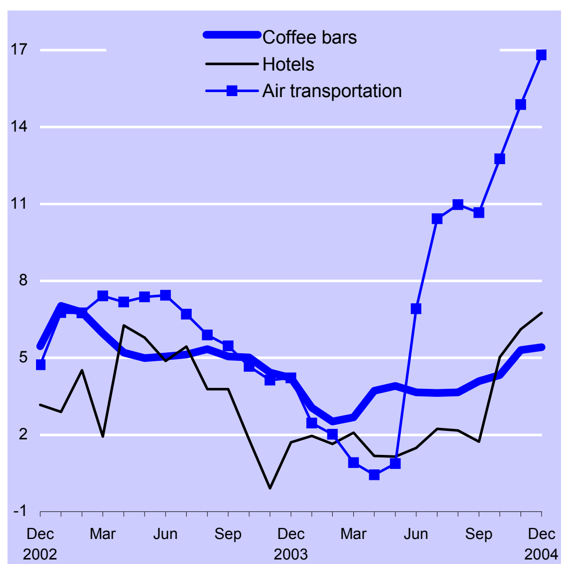


Graph 5 **Core Price Subindex (Services Excluding Housing, and Selected Items)**

Annual percentage change

a) Services Excluding Housing

b) Selected Items



II.2.2. Monthly Inflation

Monthly inflation in October, November and December 2004 was 0.69, 0.85 and 0.21 percent, respectively. In the first two months results were significantly above forecasts obtained from Banco de México's Survey of Private Sector Analysts' Forecasts prior to the beginning of the fourth quarter. The opposite results were obtained in December (Table 3). Such differences were mainly due to the volatility in non-core CPI inflation.

Table 3 **Monthly Inflation (Observed and Expected)**

Percent

	2003				2004			
	Observed			Expected 1/	Observed			Expected 1/
Month	Non-core	Core	CPI	CPI	Non-core	Core	CPI	CPI
October	0.64	0.24	0.37	0.37	1.47	0.33	0.69	0.35
November	2.00	0.30	0.83	0.56	2.08	0.27	0.85	0.62
December	0.66	0.32	0.43	0.50	0.01	0.30	0.21	0.37

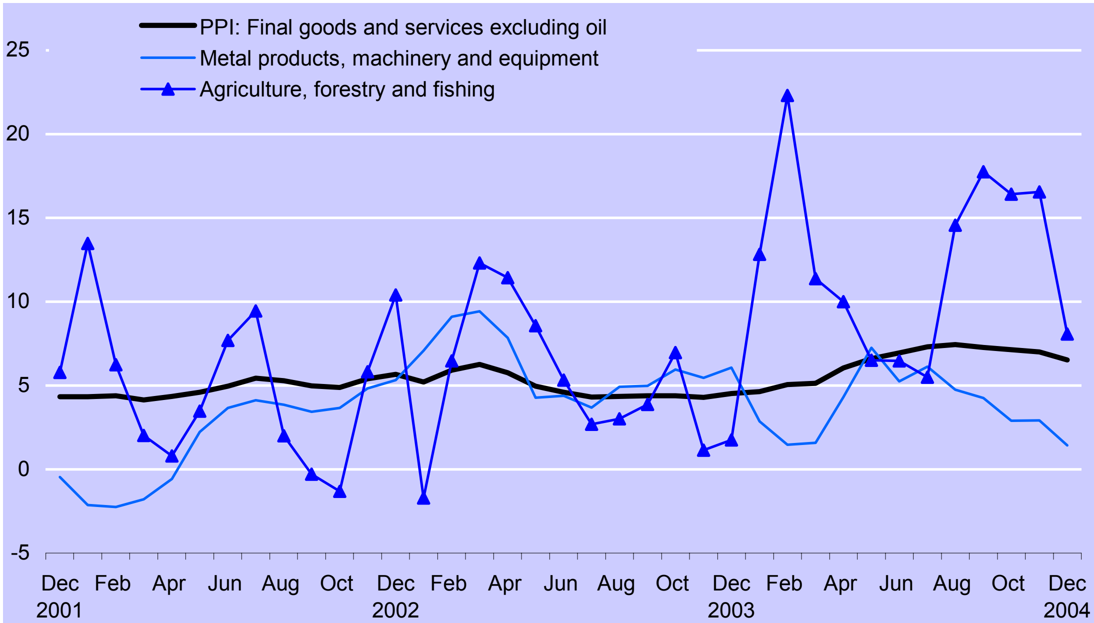
1/ Inflation expected at the end of the previous quarter according to Banco de México's Survey of Private Sector Economic Analysts' Forecasts.

II.2.3. Producer Price Index (PPI)

In December 2004, the annual growth rate of the PPI of merchandise and final services excluding oil was 6.52 percent, 0.75 percentage points below the corresponding figure in September. Such result was driven by the decline in the annual growth rate of two subindexes: agriculture, and metal products, machinery and equipment (Graph 6). In the case of the former, the items tomato, fresh chili peppers, eggs, lemon and onion contributed significantly to the decline in such rates. This reflects the normalization in the supply of such goods exhibited at the end of the year. Regarding metal products, machinery and equipment, prices of automobile, computers, and export trucks exhibited a significant reduction in their annual growth rate.

Graph 6 **Producer Price Index**

Annual percentage change



II.3. Main Determinants of Inflation

II.3.1. International Environment

The world economy continued to recover during the fourth quarter of 2004, despite the additional increase in crude oil international prices to new historically high levels. Global growth was driven mainly by the strength of economic activity in the U.S. and the East Asian emerging economies. Economic growth in the euro area and in Japan continued to be affected by the appreciation of their currencies and the increase in oil prices, among other factors. On another front, the most significant aspects characterizing financial and foreign exchange markets were the continuing gradual withdrawal of the monetary stimulus in the United States and the significant depreciation of the US dollar against other major currencies. An expanding world economy along with ample liquidity, investors' search for higher yields, and the improvement in many emerging countries' economic conditions led to a strong rebound in the issuance of bonds of such countries, and to a fall in their sovereign debt spreads to historically low levels. Despite the fact that forecasts point to a moderate slowdown in world economic growth for 2005, the favorable external conditions are expected to continue to prevail. Such scenario faces many risks, including the possibility of new surges in crude oil prices, an increase in interest rates in the U.S. at a faster pace than anticipated, and those deriving from high fiscal and current account deficits in that country.

II.3.1.1. Oil Prices

Oil prices exhibited high volatility during the fourth quarter, due to the expansion of world demand for crude oil and its by-products in a context of uncertainty regarding oil supply conditions. After having reached historically high levels on October 22, 2004 (the WTI reached 55.83 US dollars per barrel on that date), crude oil prices fell sharply as a result of an increase in inventories in OECD member countries, particularly in the U.S. This downward trend was interrupted in mid-December amid renewed fears of cold temperatures in the northern hemisphere and in the context of OPEC's decision to cut its production quota to one million barrels per day starting January 1, 2005. The average price of the WTI rose from 43.88 US dollars per barrel in the third quarter to 48.30 in the fourth, reaching 43.36 US dollars per barrel at the end of the year. The Mexican crude oil export mix averaged 33.34 US dollars in the fourth quarter, a figure similar to that observed during July-September (28.80 US dollars per barrel at the end of December).[2]

II.3.1.2. Developments in the U.S. Economy

After having weakened during April-June, U.S. economic activity strengthened during the third quarter of 2004. GDP grew 4.0 percent both at an annualized quarterly rate and at an annual rate, fueled by all components of domestic demand[3] except for inventories, which, for the first time in several quarters, contributed negatively to GDP growth. Consumption recovered from the atony exhibited during the second quarter, while fixed private investment continued to grow at a faster rate than consumption (8.8 and 5.1 percent at an annualized quarterly rate, respectively), albeit at a declining trend. The external sector remained weak and once more contributed negatively to GDP growth.

According to preliminary figures from U.S. authorities, economic activity slowed during the fourth quarter of 2004: GDP grew 3.1 percent at an annualized quarterly rate (Table 4) and 3.7 percent at an annual rate. Slower growth was due mainly to the deterioration of external sector conditions. Net exports contributed negatively to annualized quarterly GDP growth with 1.7 percentage

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[2] On January 27, the prices of the WTI and the Mexican crude oil export mix were 48.84 and 33.39 US dollars per barrel, respectively.

[3] All figures from the U.S. national accounts are seasonally adjusted.

points -the most significant negative contribution of such item in a quarter since April-June 1998. The rapid expansion of the trade deficit partly reflects the strength of domestic demand, which continued to grow rapidly despite the fading of the stimuli resulting from tax cuts and mortgage refinancing, and the effect of persistently high oil prices. Private consumption rose at an annualized quarterly rate of 4.6 percent. In this context, the savings rate fell close to historically low levels. Fixed private investment grew at a slower rate (6.7 percent at an annualized quarterly rate) than those exhibited during the second and third quarters, mainly due to a slowdown in residential investment. In contrast with July-September, during the fourth quarter of 2004 the change in inventories contributed positively to GDP annualized quarterly growth (0.4 percentage points).

Table 4 **U.S. GDP and Industrial Production in 2004 and 2005**

Annual and annualized quarterly percentage change

	GDP					
	Expected At the end of the third quarter			Most recent data	Observed	
	IV-2004[1/]	2004[2/]	2005[2/]	2005[2/]	IV-2004	2004
Consensus Forecasts[3/]	3.6	4.3	3.5	3.6	3.1	4.4
Blue Chip Economic Indicators[4/]	3.9	4.3	3.6	3.6		
	Industrial Production					
Blue Chip Economic Indicators[4/]	5.4	4.8	4.9	4.2	4.1	4.1

1/ Annualized quarterly change (seasonally adjusted series).
2/ Annual percentage change.
3/ *Consensus Forecasts* (September 13, 2004 and January 10, 2005).
4/ Blue Chip Economic Indicators (September 10, 2004 and January 10, 2005).
Source: BEA and Federal Reserve.

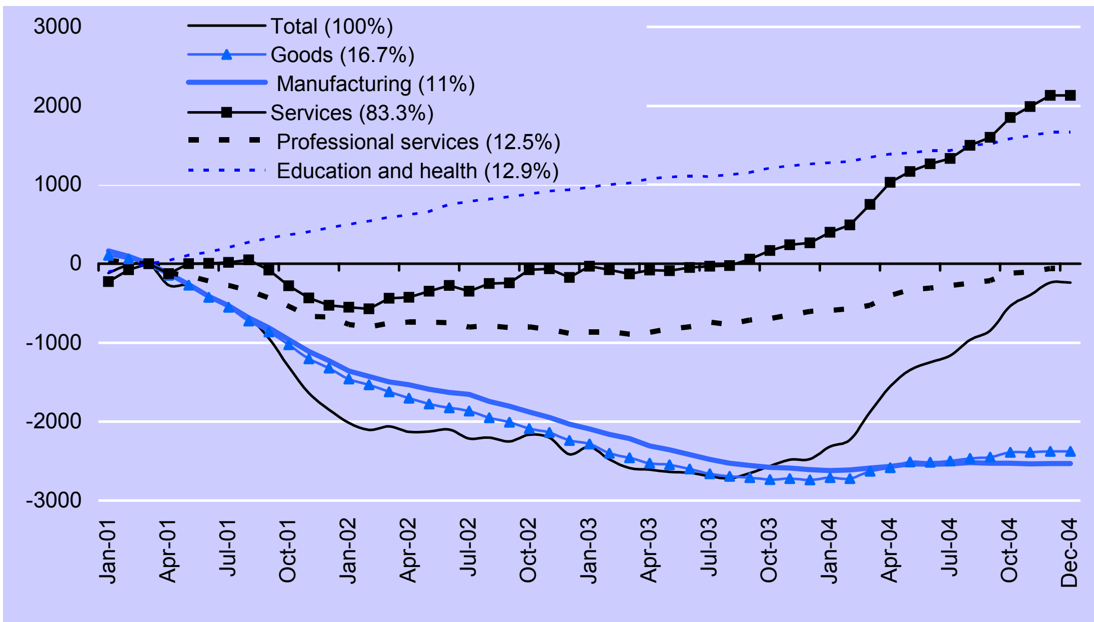
Industrial production continued to recover during October-December. After having undergone a phase of stagnation at the end of the second quarter, industrial activity rebounded in the following months, fueled by the production of investment goods. The annual growth rate of industrial production reached a peak of 5.4 percent in May, and declined to 4.4 percent in December. Thus, at year-end industrial production was expanding at a slightly faster pace than GDP and, since October, it had exceeded its previous cyclical peak.

Job creation exhibited some volatility during the final quarter of 2004, due mainly to the effects of the hurricanes that affected the states near the Gulf of Mexico in September. After having increased by 312 thousand jobs in October, the non-farm payroll rose by 137 thousand jobs in November and by an additional 157 thousand jobs in December. On average, monthly job creation during the quarter exceeded the pace needed to absorb the expansion of the labor force. Nonetheless, employment continues to grow at a pace considerably slower than that recorded in previous recoveries. Scarce job creation is particularly noticeable in the manufacturing sector (Graph 7).

Graph 7 **U.S. Non-farm Payroll**

Change with respect to the previous peak in employment (March 2001)

Thousand jobs, seasonally adjusted figures

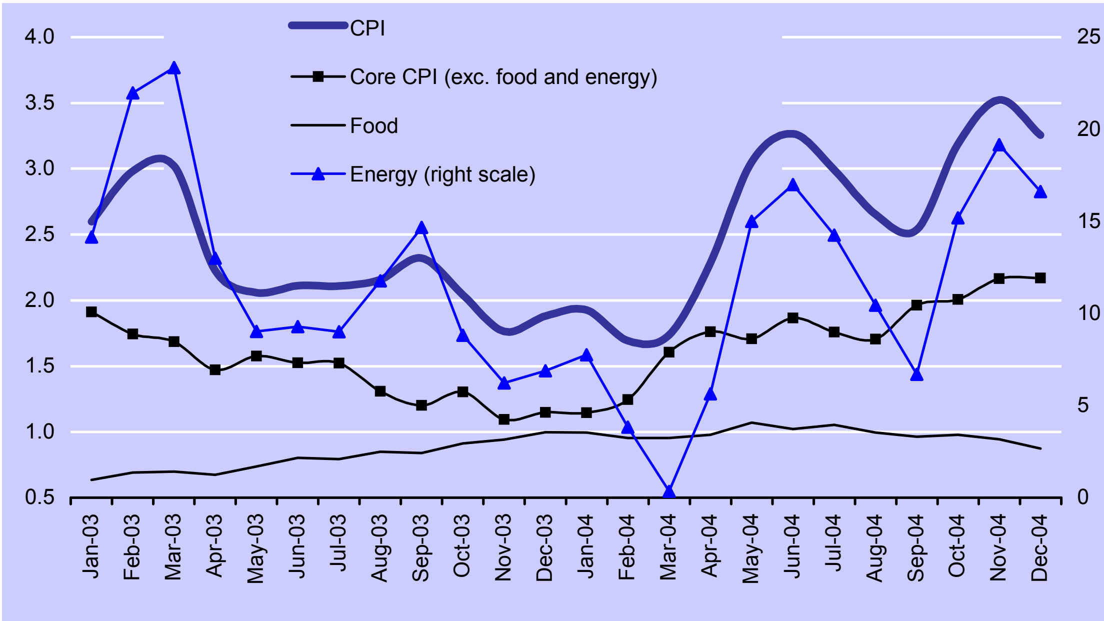


Note: Figures in ( ) correspond to each sector's share in total employment in 2004.
Source: BLS.

Headline CPI inflation in the U.S. rebounded during the fourth quarter of 2004 as a result of the sharp increase in energy prices (Graph 8). The annual growth rate of the CPI rose from 2.5 percent in September to 3.3 percent in December. As for core CPI inflation, although it followed an upward trend, it remained at moderate levels. In December, core CPI inflation was 2.2 percent at an annual rate. Furthermore, long-term inflation expectations have remained stable. One of the most important factors containing core inflation pressures has been the continuous increase in productivity. During October-December, productivity grew at lower rates than in previous quarters, but still above its historic average (Graph 9). The latter has translated into relatively stable unit labor costs, which began to exhibit positive annual growth rates only until the third quarter of the year.

Graph 8 **U.S. Consumer Price Indexes**

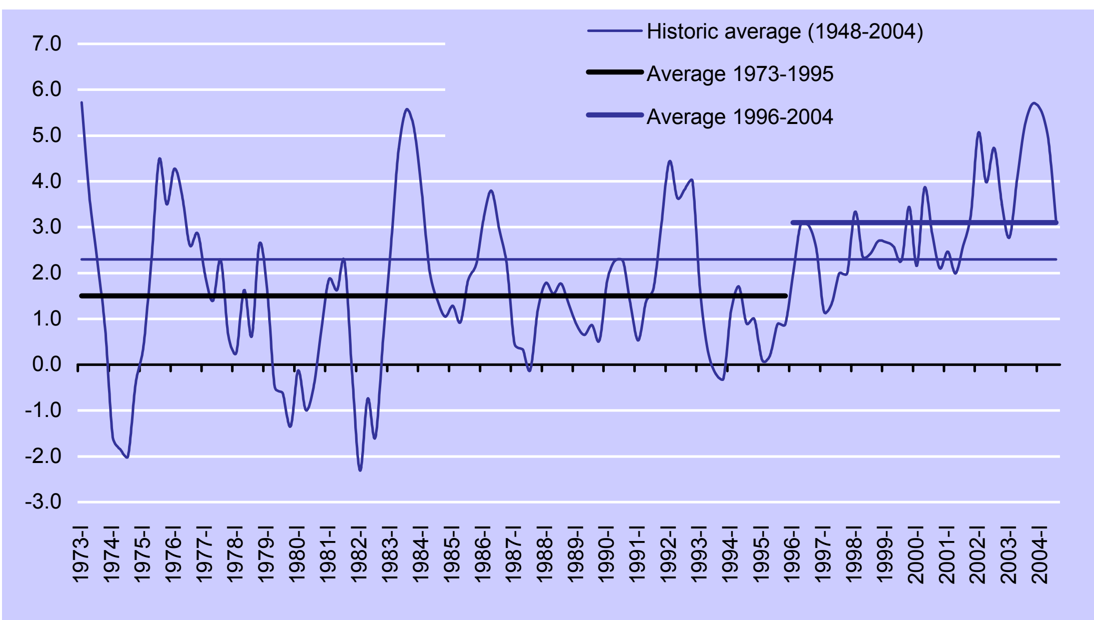
Annual percentage change



Source: BLS.

Graph 9 **U.S. Non-farm Productivity**

Annual percentage change



Source: BLS.

In a context of an economy that is perceived to be growing slightly above its potential rate, and of moderate inflation pressures and stable long-term inflation expectations, the Federal Open Market Committee (FOMC) decided to continue to withdraw the monetary stimulus at a measured pace. Thus, in its meetings of November and December the target for the federal funds rate was raised 25 basis points, ending the year at 2.25 percent (the highest figures since October 2001). As stated in its press releases, the Committee believes that the monetary policy stance remains accommodative; consequently, it is expected that the federal funds rate will continue to be raised during the coming meetings of the Committee. Past increases were fully anticipated, contributing to a smooth adjustment by financial markets.

Interest rates for the longer term exhibited a mixed behavior during the quarter, especially influenced by the release of employment figures and the consequent perception of markets regarding the strength of economic activity. At the end of the fourth quarter, the rate for the 10-year T-bill was 4.2 percent, i.e. 10 basis points above that recorded at the end of the previous quarter.[4] Several factors, among them moderate long-term inflation expectations, strong world demand for U.S. government securities, the modest demand for credit from the corporate sector, and the Federal Reserve's decision to implement actions gradually, have contributed to maintain long-term interest rates at relatively low levels and, consequently, to a flattening in the yield curve.

Stock markets exhibited some volatility during October-December; nonetheless, they ended the quarter with strong gains relative to their valuations at the end of the previous quarter (6.9 and 14.7 percent for the Dow Jones and NASDAQ indexes, respectively). The improvement during the last quarter of 2004 more than offset the poor results observed previously during the year, as both indexes had accumulated losses of 3.6 and 5.3 percent, respectively, during the first three quarters of 2004.[5]

The U.S. dollar continued to weaken during the quarter. From the end of September to the end of the year it depreciated 8.3 percent against the euro, establishing a new historical low. The U.S. dollar depreciated 6.9 percent against the yen, while against the Canadian dollar it reached levels unseen since 1992 (1.18 Canadian dollars per U.S. dollar). Thus, from the end of September to the end of December 2004, the U.S. dollar effective exchange rate *vis-à-vis* the main currencies depreciated 6.7 percent.[6] The

[4] At January 27, 2005 the interest rate was 4.2 percent.

[5] From the end of December 2004 to January 27, 2005 the Dow Jones and NASDAQ Indexes fell 2.9 and 5.9 percent, respectively.

[6] The US dollar has strengthened throughout 2005. As of January 21, 2005, the exchange rate had appreciated 2.1 percent against the other major currencies, as compared with its level at the end of the previous year.

bulging current account deficit, as well as the associated fear that non-residents' investments in U.S. financial assets might be affected, contributed to such results.

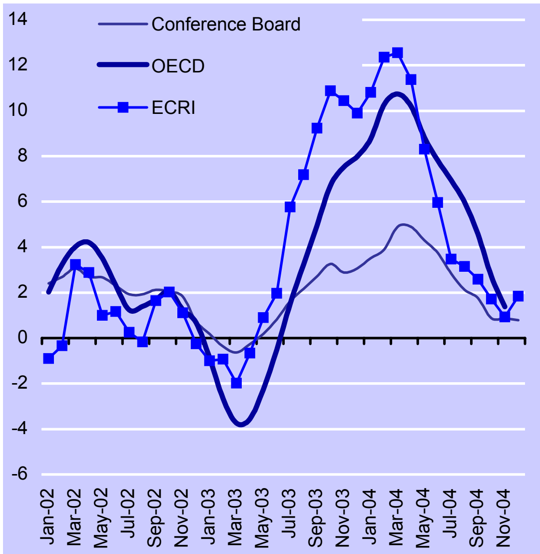
In this respect, the structural risks surrounding the U.S. economy, particularly those resulting from the high disequilibria in both the fiscal and current account accounts, should not be disregarded (Box 2). Although the federal government's deficit for the fiscal year that ended in October 2004 (3.6 percent of GDP) was significantly below forecasts, the Congressional Budget Office expects these deficits to extend into the early years of the next decade. Furthermore, the persistently high fiscal deficit, in combination with a very low personal savings rate and the recovery in non-residential investment, has brought about a widening of the current account deficit.

Despite the uncertainty originated by the external disequilibria, in general terms analysts are optimistic about the prospects for the U.S. economy in 2005. GDP is expected to grow at a rate slightly slower than that of 2004 and closer to the potential growth rate for the economy. Accordingly, leading cyclical indicators for the U.S., as in other advanced economies, have followed a downward trend in recent months (Graph 10). U.S. GDP is expected to grow by 3.6 percent in 2005, somewhat less than the 4.4 percent observed in the previous year. Industrial production is expected to grow on average 4.2 percent (4.5 percent in 2004). Low inflation rates are also anticipated.

Graph 10 **Leading Indicators of Economic Activity**

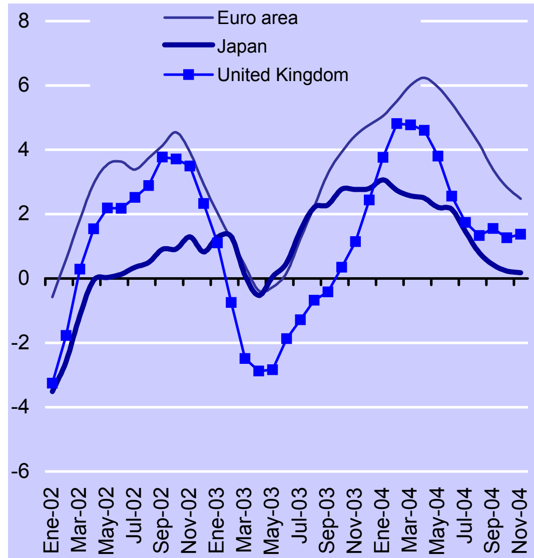
Annual percentage change

a) United States



Source: Conference Board, Economic Cycle Research Institute and OECD Main Economic Indicators.

b) Other Advanced Economies



Source: OECD Main Economic Indicators.

II.3.1.3. Developments in the Rest of the World

The euro area economy slowed unexpectedly in the third quarter of 2004. GDP growth for the euro area fell from 1.9 percent at an annualized quarterly rate in April-June, to 1.1 percent in July-September. This outcome reflects mainly the decline in net exports, which were affected by the higher prices of crude oil and the appreciation of the euro. Timely indicators suggest that the euro area grew modestly once more during October-December. Exports continued to be affected by the appreciation of the euro, while private consumption was restrained by persistently low levels of consumer confidence. Economists surveyed by Consensus Forecasts estimate GDP growth for the euro area at 1.8 percent in 2004 (Table 5),[7] while that for 2005 is anticipated to be 1.7 percent.

[7] Monthly release that includes the results of economic and financial forecasts from 240 specialized firms for more than 20 countries.

Box 2
Sustainability of the U.S. Expenditure Pattern

The configuration of global current account balances is currently one of the major risk factors for the world economy. In particular, the U.S. current account deficit has escalated to unprecedented levels, having Asia's surplus as its main counterpart (Table 1).

Table 1
Current Account Balance
Billion US dollars

	2000	2001	2002	2003	2004 1/
United States	-413.5	-385.7	-473.9	-530.7	-669.0
Euro area	-30.7	6.9	47.6	32.1	67.4
United Kingdom	-36.2	-32.2	-27.1	-33.4	-46.5
Latin America	-28.1	-35.3	0.1	13.6	17.4
Asia	209.3	183.9	243.7	303.0	310.8
Other countries	146.9	103.2	74.7	127.0	233.0
Total (discrepancy)	-152.3	-159.2	-134.9	-88.4	-86.9

1/ Estimated.
Source: OECD Economic Outlook 76, Nov. 2004.

The Asian countries, particularly China, have large trade surplus with the U.S. (Table 2). Many analysts consider that the current distribution of current account balances among different regions, and especially the U.S. current account deficit, is unsustainable in the long term.

Table 2
U.S.A.: Foreign Trade by Country
Percent and billion US dollars
Figures without seasonal adjustment on a census basis

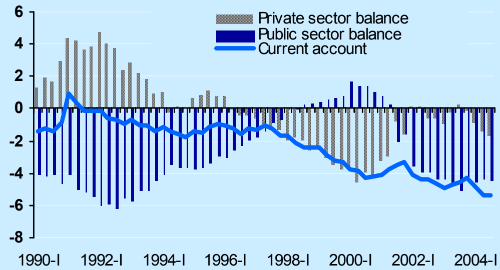
	Share %		Balance (Billion USD)	
	Jan-Nov 2004		2003	2004*
	Exp.	Imp.		Jan-Nov
Total	100.0	100.0	-532.4	-650.6
North America	36.8	28.2	-92.3	-113.4
Canada	23.2	17.5	-51.7	-67.9
Mexico	13.6	10.7	-40.6	-45.5
Euro area	15.5	14.2	-74.1	-82.2
United Kingdom	4.4	3.1	-9.0	-10.0
South East Asia 1/	25.6	33.5	-230.5	-282.0
Japan	6.7	8.8	-66.0	-74.6
China	4.2	13.3	-124.1	-161.1
South Korea	3.2	3.2	-13.2	-20.2
Taiwan	2.6	2.4	-14.2	-13.4
Thailand	0.8	1.2	-9.3	-11.1
Latin America	6.6	6.0	-26.6	-34.9

* Annualized figures.
(1) Includes: Australia, Brunei, China, Hong Kong, Indonesia, Japan, South Korea, Macao, Malaysia, New Zealand, New Guinea, Philippines, Singapore and Taiwan.
Source: Census Bureau.

The challenges posed by the U.S. current account deficit derive not only from its size, but also from the complexity of the different aspects that surround it. As shown in Graph 1, the U.S. deficit rose from 1.7 percent of GDP at the end of 1997 to 5.4 percent in the third quarter of 2004 (NIPA figures). Such result is due to different factors.

Based on public and private sector balances (i.e. the fiscal deficit and the difference between private saving and investment), the main determinants of the deficit are the gradual fall in domestic saving in the U.S., the growth in private investment, especially that observed up to the fourth quarter of 2000, and the sharp increase in the U.S. fiscal deficit since the third quarter of 2001 (Graph 1).

Graph 1
Current Account, and Public and Private Sector Balances
Percent of GDP



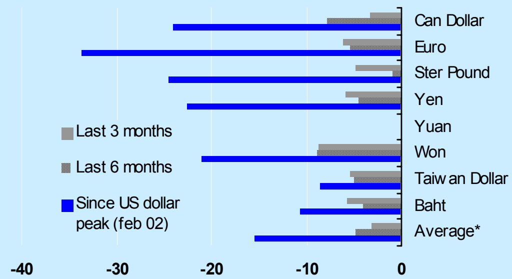
Source: BEA.

The abovementioned suggests that the strengthening of domestic public and private savings in the U.S. is crucial to reduce the current account deficit in that country. Nonetheless, this could generate a slowdown in the U.S. economy, which would in turn weaken the world economy. Therefore, an orderly adjustment of the U.S. external sector and, in general, of the disequilibria in world current accounts, would most likely require coordinated policy actions in the rest of the world.

The current account disequilibria in the world economy are partly due to a lack of coordinated policy actions among the different economic regions. In particular, the euro economies have not been able to implement counter-cyclical policies to stimulate growth. The latter, together with significant structural problems in Japan as well as in the euro area, has translated into GDP growth below that of the U.S., thus widening the U.S. current account deficit.

The problem has worsened because exchange rate policies implemented in certain economies have not allowed their exchange rates to contribute to correct current account imbalances worldwide. In particular, several Asian economies have intervened in their markets to prevent or mitigate the appreciation of their currencies against the US dollar. Thus, since the US dollar peak in February 2002 and up to the end of 2004, Asian currencies have appreciated significantly less vis-à-vis the US dollar than, for example, the euro or the Canadian dollar (Graph 2).

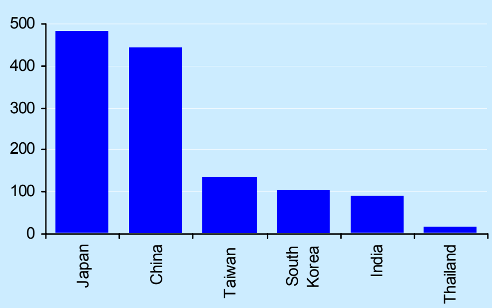
Graph 2
Appreciation of currencies against the US dollar at the end of 2004
Percent



*/ Weighted average of US dollar against currencies of 26 U.S. trading partners.
Source: Reuters and Federal Reserve.

In a context of significant surpluses in their current accounts and inflows of foreign capital, Asian economies' inflexible exchange rate policies have translated into higher international reserves, which, in the case of Japan and China, have reached particularly high levels (Graph 3). The increase in international reserves has been coupled with sterilization policies and, therefore, has not fostered an adjustment in relative prices nor stimulated domestic demand. Thus, the higher share of such economies in world production has not translated into a higher share of their expenditure at a global level.

Graph 3
International Reserve Accumulation in Asia
From December 2000 to December 2004 in billion US dollars

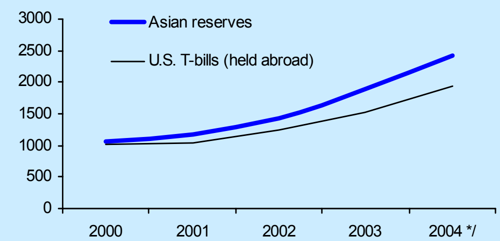


Source: Central banks.

Since a significant portion of Asian international reserves is invested in U.S. Treasury bonds (Graph 4), such demand has become a significant source of financing for the U.S. current account deficit, thus allowing the external deficit to widen without exerting significant pressure on U.S. interest rates or the US dollar.

The magnitude of the U.S. current account deficit has created uncertainty. Nonetheless, up to now the U.S. dollar has undergone an orderly adjustment since capital flows to the U.S. have easily financed the current account deficit. This situation entails several risks. First, the likelihood of a significant reduction in the demand for U.S. bonds cannot be discarded. Second, given the low level of savings and the fact that consumption growth has partly relied on asset appreciation, and that the prices of such assets could fall, many analysts consider as very unlikely that this component of expenditure will continue growing at the rate observed in the past years.

Graph 4
Asian Countries' International Reserves and U.S. External Financing
Billion US dollars
Stocks at end of period



*/ Figures of foreign holdings of U.S. T-bills as of November 2004.
Source: Central banks, U.S. Treasury and BEA.

In light of such developments, many analysts have insisted on the need to adopt measures to eliminate global current account imbalances, without affecting markets' operations or jeopardizing the outlook for world economic growth. To achieve such goal, action on several fronts is called for: U.S. public and private savings must increase; structural changes to stimulate growth in the euro area and in Japan must be implemented; and exchange rates, especially of some Asian countries with significant external surpluses, must become more flexible.

In Japan, during the third quarter of 2004 GDP grew below forecasts (0.2 percent at an annualized quarterly rate or 2.5 percent at an annual rate), due mainly to reductions in the growth rate of exports and private consumption.[8] Available information provides mixed evidence regarding the development of economic activity in the fourth quarter. Growth is expected to decelerate significantly in 2005. Analysts anticipate GDP to grow 1.1 percent in 2005, below estimates for 2004 (2.9 percent).

Table 5

GDP Growth Forecasts for Other Main Advanced Economies in 2004 and 2005

Annual and annualized quarterly percentage change

	Forecasts at the end of the third quarter			Most recent information: Estimated		Most recent information: Forecasts
	IV-2004 1/	2004 2/	2005 2/	IV-2004 1/	2004 2/	2005 2/
Canada	3.2	2.9	3.3	2.8	2.7	2.8
Euro area	1.6	1.8	2.0	1.6	1.8	1.7
Japan	1.6	4.3	1.8	n.a.	2.9	1.1
United Kingdom	2.4	3.3	2.6	2.8	3.2	2.5

n.a. not available.
1/ Annualized quarterly change (seasonally adjusted series).
2/ Annual percentage change.
Source: *Consensus Forecasts* (For annual forecasts: September 13, 2004, December 6, 2004 and January10, 2005. Annualized quarterly rates are derived from quarterly percentage change forecasts published in September 13 and December 6, 2004).

Regarding China, in light of the risk of an overheating of its economy, the authorities have implemented various administrative measures to slow public investment and to reduce excess liquidity and lending to the private sector. In this context, in October China's Central Bank decided to raise interest rates for the first time in nine years. Despite such measures, growth remains very strong, and although a modest deceleration occurred in the third quarter, GDP growth rebounded unexpectedly in the fourth (9.1 and 9.5 percent at an annual rate, respectively). Nonetheless, headline CPI inflation declined considerably at the end of the year. The economy is expected to grow at a slightly slower rate in 2005 (8.2 percent), after having grown 9.5 percent in 2004. As for other East Asian economies, although analysts project their growth rate to slow down in 2005, overall, they are expected to continue growing at higher rates than the other emerging economies.

Latin American GDP grew by an estimated 6.0 percent during 2004, the highest figure since 1980. Such development is explained, among other factors, by the increase in the terms of

[8] Since the third quarter of 2004, Japanese authorities began to publish their national accounts' figures using a new methodology based on a chain-weighted price index. The figures for GDP mentioned in the text above correspond to this new methodology. However, forecasts for 2005 in table 5 are based on the former method.

trade for several countries and its effect on exports. This has also contributed to the region's positive and increasing balance in its current account, in contrast to the pattern observed in previous recoveries. Analysts expect the current expansion to continue in 2005, although at a slower pace, with GDP growth slightly above 4 percent.

In light of the favorable conditions in international financial markets and the improvement in country fundamentals, it is estimated that the gross volume of bond issuance by emerging economies reached new records in 2004. Several of these economies have taken advantage of the favorable external financing conditions to pre-finance their requirements for 2005, and some of them have even issued domestic currency bonds in international markets. It should be noted that the current situation is not exempt of risks. In particular, the likelihood of an increase in U.S. interest rates at a faster pace than anticipated could originate fluctuations that would negatively affect emerging economies' access to external financing.

II.3.2. Earnings, Productivity and Employment

II.3.2.1. Earnings

Developments regarding earnings and productivity during the fourth quarter of 2004 were as follows:

(a) Contractual wages registered the lowest growth rate in four quarters.

(b) Minimum wages for 2005 were agreed (average weighted increase of 4.50 percent).

(c) Unit labor costs exhibited, in general terms, a favorable behavior in both maquiladora and non-maquiladora industries, and in retail.

II.3.2.1.1 Contractual Wages

During the fourth quarter of 2004, contractual wages' average nominal increase for workers under federal jurisdiction was 3.4 percent, the lowest observed in the four quarters of the year (Table 6). Such situation responds, basically, to the seasonal pattern exhibited by the referred wage indicator. During 2004, contractual wages recorded an average nominal increase of 4.1 percent, 0.6 percentage points below its observed level of the previous year.

During the fourth quarter of 2004, contractual wage increases exhibited a mixed behavior by type of enterprise. Thus, during such period, wages in private enterprises increased at an average rate of 4.3 percent, 1.3 percentage points above those in public enterprises. In general terms, during the entire year, contractual wage increases in private enterprises were above those negotiated by public ones. The average wage spread for the entire year was 1.1 percentage points.

Table 6 **Contractual Wage Increases and Number of Workers Benefited by Type of Enterprise**

Percent

	2003					2004							
	Average[1/]					Average[1/]							
	I	II	III	IV	Jan-Dec	I	II	III	IV	Oct	Nov	Dec	Jan-Dec
Contractual Wage Increase (percent)													
Total	5.1	5.1	4.8	4.2	4.7	4.5	4.5	4.3	3.4	3.2	4.1	4.3	4.1
Public Enterprises	4.3	4.3	4.3	4.0	4.1	3.9	3.9	4.0	3.0	3.0	4.3	3.4	3.5
Private Enterprises	5.2	5.4	5.2	4.6	5.2	4.6	4.6	4.7	4.3	4.6	4.1	4.4	4.6
Workers Benefited (percentage share)													
Total	100	100	100	100	100	100	100	100	100	100	100	100	100
Public Enterprises	19	22	49	67	41	20	21	48	72	88	6	12	42
Private Enterprises	81	78	51	33	59	80	79	52	28	12	94	88	58

1/ Average weighted by number of workers benefited during the period (1,763,486 workers in 2003 and 1,776,242 in 2004).
Source: Prepared by Banco de México with data from the Ministry of Labor.

II.3.2.1.2 Minimum Wage

On December 2004, the National Commission of Minimum Wages (*Comisión Nacional de Salarios Mínimos, CONASAMI*) agreed to set a weighted average increase of 4.50 percent for the General Minimum Wage as of January 1, 2005. The General Minimum Wage was set at 45.24 pesos per day (Table 7). The highest minimum wage increase was observed in geographic region “C” (4.60 percent). The indicator for regions “A” and “B” recorded variations of 3.50 and 3.70 percent, respectively. Thus, minimum wages are gradually being standardized in the three regions (Graph 11).

Table 7 **Nominal Minimum Wage**

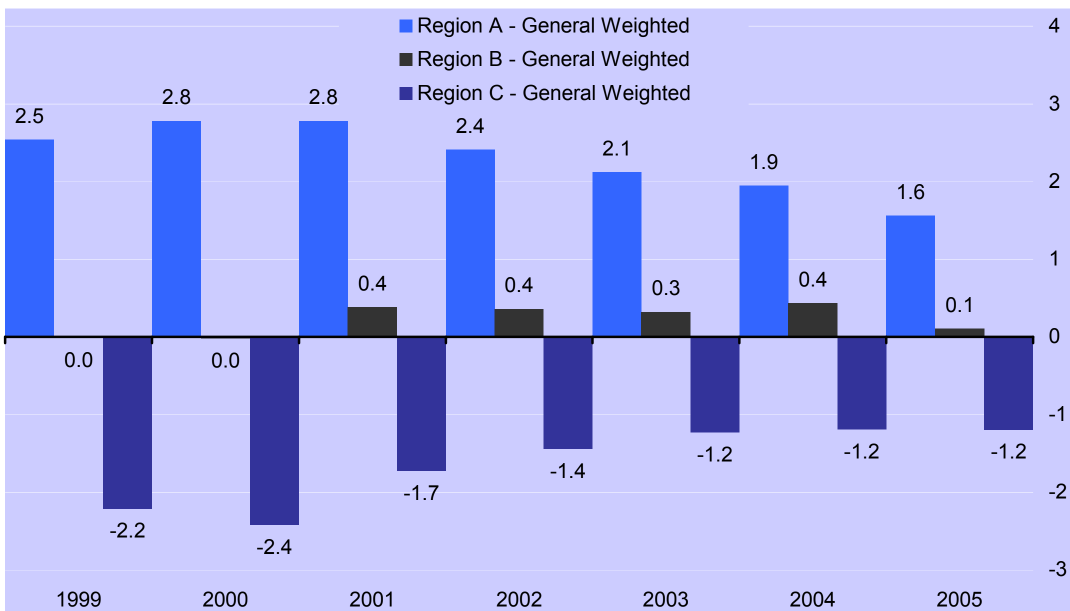
Pesos per day and annual percentage change

Period	Pesos per day				Annual percentage change			
	General	Geographic region			General	Geographic region		
		A	B	C		A	B	C
1999	31.91	34.45	31.90	29.70	14.01	14.07	13.93	14.01
2000	35.12	37.90	35.10	32.70	10.06	10.01	10.03	10.10
2001	37.57	40.35	37.95	35.85	6.99	6.50	8.09	9.68
2002	39.74	42.15	40.10	38.30	5.78	4.50	5.70	6.90
2003	41.53	43.65	41.85	40.30	4.50	3.56	4.36	5.22
2004	43.30	45.24	43.73	42.11	4.25	3.64	4.50	4.50
2005	45.24	46.80	45.35	44.05	4.50	3.50	3.70	4.60

Source: Minimum Wages' National Commission (*Comisión Nacional de Salarios Mínimos, CONASAMI*).

Graph 11 **Gap Between Regional Minimum Wage and General Weighted Minimum Wage**

Difference in current pesos



Source: Prepared by Banco de México with data from *CONASAMI*.

II.3.2.1.3 Earnings and Productivity

During January-October 2004, unit labor costs (ULC) grew negatively in both maquiladora and non-maquiladora industries, and in the retail sector. ULC results are explained mainly by the increase in average labor productivity in the mentioned sectors during the referred period.

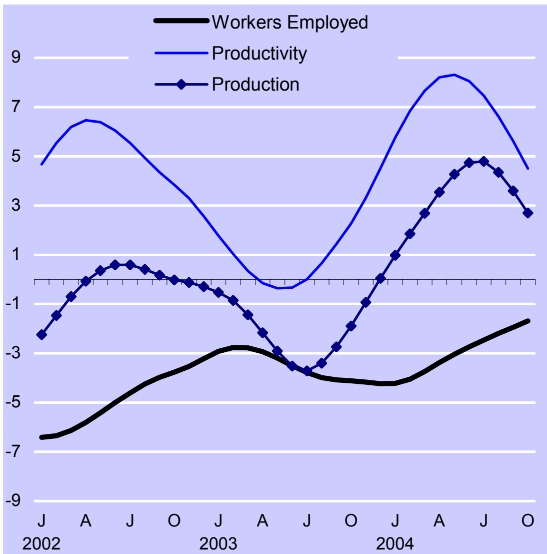
Labor productivity in the manufacturing non-maquiladora industry grew at an annual rate of 6.5 percent during January-October 2004 (Table 8). During the referred period, gains in average labor productivity offset the increases in real average earnings. Consequently, unit labor costs exhibited negative growth (such indicator fell at an annual average rate of 5.8 percent in the first ten months of the year).

Graph 12 **Non-maquiladora Manufacturing Industry**

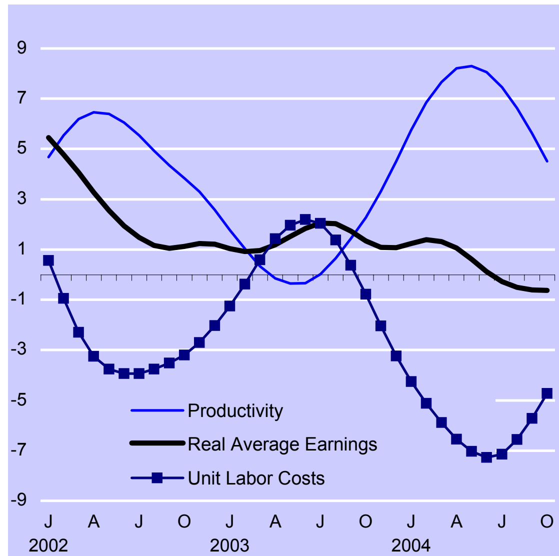
Earnings, Labor Productivity and ULC

Annual percentage change

Trend



Trend



Source: Prepared by Banco de México with data from INEGI.

On the other hand, annual labor productivity growth in the maquiladora industry was, on average, 3.4 percent in the first ten months of 2004 (Graph 13). In addition, during the same period, real average earnings rose, on average, 0.1 percent. Consequently, unit labor costs fell, on average, 3.1 percent in the same period (Table 8).

Labor productivity in the retail sector exhibited positive results during the first ten months of 2004 by increasing 7.1 percent at an annual average growth rate (Graph 14). The latter is mainly explained by sales' upward trend. Real average earnings rose 3.4 percent at an annual average rate during the same period. Consequently, unit labor costs fell 3.7 percent (Table 8).

Table 8 Earnings, Labor Productivity, and ULC by Economic Sectors

Annual percentage change

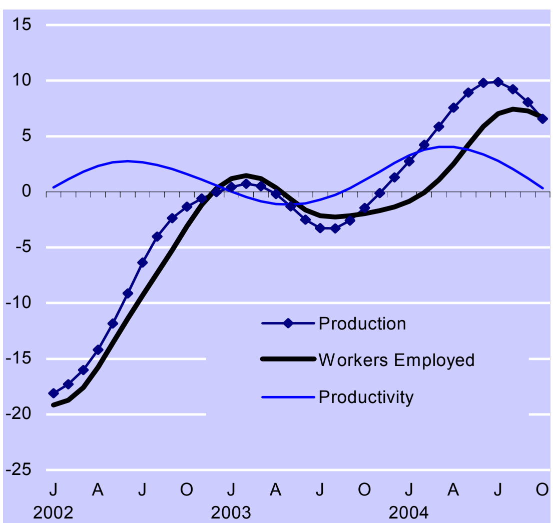
	Non-maquiladora Manufacturing Industry			Maquiladora Industry			Retail		
	Labor Productivity	Real Average Earnings	ULC	Labor Productivity	Real Average Earnings	ULC	Labor Productivity	Real Average Earnings	ULC
2003									
Jan-Jul	0.9	1.5	0.5	-0.8	-0.3	0.5	5.1	3.0	-1.8
Jan-Dec	1.4	1.4	-0.3	-0.1	0.0	0.0	5.6	3.0	-2.3
2004									
Jan	4.5	0.7	-3.6	3.2	2.3	-0.9	7.7	-0.6	-7.7
Feb	5.8	1.7	-3.9	3.0	2.0	-1.0	11.6	1.9	-8.7
Mar	10.6	1.7	-8.1	5.3	2.6	-2.6	9.7	2.0	-7.0
Apr	6.7	2.3	-4.2	5.3	1.6	-3.5	9.0	2.1	-6.3
May	5.0	-1.3	-6.0	4.6	0.2	-4.2	7.8	4.9	-2.7
Jun	9.1	0.5	-7.8	4.1	-0.1	-4.1	5.3	5.4	0.1
Jul	6.5	-1.0	-7.0	2.4	-1.7	-3.9	5.1	4.8	-0.3
Aug	7.6	-0.7	-7.8	1.4	-2.6	-4.0	3.7	12.0	7.9
Sep	6.5	1.0	-5.1	5.4	0.7	-4.5	7.2	-0.4	-7.1
Oct	2.7	-2.0	-4.6	-1.0	-3.1	-2.2	5.4	1.9	-3.3
Jan-Oct	6.5	0.3	-5.8	3.4	0.1	-3.1	7.1	3.4	-3.7

Source: Prepared by Banco de México with data from INEGI.

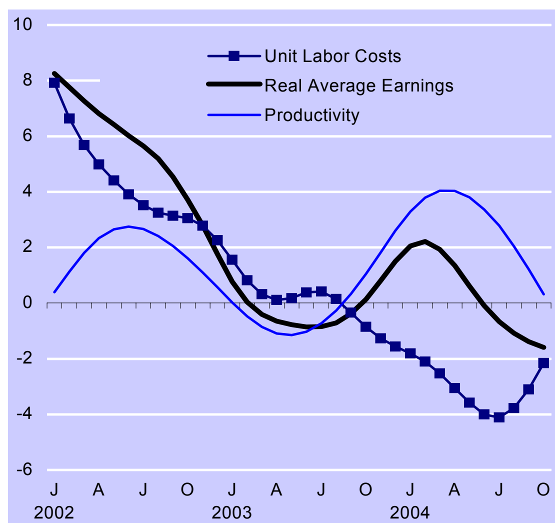
Graph 13 Maquiladora Industry

Earnings, Labor Productivity and ULC
Annual percentage change

Trend



Trend

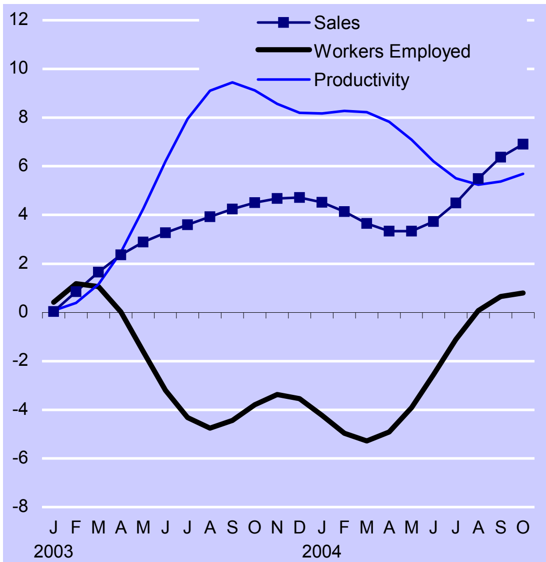


Source: Prepared by Banco de México with data from INEGI.

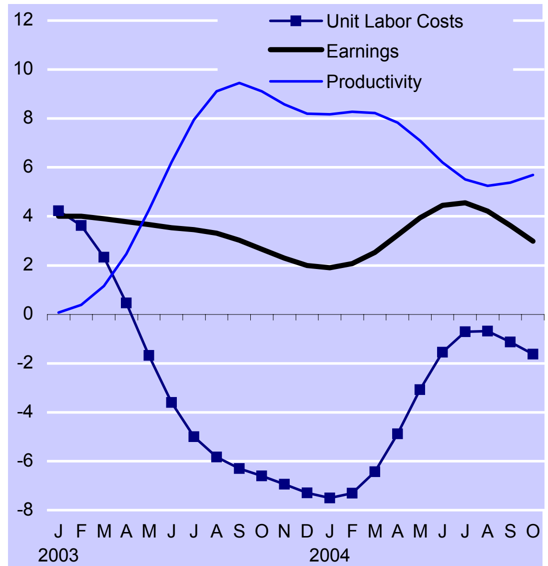
Graph 14 **Retail**

Earnings, Labor Productivity and ULC
Annual percentage change

Trend



Trend



Source: Prepared by Banco de México with data from INEGI.

II.3.2.2. Employment

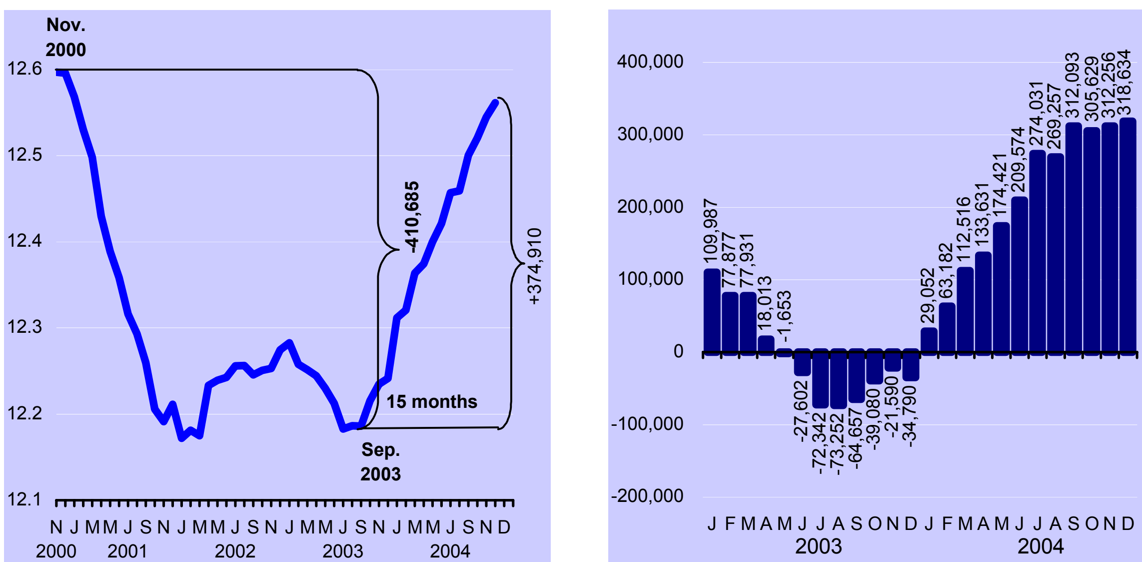
During the fourth quarter of 2004 and, in general, throughout the year, economic growth fostered the improvement in employment. The development of the labor market in 2004, particularly in the fourth quarter of that year, was characterized by the following aspects: a) an expansion in formal employment throughout the year, although at a slower annual rate during the fourth quarter; b) creation of more permanent than temporary jobs; job creation was more vigorous in larger companies; c) the expansion of formal employment practically included all states; however, it exhibited greater dynamism in the northern region; d) the number of workers insured by the IMSS rose in most sectors, including manufacturing; e) INEGI's monthly surveys of manufacturing employment reveal a significant recovery of employment in the maquiladora industry; nonetheless, its level exhibited a significant decline as compared with its maximum historic level in 2000; and f) the open unemployment rate in urban areas fell as compared with its average level in the third quarter. Nonetheless, considering the year as a whole, the open unemployment rate did not decrease given that such indicator rose in Mexico City.

The number of workers insured by the IMSS was 12,509,426 at the end of December 2004, 42,596 below the figures recorded at the end of September. Such reduction is mainly attributed to the seasonal decline exhibited always by such item during the fourth quarter of the year. In contrast, with seasonally adjusted data, the number of insured workers rose by 60,561 during the quarter. Considering the abovementioned, at the end of December the number of insured workers had already been growing at a monthly rate for fifteen consecutive months, thus totaling 374,910 new formal jobs. Nonetheless, despite such advance, the level of such indicator in December 2004 was still below that reached at the end of 2000 (Graph 15). The difference between the number of workers insured by the IMSS at the end of December 2004 and figures corresponding to December 2003 is an increase of 318,634 workers. In this regard, during the fourth quarter of the year the annual growth rate of the number of workers insured by the IMSS lost strength (Graph 15), considering than at the end of September such figure was 312,093 workers.

Graph 15 **Workers Insured by the IMSS: Permanent and Temporary in Urban Areas**

a) Million Workers Insured
Seasonally Adjusted Data

b) Number of Workers Insured by IMSS
Annual change (original data)

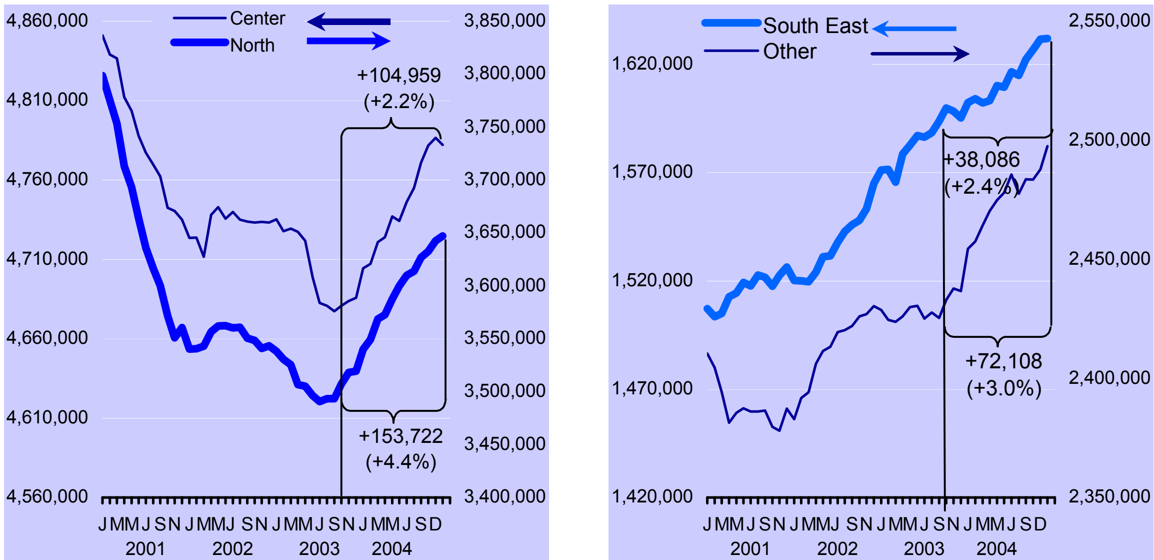


Source: IMSS. Seasonal adjustments by Banco de México.

In 2004, job creation in the formal sector included practically all states (except for Oaxaca and Nayarit, were formal employment fell slightly); however, it exhibited greater strength in northern states (Graph 16). This reflects mostly the improvement in external demand throughout the year, especially that from the U.S. Other significant aspect from such indicator in 2004 is that its recovery took place mainly in larger companies (with 101 to 500 workers, and 501 or above), while in the smallest (from 1 to 15 workers) the number of workers fell.

Graph 16 **Formal Employment by Regions***

Number of workers insured and seasonally adjusted figures



* The Center region includes D.F., Guanajuato, Hidalgo, Estado de México, Morelos, Puebla, Querétaro and Tlaxcala; the North region includes Baja California, Baja California Sur, Coahuila, Chihuahua, Nuevo León, Sonora and Tamaulipas; the Southeast region includes Campeche, Chiapas, Guerrero, Oaxaca, Quintana Roo, Tabasco, Veracruz and Yucatán; Other regions include Aguascalientes, Colima, Durango, Jalisco, Michoacán, Nayarit, San Luis Potosí, Sinaloa and Zacatecas.

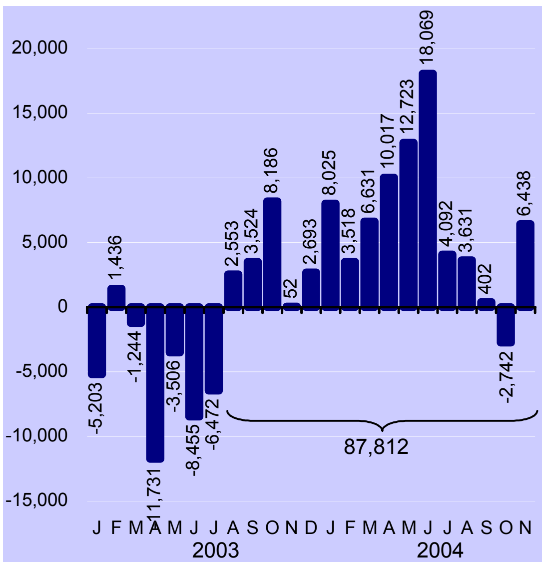
Source: IMSS. Seasonal adjustments and regional classification by Banco de México.

The improvement in formal employment was significant in most sectors, including manufacturing. Nonetheless, at the end of December 2004, formal employment in such sector still recorded a decline of 675 thousand workers in regards with its level in the same month of 2000. Within such sector, in 2004, employment rose mainly in the export-maquiladora industry. From August 2003 to November 2004 94,555 formal jobs were created in such sector, thus implying a 9 percent increase during that period (an increase of 87,812 workers with seasonally adjusted data, Graph 17). Although at the end of 2004 export and import levels were already above their historically high levels of 2000, employment still recorded a fall of more than 200 thousand workers. This is explained basically by two factors: a) a significant improvement in labor productivity in most industries of this sector, which was reflected in the reduction in the labor requirements per US dollar exported; and b) the textile industry, the most labor-intensive industry of the maquiladora sector, exhibited a significant contraction.

A significant aspect of manufacturing employment in recent years is its correlation with U.S. manufacturing employment (Graph 18). This reveals the tight link between manufacturing production in Mexico and in the U.S. Employment figures in both countries reveal a significant contraction since 2001 and an incipient recovery in 2004.

Graph 17 Employment and Unemployment

a) Monthly Variation of Number of Maquiladora Workers
Seasonally adjusted data

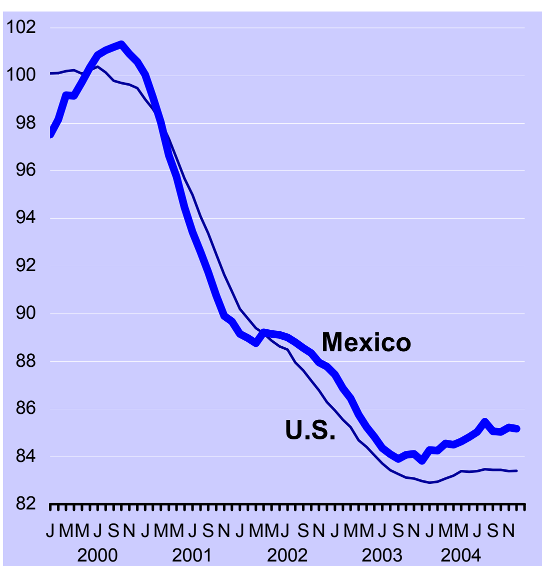


b) Open Unemployment Rate in Urban Areas: including and excluding México D.F. (Mexico City)

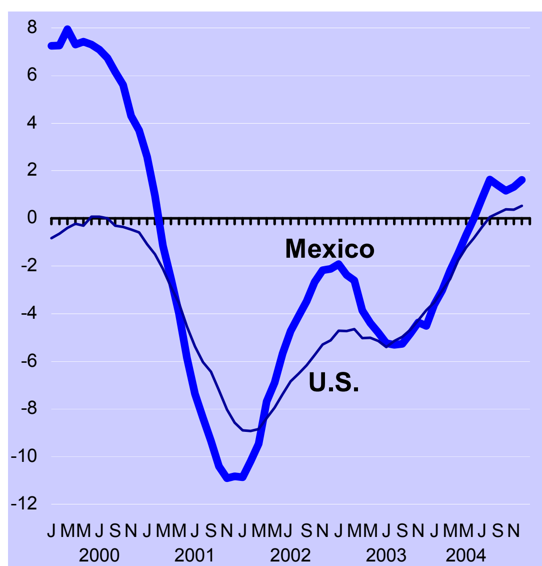
Source: a) INEGI and seasonal adjustments by Banco de México; b) Total unemployment rate in urban areas and in Mexico City (INEGI), Unemployment rate excluding Mexico City prepared by Banco de México with data from INEGI.

Graph 18 Manufacturing Employment in Mexico and the U.S.

a) Seasonally adjusted data 2000=100



b) Annual percentage change



Source: For Mexico: IMSS, and seasonal adjustments by Banco de México. For the U.S.: Bureau of Labor Statistics, U.S. Department of Commerce.

Job creation in the formal sector in 2004 did not translate into lower unemployment rate in urban areas. In the fourth quarter of the year such rate was 3.47 percent, which despite being below that of the fourth quarter (4.04 percent), remained practically the same as that of the fourth quarter of 2003 (3.46 percent). Under such context it is important to mention that after having increased in 2003, in 2004, the unemployment rate in Mexico City remained relatively high: during the fourth quarter of the year it was 4.30 percent, compared with 4.17 percent in the same quarter of 2003. Excluding Mexico City, the unemployment rate in the fourth quarter of 2004 was 2.83 percent, slightly below that recorded in the same quarter of 2003 (2.93 percent).

II.3.3. Aggregate Supply and Demand

Economic activity in Mexico exhibited significant differences in 2004 as compared with 2003, considering that the economy grew at a more vigorous rate and aggregate demand components' contribution to growth was more balanced. In 2003 GDP grew barely (1.3 percent) and relied mainly on higher consumption expenditure, as external demand's contribution was modest and that of investment expenditure was practically nil. Consequently, formal employment contracted. In contrast, in 2004, GDP grew significantly: all items of aggregate demand contributed significantly to such growth, including that of external origin (through an increase in goods and services' exports); after three years of contraction, investment expenditure recovered; and consumption expenditure, the most significant item of aggregate demand, grew considerably. Such results –as mentioned in the previous section- fostered an improvement in formal employment.

As for GDP and aggregate demand in the fourth quarter of 2004, both items continued to grow vigorously at an annual rate, due to a favorable external environment fostered by the stronger demand for Mexican exports and by a greater availability of resources, which have promoted spending. Regarding the later, oil revenues and workers' remittances, as well as the pace at which consumption and mortgage credit have been growing, deserve mention. The abovementioned enabled the continuous growth in consumption expenditure and the consolidation of the recovery in investment.

In general terms, the most significant aspects of economic activity in the fourth quarter were the following:

(a) Annual GDP growth was slightly above that recorded in the third quarter; consequently, the highest annual rates in sixteen quarters were observed in both periods. During

October-November the Global Indicator for Economic Activity (*Indicador Global de la Actividad Económica, IGAE*) exhibited an annual growth rate of 5.1 percent.

(b) Aggregate demand components -domestic and external demand- rose significantly at annual rate.

(c) For the first time in ten quarters, aggregate demand exhibited greater dynamism than GDP.

(d) Consumption growth was reflected in a wide range of indicators: i) during October-November 2004, retail sales grew at an annual rate of 6.6 percent, and in the first eleven months of the year, 4.6 percent on average; ii) ANTAD sales grew at an annual rate of 10.8 percent in the fourth quarter; and iii) retail car sales rebounded in the same quarter by growing at an annual rate of 17.7 percent, the highest growth in ten quarters (Graph 19a).

(e) As in the third quarter, investment was the component of domestic demand that exhibited the highest growth rate during the fourth quarter of 2004 (Graph 19b). In October 2004, investment grew at an annual rate of 6.5 percent, while the corresponding rate for October-November is expected to have been close to 9 percent (annual rates of 4.5, 5.8 and 8.5 percent in the first, second and third quarters of the year, respectively). During the fourth quarter, imports of capital goods rose at an annual rate of 17.5 percent. Investment's component of construction continued its expansion growing at an annual rate of 5.9 percent during October-November. Such result is attributed to the strength of both housing construction and public construction in infrastructure. As mentioned in the Credit and Monetary Aggregates' Section, during the fourth quarter of 2004, housing credit grew significantly.

(f) Industrial production improved as a result of increases in its four sectors (construction's expansion was the most significant). During October-November 2004, industrial and manufacturing production grew at annual rates of 3.7 and 3.4 percent, respectively.

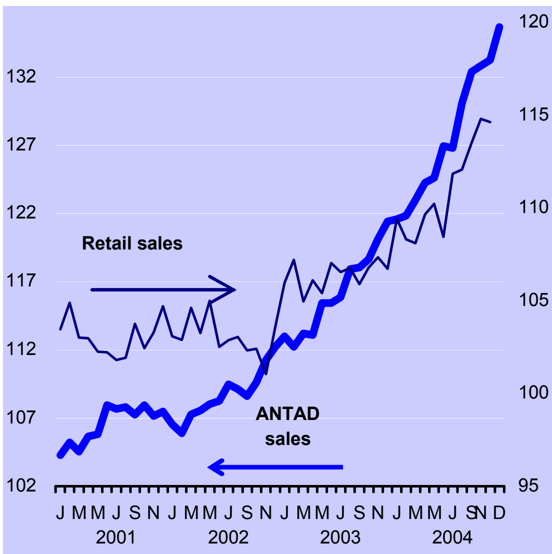
(g) Manufacturing production rose in most of its divisions, due to increased production for both external and domestic markets.

(h) Confidence and business climate indicators stopped exhibiting the weak results observed in the third quarter (Graph 20). Two out of three business confidence indicators prepared in Mexico (Consumer Confidence and Manufacturing Firms' Indexes), recorded better results in relation to their levels in the third quarter. The third one, Private Sector Analysts' Business Confidence Index, fell at a quarterly rate.

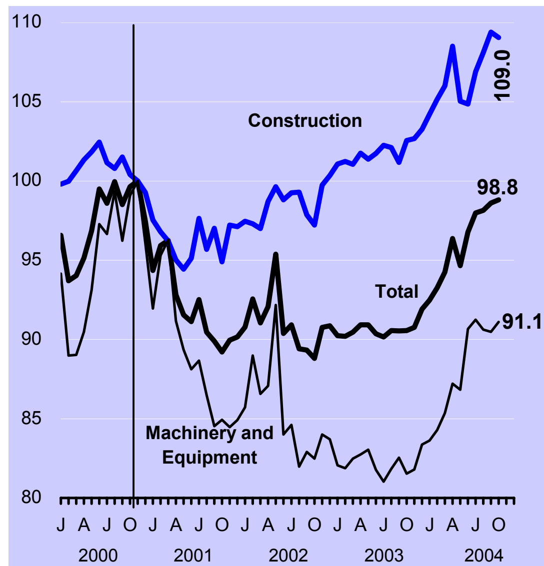
Graph 19 **Consumption and Investment Expenditure Indicators**

Seasonally adjusted figures

a) Retail Sales
2000=100



b) Gross Fixed Investment
November 2000=100

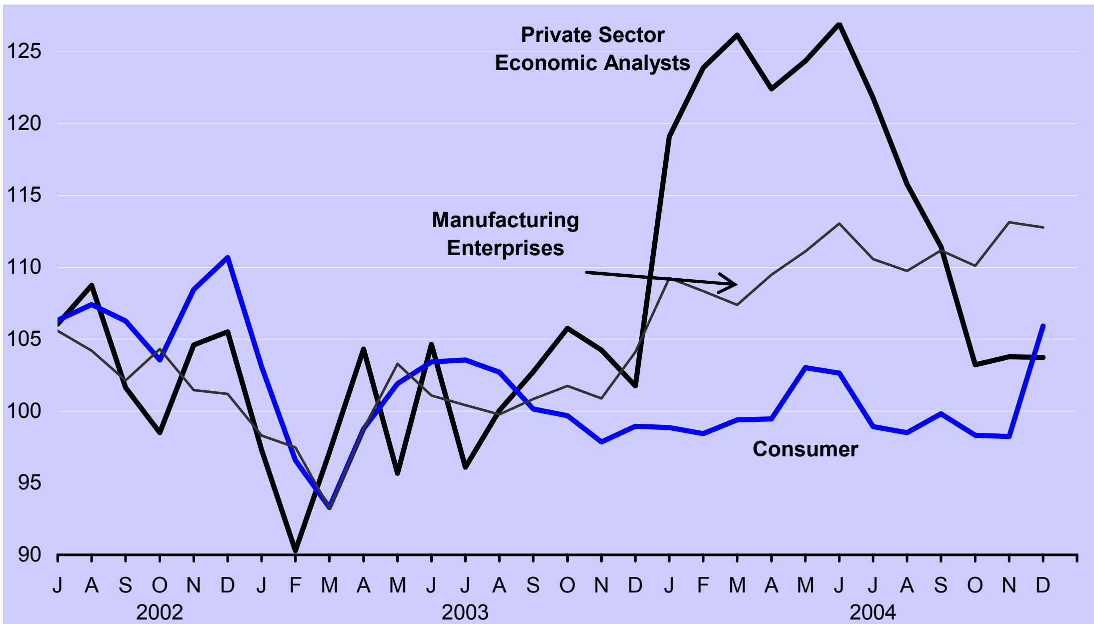


Source: a) INEGI and ANTAD. Seasonal adjustments by Banco de México; b) INEGI. Seasonal adjustments by Banco de México.

After having contracted for three years in a row, the strengthening of investment expenditure throughout 2004 allowed for such indicator to reach in the fourth quarter of the year the maximum levels recorded in November 2000 (measured at constant prices and with seasonally adjusted data). Nonetheless, within its components there are still discrepancies, given that construction expenditure exceeded significantly its maximum level of November 2000, while that corresponding to machinery and equipment is still lagging. Under such context, and as reiterated by Banco de México, the lack of advance in structural reforms has limited a more robust recovery of investment. In the surveys conducted periodically by Banco de México on manufacturing businesses, foreign investment firms, and private sector economic analysts, such factor has been pointed out in numerous occasions as the main obstacle to reach greater levels of investment and, therefore, to strengthen productivity and the competitiveness of the different sectors. In this regard, the results of a recent international study based on a survey of executive officers of the world's thousand biggest enterprises indicate that the pending structural reforms in Mexico have made the country loose attractiveness for investors against other emerging economies.[9]

Graph 20 **Business Confidence and Business Climate Indicators**

Indexes 2003 = 100



Source: Banco de México and INEGI.

Summing up, after reviewing the behavior of a broad range of indicators, in the fourth quarter of 2004, annual GDP growth is expected to have been nearly 4.7 percent, an annual rate slightly above that recorded in the third quarter. This implied that for the year as a whole, GDP grew approximately 4.2 percent, the highest growth in the last four years. [10]

Finally, despite the development of aggregate demand, no significant pressures to inflation are foreseen. Nonetheless, as the economy continues to undergo the highest phase of its cycle, idle production capacity in different sectors will continue tightening, which might create an environment where a greater number of producers would be in conditions to raise their prices more easily. This will be particularly significant in the first months of 2005, when the different subindexes that make up the core consumer

[9] A.T. Kearney, FDI Confidence Index, Global Business Policy Council, October 2004, Volume 7.

[10] The latest official available information on GDP and aggregate supply and demand corresponds to the third quarter of 2004. The annual growth in exports of goods and services (12.1 percent) and in private consumption (5.7 percent) and the expansion at an annual rate in gross capital formation (8.5 percent) were significant. The latter, as a result of the sharp annual growth in private investment (11.1 percent), given that public investment contracted 1.7 percent.

price index exhibit high seasonality, as a reflection of the greater number of goods and services' prices that are usually revised by the producers of such goods at the beginning of the year.

II.3.4. Balance of Payments and Capital Flows

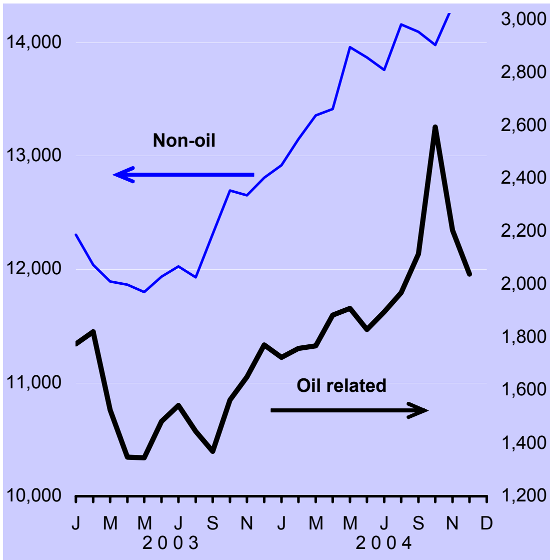
During the fourth quarter of 2004, Mexico's external sector was characterized by the following: a) a significant annual increase in non-oil exports; b) a high value of crude oil exports, which declined gradually during the quarter; c) the rapid expansion of merchandise imports (especially of capital goods, which rebounded significantly); d) moderate trade and current account deficits, which, however, were significantly wider than those recorded in the third quarter. Such results are attributed to both the higher growth in domestic demand during the quarter as compared with that of GDP and to seasonal factors; e) significant workers' remittances; f) a capital account surplus, which easily financed the current account deficit; and g) a significant accumulation of international reserves.

During the reference period, merchandise exports continued to follow the upward trend exhibited in the first three quarters of the year. Such results implied a significant increase in imported inputs for export manufactured goods. Regarding the international oil market, it continued to be characterized by high crude oil prices, therefore allowing for the value of Mexican crude oil exports to remain high. The average price of the Mexican crude oil export mix was 33.34 US dollars per barrel, similar to that recorded in the third quarter of 2004 (33.54 US dollars). Such price was one of the historically highest prices observed. On another front, the increase in both domestic economic activity and domestic expenditure were reflected in 2004 in the strength exhibited by the different items of merchandise imports (Graph 21). Under such context, and partly due to the usual seasonality of domestic consumption expenditure, foreign purchases of this type of goods rebounded in the fourth quarter of the year.

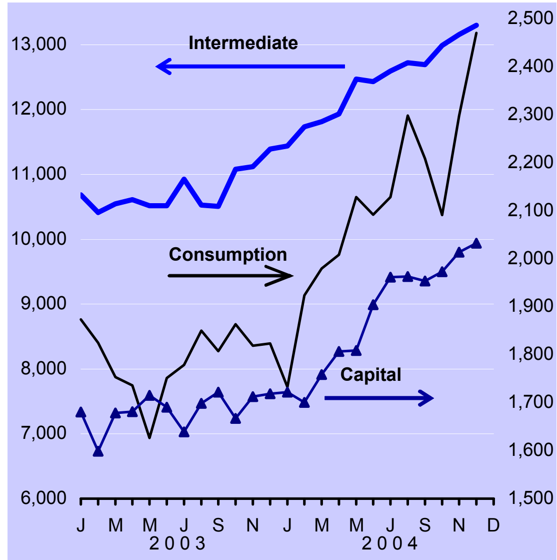
Graph 21 **Exports and Imports (Merchandise)**

Seasonally adjusted series, million US dollars per month

a) Exports



b) Imports



Source: Banco de México.

During the fourth quarter of 2004, merchandise exports grew at an annual rate of 14.1 percent, due to increases in oil and non-oil exports (37 and 11.2 percent, respectively). Regarding non-oil exports, manufactured good exports rose 10.4 percent. As for merchandise imports, these grew at an annual rate of 17.9 percent during the fourth quarter, the highest rate in the four quarters of the year. Thus, foreign purchases of intermediate, consumption, and capital goods rose 17.1 percent, 22.7 percent, and 17.5 percent, respectively. The latter was the highest figure for such item since the first quarter of 2001.

During the fourth quarter of 2004, the trade deficit was 4.760 billion US dollars, above that of the same quarter of 2003 (2.613 billion). The latter, despite the fact that in the fourth quarter of 2004, the value of oil exports was 1.793 billion US dollars above that observed in the same quarter of 2003. This result reveals that during such quarter the dynamism of domestic demand, which surpassed that of GDP, led to a widening in the trade deficit. During the entire 2004, such deficit was 8.117 billion US dollars, above its corresponding deficit of 2003 (5.624 billion).

Mexican merchandise exports to the U.S. rose at an annual rate of 13.1 percent during January-November 2004. Nonetheless, during such period, just like it happened in 2003, such expansion was less vigorous than that exhibited by total exports of the rest of the U.S. trading partners (17.4 percent). Such result implied that the share of Mexican exports in U.S. imports declined once more, from 11.03 percent during January-November 2003 to 10.67 percent in the same period of 2004 (Table 9). Excluding automotive and oil exports from total exports to the U.S., during the first eleven months of 2004 Mexican exports to the U.S. grew at a rate of 14.7 percent, below that exhibited by the rest of the U.S. trading partners (17.3 percent).

Table 9 **U.S. Imports**

Percent

	Share				Annual percentage changes: January-November 2004				
	2002	2003	Jan-Nov 2003	Jan-Nov 2004	Total	Crude Oil	Total excluding Crude Oil	Automotive	Total excluding crude oil and automotive
Total	**100.00**	**100.00**	**100.00**	**100.00**	**16.92**	**32.57**	**15.58**	**8.98**	**17.02**
Total excluding Mexico	**88.41**	**89.02**	**88.97**	**89.33**	**17.39**	**33.40**	**16.08**	**10.01**	**17.25**
Total excluding Mexico and China	**77.63**	**76.89**	**76.84**	**75.98**	**15.61**	**33.36**	**13.90**	**10.01**	**14.82**
1. Canada	18.00	17.63	17.71	17.52	15.67	32.07	14.55	12.15	15.53
2. China	10.78	12.13	12.13	13.35	28.68	61.69	28.65	--	28.65
3. Mexico	**11.59**	**10.98**	**11.03**	**10.67**	**13.10**	**27.63**	**11.44**	**4.65**	**14.66**
4. Japan	10.46	9.39	9.39	8.81	9.72	--	9.72	4.20	13.35
5. Germany	5.38	5.42	5.37	5.23	14.01	--	14.01	7.28	17.90
6. United Kingdom	3.51	3.40	3.39	3.13	8.08	--	1.78	-1.45	2.35
7. South Korea	3.06	2.96	2.93	3.16	25.89	--	25.89	26.71	25.61
8. Taiwan	2.77	2.51	2.51	2.36	10.00	--	10.00	15.13	9.74
9. France	2.43	2.32	2.29	2.14	9.01	--	9.01	--	9.01
10. Malaysia	2.07	2.02	2.02	1.91	10.73	4.93	10.78	--	10.78
Total 10 countries	70.05	68.77	68.77	68.29	16.10	39.16	15.31	8.24	17.37

Source: Prepared by Banco de México with data from the U.S. Department of Commerce.

During the fourth quarter of 2004, inflows from workers' remittances were 4.219 billion US dollars, an annual increase of 25.4 percent. The latter implied that for the entire 2004 revenues from this source totaled 16.613 billion US dollars, representing an annual increase of 24 percent. Such inflows originated from 50.9 million transactions, for an average value of 327 US dollars each. Thus, in 2004 the value of workers' remittances equaled 78 percent of the value of crude oil exports and 87 percent of the trade surplus of the maquiladora sector.

The abovementioned information, as well as that available regarding other items from the balance of payments, allow for estimating that, in the fourth quarter of 2004, the current account deficit might have been around 4.7 billion US dollars. Thus, the current account accumulated deficit in 2004 would have been 8.8 billion US dollars, equivalent to 1.3 percent of GDP, and similar to the 8.7 billion deficit of 2003. As for the capital account, it is expected to have recorded in the last quarter of 2004 a net inflow of resources for approximately 8.6 billion US dollars (including errors and omissions). Foreign investment accounted for a significant part of these funds. Such result originated from positive flows in its components of direct investment, and portfolio investment. On another front, during the fourth quarter, the first foreign placement of a perpetual bond by a Mexican private enterprise was done for 300 million US dollars. It is important to note that in the previous quarter, PEMEX did the first Mexican placement of this type of bonds.

Summing up, during the fourth quarter of 2004, the balance of payments was characterized by a moderate current account deficit of 4.7 billion US dollars, a capital account surplus of 8.6 billion US dollars (including errors and omissions), and an accumulation of international reserves of 3.881 billion US dollars. Therefore, in 2004, the capital account surplus is expected to have been approximately 12.9 billion US dollars (including errors and omissions), while net international reserves rose by 4.061 billion US dollars.

III. Monetary Policy during the Fourth Quarter of 2004

III.1. Monetary Policy Actions

In 2004, monetary policy faced the following challenges:

(a) Containing the effects of price increases of several commodities in international markets on inflation expectations and wage negotiations.

(b) Limiting inflation pressures that could originate from the economy's cyclical recovery.

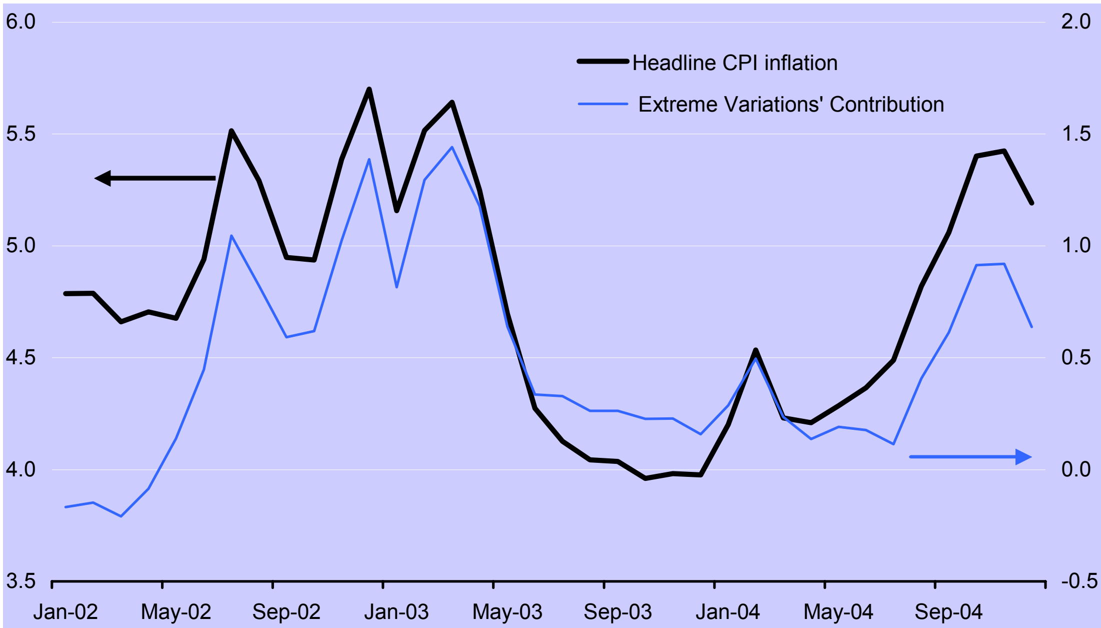
(c) Fostering an orderly adjustment of the economy to an environment of tighter global monetary conditions.

During October-December two phenomena prompted an additional rebound in inflation: i) the sharp increases in the prices of certain fruits and vegetables, especially, tomato, due to specific problems in their supply; and ii) the incidence of the subindex of administered prices on headline CPI inflation continued escalating, due mainly to the upward movement in the price of household-use gas.

Although these phenomena affected headline CPI inflation directly, just as in the case of other supply shocks that took place during the year, price increases concentrated on a few items and did not lead to an overall upward revision in prices (Graph 22).

Nonetheless, given the number and intensity of supply shocks that took place in 2004, inflation expectations for the medium term rose considerably (Graph 23). As shown in Table 10, while inflation measured at an annual rate for 2004 increased 121 basis points, expectations for annual inflation for the end of 2005 and for 2006 drawn from Banco de México's survey did so by 79 and 44 basis points, respectively.

Graph 22 **Contribution of Maximum and Minimum Extreme Variations (10 percent on CPI item prices) to Headline CPI Inflation***

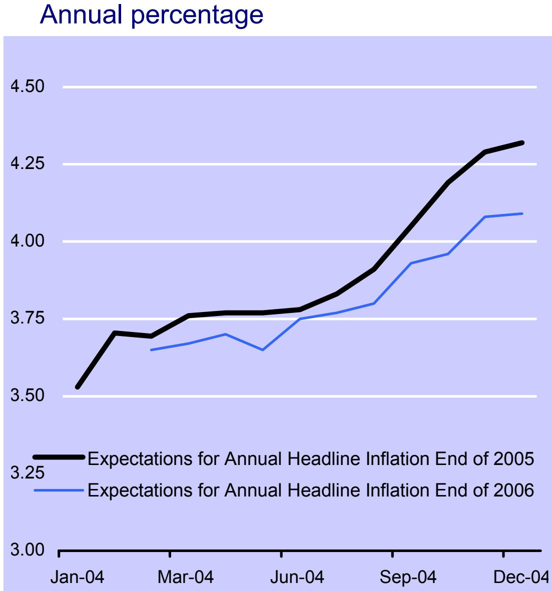


* The contribution of extreme variations in the prices of some CPI items to headline CPI inflation is calculated as follows: i) seasonally adjusted monthly variations of CPI items are ordered from maximum to minimum according to the contribution of each variation to CPI's variation; ii) the 10 percent maximum and 10 percent minimum are selected; and iii) the contributions of extreme variations to headline CPI inflation are accumulated. The contribution of extreme variations is a useful indicator for identifying if the changes in headline CPI inflation are originated by changes in the prices of certain CPI items (which occurs when the contribution of extreme variations behaves in a similar way to that of headline CPI inflation).

Graph 23 **Inflation Expectations: Banco de México's Survey**

a) Inflation expectations for the end of 2005 and 2006

Annual percentage



b) Inflation expectations for the following 12 months and average for 2005-2008

Annual percentage

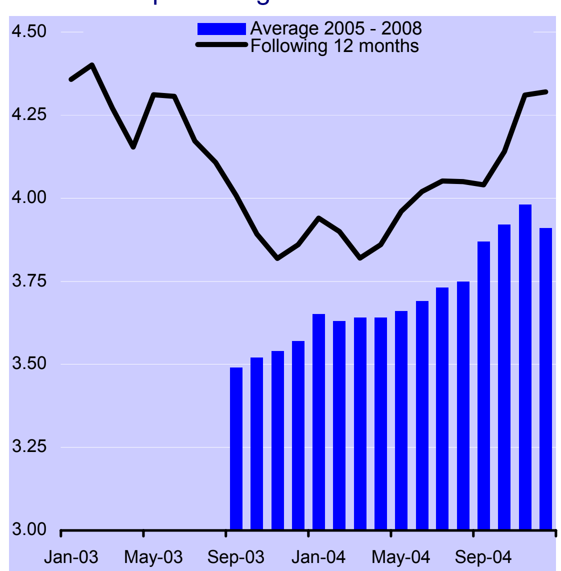


Table 10 **Annual Observed Inflation and Inflation Expectations**

	Annual Observed Inflation	Annual Expected Inflation							
		2004		2005		2006		Following 12 Months	
		Infosel[1/]	Banxico	Infosel[1/]	Banxico	Infosel[1/]	Banxico	Infosel[1/]	Banxico
Dec-03	3.98	3.99	3.86	3.69	3.53	n.a.	n.a.	3.99	3.86
Jan-04	4.20	3.89	3.95	3.65	3.70	3.73	n.a.	3.88	3.94
Feb-04	4.53	4.15	4.20	3.70	3.69	3.80	3.65	3.84	3.90
Mar-04	4.23	4.17	4.23	3.72	3.76	3.76	3.67	3.76	3.82
Apr-04	4.21	4.07	4.11	3.72	3.77	3.75	3.70	3.80	3.86
May-04	4.29	4.10	4.09	3.75	3.77	3.79	3.65	3.96	3.96
Jun-04	4.37	4.13	4.08	3.76	3.78	3.80	3.75	4.02	4.02
Jul-04	4.49	4.16	4.14	3.83	3.83	3.83	3.77	4.03	4.05
Aug-04	4.82	4.39	4.33	3.91	3.91	3.88	3.80	4.03	4.05
Sep-04	5.06	4.64	4.64	3.97	4.05	3.91	3.93	3.98	4.04
Oct-04	5.40	5.22	5.18	4.13	4.19	3.99	3.96	4.19	4.14
Nov-04	5.43	5.35	5.36	4.21	4.29	4.01	4.08	4.23	4.31
Dec-04	5.19	5.43	5.47	4.22	4.32	4.01	4.09	4.22	4.32
Dec-04 - Dec-03 (Δpb)	121	144	161	53	79	30[2/]	44[3/]	23	46

n.a. not available.
1/ Figures correspond to the last survey of the month.
2/ First survey of January 2004.
3/ First survey of February 2004.

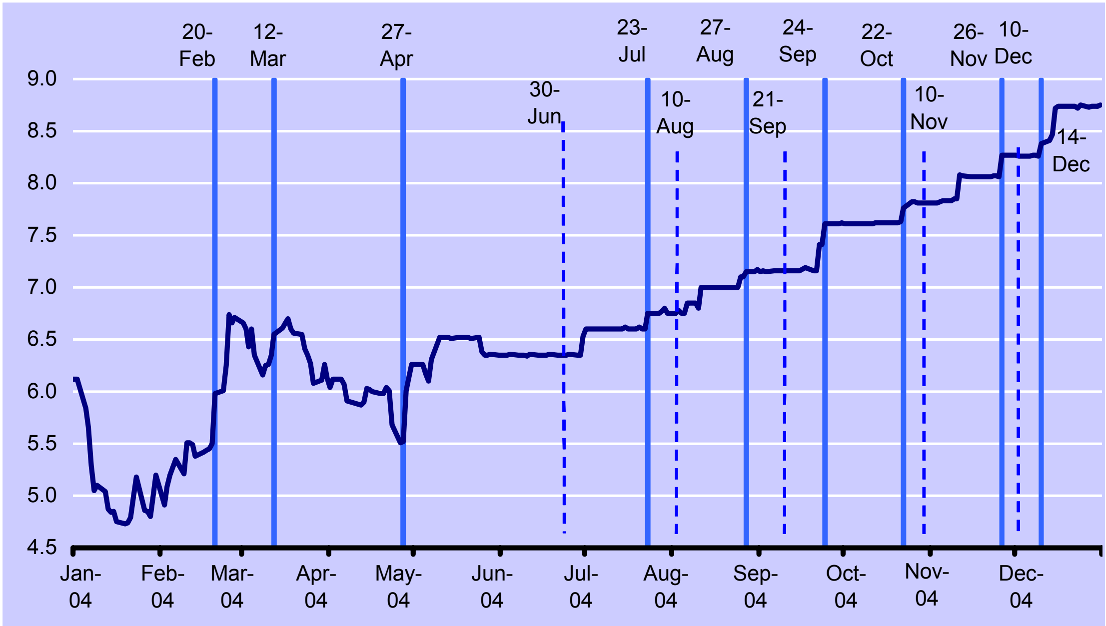
Under such environment, and in order to prevent wage negotiations and price determination from being contaminated, Banco de México tightened the monetary policy stance considerably in 2004. This was done mainly through two channels:

(a) By increasing the *corto* (short position) on nine occasions. During the fourth quarter, it was done on three occasions: on October 22, from 51 to 57 million pesos; on November 26, to 63 million pesos; and on December 10, to 69 million pesos.

(b) By stating in its press releases on monetary policy that, until deemed necessary, domestic monetary conditions should mirror, at least, the greater monetary astringency that prevails in the U.S.

As a result of the abovementioned monetary policy actions, short-term domestic interest rates rose significantly (Graph 24): the interbank funding rate increased 114 basis points in the last quarter of 2004, 263 basis points in 2004, and more than 400 basis points above its lowest level during the year (January 19).

Graph 24 **Banks' Funding Rates, Change in the *Corto*, and Change in the U.S. Federal Funding Rate***



* Continuous vertical lines indicate changes in the *corto*. Dotted lines indicate changes in the U.S. federal funding rate.

Actions to tighten the monetary policy stance in Mexico have taken place in an environment of favorable conditions in international financial markets, given the gradual withdrawal of the monetary stimulus in the U.S.

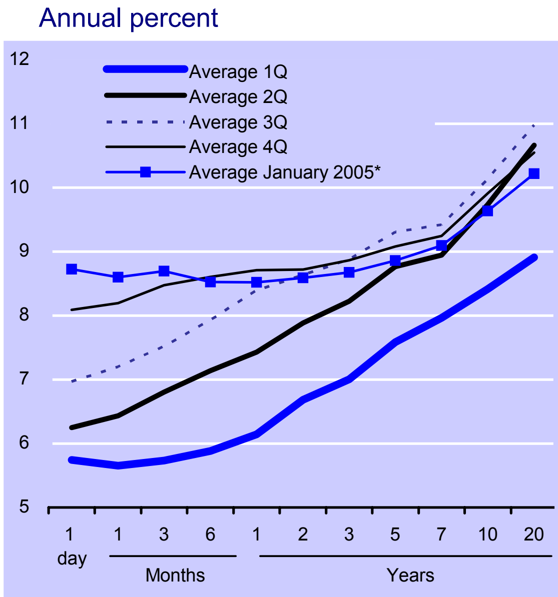
The combination of Banco de México's monetary policy actions and the relatively ample liquidity conditions prevailing in world financial markets have led to both a significant "flattening" of the yield curve in pesos, and to interest rate spreads between Mexico and the U.S. that have widened in the short term and narrowed in the long term (Graph 25).

In 2005, Mexican monetary policy will continue to face significant challenges to abate inflation; however, their relative importance will probably differ from that observed in 2004. Although the Central Bank will remain attentive so that no sequels from the significant increase in headline CPI inflation in 2004 take place, it will particularly monitor aggregate demand and any demand side pressures to inflation.

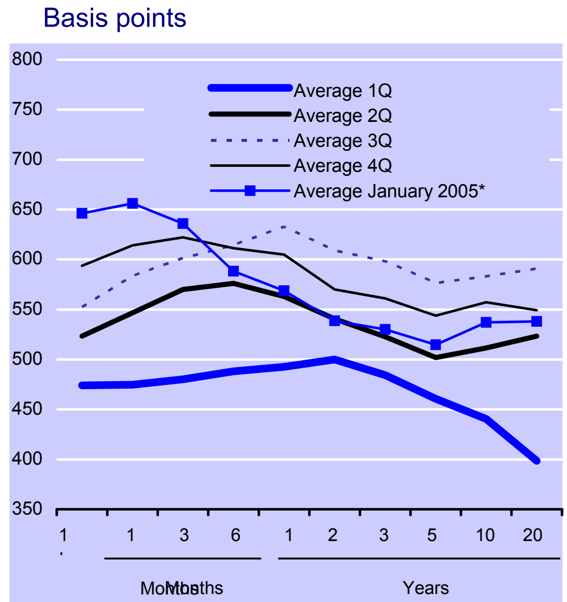
Under such context, although the different items of expenditure continue to expand vigorously, no significant inflation pressures from the demand side are envisioned. Furthermore, up to now, the upturn in headline CPI inflation apparently has not contaminated wage negotiations.

Graph 25 **Yield Curve in Mexico and Interest Rate Differential Between Mexico and the U.S.**

a) Yield Curve in Mexico



b) Yield Spread Between Mexico and the U.S.



* Observations up to January 28, 2004.

Nonetheless, the following also deserve mention: i) core CPI inflation apparently has stabilized, although at relatively high levels; ii) core inflation of services excluding housing has rebounded in recent months, due mainly to the price increase of certain items that use different commodities, whose prices underwent significant upward movements; and iii) both the levels of total core CPI inflation and its expectations suggest that the 3 percent inflation target has still not been included in a widespread fashion into the price determination process.

Given the lag under which the different passthrough channels of monetary policy operate, monetary policy must assess inflation pressures that might prevail in the coming months. Banco de México will act accordingly to curb any inflation pressures related with the economic cycle, so that inflation expectations resume their path to the inflation target.

III.2. Monetary and Credit Aggregates

III.2.1. Monetary Base, Net Domestic Credit, and International Assets

At the end of 2004, the monetary base recorded a stock of 340.2 thousand million pesos; the difference between such aggregate and its estimate for the year was, on average, -0.2 percent. During 2004, the monetary base grew, on average, 14.1 percent at an annual rate, 2.3 percentage points below that observed in the previous year.[11] As stated in previous inflation reports, although the process by which the ratio monetary base to GDP has increased (remonetization), it has lost strength in recent years.[12]

At the end of 2004, international assets rose by 5.174 billion US dollars; thus, their stock at December 31, 2004 was 64.233 billion US dollars.[13] In 2004, the monetary base grew by 36,564 million pesos. As a result, Banco de México's net domestic credit decreased by 21,004 million pesos during the year (Table 11).

International reserves increased 3.881 billion US dollars during October-December 2004. Such result originated from a decline in Banco de México's liabilities with less than six months to maturity for 1.960 billion and an accumulation of gross reserves for 1.921 billion. Gross reserves' variation was due mainly to the net effect of PEMEX's sale of US dollars for 2.977 billion, the sale of US dollars through the mechanism to slow the pace of international reserve accumulation for 1.452 billion, and the purchase of 89 million US dollars by the Federal Government. As mentioned in previous reports, such mechanism of sale of US dollars has slowed the pace of international reserve accumulation (Graph 26).

[11] Changes calculated based on the average of daily stocks.

[12] Historic evidence reveals that in low inflation economies: i) the effects of shocks to revenues or interest rates are reflected more slowly on the demand for money; and ii) such demand tends to become more sensitive to fluctuations in interest rates. Therefore, as interest rates have fallen sharply in the last years, the following was to be expected: i) a considerable remonetization process; and ii) that such process would gradually decrease.

[13] For a definition of international assets and international reserves please refer to the Glossary included in the weekly press release on Banco de México's statements.

Table 11 **Monetary Base, Net International Assets and Net Domestic Credit**

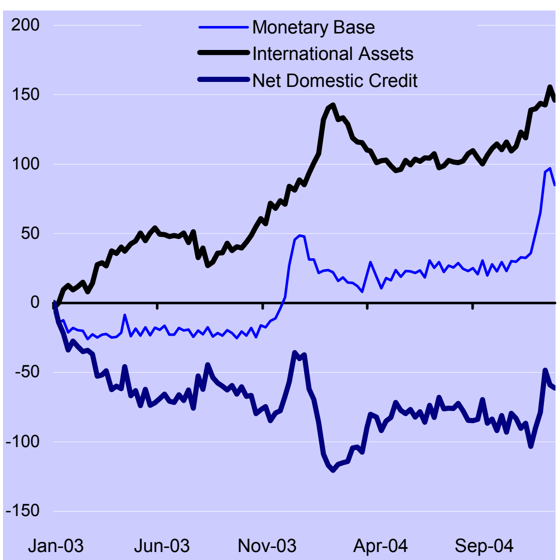
Million

	Stocks		Flows in 2004				
			Quarter				
	At Dec. 31, 2003	At Dec. 31, 2004	I	II	III	IV	Accumulated at Dec.31, 2004
(A) Monetary Base (Pesos)	303,614	340,178	-36,190	11,422	1,942	59,389	36,564
(B) Net International Assets (Pesos) 1/ 2/	663,657	716,170	28,771	-13,209	20,313	21,692	57,567
Net International Assets (US dollars) 2/	59,059	64,233	2,646	-1,186	1,800	1,915	5,174
(C) Net Domestic Credit (Pesos) [(A)-(B)] 1/	-360,043	-375,992	-64,960	24,631	-18,371	37,696	-21,004
(D) International Reserves (US dollars) [(E)-(F)] 3/	57,435	61,496	1,614	79	-1,513	3,881	4,061
(E) Gross Reserves (US dollars)	59,028	64,198	2,631	-1,183	1,800	1,921	5,169
PEMEX			3,268	2,484	5,102	2,977	13,832
Federal Government			880	-1,446	-2,585	-89	-3,240
Sale of US dollars 4/			-1,938	-1,892	-1,430	-1,452	-6,712
Other 5/			421	-329	712	485	1,290
(F) Liabilities with less than six months to maturity (US dollars)	1,593	2,701	1,017	-1,262	3,313	-1,960	1,108

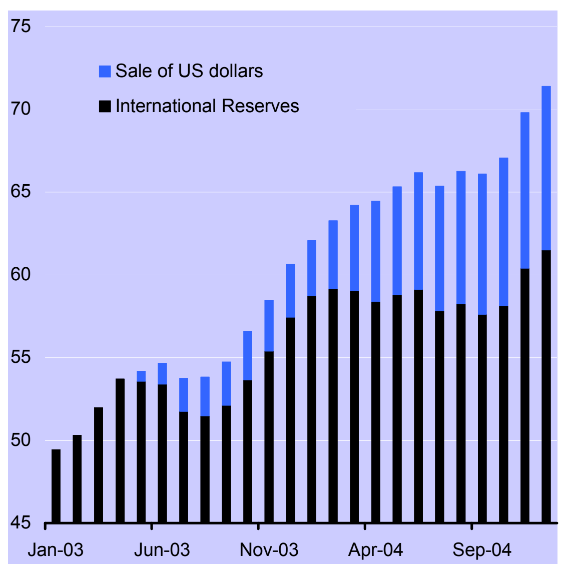
1/ Net international assets' cash flows in pesos are estimated based on the exchange rate applied to each transaction.
2/ Net international assets are defined as gross reserves plus credit agreements with foreign central banks with more than six months to maturity, minus total liabilities payable to the IMF and credit agreements with foreign central banks with less than six months to maturity.
3/ As defined by Banco de México's Law.
4/ Daily sales of US dollars according to the mechanism to slow the pace of international reserve accumulation (see Exchange Commission's Press Release of March 20, 2003).
5/ Includes yields on net international assets and other transactions.

Graph 26 **Monetary Base and International Reserves**

a) Monetary Base, International Assets, and Net Domestic Credit
Effective flows accumulated since 2003
Thousand million pesos



b) Stock of International Reserves and Sale of US dollars
Billion US dollars



III.2.2. Monetary Aggregates and Financing

From January to November 2004, Money (M1) grew at an annual average growth rate of 9.2 percent. Such result is due to both the remonetization process involving all payment means, and the dynamism of payroll accounts. At November 2004, this type of accounts accounted for 20 percent of liquid bank deposits; during the year, they grew at a real annual average rate of 18.2 percent (Table 12).

As for the broad monetary aggregate (M4), the recovery of bank deposits and the increase in non-resident savings in domestic financial instruments, mainly fixed rate long-term public securities deserve mention.[14] Commercial banks' efforts to obtain resources are partly associated with the growth in financing to the private sector (Graph 27a). In this regard, direct performing credit grew at a real annual rate of 21.3 percent in November. As for its components, at November, credit to households rose at a real annual rate of 38.9 percent. Within the latter's components, both consumption credit and mortgage credit have grown at real annual rates of 47 and 22.8 percent, respectively (Graph 27b). Nonetheless, it is important to consider that the stock of bank lending to households is still very small, only 3.22 percent of GDP.

Bank credit to enterprises has begun to recover in recent months, reaching in November a real annual growth rate of 10.7 percent (refers to direct performing credit).The expansion of credit to the private sector is due to many factors, both structural and those pertaining to Mexico's current economic conditions. Regarding the former, progress in price stability and the different financial reforms adopted in the last years, which have contributed to the granting of credit in better terms, both for debtors and creditors. As for the factors regarding Mexico's current economic conditions, the cyclical recovery of economic activity deserves mention.

[14] Security holdings by non-residents rose by 54.6 thousand million pesos in the first eleven months of 2004, thus accounting for 15.3 percent of the flow of M4.

Table 12 **Monetary Aggregates**

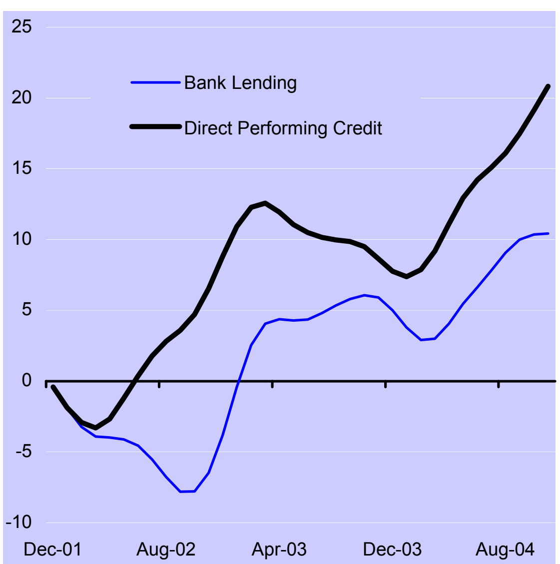
Real annual change of average stocks

	2003	2004 Quarters I	II	III	Nov
Currency Held by the Public	9.8	7.9	10.5	10.4	8.3
Checks in Pesos	7.3	7.7	9.2	4.9	2.6
Current Account Deposits	15.3	23.2	20.8	16.4	7.8
Checks in Foreign currency	-8.7	-6.5	3.0	19.0	26.0
M1	7.0	8.0	10.4	9.6	7.4
M2	7.0	7.7	8.3	7.0	5.3
M3	7.2	8.4	8.6	7.4	6.6
M4	6.9	8.2	8.5	7.3	6.6
Memo:					
Domestic Banks' Deposits	5.6	0.5	6.6	7.7	9.4
Non-resident Savings	33.8	63.7	43.2	42.5	133.4

Graph 27 **Commercial Banks' Direct Performing Loans Granted to the Private Sector**

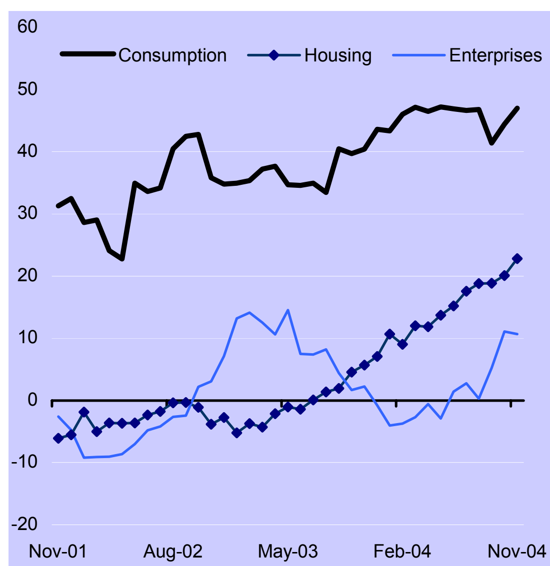
a) Bank Deposits and Direct Performing Credit Granted to the Private Sector

Real annual percentage change of trend series



b) Direct Performing Credit Granted to the Private Sector (excluding portfolio associated with debt-restructuring programs)

Real annual percentage change



IV. Private Sector Outlook for 2004-2005

IV.1. Forecasts for Economic Activity and for Different Determinants of Inflation

During the fourth quarter of 2004, private sector economic analysts modified their forecasts regarding the main macroeconomic variables. In general terms, the most significant aspects of private sector expectations were the following: a) expected inflation for both 2004 and 2005 was revised upward; b) expected economic growth for 2004 was slightly revised upward; and c) confidence and business climate indicators stopped exhibiting the weak results recorded during the third quarter of the year. In fact, two out of three business confidence indicators prepared in Mexico exhibited an improvement in relation to the third quarter.

In the survey conducted in December, private sector economic analysts' forecasts were as follows: i) GDP is expected to have grown 4.08 percent in 2004, above September figures (4.02 percent) [Table 13]. A slight reduction in GDP's growth rate is expected for 2005 and 2006 (3.74 and 3.83, respectively); ii) in 2005, 401 thousand jobs are expected to be created in the formal sector; iii) expectations regarding domestic interest rates for the following months were revised upward as compared with those forecasted in September; iv) expectations regarding the peso exchange rate for the following months and for the end of 2005 were revised downward as compared with those forecasted in September; and v) moderate trade and current account deficits are expected for 2004 and 2005.

Analysts surveyed in the fourth quarter of 2004 insisted that the two main factors that might limit both economic activity and higher levels of investments in the next months are: a) the lack of progress in pending structural reforms; and b) some domestic political uncertainty perceived during the reference period.

Table 13 **Private Sector Economic Analysts' Forecasts: September and December 2004[1/]**

	September 2004	December 2004		September 2004	December 2004
Real GDP Growth in Mexico			**Exchange Rate (Pesos/US dollar, year-end)**		
2004	4.02%	4.08%	2004 (Banxico Survey)	11.58	n.a.
2005	3.74%	3.74%	Futures [4/]	11.52	11.26
Trade Deficit (Million US dollars)			2005 (Banxico Survey)	11.92	11.86
2005	9,924	8,526	**Mexican Crude Oil Mix (Average US dollars per barrel)**		
Current Account Deficit (Million US dollars)			2005 (Banxico Survey)	27.06	27.58
2004	9,455	7,985	**Wage Increases**		
2005	13,803	12,314	January 2005	n.a.	4.60%
Foreign Direct Investment (Million US dollars)			February 2005	n.a.	4.59%
2004	15,327	14,501	**Business Climate**		
2005	13,431	13,852	1998=100 [5/]	144.0	128.2
Real GDP and Industrial Production Growth in the U.S. in 2004 and 2005					
GDP Growth in 2004			**GDP Growth in 2005**		
Banxico Survey	4.28%	4.49%	Banxico Survey	3.60%	3.51%
Consensus Forecasts [2/]	4.3%	4.4%	Consensus Forecasts [2/]	3.5%	3.5%
Blue Chip Economic Indicators [3/]	4.3%	4.4%	Blue Chip Economic Indicators [3/]	3.6%	3.5%
Industrial Production in 2004			**Industrial Production in 2005**		
Blue Chip Economic Indicators [3/]	4.8%	4.5%	Blue Chip Economic Indicators [3/]	4.9%	4.2%

n.a. not available.
1/ Unless otherwise stated, data are obtained from Banco de México's monthly Survey of Private Sector Economic Analysts' Forecasts.
2/ *Consensus Forecasts (*September 13 and December 6, 2004).
3/ Blue Chip Economic Indicators (September 10 and December 10, 2004).
4/ Exchange rate futures at September 30 and December 13, 2004.
5/ Average level of third and fourth quarters.

IV.2. Inflation Expectations

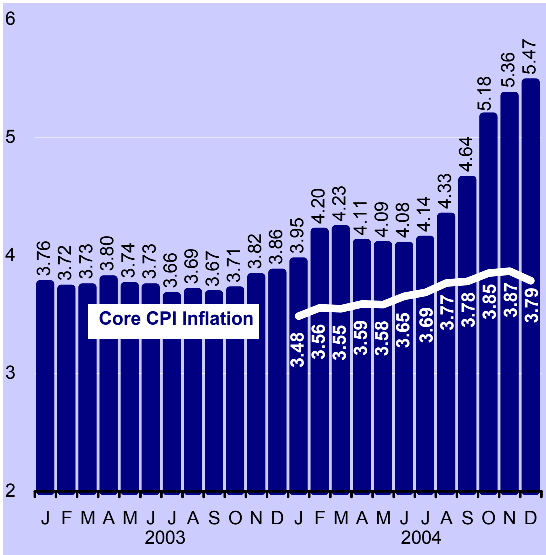
During the fourth quarter of 2004, private sector analysts revised upward their forecasts for inflation for different terms. In the December survey, expected headline CPI inflation for 2004 was 5.47 percent, above that forecasted in September (4.64 percent), and that observed for the entire year (5.19 percent).[15] As for core CPI inflation for 2004, expectations remained practically unchanged: 3.79 percent in December (in the September survey, estimates for core CPI inflation were 3.78 percent; however, observed core CPI inflation turned out to be 3.80 percent). Responses from the December survey showed increases in expected inflation rates for 2005, 2006, 2007 and the average for 2006-2009: 4.32, 4.09, 3.95 and 3.91 percent, respectively.

[15] Banco de México's Survey of December was conducted during the second week of that month; therefore, inflation at the end of December 2004 and at the beginning of 2005 was not announced at that time. In other surveys conducted more periodically certain indicators of expected inflation have exhibited some reduction.

Graph 28 **Economic Analysts' Inflation Expectations for 2004-2008**

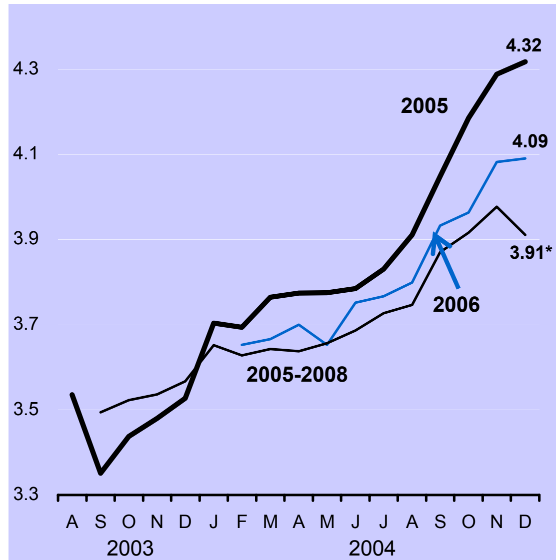
a) Headline and Core CPI Inflation in 2004

Percent



b) Average Inflation for the Short and Long Terms

Percent



* Expectations obtained from the survey of December correspond to period 2006-2009.
Source: Survey of Private Sector Economic Analysts' Forecasts.

V. Balance of Risks and Final Remarks

Banco de México's expected scenario for 2005 is based on the following assumptions:

(a) A positive outlook for the world economy. The U.S. economy is expected to continue growing at a pace closer to its potential rate, while the main analysts anticipate it will grow, on average, 3.6 percent. Regarding industrial production in that country, it is expected to expand at a higher growth rate than GDP in 2005 (4.2 percent).

(b) U.S. core CPI inflation and its expected level are anticipated to continue evolving within moderate levels; therefore, the Federal Reserve would be expected to withdraw the monetary stimulus gradually. In light of such environment, favorable conditions in international financial markets are foreseen in 2005. The combination of favorable conditions of access to foreign financing, oil revenues, and workers' remittances, envision that there will be an ample availability of resources to boost domestic expenditure.

Considering the abovementioned macroeconomic environment and most recent information on the development of the Mexican economy, Banco de México's baseline scenario for 2005 is as follows:

GDP Growth: GDP is expected to grow between 3.5 and 4.0 percent, slightly below estimates for 2004, and consistent with the world economy's scenario.

Employment: Nearly 400 thousand jobs are expected to be created in the formal sector.

Current Account: A moderate deficit in the current account of the balance of payments is expected (approximately 2 percent of GDP).

Inflation: Headline CPI inflation is expected to follow a downward trend and, at the end of the year, to fall within the variability interval set around the inflation target. Such consideration is based on the following:

During 2004, inflation was subject to many supply shocks, mainly associated with the upward movement in the price of a rather larger number of commodities. In the last months of 2004 such environment worsened even further by the presence of weather-related phenomena that affected the crops of many agricultural products in Mexico and the U.S.

Some of these weather-related shocks have already begun to ease and it is expected that others will gradually do so. In fact, futures' markets suggest that prices for crude oil and its by-products will gradually fall in the following months. In the meantime, international prices of food and agriculture commodities have been declining.

Regarding non-core inflation and its impact on headline CPI inflation:

(a) The prices of several commodities, which have increased significantly, are expected to exhibit a more favorable behavior. Such consideration is based on the prevision that the economic growth rate of the world will slow down slightly and to the fact that the supply of such goods has increased along with their production profitability. Energy prices have probably reached their highest levels, while prices of certain grains and cereals and other basic foodstuff commodities have fallen.

(b) Prices of meat products increased sharply in 2004 due to higher world demand for such products. In addition, at the end of 2003 and at the beginning of 2004, sanitary problems were detected in Mexico's suppliers of meat products, which brought about restrictions of such imports of meats and consequently a decline in the domestic supply of such goods, therefore affecting their sale prices. Futures' markets suggest that pork meat prices will fall in 2005, while those of beef will remain stable. Should this be the case, the annual price variation of such items would fall.

(c) Goods and services with prices administered by the public sector are expected to follow a path in line with the one suggested by futures' markets. This applies for gasoline at the borders, and for liquid propane and natural gas. As for electricity rates, the Federal Government has announced that it will moderate its increments.

(d) The supply shocks that led to an upward revision in inflation expectations have started to ease; consequently, the latter have begun to be revised downward. This suggests that an inflection point in inflation expectation's trend might have already taken place.

(e) Supply shocks apparently have had a limited effect on wage negotiations.

Regarding core CPI inflation:

(f) Concerning the merchandise subindex, annual food inflation is expected to reduce its growth rate in line with the development of food prices in the international markets. The other items of the merchandise subindex are expected to follow a lateral trend. Consequently, the trend for total core merchandise inflation is expected to decline in 2005.

(g) The annual variation of the housing services' subindex is expected to remain around its current levels, while that of the rest of the services could continue to increase in the following months and afterwards stabilize. The latter consideration is based on the fact that the increase in the price quotes of certain services is mainly attributed to the higher prices of certain commodities which are used as inputs in the production of such services. As long as the outlook for commodity prices improves and no pressures on wages arise, services' inflation would be expected to eventually stabilize after the mentioned rebound. Summing up, total core services' inflation is expected to follow a moderate upward trend in the first months of the year and then remain stable.

(h) The path of total core CPI inflation will depend mainly on the development of prices of both food and services excluding housing (items that have practically the same weight in the CPI). Therefore, total core CPI inflation is expected to follow a lateral path in the first months of 2005 and afterwards begin to decline.

In general terms, the outlook for inflation in the following months will depend on the interaction of the abovementioned factors. The combination of a more positive outlook for commodity prices and the handling of monetary policy suggest that inflation will follow a downward path in 2005. Should the abovementioned outlook for the different price subindexes materialize, headline CPI inflation at the end of 2005 would be expected to reach levels similar to those observed at the end of 2003.

The abovementioned scenario implies that the reduction in headline CPI inflation in 2005 would mostly be attributed to the non-core component. Such consideration confirms that the convergence of inflation to its target still faces significant challenges. In particular:

(i) Core CPI inflation has exhibited some downward resistance.

(ii) Core services' inflation excluding housing has rebounded, due mainly to the increase in food and energy prices in the previous months.

(iii) Both the levels of core CPI inflation and its expectations suggest that the long-term inflation target still has not been fully included in the price determination process.

Under such context, Banco de México will conduct monetary policy so as to procure that monetary conditions facilitate the convergence of inflation to its target.

* * *

The expected macroeconomic scenario is mainly subject to two types of risks that act in opposite directions: those affecting inflation and those affecting growth.

Regarding the former, inflation pressures from U.S. and world aggregate demand could heighten. Such scenario could also have the following consequences: first, external interest rates would be pressured upward, which, in turn, would lead to higher volatility in financial markets and, therefore, to a worsening in emerging economies' conditions to access external financing; and second, international commodity prices could continue to increase, thus affecting the outlook for inflation in Mexico considerably.

The major risks associated with inflation abatement probably stem from Mexico's domestic economic conditions. In this regard, Banco de México will monitor closely the development of aggregate demand and wage negotiations, as well as any pressures that both could have on inflation.

As for risks associated with economic growth, U.S. economic activity could slow down significantly. Additional price increases in crude oil and its by-products or a sharp decline in real estate prices may contribute to the materialization of this scenario. Under such setting, the Mexican economy would be affected by a decrease in the demand for its exports, which, in turn, would reduce forecasts for growth and employment. Should crude oil prices increase significantly, these would also have a negative effect on inflation.

Other series of events could affect the Mexican economy. Nonetheless, there are two additional sources of uncertainty that, given their nature, could affect the economy in a longer horizon.

On the one hand, the upward trend and unprecedented level of the U.S. current account deficit, which seems to be unsustainable in the long run, is of great concern. That is, the net debtor position of the U.S. economy may turn unsustainable in the future. Should this scenario materialize, volatility in international financial markets would increase significantly, restricting emerging markets' access to financing. Furthermore, the contraction of external demand would slow economic activity significantly.

On the other, as 2006 federal elections in Mexico near, adverse conditions for the economy could materialize: first, the lack of consensus to reach agreement on the structural reforms needed to increase the competitiveness of the economy could be further complicated; and, second, political uncertainty could increase the volatility in Mexican financial markets.

A careful evaluation of the abovementioned risks indicates that in the following months, the economy's macroeconomic anchor, of which monetary policy plays a crucial role, will probably gain relevance. For this reason, it is very important that an autonomous institution like Banco de México sustains price stability as its main goal.

Throughout the world, inflation abatement is a gradual process that must be carried through a long-term horizon. Therefore, although a series of exceptional shocks affected such process during 2004, the Central Bank reiterates its commitment to price stability, therefore safeguarding the basic conditions to produce and invest. By doing so, Banco de México will contribute to an environment of certainty, which, to the extent possible, will isolate economic activity from eventual external or domestic shocks and help to foster the country's growth potential.

VI. Monetary Program for 2005

Monetary policy conduct in Mexico is based on an inflation targeting framework. Inflation targeting consists of: a) the announcement of explicit multi-annual inflation targets; b) a systematic analysis of the current economic conditions and of inflation pressures; c) a description of the instruments used by the Central Bank to attain its objectives; and, d) a communication policy that fosters the transparency, accountability and effectiveness of monetary policy.

1. Objectives

Banco de México's monetary policy objective is to attain an annual inflation rate of 3 percent and make it remain permanently at that level, considering a variability interval of plus/minus one percentage point. Therefore, the inflation target operates continuously and not only for the year-end annual inflation rate.

The variability interval is intended to accommodate shocks to relative prices, which usually have a temporary effect on inflation. The unexpected nature of such shocks makes it difficult for the Central Bank to counter them accurately.

2. Monetary Policy Decisions

Central bank's monetary policy actions have a lagged effect on the economy, and especially, on the price level. Therefore, to reach the inflation target, the monetary authority must base its decisions on a careful assessment of both the current economic conditions and the outlook for inflation.

Under an inflation targeting regime, when inflation pressures come from the demand side it is usually suggested that the monetary authority should tighten the monetary policy stance in order to promptly contain such pressures from becoming widespread and therefore prevent a permanent rebound in inflation.

On the other hand, when inflation pressures come from the supply side, they usually reflect changes in relative prices, which affect inflation temporarily. In such case, the monetary authority should not counter such pressures, unless these contaminate inflation expectations and the price determination process, in which case the Central Bank would need to tighten the monetary policy stance to prevent subsequent price increases (second round effects). Nonetheless, such recommendation must consider unforeseen factors in the case of economies that have not concluded their disinflation processes. In such cases, regardless of the inflation pressures that arise, monetary policy must remain tight.

An accurate identification of the origin of inflation pressures and its possible effects on economic agents' expectations is crucial for monetary policy decisions. Banco de México carries out a systematic analysis of the current economic conditions and of the inflation pressures originated by such conditions, using a wide range of variables and indicators and different economic and statistical models.[16] Such analysis allows to identify the factors that affect the expected development of inflation and to evaluate its impact on economic agents' inflation expectations.

3. Monetary Policy Implementation

Central banks conduct monetary policy by affecting the conditions under which they supply liquidity to money market participants. Such conditions depend both on the terms used by the central bank to carry out its open market operations and on the central bank's management of commercial banks' current accounts.

Banco de México's implementation of monetary policy allows interest rates to be determined freely in the money market. Nonetheless, the Central Bank can influence them whenever it considers that monetary conditions are not consistent with the attainment of the inflation target. This has been achieved through different channels, such as the changes in Banco de México's objective for commercial banks' daily balances at the Central Bank (*corto*) and the statements included in the monetary policy press releases, which allow the Central Bank to communicate its monetary policy stance to the public.

Regarding Banco de México's management of banks' current accounts, from the total amount of resources demanded by banks, that corresponding to the negative daily balances' objective (*corto* or short position) is supplied at an interest rate above that in

[16] A forecast for the monetary base for 2005 (which can serve as a general reference to monitor the current economic conditions) can be found at Banco de México's web page (www.banxico.org.mx).

the market. This is done by inducing credit institutions to incur in a daily overdraft with Banco de México. Such overdraft is charged at twice the daily inter-bank funding rate.[17] Throughout the entire process, Banco de México provides at all times the liquidity demanded by the money market.

When Banco de México decides to signal market participants of a tightening in monetary conditions in order to induce an increase in short-term interest rates through the daily balances' objective, it raises the amount of resources supplied at an interest rate higher than that in the market (increase in the *corto*). On the other hand, when the Central Bank wants to signal market participants of a lesser tightening in monetary conditions, it reduces the amount of money supplied at an interest rate above that in the market (reduction in the *corto*). Since the main objective of such implementation is to communicate the Central Bank's monetary policy stance to the public, the amount of money supplied at interest rates above those in the market (*corto*) is small compared with the total liquidity demanded by the money market.

Thus, monetary conditions are the result of the interaction between money market participants and the monetary authority. The change in the amount of money that is supplied at interest rates different from those in the money market (the change in the objective for daily balances or *corto*) and Banco de México's statements included in its monetary policy press releases, are some of the elements used to make monetary conditions and inflation expectations compatible with the Central Bank's inflation target.

4. Communication Policy

In order to attain price stability via an inflation targeting framework, the Central Bank must transmit clearly to the public its objectives, strategy and instruments. The announcement of inflation targets is significant inasmuch as it facilitates the convergence of economic agents' expectations with such targets. The transparency in the process of monetary policy decisions has allowed the Central Bank to explain the motives supporting such actions, making the Central Bank act in a more predictable way under different scenarios. Such transparency creates more certainty among the public, fosters the attainment of the Central Bank's objectives and, in turn, reduces the cost of inflation abatement. In addition, more transparency has contributed to strengthen the accountability inherent to any democratic system.

[17] Positive balances of banks' current accounts at Banco de México are not remunerated.

Among the documents that support Banco de México's communication strategy with the public are the Monetary Program and the Inflation Reports. In addition, since 2003, the Central Bank has been announcing on pre-established dates its monetary policy decisions, together with a press release which explains the motives behind any change or maintenance of the daily balances' objective and presents the Central Bank's opinion regarding monetary conditions compatible with the inflation target.[18]

[18] Such dates are announced on the Inflation Report of the third quarter of the previous year.