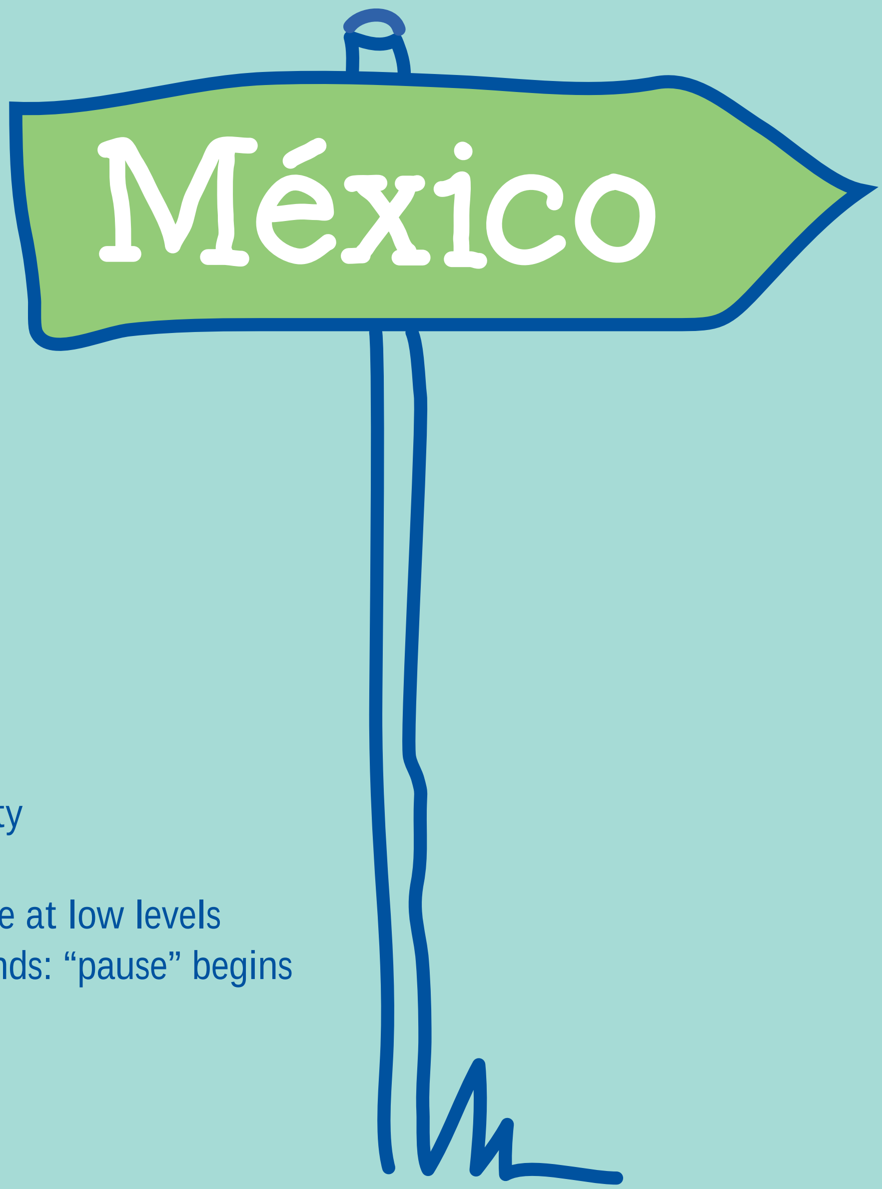
BBVA Bancomer

Situación

Economic Research Department

Second Quarter 2006



The risks: from oil to lower activity
Growth is not yet generalized
Inflation challenge: to consolidate at low levels
The drop in interest rates cycle ends: “pause” begins
Greater peso volatility
Entering final stage in elections

Mexico: Editorial

The first quarter of 2006 has closed, still without the official figures being released, with high economic growth in Mexico. This leads us to think that for the year as a whole, the economy could advance around 3.6%, surpassing the 3.2% that we previously estimated. The scope of the recovery in automobile exports following the introduction of new models in the second half of 2005 and the relative solid strength of domestic demand, especially investment in construction and services, is behind this improvement in outlook. These growth rates are slightly above the current potential expansion of the Mexican economy. In addition, not only are such rates allowing the present cycle of economic recovery to extend for more than three years now, in line with the upward cycle of the U.S. and world economy, but they also enable us to banish the specter of moderation in growth, which could be deduced from the discouraging data regarding growth for the first half of 2005. However, within this panorama there are signs that urge caution and as a result we are not increasing our growth outlook for 2006 nor modifying our projections for 2007. The recovery of manufacturing production is not solid beyond the automotive sector, nor is the recovery of consumption sufficiently extended to believe that its growth rate could be accelerated.

This economic cycle has been accompanied by a significant reduction in inflation, moving toward the central bank target, with very good results in core inflation. This has meant that following the increases in bank funding rates to levels of 9.75% in the summer of 2005 to head off the risk of a transference of the agricultural recession of 2004, the central bank has brought funding rates down to 7%, 225 basis points higher than federal fund rates in the United States. And all this with a peso that, despite the depreciation between February and April, has remained appreciated in real terms in relation to its historical average, given the abundance of flows.

There is no doubt that the relative speed in the rate of the recent depreciation of the peso will generate certain caution on the part of the Banco de México, which has seen how the low spread between Mexican and U.S. rates following their aggressive cycle of declines in the past seven months is no longer enough to protect the peso from greater weakness and volatility in response to the change in expectations on the part of the market with regard to increases in federal fund rates in the United States. In this sense, we can expect a pause in the downward trend to avoid aggressive depreciations of the peso that can worsen inflationary expectations and which, for the time being, have allowed us to see minimum levels in funding rates. The outlook for inflation remaining within the central bank's tolerance range leads us to think that once expectations for increases in Federal Reserve rates, which we believe will stop at 5%, calm down, if the international flows continue and tend to appreciate the peso, there could be additional maneuvering room for a decline in the second half of the year.

Except for surprises, a central bank with an inflation target that is being met, with inflationary expectations on quiet ground, and with a peso slightly appreciated in real terms, we would have to see many dangers for inflation on the horizon in order to expect price increases in the next few months. And for now, it is difficult to see such dangers, even with or without elections, and especially in a context of solid fundamentals in the Mexican economy.

Contents

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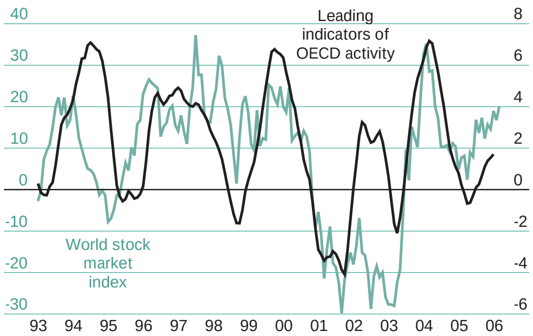
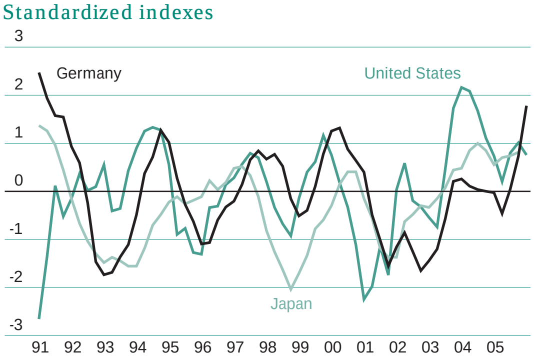
Leading Indicators of Activity



Source: BBVA with OECD and Morgan Stanley data

Industrial Confidence

Standardized indexes



Source: BBVA with IFO, ISM and Tankan data

Economic Outlook

	2005	2006f	2007f
GDP (real % change)	3.5	**3.3**	**3.2**
CPI (% change)			
Headline	3.4	**2.9**	**2.1**
Core	2.2	**2.5**	**2.3**
Federal Funds (% eop)	4.25	**5.00**	**5.00**

eop end of period
f forecast
Source: BBVA US

Dynamic World Activity

World economic activity has remained relatively dynamic despite high oil prices. The indicators published in the first months of 2006 point to high growth in the industrialized countries, including Japan. In particular, in the U.S., annualized quarterly growth in the 1Q06 will be around 5%, spurred by a rebound in the expansion of consumption, compared to growth registered in the 4Q05, mainly in durable goods. Economic growth will be more moderate later, in line with its potential.

Thus, we expect GDP growth of 3.3% in 2006 and 3.2% in 2007. The moderate drop in the growth rate in the U.S. compared to 2005 will be the result of lower real estate wealth extraction—in view of lower appreciation of housing prices and the rise in interest rates—, which will cause consumption to moderate its expansion rate to levels more in line with the growth rate of disposable income. Also, job creation seems to have reached its maximum in the current expansion cycle, and everything points to the fact that it will maintain a stable trend in the coming quarters at an average annual rate of between 1.2% and 1.7%. Non-residential investment will continue to grow over the rest of the economy, supported by a favorable outlook and strong business profits obtained through solid gains in efficiency and high productivity.

Lower growth in domestic demand and, particularly, in consumption in 2006 could be partially offset by greater growth of foreign demand. On the one hand, in Europe, the recovery of confidence is a fact and should be accompanied by an improvement in activity data, especially in countries that, up to now, have shown moderate growth, like Germany. The favorable financial conditions for companies or the recovery of families' disposable income within a context of job creation are solid bases to further European domestic demand. On the other hand, Japan continues to show notable growth, superior to its potential, which could lead to the end of deflation in 2006.

Despite the environment of solid growth and high oil prices, inflation has remained within a relatively narrow range, especially in the core component. Even in the U.S., where the use of productive resources, capital and work has risen significantly and surpassed its historic averages, the rally in energy inflation has been barely transferred to final prices. In fact, the impact of globalization and the performance of real wages, with practically nil growth rates, despite the cyclical situation of the economy, provide a certain margin for inferring that any rally in inflation will be relatively limited. The forecast for core inflation in the U.S. for this year is of annual 2.5% growth, which implies a moderate trend upward as of the 2Q06. The expectation for headline inflation is that it will remain contained at an annual average of 2.9% in 2006.

Within a context where idle capacity continues to diminish and core inflation presents potential upward risks, we expect the Fed to continue to restrict monetary policy. Nevertheless, to the extent that idle capacity seems to have reached its lowest level, core inflation and inflationary expectations will remain delimited, and economic indicators will validate, as we expect, a moderation in activity going forward, mainly in the real-estate market. We anticipate a pause in the restrictive cycle of monetary policy when it reaches 5% in May, although, to the extent that greater pressure is perceived on core inflation in a context of high growth, the FOMC could act cautiously and delay this pause.

There is no doubt that as the end of the cycle of monetary policy approaches, uncertainty regarding its future course increases, giving space for periods of greater volatility in the forecasts than those seen in recent quarters. However, with the economy growing near its potential and stable core inflation, we believe the pause could be prolonged, as occurred following the restriction cycle in 1995.

In the EMU, interest rates will continue to rise also gradually and calmly, until they stand at 3% by the end of 2006. Japan also took the first step in changing its monetary policy: it modified its policy of "quantitative" monetary easing that could signal the abandonment of zero interest rates toward the end of this year. Jointly, the main central banks are moderating the degree of easing that has characterized monetary policy in previous years, even though the expected interest rates are still lower than the maximums reached in previous tightening cycles.

A world with structural changes?

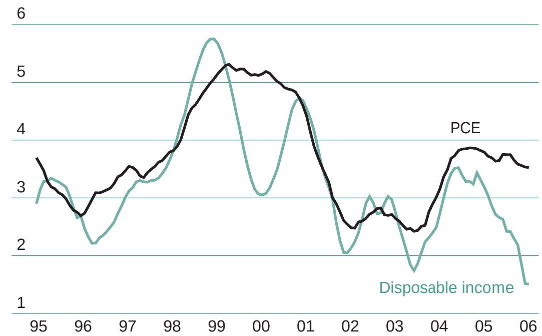
Today, one of the most vivid debates among economists is the sustainability of the current model for world growth in which, by way of simplifying, China invests and exports, while the U.S. imports and consumes, at the same time that inflationary pressure remains low at a global level. This model is mirrored in excess savings in China (similar to other Asian countries and oil-producing countries), which finances negative savings in the U.S. (with a current account deficit of 7% in GDP) and helps long-term interest rates remain low.

In addition to greater credibility of the fight against inflation by the central banks, there are other factors that provide support for this situation to respond, in part, to structural change, such as the technological development and globalization of activity with new participants in the market economy, which is assuming a change in the traditional mechanisms for the transmission of prices and wages. This globalization, transferred to the financial markets together with the lower volatility of macro variables, implies a reduction in the risk premiums and, therefore, presumes a reduction in long-term interest rates.

This last novel factor could explain the fact that, despite the rise in the U.S. federal funds rate, long-term interest rates have remained relatively stable, thereby leading to a significant flattening of the yield curve, and even at some moments to its slight inversion.

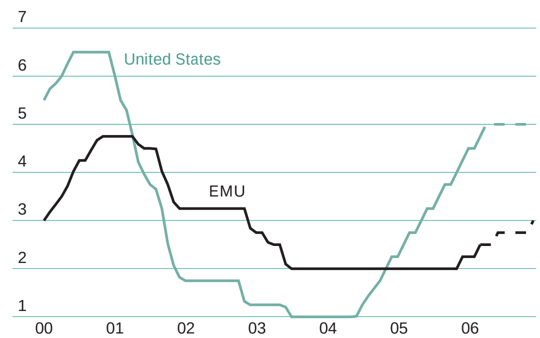
Usually, an inversion of the yield curve is interpreted as a signal of economic recession, with an average advance notice of four quarters. Now, on this occasion, it is possible to add, as Bernanke has

U.S.: Disposable Income and Personal Consumption Expense (PCE)
Real annual % change, 12-month moving average



Source: BBVA with BEA data

Official Interest Rates



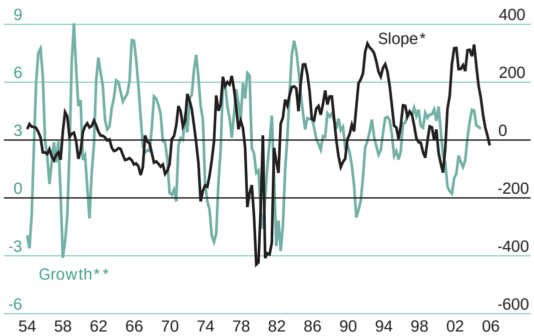
Note: Estimated as of April 2006
Source: BBVA with Federal Reserve and BCE data

Decomposition of the Explanatory Factors for the 10-Year Rates

	10-year rate	Real rates
1990	8.70	4.00
2005	4.30	2.00
Change	**4.40**	**2.00**
Real rate expectations	-90	
Inflationary expectations	-100	
Premium in real terms	-150	
Risk premium due to inflation	-30	

Source: BBVA

U.S.: Growth and Slope



* 10 years / 3 months
** 6 quarters lagging
Source: BBVA with BEA and Federal Reserve data

Evolution of the Yuan / Dollar Since the Revaluation of July 2005

Source: BBVA with Bloomberg data

recently indicated, that the flattening of the debt curve could be the result of a lower risk "premium", derived from lower macroeconomic uncertainty and greater demand for bonds by agents who are not too sensitive to the profitability-risk criteria. This explanation could assume that a flat yield curve is compatible with stable growth in the coming months.

In addition to these structural factors, some temporary situations are contributing to reducing the risks in the current situation. In the first place, the progressive adjustment to a rise in the official interest rates constitutes a first step for limiting excess liquidity that could have led to undervalue the risk in some assets. Secondly, the difference in the growth of domestic demand between the U.S. and other economies is moderating, at the same time that growth in Europe and Japan is being boosted, and growth in the real-estate sector and consumption in the U.S. economy has moderated. Finally, the growth of the Chinese economy is allowing it to slowly but gradually adjust its exchange rate to the dollar.

Risk scenarios on activity: not very likely

Despite these structural changes, which are the support of the base scenario for growth in the world economy, there are some elements that could presume downward risks to activity. The probability that the valuation of risk on the part of investors is too low, causing an increase in the asset prices in an environment in which families are highly indebted, could imply an economic adjustment. Similarly, the high and growing current account deficit in the U.S. is an uncertainty factor, especially considering that part of the deficit is being financed by the surplus of the oil-exporting countries and by official capital flows stemming from the accumulation of international reserves from a series of countries, in particular emerging Asian countries that are trying to avoid the revaluation of their currencies.

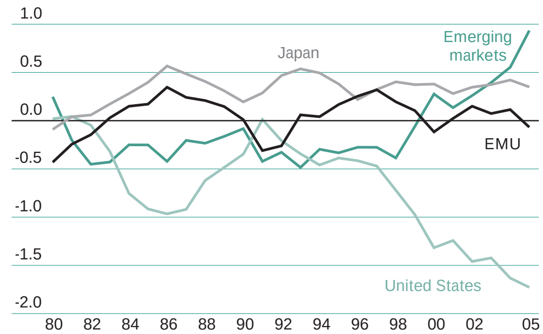
Now then, together with the previously mentioned support factors, it should be pointed out that, in any case, it is not easy to anticipate either the form of a potential adjustment or its detonator. A real "shock", such as a sudden increase in oil prices might be, as the result of a significant reduction in supply, would not necessarily cause a strong rise in inflation and could lead to a recession in the economies and lower interest rates. A financial "shock", in which the rise in the risk aversion could lead investors to request higher remuneration for U.S. assets and could cause a depreciation of the dollar, would mean a notable increase in the debt profitability in that economy. An error in monetary policy that were to imply too-high official interest rates and were to provoke a drop in the price of real-estate assets more than a moderation in its price growth rate, would lead to a significant recession and to a drop in interest rates in the future. Evidently, any of these scenarios would have more negative consequences on the prices of assets if accompanied by a rise in inflation, within a context in which the gains in productivity in the U.S. were doubted and there were a regression in globalization, derived from having adopted protectionist steps in world trade. The risk map, consequently, is diverse and the detonator of an adjustment is difficult to anticipate. In any case, when a balance is made of the support factors and the risk elements, the conclusion is that the probability of these adjustment scenarios, within the current context, is low.

Long-term interest rates with a limited upward run and a stable dollar

Consequently, in the central economic scenario, the yield curve slope in the U.S. will remain relatively “flat”, although to the extent that uncertainty regarding monetary policy rises and some capital flows of non-residents slow down, it could show a slight slope. Long-term rates in the U.S. will stand at 4.8% and at 5.1% on average in 2006 and 2007, respectively. In Europe, the long-term rates that dropped significantly in 2005 will remain at historically low levels to the expected scant upward run for official interest rates and to the demand for long-term assets of domestic investors, to a large extent as a result of regulatory measures. Thus, on average, ten-year interest rates in Europe will stand at 3.7% and 4.1% in 2006 and 2007, almost one point below those of the U.S. This spread in the interest rates will continue to be one of the main supports for the dollar, which, in relation with the euro, will remain within a stable range of about 1.21% in 2006 and 1.25% in 2007. Now then, the situation of the current account balance in the U.S. implies a balance of downward risks for the dollar.

Current Account Balance

% of world GDP



Source: BBVA with IMF data

Financial Outlook

	2005	2006f	2007f
		End of period	
United States			
Official rates	4.25	**5.00**	**5.00**
10-year rates	4.50	**5.20**	**5.10**
EMU			
Official rates	2.25	**3.00**	**3.25**
10-year rates	3.40	**3.80**	**4.20**
Currencies			
Dollar / euro	1.19	**1.23**	**1.26**
		Average	
United States			
Official rates	3.20	**4.90**	**5.00**
10-year rates	4.30	**4.80**	**5.10**
EMU			
Official rates	2.00	**2.60**	**3.20**
10-year rates	3.40	**3.70**	**4.10**
Currencies			
Dollar / euro	1.24	**1.21**	**1.25**

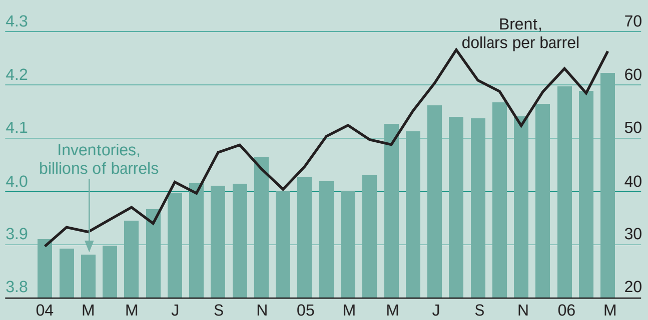
f forecast
Source: BBVA US

Oil Market: Hysteria or Hysteresis

The fundamentals support a decline in prices

Between June 2004 and March of this year, we have noticed a structural change in the oil market. Demand has increased 3.8%, representing an average rise of 3 million barrels daily, which in annual terms reflects accumulated growth of an additional 1.14 billion barrels. About 70% of the growth of this demand comes from the emerging markets, especially from China, which accounts for 40% of the total. However, in this same period, about 255 million barrels in total inventories have been created for the OECD countries, bringing the total inventory stock to more than 4.22 billion barrels, equivalent to 137 days of current production of all the OPEC member states, including Iraq. Paradoxically, the Brent price has doubled since June 2004. It would seem that the current price cycle is disconnected from the fundamentals of supply and demand, which should have given rise to a decline in crude oil prices (correction due to the effects of the hurricane season).

OECD Inventories and Brent Prices



Source: BBVA Banco Provincial Economic Research Department

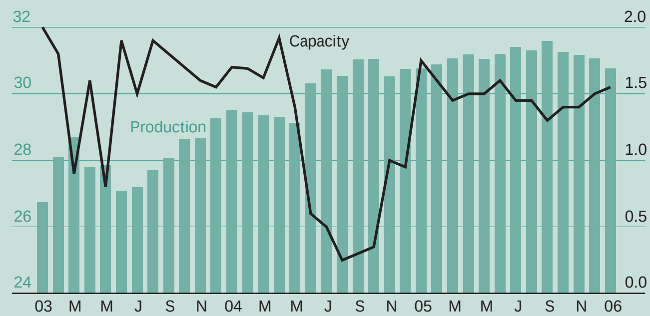
New focus: the risk “premiums”

Given this behavior, in order to analyze the oil market, it would be pertinent to consider the hysteresis models, in which expectations, which have an important weight, are an exogenous variable that has been subject to a permanent change, leading to new long-term equilibrium values. The elements that feed the expectations have to do with the fact that the emerging economies, the current driving forces of demand, will face a growing need for energy in proportion to their GDP, for the simple reason that a convergence is underway in consumption toward levels in the developed countries.

On the supply side, the concentration of more than 60% of oil reserves in the Middle East incorporates a premium (different from the case of other commodities) that we would have to term “geopolitical” and that represents, in fact, a structural element. Moreover, continuing on the subject of supply, the non-OPEC countries face declining production rates, and therefore for purposes of analysis, this can presuppose static behavior, without a significant contribution to supply.

OPEC Additional Capacity and Production

Millions of barrels daily



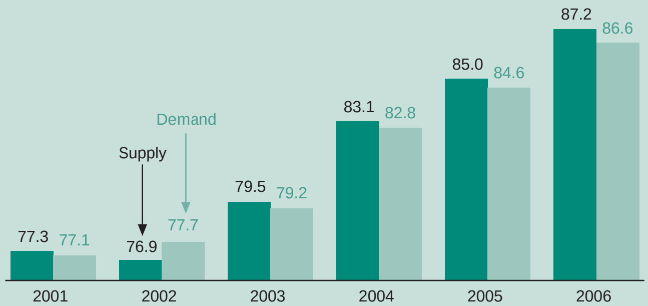
Source: BBVA Banco Provincial Economic Research Department

In analyzing these elements, considering a long-term horizon, demand on the part of the emerging markets based on convergence has not been growing at rates expected by the analysts. Part of this growth can be absorbed via a gain in efficiency, thus softening the growth in projected demand.

On the supply side, real oil prices above 40 dollars would activate 95% of the projects that were not feasible at prices close to 20 dollars. To quantify this potential impact, there would be approximately 128 billion barrels of non-OPEC reserves, equivalent to 1,500 days of current world demand and 4,153 days of current OPEC production. Of course, should such a situation occur, the central question is the rate of investments and the time frame for placing this potential production in the market.

The element of geopolitical risk would have two components, a structural factor associated with the Middle East and a situational aspect, such as the cases of Iran and Nigeria. A central element in evaluating the geopolitical shocks that lead to fears of a contraction in oil supply is that they will generate a price increase similar in scope and persistence to the shocks that have been associated with actual declines in production. In fact, a larger proportion of the historical fluctuations in Brent prices can be attributed to the former rather than the latter, given that they are a strong conditioning factor in current prices, even if the feared reduction in production does not take place.

Balance Between Supply and Demand for Oil
Millions of barrels daily



Source: BBVA Banco Provincial Economic Research Department

In short, these geopolitical risk factors have led to constant pressure from speculative purchases that translate into additional demand, which does not consider the major equilibriums in the market and that partially explain the behavior of oil inventories. In addition, the growing world liquidity has also been directed at future purchases in the oil market, which has incorporated elements characteristic of financial assets that have limited prices. This has resulted in greater short-term stability in current levels and responds less to the fundamentals typical of current supply and demand.

The Nigeria effect: an additional "premium"

An armed organization, the self-proclaimed "Movement for the Emancipation of the Niger Delta" (MEND), established in December 2005, demands greater control of oil resources for Nigeria and wants to eliminate the power of the transnational companies in this regard. To achieve its objective, the MEND has engaged in attacks on the oil industry that have resulted in a decline in production of approximately 600,000 barrels daily. The International Energy Agency has pointed out that the OPEC has covered this drop in production and that it is not necessary to establish an emergency policy for crude oil inventories involving OECD member states, while at the same time Nigeria has announced the prompt restoration of production. This factor represents an element of geopolitical risk that has been having an impact since the end of 2005 and which is beginning to have a greater effect due to Nigeria's market share in the current cycle.

Iran: little likelihood of an embargo

The main geopolitical risk factor that affects the oil market is the complicated situation in Iran regarding the country's decision to resume its program of uranium enrichment for the generation of energy. The West views this decision with caution since it believes the program is aimed more at developing the country's arms than energy resources.

The case has been the subject of a unanimous motion by the United Nations Security Council demanding that Iran completely suspend all activities in uranium enrichment within 30 days, the deadline for which expired at the end of April. The key question is whether this dispute will end in an embargo on Iranian exports. It would appear that the trivial answer is no. From the Iranian point of view, the country has less maneuvering room than expected in relation to an embargo. The country's international reserves, excluding gold, only cover 10 months of imports (22% of GDP). At the same time, public spending represents 40% of GDP, with a strong component of direct subsidies to the population, with fiscal oil revenue accounting for 55% to 60% of the total.

From the standpoint of the West, given the weak additional production capacity that the world currently has, it would be very difficult to cover the withdrawal of Iranian exports, currently at 2.9 million barrels daily, from the market. This would generate a strong short-term impact on prices. It would appear there are objective conditions to extend the time frame for adopting a decision or to reach an "honorable" solution for the parties involved.

To place the situation in context, the typical occasions in which there has been a contraction in Iranian oil production that have occurred since 1985 have usually been transitory, with oil production recovering within a few quarters, and have been relatively minor in relation to the size of the decline (an average of 5%, maximum of 10%, which today would represent 200,000 and 400,000 b/d, respectively).

On those occasions, the suppliers of crude oil rapidly boosted their production to compensate the reduction in Iranian output, which cushioned its impact on oil prices. Such prices progressively rose, accumulating an increase of 3% in real terms four quarters after the reduction in production and dropping again, also progressively, in the following quarters. However, a reduction five times greater than the maximum registered in the past, in the current situation marked by reduced surplus production capacity, could not be offset by the remaining oil producers, and would thus generate a strong real increase in oil prices. The leveling of future prices around the current price levels would appear to be discounting a scenario of low probability of an embargo, but also of the persistence of a risk premium in the next few months.

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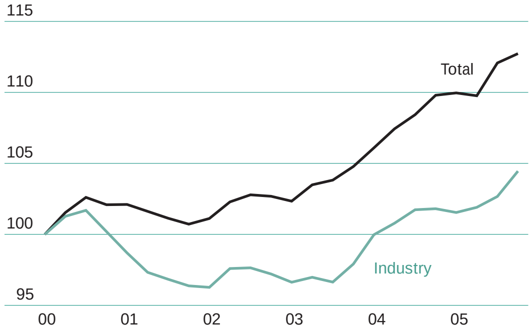
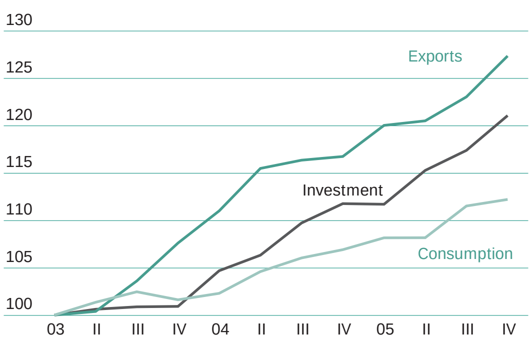
2006 a Better Year in Activity; Consumption will Determine the Growth Rate

GDP Mexico
1st quarter 2000 = 100, seasonally-adjusted



Source: BBVA Bancomer with INEGI data

Components of Aggregate Demand
1st Quarter 2003 = 100, seasonally-adjusted



Source: BBVA Bancomer with INEGI data

Global Economic Activity Indicator
% change

	Annual, original series				Qrtr.*
	Total	Agriculture	Industry	Services	Total
1st qrtr. 05	2.4	0.4	0.1	4.1	0.1
2nd qrtr.	3.2	-2.5	3.0	4.1	0.0
3rd qrtr.	3.4	12.8	0.7	4.5	2.1
4th qrtr.	2.7	-7.0	2.8	4.1	0.6
Jan. 06	5.7	8.5	6.0	5.6	1.0

Qrtr. Quarterly change, seasonally-adjusted
Source: BBVA Bancomer with INEGI data

Recovery Resumes

Following a slowdown in activity in the second quarter of 2005, which held back the recovery rate seen since the middle of 2002, the drive in the economy was once again resumed. The monthly growth rates are showing strong recovery since the third quarter of last year, with a slight moderation in the fourth quarter and a vigorous advance at the beginning of this year. In annualized terms, growth in the second half of 2005 was 5.6% compared to practically zero in the first half of the year. In January of this year, the global economic activity indicator (GEAI) reported a 5.7% rise in annual terms, three percentage points over the close of the immediately previous year. This dynamism was surprising due to its force although not for its direction, and what is relevant at this time is to determine the ability to sustain a high growth rate beyond temporary situations or events, such as the electoral process next July.

Between the fourth quarter of 2005 and the initial months of 2006, there is a substantial improvement associated, in part at least, with the improvement in the natural climatic conditions prevailing mainly in the south of the country. The strongest impact was felt in the agricultural and livestock sector: in addition to the volatility characteristic of this activity, there was the negative effect of hurricanes Stan and Wilma and the lag they caused on agricultural land. Necessarily, services also felt the effects of the natural conditions, in particular those related to tourism (commerce, restaurants and hotels) due to their impact on the main tourist reception center, such as Cancun. Given that the dynamics in industry is different, since the driving force is not associated with climatic characteristics, it presents the most interesting and outstanding change. Thus, the circumstantial conditions at the beginning of the year magnify the advance. In this context, this section reviews the determining factors of growth, their strength and their outlook.

Automotive: the driving force of the industrial sector

In manufacturing, the automotive industry is outstanding in its performance. In particular, passenger vehicles showed renewed exporting strength and, consequently, production, which in January reached annual growth of 90% and 69%, respectively, in number of units. In cargo vehicles and auto parts, the results were also outstanding. Their impact on the economy as a whole is relevant. This sector represents 3% of total GDP, 14% of manufacturing production and 26% of manufacturing exports. The automobile industry began its recovery in the second half of last year after facing a certain weakness in the foreign market, in particular, changes in consumer preferences and more competitive products for the export market. Consequently, once the effect of the incorporation of the new products runs out, it is foreseeable that these favorable trends will tend to consolidate at lower rates throughout this year. The recent performance of the industry shows that investment projects of several years back have materialized. Unfortunately, when the effect of the automobile sector is eliminated, the results of manufacturing production are not so good, and a moderate advance is evident. In fact, 63% of the productive branches posted positive results in the fourth quarter of 2005, among which the following are significant: leather and footwear, machinery and electrical equipment and hydraulic cement. However, and on average, once the automotive sector is eliminated, the growth of the rest is modest.

Investment, the most dynamic demand component

Investment also renewed its drive in the second half of 2005. From a bad start in construction, the result of a slow absorption of new homes and a change in government policies for granting credit, lower interest rates and greater competition in mortgage loans have led to a rebound in this activity, with a growth rate higher than 6%. In terms of investment in plants and equipment, the greater dynamism is also notable, similar to that seen in other cycles of recovery. What is outstanding now is the imported component in that demand, greater than that of other cycles, and partly the result of greater commercial integration and the relative strength of the peso.

Services sector: growth higher than the average

In terms of its recent performance, the services sector contrasts favorably with the agricultural and livestock, and the industrial sectors, with annual growth at 5.6% in January 2006 and consistently higher than 4% throughout 2005. It is the sector that generates the greatest contribution to total growth in the economy, thanks to its high share (70%) in GDP. Also, it is the most stable, since its fluctuations are lower than the average (it was between 4.1% and 5.6% in the last two years). Growth in January of this year seems to be offsetting a slowdown in services in the 4Q05, considering that income from foreign tourism registered a 6% contraction in the last months of last year, as a result of the effects of the various hurricanes. Although recovery in this sub-sector has not been achieved totally, the impact is now much lower and with a trend toward normalization and even improvement.

It is important to note that financial and telecommunication services maintain an appreciably higher growth rate, a result of the expansion of credit, unsatisfied demand, new products, etc. Services reflect the performance of domestic demand, which is expanding: available leading indicators confirm the good conditions for maintaining their strength: bank loans are growing in real terms at 45% and total wages (the combination of employment and real wages) have been growing gradually, in December 6.6% (300 bp higher than in the same month of the previous year).

Expansion in employment: Is it solid? ...

The key to analyzing the outlook for domestic demand going forward is found in the performance of employment. Through February, private formal employment is showing its best side in the last five years: 629,000 new jobs in twelve months and 5% growth. Even though the data are positive, there are some doubts regarding their breakdown: of the new jobs, 71% are temporary and 29% permanent. These figures could be indicating greater prudence by companies, or that, in view of labor rigidity, they prefer to make use of the temporary type of contract: One last option is found in the improved supervision by the Mexican Institute of Social Security (IMSS) in the registry of its affiliates in activities such as, for example, construction. Thus, employment in construction reports the most marked relative change with a total of 115,000 new jobs. However, beyond these doubts,

Automotive Industry
Annual % change

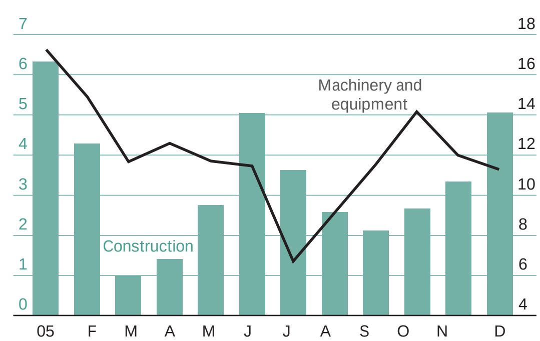
Source: BBVA Bancomer with INEGI and Banco de México data

Manufacturing Production
Annual % change

	2004	2005	2005 1 qrtr.	2005 2 qrtr.	2005 3 qrtr.	2005 4 qrtr.
Total	**4.0**	**1.2**	**-0.6**	**2.8**	**0.3**	**2.4**
Maquiladoras	7.6	3.5	5.8	2.2	2.7	3.5
Non-maquila.	3.7	1.0	-1.1	2.9	0.1	2.3
Vehicles	2.0	6.1	-8.3	3.7	3.6	25.3
Auto parts	9.3	3.8	0.8	4.7	3.4	6.3
Manufacturing w/o auto ind.	3.2	0.5	0.0	2.2	-0.2	0.0

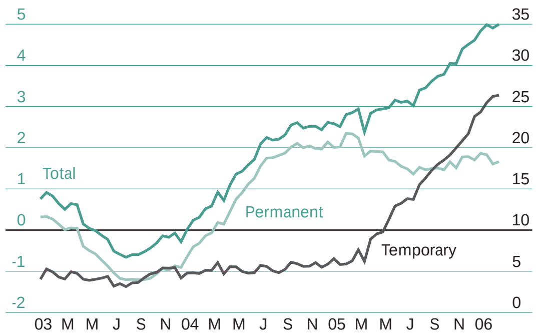
Source: BBVA Bancomer with INEGI data

Gross Fixed Investment
Annual % change, 3-month moving average



Source: BBVA Bancomer with INEGI data

IMMS-registered Workers
Annual % change, last 12 months, biweekly data

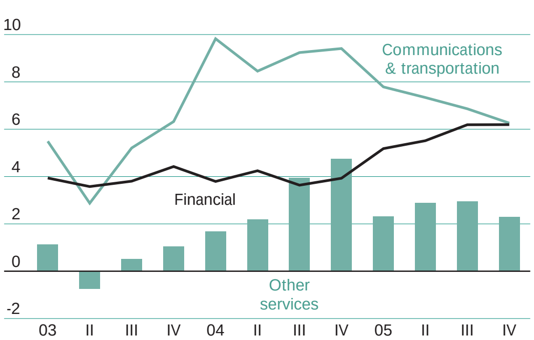


Source: BBVA Bancomer with IMSS data

Real Total Wages
Annual % change

ARW Average Registered Wage
Source: BBVA Bancomer with IMSS data

Services by Activity
Annual % change



Source: BBVA Bancomer with INEGI data

the balance leans toward a recovery in employment. In absolute terms, it is the services sector that makes the greatest contribution to employment growth (417,000). The expansion in employment intensified in the second half of the year and this coincides with the improvement in economic activity and the trend toward the reduction of the open unemployment rate.

Outlook for 2006: a better year although still in certain sectors

In view of the strength in the data of the early months of the year, particularly regarding growth in the export sector, the strength in investment and in face of expectations of a consolidation in consumption, they support higher growth in the Mexican economy. This scenario is supported by the drop in inflation, lower interest rates, credit flows, job generation and a slight improvement in real wages. To this environment is added a greater fiscal boost from oil surpluses, non-assigned resources during last year due to the constitutional controversy and the electoral year itself. Although the GDP growth rate could surpass 3.6%, this would only be possible and sustainable if the recovery in consumption is generalized, something still unclear for the immediate future.

In terms of the annual profile, greater growth is expected in the first part of the year than in the second. In particular, the first quarter will be favored by the calendar effect (Holy Week, with a higher number of working days in the first quarter) and offsetting the diverse conditions at the close of the previous year. Thus, GDP growth in the first quarter could surpass an annual 5%, equivalent to 4% in a seasonally-adjusted series. Despite everything, the risks of this scenario remain downward: a more severe adjustment in the U.S. economy that could generate, as a first impact, lower availability of resources to the emerging countries and, in a second stage, a moderation in their exports. On the domestic front, the electoral process, in addition to generating greater volatility in the financial variables, could translate into real effects in activity, in view of the delay in investment and consumption decisions in view of possibly greater electoral uncertainty.

Macroeconomic Chart of Mexico
Annual % change, seasonally-adjusted series

	2004	2005	2006e	2007e
GDP	**4.2**	**3.0**	**3.6**	**3.2**
Total demand	6.2	4.6	4.8	4.4
Domestic	4.3	5.1	4.7	4.5
Consumption	3.6	4.8	4.3	4.2
Private	4.1	5.4	4.5	4.5
Public	-0.4	0.3	2.1	1.4
Investment	7.5	6.2	6.7	5.6
Private	8.5	10.0	6.4	5.2
Public	3.6	-9.6	7.7	7.4
Foreign	11.7	6.8	8.0	6.6
Imports of goods and services	11.6	8.6	7.6	7.5

* estimated
Source: BBVA Bancomer with INEGI data

New Budget Law and Fiscal Responsibility

On April 1 a new regulatory framework entered into effect that concentrates, updates, and modernizes the different budgetary classifications, once approved by Congress. Due to its importance for macroeconomic stability, in the following section we offer details on and an appreciation of this new law.

Placing fiscal discipline on the level of law

The country's experience of continuous financial crises in which the common element has been fiscal vulnerability has generated a consensus in relation to the need to maintain fiscal discipline as a necessary condition for stability. History has demonstrated that expansive spending policies that are not accompanied by healthy financing and an attempt to seek a balanced budget over the long run lead to crisis, recession, and greater unemployment. In this context, the contributions of this new law are:

a) It establishes a balanced budget as an explicit objective. Bringing revenue into line with expenditures. A deficit can be resorted to in exceptional cases and will be accompanied by an explanation of the reasons for such a move and the conditions to return to a balanced budget.

b) Any new stipulation that might imply higher spending will be justified with its source of income (or with the respective expenditure reassignment) and with a technical study of its economic impact.

c) If the revenue registered is less than that projected, rules for its control will be established and "automatic stabilizers" strengthened. It will be possible to resort to the stabilization fund and if the gap between revenue and expenditures exceeds 3%, areas in which spending can be reduced will be defined, such as press and public relations, administrative expenses, etc. The aim is not to have to modify investment expenditures.

d) Incorporating autonomous government agencies, such as the Federal Electoral Commission, the National Human Rights Commission, etc. in the budget, which provides the benefits of budgetary integration.

Greater transparency and a less discretionary approach

Year after year, budgetary exercises face difficulties, especially in the case of Mexico in which oil revenue represents a high percentage of the total and due to its nature, is volatile. In this sense, the advances are the following:

a) Rules will be established to determine oil prices. The formula considers the price for the different Mexican oil mixes registered in the past 10 years and future prices for the following three years. This will reduce discretionary policies and the continuous conflicts to raise the estimated price. Furthermore, as a reference the period will be long term.

b) Rules will be defined for the distribution of oil revenue surpluses. The measures adopted in the past few years will be institutionalized and perfected. Three investment funds will be established: a stabilization fund under the responsibility of the federal government, in Pemex for infrastructure, and in the states.

c) Multi-annual commitments can be established, which will allow continuity in public work projects and incentives to be generated in order to obtain better prices.

d) The law defines different concepts, a new presentation of the budget (of a functional character) and rules to avoid sub-budgets. The idea is to increase transparency, to facilitate communication between the different branches of government and reduce discretionary authority.

Greater time frame for analysis and discussion

To avoid hurried approval of budgets that lead to errors, the time frame has been expanded:

- April 1: budget scenarios and key variables, with the corresponding target deficit (or balanced budget or surplus).
- June 30: advances and general proposal
- Sept. 8: General Criteria on Economic Policy, estimation of oil prices, revenue bill and expenditures proposal.
- October 20: deadline for the approval of the revenue law by the Chamber of Deputies.
- November 15: deadline for the approval expenditures proposal by the Chamber of Deputies.

Pending tasks remain

This new law represents a significant advance in providing a transparent reference framework, to reduce discretionary authority and to promote the rendering of accounts. Therefore, it should be positively evaluated. However, this does not eliminate the underlying problems in public finances: neither low tax revenue and a high dependence on oil income, nor the lack of incentives for the states to reduce tax evasion and boost tax collection, nor measures to improve the quality and allocation of expenditures (establishing, for example: performance indicators as the law itself indicates). In addition, the state should concentrate on improving the quality of public goods (for example, security, property rights, education, and basic health care, etc.) and reducing its presence in private goods that it supplies. To the extent that these changes occur, fiscal policy will be more solid and its macro function of cushioning the economic cycles through the adoption of pro or anti-cyclical measures could be strengthened.

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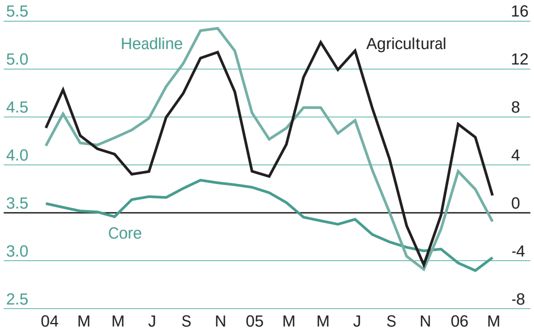
Inflation 2006: Will it Consolidate at Low Levels?

Inflation
Annual % change



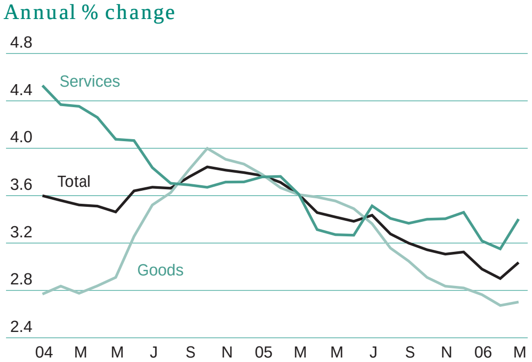
Source: BBVA Bancomer with Banco de México data

Inflation

	Weight (%)	Annual % chg. Mar'05	Mar'06	Dif. (pp)	Contrib. (pp)
NCPI	**100.0**	**4.4**	**3.4**	**-1.0**	**-1.0**
Core	69.6	3.6	3.0	-0.6	-0.4
Goods	37.0	3.6	2.7	-0.9	-0.3
Services	32.5	3.6	3.4	-0.2	-0.1
Non-core	30.4	6.0	4.2	-1.8	-0.6
Agricultural	8.1	5.7	1.5	-4.3	-0.3
Managed & reg.	17.2	5.7	4.8	-0.9	-0.2
Education	5.2	7.5	6.5	-1.1	-0.1

Source: BBVA Bancomer with Banco de México data

Core Inflation
Annual % change



Source: BBVA Bancomer with Banco de México data

Since the end of 2004, inflation in Mexico has mainly experienced a downward trend. Since the second half of 2005, inflation has been between 3% and 4%, below the upper limit of the variability range projected by the Banco de México and, at the end of that year, it was even under U.S. levels. Although inflation in Mexico has experienced episodes of volatility, which is intrinsic to the NCPI given the latter's structure (high relative weight for prices of agricultural products and government-managed services), the growth in prices for most of its components have been on the decline. Most important has been the performance of core inflation, which registered levels even below 3% at the beginning of 2006.

In addition to knowing the factors that explain the moderation of inflationary pressures, what is important is to determine if a convergence toward stability will be consolidated, especially in the case of core inflation. This is especially the case if, as we anticipate, 2006 will be a year marked by a recovery of economic activity and in particular, accelerated growth of domestic demand.

With the help of the volatile components?

Through March 2006, inflation had dropped by one percentage point compared to the previous year, from 4.4% to 3.4%. It can be argued that the greatest contribution to this result, 0.6 points, came from the volatile components of the NCPI, although only half corresponded to agricultural prices. That is, of the decrease in inflation, 0.7 points corresponded to the alignment of public prices with the central bank's target (0.2 points), to a progressive convergence of educational costs (0.1 points), as well as to the decline in core inflation (0.4 points).

Core inflation, without external pressures

Among the factors that have most contributed to the decrease in core inflation in 2005 and the beginning of 2006 is the "imported goods" component. In the goods sub-index, which represents 55% of the total, there is a close relation with U.S. prices, since a significant convergence has been achieved in prices between the two economies. Of particular importance, of course, is the behavior of tradable goods. For example, for the apparel, food, and transportation (automobiles) segments, which represent close to 65% of goods: considered jointly, the rate of annual change for these three items went from 4.2% to 2.8% between March 2005 and March 2006, which accounted for 0.5 of the 0.7 percentage points in which the goods subindex decreased in the same period. In the United States, the evolution of these three categories of goods also displayed a pronounced downward trend, even reaching negative or close to zero levels (apparel and transportation).

In relation to the exchange rate, although in previous years (prior to 2000) its contribution to the variability of inflation was important, to the degree that its volatility has decreased, so has its impact on core inflation. Thus, with core inflation in the United States at levels below 2.5%, and without obvious pressure from the main components that have a direct impact on inflation in Mexico, in addition to the expectation of modest volatility anticipated in the exchange rate, the goods sub-index could continue supporting the decline in core inflation, or at least contribute to its stability.

Services, the key

In relation to services, the trend, although also downward, is less clear than in the case of goods. The housing component, which contributes 55%, has begun to rebound slightly since the end of 2005, although from particularly low levels. The increase in housing prices maintains a high correlation with the prices to producers of the construction sector, which has posted a significant recovery since the second half of 2005, and is projected to continue for the rest of 2006. Prices of raw materials, particularly for steel and concrete, are the main determining factors for this component of the inflationary index, which is why, to a large extent, the performance of housing services depends on them. In the case of steel, international prices could keep upward pressure within bounds.

For the rest of the services, the greatest growth in prices is registered for financial and telecommunications services, which contribute to generating greater supply in the economy. Thus, there are mixed signals, given that although for some categories the downward trend continues, the recovery of the economy has begun to generate increases in other sectors. The highest rates of annual change have been posted, generally, in core inflation, and at the close of the first quarter of 2006, they fluctuated within a range between 3% and 4%. More than a risk of a turnaround, the performance of the services sector could limit the downward margin for core inflation. Although the process of price stabilization has been accompanied by an increase in the contribution of demand pressure to the variability of core inflation, the econometric analysis suggests that at the levels of economic growth such as those estimated for 2006, namely 3.6%, the pressure would be marginal (see Chart).

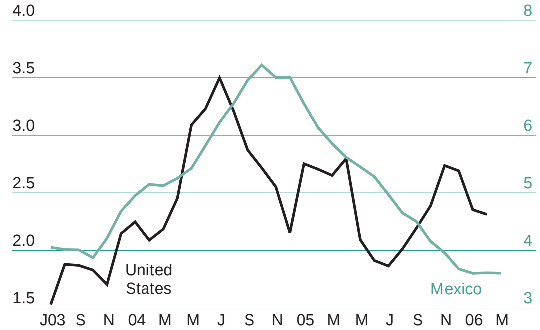
At the same time, with better than anticipated inflationary results in the first few months of 2006, expectations of price growth have been moderated. Such expectations bear a direct relationship with wage negotiations, and the latter with the services sub-index. Downward expectations could at least partially counteract the increases in some components of core inflation. The estimation models coincide in pointing out that in the current context, marked by relative stability in the exchange rate, moderate economic growth, and downward expectations, core inflation does not face pressure, and although it is not clear what margin might exist for additional declines, it could stabilize toward levels close to 3%.

In short, a more favorable scenario

In general, the short-term outlook points toward a more favorable inflationary panorama. Our new projections, which can be considered more of an update than a new appraisal of inflation, are for 3.3% growth in headline inflation and a 2.9% increase in core inflation for the end of the year.

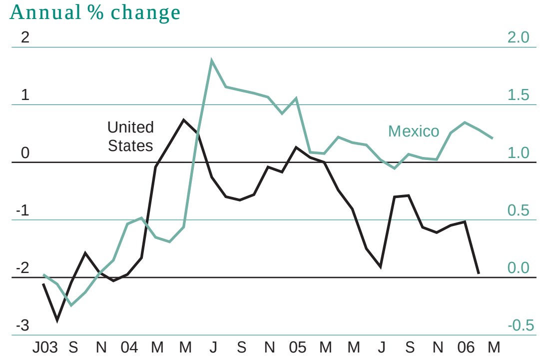
Finally, although the outlook is more optimistic, risks are still present. Such risks could include supply pressure tied to prices of agricultural products, oil (which could prevent the convergence of public prices), and raw materials (steel, cement), or from demand, such as growth in private consumer spending above projected levels. Therefore, even though the scenario for 2006 has been marginally modified, for 2007 the outlook remains unchanged, with headline inflation projected at 3.5% and core inflation at 3% at the close of the year.

Inflation: Food*
Annual % change



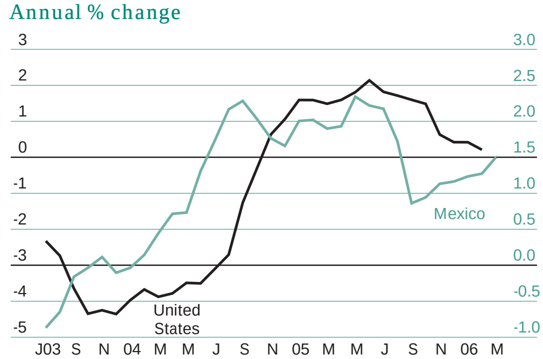
* Excludes fruits and vegetables, and meat and eggs in both countries
Source: BBVA Bancomer with Banco de México and BLS data

Inflation: Apparel
Annual % change



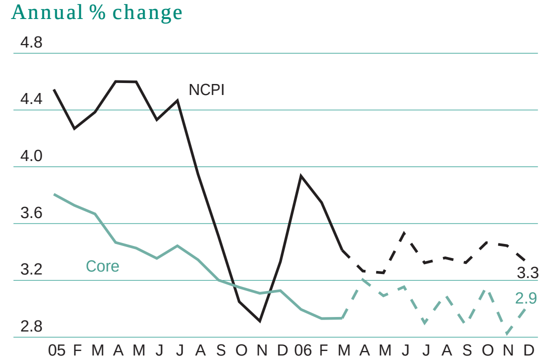
Source: BBVA Bancomer with Banco de Mexico and BLS data

Inflation: Transportation*
Annual % change



* Only considers automobiles
Source: BBVA Bancomer with Banco de México and BLS data

2005-2006 Inflation
Annual % change



Note: Estimated as of April 2006
Source: BBVA Bancomer with Banco de México data

The Pass-through of Economic Activity to Prices: How Much and Since When?

Following a period of more than three years of expansion, and with signs of an acceleration of such growth at the beginning of 2006, the Mexican economy is approaching a cycle of more stable growth, in which the recovery of internal demand has been the key factor. An important part of this process has been the moderation of inflationary pressures, which toward the end of 2005 had already achieved a convergence toward the long-term target set by Banco de México. The question is: How much further can such convergence go? For core inflation, once the 3% level is reached, signs begin to appear of difficulties in achieving additional declines.

The current growth cycle of the Mexican economy is not determined by strong recoveries following external shocks or internal imbalances, which is new. The normality of the economic cycle is allowing us to identify a clearer relationship between economic activity and its transmission to prices, which has intensified in the past few years. An analysis of variance decomposition for core inflation shows that, prior to 2000, the very inertia of inflation and the exchange rate were the main factors in explaining inflationary volatility. As of that year, more importance was assumed by growth and the evolution of energy prices, which have experienced greater variability in the past few years.

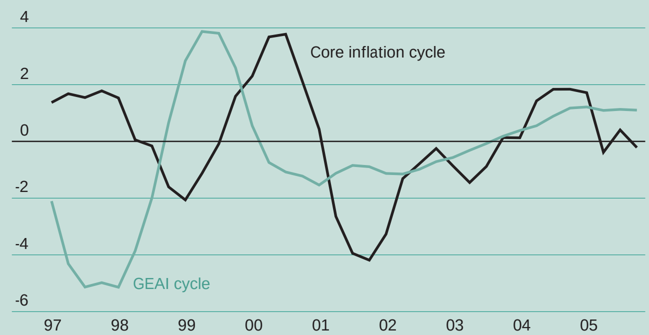
Core Inflation: Variance Decomposition
% contribution

	1996-2000	2001-2005
Raw materials	1.7	19.6
Energy	1.3	27.1
GEAI	8.9	21.3
Peso	28.5	19.8
Wages	17.1	7.2
Core	32.6	2.3
Rate	10.0	2.7

Source: BBVA Bancomer with Banco de México data

This makes sense given that the process of macroeconomic stabilization throughout the past decade has been characterized by periods of high volatility both in terms of inflation as well as in growth, which led to market distortions that hindered a rapid response via the mechanism of prices. Thus, for example, in the 1996-2000 period, it would appear that prices had taken a year to react to changes in demand. In fact, it was as of 2001, when the economic cycle "normalized" (that is, growth was not determined by adjustment policies) and the convergence of inflation with the central bank's target accelerated, that it is possible to identify a direct relationship between the two variables.

Divergences with Respect to Inflation Trends
Percentage points



Source: BBVA Bancomer with Banco de México and INEGI data

An analysis based on VAR models of core inflation in relation to GDP, the exchange rate, and expectations, as well as lineal regression[1] exercises, reveals that the most stable relationship between growth and inflation can be established beginning in 2002. In accordance with these estimates, the response of core inflation to a one-percentage point change in economic growth above its long-term potential (currently estimated at around 3%) could be up to 0.1 percentage points a quarter later. Its effect however, would be persistent and growing, given its impact on inflationary expectations. The shock would reach its maximum impact in the sixth quarter, and would begin to diminish gradually from that point on.

What seems clear is that in the process of price formation, the most important variable is the inflationary expectation itself. In the current context, with the process of convergence toward the Banco de México's target practically concluded (which also tends to stabilize expectations) and growth slightly above the potential, it will be difficult for core inflation to achieve significant additional reductions.

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1 A core inflation model was specified that takes into account demand pressure, expectations, seasonal factors, and the exchange rate, with monthly series for the 2002-2005 period based on the following structure:

$$Core_t = \underset{(2.5)}{0.01} * ExchR_{t-3} + \underset{(5.3)}{0.17} * Core_{t-12} + \underset{(4.3)}{0.10} * OutputGap_{t-1} + \underset{(20.1)}{0.69} * Exp12_{t-3}$$

$R^2 = 0.73$

Values in parenthesis refer to the -T statistic for each coefficient

The Financial Markets Prior to the Federal Elections

Short-term interest rates maintained the downward trend that had started in August 2005, which was accompanied by reduced volatility. This performance can be characterized both by the gradual withdrawal from the restrictive monetary policy by Banco de México—in view of the drop in domestic inflation—and by the persistence of the abundance of international liquidity that has maintained the peso's strength. This development contrasts with that of long-term interest rates. While in January and February the long-term rates also registered a decline, in March and April they corrected this trend when they posted increases both in level and volatility. This performance is the sum of diverse factors: the greater sensitivity to the behavior of long-term interest rates of the industrialized countries (in particular, the U.S.), the outlook for higher growth in Mexico compared to the previous year, and rigidity on a downtrend for medium-term inflationary expectations.

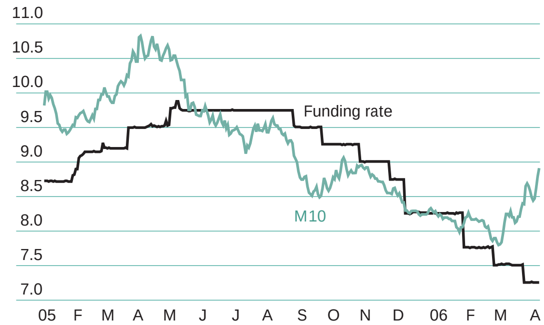
Going forward, it is foreseeable that greater uncertainty will be added to the previous elements, in view of the electoral process and the direction that U.S. monetary policy will take. However, economic fundamentals continue to indicate a more favorable year-end (that is, favorable inflationary expectations). In this environment, it is appropriate to question what the main determinants of the performance of interest rates will be in the coming months and to what extent specific events—such as the elections—will have a bearing on their dynamics in the short term.

Determining factors of interest rates in the coming months

For short-term interest rates, the relevant variables—to be monitored by the Banco de México—will be the performance of domestic inflation and international financial conditions (due to their relation with the exchange rate). With regard to prices, in the coming months we will be able to see a drop in headline inflation to levels close to the target, and in core inflation to around 3%. While lower inflation is favorable, financial conditions in the U.S.—with a bias toward higher short- and long-term interest rates—lead to greater uncertainty regarding the exchange rate and have a bearing on Banco de México to maintain a pause in the downward cycle in the bank funding rate at levels of 7%, which could be maintained at least until the electoral period is over. Given the current growth levels of the economy and of inflationary expectations, we believe that the downward cycle of the funding rate has ended. Additional drops in the funding rate could be seen in the second half of the year, only in case of a convergence of inflationary expectations closer to the target (3%).

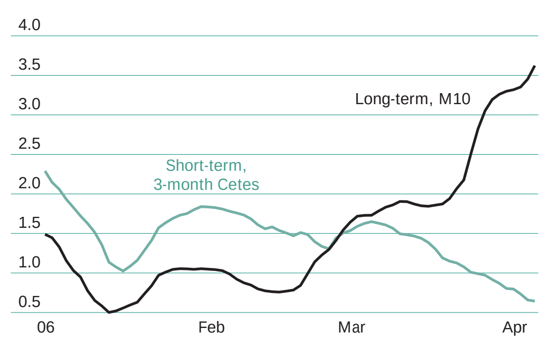
As regards ten-year bond rates, it is likely that they will register higher volatility in the second quarter of the year. While there are factors that contribute to limiting the rise in these yields (for example, low expected inflation, international liquidity and an outlook for a reduced fiscal deficit), we believe that, in the coming months, the dominant factors on these rates will be the expectations of higher yields in the U.S. and the latent increase in the risk "premium" in view of the domestic political developments (pre / post electoral).

Bank Funding Rate and 10-Year Bonds
Annual %



Source: BBVA Bancomer with Banco de México data

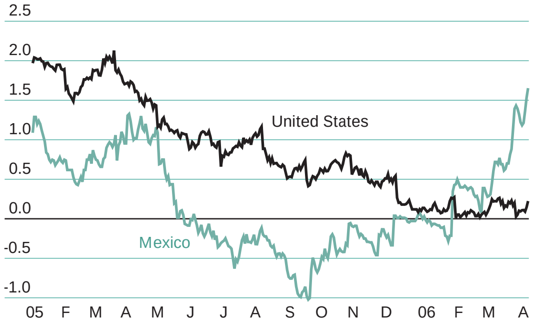
Interest Rate Variation Coefficient
Deviation % with respect to the average for the period, 30 days



Source: BBVA Bancomer with Banco de México data

Yield Curve Slope

10-Year bonds minus funding, percentage points



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

Flow Moderation Base Scenario

%, end of period

	Bank Funding	M10
1st quarter 2006	7.25	8.6
2nd quarter 2006	**7.25**	**8.8**
3rd quarter 2006	**7.25**	**8.5**
4th quarter 2006	**7.00**	**8.2**

M10 10-year bond rate
Source: BBVA Bancomer estimates

High Flow Scenario

%, end of period

	Bank Funding	M10
1st quarter 2006	7.25	8.6
2nd quarter 2006	**7.00**	**7.5**
3rd quarter 2006	**6.75**	**7.5**
4th quarter 2006	**6.75**	**7.1**

M10 10-year bond rate
Source: BBVA Bancomer estimates

We do not rule out the possibility that during the second quarter, domestic and international uncertainty will cause transitory rises in the M10 (even above the current level, 8.6%). Nevertheless, to the extent that the political direction is defined in the second part of the year and that conditions of international liquidity are maintained—we estimate a relatively flat curve in the U.S.—the M10 rate will tend to drop to levels of 8%. These estimates take into account the permanence of the position of foreigners' bond holdings in Mexico and the increase in the position of local investors, in view of the fact that long-term rates in the U.S. could stabilize at levels close to 5%.

Up to What Level Could Volatility Rise?

Our base scenario ("moderation of flows") assumes a gradual correction in the international flows to the extent that the main world central banks continue their upward cycle in the reference rates. However, this scenario does not rule out a "bubble" of greater financial uncertainty as of the second quarter, linked to the rate of adjustment of interest rates in the U.S. and to the domestic political situation. An exercise on the financial volatility in Mexico indicates that in view of a drop in the spread between funding rates in Mexico and the U.S. of 25 bp, the implicit volatility in the exchange rate and in the M10 rate rises 1.3 and 1.1 times, respectively, in the weeks following the event. Also, the impending political events imply a rise in volatility of 2 and 1.7 times, respectively, in accordance with what was experienced in the elections of 2000.

Thus, and as an exercise, if we were to simulate a 25 bp increase in the Federal Reserve rate (May 10) together with a 25 bp decrease in the bank funding rate (May 26), and with an intensification of the political debate a month from the elections, the exchange rate could reach 11.9 ppd, which would imply a higher risk premium incorporated in the interest rates, which could go up to 9.6% for the M10. Nevertheless, these impacts would tend to dilute to the extent in which the course of inflation would descend and the post-electoral conflict were not exacerbated.

The Risks Are Accumulating for 2007

The current economic conditions of inflation (close to 3%) and of growth close to the potential, together with expectations of a swift stop in the rising trend of the Federal Reserve rate (at 5%) suggest that we are approaching the end of the downward cycle in the bank funding rate. However, it is important to enumerate the risks that could materialize in 2007, in addition to those existing for the U.S., and that could affect future monetary direction: first, the risk of an upturn in expected inflation is still latent in view of a potential rally in the international prices of tradable goods and economic growth higher than the potential; and, second, the implementation of new economic policies that imply higher risk premiums for the country could limit the efficiency of the monetary policy. In any case, it is imperative to highlight the importance of having monetary policy managed in such a way that it will not trigger erratic changes of direction in interest rates and that would ratify its commitment to counteract medium-term inflationary pressures. In this sense and in view of a central bank with one inflationary target—with expectations of being met in the medium term—and a real interest rate of 4%, there is no reason to expect rallies in the funding rate, except if some risk scenario were to materialize.

Period of Greater Exchange Rate Volatility Begins

Nervousness on the international markets reverts the peso's appreciation trend

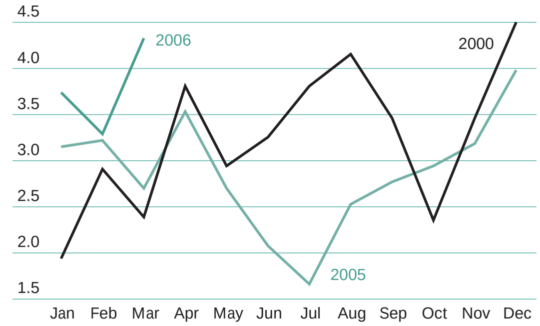
In these first months of 2006, just as we expected, the Mexican currency has shown greater volatility than that observed during the entire year of 2005, and even that of 2000. After having started a nominal appreciation period, which has lasted approximately one year and a half, the peso showed the first important regression in a period slightly longer than one month (from March 1st to April 7th, fluctuating from 10.46 to 11.14 pesos per dollar). The peso's strength in 2004 and 2005 was supported by the favorable macroeconomic situation, which reflects the persistent downtrend of inflation and inflationary expectations, stability in economic growth, financial armor and high capital flows from remittances and oil (in addition to those derived from excess global liquidity and attractive interest rates on the domestic market). However, after six months of a monetary slackening and the lack of coordination in U.S. domestic monetary policy, nervousness has returned to the financial markets in view of expectations that international interest rates might rise more than projected (financial active effect), which has had an impact on the risk premiums of interest rates and pressured the Latin- American currencies.

Periods of greater uncertainty are approaching: the fundamentals will delimit the pressure.

It is quite probable that the general trend of the peso's performance will not change in the following months and that we will continue to see higher volatility levels than last year. The pressure upward will continue to originate within the international financial context, which, should it continue to consider a scenario of high interest rates and a possible complacent adjustment of the current account deficit in the U.S., will increase the aversion to risk and, thus, the attraction to assets from emerging countries. Likewise, the exchange rate in the 2Q06 will reflect the intensification of the political noise, which will give rise to greater nervousness among investors in view of the uncertainty surrounding the future of economic stability.

It should be pointed out that the current spread between interest rates in Mexico with the U.S. does not guarantee being an anchor any longer, in view of a context of greater risks. Despite the fact that the spread has been diminishing since the end of August 2005, it was still attractive in an environment of a lower country risk. However, in view of expectations of a rise toward 5.25% in the federal funds rate, which is currently being discounted by the markets, the interest rate spread no longer offsets the risk premium required in long-term instruments, which generated a speculative movement against the peso. In this sense, we believe that Mexico's central bank will moderate its actions in order to avoid contributing to the variability of the financial variables, which implies a funding rate no lower than 7% until after the elections, in which, subject to the development of the macroeconomic situation, a possible additional adjustment could be considered.

Annualized Monthly Volatility of the Exchange Rate
Pesos per dollar



Source: BBVA Bancomer with Banco de México data

Exchange Rate
Pesos per dollar

Source: BBVA Bancomer with Banco de México data

Long-Term Interest Rates in Mexico and the United States
%

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

Exchange-Rate Index at the Start of the Electoral Year

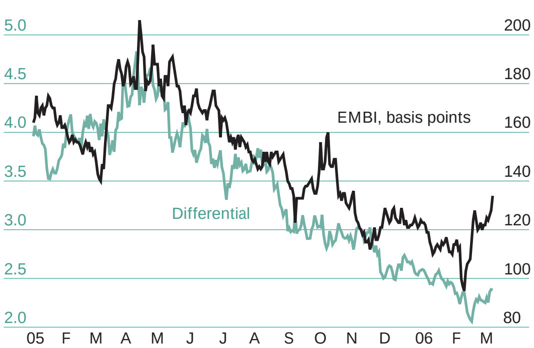
Source: BBVA Bancomer with Banco de México data

Exchange-Rate Projection
Pesos per dollar, end of period

	Moderation (cautiousness)	Flows
1st quarter 2006	10.8	10.8
2nd quarter 2006	**11.4**	**10.8**
3rd quarter 2006	**11.3**	**10.7**
4th quarter 2006	**11.3**	**10.6**

Source: BBVA Bancomer

Adjusted Interest-Rate Spread due to Risk and Sovereign Spread (EMBI)



Source: Bancomer with Banco de México data

Thus, the conditions having a bearing on a depreciation of the peso will be maintained, although still at a level of strength (base scenario of a moderation of flows); that is, the real exchange rate will continue to stand below its equilibrium of recent years. We believe that toward the end of 2006, the fundamentals will moderate the loss of attractiveness of the peso due to uncertainty, since we envision a good year in inflationary terms, a rally in economic activity, firmness in public finances (without exposure to foreign-exchange risk) and the continuation of oil and remittance flows (moderation of financial flows but not reversion). As a whole, the exchange rate will be around 11.3 ppd at the end of the year, with the greatest pressure being in the second quarter, when it could reach 11.4 ppd.

Interest rate spread: Why had the highly expected adjustment in the peso/dollar exchange rate been delayed so long?

From August of last year to the beginning of March 2006, the short-term interest rate spread has dropped 375 bp and the long-term 210 bp. Despite this, peso-dollar parity fluctuated within very narrow ranges—and the peso appreciated almost 4.0% through the first days of March.

The effect that the interest rate spread has on the exchange rate depends on what causes an adjustment in the spread. Thus, more than a risk premium, it should reflect the expectations for the exchange rate in the medium and long terms, which, in turn, depend on the fundamentals (mainly prices).

In these last few months, the monetary slackening and the reduction of interest rates throughout the curve are the result of the process of inflationary convergence, which has removed pressure from the peso. This means that we have seen a transition to a possible new equilibrium, which represents lower expected inflation, and, therefore, an also narrower interest rate spread. In the process, the adjustment variable, which in this case is the peso, was favored.

At the same time, just as we have documented in previous issues, the strength of the peso has been magnified in view of the extraordinary revenues from high oil prices and remittances. Jointly, the excess liquidity on the international markets has sensitized the appetite for risk even more, giving room to lower interest rates. For example, the risk-adjusted spread has diminished (through February) 51 bp less than the non-adjusted. The bond yields in the U.S., European and some Asian markets have been at minimums in recent years, which has given rise to an exhaustive search for profitability, which some Latin American countries have taken advantage of to place cheaper debt and thus, as is the case of Mexico, develop a more liquid domestic debt market.

If the interest-rate spread already represents an equilibrium of the inflationary spread with the U.S., and if the central bank firmly establishes its credibility, we will expect that, on average, changes in interest rates, induced by monetary policy, will maintain an inverse relationship with the peso-dollar exchange rate, particularly if these modify the funding opportunities of one currency over another. This is why, today, the interest-rate spread no longer guarantees being an anchor, in face of greater financial uncertainty in the short term, since the spread represents nominal stability in Mexico and does not offset, through the monetary policy, changes in the risk perception.

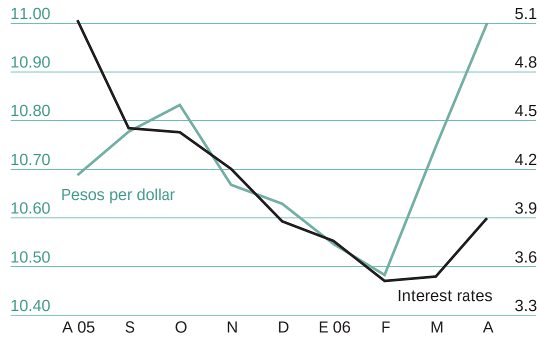
The nominal strength of the peso is not ruled out completely

Even though pressure periods for the exchange rate are not expected, we also ascribe a probability, although lower to that of the base scenario, that the gradual reversion of the flows will be delayed, and together with macroeconomic support, will maintain the peso at very solid levels (and the volatility will be subject only to the uncertainty surrounding the elections this year). In fact, today, the investment opportunities in domestic instruments are maintained and the macroeconomic data (inflation, economic activity, remittances and oil) continue to support currency exchange fluctuation within a range of strength. This would imply that should the political risk revert after the elections and should the increases in international interest rates not be sufficient to remove the excess liquidity in the emerging countries, the Mexican currency would present conditions for an exchange rate below 10.8 ppd at the end of the year.

Indications that the real depreciation will heighten

There are four factors that will have a bearing on the exchange rate during 2007 and that could give rise to adjustments to the real exchange rate: a) the possible correction of the current account deficit in the U.S., which could begin to have a bearing on the dollar and the peso as of the end of 2006; b) the combination between the already imminent intensification of an increase in interest rates in other regions of the world; c) the delay in terms of the competitiveness of our economy; d) the reduced short-term interest rate spread. Only an excessive impetus on the financial markets at the start of the new administration and the yet existing strength of the foreign accounts would moderate, or appreciate the Mexican currency (a scenario to which we ascribe less probability).

Long-Term Interest Rate Spread and Exchange Rate



Source: BBVA Bancomer with Banco de México data

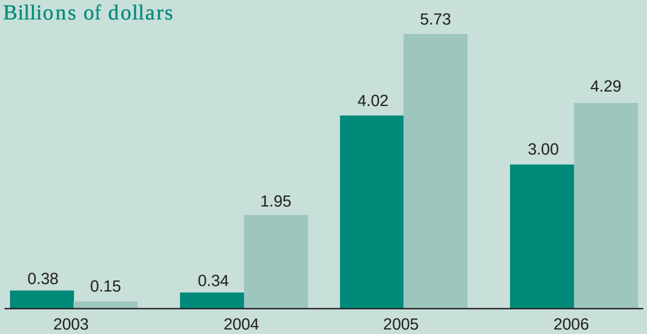
Emerging Markets, Are They All the Same?...

Good 2006 start in flows to emerging markets

For the emerging markets, 2005 was a year in which the stars were all aligned. In this alignment, the brightest stars were high international liquidity, low risk aversion, high prices of raw materials, and favorable world economic growth. All this resulted in a 2005 in which the emerging markets received significant net capital inflows. Thus far in 2006, the emerging markets have received net fixed income inflows that surpass 70% of the accumulated total for 2005. During the first quarter of 2006, variable income inflows to Latin America already represent 75% of the accumulated 2005 total. With the spectacular beginning of 2006, coupled with an excellent 2005, the question that arises is whether the changes due to the favorable context will remain or if, on the contrary, we are facing a situation in which investors will try to obtain high profits before a change takes place in market conditions. There are economies that have taken advantage of the current situation "to settle accounts", and this could be taken into account by investors when the time comes to penalize or reward such nations.

Net Accumulated Variable Income Flows to Latin America and Bonds to Emerging Economies

Billions of dollars



Source: BBVA - Capital Flows, EPFR

In principle, volatility is not cause for concern

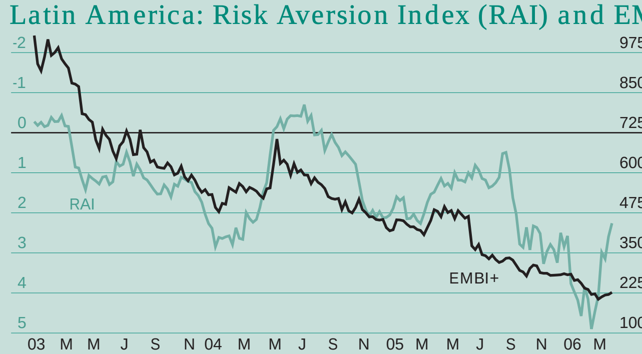
One of the first variables that can be considered in attempting to judge whether the current situation of the emerging markets is cause for concern is, for example, a perception of the development of volatility in these markets. Both globally as well as regionally, volatility remains at low levels. More specifically, and if we observe the results of the past two years, the behavior of the Latin American markets is not cause for concern; in fact, the opposite is the case. On a country-by-country breakdown, in Latin America the great majority of the markets are not experiencing renewed volatility. Peru and Mexico, due to the uncertainty surrounding their respective elections, are an exception, although in any event their increased volatility has been moderate.

In the past few weeks we have noted some developments that in previous years might have implied a general penalization of all the emerging markets, which did not occur this time around. This is the case of Iceland, which to date in 2006 has accumulated a 12% depreciation of its currency and has had serious problems in placing its latest four-year debt issue, given a high deficit in its current account, which ended with the country's monetary authorities raising interest rates. Investors were able to precisely pinpoint the problem, and only penalized this market.

Slight risk aversion, but caution

In addition to analyzing the volatility of the markets, it is useful to review the information obtained from risk aversion indexes. In general, risk aversion indexes[1] have remained at low levels, although they have begun to show signs of a turnaround, both globally as well as regionally. In Asia, such signs began to be seen since the beginning of 2006, while in Latin America a clear turnaround has yet to be observed.

Latin America: Risk Aversion Index (RAI) and EMBI



Source: BBVA - Capital Flows

In conclusion, more selective investors

If we consider the increase in volatility that is occurring in some markets, and although not contemporary, the slight rise in risk aversion, it could be noted that investors could begin to selectively penalize some of the emerging economies. A greater than projected rise in interest rates in the developed countries would result in lower liquidity, a phenomenon that would lead to a selective increase in credit differentials, and thus, the opportunity cost of investing in some economies would increase. The reality and the evolution of some markets show that the first signs are emerging that indicate that all markets are no longer the same in the eyes of investors.

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1 See technical article "¿Señales de cambio en la aversión al riesgo?" dated March 9, 2006, which presents a detailed analysis of this issue.

How Will Reduced Financial Flows Affect Mexico?

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The extraordinary inflows of financial resources to emerging economies in the past few years continue to attract attention and be the subject of controversies. For 2005 it is estimated that such flows totaled more than 26 billion dollars in the money and variable income securities market. In the first four months of 2006 alone, a similar dynamism, as occurred throughout 2005, has been noted. This is part of a global phenomenon seen in the past few years in which it is estimated that the international volume of such investment flows represents 10% of world GDP.

In Mexico, this situation was one of the reasons that enabled a favorable performance of the country's financial markets from mid-2004 until the first quarter of 2006. These flows allowed the peso to begin a period of continuous strengthening, the country risk dropped to minimum historical levels, long-term interest rates diminished, and the stock exchange enjoyed a sustained rebound. Nevertheless, the experience of massive capital outflows in periods marked by elections and/or moments of international uncertainty raises concerns over the consequences of the emergence of greater volatility in the future and suggests the advisability of considering the capacity of the country's economy to deal with a potential reduction in international liquidity.

What is Mexico's position in relation to lower international liquidity?

Given the considerable availability of international resources, Mexico has chosen to promote prudent measures in order to support macroeconomic stability. On the one hand, the country's fiscal policy has been focused on reducing the financial requirements of government expenditures and improving the profile of its public debt by extending payment deadlines and limiting its exposure to foreign-exchange and interest-rate risks. On the other hand, in monetary and exchange-rate policy, a consensus has been achieved on the benefits of the central bank operating with inflation targets—with a 3.0% target and a variation range of + / - one percentage point—and having a flexible exchange rate régime.

Authorities have promoted the development of an internal financial system that has not only allowed for its further expansion, but has also favored the creation of new markets (for example, derivative products, MexDer). These advances allow for better management (or coverage) of financial risks and promote long-term planning in the economy. At the same time, the prudent management of economic policies, the strengthening of financial institutions (with greater capitalization, better international practices, etc.) and the change in regulations contribute to preventing the banking system from becoming the source of the transmission of financial crisis, as was the case in the past.

To sum up, the strategy that has been followed has generated favorable conditions to attract and retain financial flows and prevent an abrupt withdrawal of capital investments. This has led to a solid economic framework that contributes to tempering the volatility of the markets.

Capital flows are a global phenomenon

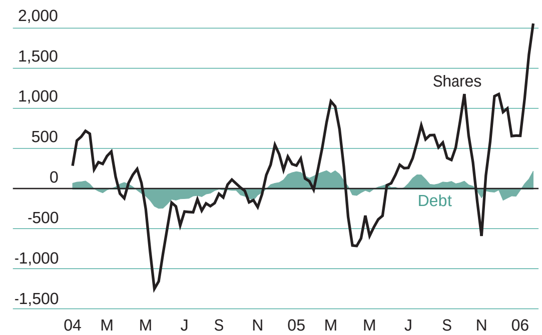
The structural changes have allowed Mexico to benefit from the high international liquidity. However, the world context has expanded the

Financial Market Levels
June 2004 vs. March 2006, average

	June 2004	March 2006
Exchange rate (ppd)	11.39	10.76
EMBI+ (bp)	213	123
Bank funding (%)	6.36	7.45
M10 (%)	10.37	8.26
IPC market index (annual % chge.)	45.4	43.2

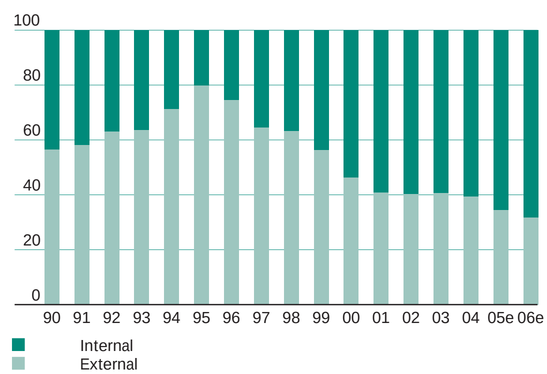
Source: BBVA Bancomer with Banco de México and Bloomberg data

Flows to Emerging Markets
Millions of dollars, 4-week moving average



Source: BBVA Bancomer with EPFR data

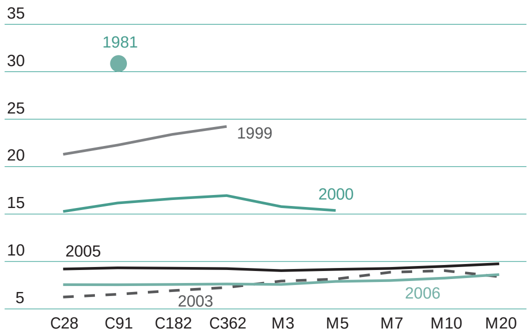
Net Internal and External Debt
% of total



Source: BBVA Bancomer with SHCP data

Evolution of the Yield Curve

%



Source: BBVA Bancomer with Banco de México data

markets' interest in investment in emerging economies. A wide range of global events has coincided to generate excess liquidity, among which three are significant:

First, interest rates in different regions (United States, Europe, and some Asian countries) have remained extremely low as a result, on the one hand, of the expansive monetary policy of various central banks following the decline of inflation in the world in the past few years. On the other hand, there is a high and growing participation of institutional investors[1], particularly in the bond market, pressuring yields downward in the industrialized countries. At the same time, a significant group of emerging economies face a prolonged favorable period in their external accounts.

Second, there is an excess of savings over investment in a large number of countries. The significant renewed increase in prices of raw materials has strengthened the revenue of supplier countries and led to an abundance of resources, which translates into high demand for U.S. assets, which allows financing that country's fiscal deficit and current account.

Third, the contribution of emerging economies to global economic stability is more evident. Their integration in the international markets has not only resulted in lower commodity prices, but has also expanded opportunities for international investment. At the same time, multinational companies have experienced an unprecedented expansion in these economies that—supported by world growth—have strengthened their balance sheets and the resources available for investment.

The causes of such excess financial resources make a sudden reversal of international capital investment strictly sustained on domestic economic developments unlikely. The structural weaknesses that persist in Mexico will only be evident in the short term in response to a context of sharp uncertainty that we feel is not very probable. Even in the event that this were to occur, the solid macroeconomic fundamentals that are currently at play would tend to limit the periods of volatility and mitigate the severity of any possible financial adjustment.

Two potential causes of the adjustment in flows: imbalances in the U.S. and a confidence crisis in relation to Mexico

Although we feel that it is not very likely that there will be an abrupt and long-lasting reversal of the international flows, it is advisable to analyze the developments that could trigger an environment of high uncertainty as well as the channels through which it could be transmitted to the financial markets in Mexico. By the same token, this exercise allows us to consider the strengths and weaknesses of the Mexican economy in relation to such developments as well as the degree of severity that these adjustments could have on the country's economy.

International causes: adjustment due to imbalances in the United States

The U.S. economy is experiencing a period marked by a high current account deficit (6.4% of GDP in 2005, equivalent to 805 billion dollars), which is mainly the result of a decline in family savings (-0.5% of disposable personal income) and a high fiscal deficit (2.6% of GDP)[2]. Nevertheless,

Mexico: Economic Fundamentals

	1988	1994	2000	2006
Inflation (ann. % chge, eop)	51.7	7.1	9.0	3.6
Fiscal deficit (% of GDP)	7.4	0.1	1.1	0.2
Public Sec. Fin. Req. (% GDP)	nd	3.0	3.3	1.9
Net public debt (% of GDP)	54	37.6	23.1	21.0
Current acc. def. (US$ billions)	2.4	29.7	18.5	16.4
Current acc. deficit (% GDP)	1.3	7.0	3.2	2.1
International reserves[1]	11.9	17.9	32.4	64.0
Current account financing[2]				
FDI	21.2	37.0	90.6	109.8
Remittances	79.9	11.7	35.5	121.9
International reserves	494.1	60.4	175.2	390.2

1 US$ billions, average
2 % of current account
Source: BBVA Bancomer with Banco de México, INEGI and SHCP data

1 Both traditional funds as well as pension and retirement funds, and those of a speculative nature, such as hedge funds.

the surplus resources generated by Asian economies and by exporters of raw materials (particularly oil producing countries) have not only allowed this high U.S. current account deficit to be financed, but also to do so with low interest rates by incorporating reduced risk premiums, the result of the reduced volatility in the world cycles of economic growth and inflation.

Although these imbalances will tend to experience a correction, it is not completely clear when this will occur, with what characteristics, nor the scope of this process or what will be its immediate detonator. In any event, the adjustment should register a downturn in U.S. consumption and an increase in world interest rates associated with greater risk premiums. Nevertheless, it is debatable whether this readjustment will emerge gradually or abruptly in a way that would imply a scenario of economic "stress", with a recession in the United States, a possible increase in global inflation if this scenario is produced by additional hikes in oil prices, growth in interest rates due to higher risk premiums (an obstacle to investment flows), and a depreciation of the dollar in relation to Asian currencies.

At present, there are indications to believe that the adjustment in international imbalances will be gradual.[3] Nevertheless, and by way of an exercise, it is interesting to consider how an abrupt correction in the United States would affect the Mexican economy under current circumstances. Qualitatively, this adjustment would be transmitted to Mexico through a turnaround in the trade deficit (fewer exports of manufactured goods and hydrocarbons), which would lead to a slowdown in industrial activity as well as in investment and employment. This would be coupled with reduced international liquidity, which would lead to a greater depreciation of the peso and would contribute to an upturn in domestic inflation. With it, interest rates would increase (higher risk premium and greater projected inflation) and discourage domestic demand in Mexico.

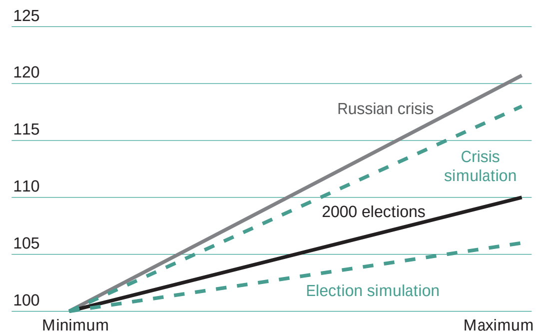
Assuming, for illustrative purposes, as a risk scenario, that in response to an additional significant increase in oil prices, the U.S. economy were to experience a slowdown in 2006 and 2007 (growth of 2.9% and -0.4%), inflation were to rebound to 4% and 3.3%, long-term interest rates were to rise to 6.3% and 7.8% and the dollar were to depreciate toward levels of 1.40 per euro, we would experience an international rebound in risk premiums (between 2 and 3 times the levels currently seen) that would reduce the availability of resources for the Mexican economy. In the current context of this economy (flexible exchange régime, depth of the financial markets, long-term single digit inflation expectations, reduced fiscal deficit, and improved public debt), our exercises indicate that for the financial markets this decline in international resources would imply: (i) a depreciation of the peso that would bring the exchange rate to 12 and 13.6 pesos to the dollar; (ii) a turnaround in short- and long-term interest rates (with yields on the 91-day Cete increasing toward levels between 9.2% and 10.5% and for the 10-year bond between 11.6% and 14.7%);

2 In the short term, a growing effect of high oil prices can be seen in the U.S. external accounts, to the extent of contributing the equivalent of up to 1% of GDP in Washington's trade deficit in the past 12 months.

3 Among the elements that point to a gradual adjustment we have a trend toward increases in central bank interest rates throughout the world to limit the inflationary risk by moderating strong growth in consumption; production growth persisting in China, which generates surplus reserves and a high demand for raw materials; advances in foreign exchange flexibility in Asian countries; an increase in family income in the United States; and international inflation within low ranges. In addition, U.S. productivity remains within very favorable ranges.

Exchange Rate Adjustment Index

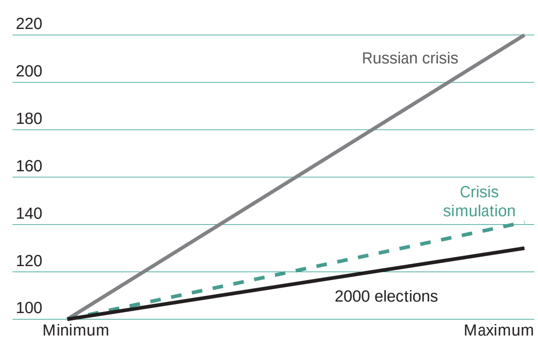
Represents the trend between the minimum and maximum value achieved during the event



Source: BBVA Bancomer with Banco de México data

Interest Rate Adjustment Index

Represents the trend between the minimum and maximum value achieved during the event

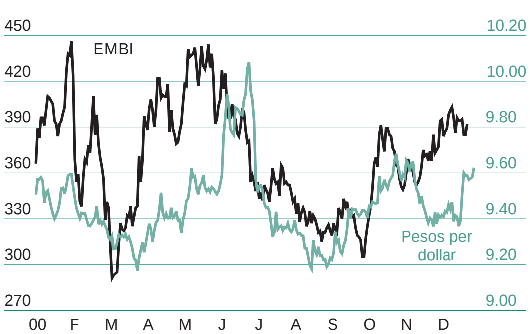


Source: BBVA Bancomer with Banco de México data

Brazilian Real and Spread
6 months before and after the 2002 elections

Source: BBVA Bancomer with Bloomberg data

Mexican Peso and Spread
6 months before and after the 2000 elections



Source: BBVA Bancomer with Bloomberg data

and (iii) contraction of the stock market index of between 15% and 20% in annual terms at the close of the next two years.

In any event, what these figures show is the progress registered in placing the economy on a solid footing in order to face an external "shock" of this nature. That is, in comparative terms, the impact on the different variables is less than was the case at other moments of uncertainty for the Mexican economy.

National causes: confidence crisis in relation to Mexico

National elections will be held in Mexico on July 2. The Mexican federal elections are part of a political cycle that encompasses several Latin American countries (Chile, Bolivia, Peru, Brazil, and Venezuela, with some of these elections already having been held) over a relatively short period of time. Traditionally, these periods of political activism have been accompanied by a change in the perception of the country risk, depreciations of the Latin American currencies, and reduced demand for the region's assets. This has led to periods of economic sluggishness and, on occasions, of financial crisis.

Mexico is currently facing its federal elections in a quite favorable internal economic framework, to the degree that it has been decades since the country experienced an alignment of elements such as healthy public finances and external accounts, refinancing of the external debt covered for the next two years, low inflation, and the development of the financial and banking market.[4] Nevertheless, we cannot completely rule out that the mood in the market will shift with the approach of the elections. This has, in fact, occurred, in varying degrees, in previous elections in Latin America. For example, the last instance that triggered a substantial increase in volatility in the region was the Brazilian elections in 2002. On that occasion, speculation grew in the markets—and consequently nervousness—when the possibility arose of a victory at the polls by the left-wing candidate at the time, Luiz Inácio Lula Da Silva, who was perceived as a populist and was associated with the possibility of a suspension of payment on the foreign debt. The sovereign spread increased by more than 1,600 bp in the previous six months, while the Brazilian real depreciated more than 60%. Once the elections were over—and after Lula Da Silva announced his cabinet and moderated his political direction toward a more orthodox position—the financial markets once again resumed their optimism on Brazil, a situation that, with some setbacks, has been maintained to this day.[5]

The 2000 elections in Mexico generated less agitation compared to the race in Brazil. However, there was indeed a period marked by greater uncertainty, which moderately increased the volatility of the exchange rate and the country risk. Thus, the peso weakened from 9.5 per dollar in January 2000 to 10.08 the week prior to the elections. In addition, Mexico's EMBI+ fluctuated within narrower ranges that those of Brazil, rising almost 150 bp in the weeks before the elections.

At the present time, a perception of greater uncertainty would not appear to be justified given the economic strength of the economy's

4 Elements that comprise the current "financial armor-plating."
5 Brazil faced these elections with a very unfavorable financial and economic context compared to the situation of the Mexican economy in 2000 and at present. In particular, the Brazilian economy experienced greater vulnerability in its external accounts (a high current account deficit), financing with short-term flows, public debt that was high and sensitive to the volatility in interest rates and the exchange rate.

fundamentals and the progress made in containing inflation. On the political level, the elections are backed by institutions that guarantee that the vote will be respected and democracy ratified. Together with the economic reforms, this is part of the country's structural transformation package of recent years.

So, what, in fact, would generate a shift in investor sentiment in relation to the elections? Uncertainty on the continuation of economic stability is, in the electoral period, the source of speculative movements. Elections generate doubts associated with the incoming administration's ability to face new challenges, the mechanisms and ideologies used to achieve this, and even the credibility of the candidates' arguments. It is, in principle, a subjective appraisal that does not always leave room for the benefit of the doubt. However, despite the sensitivity of the market's feeling toward a given emerging economy, the economic justification resides in the possibility (albeit remote) that the projected return on investments could become negative from one moment to the next. And it is at that point that investors might pack their bags and demand a higher risk premium.

The elections in Mexico are not immune to a possible loss in investor confidence. Nevertheless, the strength of the economy's fundamentals will mitigate the short-term pressure. As an illustrative exercise, we have calculated the effect that an increase in volatility in the main financial variables estimated at twice the level of the 2000 elections would have on the exchange rate. With the exchange rate at the close of this issue at close to 11.0 pesos to the dollar, if the elections were held in one month, our simulation of two times the amount of uncertainty present in the previous elections would result in an exchange rate of 11.59 pesos to the dollar, spreading out the effect over three months. This simulated 5.36% depreciation does not represent a risk scenario, but does reflect greater uncertainty in a context of structural strength.

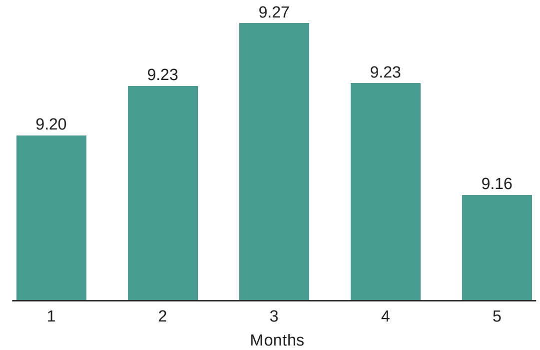
From another standpoint, the scope of movements in the exchange rate once again demonstrates the progress made in strengthening the economy by counteracting the volatility of the financial markets, given that the adjustment would take peso/dollar parity to levels similar to those of October 2004.

Conclusions

In this article, we have offered a general presentation of the conditions under which the economy could face a period of greater financial volatility and their possible origins. With this in mind, we have analyzed and simulated what, in our opinion represent the main sources of risk, namely, an adjustment in international imbalances and a possible change in the market's perception in response to the July 2 elections. It is an illustrative exercise to which a much lower probability is assigned than that of the base scenario, and leads to the conclusion that there is less likelihood of the markets facing a financial crisis similar to those of the past. However, the causes and mechanisms of the developments that could lead to greater uncertainty should be recognized and some simply indicative estimates identified. Mexico, together with Chile at one point, is the country that enjoys the strongest economic fundamentals in the context of an electoral scenario. As a result, the conditions are present to contain and limit the volatility of the financial markets, if this were to occur. In this sense, this potential volatility is not synonymous with crisis, but shows the capacity to absorb such factors.

Simulation of the M10 with an Increase of 2 Times the Risk Premium Associated with the 2000 Elections

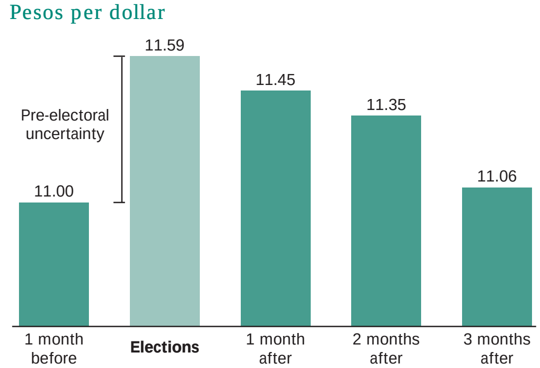
Base = 8.6%



Source: BBVA Bancomer

Simulation of the Exchange Rate with 2 times the Risk of the 2000 Elections

Pesos per dollar



Source: BBVA Bancomer

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Mexico: The Run-up to the Elections of July 2nd

On July 2, 1,431 Elective Posts Will be Renewed

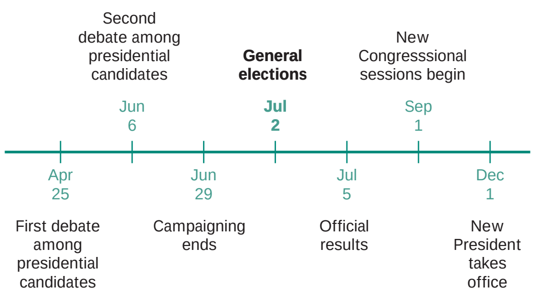
- 1 President
- 128 Senators
- 500 Federal Deputies
- 3 Governors
- 423 Mayors
- Mexico City Head of Government
- 16 Mexico City Precinct Heads
- 359 Local Legislators

Source: IFE

On July 2nd, voters will elect the new President of Mexico for the 2006-2012 period, as well as the 500 deputies and 128 senators who make up the two houses of Congress. There will also be elections to choose the mayor of Mexico City, the local Legislative Assembly and leadership of the 16 Mexico City precincts, as well as the governors of Guanajuato, Jalisco and Morelos. In addition, the legislatures and mayoralties of nine states (Campeche, Colima, Guanajuato, Jalisco, Morelos, Nuevo León, Querétaro, San Luis Potosí and Sonora) will be renewed. In short, 1,431 public posts are up for election.

The formal campaigns of the candidates for the Presidency began on January 19. Of the five presidential hopefuls who are standing in this election, only three are competitively placed: Andrés Manuel López Obrador (PRD); Felipe Calderón Hinojosa (PAN); and Roberto Madrazo (PRI). López Obrador also has the backing of two other parties, the PT and Convergencia Democrática, while Madrazo has the support of the PVEM. The PAN candidate is the only one of the three who did not establish an electoral alliance with another political force. The other two presidential candidates are Patricia Mercado (Alternativa Socialdemócrata y Campesina) and Roberto Campa (Nueva Alianza).

Political Calendar
April - December 2006



Source: BBVA Bancomer

The Electoral Infrastructure is a Factor of Confidence

In face of the possibility of a hard-fought election, the electoral infrastructure constructed in recent years is a factor of confidence. Today, there are 73 million persons registered in the voter rolls, 20% more than in the elections of 2000. For the elections this July 2nd, 226.7 million ballots will be printed, 18% more than six years ago. These ballots contain new safety measures, including special paper, watermarks and optic fibers. There will be 5.8 million election certificates. The voting will take place at 134,000 booths, 18% more than in 2000. There will be special attention booths at 5,353 electoral sections. According to the Federal Electoral Institute (IFE for its Spanish initials), there will be almost one million officials on hand at the booths, 23,791 training assistants and 3,265 electoral supervisors. As in the two previous presidential elections, this civic event will count on the presence of a large number of electoral observers and foreign visitors. The Preliminary Electoral Results Program (PREP), an improved fast-count system and the exit polls will allow the results to be known on election night itself.

Popularity of Presidential Candidates
March – April 2006, %

	AMLO (PRD)	Madrazo (PRI)	Calderón (PAN)	Difference 1^{st} - 2^{nd}
Parametría	40.0	29.0	29.0	11.0
Reforma	41.0	25.0	31.0	10.0
Mitofsky	38.0	29.0	31.0	7.0
Mark. Pol.	37.0	29.0	32.0	5.0
Arcop	31.0	23.0	27.0	4.0
El Universal	38.0	25.0	34.0	4.0
Milenio	34.0	31.0	31.0	3.0
GEA-ISA	34.0	28.0	36.0	2.0
Beltrán	36.0	28.0	34.0	2.0
Average	**36.6**	**27.4**	**31.7**	**5.3**

Source: National survey by respective polling firms

The country has the juridical-institutional “armour” with which to resolve any controversy stemming from the voting. The Electoral Tribunal of the Federal Judiciary Branch (Trife for its Spanish initials), created in 1996, has among its functions: to undertake the final vote tally, to qualify the election of the President of the Republic and to declare the President-elect (previously the responsibility of the Congress through the Grand Electoral College); to resolve in a definitive and unimpeachable manner any challenges that might arise regarding federal electoral issues; and to strengthen the system of measures dealing with electoral challenges so as to guarantee the principles of constitutionality and legality of electoral acts and resolutions. The electoral magistrates do not depend on the Federal Executive Branch. The Trife generates confidence and is the maximum authority for resolving disputes. In fact, it annulled two elections for governor in the states of Tabasco and Colima. Even though the current magistrates will be replaced in September 2006, the Trife would take no longer than six weeks to resolve an electoral controversy.

López Obrador leads in almost all the polls

From the start of the presidential race, almost all the polls place López Obrador at the head of voter preferences, while Calderón and Madrazo are battling for second place. According to the opinion polls of the *Reforma* daily and *Consulta Mitofsky* published in the month of March, the PRD candidate enjoys an advantage of between seven and ten percentage points over his closest opponent. The GEA-ISA poll is the only one that places Calderón ahead of López Obrador. In any case, the most recent poll of the *Milenio* daily, published in the first week of April, could indicate that the electoral dispute is becoming more competitive, since the PRD candidate commands 34% of voting intentions, while Madrazo and Calderón are only three points behind him, each with 31%. Independently of the backing that the candidates to the presidency have, the opinion poll taken by the *El Universal* daily revealed that 42% of those consulted believe that López Obrador is going to win the elections. Only 19% shared this same opinion with regard to Calderón and Madrazo.

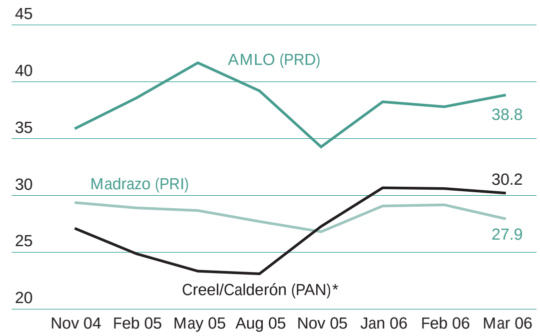
Assessment

The decisive phase of the electoral campaign will be in May and June, after the Holy Week "truce". During those months, the electoral battle is expected to become harsher, and personal attacks among the presidential hopefuls will take on a more strident tone. The candidates will participate in two televised debates. The first of these debates will take place on April 25; the second is scheduled for June 6. The available information indicates that López Obrador will only go to the second of these encounters. The debates will allow voters to carefully assess the qualities of each candidate. On the other hand, financial markets expect the two events to provide them with greater economic leads. In face of the expectation of a hard-fought election, the candidates will intensify their efforts to obtain the support of those who have not yet decided whom they will vote for. Most polls agree that approximately 20% of voters fall into that category. Many of them will not go to the polls; however, if a numerous group of the remainder lean toward the same candidate, this could determine the final result.

If the difference between the first and second placed candidate amounts to a single percentage point, this could cause nervousness. However, assuming that one candidate secures 37% of the vote and another 36%, with a participation of 60% of the voters (that is 43.8 million), this percentage point would represent 400,000 votes, a considerable number. In a democracy, elections are won or lost by one vote. The presidential contest in Costa Rica (February 5) is a good example of how close an election can be. The winning candidate, Oscar Arias Sanchez, led his closest competitor, Otton Solis Fallas, by barely 18,169 votes: 40.9% vs. 39.8%. This outcome did not spark any questioning on the part of the loser and in the following days, the discussion revolved around the feasibility of holding a second electoral round or not (Solis ultimately recognized his defeat). One cannot rule out the possibility that in Mexico the coming elections might produce a close result; nevertheless, this would make palpable the vitality of the democratic system. In the final balance, the infrastructure at the disposal of the IFE to organize the voting process, along with the Trife's well-earned credibility for resolving electoral controversies are elements of certainty that must be taken into account.

Support for Presidential Candidates

Three-poll average, %

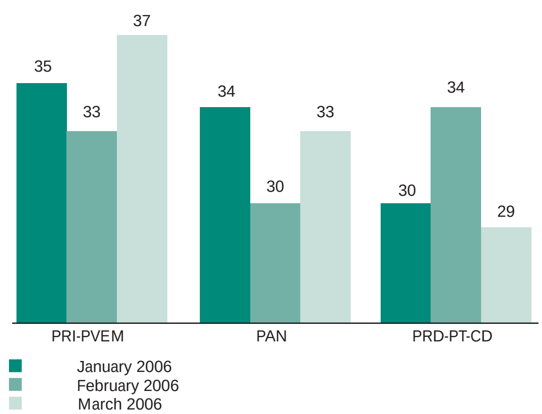


* Through August 2005 the poll results for the PAN were based on Creel and as of Nov. on Calderón

Source: National surveys by *Milenio*, *Reforma* and *Consulta Mitofsky*

Federal Deputies: Electoral Preference

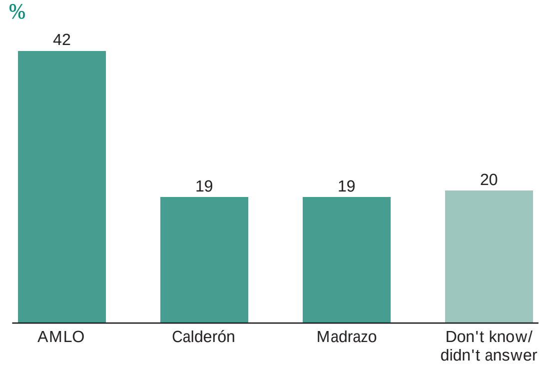
%



Source: National surveys by *Consulta Mitofsky*, January-March 2006

Which Candidate Do You Think Will Win the Next Elections?

%



Source: National surveys by *El Universal*, March 3-6, 2006

United States Indicators and Forecasts

	II'05	III'05	IV'05	I'06	II'06	III'06	IV'06	I'07	2005	2006	2007
Economic Activity											
GDP (real annual % change)	3.6	3.6	3.2	**3.5**	**3.4**	**3.0**	**3.4**	**3.1**	3.5	**3.3**	**3.2**
Personal consumption expenditures	3.9	3.8	2.9	**3.3**	**3.3**	**3.0**	**3.4**	**3.0**	3.5	**3.3**	**3.0**
Gross fixed investment	8.0	7.9	7.1	**7.1**	**5.9**	**4.7**	**6.2**	**5.6**	8.1	**6.0**	**5.7**
Non-residential	9.2	8.3	6.8	**8.2**	**7.5**	**6.3**	**7.7**	**6.4**	8.6	**7.4**	**6.7**
Structures	1.7	1.9	1.5	**2.0**	**0.4**	**0.6**	**0.4**	**0.5**	2.0	**0.9**	**0.5**
Equipment and software	11.8	10.6	8.7	**8.3**	**7.7**	**6.0**	**7.8**	**7.8**	10.9	**7.5**	**8.1**
Residential	6.1	7.2	7.6	**5.8**	**3.7**	**2.3**	**4.0**	**3.8**	7.1	**3.9**	**3.5**
Total exports	7.7	6.9	6.4	**6.4**	**5.7**	**7.0**	**8.4**	**7.5**	6.9	**6.9**	**7.0**
Total imports	5.7	5.1	5.3	**5.3**	**6.9**	**7.8**	**7.0**	**6.1**	6.3	**6.7**	**6.4**
Government consumption	1.8	2.0	1.6	**2.2**	**2.2**	**2.2**	**2.2**	**2.3**	1.8	**2.1**	**2.3**
Contribution to Growth (pp)											
Personal consumption expenditures	2.7	2.7	2.1	**2.3**	**2.3**	**2.1**	**2.4**	**2.1**	2.5	**2.3**	**2.1**
Private investment	0.7	0.7	1.1	**1.0**	**1.2**	**1.1**	**0.9**	**0.8**	1.0	**1.0**	**0.9**
Net exports	-0.1	-0.1	-0.2	**-0.2**	**-0.5**	**-0.5**	**-0.2**	**-0.2**	-0.3	**-0.4**	**-0.3**
Government consumption	0.3	0.4	0.3	**0.4**	**0.4**	**0.4**	**0.4**	**0.4**	0.3	**0.4**	**0.4**
Prices and Costs (annual % change, average)											
CPI	3.0	3.8	3.7	3.7	**3.7**	**2.5**	**1.9**	**1.9**	3.4	**2.9**	**2.1**
Core	2.1	2.1	2.1	2.1	**2.3**	**2.7**	**2.7**	**2.7**	2.2	**2.5**	**2.3**
PCE	2.5	3.1	3.0	**2.9**	**2.9**	**2.0**	**1.7**	**1.6**	2.8	**2.4**	**1.6**
Core	2.0	1.9	2.0	**1.8**	**1.9**	**2.1**	**2.2**	**2.1**	2.0	**2.0**	**1.9**
GDP deflactor	2.5	2.9	3.1	**3.0**	**3.0**	**2.4**	**2.2**	**1.9**	2.8	**2.7**	**2.0**
Productivity	2.4	3.1	2.4	**2.8**	**2.8**	**2.8**	**2.8**	**2.5**	2.7	**2.8**	**2.5**
Real compensation per hour	2.7	1.7	0.1	**1.9**	**1.9**	**1.9**	**1.9**	**1.8**	2.0	**1.9**	**1.8**
Unit labor cost	3.2	2.4	1.3	**2.4**	**1.3**	**1.4**	**1.4**	**1.4**	2.6	**1.6**	**1.3**
Other Indicators											
Industrial production (real annual % change)	3.0	2.8	3.0	3.2	**3.5**	**4.1**	**3.7**	**3.7**	3.2	**3.6**	**3.4**
Capacity utilization (%)	79.9	79.9	80.5	81.0	**81.1**	**81.3**	**81.5**	**81.7**	80.1	**81.2**	**81.9**
Light weight vehicle sales (millions, annualized)	17.2	18.0	15.9	16.9	**17.0**	**16.9**	**16.9**	**16.9**	16.9	**16.9**	**16.9**
Housing starts (thousands, annualized)	2,044	2,101	2,059	2,131	**1,906**	**1,868**	**1,869**	**1,869**	2,072	**1,944**	**1,890**
Nonfarm payrolls (thousands of new jobs, average)	167	155	179	197	**160**	**160**	**160**	**140**	165	**169**	**140**
Unemployment rate (average, %)	5.1	5.0	4.9	4.7	**4.7**	**4.7**	**4.7**	**4.7**	5.1	**4.7**	**4.6**
Personal savings rate	-0.2	-1.8	-0.4	**-0.7**	**-0.9**	**-0.2**	**0.7**	**0.9**	-0.5	**-0.3**	**1.1**
Trade balance (US$ billions)	-197	-185	-225	**-217**	**-223**	**-226**	**-230**	**-229**	-724	**-828**	**-884**
Current account balance (US$ billions)	-788	-742	-906	**-868**	**-892**	**-906**	**-921**	**-915**	-805	**-897**	**-946**
% of GDP	-6.4	-5.9	-7.1	**-6.7**	**-6.8**	**-6.8**	**-6.8**	**-6.7**	-6.5	**-6.8**	**-6.8**
Fiscal balance (US$ billions, fiscal year)	—	—	—	**—**	**—**	**—**	**—**	**—**	-318	**-352**	**-285**
% of GDP	—	—	—	**—**	**—**	**—**	**—**	**—**	-2.6	**-2.7**	**-2.0**
Brent (dollars per barrel, average)	53.9	65.5	61.1	66.4	**65.6**	**60.8**	**59.4**	**58.1**	58.3	**63.1**	**56.7**
Financial Markets (eop)											
Fed Funds (%)	3.25	3.75	4.25	4.75	**5.00**	**5.00**	**5.00**	**5.00**	4.25	**5.00**	**5.00**
3-month Libor (%)	3.52	4.07	4.54	5.00	**5.37**	**5.37**	**5.37**	**5.37**	4.54	**5.37**	**5.37**
10-year Treasury Note (%)	3.91	4.32	4.39	4.85	**4.90**	**5.00**	**5.20**	**5.18**	4.39	**5.20**	**5.10**
Dollar/euro	1.21	1.20	1.18	1.21	**1.21**	**1.22**	**1.23**	**1.24**	1.18	**1.23**	**1.26**

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

Mexico Indicators and Forecasts

	2002	2003	2004	2005	2006	I'05	II'05	III'05	IV'05	I'06	II'06	III'06	IV'06
Economic Activity													
GDP (seasonally-adjusted series)													
Real annual % change	0.8	1.4	4.2	3.0	**3.6**	3.6	2.2	3.4	2.7	**4.1**	**4.6**	**3.2**	**2.4**
Per inhabitant (US dollars)*	6,520	6,355	6,727	7,418	**7,544**	6,992	7,412	7,406	7,862	**7,404**	**7,614**	**7,268**	**7,891**
US$ billions	649	639	676	755	**799**	707	750	748	814	**808**	**808**	**764**	**816**
Inflation (eop, %)													
Headline	5.7	4.0	5.2	3.3	**3.3**	4.4	4.3	3.5	3.3	3.4	**3.5**	**3.3**	**3.3**
Core	3.8	3.7	3.8	3.1	**2.9**	3.6	3.4	3.2	3.1	3.0	**3.0**	**3.0**	**2.9**
Financial Markets													
Interest rates (eop, %)													
Bank funding	—	6.1	8.8	8.3	**7.0**	9.5	9.8	9.3	8.3	7.3	**7.0**	**7.0**	**7.0**
28-day Cetes	7.0	6.0	8.6	8.0	**7.0**	9.6	9.6	9.0	8.0	7.3	**7.1**	**7.0**	**7.0**
28-day TIIE	8.5	6.3	9.0	8.6	**7.3**	9.9	10.0	9.5	8.6	7.6	**7.4**	**7.3**	**7.3**
10-year Bond	10.1	8.3	9.7	8.5	**8.2**	10.5	9.6	8.5	8.5	8.7	**8.8**	**8.5**	**8.2**
Exchange rate													
Pesos per dollar, eop	10.3	11.2	11.3	10.7	**11.3**	11.3	10.8	10.8	10.7	11.0	**11.4**	**11.2**	**11.3**
Public Finances													
Fiscal balance (% of GDP)	-1.2	-0.6	-0.3	-0.1	**0.0**	nd	nd	nd	-0.1	**nd**	**nd**	**nd**	**0.0**
FRPS (% GDP)	3.3	3.1	2.7	2.1	**1.5**	nd	nd	nd	2.1	**nd**	**nd**	**nd**	**1.5**
External Sector**													
Trade balance (US$ billions)	-7.6	-5.8	-8.8	-7.7	**-7.3**	-10.2	-9.7	-9.5	-7.7	**-6.2**	**-6.0**	**-7.1**	**-7.3**
Current account (US$ billions)	-13.5	-8.6	-7.2	-5.7	**-7.0**	-8.8	-8.3	-9.4	-8.1	**-6.7**	**-8.3**	**-7.7**	**-7.0**
Current account (% of GDP)	-2.1	-1.3	-1.1	-0.7	**-0.9**	-1.3	-1.2	-1.3	-1.1	**-0.9**	**-1.0**	**-1.0**	**-0.9**
Oil (Mexican mix, dpb, eop)	24.7	25.0	32.4	48.5	**45.5**	33.7	40.1	50.7	48.5	**47.3**	**47.3**	**46.5**	**45.5**
Monetary Agreggates & Banking Activity (ann. % chge.)													
Core bank deposits	-5.5	7.5	6.3	4.4	**4.8**	3.1	2.3	4.0	4.4	**6.8**	**3.7**	**4.1**	**4.8**
Commer. banks performing loans***	8.5	8.6	26.1	27.0	**21.9**	29.6	30.0	29.3	27.0	**25.9**	**25.4**	**23.4**	**21.9**
Agreggate Demand (ann. % chge., seasonally-adjusted)													
Total	1.0	1.2	6.2	4.6	**5.3**	4.3	4.1	4.9	4.9	**5.4**	**6.3**	**5.1**	**4.3**
Domestic demand	0.9	1.8	4.3	5.4	**5.3**	5.8	4.4	5.5	6.0	**5.8**	**5.6**	**5.2**	**4.7**
Consumption	1.3	2.1	3.6	4.8	**4.7**	5.7	3.4	5.2	5.0	**4.9**	**4.9**	**4.6**	**4.4**
Private	1.5	2.2	4.1	5.4	**5.1**	6.6	3.8	5.9	5.3	**5.3**	**5.2**	**5.0**	**4.8**
Public	-0.2	1.0	-0.4	0.3	**1.6**	-0.6	0.2	-0.2	2.0	**1.8**	**2.0**	**1.3**	**1.3**
Investment	-0.7	0.4	7.2	8.0	**7.8**	6.3	8.4	6.9	10.3	**9.4**	**8.7**	**7.6**	**5.6**
Private	-4.1	-1.5	8.5	10.0	**7.9**	4.4	7.6	6.5	23.6	**9.0**	**8.5**	**8.0**	**6.0**
Public	16.8	8.5	2.5	-0.3	**7.3**	17.1	12.2	9.3	-19.6	**11.5**	**9.5**	**5.8**	**4.1**
External demand	1.4	2.7	11.7	6.8	**10.5**	8.1	4.4	5.7	9.1	**9.0**	**9.4**	**11.3**	**12.1**
Imports	1.4	0.7	11.6	8.6	**9.4**	6.1	8.9	8.9	10.5	**8.7**	**10.6**	**9.6**	**8.6**
GDP by sectors (annual % change)													
Agriculture	0.2	3.1	3.4	-1.2	**0.3**	-0.6	-3.4	6.1	-6.3	**-0.3**	**5.2**	**2.9**	**-7.0**
Industrial	-0.1	-0.1	4.2	1.5	**3.7**	1.6	1.1	0.9	2.6	**4.1**	**4.6**	**4.1**	**2.2**
Mining	0.4	3.7	3.5	1.2	**3.0**	-0.2	0.6	1.5	3.0	**5.5**	**1.7**	**2.9**	**2.2**
Manufactures	-0.7	-1.2	3.7	1.4	**3.8**	2.4	0.6	0.5	2.0	**3.8**	**4.8**	**4.4**	**2.3**
Construction	2.1	3.3	6.1	3.2	**4.2**	2.6	3.1	2.2	4.8	**6.3**	**4.7**	**4.1**	**1.9**
Electricity, gas and water	1.0	1.5	2.8	1.4	**2.0**	0.5	2.9	1.8	1.1	**2.3**	**0.8**	**2.1**	**2.9**
Services	1.5	2.1	4.4	4.2	**4.0**	4.9	3.6	4.4	3.9	**4.6**	**5.2**	**3.4**	**2.9**
Retail, restaurants and hotels	-0.1	1.5	5.4	3.3	**3.0**	5.1	2.8	3.2	2.2	**3.0**	**4.9**	**2.8**	**1.4**
Transportation and communications	1.8	5.0	9.2	7.0	**7.4**	8.1	6.7	6.8	6.5	**8.3**	**8.6**	**7.0**	**5.7**
Financial, insurance and real-estate	4.2	3.9	3.9	5.7	**5.1**	5.2	5.5	6.1	6.0	**6.0**	**5.4**	**4.8**	**4.2**
Community and personal	0.9	-0.5	0.5	2.3	**1.9**	2.1	1.9	2.6	2.6	**2.7**	**2.7**	**0.8**	**1.4**

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

Economic Research Department Presentations

Title	Institution - Client	Place and date
Bogota www.bbva.com.co		
Situación Macroeconómica Colombiana	Standard & Poor´s	Bogota, January 2006
Situación Macroeconómica Colombiana	IMF	Bogota, March 2006
Algunas Consideraciones sobre la Coyuntura Económica	Fedesarrollo	Bogota, March 2006
Buenos Aires www.bancofrances.com.ar		
Panorama Macroeconómico de Argentina 2005/2006	Corporate Banking Clients	Buenos Aires, February 2006
Canales de Transmisión de la Pol. Monet. y Cambiaria en Argentina	Central Bank of Argentina	Buenos Aires, March 2006
Caracas www.provincial.com		
Perspectivas Macroeconómicas 2006-2007	Meeting with Clients	Caracas, January 2006
Mercado Petrolero	Wholesale Banking	Caracas, February 2006
Venezuela: Proyección Económica 2006-2008	XIV Cavidea Assembly	Caracas, March 2006
Venezuela: Economic Outlook 2006-2007	Wholesale Banking	Caracas, March 2006
Lima www.bbvabancocontinental.com		
Situación Económica	KIA	Lima, January 2006
Peru: Economic Outlook	AMEX	Lima, January 2006
Las Claves de la Economía Peruana	Economic Meeting for Executives	Lima, February 2006
Perú: Situación Económica	Economic Meeting for Executives	Lima, March 2006
Situación Económica	Moody’s	Lima, March 2006
Madrid www.bbva.com		
Flujos de Capitales a Emergentes: Situación Actual y Perspectivas	BBVA	Madrid, January 2006
Perspectivas para América Latina	Press	Madrid, January 2006
Situación Inmobiliaria	Press	Madrid, February 2006
Tendencias en la Economía Mundial	Clients	Lima, February 2006
Entorno Internacional y su Impacto en los Mercados Inmobiliarios	BBVA	Bogota, February 2006
Entorno Económico Mundial	Press	Madrid, March 2006
Recuperación de la UEM: ¿Mito o Realidad?	Intermoney	Madrid, March 2006
Mercado Cambiario Internacional: ¿Una Nueva Etapa?	Universidad Autónoma, ICAE	Madrid, March 2006
México www.bancomer.com		
Mexican Banking and Financial System	University of Columbia	Mexico City, January 2006
Crédito al Consumo: Perspectivas y Factores de Riesgo	IMF-WB Mission to Mexico	Mexico City, January 2006
México: Perspectivas Económicas en un Año de Elecciones	Regional Councils	Nat‘l Tour (8 cities), Feb. 2006
México ante las Elecciones de 2006	Hipotecaria Nacional	Nat‘l Tour (8 cities), Feb. 2006
México: Retos y Oportunidades	Corporate Clients	Mexico City, February 2006
México: en el Contexto Global y ante las Elecciones	Private and Capital Banking	Nat‘l Tour (8 cities), March 2006
Perspectivas Internacionales... con una Atención Especial a México	Private Banking	Mexico City, March 2006
BBVA USA www.bancomer.com		
U.S. Economic Perspectives: The Importance of the Housing Sector	Corporate Banking	San Juan, Puerto Rico, Jan. 2006
U.S. Economic Perspectives	Corporate Banking	San Juan, Puerto Rico, Jan. 2006
Santiago de Chile www.bhif.cl		
Desafíos para Chile en el Contexto Global 2005-2006	BBVA Personal Banking Agents	Valparaiso, January 2006
Panorama Económico Mensual	BBVA Corporate Banking	Santiago, January 2006
Panorama 2006-2007	BBVA Provida Executives	San Esteban, March 2006
A 25 Años de la Reforma del Sistema de Pensiones	Press and BBVA Provida Executives	Santiago, March 2006

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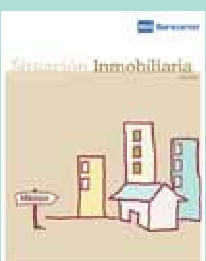



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