

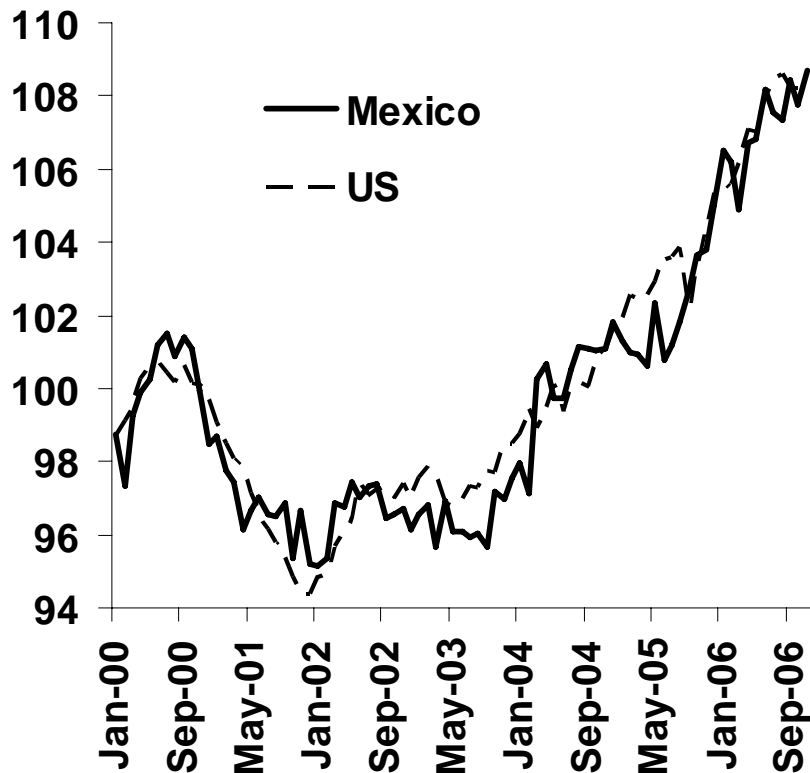


The Mexican Economy: Current Situation, Challenges, and the Economic Program

February 2007

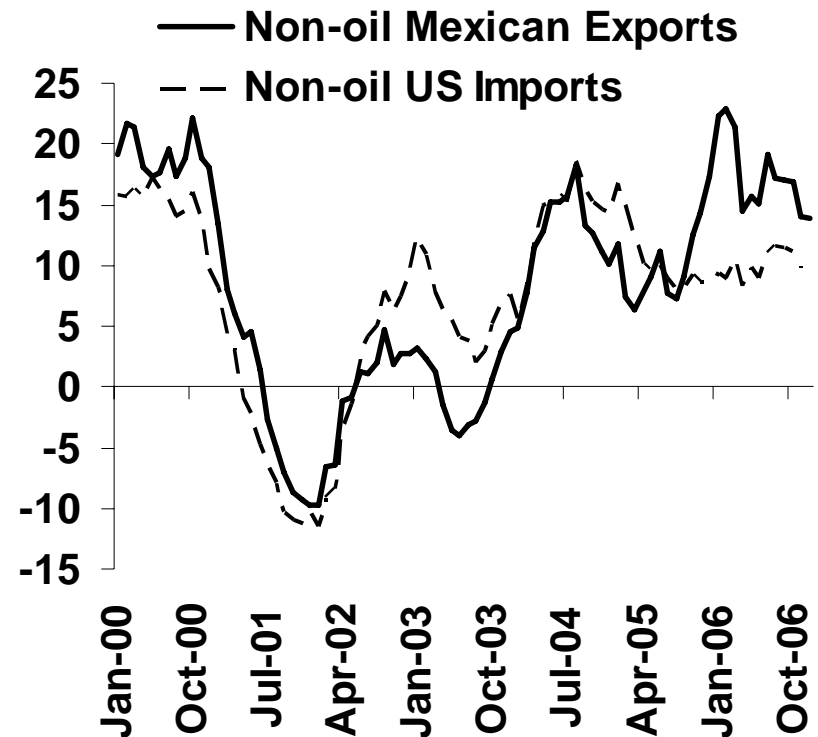
During 2006, industrial production registered high growth rates in line with exports and external demand.

Industrial Production
(Index, 2000 = 100)



Source: INEGI and the Federal Reserve.

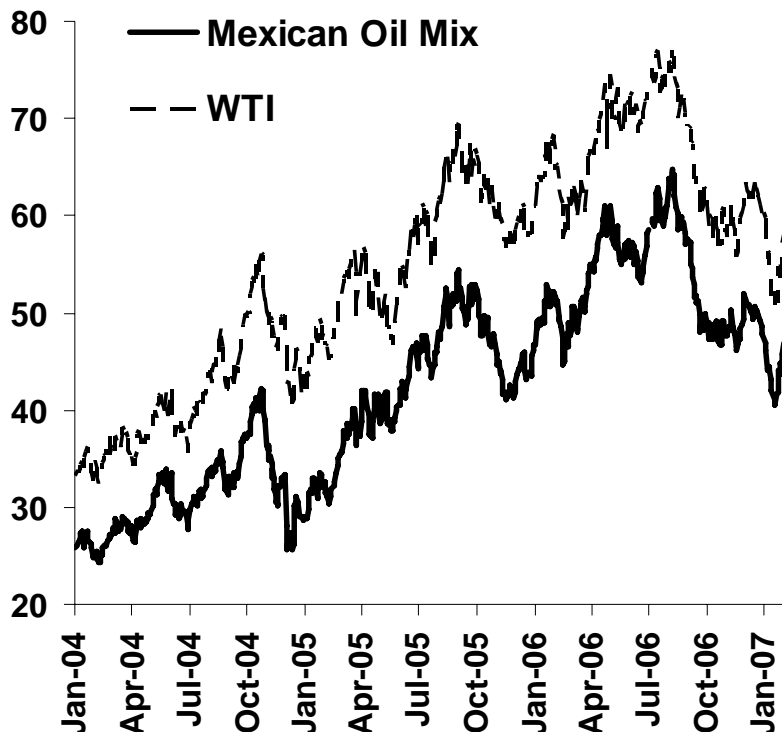
Mexican Non-oil Exports and US Non-oil Imports
(Annual growth, 3 month ma, %)



Source: INEGI and USITC.

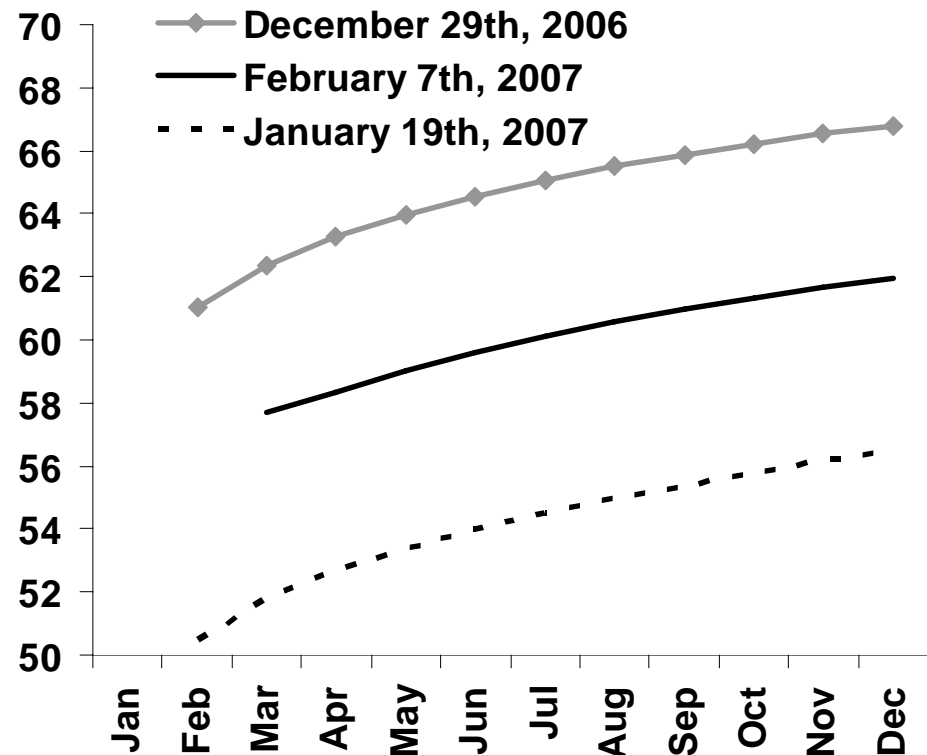
The oil market is characterized by its high volatility. Oil prices have recently decreased to the levels seen at the end of 2005 though futures markets expect a recovery to take place throughout the year.

Oil Prices: Mexican Oil Mix and WTI
(Dollars per barrel)



Source: Bloomberg.

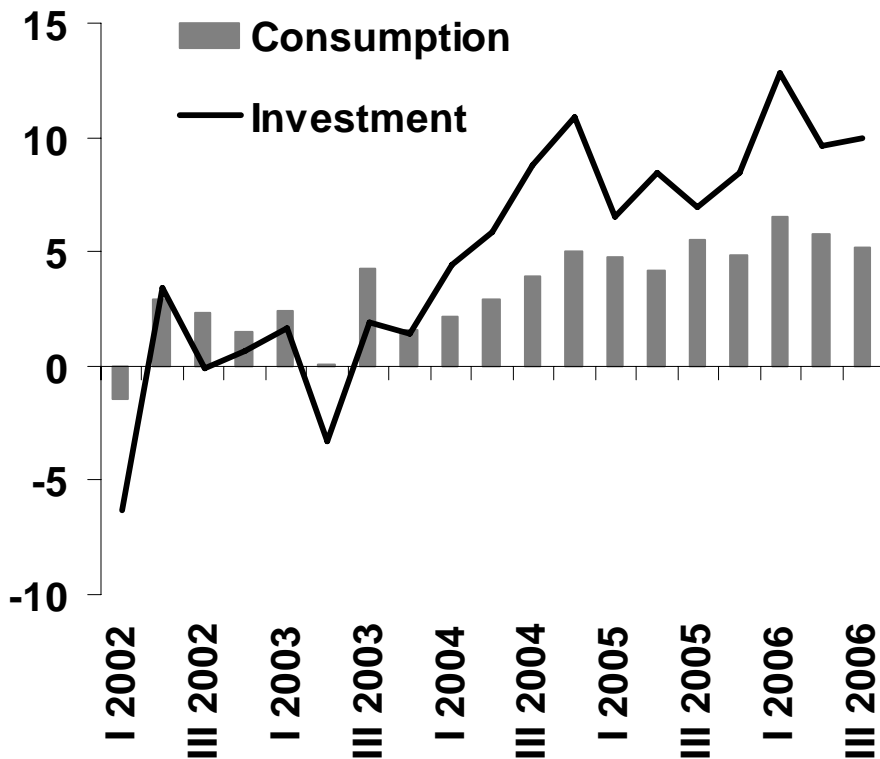
Crude Oil Futures: WTI
(Dollars per barrel)



Source: Bloomberg.

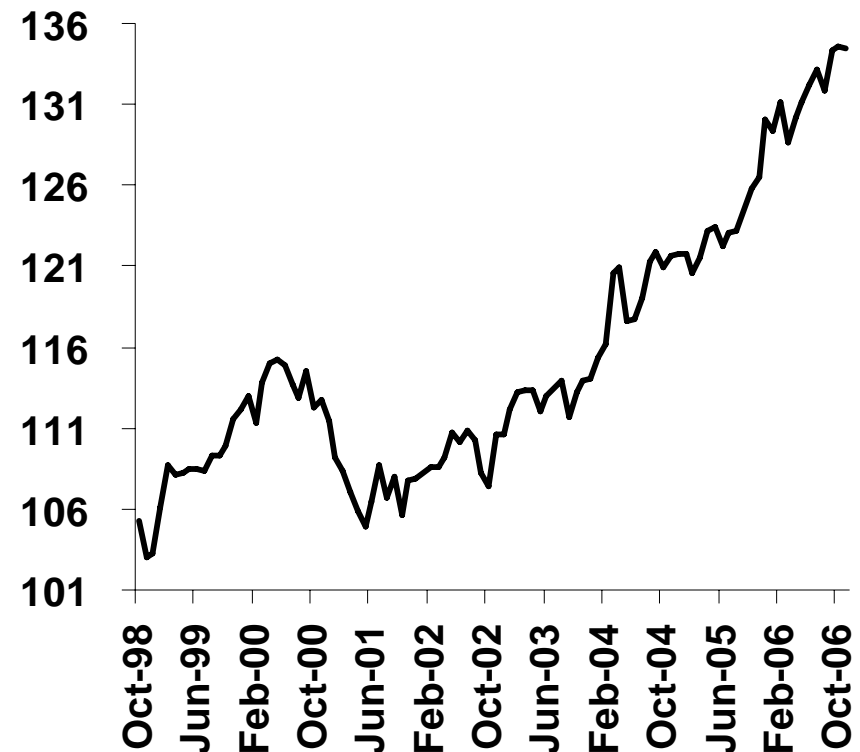
Domestic demand has consolidated in recent years. Worth highlighting is the important expansion of the construction sector.

Consumption and Investment
(Real annual growth, %)



Source: INEGI.

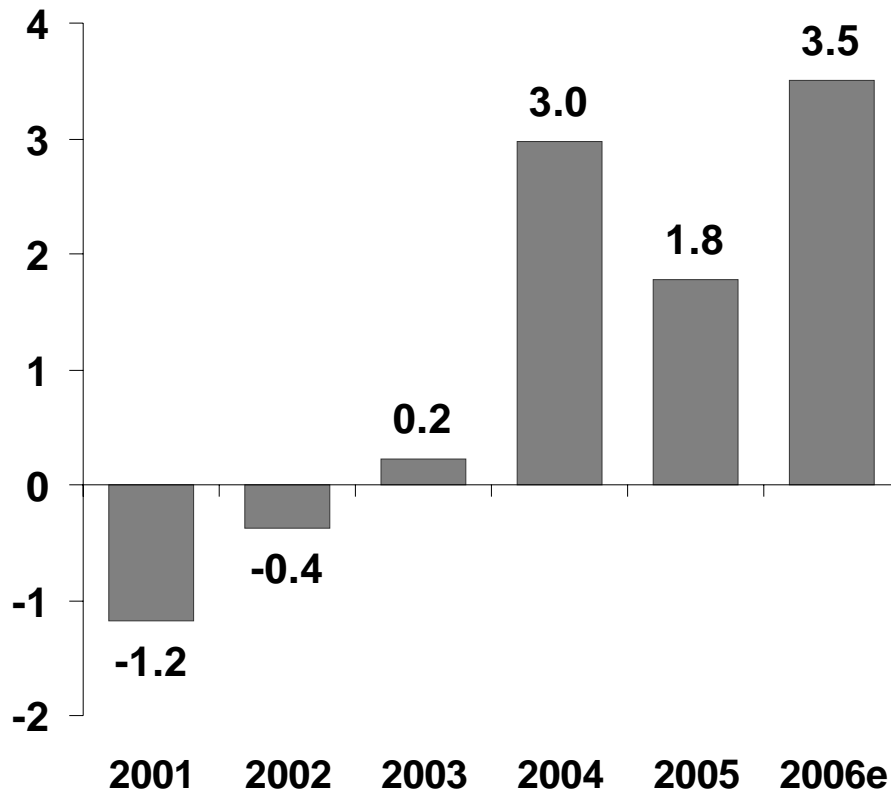
Construction Industry
(Index, 1993=100)



Source: INEGI.

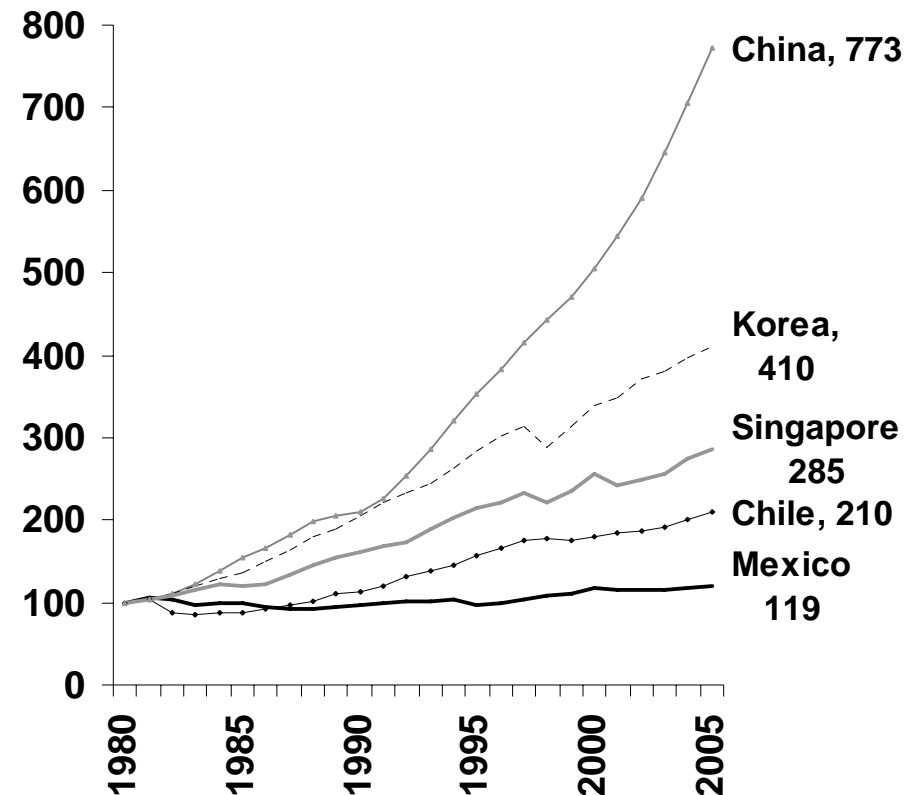
Although the country's per capita income has recovered, its growth must be accelerated.

Per Capita GDP Growth
(Real annual change, %)



Source: INEGI.

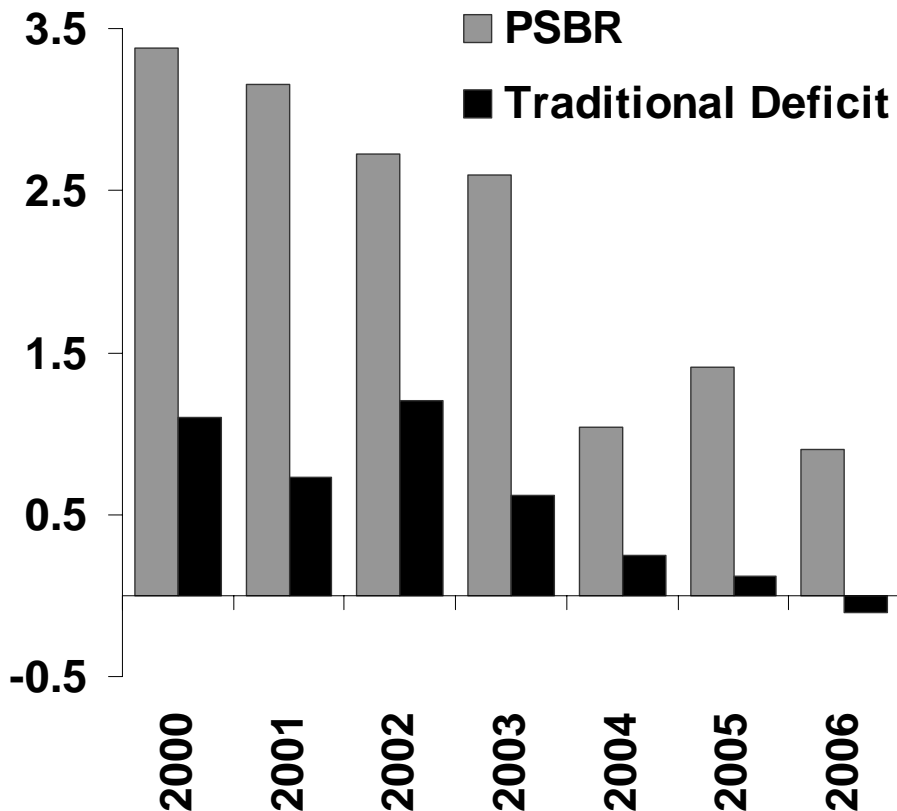
Per Capita GDP
(Index, 1980 = 100)



Source: *World Economic Outlook*, September 2006, IMF.

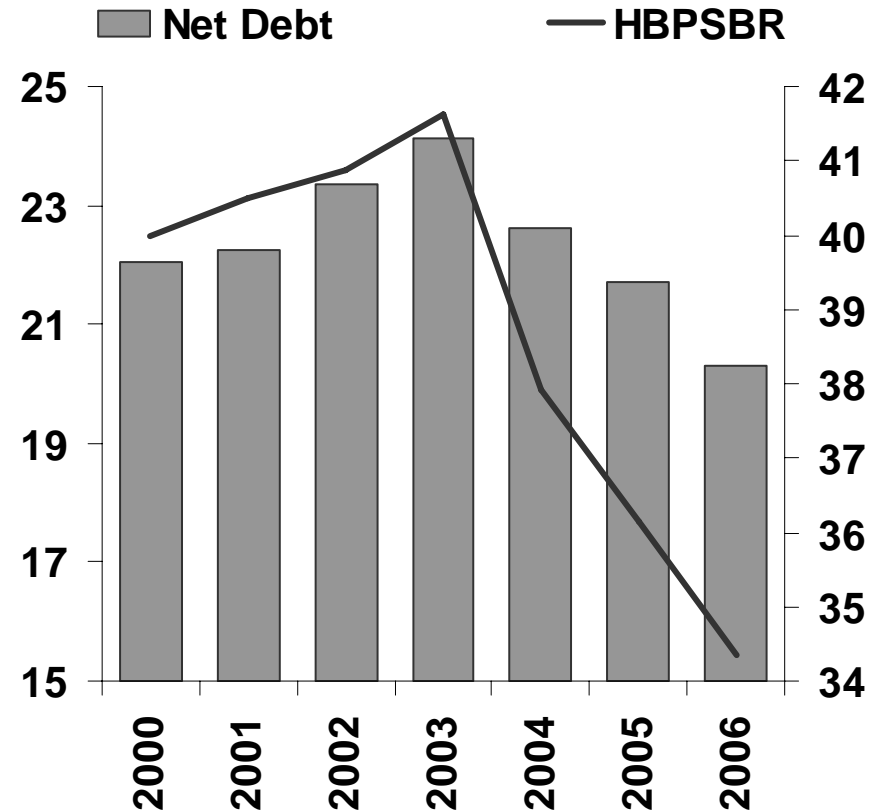
In recent years, public finances have been put on a sustainable path and the public debt to GDP ratio has diminished.

Public Deficit and Public Sector Borrowing Requirements
(% of GDP)



Source: SHCP.

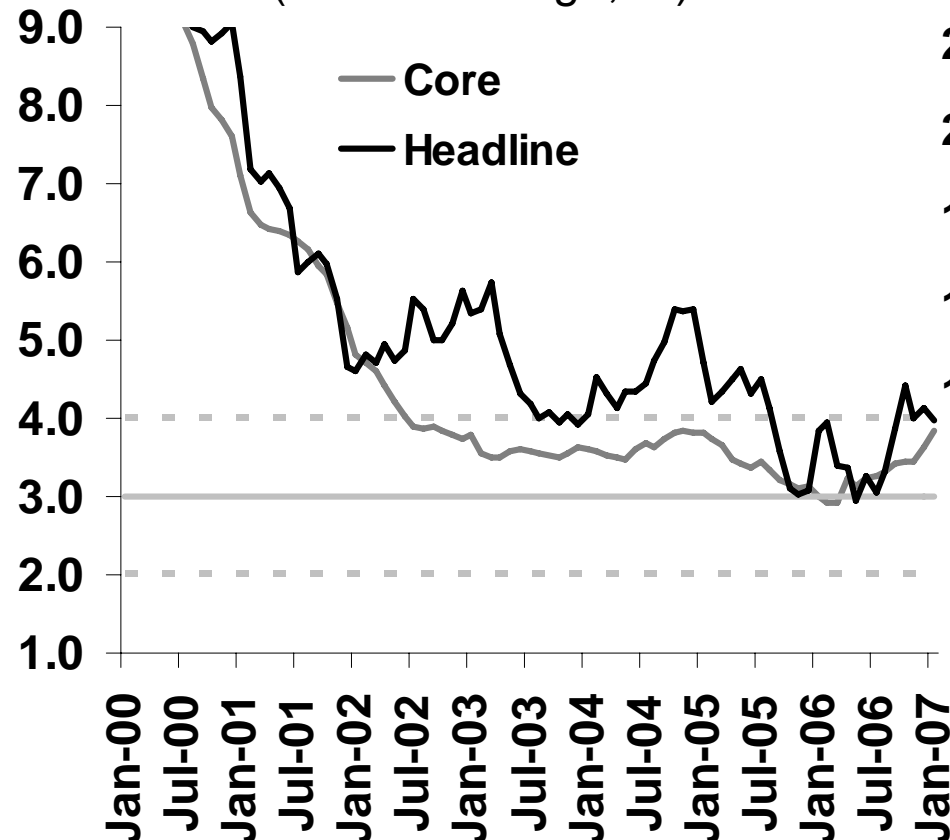
Public Debt and the Historical Balance of the PSBR
(% of GDP)



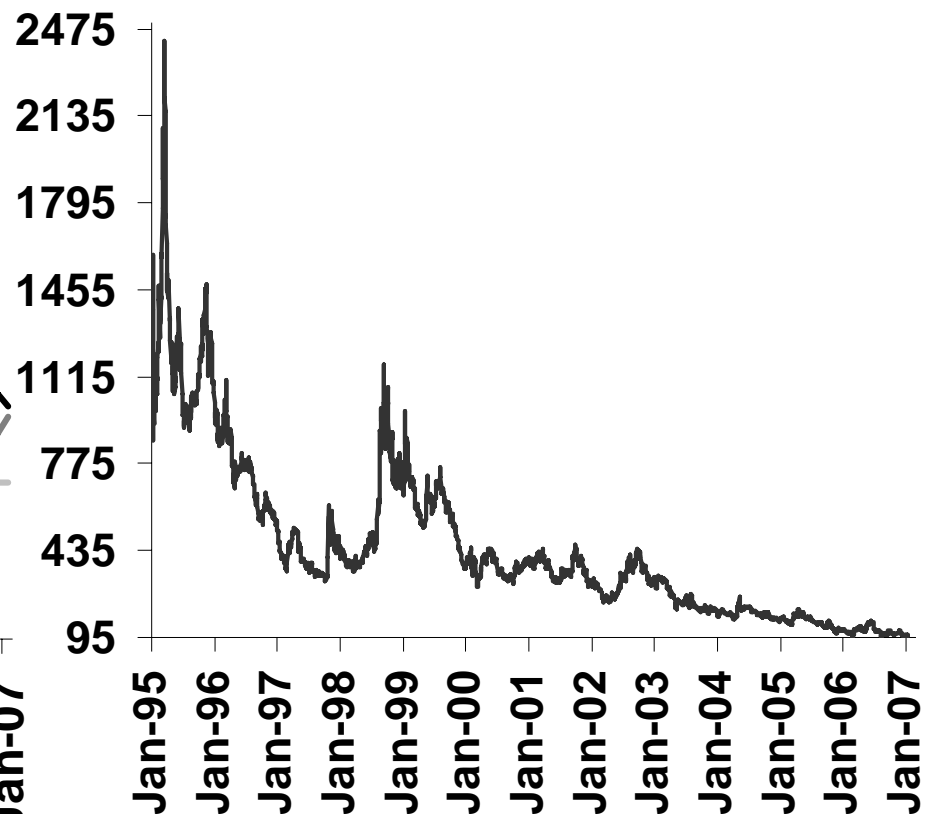
Source: SHCP.

Stabilization policies have resulted in inflation rates similar to those of developed economies and historically minimum levels of country risk.

Inflation
(Annual change, %)



Country Risk: EMBI + Mexico
(Basis points)

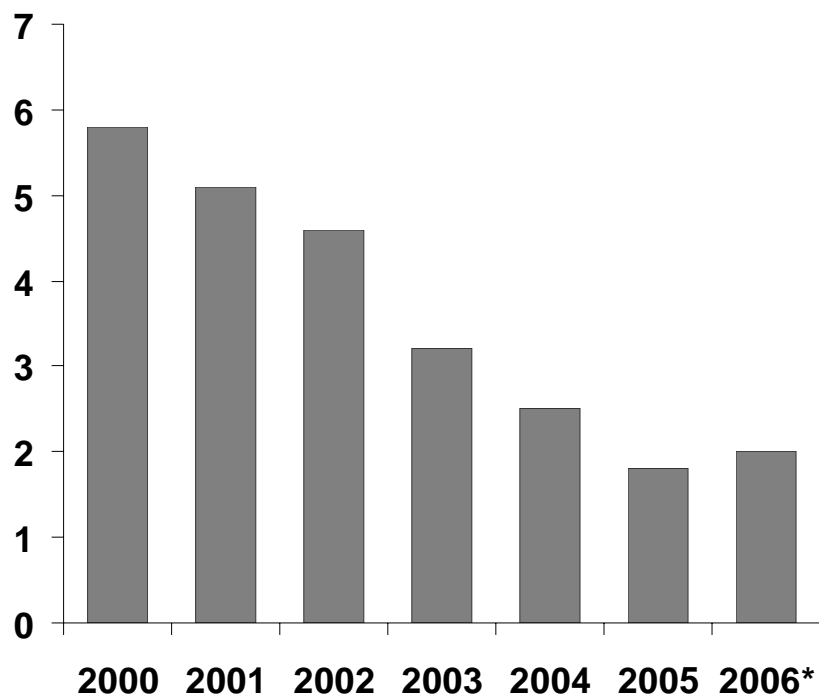


Source: Banxico.

Source: JP Morgan.

Credit to the private sector grew from 15.1% of GDP in 2005 to 16.9% (1.56 trillion pesos) in 2006.

Delinquency Index^{1/} (%)

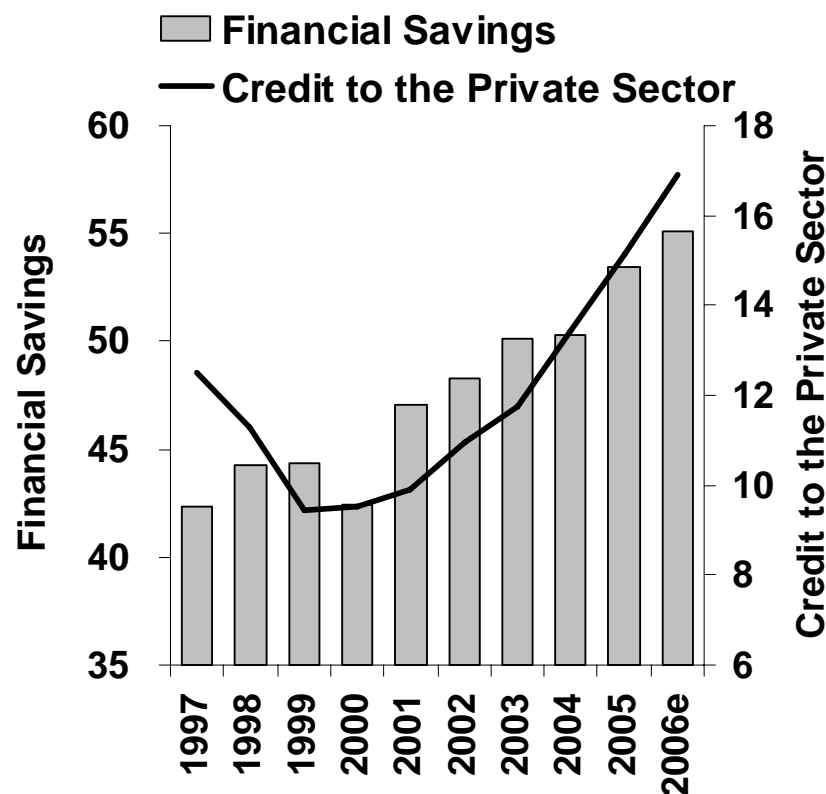


1/ Past due loans / total loans.

* Data up to October of 2006.

Source: CNBV.

Financial Savings and Credit in Mexico (% of GDP)

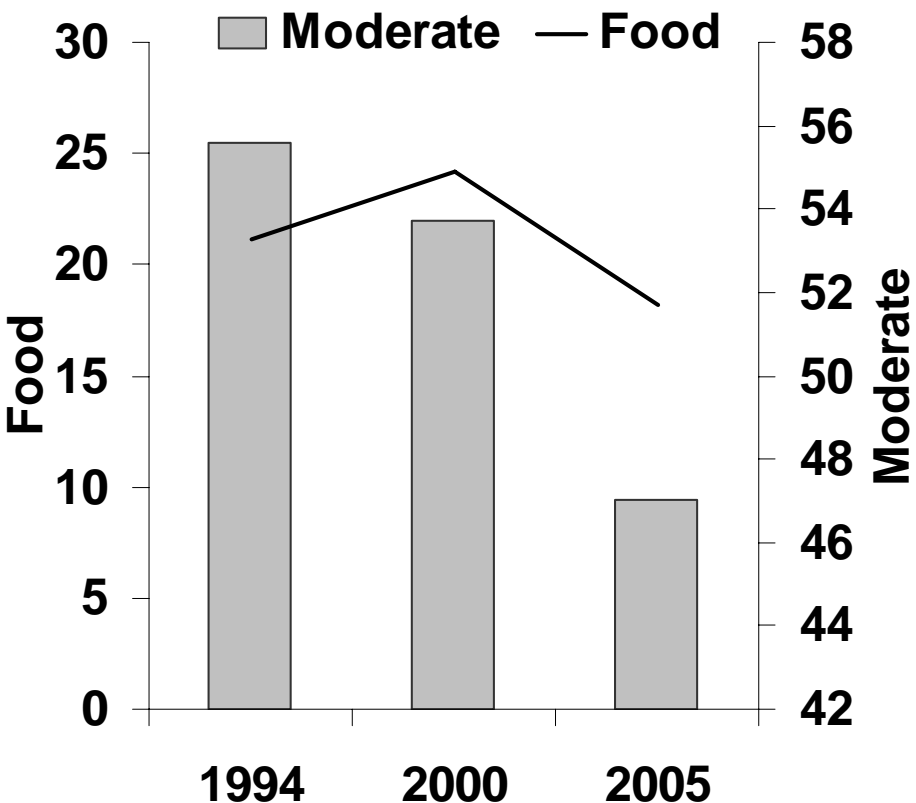


Source: Banxico and INEGI.

Although there has been important progress in the fight against poverty, marginalization and regional inequality remain as important problems.

Poverty: Food and Moderate

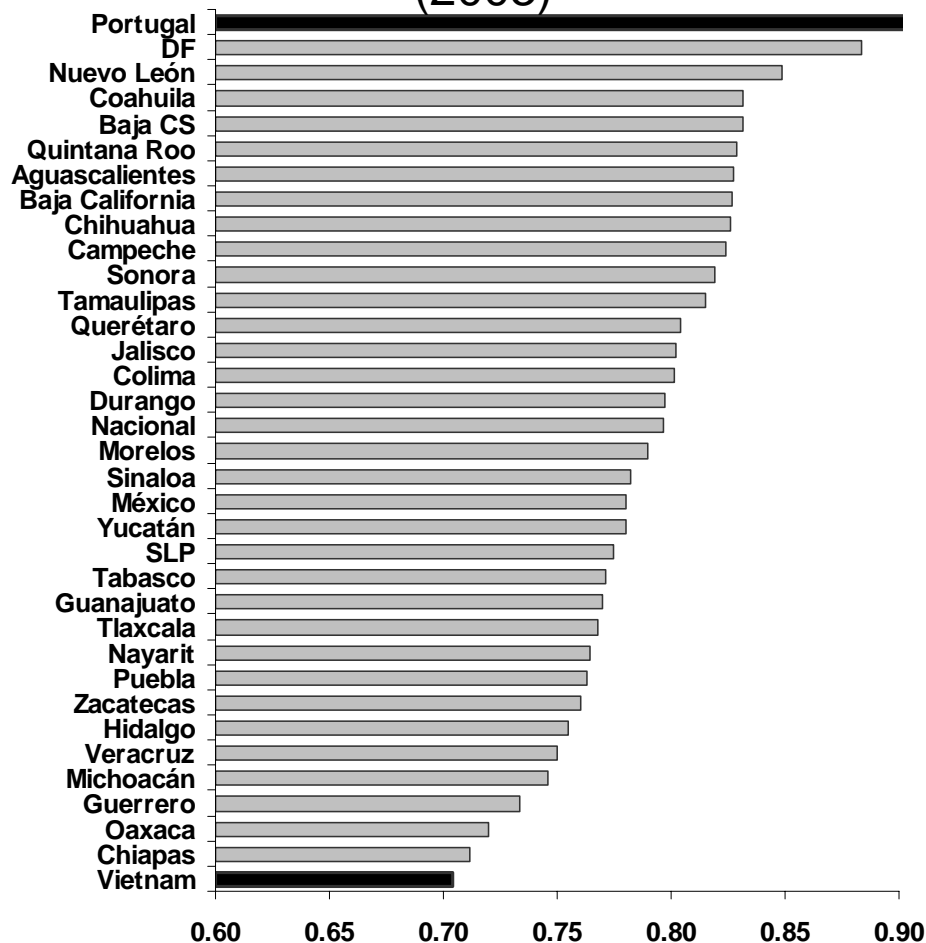
(percentage of the population beneath the respective poverty line, %)



Source: SEDESOL

Human Development Index

(2003)



Source: Indicadores de Desarrollo Humano y Género en México, PNUD, 2006

Therefore, one of the Administration's priorities is attaining higher degrees of social development and the reduction of poverty.

The following are needed to reach this objective while maintaining stability :

- **Increasing the capabilities of individuals through higher investment in human capital.**
- **Generating higher job growth through higher fixed investment so that individuals can take advantage of their capabilities.**
- **This would generate higher economic growth which in turn would create a virtuous cycle through higher income levels that would result in higher levels of human and physical capital.**

To reach these objectives, the State will use all the instruments under its control:

- **A rational spending policy in health and education and in the fight against poverty.**
- **Fostering those sectors with highest job creation (housing, tourism and the agricultural sector, amongst others).**
- **Focusing on infrastructure projects that reduce regional inequality.**
- **Supporting productive activities through the financial intermediation of development banks.**
- **Applying better regulation or deregulation, according to the specific case, of both public and private activities.**

The regulatory reform must allow individuals to participate more fully in all economic activities. For this to happen, progress is needed in two fronts:

- **Open markets so that:**
 - **Existing investment opportunities are taken advantage of,**
 - **Greater economic competition is generated,**
 - **Prices of products decrease, and**
 - **There are higher incentives for improvements in productivity and more technological innovation.**

- **Reduce transaction costs in all fields including: opening a business, enforcing contracts and improving the rule of law. This is particularly important for the creation and operation of small and medium businesses.**

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

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

Macroeconomic Outlook, 2006 – 2007^{e/}

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

*/ Economic Program for 2006 approved by Congress.

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

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

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

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

Increases to social spending, infrastructure and public safety stand out in the 2007 Budget. Also, expected savings for 35.5 billion pesos from excess oil revenues are included.

Approved Programmable Expenditures
(Billion pesos of 2007)

	2006	2007	Difference	
			Absolute	%
Administrative Branches	476.7	544.6	67.8	14.2
Health	43.8	55.6	11.7	26.8
Public Education	142.4	152.0	9.6	6.7
Social Development	27.5	34.9	7.4	26.9
Natural Resources & Environment	22.1	29.0	6.9	31.3
Agriculture and Fishing	52.8	58.4	5.6	10.6
National Defense	26.9	32.2	5.3	19.5
Energy	28.3	32.8	4.5	16.0
Transport and Communications	34.9	39.2	4.3	12.3
Public Safety	9.6	13.7	4.1	42.4
SHCP (own)	4.6	3.8	-0.8	-17.0

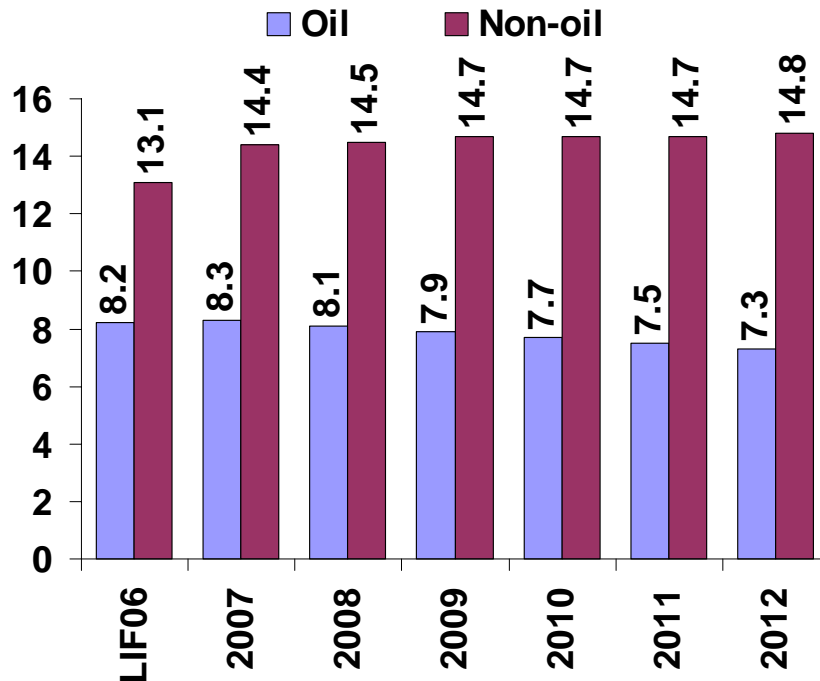
In case of a sustained decrease in oil prices, elements incorporated in the budget would be put to use in order to absorb part of this shock.

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

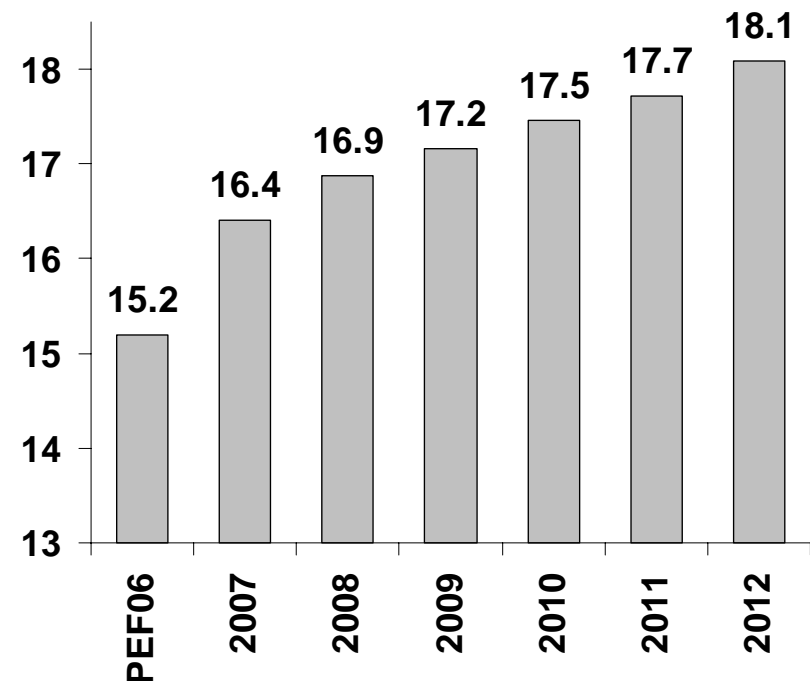
Public finances will continue facing important challenges during the rest of the Administration.

- A decrease in oil revenues as a percentage of GDP is expected during the next six years. This will be partially compensated by efficiency gains in tax collection.
- Expenditure pressures are due to expenditure on pensions and PIDIREGA projects.

Budgetary Revenues
(% of GDP)

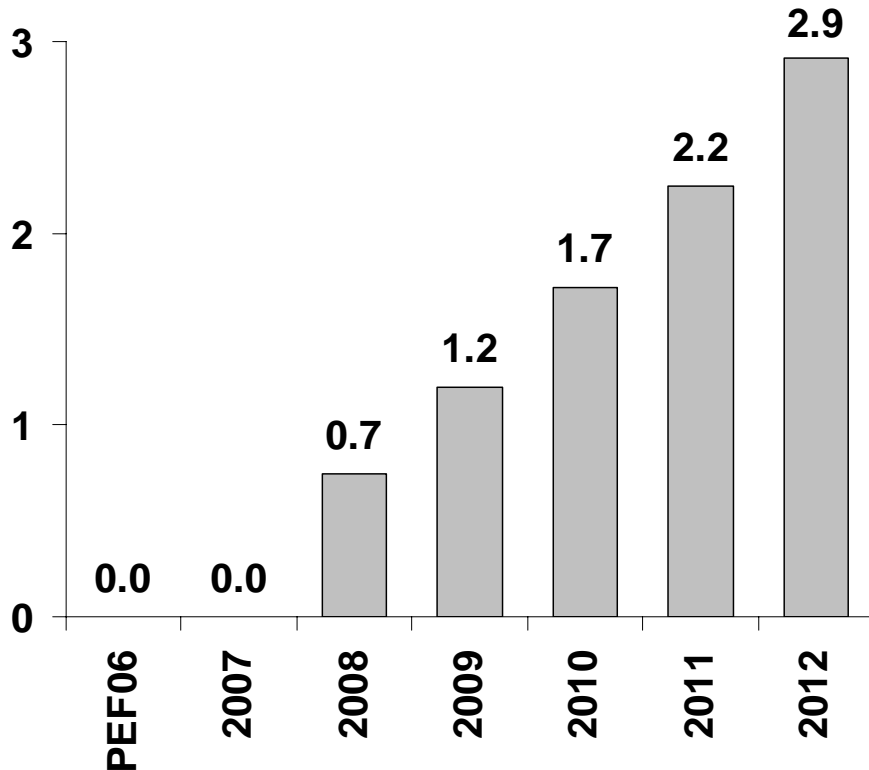


Programmable Expenditures
(% of GDP)

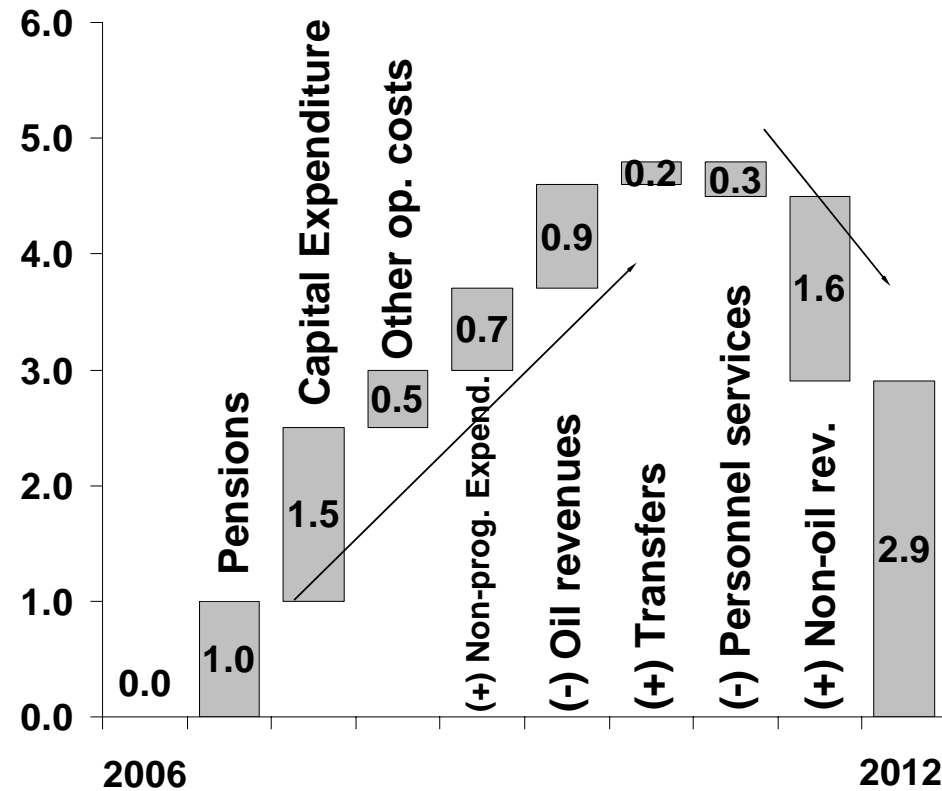


The higher expenditure growth would result in an important deterioration of the public balance.

Public Deficit
(% of GDP)



Pressures on Public Finances
(% of GDP)



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

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

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

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

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

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

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