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Summary of the Proposed Economic Program for 2006

- Today, the Federation's Expenditures Law Initiative for 2006, the Federation's Revenues Law Initiative for 2006, and the General Economic Policy Guidelines were sent to Congress.
- A real GDP growth rate of 3.6 percent is estimated for 2006.
- A public sector surplus of 0.2 percent of GDP, equal to 17.6 billion pesos, is proposed for 2006 in accordance with the National Program for Financing Economic Development 2002-2006 (PRONAFIDE).
- Fiscal responsibility is the priority in order to enable public finances to face their medium and long-term challenges.
- The reference price for the Mexican oil mix is consistent with the formula established in the Budget and Fiscal Responsibility Law Initiative approved by the Chamber of Deputies' Budget Committee.
- The proposed total net expenditures amount to 1,881.2 billion pesos.
- Primary expenditures, defined as the difference between total net expenditures and the public sector's financing costs, would amount to 1,617.9 billion pesos of which the largest fraction, 36 percent, will be channeled to Federalized Expenditure of States and Municipalities.
- Expenditures destined to public safety and social development will increase by 21 percent and 16 percent in real annual terms, respectively.

ECONOMIC POLICY GUIDELINES AND THE FEDERATION'S EXPENDITURE LAW PROPOSAL FOR 2005

As established in Article 74 of the Constitution, the Economic Program for 2006 was sent to Congress today.

The Mexican Economy in 2005

During the last thirteen quarters, the Mexican economy went through an expansionary cycle which led to an accumulated growth of 13.3 percent in real terms and to the creation of 670 thousand 415 formal jobs.[1]

It should be pointed out that economic growth was slower in the first half of 2005 than at the end of 2004. This is mainly due to two reasons:

i. During the first half of 2005, the deceleration of manufacturing production in the United States negatively affected the growth rate of Mexican industrial activity.
ii. Mexico's industrial sector was slowed by a significant reduction in automobile production associated with a weak demand for American vehicles in the United States, as well as by the substitution of several models in Mexican plants' production lines. Therefore, an important part of the deceleration was associated with transitory factors.

It should be noted that economic growth is now more closely related to the dynamism of the service sector (which grew at an annual rate of 4.1 percent in the first semester of 2005) and to the expansion of domestic spending — mainly in the growth of private expenditure and public investment — and is relatively less sensitive to external fluctuations.

Albeit a slower growth of manufacturing, formal employment continued to increase due to the expansion of the service sector. The number of employees affiliated to IMSS grew by 373 thousand 817 during the first seven and a half months of 2005, a 3.0 percent increase with respect to the end of 2004. Compared to the same month of the previous year, formal employment increased by 423 thousand 439 workers.

According to the recent evolution of several macroeconomic indicators, we anticipate that the annual growth of GDP for 2005 will be 3.5 percent. If this forecast is accurate, the economy will have grown faster in the second half of 2005 than in the first.

It is estimated that, by the end of 2005, the public deficit excluding those expenses from the Conclusion of the Labor Relationship program (CRL), will be 14.8 billion pesos (0.2 percent of GDP), thus complying with the deficit ceiling established in the Federation's Expenditures Law for 2005 (PEF05). Additionally, the primary surplus, defined as the difference between total

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[1] The number of formal jobs refers to the increase of urban employees, both permanent and temporary, affiliated to IMSS between March 31st of 2002 and June 30th of 2005.

revenues and expenditures other than financing costs, is expected to reach 2.6 percent of GDP.

Budgetary revenues for the year are estimated at 112 billion pesos above those projected in the Federation's Revenues Law for 2005 (LIF05). This is mainly due to an increase in oil-related revenues associated to higher oil prices and augmented revenues from *public entities under direct budgetary control* (PEDBC) other than PEMEX. Budgetary revenues will reach 23.0 percent of GDP, slightly less than the figure posted in the previous year. This decrease is explained by lower non-recurring revenues in 2005 than in those obtained in 2004.

With respect to public sector programmable expenditure, it is estimated that it is going to be augmented by 89 billion pesos, due to the excess revenues available in 2005. These excess revenues will have been channeled mainly by applying the collection of the *Aprovechamiento* for oil prices above 27 dollars per barrel (36.7 billion pesos), to PEMEX's investment expenditure (50 percent) and to states infrastructure (50 percent). Additionally, the excess revenues are also assigned to some entities that generated additional revenues (49.6 billion pesos), to the Oil Stabilization Fund (2.7 billion pesos) and to investments in PEMEX through the excess revenues channeled through line "J" of Article 21 of the PEF05.

With respect to programmable expenditure, those resources channeled to social development areas, poverty reduction and infrastructure have been favored. Within this item, the expected 4.0 percent real increase in 2005 of the expenditure oriented to social development stands out. Furthermore, it is expected that federal resources transferred to States and Municipalities (*Ramo 33*) and federal contributions to education (*Ramo 25*), along with decentralized expenditure through agreements and the Federal Program for the Strengthening of Federal Entities (PAFEF) will increase 6.0 percent in real terms.

At the end of 2005, it is estimated that physical investment fostered by the Public Sector, which includes budgetary investment and resources exercised by third parties through financed investment, will slightly exceed the amount registered in 2004, reaching its highest level during the current Administration. Social investment is also expected to increase 2.7 percent in real terms with respect to 2004. It is worth mentioning that this indicator encompasses all public expenditures that imply a direct service to the public and increases the physical or human capital of the population.

It is estimated that non-programmable expenditure will exceed the amount projected by 20.6 billion pesos. This difference can be explained by the following: i) the payment of accrued expenditures from the previous year (ADEFAS), as stated in PEF05 and approved in the LIF04, was reduced by the Chamber of Deputies; ii) greater contributions to the States and Municipalities resulting from increased federal distributable revenues; and iii) the increase in financing costs due to observed interest rates that were higher than expected.

Regarding Public Sector Borrowing Requirements (PSBR), they are estimated at 2.3 percent of GDP by year's end.

Public Sector Borrowing Requirements, 2004-2005 (% of GDP)				
	2004*/	2005		
		Approved	Estimated	Difference
I. Public Deficit excluding CRL	**0.2**	**0.2**	**0.2**	**0.0**
A. Budgetary Revenues	23.2	22.4	23.0	0.6
Oil related	8.3	7.8	8.7	0.9
Non-oil related	14.9	14.7	14.4	-0.3
Tax	9.4	9.9	9.5	-0.4
Non-Tax	1.4	0.7	0.7	0.0
PEDBC	4.1	4.0	4.2	0.2
B. Net Budgetary Expenditures	23.4	22.7	23.2	0.5
Programmable	17.1	16.3	16.9	0.6
Non Programmable	6.3	6.3	6.3	0.0
Financing Costs	2.7	2.8	2.8	0.0
Revenue Sharing	3.1	3.4	3.4	0.0
ADEFAS and Others	0.4	0.1	0.2	0.1
C. Non-Budgetary Deficit	0.0	0.0	0.0	0.0
II. Public Deficit including CRL	**0.3**	**0.2**	**0.3**	**0.1**
III. Adjustments	0.7	2.1	2.0	-0.1
PIDIREGAS	1.1	1.0	1.0	0.0
IPAB	-0.7	0.3	0.4	0.0
Registry Corrections	0.1	0.1	0.2	0.0
Debtor Support Programs	-0.2	0.1	0.0	-0.1
FARAC	0.2	0.0	0.0	0.0
Financial Intermediation	0.2	0.5	0.4	0.0
IV. PSBR (II+III)	**0.9**	**2.3**	**2.3**	**0.0**
Excluding Non-recurrent Revenues	**2.4**	**2.4**	**2.4**	**0.0**

*/ IPAB includes PCCC.

Evolution of the Financial System 2001 – 2005

The National Program of Economic Development Financing 2002-2006 (*PRONAFIDE*) sets concrete policies to promote domestic private savings, particularly long-term and popular savings, while strengthening fiscal discipline in order to increase public savings. Pursuing this objective, during 2001-2005 the Mexican financial system experienced several transformations from both changes in laws and government actions, which had greater impact due to the economic stability and healthy public finances.

In 2000-2005, domestic financial savings increased from 42.4 to 51.0 percent of GDP. Increased domestic savings allowed total resources channeled from the financial system to the private sector to grow considerably. In March 2005, total financing amounted to 1,796 billion pesos or 22.7 percent of GDP, while in December 2000 these resources amounted to 17.9 percent of GDP. This represents a 1 percent of GDP increase per year. Similarly, total financing to the non-financial private sector increased from 16.9 percent of GDP in 2000 to 20.1 percent in March 2005. This represents a 32.7 percent increase in real terms.

Credit from the banking system increased 21.2 percent in real terms from December 2000 to March 2005, which represents an average annual growth rate of 4 percent in real terms (in the past 27 months it increased by 22.4 percent). Banking credit for consumption increased at an average annual rate of 41 percent during 2000-2005, while banking credit for housing went from 0.8 in 2003 to 1 percent of GDP in March 2005. Banking credit to firms increased at an average annual rate of 4.9 percent between 2001 and March 2005. This increase is lower than those registered for housing and consumption due to firms' financing through different intermediaries. On the other hand, non-banking credit has grown even faster than banking credit, increasing 61 percent in real terms between 2000 and 2005, equal to an average annual growth rate of 10 percent, thus reaching 13.3 percent of GDP in March 2005.

Economic Policy Guidelines for 2006

In 2006, economic policy will continue to focus on reaching the consensus to get structural reforms approved and the further consolidation of macroeconomic stability. International experience has shown that structural reforms are the way in which an economy can achieve sustained increases in productivity. It also shows that countries which have achieved sustained growth are the ones that have implemented deep reforms on the financial sector, labor market, and fiscal regime, diminishing over-regulation of economic activity, establishing anti-trust laws and opened key sectors of the economy, such as energy and telecommunications, to competition.

Accordingly, the current Administration established a structural reform agenda to increase the potential growth of our economy. Therefore, it is of the utmost importance to advance on the pending structural reforms, amongst which the following stand out:

- Reform to the ISSSTE pension system. Currently, the pension system for government employees works under the pay-as-you-go scheme. Therefore, the pensions of the retired workers are financed by active employees, so the viability of the system depends on their demographic structure. It should be pointed out that life expectancy in Mexico went from 64.4 years in 1975 to 75.3 years in 2000, while the average retirement age amongst those insured by ISSSTE dropped from 61.9 to 55 years in the same period. This increased the average time span a retired employee receives a pension from 2.5 years in 1975 to 19 years in 2000, while the number of active workers per retired worker fell from 20 to 5.2. Consequently, amongst the resolutions of the National Fiscal Convention (*Convención Nacional Hacendaria*, CNH), the proposal to create a pension system based on individual accounts and minimum guaranteed pensions stands out. In addition to insuring the equality and certainty of the pension payments, the employees would enjoy greater labor mobility under the new system.

- Labor Market Reform. The values of a new labor culture will favor an increase in productivity and competitiveness. A more transparent regulatory framework with greater certainty in the labor relationship and the flexibility needed for the better development of productive activities must be set up.

- Fiscal Reform. Albeit the actions undertaken by the present Administration in terms of tax efficiency and surveillance, non-oil tax revenues are still small compared to the Government’s need for resources and the vulnerability of public finances to shifts in international energy markets remains. In fact, there is a consensus for the need to increase public revenues on a sustained basis so, amongst the works accomplished in the CNH, the necessary changes to the tax and fiscal coordination systems were identified.

- Budgetary Process. The various developments we have seen in our country require the modernization of the legal framework which regulates the approval and execution of the Federal Budget. As part of this modernization process, it is necessary to formalize the communication and coordination mechanisms between the Legislative and Executive Branches. Furthermore, it is necessary to establish clear rules for the determination of key parameters in the budget, such as the reference price for the Mexican oil mix and to guarantee the execution of approved government programs. Just as important is the need to consolidate the fiscal discipline by establishing laws on fiscal responsibility. This would contribute to reinforce the macroeconomic stability recently achieved.

- Energy Reform. The energy sector is crucial for economic development, as it produces key inputs for the expansion of productive activity. Therefore, accomplishing the necessary changes in order to increase productivity in this sector is of the utmost importance.

- Corporate Governance of State-owned Enterprises. An important part of the proposed restructuring of the energy sector is the improvement of the management and organizational structure of state-owned enterprises through a reform of their corporate governance regimes. This reform will increase their value and efficiency, with the consequent contribution to the development of Mexico.

- Securities Law. The financial reforms approved during the last few years have encouraged the development of the domestic financial markets and a greater availability of credit for Mexican businesses, along with investment alternatives. However, these markets have not developed to their full potential, it is possible to increase the financing options for medium-sized businesses through the development of venture capital markets

- Banking Resolutions. The proposal intends to introduce to the banking legislation a scheme that sets up the measures and mechanisms needed to deal with the insolvency of a universal banking institution.

In general terms, a stable macroeconomic environment preserves household's wealth and purchasing power, promotes economic growth, reduces poverty, helps real wages to recover, and improves income distribution. In this regard, the evolution of public finances has been a key element for the consolidation of macroeconomic and financial stability. As public finances will face considerable pressures in the coming years, PSBR are still high, and public revenues are being helped by an important oil-related windfall, the opportunities provided by this favorable environment should be seized by achieving a public sector surplus.

Therefore, the program proposes to achieve a 0.2 percent of GDP public sector surplus in 2006. The following objectives will be targeted: i) to reduce public sector's crowding-out effects in financial markets, ii) to adjust smoothly to medium-term fiscal pressures, iii) to consolidate the credibility of fiscal policy, and iv) to make the most out of high oil prices to reduce public sector indebtedness. Also, it is estimated that PSBR will be around 1.5 percent of GDP in 2006. This figure is 0.7 percentage points of GDP below that for 2005.

The LIF06 Initiative considers an average reference price for the Mexican crude oil mix which is established using the formula contained in the Budget and Fiscal Responsibility Law Initiative, approved by the Chamber of Deputies' Budget Committee. This formula incorporates the past price history, as well as medium-term expectations reflected in the futures market. It must be emphasized that current high oil prices are transitory, so excess revenues should be channeled to the development of infrastructure or saved. The negative effects of a fall in oil revenues on public finances and on the domestic economy, which have taken place in the past, could be mitigated by these measures. Therefore, the PEF2006 Initiative includes a clear set of rules to channel excess oil revenues to saving and investment, in case they exist.

Due to the high volatility of oil-related revenues and their considerable contribution to the financing of public expenditures, it is possible that such revenues could fall below the projected level. Under these circumstances, expenditures would have to be adjusted. As has been done since 1998, the PEF Initiative includes mechanisms for expenditure adjustments in order to insure that they comply with the public balance objective in case public revenues result lower than anticipated. As has been the case in recent years, the potential application of these mechanisms would maintain expenditure in strategic areas of top priority for national development, such as education, health, equal opportunities, rural development and infrastructure.

It is estimated that budgetary public revenues in the 2006 fiscal year, excluding financing revenues, will be 1,879 billion pesos or 21.3 percent of GDP. This amount is 1.7 percentage points of GDP lower than the equivalent figure for 2005 and the difference is explained by the following:

- A reduction of oil-related revenues of 0.7 percentage points of GDP, as a result of lower crude prices in international markets.
- A reduction of non-oil tax revenues of 0.6 percentage points of GDP, a consequence of lower income tax revenues in 2006 caused by the changes to the tax laws approved by Congress in late 2004, as well as the negative impact on imports' taxes revenue derived from lower tariffs agreed by Mexico in international free trade treaties.
- Non-tax non-oil related revenues will be 0.3 percentage points of GDP lower, due to smaller non-recurring revenues.

It is worth to highlight that the above estimations do not consider changes in the current tax system, i.e. the effects of shifts in the different tax treatments on revenues.

Public Expenditure Strategy for 2006

This Administration's expenditure strategy has focused on maintaining the consistency between expenditures and revenues, t a result-oriented budget, and the incorporation of several mechanisms to modernize and simplify the budget preparation process. The PEF06 intends to continue contributing to these objectives. More specifically:

- Maintain the fiscal discipline so that the level of public expenditures is in line with the availability of resources and with the generation of a small public sector surplus.
- Increase expenditures destined to social development by supporting actions that benefit the general population, mainly the families that face the greatest hardships.
- Foster economic growth by promoting investment and the creation of employment opportunities, thus strengthening the competitiveness of the productive sector.
- Achieve a better distribution of expenditure destined for rural development with the purpose of increasing the standard of living of peasant households and their contribution to economic growth.
- Consolidate Federalism so assigned resources and responsibilities allow for a better provision of public goods and services.
- Moderate the growth of personnel expenditures and increase the level of professionalization of public servants.
- Give priority to resources destined for public safety in order to attend one of the populations most important demands.
- Promote sustainable development to preserve the environment and use our natural resources adequately.

The Federal Government will give priority to social programs focused on improving the living conditions and encouraging the development of those households whose income is lower than the minimum required to satisfy their basic needs. In addition, public expenditure for the next year will also focus on promoting higher economic growth. In order to achieve this, the government will foster productive projects either directly through public investment or capital good acquisitions, or indirectly, through public and private coordinated programs, with which the production possibilities and job creation will increase.

As in previous years, the level of expenditure will be consistent with the availability of resources, while keeping an expenditure allocation which reflects the priorities and demands of the population. The main goals incorporated in the PEF06 are to give priority to expenditure on social development, promoting economic growth, pursuing a better allocation of spending to rural development, consolidating federalism, increasing resources for public safety and to keep reducing personnel expenditure.

Among the main aspects of public expenditure policy, the following stand out:

- Proposed total net expenditures amount 1,882 billion pesos, a similar amount to that approved for 2005 and 5.6 percent below the closing estimation for the current year.
- According to the proposal, primary spending, defined as the difference between total net expenditure and the financing cost of the public sector, is 1,617.9 billion pesos. Within this amount, 36 percent corresponds to federalized expenditure (channeled to states and to municipalities), 35 percent to spending by PEBDCs, 25 percent to the central government, and 3 percent to autonomous entities. The remaining 1 percent corresponds to ADEFAS.
- The financing cost of public debt and expenditures to cover the cost of borrowers and lenders support programs will be 10.8 percent higher in real terms than that estimated for the current year. This is the result of higher expected real interest rates in 2006, which increases both the financing cost of the Federal Government internal debt as well as that of PEBDCs.
- The proposed amount of programmable expenditures is 1,319.5 billion pesos, 3.1 percent higher in real terms than the amount proposed for 2005. Also, non-programmable expenditures are estimated at 561.7 billion pesos.
- Federalized expenditure, which is channeled to States and Municipalities, is 3.3 percent higher in real terms to the amount proposed for 2005. On the other hand, expenditure on the central government is 4 percent higher while that of PEBDC's is 1.3 percent higher to that established in PEF05 initiative.
- According to the proposal, Health and Commerce Departments will have a higher budget in the next year with respect to 2005, by 20.1 and 7.7 percent respectively. This will allow them to provide an increasing amount of resources to fund the *Seguro Popular* and to support the development of small and medium size firms, respectively.
- Those resources for Public Safety Department would increase 21 percent with respect to 2005. Therefore, the total spending on public safety exercised by the central government would increase 17.3 percent in real terms with respect to 2005.
- The next year current expenditures would post a fall of 4.7 percent in real terms with respect to 2005. On the other hand, the proposed physical budgetary investment in 12.12 percent higher in real terms than the one

observed in the PEF05 initiative. It is worth mentioning that this investment is complemented by other investment figures, involving public and private participation.

The efforts to reach agreements between the Legislative and the Executive Branches will continue in order to reform the legal framework required to incorporate the fiscal responsibility principles to the annual budget approval process. This will build stronger institutions aimed at providing stability and economic certainty in the medium and long run.

Public Debt Policy for 2006

The general objective of the public debt policy for 2006 subject to Congress's consideration is to obtain the financial resources required to meet the current debt obligations and the financial needs at the lowest possible cost, while keeping a prudent risk level.

The debt management strategy implemented in the past few years has followed three guidelines: i) the public deficit has been financed entirely through domestic debt, and foreign debt reduction goals have been set; ii) the domestic financing has been carried out in an orderly fashion; and iii) the external debt composition has strengthened in terms of cost and maturity through active and timely liability management policies.

Average net financial cost of the Federal Government in 2001-2006 is estimated at 2.5 percent of GDP, which is 0.8 percentage points lower than the one observed in the past Administration. Therefore, the accumulated savings due to a prudent debt management during this Administration are estimated at 338 billion pesos of 2005, which will be used to meet the priority needs of a social character.

The PEF06 establishes a surplus balance for the public sector of 17.6 billion pesos, which is the result of a Federal Government deficit of 159 billion pesos and a surplus of PEDBC's of 176.6 billion pesos. According to these figures, the LIF06 Initiative that has been sent to Congress requests a 180 billion peso net domestic indebtedness ceiling for the Federal Government. Furthermore, it requests a reduction in net external indebtedness of the public sector of at least 500 million dollars.

To meet these financing needs, the Federal Government's public debt policy will pursue the following guidelines in 2006:

1. The net amount of resource obtained by the Federal Government will be carried out through security auctions in the domestic market, in particular and as in previous years, with long-term fixed-rate *Bonos* sales. This will help reduce the vulnerability of public finances against adverse movements in interest rates and strengthen the long-term yield-curve.
2. The Federal Government will continue the periodical sale of long-term inflation-indexed securities (Udibonos) in order to complement the current sale of this type of bonds with 10-year maturities. The reduction

of the net financial requirements from FARAC in 2006 allows us to anticipate that the sales of long-term inflation-indexed bonds of this program will conclude at the end of this fiscal year.

3. Pre-financing operations carried out in the last few months allow the Economic Program for 2006 not to include the need for further foreign currency denominated debt issuances for the refinancing of the programmed market debt payments, notwithstanding the good credit rating of Mexico.

These guidelines will help the Federal Government to achieve a more adequate mix of internal and external debt by diminishing the share of foreign-currency denominated liabilities in net total debt. These actions will continue the joint efforts of Congress and the Executive carried out since the beginning of this Administration.

It is important to highlight the expected net external debt reduction, not only with respect to the size of the economy, but also as proportion of net total liabilities. In particular, it is estimated that the net external debt of the Federal Government will be equal to 6.8 percent of GDP at the end of 2006, which is an historical minimum in the recent history of our country.

Tax Dispositions and the Fiscal Code for 2006

The changes proposed for 2006 are aimed to encourage investment through fiscal incentives and increased judicial certainty. The most relevant changes are the following:

- Regarding the LIF06, the surcharge rate is held constant as well as the mechanism employed to reduce it according to inflation.
- With respect to tax credits, new ones are enacted and those already in effect are extended. In this sense, a tax credit for excise taxes (IEPS) on diesel for final consumption is proposed and to be applied in the same conditions to the public and private transport of people or goods.
- Additionally, the withholding rate for interests paid by financial institutions is maintained.
- As in previous years, the Revenue Service (SAT) keeps the right to cancel fiscal credits in case of the practical impossibility of levying them.
- Accordingly, the Program for the Enlargement and Actualization of the fiscal identification code (RFC) is maintained. Additionally, it is expected that States carry out the program partially or entirely.
- The SAT retains the possibility of developing agreements with tax-payers in order to condone part or the total amount of fines or surcharges on taxes due.
- It is worth mentioning that the dispositions related to PEMEX tax treatment in the LIF06 are made considering the current regime and therefore, once its new fiscal regime is finally approved, it will be necessary to make the corresponding modifications.
- In terms of the income tax, there is an improvement to the tax credit approved by Congress in 2003 in order to attract greater investment into

real estate development trust funds, mainly from investors in the stock market. This credit is complemented by a similar treatment of the VAT.

- In order to prevent the Federal Government instruments to be less attractive, there is a proposal to incorporate as legal dispositions the exemption of income tax for interests paid by these instruments, as long as they are issued and paid in Mexico to foreign residents that comply with certain requirements. A similar treatment is given to the financial instruments derived from such a debt.
- According to international practice, and in order to avoid the manipulation of the methodology used to determine transfer prices, the prioritization of these in the Income Tax legislation is proposed so the tax-payer will use first the comparable non-controlled price method.
- To contribute to an environment free of non-reusable plastic containers, a modification of the excise tax on beer is proposed. According to this modification, the amount paid will be the greatest between the excise tax and a fixed amount per liter, diminished by a tax credit for recyclable containers. The tax paid will never be less than what is currently established by the law.
- In order to compensate local governments for the reduction of revenues due to the tax credit related to the ISAN, the creation of a Compensation Fund, constituted by an annual amount equal to the estimated loss and distributed on a monthly basis amongst the entities, is proposed.
- In terms of the Fiscal Code, and according to recent international practice, it is proposed to incorporate to such code new rules that refer to the independence of those who audit financial statements for fiscal purposes.
- Finally, on fiscal crime matters, the possibility that a judge can condemn damage reparations except when the suspect has paid the contributions, sanctions and other fees that arise from the crime is proposed.

Economic Outlook for 2006

For 2006, we anticipate a favorable global economic environment for Mexico. Particularly, we expect the US economy to keep growing fast and above its potential, but at a slower pace than that observed in 2004 and 2005.

Market analysts forecast that the US economy will expand at a 3.3 annual rate in 2006 in real terms. Projections for the industrial production growth rate in 2006 anticipate a similar pace to that posted in 2005, 3.5 percent.

In the last years, international oil prices have remained high. This is explained fundamentally by a growing global demand for oil products, and a steady supply which is perceived to be subject to a high risk of disruptions. While oil market analysts do not expect immediate changes in the oil market outlook, they share the view that oil prices are above their long-run trend. Among those elements that could lead to an eventual downward adjustment in oil prices, the following stand out: i) a negative revision of global economic growth forecasts, ii) a fall in demand which makes the current level of crude inventories to be excessive, iii) the materialization of a considerable number of projects, driven by the current high prices, and iv) an important substitution of oil and its derivatives for alternative energy sources which may lead to a fall in demand.

These factors may accelerate the return international oil prices to their long-run trend, in which case the Mexican oil mix price would show a similar behavior. Notwithstanding, such risk factors are already taken into account in the formula for the Mexican oil mix reference price, contained in the Budget and Fiscal Responsibility Law initiative, approved by the Chamber of Deputies' Budget Committee. Applying the formula yields a reference price for the Mexican oil mix of 31.5 dollars per barrel in 2006.

We anticipate that the Mexican economy will grow at a 3.6 percent annual rate in 2006. This figure is in line with private sector's expectations.

Public sector borrowing requirements (PSBR) for 2005 are estimated at 1.5 percent of GDP, which represents a reduction of 0.7 percentage points with respect to the same figure for 2005.

Public Sector Borrowing Requirements, 2005-2006
(% of GDP)

	2005	2006	Difference
I. Public Deficit excluding VRP	**0.2**	**-0.2**	**-0.4**
A. Budgetary Revenues	23.0	21.3	-1.7
Oil Related	8.7	8.0	-0.6
Non-oil Related	14.4	13.3	-1.0
Tax	9.5	8.9	-0.6
Non-Tax	0.7	0.4	-0.3
PEDBC	4.2	4.0	-0.1
B. Net Budgetary Expenditures	23.2	21.1	-2.1
Programmable	16.9	14.8	-2.1
Non Programmable	6.3	6.4	0.0
Financing Costs	2.8	3.0	0.2
Revenue Sharing	3.4	3.2	-0.2
Adefas and Others	0.2	0.2	0.0
C. Non-Budgetary Deficit	0.0	0.0	0.0
III. Adjustments	**2.0**	**1.7**	**-0.3**
PIDIREGAS	1.0	0.9	-0.2
IPAB	0.3	0.2	-0.1
Registry Corrections	0.1	0.1	0.0
Debtor Support Programs	0.1	0.1	0.0
FARAC	0.0	0.0	0.0
Financial Intermediation	0.4	0.4	0.0
IV. PSBR (II+III)	**2.2**	**1.5**	**-0.7**
Excluding Non-recurrent Revenues	**2.3**	**1.5**	**-0.8**

* Does not include expenditure for the Conclusion of the Labor Relationship (CRL)

Medium-Term Economic and Public Finance Perspectives

The medium-term expectations for the US economy point towards continued growth during the next ten years. However, the growth rate is expected to be less vigorous than that observed during the past two years. For the 2006-2009 period, the expected average growth rate is 3.6 percent.

With respect to the global oil market, analysts agree that crude oil prices are considerably above its long-term trend. Even amongst those who believe that the global economy has begun an era of high oil prices, most analyses point to a downward adjustment in the medium-term. This has been reflected on the decisions of those economic agents most affected by developments in the oil market: i) Oil companies have been cautious about high oil prices and have not considered them in their long-term investment plans, ii) fiscal authorities whose public revenues depend heavily on oil sources have made conservative oil price assumptions in their 2006 budgets.

This shows that agents, both public and private, facing potentially high costs of overestimating future oil prices have chosen to make conservative assumptions regarding oil prices when taking long-term investment or expenditure decisions. Therefore, a multi-annual oil price perspective for purposes of public finance planning must be based on cautious elements that include the decreasing trend anticipated by analysts and the high volatility that will characterize oil markets in the next few years.

For Mexico, the macroeconomic projections for 2006-2009 estimate average GDP growth at 3.6 percent annually. The downward revision with respect to the 2005 Economic Program forecast is due mainly to the deceleration of the US economy expected in the medium term. Additionally, inflation is expected to continue its downward trend and stabilize around the 3.0 percent plus/minus one percent objective established by Banco de México. The balance of payments is expected to post a moderate deficit within 3.0 percent of GDP in every year of the period.

With respect to public finances, the strategy must acknowledge that the advances that have been made during the past few years must be consolidated. The fiscal effort allowed the public finance objectives to be met, thus correcting the imbalances along 2001-2005. In this regard, the public deficit as a percentage of GDP went from 1.1 percent in 2000 to 0.2 percent in 2005, while PSBR decreased from 3.3 percent of GDP to an expected level of 2.2 percent in the same period. However, it should also be noticed that high international oil prices, non-recurring public revenues, and decreased financing costs, helped decisively to meet the fiscal objectives. These factors allowed for a simultaneous reduction of the public deficit and an increase of expenditures, mainly those channeled to social development.

In the medium-term strategy for 2006-2009, the following aspects stand out:

- The Government reiterates its objective of achieving a fiscal surplus in 2006. The objective of achieving a positive balance arises from the need to diminish the economy's debt levels and from the additional benefits that would result from this reduction in terms of the financing costs.
- The strategy must continue with further reductions of PSBR to increase the credit resources available for the private sector productive projects.

Therefore, the decreasing trend of the Historical Balance of the Public Sector Borrowing Requirements (HBPSBR) associated to the objective balances that have been proposed here would imply a level of this broad measure of indebtedness below 32 percent of GDP by 2009.

However, it should be pointed out that the consolidation of the public finances in the next few years will face important challenges, created by the following pressures: i) a reduction of oil-related revenues of about 1.7 percent of GDP between 2005 and 2009, ii) an increase of pension payments obligations that will go from 2.2 percent of GDP in 2005 to 2.8 percent in 2009, and iii) due to the program's advancements and the average maturity of the projects undertaken under this program, the fiscal pressure from PIDIREGAS will increase considerably from 1.3 percent of GDP in 2005 to 2.0 percent in 2009.

Concluding Remarks

External conditions will be favorable for the Mexican economy in 2006. However this scenario is not immune to important risks. The positive environment should not distract us from the important pressures that exist for public finances in the medium and long-term. Therefore, the fiscal responsibility that has characterized this Administration will be reinforced in 2006, considering the need to shield the economy from any instability associated to the federal elections and the start of a new Administration in December of 2006.

The spirit of fiscal responsibility is present when insisting on the temporary nature of the extremely high oil prices, the proposal to start a series of successive public surpluses in 2006, and the reiteration that Mexico continues to grow below its potential due to the lack of the much needed structural reforms. The medium-term pressures on the public finances due to, amongst others, the pension-related obligations should not be eluded either. As it has been pointed out before, these pressures call for an adequate set of structural reforms. This must be done now or else it could be too late.

The Congress and the Executive share this spirit of fiscal responsibility. Rising above our healthy differences, together we will be able to shape an Economic Program for 2006 that promotes the well-being of current and future generations of Mexicans.

MACROECONOMIC SETTING, 2005-2006 e/		
	2005	**2006**
Gross Domestic Product		
Real Growth (%)	3.5	3.6
Current Prices (billion Pesos)	8,226.2	8,803.6
GDP Deflator (average growth, %)	4.1	3.4
Inflation		
Dec./Dec. (%)	3.7	3.0
Exchange Rate */		
Average (Pesos per US Dollar)	11.0	11.4
Interest Rates (Cetes, 28 days)		
Nominal Average (%)	9.4	8.9
Real Average (%)	5.8	6.1
Current Account		
Million US Dollars	-9,892.2	-16,611.5
% of GDP	-1.3	-2.2
Fiscal Balance		
Traditional Balance (% of GDP)	-0.2	0.2
PSBR (% of GDP)	2.2**	1.5
Other variables:		
US GDP		
Real Growth (%)	3.6	3.5
US Industrial Production		
Real Growth (%)	3.4	3.5
US Inflation		
Dec./Dec. (%)	2.2	1.9
Oil (Mexican Mix)		
Average price (dpb)	39.8	31.5
Average Export Platform (mbpd)	1,826	1,868
Foreign Exchange Rates		
LIBOR (average, %)	3.5	4.4
Federal Funds Rate (average, %)***	3.3	4.4

e/ Estimated.

*/ Since the exchange rate flotas freely, this does not constitute a forecast. However, these levels were used to estimate some budgetary figures.

**/ Does not include expenditure for the Conclusion of the Labor Relationship (CRL).

***/ Based on the corresponding futures.