



BANCO DE MÉXICO®

# Executive Summary of the Financial Stability Report

June 2023

## Executive summary

The Mexican financial system, and particularly commercial banks, continue to be in a solid and resilient position despite the complex global environment during the first half of 2023, which has been characterized by greater uncertainty and volatile global financial markets. This environment was partly due to difficulties experienced by some banking sector institutions in developed countries, more persistent global inflationary pressures than expected and the response implemented by the main central banks, as well as continued tightening of overall financial conditions.

Although during the fourth quarter of 2022 economic activity in Mexico decelerated compared to the dynamism registered in the first three quarters of that year, the economy expanded during the first quarter of 2023. Whether economic growth will remain positive remains uncertain.

The International Monetary Fund's (IMF) global growth forecasts were revised marginally downwards for 2023 and 2024. These adjustments are related to the possible adoption of tighter monetary policies to combat inflation, a further tightening of financial conditions, a prolonged military conflict between Russia and Ukraine, and the potential risk of a fragmentation of global production chains. In this environment, they expect global inflation to continue to be above central banks' targets.

The monetary policy challenges around this could increase uncertainty and volatility in financial markets. Therefore, given the risk of prolonged inflationary pressures, a worsening of geopolitical tensions and tighter financial conditions, it will be important to monitor the evolution of the financial system

Since our last report, international financial markets have been affected by the persistence of global inflationary pressures and the continuing tightening cycle of monetary policy in most countries, as well as by the period of financial stress caused by the problems in the US and European banks, and to a lesser extent by the budget debate regarding the United States government debt ceiling. However, it should be noted that, in recent weeks, markets have recovered and stabilized, due to reduced concerns about the materialization of a systemic event in the global banking sector.

The effects of financial market turmoil between March and May 2023 on emerging market economies

have been limited so far. Stock market performance was characterized by positive returns and, since December 2022, the currencies of this group of countries have appreciated, with the Mexican peso standing out as one of the best performing currencies among emerging market currencies. This behavior is due, among other factors, to the prudent conduct of fiscal and monetary policies, the balance of external accounts, significant remittance flows, the interest rate spread compared to other economies, the lower volatility of the Mexican peso compared to that observed in other currencies and, overall, to a relatively more favorable macroeconomic position than that of other economies.

During the first three months of 2023, Mexican aggregate risk indicators, such as the Mexican Financial Markets Stress Index (IEMF, for its acronym in Spanish) and the domestic Financial Conditions Index (ICF, for its acronym in Spanish) increased slightly, due to volatility in global financial markets during that period. Nevertheless, uncertainty in the markets decreased and these indicators showed some improvement in recent weeks. On the other hand, the aggregate risk of the financial system, as shown in the heat map, decreased during the first quarter of 2023 with respect to that observed in the previous *Report*. Uncertainty persists regarding the future evolution of financial markets, and additional episodes that could lead to a new tightening in financial conditions cannot be ruled out. In this situation, capital flows to emerging market economies, including Mexico, could be affected, and financing costs for firms and households could increase.

Certain vulnerabilities and risks for the domestic financial system have increased at the margin. In terms of policy, during the first five months of 2023, mixed results have been observed in the level of the Mexican Economic Policy Uncertainty Index (EPU), which shows an increase from the lowest levels observed during the first quarter of 2023.

Credit dynamics have remained moderate. The financing gap, has worsened, registering eight consecutive quarters of negative values. In particular, during the first quarter of 2023, total financing to the non-financial sector of the economy, in real annual terms, remained at low levels and similar to those observed in 2015. Specifically, financing to the non-financial private sector, continued to contract, although at a slower pace than in the previous six months. Meanwhile, financing for household consumption increased significantly compared to the

end of 2022, while household leverage remained at similar levels. During the period covered by this *Report*, consumer credit granted by commercial banks and their subsidiary sofomes registered positive annual growth rates in all segments, with the highest growth in credit cards. Meanwhile, total mortgage loans grew marginally in real annual terms, which contrasts with the decline observed in the previous *Report*.

Finally, total financing to non-financial private firms in Mexico continues decreasing in real terms, although the rate of contraction is slower than that observed in the previous *Report*. In particular, external financing from outside of Mexico to this sector once again contracted in the second quarter of 2023 versus the same quarter in 2022, which means that it has been decreasing for ten consecutive quarters. It is worth noting that few firms will have external debt obligations maturing during the next two years. Meanwhile, domestic financing grew compared to the same period last year, mainly due to the increase in the portfolio of large companies, although in recent months the portfolio of smaller companies has also grown.

Regarding the public sector's financial position, at the end of 2022, the budget deficit registered a lower deficit than estimated in the 2022 Economic Package. Both revenues and budgetary expenditure were higher than programmed. As for state-owned enterprises, at the end of March 2023, Pemex registered a quarterly profit lower than that observed in the last quarter of 2022. Meanwhile, the Federal Electricity Commission (CFE, for its acronym in Spanish), at the end of March 2023, registered a profit three times higher than that observed in the same quarter of the previous year. This is explained by higher revenues due to higher electricity demand, lower operating costs, and an increase in foreign exchange gains derived from the appreciation of the Mexican peso against the US dollar.

With respect to capital flows, during the last quarter of 2022, capital outflows were more than offset by capital inflows in the first quarter of this year. Mexico has maintained solid macro financial fundamentals and continuing to do this will contribute to preserving investors' confidence and minimizing the effects of a possible decline in the supply of external financing.

With respect to the banking sector, commercial banks registered an expansion in their credit portfolios and increase in securities' transactions since the previous *Report*. However, the value of commercial banks' loan portfolios continues to be

lower than the amount raised from their funding sources. The recovery of the credit portfolio, as well as the increase in funding costs, was reflected, in aggregate, as an increase in commercial banks' net interest margin, although with differences among institutions.

During the first quarter of 2023, commercial banks' liquidity, credit, contagion and market risks remained stable and limited. In particular, during the first quarter of 2023, both the capitalization and liquidity position of the Mexican banking system have remained, overall, far above regulatory minimums. Similarly, it should be noted that, despite the increase in uncertainty during March, due to the events in the US and European banking systems, no increase in risk contagion was observed. Thus, the banking sector has continued to contribute to the overall financial system's resilience and sound position. Nevertheless, it will be important to monitor the evolution of these banks' positions as conditions evolve.

Development banks and other development financial institutions remain financially sound, despite having a lower balance of financing and a higher constitution of preventive reserves. The favorable evolution of the main balance sheet and financial statement items stands out; in particular, these banks maintained positive net profits and an adequate capitalization positions during the period covered by this *Report*.

The other non-bank financial intermediaries' sector (OIFNB, for its acronym in Spanish) continues to face challenges, particularly related to tighter financial conditions. This tightening has affected both the cost and access to new financing for these entities. In particular, the situation in the non-regulated sector poses complex challenges, including the refinancing of their debt in a context of greater risk aversion among investors due to the default of some entities in the sector with international bond liabilities in the past few years. This sector's assets represent a small fraction of the financial system and these entities have a low level of interconnection with the country's banks and other financial intermediaries. Hence, they do not constitute a systemic risk at this time.

This *Report* analyzes the following macro-financial risks to financial stability: i) a greater and longer lasting tightening of financial conditions; ii) lower-than-expected global economic growth, with a downward trend; iii) the occurrence of a systemic event that affects the global financial system; iv) a weakening of aggregate demand; and v) adjustments



of credit ratings for both Mexican sovereign debt and Pemex.

Stress tests were also conducted to evaluate the resilience and loss absorption capacity of Mexican banking institutions under extreme adverse, but possible, scenarios. As part of the stress tests conducted in this Report, four sets of macroeconomic scenarios consistent with the macrofinancial risks presented in this document are considered, as well as four sets of historical scenarios qualitatively similar to crisis episodes that the Mexican economy has faced. The results suggest that Mexico's banking system has sufficient capital levels to face simulated adverse scenarios. Nevertheless, some banks, representing a low percentage of total assets in the system, would conclude the stress horizon with more limited capital levels. Similarly, concentration risk would generate additional pressures on the system's capitalization level. With respect to the leverage ratio of the system, at the aggregated level, these would remain above regulatory minimums.

In addition to the risks analyzed in the stress tests, there are others related to financial institutions' operations, such as business continuity risk. In recent years, in general, this risk has been closely monitored by supervisors of the financial system and particularly, by Banco de México. The financial market and payment systems infrastructures that Banco de México manages and operates have maintained high levels of operability, with no

incidents reported in either their technological infrastructure or in their operating processes. Meanwhile, cyber-risks remain among the major risks for the global financial system. Thus, financial entities and authorities have adopted different measures to monitor cybersecurity risks and threats, in Mexico and globally. This *Report* includes the monitoring of the Cyberattack Risk Index in Mexico and the Cyberattack Risk Perception Index for the Financial Sector.

In addition to these risks, Banco de México has been actively working on making Mexico's financial system participants include climate-related risks in their risk management practices. Economic and financial effects associated with climate change, as well as risks associated with the transition to a lower-carbon economy, may lead to substantial future losses for financial institutions and could represent a risk for the financial system in general. Banco de México is also continually improving and developing tools and conducting analysis related to climate change.

Finally, Banco de México will monitor the evolution of Mexican financial markets and will continue to take actions if necessary, in compliance with the legal framework and in coordination with other financial authorities, to preserve the stability of the financial system and the proper functioning of the payment systems.



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