

Mexico's Economic Policy under External Constraints

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BANCO DE MÉXICO

Adam Smith Seminar, Schloss Spiez, Switzerland, June 27, 2012

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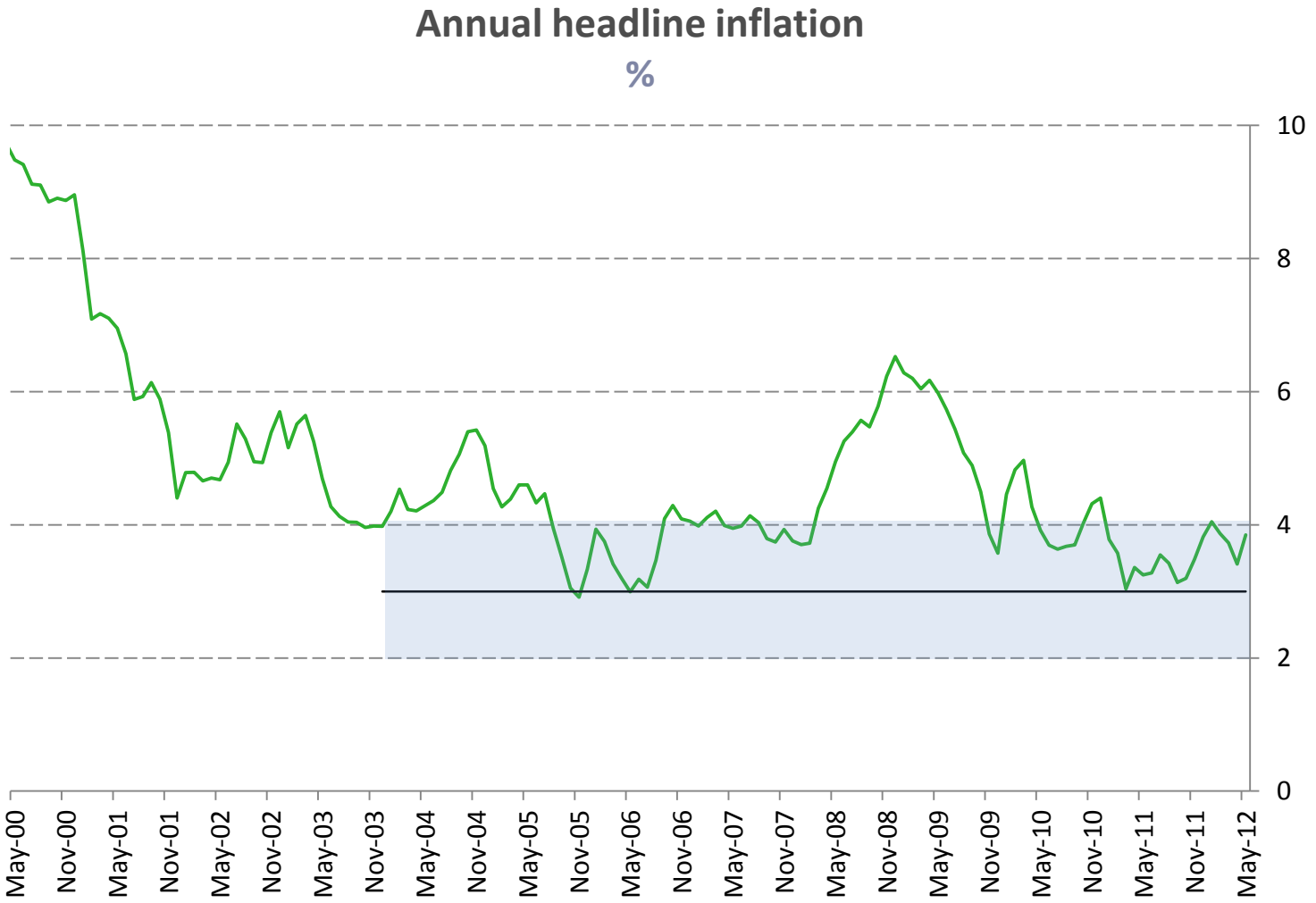
2 Implications of European Uncertainty

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During the last ten years monetary policy in Mexico has been implemented under an inflation targeting regime

- Stabilization has been gradual to minimize possible social costs
  - ✓ Declining inflation targets at first, then fixed
  - ✓ Since 2003, 3% permanent target, with a variability range of plus/minus one percentage point
- Communication has been key to the effectiveness of monetary policy
  - ✓ Quarterly inflation reports and press conferences
  - ✓ Monetary policy communiques
  - ✓ Minutes from Board policy decision meetings

On the back of prudent fiscal policy, inflation has dropped and has been converging towards the permanent target



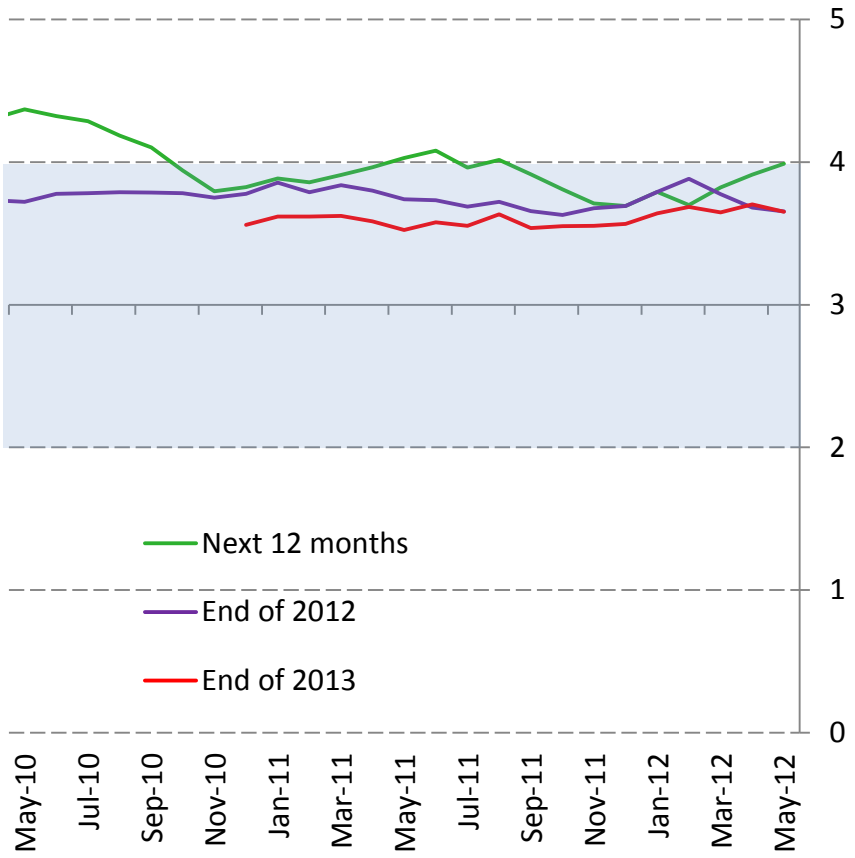
Source: INEGI and Banco de México

A crucial challenge to convergence continues to be the persistence of inflation expectations above the target

Inflation expectations

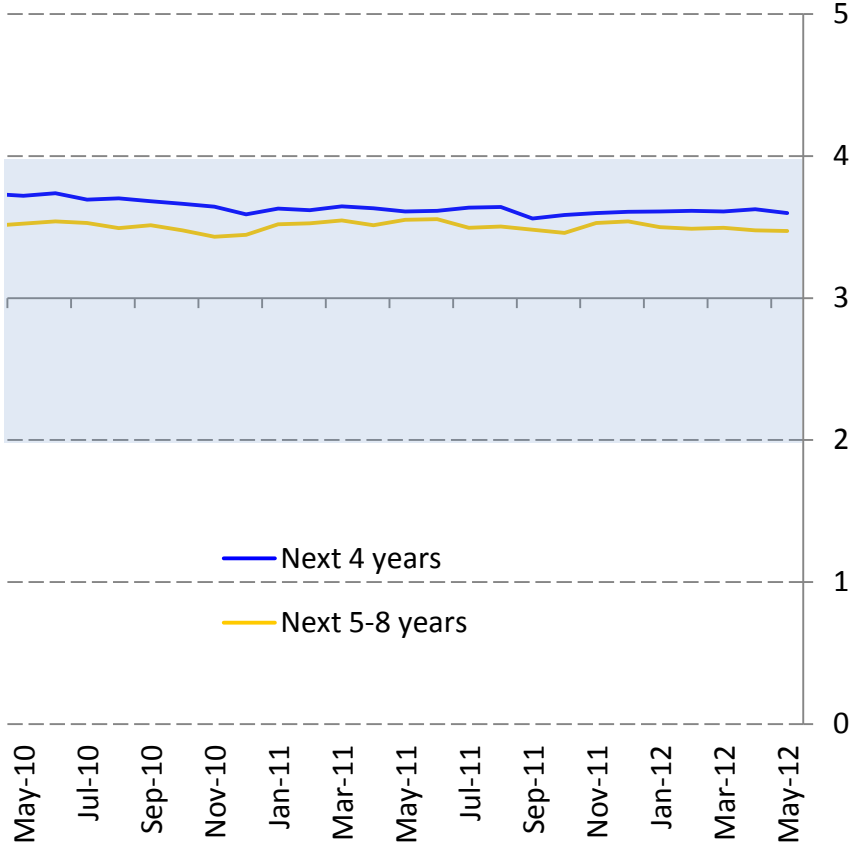
%

Short and medium-term



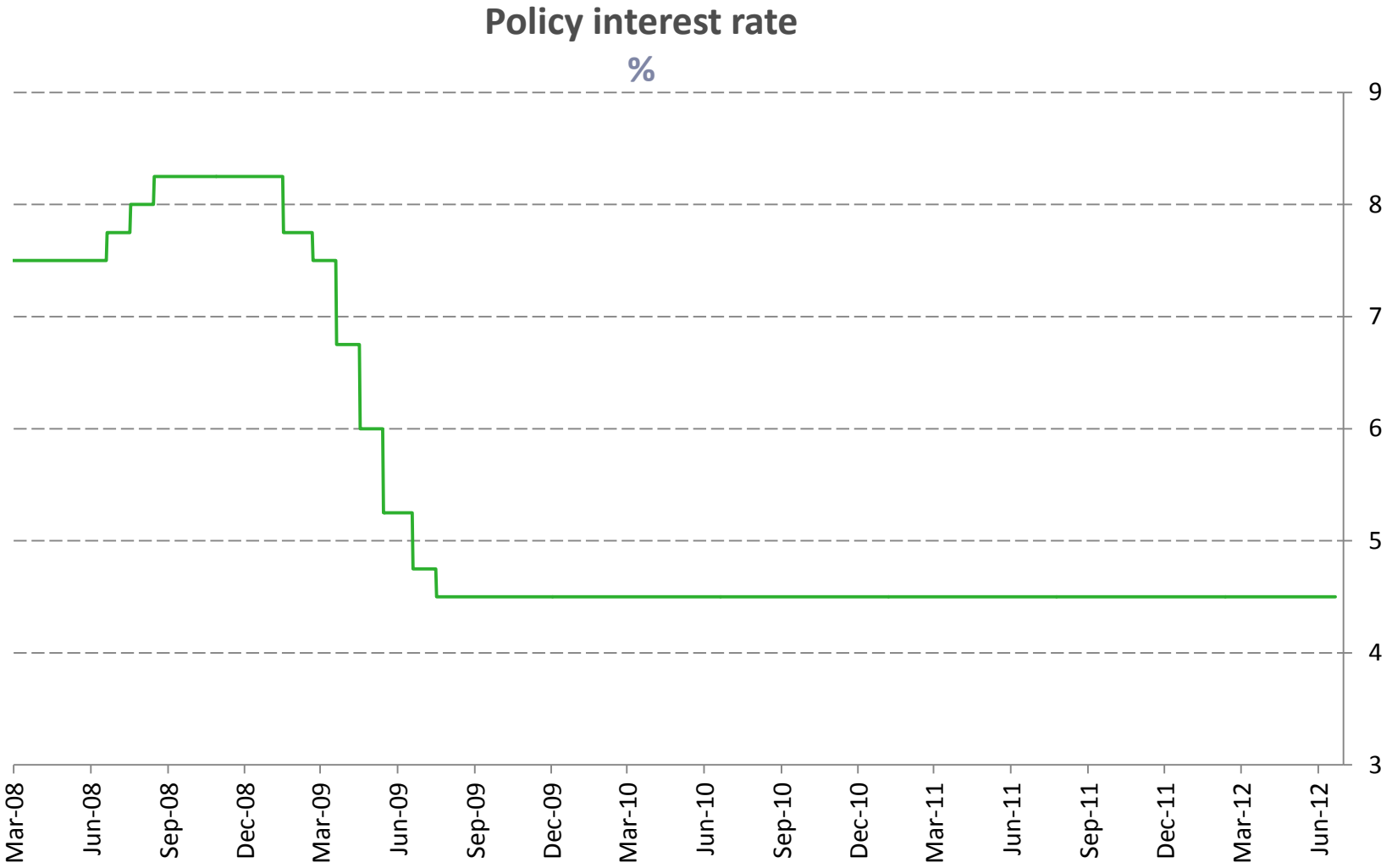
Source: Banco de México

Long-term



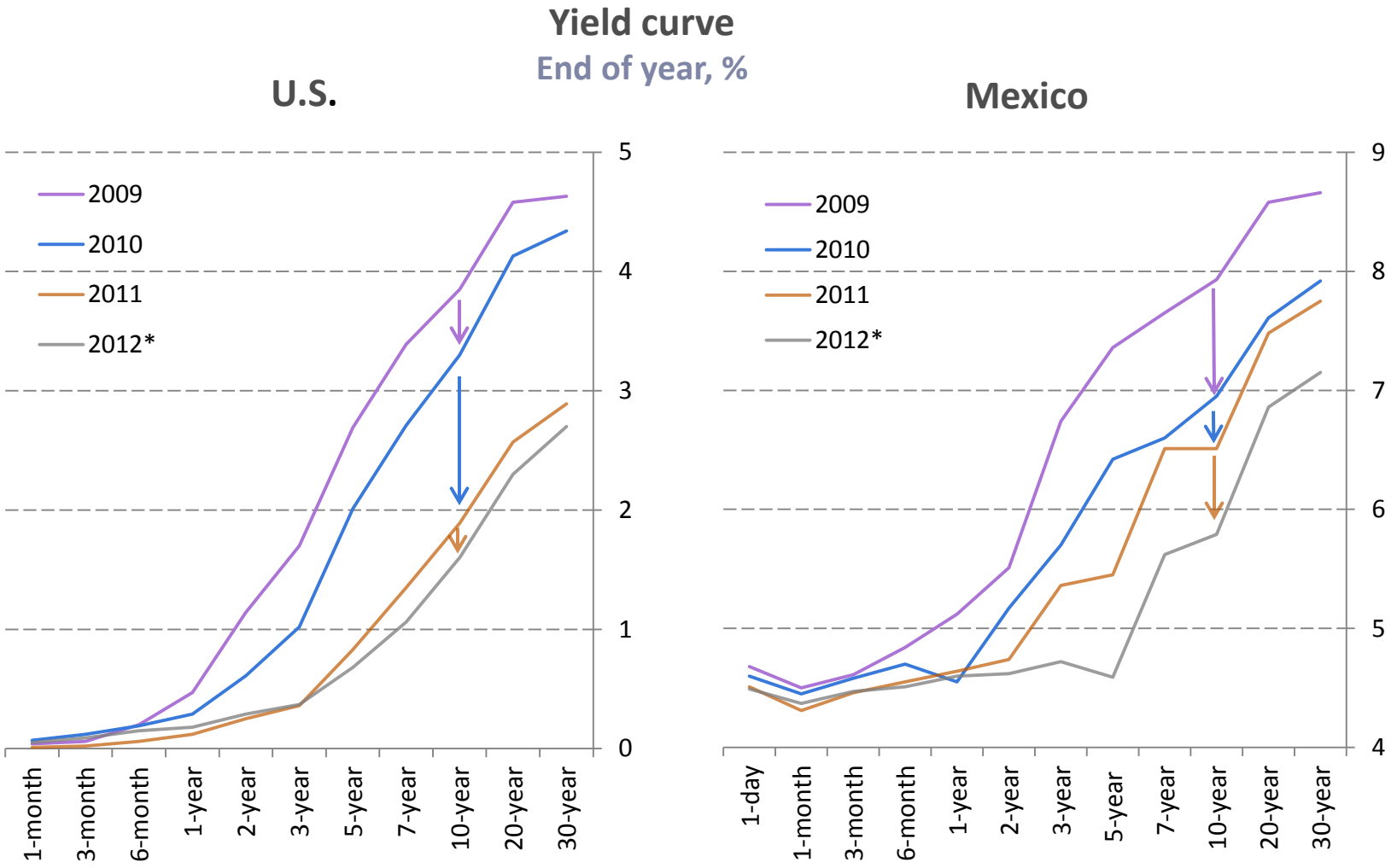
Source: Banco de México

The policy interest rate responded to cyclical conditions, and has been constant for almost three years

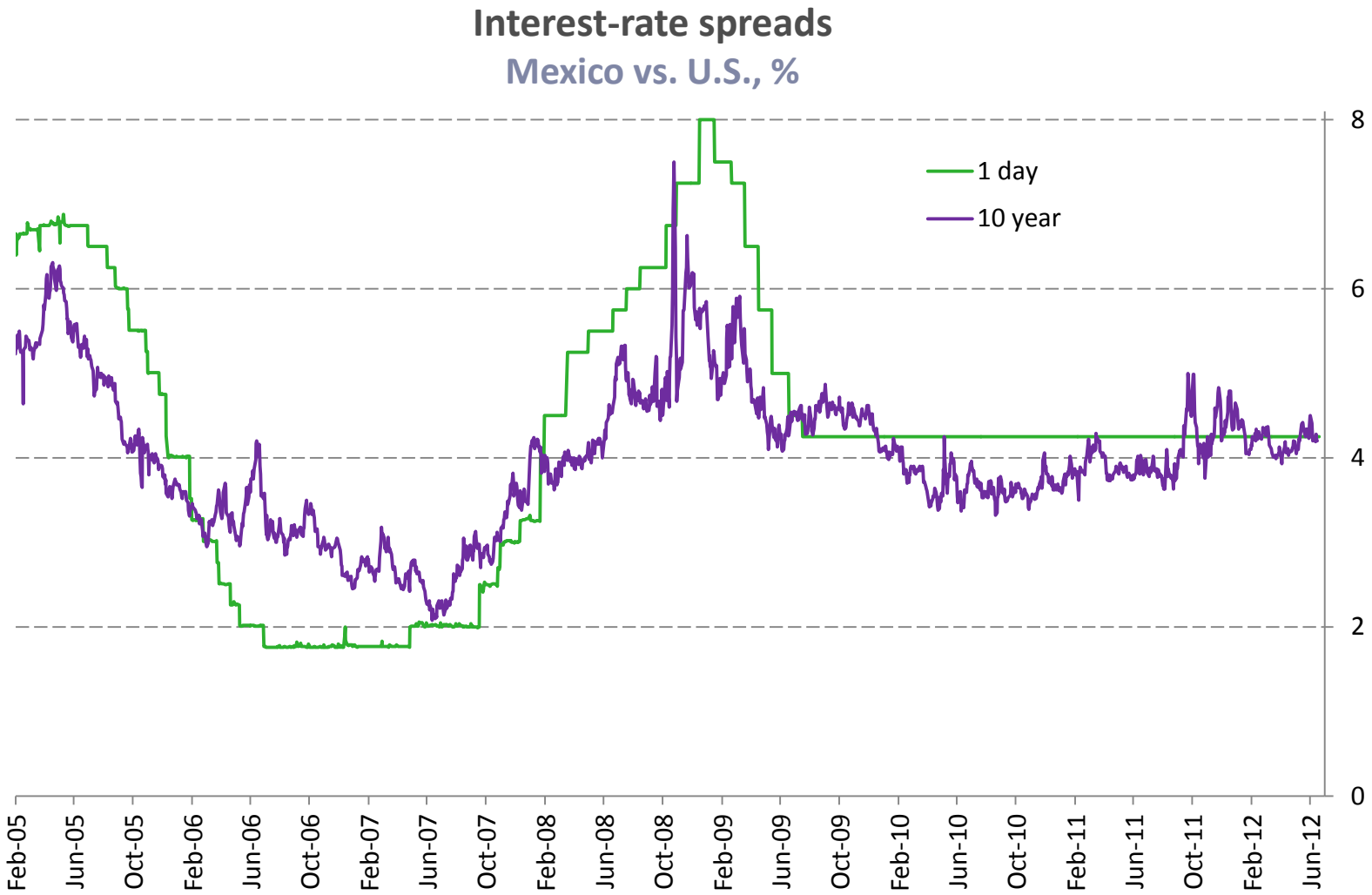


Source: Banco de México

The yield curve has been shifting with that of the U.S., reflecting the extraordinary monetary accommodation in that country



The resulting recent interest-rate spreads have been wide and relatively stable

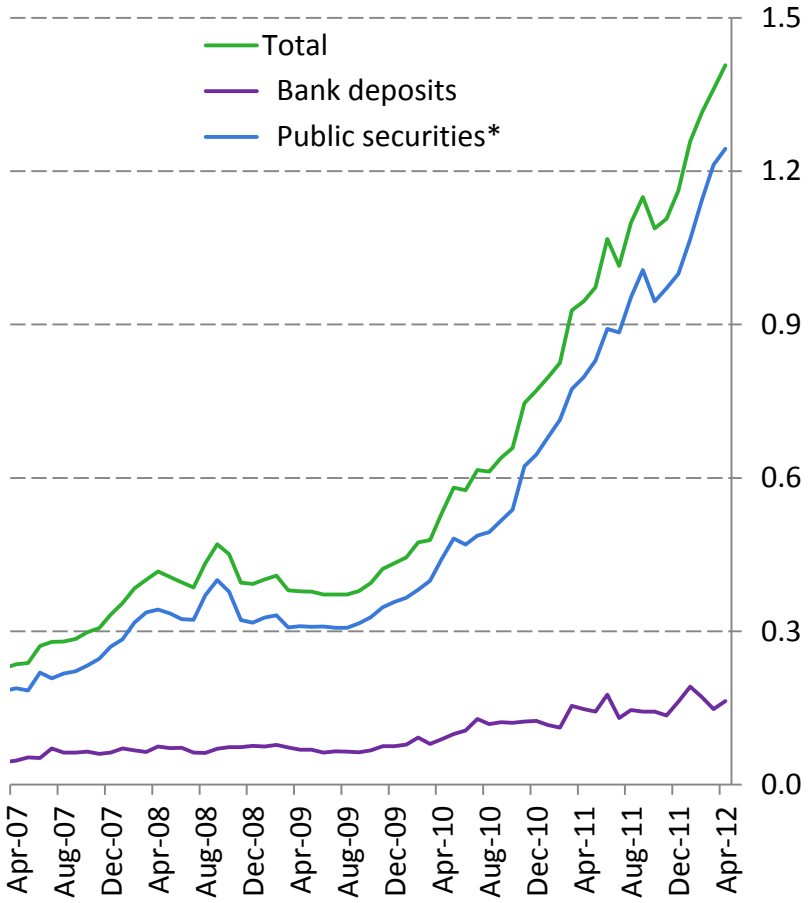


Source: Banco de México and Federal Reserve

… and have given rise to substantial capital inflows to Mexico, especially in the bond market

M4 held by non-residents

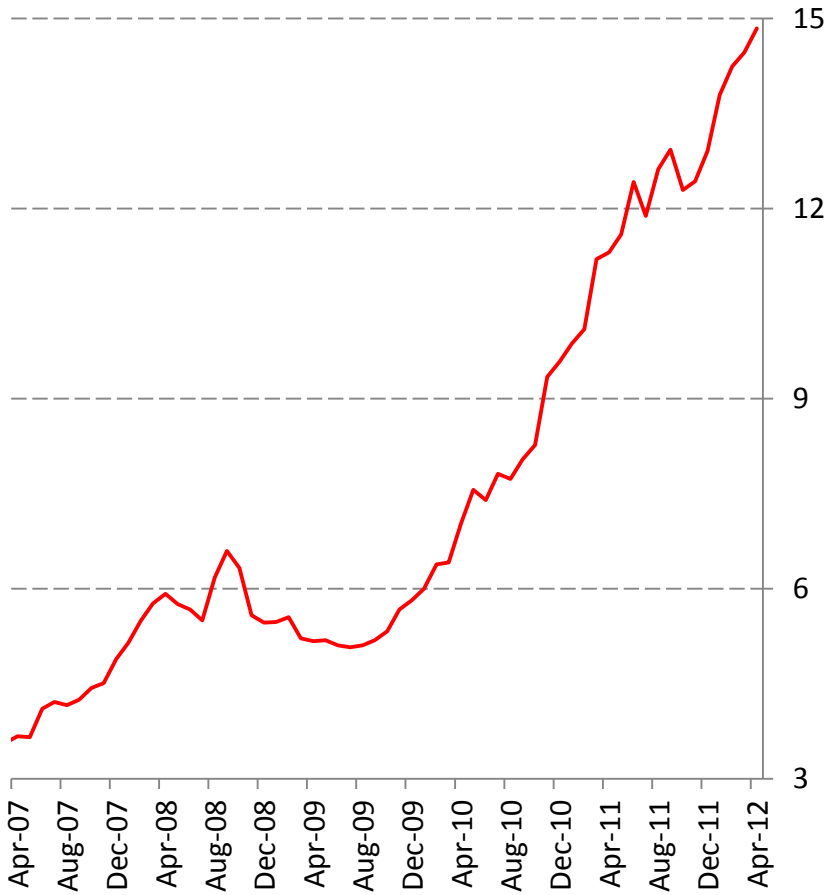
Trillion pesos at April 2012 prices, s. a.



* Marked to market

Source: Banco de México

% of M4



Source: Banco de México

Typically, some dangers may arise in episodes of strong capital inflows

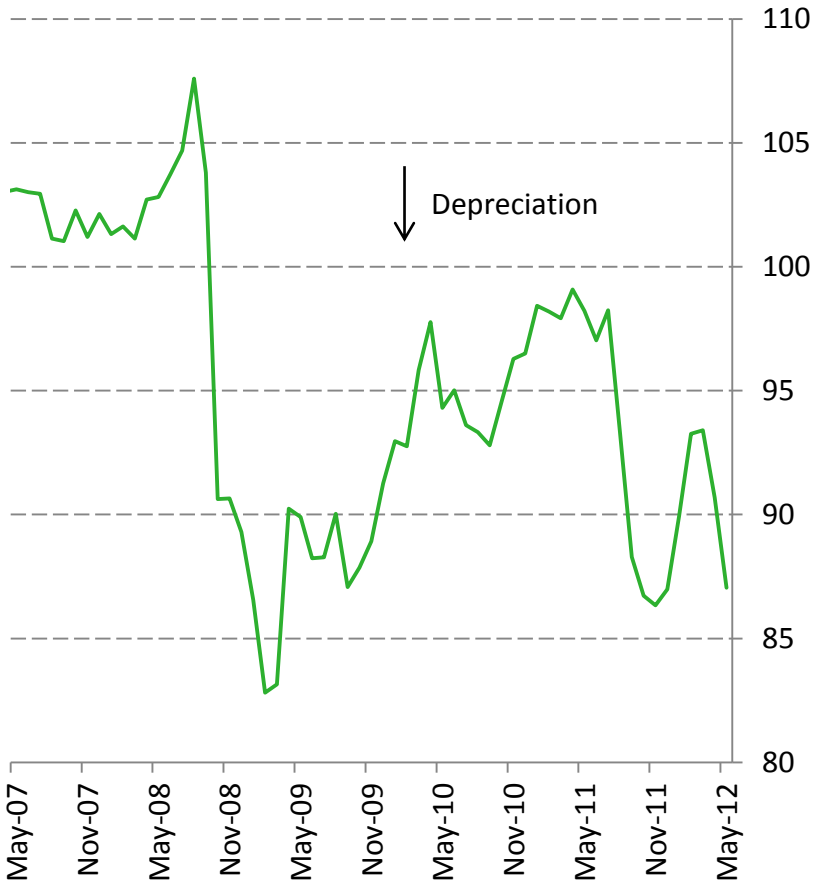
- An excessive currency appreciation[1]
  - ✓ Worsening of the trade balance
  - ✓ Output contraction
  - ✓ Lower policy interest rate usually recommended
- Asset price bubbles[2]
  - ✓ Credit and consumption boom
  - ✓ Output expansion
  - ✓ Advised higher policy interest rate to prick the bubbles could further attract capital inflows

1/ Svensson, L.E.O. (2011). "Monetary Policy after the Crisis". Speech at the Federal Reserve Bank of San Francisco, November 29
2/ Plantin, G. and H.S. Shin. (2011). "Carry Trades, Monetary Policy and Speculative Dynamics". Presented at the IMF Conference Macro-Financial Stability in the New Normal, April 7

In Mexico, the first danger does not seem to have materialized as implied by a relatively weak peso and high export growth

Real effective exchange rate

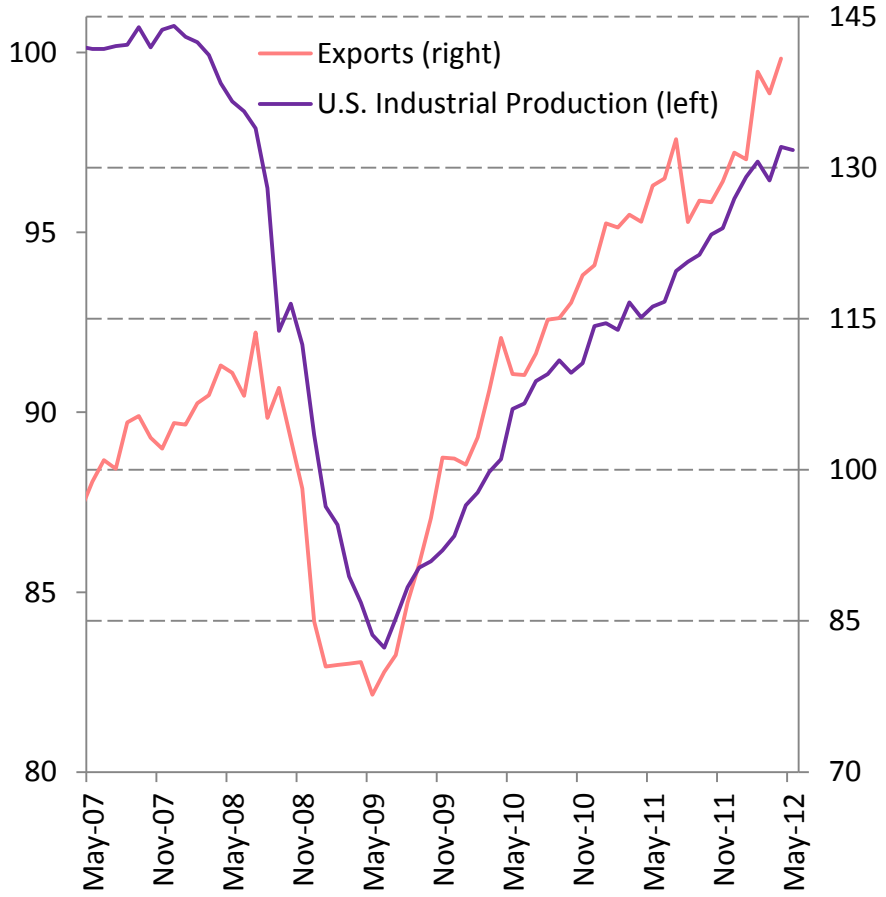
2008=100



Source: Bank of International Settlements

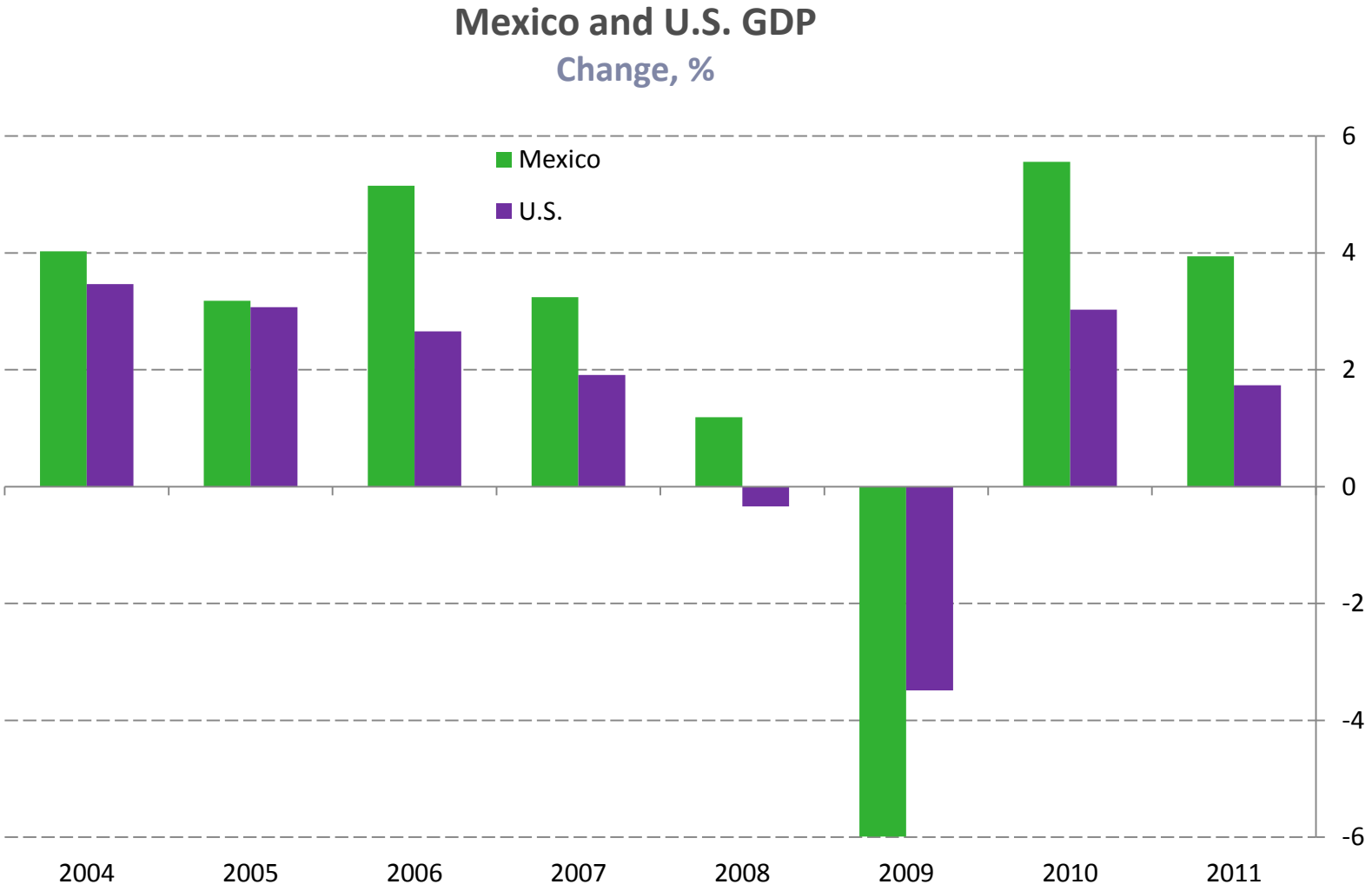
Manufacturing exports

2007=100, s. a.



Source: Banco de México

In fact, except for 2009, the Mexican economy has expanded faster than that of the United States

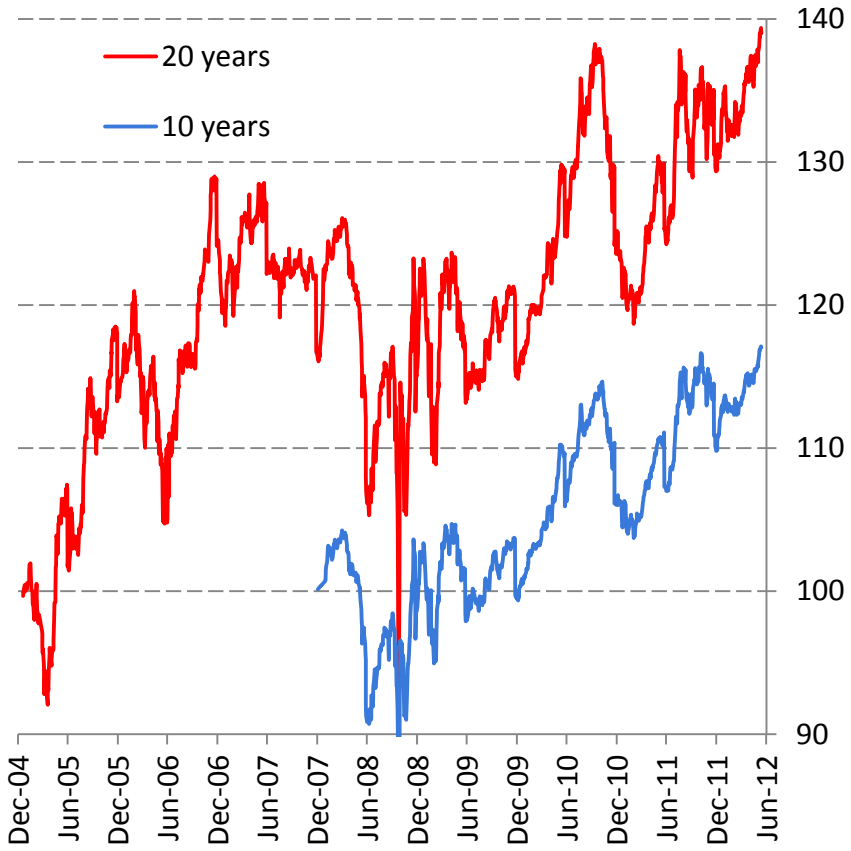


Source: INEGI and Bureau of Economic Analysis

The clearest effect of capital inflows seems to be their contribution to the rising trend of Mexican bond and stock prices

Fixed-rate bond price*

100=face value



*10-year bond issued in December 2007 and 20-year bond issued in December 2004 (both 80% held by non-residents)

Source: Calculations with VALMER and PIP data

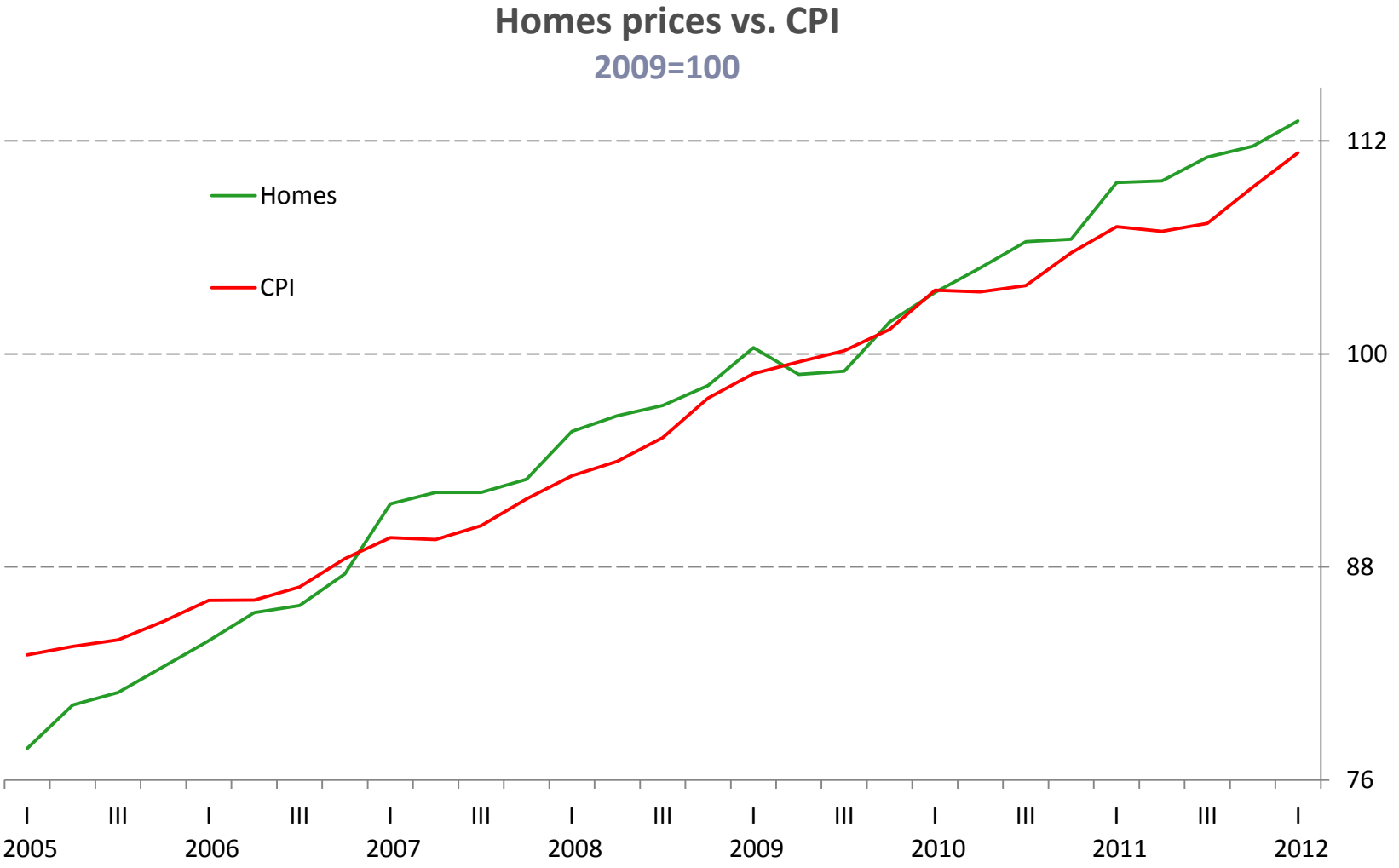
Stock market price index (IPC)

2009=100



Source: Bolsa Mexicana de Valores

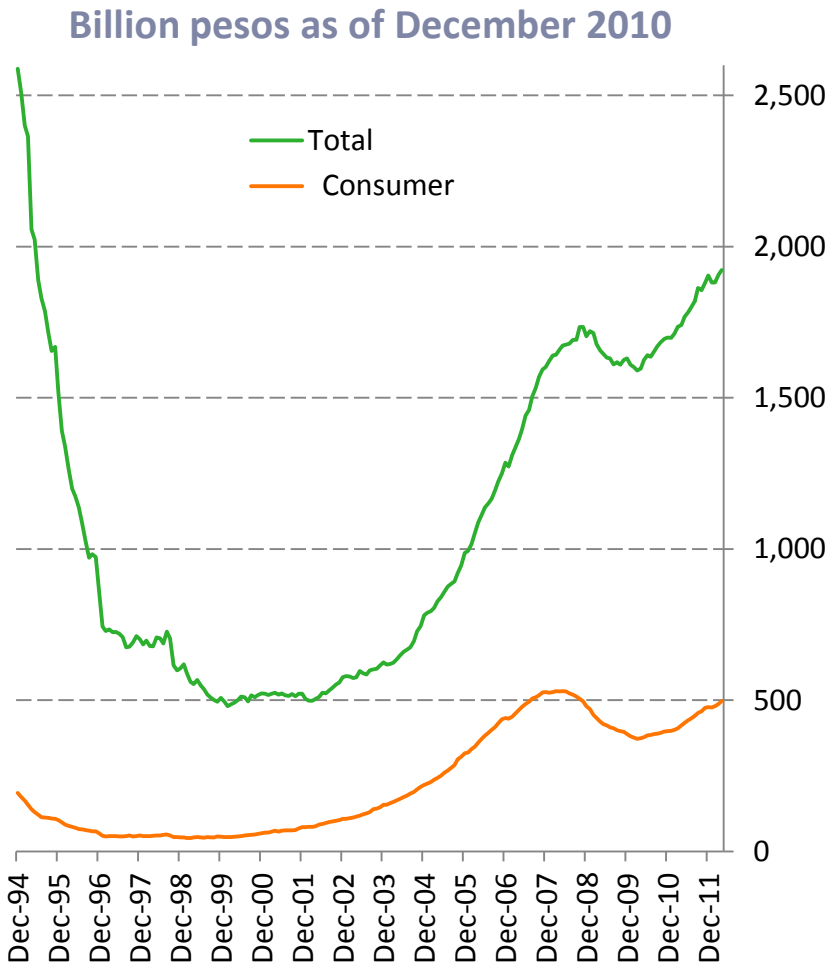
However, there are no visible signs of the second danger in the real estate market



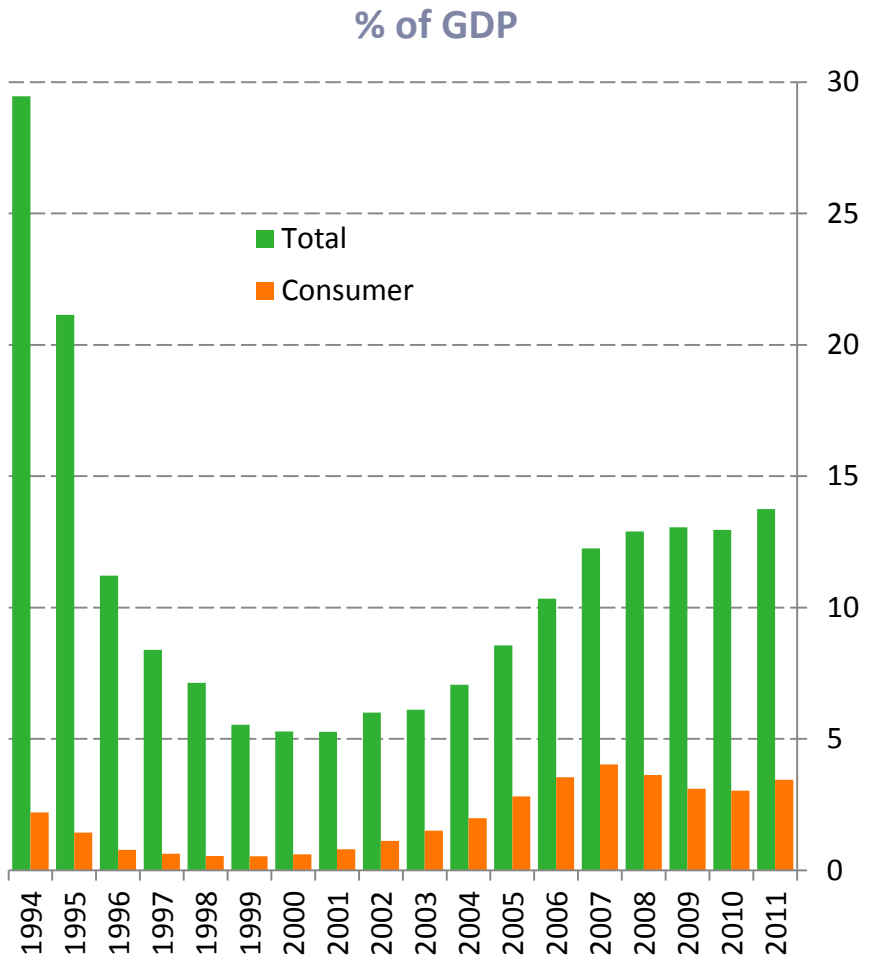
Source: Sociedad Hipotecaria Federal and INEGI

… or in the credit market, which has seen an incipient but recently weakened recovery process

Commercial banks' performing loans to non-financial private sector

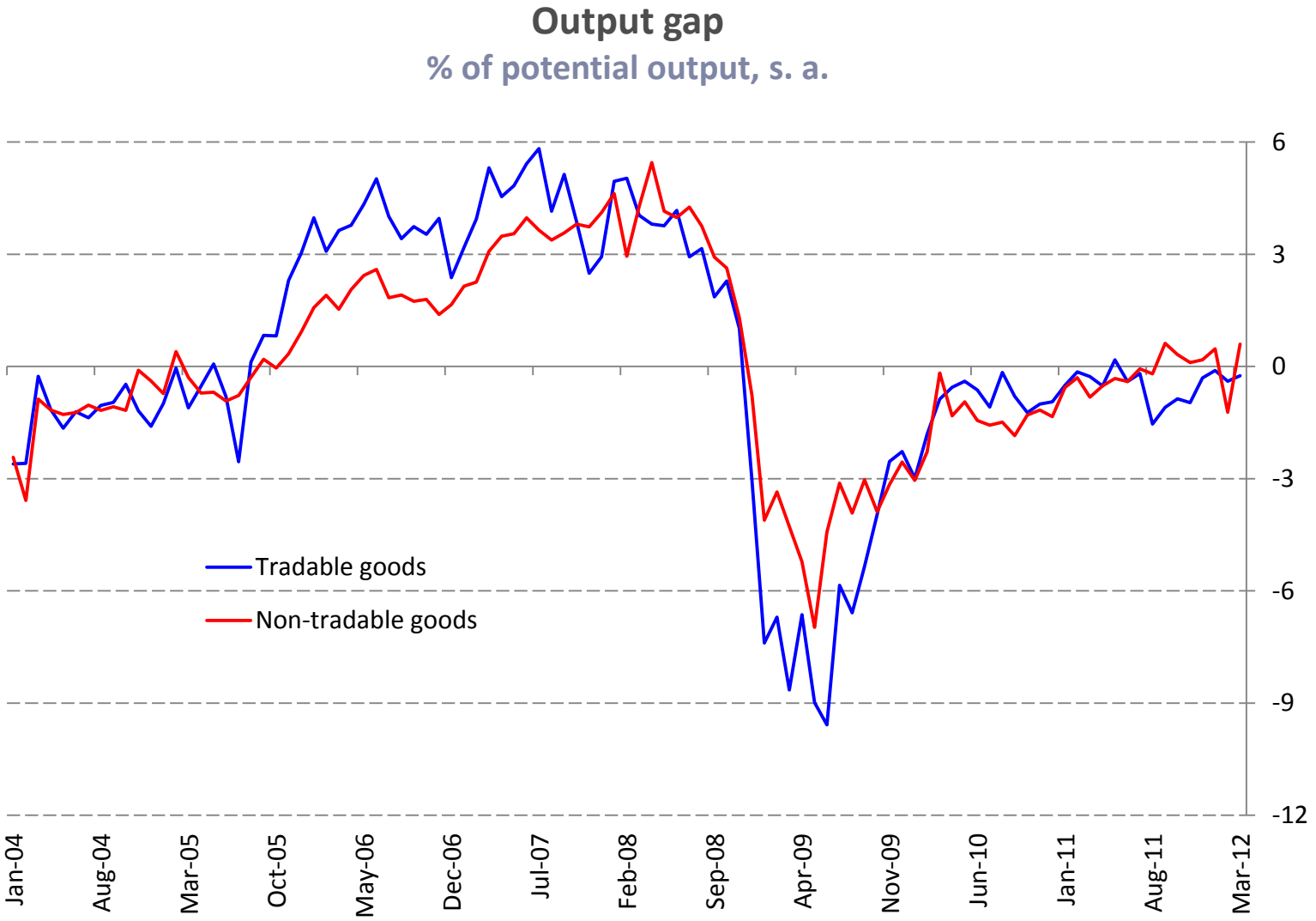


Source: Banco de México



Source: Banco de México and INEGI

… or in the form of significant aggregate demand pressures



s.a./ Seasonally adjusted

Source: Calculated by Banco de México with data from INEGI

The absence of major demand pressures is partly explained by the monetary policy stance and sterilization of international reserves

Sources and uses of the economy's financial resources*

% of GDP, end of period

	2009	Q1 2012	Change
Economy's financial resources	72.4	81.4	9.0
Sources			
M4	56.3	64.2	8.0
Held by non-residents	3.2	9.0	5.8
External financing	16.1	17.2	1.1
Uses			
International reserves	9.4	12.9	3.5
Federal public sector	34.6	36.7	2.0
Private sector	29.6	31.7	2.1
States and municipalities	2.2	2.5	0.4
Other items	-3.4	-2.4	1.0

*/ Figures may not add up due to rounding
Source: Banco de México

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During the last two years the Eurozone has been the most important source of global uncertainty

- Skepticism over long-term fiscal consolidation plans
- Tensions between needed austerity measures and growth
- Increasing market expectations about the size of firewalls
- Banks' rising loan losses, deleveraging and capital requirements
- High funding costs and liquidity pressures faced by banks
- Lack of competitiveness

The main effect on Mexico has been financial, mostly through exchange rate volatility

Exchange rate implied volatility

One-month peso-dollar option, 2008=100



Source: Bloomberg

Exchange rate risk reversal

One-month peso-dollar option, 2008=100

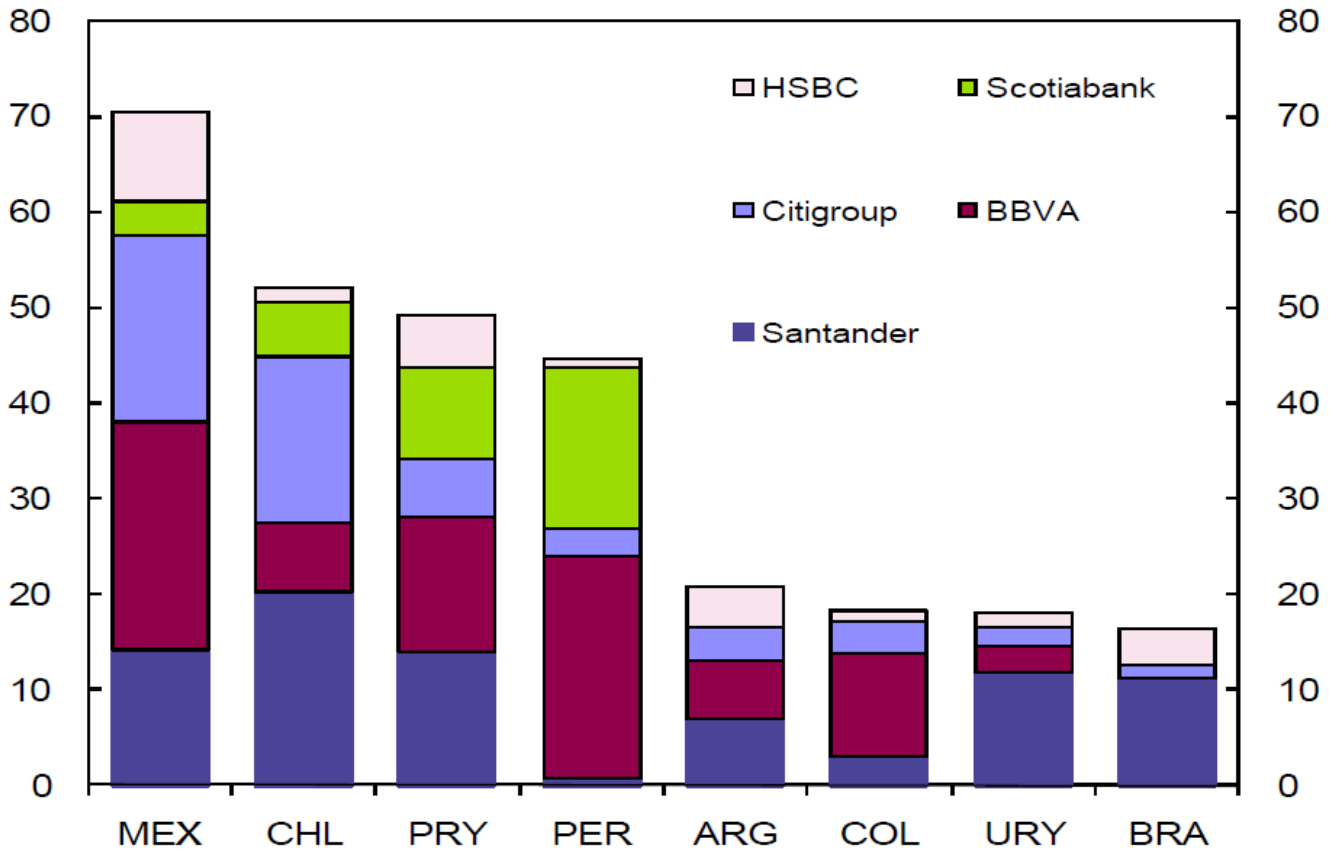


Source: Bloomberg

A possible source of concern is the high participation of Mexican banks with headquarters in the Eurozone

Share of banking assets held in subsidiaries or branches of global banks*

% of total banking system assets, end of 2008



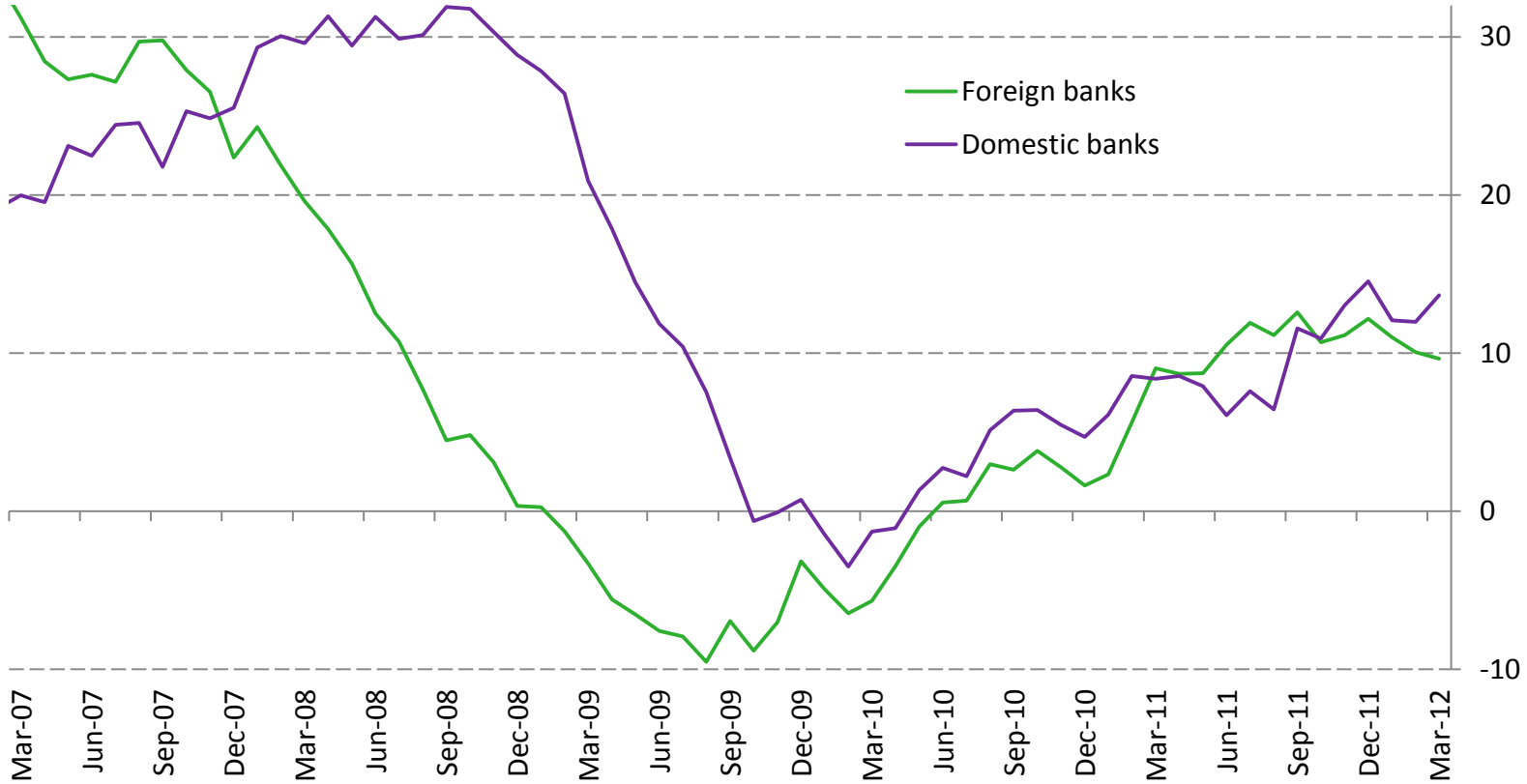
*/ The number of foreign banks may not be exhaustive for some countries, e.g. Mexico

Source: Kamil, H. and K. Rai (2010). "The Global Credit Crunch and Foreign Banks' Lending to Emerging Markets: Why Did Latin America Fare Better?" *IMF Working Paper*, April

Notwithstanding time lags, domestic and foreign bank lending has exhibited similar cyclical behavior

Commercial banks' performing loans to the non-financial private sector*

Real annual change, %



* Data include all foreign and domestic banks in the system

Furthermore, longstanding regulation has shielded financial intermediaries against external shocks

- Foreign banks operate only through subsidiaries
- Regulation for all banks
  - ✓ Capitalization standards
  - ✓ Minimum capital for dividend distribution
  - ✓ Limits on related-party lending
  - ✓ Restrictions on FX transactions
    - Deposits
    - Net liabilities
    - Net open position
    - Liquidity ratio

Banks in Mexico satisfy high capitalization, provisioning and liquidity standards

Banking system indicators

	2006	2009	Q1 2012
Net Capital (% risk-weighted assets)	16.09	16.51	15.73
Tier 1 capital (% net capital)	93.79	88.46	87.78
Past-due loan portfolio (% total loan portfolio)	2.31	3.65	2.94
Provisions for expected losses (% of the past-due loan portfolio)	224.96	161.76	180.40
Liquid assets* (% net cash outflows)	…	427.81	413.40

*/ Calculations based on Basel III liquidity coverage ratio
Source: CNBV and Banco de México

Additionally, the recent crisis has led authorities to implement several macroprudential initiatives

- A faster pace of international reserves accumulation
- IMF flexible credit line
- Mexico's Financial System Stability Council
  - ✓ Identifies systemic risks and proposes policies and solutions

Financial authorities continue monitoring external risks and domestic vulnerabilities

- Risks arising from abroad
  - ✓ Deterioration of the world economy
  - ✓ Spillovers from a worsening of the Eurozone crisis
  - ✓ Sudden capital stops and reversals
- Domestic vulnerabilities
  - ✓ Banking industry highly concentrated
  - ✓ Some banks exposed to liquidity risk if faced with higher market volatility
  - ✓ Some bank portfolios carry a heavy weight of loans to subnational governments

Sources: Consejo de Estabilidad del Sistema Financiero (2012), Informe Anual, March; and IMF (2012), "Mexico: Financial System Stability Assessment", *Country Report* No. 12/65, March

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Since 2009, Mexico has undergone a process of economic recovery along with the U.S. economy

Gross Domestic Product

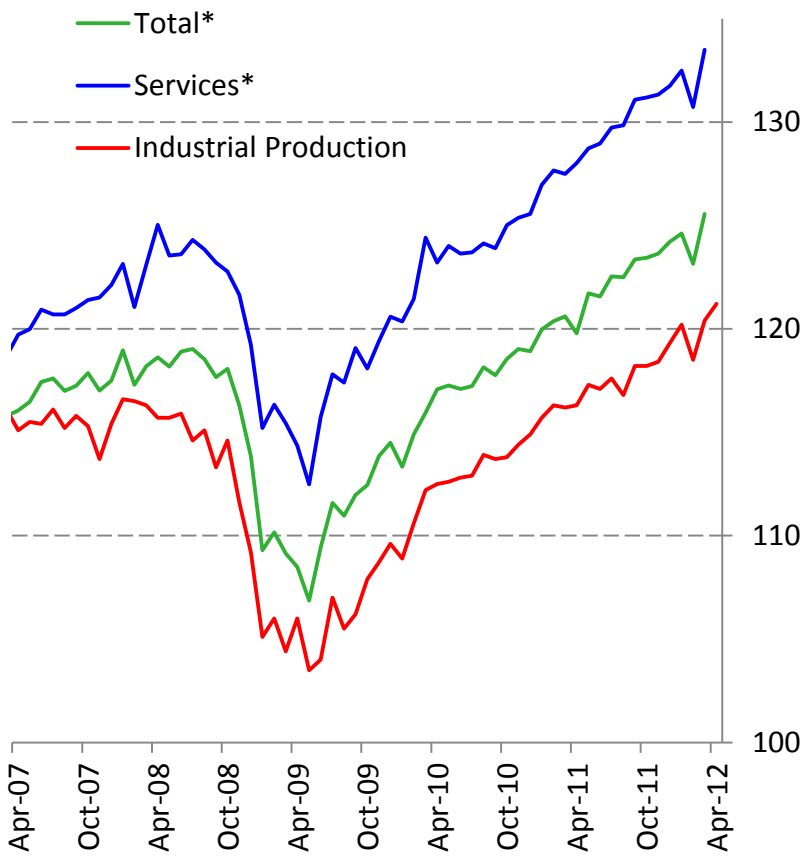
Annual growth, %

	2011		2012
	I	IV	I
Total	4.42	3.85	4.63
Agriculture	-2.92	0.27	6.82
Industrial	5.45	3.49	4.48
Manufacturing	7.45	3.95	5.48
Services	4.19	4.36	4.98

Source: INEGI

Economic activity indicators

2003 = 100, s. a.



s.a./ Seasonally adjusted

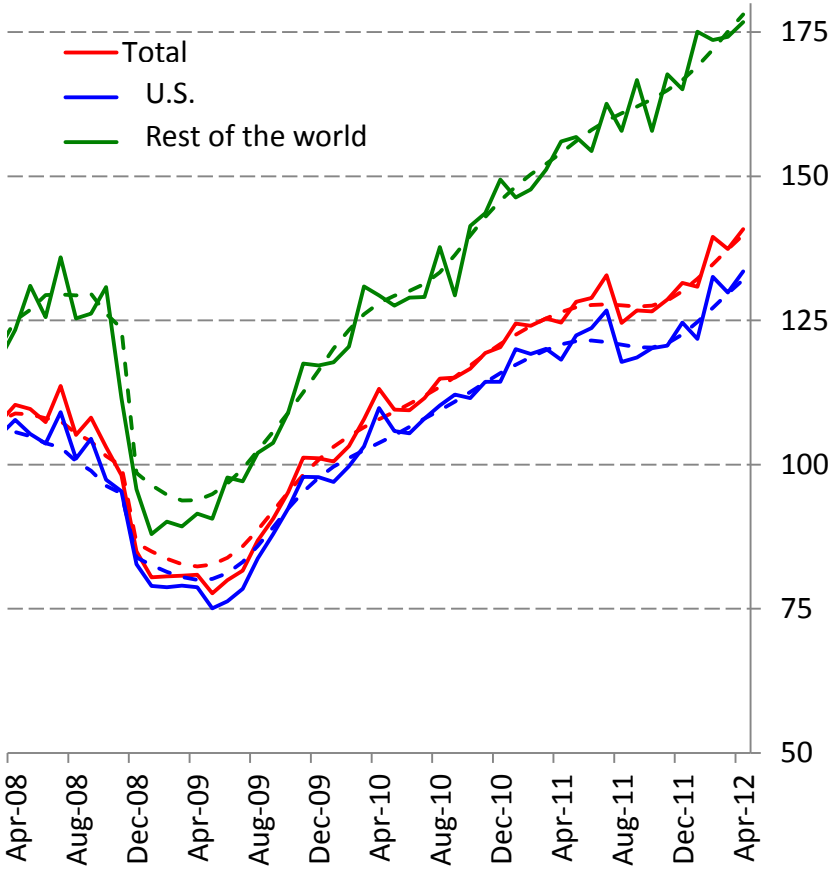
*/ Global Economic Activity data until March 2012

Source: INEGI

Manufacturing exports by sector and destination have continued to post high rates of growth

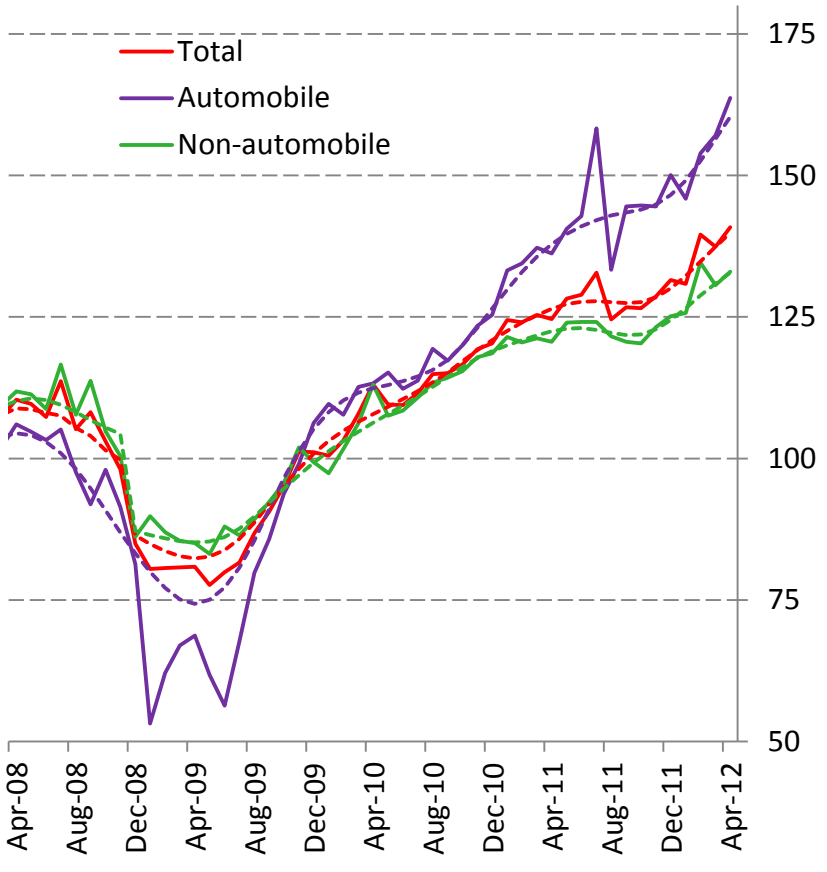
Manufacturing exports

2007=100, s. a.



s.a./ Seasonally adjusted and trend data

Source: Banco de México



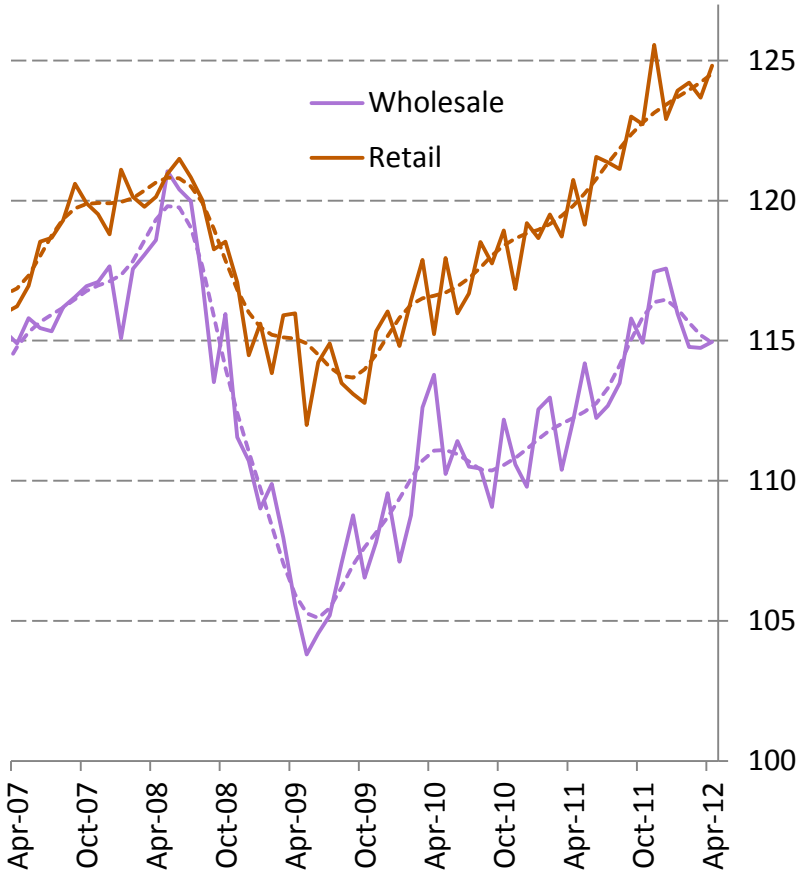
s.a./ Seasonally adjusted and trend data

Source: Banco de México

Also, expansion of sales and investment remains uninterrupted

Wholesales and retail sales

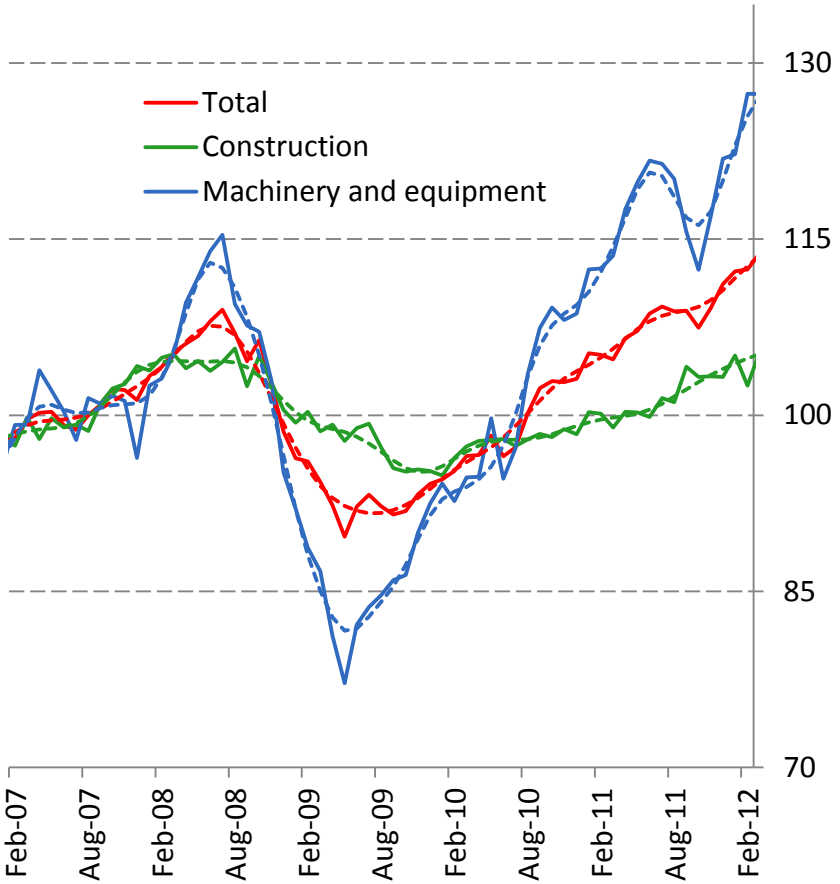
2003 = 100, s. a.



s.a./ Seasonally adjusted and trend data
Source: INEGI

Gross Fixed Investment

2008 = 100, s. a.

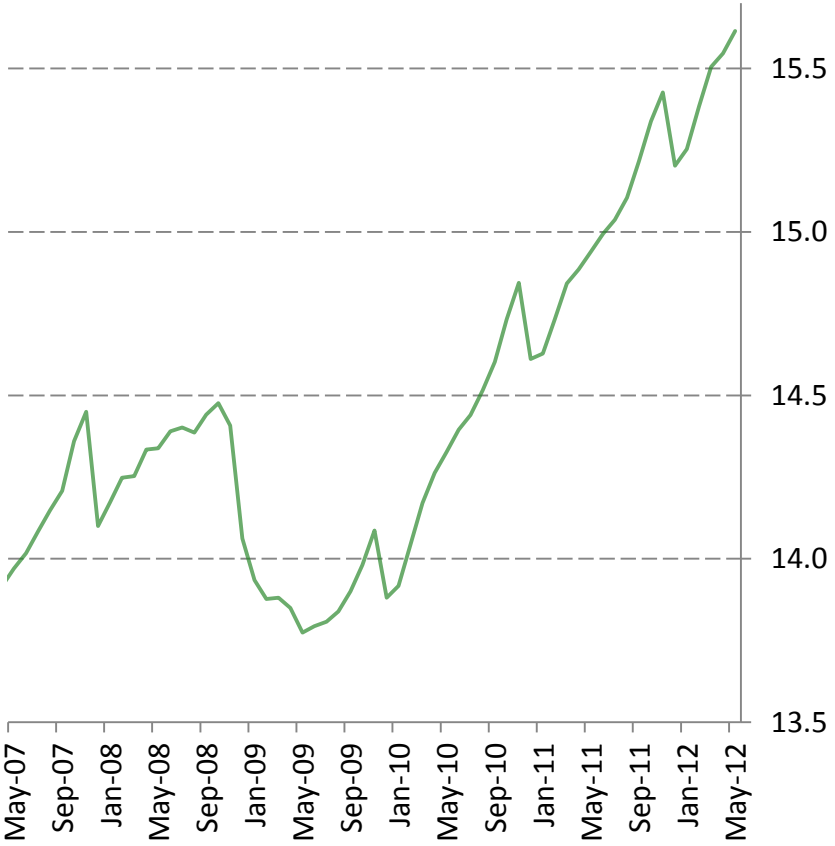


s.a./ Seasonally adjusted and trend data
Source: INEGI

Dynamic domestic demand has been supported by job creation and greater consumer confidence

Formal employment*

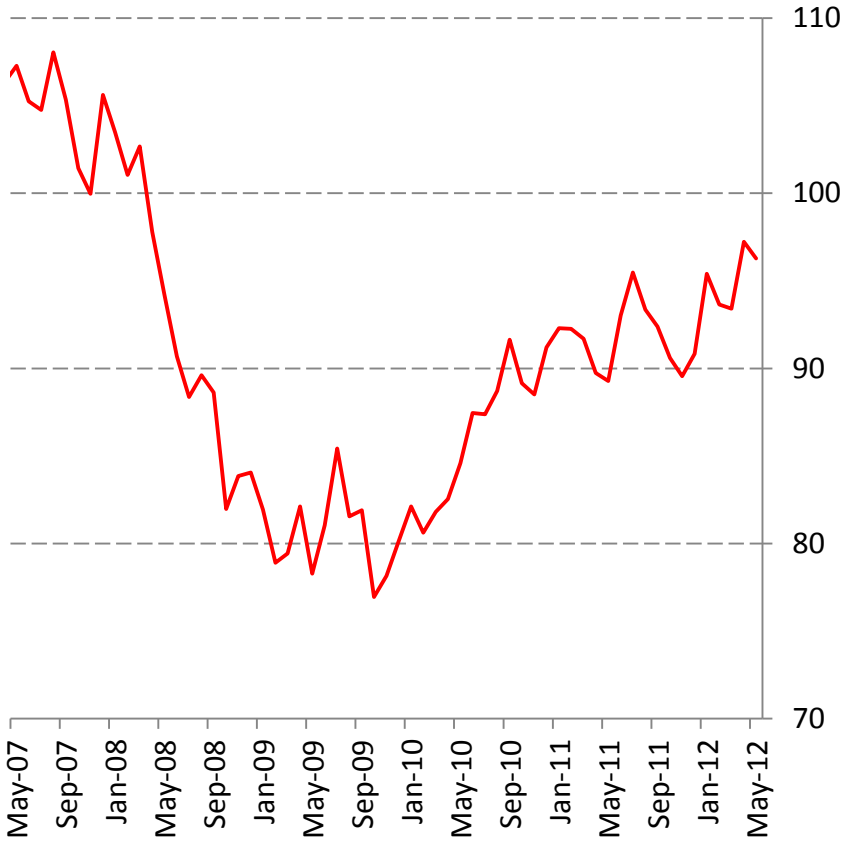
Millions of workers



*/ Workers insured by the Mexican Social Security System (IMSS)
Source: IMSS

Consumer confidence

2003=100

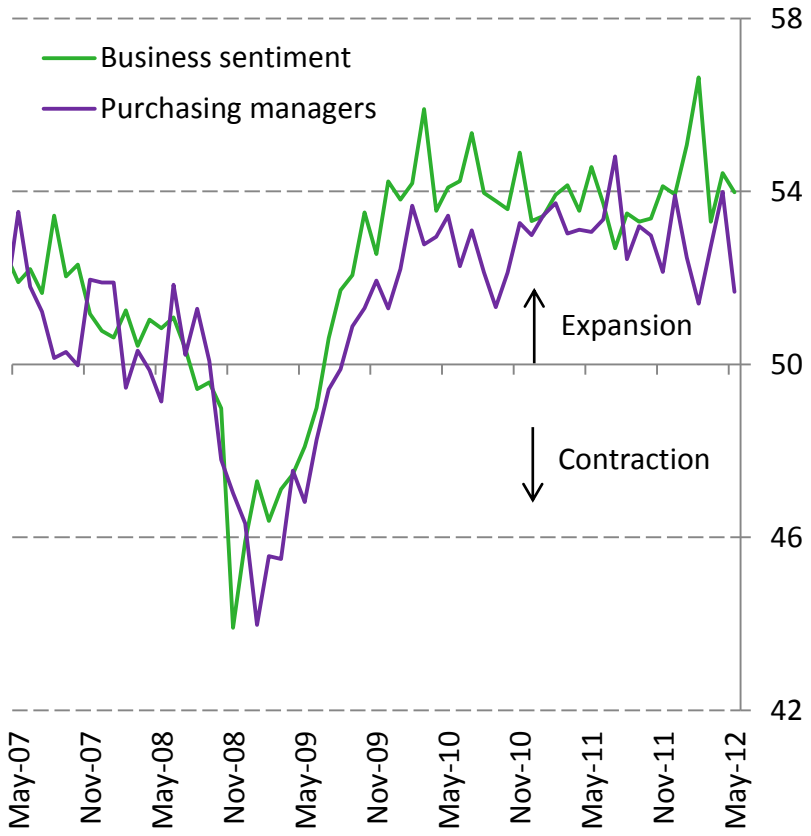


Source: Encuesta Nacional sobre la Confianza del Consumidor (ENCO), INEGI and Banco de México

... as well as an improvement in business perception and the expansion of credit

Prospective indicators for manufacturing

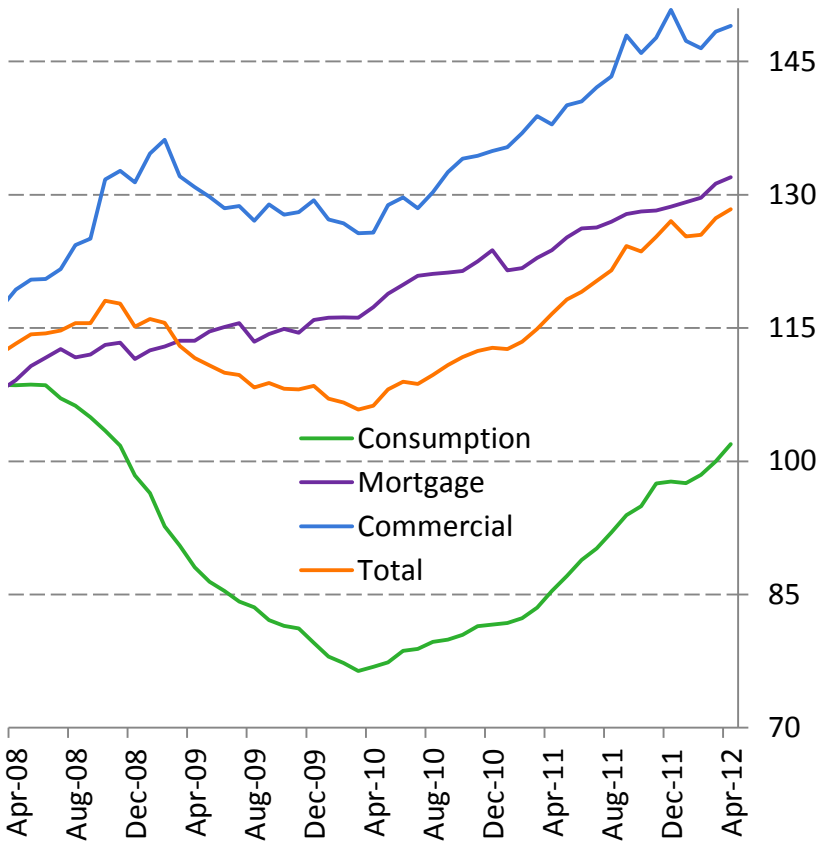
50 points reference; s. a.



s.a./ Seasonally adjusted
Source: Banco de México, INEGI and IMEF

Commercial banks' performing loans to the non-financial private sector

2007=100



Source: Banco de México

The Mexican economy is expected to continue growing at a stable, moderate pace

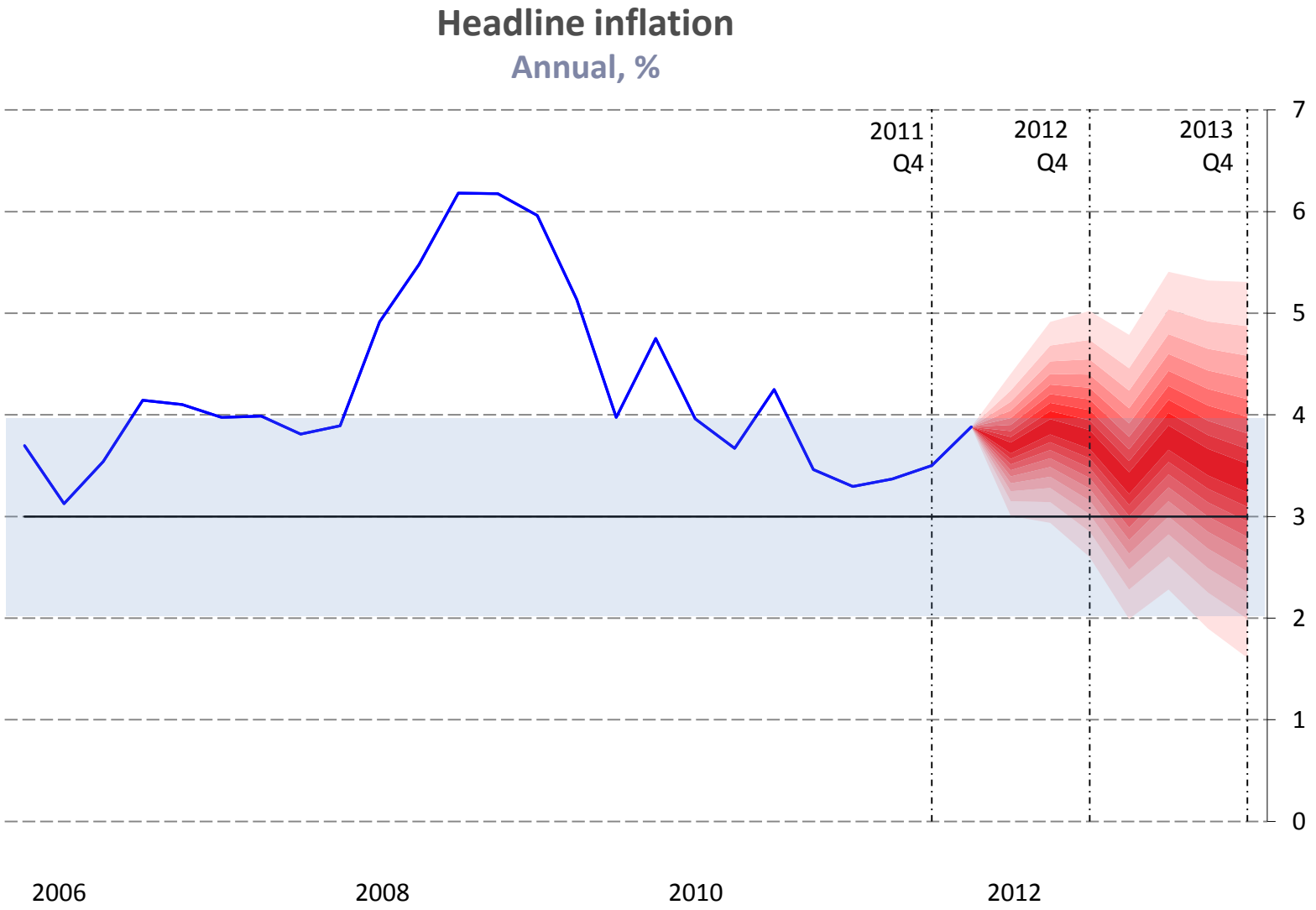
GDP

Change, %

	2011	2012^{F}	2013^{F}	2014^{F}
World	3.9	3.5	4.1	4.4
U.S.	1.7	2.1	2.4	2.9
Mexico	**4.0**	**3.6**	**3.7**	**3.8**

Source: IMF (2012), *World Economic Outlook*, April

The most likely inflation path will lie within a 3-4% interval



Source: INEGI and Banco de México

Finally, there are risks to both output growth and inflation

- Output
  - ✓ Lower-than-anticipated expansion of the U.S.
  - ✓ Global economic weakening due to a worsening of Eurozone problems
- Inflation
  - ✓ Persistent weakness of the peso and greater-than-expected pass-through to prices
  - ✓ Aggregate demand pressures

Final remarks

- Inflation has been converging towards the permanent target
- Wide yield spreads have drawn capital inflows which have contributed to high bond and stock prices
- No clear signs of a bubble in the real estate and credit markets or excessive pressures on aggregate demand
- The main effect of global turmoil in Mexico has been FX volatility
- Banks in Mexico meet high capitalization, provisioning and liquidity standards. Several macroprudential initiatives are in place
- Since 2009, Mexico has undergone a process of economic recovery and is expected to continue growing at a stable, moderate pace



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