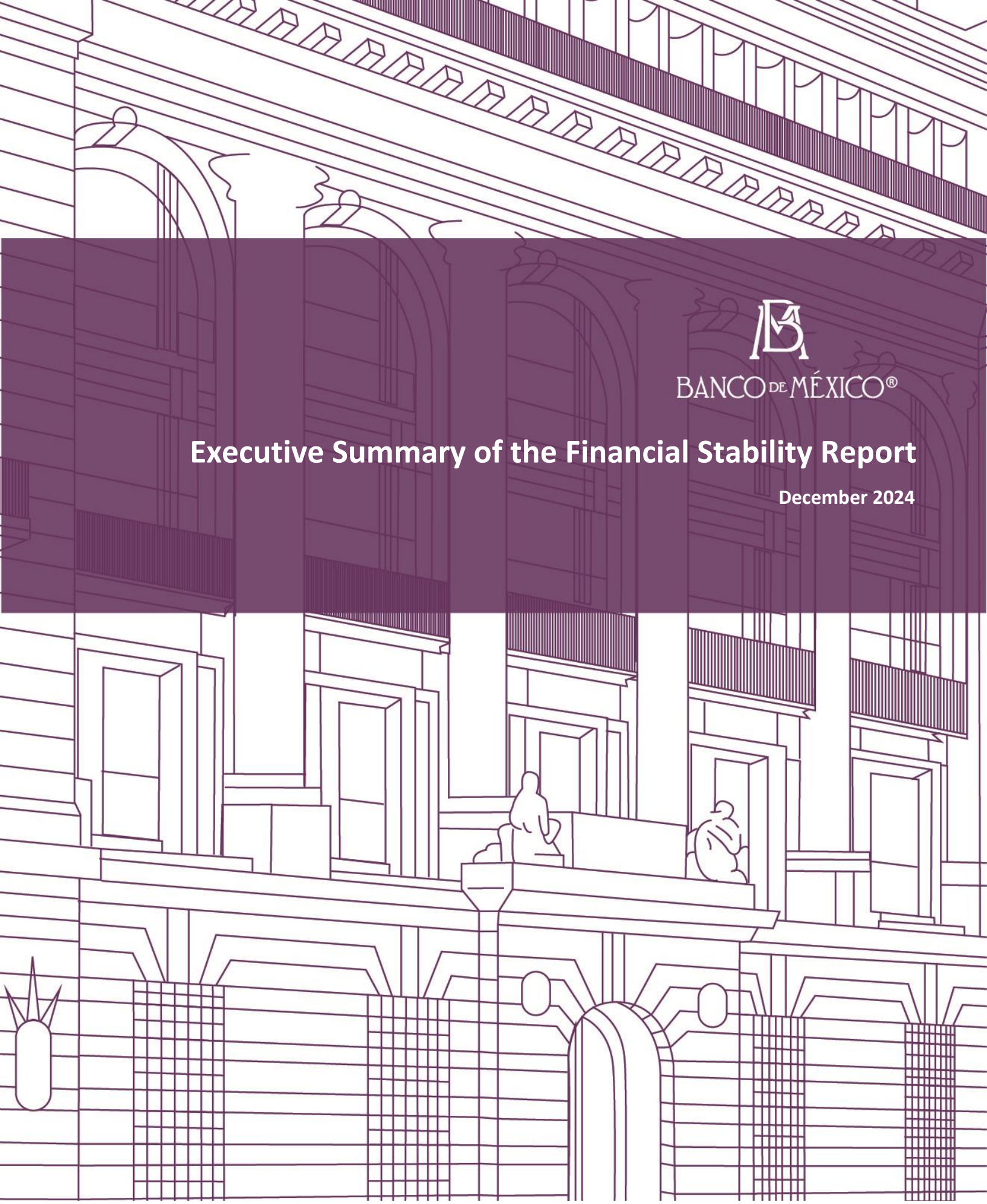


BANCO DE MÉXICO®

Executive Summary of the Financial Stability Report

December 2024

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Executive summary

The Mexican financial system maintains a solid and resilient position, in the context of an international environment characterized by slower global economic growth, rising geopolitical tensions, and the beginning of a cycle of monetary policy adjustments in advanced economies towards less restrictive stances. The global economy has demonstrated resilience in light of the disinflation process and has thus far avoided a recession.

Domestic economic activity exhibited marked weakness during the second quarter of 2024, although GDP registered seasonally adjusted quarterly growth of 1.1% in the third quarter. The domestic financial system has remained stable due to the soundness of its institutions. Commercial banks have maintained capital and liquidity levels above the regulatory minimums, as well as increasing assets and profitability. While vulnerabilities and risks to financial stability are considered to be limited overall, unexpected or severe shocks could disrupt the proper functioning of the financial sector. Therefore, it is necessary to remain vigilant and to monitor potential risks in the context of the current complex and uncertain global environment.

This *Report* groups the main identified risks in two categories:

1. **Macrofinancial risks**: risks that could arise from the deterioration of aggregate financial and macroeconomic variables, both domestically and internationally.

2. **Risks inherent to the financial system**: these include vulnerabilities and risks emanating from different sectors of the economy that the financial system serves, namely, households, firms, the public sector, and financial institutions. In addition, this risk category also includes disruptions that could occur in the financial markets and payment systems.

This *Report* analyzes the following macrofinancial risks that, if realized, could affect the stability of the Mexican financial system: i) unexpected shifts in global financial conditions relative to expectations; ii) the escalation of geopolitical tensions or trade conflicts; iii) a systemic event with implications for the global financial system; iv) a further weakening of the domestic economy, and v) unforeseen adjustments in the credit ratings of key domestic issuers.

Aggregate risk indicators show that, first, financial conditions in Mexico have tightened further and remain restrictive. Second, based on Banxico's macro-financial vulnerabilities index (a forward-looking, early-warning indicator), the Mexican economy as a whole does not exhibit significant vulnerabilities in any of the analyzed sectors: financial, real, external, and public. Third, Banxico's financial market stress index for Mexico increased slightly and remains at high levels, mainly due to increased volatility in variables associated with debt, foreign exchange, and stock markets. Finally, risks in the Mexican financial system, tracked using heat maps, remain at levels similar to that observed in the previous *Report*.

Macrofinancial Conditions

International Environment

Global economic activity decelerated during the second quarter of 2024, with slower growth registered in emerging economies and faster growth in advanced ones. Global growth is expected to have remained stable in the third quarter, with mixed performance across countries. The International Monetary Fund's (IMF) projections for annual global growth for 2024 and 2025 remained unchanged. The IMF highlighted the resilience of the global economy amid disinflation, avoiding a recession, and foresaw stable growth ahead. US growth prospects also improved, compensating for the declines in other advanced economies. However, downward risks persist, especially in emerging economies, mainly due to geopolitical tensions and potential financial volatility.

During the second and third quarter of 2024, inflation diverged significantly across countries. In some advanced economies, such as the United States, annual inflation decreased due to declines in services and energy prices. In contrast, some emerging economies registered an increase in inflation in the second quarter, although in most of them it declined during the third quarter.

In light of the above, some of the main central banks in advanced economies began a rate-cutting cycle, and some emerging economies continued lowering their reference rates. The US Federal Reserve (Fed) kept its target range for the federal funds rate unchanged in June and July 2024, but implemented rate cuts in September and November, reflecting its readiness to adjust monetary policy according to economic conditions.

Domestic Environment

In the second quarter of 2024, economic activity exhibited weakness, with GDP growth of 0.4%. However, in the third quarter, GDP rose at a rate of 1%, reflecting an increase in activity in the three major economic sectors. Inflation accelerated from 4.77% in the second quarter to 5.04% in the third, driven by atypical pressures on energy prices and on agricultural and livestock product prices. However, these pressures started easing in August, and core inflation continued slowing due to monetary policy tightening measures implemented and the fading effects of global shocks. For the month of November, headline inflation decreased to 4.55%.

Banco de México's Governing Board maintained the reference rate at 11% in June and lowered it by 25 basis points at each of the August, September and November meetings. Since November 15, the reference rate has been at a level of 10.25% and, based on the latest Quarterly Report, headline inflation is expected to converge to its target by the fourth quarter of 2025. The Governing Board reaffirmed its commitment to ensure monetary policy remains consistent with the trajectory needed to achieve their price stability goal.

The Mexican peso exhibited considerable volatility and a sizable depreciation, largely attributable to global influences and the evolving idiosyncratic risk environment. Notwithstanding these circumstances, the Mexican financial markets remained relatively stable.

The economic environment will continue to be complex, with multiple risk factors at play. Despite the encouraging rate of economic growth observed in the third quarter, projections suggest a challenging outlook. This highlights the need to focus vigilantly on the risks that could affect the Mexican financial system.

Total financing to the Mexican economy increased in real terms to a level of 97% of GDP, 57% of which went to the public sector, 25% to non-financial companies, and the remainder to households (consumption and housing).

Risks identified in the financial system

Banco de México employs a dual approach to risk assessment, using both qualitative and quantitative indicators to evaluate macrofinancial risks and inherent risks within the financial system. The main findings are summarized below:

Households

- As of September 2024, average household leverage, measured as the ratio of monthly income available to pay down debt, remained at levels similar to those a year ago. However, said leverage was higher among lower-income borrowers.

- The total stock of consumer loans increased in real annual terms, albeit at a lower rate than in the previous *Report*. In the banking sector, non-performing loan rates on payroll and personal loans trended downwards, as a result of growth of their performing portfolios. Non-performing loan rates on credit card and automotive loans showed little change.

- These data suggest that, despite the complex economic environment, demand for consumer credit remains strong. Stability in the probability of default for most new loans suggests resilience among borrowers. However, the modest uptick in revolving credit defaults merits close observation, though it remains at relatively moderate levels.

- In September, total mortgage loans rose slightly, with a rebound in the Infonavit housing portfolio and stability in bank loan originations. Non-performing loan rates in this segment of the bank loan portfolio remained at historically low levels, although

exhibiting an upward trend. The non-performing loan rate in Infonavit decreased; however, in Fovissste, it increased and is at high levels relative to its previous performance.

Businesses

- Total financing to non-financial private firms in Mexico increased in real annual terms up until September. Domestic credit has grown through its main sources: bank credit, non-bank credit, and debt issuance. In contrast, external financing to this sector has contracted for sixteen consecutive quarters, affected by a decrease in international bank credit and lower debt issuance abroad.

- Despite lower growth rates since the beginning of 2024, lending to non-financial private firms increased, among both large- and other types of companies. Non-performing loan rates remained stable in the banking portfolio, although non-performing loans rose marginally for smaller firms. Banxico's vulnerability index of listed non-financial private companies deteriorated slightly, which was related to those firms' leverage, profitability, and debt-service capacity. The annual operating cash flow generation of these companies has declined in real terms for the ninth consecutive quarter, although at a slower pace of contraction. Despite these challenges, the banking system's exposure to vulnerable businesses is low in relation to its regulatory capital.

Public Sector

- The Public Sector Borrowing Requirements (RFSP, for its acronym in Spanish) are expected to reach 5.9% of GDP by the end of 2024, based on Federal government projections. Public debt, as a share of GDP, remains within an adequate range, while state and local government debt levels are considered, for the most part, sustainable.

Banking sector

- Commercial banks maintain high capitalization and liquidity levels that exceed regulatory minimums. The stress tests confirmed that the banking system, in aggregate, has the capacity to absorb significant shocks.

- Liquidity and credit risks remained stable and limited, while market risk decreased slightly and contagion risk increased marginally.

Cyber and climate-related risks

- Cyber risks related to the increasing use of Artificial Intelligence (AI) and the digitalization of finance are a global concern. However, cybersecurity levels in Mexico are adequate.

- Climate-related risks pose a threat to the stability of the financial system as a whole, which is why Banco de México, in collaboration with other authorities, monitors and assesses their adverse impact on the economy and the financial sector. This analysis is shared with financial institutions for their knowledge and to promote risk mitigation. In particular, the latest analysis identified that commercial banks decreased their direct exposure to transition risks, while indirect exposure increased.

Policy Measures Implemented

Banco de México introduced exceptions to facilitate the transition to reference rates based on real operations, allowing the use of the Interbank Equilibrium Interest Rate (TIIE, for its acronym in Spanish) in certain operations until 2026. Amendments were also made to regulate hedge funds and improve the supervision of derivative transactions. The CNBV updated the *Circular Única de Bancos* (CUB, for its acronym in Spanish) to strengthen internal controls, regulate technological commission agents, as well as to adjust capital requirements for operational risk. Finally, guidelines for the simplified registration of securities in the National Securities Registry were released for public consultation through the National Regulatory Improvement Commission (Conamer, for its acronym in Spanish),

which will facilitate access to financing through simplified issuances.

Final remarks

Banco de México remains vigilant about the health of Mexico's financial markets and will take the necessary measures, in coordination with other authorities, in exercise of its powers and in strict compliance with the legal framework, to preserve the stability of the financial system and the proper functioning of the payment systems.



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