Outline

1. Balance from the global financial crisis
2. Current economic conditions and outlook
3. Monetary policy
4. Policy challenges
The effects of the global crisis on Mexico’s financial markets were relatively contained

- High volatility in asset prices mainly during 4Q08-1Q09
- Flexible exchange rate system as a shock absorber
- Banking system’s resilience
  - No previous real estate/credit bubbles
  - Moderate deterioration of loan portfolio quality
  - No liquidity shortages
  - Adequate capital
Economic policy measures were prudent and temporary

- Actions to stabilize the financial system
  - FX interventions by the central bank
  - Extended liquidity facility
  - Other measures to restart lending and stabilize financial markets
- Monetary policy adjustment
  - Lower interest rates
- Countercyclical fiscal policy
  - Moderate rise in public debt to GDP ratio
However, the negative effect in terms of output contraction was substantial

- Sharp output fall largely due to global trade reduction
  - GDP decreased by 6.1% in 2009
  - Between Q208 and Q209 per capita GDP plummeted by more than 10%
- Moreover, inflation convergence deviated from its long-term 3% target
  - Pressures from commodity prices, currency depreciation, and higher taxes
Outline

1. Balance from the global financial crisis
2. Current economic conditions and outlook
3. Monetary policy
4. Policy challenges
The outlook for the Mexican economy is one of continued economic growth.

<table>
<thead>
<tr>
<th></th>
<th>2010</th>
<th>2011&lt;sup&gt;e&lt;/sup&gt;</th>
<th>2012&lt;sup&gt;e&lt;/sup&gt;</th>
</tr>
</thead>
<tbody>
<tr>
<td>US GDP</td>
<td>2.9</td>
<td>2.6</td>
<td>3.1</td>
</tr>
<tr>
<td>US industrial production</td>
<td>5.3</td>
<td>4.5</td>
<td>4.1</td>
</tr>
<tr>
<td>Mexico’s GDP</td>
<td>5.5</td>
<td>4.0-5.0</td>
<td>3.8-4.8</td>
</tr>
</tbody>
</table>

<sup>e</sup>/ estimated
Source: Blue Chip, June 2011 and Banco de México

![Mexico’s Output Growth Fan Chart](image)

Source: Banco de México

---

The Mexican Economy: Outlook and Challenges
Along with the US, since 2H09 the Mexican economy has been exhibiting a recovery.

Global Economic Activity
January 2007 = 100; s.a.

Industrial Production
January 2007 = 100; s.a.

Source: INEGI
... which initially stemmed from the upturn in external demand
This recovery has gradually incorporated the main components of domestic demand.
The economic rebound has been supported by shrinking unit labor costs.

**Unemployment Rate**

- % s.a.

**Unit Labor Cost***

- January 2007=100; s.a.

*Defined as labor cost per unit of manufacturing product

Source: Banco de México with INEGI data
Public finances have remained healthy and the banking system well capitalized

**Stock of Public Sector Borrowing Requirements**

<table>
<thead>
<tr>
<th>Year</th>
<th>% of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>30.7</td>
</tr>
<tr>
<td>2001</td>
<td>32.1</td>
</tr>
<tr>
<td>2002</td>
<td>34.6</td>
</tr>
<tr>
<td>2003</td>
<td>34.5</td>
</tr>
<tr>
<td>2004</td>
<td>31.5</td>
</tr>
<tr>
<td>2005</td>
<td>30.6</td>
</tr>
<tr>
<td>2006</td>
<td>29.1</td>
</tr>
<tr>
<td>2007</td>
<td>27.8</td>
</tr>
<tr>
<td>2008</td>
<td>33.3</td>
</tr>
<tr>
<td>2009</td>
<td>34.7</td>
</tr>
<tr>
<td>2010</td>
<td>34.9</td>
</tr>
</tbody>
</table>

Source: Ministry of Finance (SHCP)

**Commercial Banks’ Capital Adequacy Ratio**

<table>
<thead>
<tr>
<th>Year</th>
<th>Capital Adequacy Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>14.32</td>
</tr>
<tr>
<td>2006</td>
<td>16.09</td>
</tr>
<tr>
<td>2007</td>
<td>16.12</td>
</tr>
<tr>
<td>2008</td>
<td>16.15</td>
</tr>
<tr>
<td>2009</td>
<td>17.28</td>
</tr>
<tr>
<td>2010</td>
<td>16.55</td>
</tr>
</tbody>
</table>

1/ Capital adequacy ratio: net capital / risk-weighted assets

Net capital: basic capital + complementary capital

Source: CNBV

The Mexican Economy: Outlook and Challenges
Hence the recovery has also been supported by a steady return of bank lending to the private sector.

**Commercial Banks’ Loans to Private Sector**

January 2007=100

![Graph showing Commercial Banks’ Loans to Private Sector](image)

**Adjusted Delinquency Rate**

%  

![Graph showing Adjusted Delinquency Rate](image)

*Past due loans plus previous 12-month write-offs to outstanding loans plus previous 12-month write-offs*  

Source: Banco de México

*Source: Banco de México*
Along with a lower “country-risk” perception, the Mexican peso has been appreciating against the US dollar.
... while portfolio capital inflows have been booming

**Government Securities Holdings***

**Billion pesos**

<table>
<thead>
<tr>
<th></th>
<th>Jun-06</th>
<th>Sep-06</th>
<th>Dec-06</th>
<th>Mar-07</th>
<th>Jun-07</th>
<th>Sep-07</th>
<th>Dec-07</th>
<th>Mar-08</th>
<th>Jun-08</th>
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</thead>
<tbody>
<tr>
<td><strong>Foreign investors</strong></td>
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<tr>
<td><strong>Pension funds</strong></td>
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</tbody>
</table>

*Includes CETES and fixed-rate bonds
Source: Banco de México

**International Reserves**

**Billion dollars**

<table>
<thead>
<tr>
<th></th>
<th>Jun-06</th>
<th>Sep-06</th>
<th>Dec-06</th>
<th>Mar-07</th>
<th>Jun-07</th>
<th>Sep-07</th>
<th>Dec-07</th>
<th>Mar-08</th>
<th>Jun-08</th>
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</tbody>
</table>
The main risks for Mexico’s economic outlook are external

- US economic slowdown
- EMU financial disruption
- Sustained high oil prices
- Deeper-than-expected recession in Japan
Outline

1. Balance from the global financial crisis
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The Mexican Economy: Outlook and Challenges
After a long history of high and volatile inflation, Mexico has been converging towards price stability.
Main progress against inflation has occurred during this century

- Mexico formally implemented an inflation targeting regime in 2001

- Targets have gone from 10% in 2000 to 3% since 2003

- The monetary policy instrument shifted from a quantity reference to an overnight interest rate
After a spike during the crisis, annual inflation has been nearing its long-term target.
Lower inflation has greatly benefited from a negative output gap

Output Gap*
% of potential GDP

* Estimates based on a Hodrick-Prescott filter with tail corrections; see Banco de México (2009), “Inflation Report, April-June 2009 “, p.74

The shaded area is the 95% confidence interval of output gap calculated with an unobserved components method. Based on the Global Economic Activity Index (IGAE) to March 2011 and GDP data to Q111

Source: Banco de México with INEGI data
Due to lower expected inflation and a better “country-risk” perception, the yield curve in Mexico has shifted downward.

![Yield Curve](image)

**Source:** US Treasury

**Source:** Banco de México

**The Mexican Economy: Outlook and Challenges**

22
Annual inflation is expected to continue its convergence towards the 3% target.
A central challenge for remaining on this path is the divergence of inflationary expectations with the central bank’s target.

![Inflation Expectations](image)

End of 2011

Survey averages %

Medium term

End of 2012

Next 4 years

Next 5 to 8 years

Source: Banco de México
The outlook for inflation faces several risks

✓ Shrinking output gap
✓ Currency depreciation
✓ Volatile commodity prices
✓ Public sector price adjustments
Outline

1. Balance from the global financial crisis
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Mexico’s main challenge is to enhance long-term economic growth

Per capita GDP*
1955=100; PPP based

* / Prices of 2005
Source: Penn World Tables 7.0
The secular problem of the Mexican economy has been a weak total factor productivity

Growth Accounting for Mexico*
(1980=100)

Stability tasks include strengthening both public finances and the banking system

- Public finances
  - Tax efficiency and less dependence on oil
  - Better composition of expenditures
  - Stronger federalism

- Banking system
  - Microprudential: capital and liquidity standards
  - Macroprudential: measurement and early detection of systemic risk (including shadow banking)
  - Bank resolution mechanism: powers and tools, cross-border dimension
Structural reforms should be geared to improving economic incentives

- Stronger and more efficient institutions
  - Rule of law
- Higher quality of education
  - Competition between schools
- Legal labor market flexibility
- Further elimination of barriers to entry and competition, e.g.,
  - Energy
  - Telecommunications
Conclusions

- While relatively contained in financial markets, the global crisis had a significant negative effect in terms of output contraction.
- After having regained its pre-crisis level, the Mexican economy is expected to continue growing in 2011-2012. Main risks for this outlook are external.
- Annual inflation will continue its convergence to the 3% target.
- Structural reforms to attain higher prosperity should be geared towards fostering total factor productivity.
Mejoran las perspectivas económicas mundiales