The Euro, the U.S., and the Mexican Economy
Manuel Sánchez, Member of the Governing Board

Bonds & Loans Mexico, Mexico City, November 16, 2011
1. The painful journey of the euro

2. The unusual U.S. economic recovery

3. Mexico’s economic outlook
The Eurozone is afflicted by mounting financial problems stemming from heightened sovereign and bank risks.

Credit Default Swaps
5 years, basis points

Source: Bloomberg
The critical financial situation has dampened the economic recovery and aggravated unemployment rates.
Ironically, the current problems are the sequel to the initial success of the euro, allowing convergence to lower inflation.
...hence making borrowing more accessible for all countries.

Interest Rate
%

Source: Government bonds, IFS
...while speeding up the process of real economic convergence

Real GDP per capita
PPP adjusted; constant 2005 US dollars

Source: Penn World Table 7.0
However, massive capital inflows led to overspending and real exchange rate misalignment in the peripheral countries.

**Current account balance % of GDP**

![Graph showing current account balance as % of GDP from 1990 to 2010 for various countries.](Source: IMF)

**Effective Real Exchange Rate 1999=100**

![Graph showing effective real exchange rate from 1999 to 2010 for various countries. Depreciation indicated by arrow.](Source: BIS)
and credit and asset bubbles in some economies

Domestic credit to private sector
(% of GDP)

Source: World Bank
The generalized worsening of the fiscal position was mainly a result of the financial crisis.

**Gross Public Debt**

- Portugal
- Germany
- Greece
- Ireland
- Italy
- Spain

**Primary Balance**

- Portugal
- Germany
- Greece
- Ireland
- Italy
- Spain

Source: IMF
The complexity of current euro area economic conditions includes worrisome feedback loops.

- **Sovereign risk and weak fiscal position**
- **Bank risk, financial losses and contagion**
- **Deleveraging and economic slowdown**
Some structural elements make adjustment more difficult

- Asymmetric balance-of-payments shocks
- Insufficient labor mobility due to market rigidities
- The limitations of countercyclical fiscal policy measures
- The impossibility of country-specific monetary policy and exchange-rate adjustment
The solution cannot be based only on austerity programs, or on ever-increasing rescue funds

- Debt restructuring
- A credible long-term fiscal consolidation plan
- Market-based bank capitalization
- Reforms that foster productivity
- A supranational authority for fiscal supervision and control
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A U.S. economic recovery has not been as slow as the current one since the Great Depression

U.S. Actual and Potential GDP
Billions of dollars as of 2000

Based on Bureau of Economic Analysis data and Economic Projections from Federal Reserve Board Members and Federal Reserve Bank Presidents, November 2011
This is even more striking given the unprecedented monetary and fiscal expansionary policies.
Although recent data reflect some economic slowing, the probability of another recession has apparently diminished.
Overcoming the obstacles to economic recovery goes beyond policies that stimulate aggregate demand

- A more favorable business environment
- Certainty on economic policy, particularly regarding fiscal consolidation
- A lighter regulatory burden
- Programs to facilitate consumer deleveraging

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European woes and recession fears seem to lie behind recent financial volatility, which has included Mexico.
Higher risk aversion has not precluded the persistence of capital inflows to Mexico.

**Government Securities Holdings***

Billions of pesos

- **Foreign investors**
- **Pension funds**

*Includes CETES and fixed-rate bonds

Source: Banco de México

**Yield Curve**

%  

- 31-Dec-10
- 22-sep-11
- 11-nov-11

Source: Banco de México
Mexico’s economy continues growing, though with some recent signs of weakening coming from external demand.

IGAE and Industrial Production
August 2008 = 100; s.a.

- Green line: Global Economic Activity: Total
- Red line: Global Economic Activity: Services
- Blue line: Industrial Production

Source: INEGI

Manufacturing Exports
January 2007 = 100; s.a.

- Black line: Manufacturing
- Orange line: Automotive
- Blue line: Non-automotive

Source: INEGI
The domestic market has lost some steam and activity levels remain relatively moderate

**Retail Sales**
August 2008 = 100; s.a.

**Gross Fixed Investment**
August 2008 = 100; s.a.

*Source: INEGI*
An upturn in employment and bank lending may be expected to continue supporting domestic demand.

Workers insured by the IMSS

Millions of people

Source: IMSS

Commercial Banks’ Performing Credit for Consumption

Real annual % change

Source: Banco de México
A deeper-than-expected deceleration in the U.S. would translate into lower growth prospects for Mexico.

GDP forecasts over time

% annual

Source: Blue Chip
The monetary policy stance has been adequate as inflation has been converging to the 3% permanent target.

Source: INEGI
A crucial challenge is for inflation expectations to become anchored around this target.
Risks to this scenario persist

- Prolonged global financial instability
- Greater economic slowing in the U.S.

In the current context, Mexico can face these challenges with a long-term perspective:

- By strengthening the pillars of stability
- By pushing reforms that fuel productivity
Final remarks

- Current euro area economic conditions include worrisome feedback loops, and some structural elements make adjustment more difficult.
- The solution to the problems cannot be based only on austerity programs, or on ever-increasing rescue funds.
- The U.S. economic recovery has been unusual, and overcoming the obstacles goes beyond policies that stimulate aggregate demand.
- Higher risk aversion has not precluded the continuation of capital inflows to Mexico.
- Mexico’s economy continues growing, but a deeper-than-expected deceleration in the U.S. would translate into lower growth forecasts.
- For the convergence of inflation to the permanent target, a crucial challenge is to anchor expectations around this benchmark.
Mejoran las perspectivas económicas mundiales