

# Annual Report 2011

## Summary

In 2011 the world economic recovery, which had begun in the second half of 2009, lost its momentum. This was due to the adverse effects of the natural disasters in Asia, the sharp increase in commodity prices in the first half of the year and the sovereign debt crisis in the Euro zone. In an environment of deteriorated confidence at the global level, particularly during the second half of the year, negative feedback was observed between the weakness of the financial system and the economic activity.

In particular, in the Euro zone a strong deterioration of households' and firms' confidence, a fiscal adjustment greater than expected and the process of banks' deleveraging had a negative impact on the economic activity. Although emerging economies continued demonstrating a high growth rate, it moderated towards the end of the year. As a result, world economic growth prospects have been generally revised downwards throughout the year.

In this context, after various attempts to contain the deterioration of the abovementioned markets, the European authorities implemented unprecedented measures, among which stood out the long-term refinancing operations and the extension of the collateral accepted by the European Central Bank (ECB). Thus, the situation in the international financial markets improved by the end of the year.

Increased risk aversion caused by the Euro zone crisis had a negative impact on the financial markets of emerging economies in the last two quarters of 2011. In this environment, the capital flows were affected and the exchange rates of most emerging economies depreciated against the USD. However, as a result of the abovementioned measures taken by the ECB, the search for yield was resumed by the end of the year, leading to a general slight increase in financial assets' prices.

On the other hand, the upward trend of inflation observed during the first months of 2011, in both advanced and emerging economies, reverted in the second half of the year. Thus, lower inflationary pressures, together with the weakness of the economic activity, propitiated a change in direction of the monetary policy in the vast majority of economies

towards a more accommodative stance as the year progressed.

In Mexico, the economic activity presented a positive trajectory in 2011, even though the international economic situation propitiated a less favorable environment for economic growth in the country. Particularly, lower external demand, especially from the U.S., led to a gradual slowdown of the Mexican economy in the second half of 2011. Nevertheless, due to solid economic fundamentals, it continued the recovery process initiated in the second half of 2009, registering a GDP growth rate of 3.9 percent for the year as a whole. In this environment, both the performance of the aggregate demand and the persistent slackness in the labor market led to the absence of demand pressures on both the price levels and the country's external accounts. In particular:

- i. Due to the moderation in the economy's growth pace of the economy during 2011, the output gap continued to close at a lower rate than expected and remained negative throughout the year.
- ii. Market indicators show that slack conditions persisted during the reported year. Particularly, the unemployment rate, the informal sector employment and the underemployment rates remained at levels considerably higher than pre-crisis levels, despite the increase in the number of IMSS-insured workers.
- iii. Installed capacity utilization in the automobile sector registered relatively high levels, while in other manufacturing sectors it remained below the levels observed before the crisis onset in 2008.
- iv. Total financing of the non-financial private sector increased continuously in 2011, although it moderated its growth pace during the fourth quarter. Thus, this sector's financing dynamics did not point to possible problems of overheating of the economy or pressures on the interest rates.
- v. Although the current account deficit in 2011 was larger than in the previous year, it was still one of the lowest deficits registered since the nineties. In fact, it was easily financed by inflows in the

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balance of payments' financial account, indicating the absence of excessive domestic spending.

As regards inflation performance, during 2011 it presented lower levels than in the previous year. In particular, its average level was 3.41 percent (in 2010 it was 4.16 percent), bearing in mind the 3 percent annual headline inflation target established by Banco de México, and the variability interval of plus/minus one percentage point. Besides the monetary policy stance, lower inflation observed in 2011 was influenced by various factors, among which stand out the following:

- i. Slack conditions in the economic activity.
- ii. Absence of labor cost-related pressure on the price formation process.
- iii. Increased competition levels.
- iv. Fading of the impact related to fiscal adjustments and increased fares and public prices that came into force at the beginning of 2010.

The monetary policy conduction, aimed at ensuring price stability, prevented the period of financial turmoil in the world economy and the consequent adjustment of the exchange rate, given a less favorable international environment, from contaminating the price formation process in the domestic economy. Thus, despite the deterioration of the external environment, the solid fundamentals of the Mexican economy allowed the expansion of the economic activity and the continued convergence of inflation to the 3 percent permanent target.

In this context, Banco de México's Board of Governors closely monitored the evolution of inflation expectations, ensuring they remain well-anchored, and maintained the target for the Overnight Interbank Interest Rate at 4.5 percent during the whole year.