

Annual Report 2010

Summary

During 2010, the world economy consolidated its recovery which started in the second half of the previous year. Economic performance was uneven since emerging economies exhibited a greater dynamism than advanced economies. In the latter case, the growth resulted primarily from fiscal and monetary stimuli. In contrast, emerging economies' growth was driven by their domestic demand, in various cases due to improved terms of trade.

Episodes of considerably increased uncertainty in the financial markets were registered during the year. These were caused by doubts about fiscal sustainability and solvency of the banking system in some European countries. The European Union, in coordination with the International Monetary Fund (IMF), implemented diverse measures designed to provide financial assistance to the countries in distress.

World inflation during 2010 was low, although it rebounded by the end of the year, mainly due to increases in international commodity prices. Inflation performance in advanced economies was different from that in emerging economies. In the first group, core inflation remained at low levels and long-term inflation expectations stayed anchored throughout the year. On the other hand, some emerging economies, characterized by going through an advanced phase of their economic cycle, in addition to the impact on headline inflation produced by the increase in commodity prices, also faced deterioration in inflation expectations.

In this environment, central banks of the major advanced economies maintained their monetary policy rates at very reduced levels and, in some cases, expanded their unconventional liquidity measures. In turn, emerging economies' central banks, which faced more widespread inflation pressures, started to withdraw the implemented strong monetary stimulus.

The improvement in emerging economies' fundamentals and the search for yield, given the environment of abundant global liquidity, boosted considerable capital inflows to these economies. Some emerging economies, in order to contain the currency appreciation and to lower the risk of a possible capital flow reversal, responded with various measures, ranging from international reserve accumulation to actions aimed at directly limiting capital flows.

Despite the fact that the recovery of the world economy in 2010 exhibited important progress, the composition of the expansion and the policies adopted during the

year in order to boost economic activity might have an impact on the foundations of the future growth. In particular, two elements of concern are the latent risk of an increase in global imbalances and the persistent fiscal weakness in advanced economies.

In Mexico, during 2010 the process of reactivation of the economic activity, which started in the second half of 2009, was consolidated. The recovery of production levels was a consequence of the growth exhibited by the world economy, in particular, US industrial activity growth. It provided considerable boost to Mexican exports, which was gradually transmitted to domestic spending components.

This year, real GDP registered an annual increase of 5.5 percent, as compared to the contraction of 6.1 percent observed during the previous year. This expansion led to the significant generation of formal employment in the economy, which reached levels exceeding the ones observed before the onset of the global crisis. Despite that, during the year the economy continued operating below potential GDP, avoiding the presence of demand pressures on the price formation process. In this sense, the following stand out:

- i. Although the expansion of the aggregate demand led to a closing of the output gap, it maintained at negative levels during 2010; i.e., the output gap estimation suggests that during the year GDP was located below the level consistent with the full utilization of production factors.
- ii. Despite the observed considerable recovery of the economy's formal employment, the fact that unemployment and underemployment rates remained at levels higher than those prevailing during 2008, before the outbreak of the global crisis, suggests that slack labor market conditions persisted.
- iii. During 2010, a gradual recovery of total financing to the economy took place, which implied a moderate growth rate in real annual terms. This expansion was well below the levels observed prior to the outbreak of the financial crisis, and at no time were pressures perceived on the loanable funds market.
- iv. The recovery of the export level and, therefore, of the manufacturing sector production was reflected in higher levels of installed capacity utilization of this industry. Nevertheless, in late 2010, capacity utilization levels remained well

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below those observed before the crisis and in more advanced phases of the previous business cycles.

- v. Although economic activity growth was reflected in a recovery of imports, the trade balance and current account deficits remained at reduced levels due to the expansion rate of exports. In fact, in 2010, the current account deficit as a share of GDP reached one of the lowest levels since 1990.

In this context, annual headline inflation during 2010 was on average lower than the one registered in 2009, having decreased from 5.30 to 4.16 percent. The registered annual headline inflation also resulted lower than that forecasted by Banco de México at the beginning of the analyzed year and lower than the inflation expectations reported by the financial analysts in Banco de México's survey. These inflation expectations at the beginning of 2010 registered an average level of 4.9 percent for the end of the year. These results were due to various factors, among which stand out the following:

- i. The exchange rate appreciation.
- ii. The output gap levels.
- iii. The moderate wage increases which mitigated labor cost pressures.
- iv. The absence of second-round effects derived from fiscal changes implemented this year.

To all this, a number of advances in communication and transparency matters by the Central Institute must be added. In particular, it was announced that from 2011 onwards, the Minutes of the Board of Governors Meetings regarding monetary policy decisions will be published in order to provide more information about the monetary policy decision making process to the markets and to the public in general. It was also announced that, starting with the Inflation Report, October-December 2010, the publication format of the main macroeconomic variables' forecasts will be modified, using Fan Charts.

Considering the abovementioned, it can be concluded that in 2010 the economy grew more than expected, while inflation was lower than forecasted. In this environment, Banco de México decided to maintain the Overnight Interbank Interest Rate unchanged during 2010.