Annual Report 2009

Summary

World economic activity started to recover in the second quarter of 2009, after having declined substantially during the six preceding months. The economic rebound responded to the fiscal and monetary stimulus measures implemented in most advanced economies and some emerging economies, as well as different measures adopted to stabilize the international financial system. Nevertheless, after having grown on average 4.4 percent in annual terms during the previous three years, the global economy fell 0.6 percent during the entire 2009, its first contraction in the postwar period.

The world economy recovered differently among countries and regions. Although the U.S. economy experienced significant growth during the second half of 2009, GDP in this country fell 2.4 percent during the year, its largest contraction in more than six decades. Economic activity in the Eurozone and Japan also rebounded, although at slower rates. GDP of these economies decreased 4.1 and 5.2 percent, respectively, in 2009. The strongest expansion was observed in emerging economies, particularly those of Asia, mainly due to the growth of domestic demand and exports. In particular, the economies of China and India grew 8.7 and 5.7 percent, respectively. In contrast, Latin America contracted 1.8 percent.

At the start of the year, financial markets continued to show signs of weakness as a consequence of the crisis that broke out at the end of 2008. The coordinated response of the monetary and fiscal authorities of the major advanced and emerging economies helped to prevent the collapse of the financial system and later led to an improvement in financial market conditions, especially from the second quarter of 2009 onwards. International cooperation efforts, such as the measures announced by the Group of Twenty (G-20) at the beginning of April, also contributed to such an improvement. These measures included strengthening the international framework of financial regulation and supervision, increasing the funding available for international financial organizations significantly, and creating the Financial Stability Board (formerly known as the Financial Stability Forum until April 2009). The aforementioned resulted in a positive feedback between financial conditions and economic activity growth. Nevertheless, financial markets did not fully return to normal and market confidence fluctuated abruptly during the year in response to a change in risk perception worldwide.

Among the coordinated efforts among the authorities of several economies worth mentioning are the fiscal stimulus measures, which prevented a widespread collapse of financial markets, particularly in advanced economies, and contributed to restore confidence and laid the foundations for global recovery. However, fiscal support policies implied a significant growth in public sector's deficit and debt, especially in advanced economies. The average public deficit in these economies rose from 1.1 percent in 2007 to around 9 percent of GDP in 2009. The debt to GDP ratio also increased, from 73.7 to 91.3 percent during the same period.

World inflation remained at low levels during 2009, although it rebounded slightly during the second half of the year. Annual inflation in most of the major advanced economies continued to post negative figures during the first half of the year, reflecting the prevailing economic slackness and the lower decline in commodity prices as compared with their record highs of the previous year. However, the increase in energy prices during the second half of 2009 pushed annual inflation into positive ground in most of these countries, except Japan. In emerging economies, annual inflation followed a downward pattern for most of 2009; nevertheless, towards the end of the year it rebounded in response to a significant expansion of domestic demand in some of these economies and the impact of adverse weather conditions on food prices in others.

The absence of inflationary pressures allowed the major advanced economies' central banks to continue implementing extraordinarily accomodative monetary policies. During the first half of 2009, reference interest rates were either cut aggressively or kept at historically low levels, and then kept at those levels for the rest of the year. Most emerging economies' central banks also relaxed their monetary policy stances although less than those of advanced economies.

The negative trend of capital flows to emerging economies during most of 2008 and the first few months of 2009 reverted. The latter resulted from the large spread between interest rates in advanced economies and those in emerging economies, combined with expectations of this situation continuing for a long period, greater appetite for risk, and better prospects for growth in most emerging economies. The return of capital inflows allowed for a recovery of exchange rates against the US dollar and financial asset prices in general, and a decline in emerging economies' sovereign risk indicators.

The international environment in 2009 led to a significant fall in the demand for Mexican exports and in other current account revenues, a significant tightening in external financing, and to a shock on Mexico's terms of trade. The outbreak of the influenza A (H1N1) virus was an additional factor that further contributed to the contraction of economic activity during the second quarter of the year and its effects on the demand for many services.

As a result of the aforementioned, Mexican GDP contracted 6.5 percent in annual terms, figure similar to the 6.2 percent registered during the 1995 crisis. During 2009, productive activity in Mexico underwent two different phases:

1. During the first half of the year, economic activity fell substantially in response to the contraction of external demand and the pass-though of this shock

to the domestic market, as well as the impact of other temporary factors on production. Noteworthy among the latter were the outbreak of the influenza A (H1N1) virus and the temporary shutdown in Mexico of two American car makers that began bankruptcy proceedings. As a result, GDP contracted significantly during the first half of 2009, 8.9 percent in annual terms.

2. From the second half of the year, manufacturing exports rebounded mainly as a result of gradually improving external conditions. This behavior, combined with the fading of the shocks which had affected the economy during the second quarter of the year, contributed to the positive pattern followed by economic activity. Thus, seasonally adjusted GDP grew in quarterly terms 2.5 and 2 percent in the last two quarters of the year, respectively. Consequently, the rate of annual contraction of this aggregate decreased significantly. Nevertheless, domestic demand stemming from the private sector recovered less vigorously than external demand. As a result, the current account deficit remained low and economic conditions slackened.

A number of countercyclical measures were implemented in Mexico to reduce the effects of the international environment on domestic economic activity. On the one hand, sound public finances allowed for fiscal policy, through higher public expenditure, to take an active role in offsetting the fall in aggregate demand. On the other, Banco de México's Board of Governors loosened its monetary policy stance in a setting where medium and long-term inflation expectations remained well anchored.

During the first few months of 2009, concerns arose regarding the Mexican economy's sources of external financing. This was due to the deteriorating prospects for external revenues, particularly oil revenues, which together with the astringency in international capital markets raised the levels of uncertainty. The Ministry of Finance and Banco de México responded to this situation by adopting a series of coordinated measures. As for exchange rate policies, the Foreign Exchange Commission implemented different mechanisms to sell US dollars in order to prevent this market from facing liquidity problems. Access to international liquidity facilities was also agreed with the U.S. Federal Reserve and the International Monetary Fund. These measures improved confidence, fostering more orderly conditions in foreign exchange and financial markets in general.

Headline inflation in Mexico followed a downward path during 2009, in an environment characterized by the absence of demand-related pressures due to weak economic activity. This behavior resulted from a combination of different factors which affected both core and non-core price indices. In particular, the supply shocks which had exerted a significant upward influence on inflation during 2008, especially those associated with international commodity prices, were finally absorbed. The same way, the Mexican government's policy of administered and regulated prices also contributed significantly to the decline in inflation, particularly the reduction and freezing of different energy goods' prices within the framework of the National Agreement in Favor of the Household Economy and Employment. In general terms, the main factor limiting the decline in inflation during 2009 was the effect of the depreciation of the exchange rate -which took place towards the end of 2008 and at the start of 2009- on tradable goods' prices. As a result, annual headline inflation fell from 6.53 to 3.57 percent between the end of 2008 and December 2009, while core inflation from 5.73 to 4.46 percent during the same period.

During the first half of the year, the balance of risks faced by monetary policy was more influenced by the behavior of economic activity than by inflation's trajectory. Banco de México took preventive monetary policy actions aimed at reducing the unfavorable effects of the external shock. Banco de México's Board of Governors decided to reduce the target for the Overnight Interbank Rate by a total of 375 basis points, from 8.25 percent at the end of 2008 to 4.50 percent on July 17, 2009. After taking into account the anticipated temporary effects of the fiscal measures for 2010 on inflation and economic activity, the Board of Governors kept the referred target unchanged for the rest of 2009. Banco de México was at all times alert to prevent the Mexican economy's price formation process from becoming contaminated and ensure that medium and long-term inflation expectations remained well anchored.