The Mexican Economy and the International Financial Crisis

by Juan Carlos Moreno-Brid *

Draft, September 2010

* Research Coordinator, Economic Commission for Latin America and the Caribbean (ECLAC), Subregional Headquarters in Mexico. The opinions here expressed are the sole responsibility of the author and do not necessarily coincide with those of ECLAC or of the United Nations Organization.

I. Introduction.

In 2008-09 the world economy faced its worst crisis since the Great Depression. The burst of the sub-prime housing bubble in the US detonated a series of dramatic shocks in the world economy, causing the collapse of numerous banks, big corporations, small and medium sized firms and pushing some governments to a virtual default. The crisis caused a sharp decline in credit flows and in economic activity in the United States and in the OECD that affected all emerging markets. Latin America was severely affected. Indeed, the region experienced a major economic slowdown, and in many countries output and employment declined. In 2008, Mexico´s real GDP expanded only 1.5%, much lower than the 3.3% reached the year before. And in 2009 it was the Latin American economy with the largest drop in real GDP (-6.5%): a contraction of a magnitude not seen in the country in more than 40 years!

In the fourth quarter of 2009, economic activity in Mexico began to recover pulled by the, albeit modest, expansion of the US economy and a process of inventory rebuilding. Its rebound continued in the first half of 2010, though recently losing impulse. Indeed, Mexico's industrial production in June 2010 -seasonally adjusted- declined 0.4% relative to its level in May, Construction declined 1.4%, mining 1.2% and manufacturing 0.1%. The preliminary figures so far indicate that in 2010 Mexico will not be able to fully recover from last year´s recession, and real GDP is expected to expand between 4% and 5%.

The purpose of this paper is to point out the channels of transmission of the impact of the international financial crisis to the Mexican economy, and to evaluate the economic policies implemented by the government to face it. The work is organized as follows. The first section examines the strengths and vulnerabilities of the Mexican economy up to the inauguration of the financial crisis in late 2008. The second one identifies the channels of transmission of the effects of the international financial cum economic crisis to the Mexican economy. The following one discusses the policy responses of the government. The final section presents our conclusions on the challenges, that economic policy faces in Mexico in order to, on the one hand, reduce the adverse, short-term impact of the financial crisis and to, on the other hand, remove the key binding constraints on Mexico's long-term economic growth.

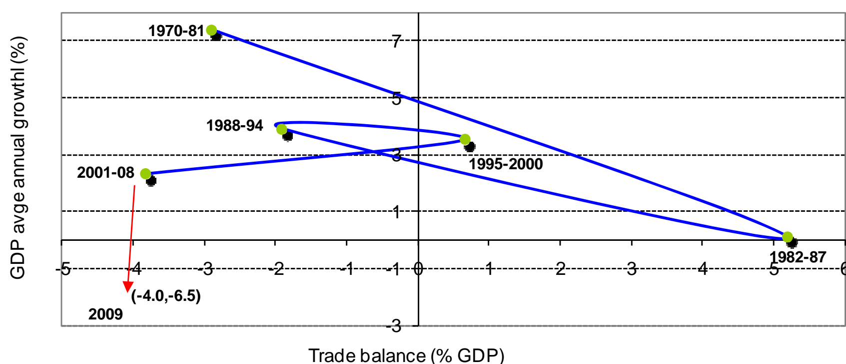
II. Strengths and vulnerabilities of the Mexican economy and the international financial crisis of 2008-09.

There is consensus that Mexico's current economic structure and mode of insertion in the world economy is the outcome of the neo-liberal reforms implemented since the mid-1980s. The reforms changed its traditional pattern of economic development based on import substitution and State intervention in investment and in the allocation of resources. They favored, instead, a market based approach to development aimed at placing non-oil exports and private investment as the new engines of Mexico´s economic growth. Instrumental to such goal were the drastic liberalization of the domestic trade and financial markets, the downsizing of the public sector, the virtual elimination of the fiscal deficit and the phasing out of industrial policies. With these reforms Mexico went, from being a highly protected mid-sized economy, to becoming one of the most open economies to foreign trade and international financial flows. Indeed, by 1994 it had signed the North America Free Trade Agreement (NAFTA) with the US and Canada with the commitment to fully liberalize trade and investment in 15 years. Most significant, the role of the State in the economy was radically diminished, as its traditional instruments of industrial policies, public investment and development banking were considerably weakened.

The reforms succeeded in reducing inflation and cutting down the fiscal deficit. Annual inflation, after reaching three-digit levels in the mid 1980s, sharply fell and since 2000 it remains at a one digit level. The fiscal deficit was slashed, mainly by cutting public spending -particularly investment- rather than by rising tax revenues. The public sector's external debt was reduced, and by the end of 2008 it stood at US $56 billion dollars (6.1% GDP, and 40% lower than its level in 1998). By then, total public debt had been also brought down to the equivalent of 40% of GDP, one of the lowest ratios in the OECD. Moreover, in the last ten years, the fiscal balance -excluding contingent liabilities due to pensions of the social security system- has remained close to nil. In March 2006, Mexico's Congress approved the *Law for Fiscal Responsibility (LFR)* to impose the annual obligation to maintain a zero fiscal balance. The possibility of authorizing a fiscal deficit can be allowed by Congress, but only under extraordinary macroeconomic circumstances. In addition, the Central Bank was granted autonomy with its key objective being to keep a low and stable inflation.

The market reforms -and NAFTA- did stimulate a boom in Mexican exports of manufactures and in foreign direct investment. In a few years Mexico's exports doubled as a share of GDP, reaching 35%. Exports of manufactures grew at annual rates over and above 10% -a performance among the most dynamic in the world- helping to generate a trade surplus with the US. But Mexico's trade deficit with the rest of the world soared, as the export boom was more than compensated by the expansion of imports. The doubling of the income elasticity of imports, coupled with a tendency of the real exchange rate to appreciate and the breakdown of domestic linkages in Mexico´s industrial structure undermined the capacity of the exports´ boom to pull the rest of the economy into a path of high and sustained expansion.

Figure 1 Mexico: Trade balance and economic growth, 1970–2009



Source: Own elaborations based on data from INEGI and Banco de Mexico

Figure 1 reveals how in 2001-08, almost twenty years after the neo-liberal reforms were initiated, the Mexican economy had, on average, a trade deficit similar to that of the 1970s, but grew at a mere 2.2% per annum; much slower than in the 1970s (7.2%). Thus, with a similar "use" of foreign exchange the economy grows now at a much slower pace than before the neo-liberal reforms started. If oil exports are excluded, the trade deficit is much higher. One reason behind Mexico's slow economic growth post-reforms -notwithstanding the export boom- is the weak response of investment. Indeed, fixed capital formation peaked during the 1980s oil boom, but collapsed later. Its performance in the last ten to twenty years has been disappointing. Today it amounts to approximately 20% of GDP, a proportion way below the 25% threshold identified by UNCTAD as a minimum ratio to attain annual rates of growth in GDP of 5%. Among the reasons behind its poor response are the cuts in public investment, the insufficiency of private bank´s credit for SMEs, the virtual dismantling of development banks, and

the phasing out of industrial policies. In particular, the real exchange rate appreciation has had a negative impact on investment in "tradable" activities. Moreover, the neo-liberal reforms did not correct two main flaws of Mexico's fiscal structure: the weakness of its tax revenues and their dependence on oil exports. Indeed, Mexico's tax revenues (including oil) amount to less than 18% of GDP; one of the lowest ratios in the OECD. Most worrisome, oil income provides a vast proportion of Mexico´s fiscal revenues.

III. Main channels of transmission of effects of the crisis on the Mexican economy.

The financial crisis led to a contraction of world trade and capital flows. Its impact was particularly severe on the Mexican economy given its close linkages with the US; the epicenter of such crisis. Indeed, Mexico suffered in 2009 a sharp reduction of exports of goods and services (-15% in real terms) and of foreign direct investment (-53%, measured US dollars). The decline of oil exports -at quarterly rates of 50.3% in the fourth quarter of 2008 and 25.7% in the first quarter of 2009- deteriorated Mexico's balance of payments position and drastically undermined its fiscal resources given that oil contributes with approximately 40% of public sector revenues In addition, the collapse of employment in the US induced a slowdown of migration of -legal and illegal- Mexican workers as well as a contraction (-16%) in the volume of family remittances.

To the extent that Mexico´s outward migration has slowed down with the international financial crisis, it becomes more difficult to domestically generate the number of jobs needed by Mexico´s rapidly expanding labor force. In fact, unemployment and informal employment in Mexico have vastly increased since the beginning of the international financial crisis in late 2008. By September 2009 open unemployment peaked at 6.4%, twice as high as its level in May 2008. Although it has declined since then, the most recent official data placed it at 5.1% for June 2010. (INEGI and IMSS, monthly reports).

To a certain extent, the impact of the crisis was felt in Mexico also through certain financial channels. On the one hand, the crisis provoked an increase in the risk premium of emerging markets, a collapse of the stock market, increased volatility of short term

capital flows and major movements in the exchange rate. Indeed, short-term capital flows showed sharp fluctuations and eventually a contraction during 2009, affected by speculative pressures and the private sector´s quest for “safe assets” denominated in foreign currency, inter alia US Treasury bonds. The credit crunch in the world caital markets affected a number of big conglomerates in Mexico that typically relied on external funds for their operations. Indeed, the crisis led to an acute rationing in their access to the international credit market, to a reduction in local banks’ supply of funds to private businesses. In addition, some banks and firms experienced a worrisome deterioration in their balance sheet positions as the depreciation of the peso vis-a-vis the US dollar ballooned their debit side measured in local currency. Such problems created pressures in the foreign exchange market, given that 55% of Mexico’s external debt is owed by the private sector.

On the other hand due to its insufficient depth and, say, lack of sophistication Mexico’s domestic banking system was insulated from the toxic-asset problem that laid at the core of the international financial crisis. However, Mexico´s banking sector is mainly conformed by subsidiaries of foreign banks. To the extent that they face mounting pressures from their headquarters to transfer profits back home in order to strengthen their capital positions, local credit availability to Mexico´s private sector is significantly and increasingly constrained. This credit crunch plus the volatility of the exchange rate, the stock market and the uncertainty on the depth and duration of the recession of the US economy induces the private sector to postpone or to cancel various investment projects in Mexico. Total investment fell 10% in real terms in 2009.

An additional concern is the impact of the crisis on the public sector revenues. As economic activity and trade declined, and firms’ revenues and profits fell and formal jobs were eliminated, taxable income and fiscal revenues decreased. Indeed, total public sector revenues were the equivalent of 22.4% of GDP in 2009, compared to 23.6% in 2008. The collapse of oil revenues was particularly acute, as they went from an amount equivalent to 8.7% of GDP in 2008 to 6.6% of GDP in 2009.

IV. Mexico's policy responses to the world crisis.

The first point to stress is that the Mexican economy arrived in a much stronger position to the international financial crisis of 2008-09 than to previous crises. Indeed, as mentioned above, for quite a number of years before the onset of the crisis, Mexico's domestic inflation had been on stable and low –less than 5% on annual terms-, its fiscal deficit had been practically eliminated and its external debt had been markedly reduced as a proportion of GDP to levels lower than the OECD´s average. These strengths, plus the floating exchange rate regime adopted years earlier and the substantial level of foreign reserves accumulated by December 2007, left somewhat ample room of policy maneuver to respond to the international financial crisis of 2008-09; at least much more than to previous external shocks.

The Mexican government's initial discourse in response to the global financial crisis tended to minimize the importance of its potential impact. It argued that Mexican economic performance had decoupled from that of the United States. They stated that Mexico´s "solid macroeconomic fundamentals" shielded it from the recessionary and financially de-stabilizing influences coming from the US economy. As the external crisis deepened, the official position gradually shifted to express increasing concern. These shifts were mirrored in the policy responses adopted. During the second half of the year, Banco de Mexico actually augmented four times its target interest rate; pushing it up 100 base points, to reach 8.25%. It may be important to point out that in the third and fourth quarters of 2008 many OECD countries and a number of developing ones had already begun to reduce their interest rates in an attempt to boost their domestic economies. It may be said that Banco de Mexico, caught between inflation and economic growth concerns, its decisions on the reference interest rate up until the end of 2008 reflected much more the worries on inflation cum balance-of-payments performance than on growth.

On the fiscal side, a first policy response by the Mexican government to the uncertain external economic environment was the creation of a National Infrastructure Fund, in February 2008. It aimed to revitalize the domestic market by expanding the infrastructure in a period of five years. The other, a priori important initiative by the government in 2008 was the Program to Boost Growth and Employment (PICE). It was

launched in October, and it allegedly included actions to expand and reorient public expenditure -particularly in investment in infrastructure-, additional financial support to small and medium sized enterprises, the simplification of foreign trade administrative procedures and to induce FDI in the country and, most important, the construction of an oil-refinery. This last project was heavily publicized, and a long and winding process cum competition was organized to select the federal entity where it would be constructed. However, having been identified as perhaps one of the key infrastructure projects of President Calderón administration at the time of writing the construction has not been initiated. It has been subsequently postponed to 2012, but some analysts believe that the whole viability of the project has begun to be questioned and compared to an alternative option that may be the purchase of an already existing oil refinery in the Unied States.

Notwithstanding the merits of the above mentioned programs, it may be safely argued that in 2008, Mexico´s fiscal response to the crisis was rather orthodox and not really counter-cyclical. Indeed, notwithstanding that the rate of expansion of real GDP slowed down considerably in the year (from 3.3% in 2007 to 1.5% in 2008), the fiscal deficit remained virtually identical (-0.1% of GDP in 2008 versus 0.0% of GDP in 2007).

The exchange rate was the major macroeconomic policy tool used in 2008 to, say, protect the rhythm of expansion of the domestic economy from the exogenous, adverse effects of the international financial crisis. Starting in August, after 24 months of systematic appreciation, it began to rapidly depreciate reflecting the impact of capital flight and the contraction of exports and other sources of foreign exchange. By the end of December, in just five months, it had depreciated 21% in real terms (Banco de Mexico, Informe Anual 2009). And, in order to reduce the speculation against the Mexican peso, the Central Bank arranged with the US Federal Reserve I October 2008 a liquidity swap facility of a maximum of US $30 billion, an arrangement that boosted Mexico´s foreign exchange reserves. It has been subsequently renewed.ost recently in June 2009.

By the end of 2008, the Mexican government was convinced that the external shock associated with the international financial crisis was exerting a severe, unfavorable impact on the Mexican economy. Consequently, it gradually began to put in place

diverse policies, programs and initiatives to try to counterbalance some of the adverse effects of the external shock on output and employment. The first step in this direction was the reduction of the Central Bank´s target interbank interest rate in January 2009 in 50 basis points. Moreover, additional reductions of similar magnitudes –between 75 and 25 basis points- were undertaken every month up until 17 July 2009. Since then, until the time of writing September 2010, it has remained constant at 4.5% (versus 8.25% in December 2008). Given the weak response to changes in the interest rate by the banking sector´s availability of credit for private business, the Mexican government opted to rely more on a once-traditional policy instrument that had been virtually abandoned: the development banks. Though starting from very modest levels, development banks´ supply of funds to private investors was significantly augmented; specially targeted to credit-rationed sectors such as small and medium enterprises, the agricultural sector, low cost housing and infrastructure projects (Banco de Mexico, Informe Anual, 2010). In addition, in April 2009 Congress approved a change in the regulating legal framework on saving and loans cooperatives, to better monitor them and to avoid the speculative use of their funds. Another legal reform by Congress increased the Central Bank's power over commercial banks to in principle ensure that they adequately grant credit and gave it the potential capacity to set caps on some interest rates and fees charged by banks. Whether these regulatory changes will be of any practical significance in the future is too early to tell and remains to be seen.

The exchange rate continued to depreciate in real terms up until March 2009. By then it had fallen 28% in real terms relative to its level in August 2008 (Banco de Mexico, Informe Anual, 2009). This same month, the IMF announced it had granted a no-strings-attached flexible credit line to Mexico of US $47 billion. This facility, coupled with the arrangement with the FED implied the doubling of Mexico´s foreign reserves. The acute nominal exchange rate depreciation did not lead to a rebound of domestic inflation; partly because international food prices collapsed and partly because the slowdown in Mexico´s economic activity was not conducive to price hikes by local businesses. In any case, concern with the eventual impact -pass-through- on domestic inflation led the Central Bank to take a number of steps to partially reverse the exchange rate depreciation. From March to October 2009, it carried out daily sales -initially of US$ 100 million, later reduce to US$ 50 million- as well as daily auctions of up to US $400 million at specified minimum exchange rates. In this process, in real terms, by

December 2009 the peso appreciated 7% relative to its peak of March, and by June 2010, the cumulative real exchange rate appreciation (again, relative to March 2009) was 16%. By then, and compared to August 2008, Mexico´s exchange rate showed a 10% appreciation in real terms. (Banco de Mexico, Statistical Indicators, 2010).

In January 2009, the National Agreement to protect Families' Economy and Employment was launched, composed by concerted actions between the Federal Government, state governors, the Legislative Power and organizations from the social sector, the business and the workers. Such actions cover the support of a temporary employment program, the freezing of petrol prices for the rest of the year, and the reduction in the price of utilities (electricity and LP Gas), plus more funding for the development banks (NAFINSA and BANCOMEXT). On February 10, President Calderon sent two more initiatives to the Congress to amend the *Law of the Mexican Institute for Social Security (IMSS*) and the *National Institute of the Housing Development (INFONAVIT),* to partially protect the income of employees that lose formal jobs by providing earlier access to their long-term savings' account at INFONAVIT (initially destined for housing purposes).

Various statements by the Minister of Finance issued early in 2009 stated that the government was keen on implementing a countercyclical economic policy, albeit of a somewhat moderate magnitude when compared with other international experiences in emerging markets. In his words:

> *"counter-cyclical measures for 2009, included in the PICE and the Agreement...imply an [additional] fiscal incentive of 1.8% of GDP".*

Other sources offer somewhat different estimates. For the IMF, Mexico´s fiscal stimulus in 2009 was 1.5% of GDP. The OECD instead puts it a bit lower (1.4% of GDP). However, to implement even a moderate expansionary fiscal policy, it was first necessary to ease the legally binding restrictions imposed by Congress on the possibility of incurring in deficit spending by the government. In fact in 2009 the Law of Fiscal Responsibility –explained above- was modified and the amount of investment carried out by PEMEX (Mexico's national oil monopoly) would be formally excluded from the

budget calculations subject to the zero-balance imperative. This legal modification gave some room to carry out an (moderately) expansionary fiscal and, simultaneously to devote resources for a much needed expansion and modernization of Mexico´s oil industry. In practice, the removal of PEMEX´s investment from the balanced budget rule freed up resources in the amount of 78.3 billion pesos in the 2009 budget (or about 5.5 billion dollars), two thirds of which were allocated to additional infrastructure investment (see SHCP, 2010 and OECD 2009b). Ros (2010) stresses three additional actors that made possible deficit spending in 2009, these are: i) "the hedging of oil prices for 2009 at USD 70 per barrel (twice the level at the end of 2008), ii) the depreciation of the peso increased the domestic currency value of oil export revenues, and iii) the use of non-recurrent revenues in the oil stabilization fund and the operation surplus of the Central Bank for the fiscal year 2008 (SHCP, 2010)." Whether these factors will be available in 2010 is not clear.

V. Final thoughts.

Although the amount of Mexico´s fiscal package of 2009 was smaller than the programs of Brazil and China it, nevertheless, reveals a certain intention to adopt counter-cyclical, though moderate, policies. According to a recent study based on the structural balances methodology, carried out by the economic department of Banco Bilbao Viscaya (BBVA 2010), in 2009 was the first time in decades when Mexico managed to put in place a countercyclical macroeconomic policy! This is certainly something to be welcomed and, hopefully, in the future to be significantly and formally embedded in its fiscal policy design.

Clearly some of the major announced actions on the expenditure side have in practice to be implemented. In fact execution problems of projects by the public sector have been stressed by some private entrepreneurs. Most likely, as the external crisis unfolds and its effects are felt in the Mexican economy, the Federal government -and state and local authorities- will launch additional countercyclical initiatives.

A key challenge on the social side is to extend the coverage of social protection to urban centers –for example through the conditional cash transfer program *Oportunidades*- that will suffer acutely the adverse effects of the crisis. The economic

decline of certain groups of the middle classes should merit special attention, as well as the adverse impact that it will have on the poor. The stress that the labor market experiences, with its massive informal sector, is severe and must be soon and properly tackled. It should be evident that Mexico cannot base its international competitiveness on cheap labor. The issue of labor reform will surely be brought to debate. In this regard, a key point will be to identify how to mix changes in labor regulations to lower the costs of recruitment of the workforce, with incentives to increase in-job training and the universalization of basic social protection.

The crisis of 2008-09 and the so far still insufficient recovery of 2010 reveal their structural challenges of the Mexican economy. Among them stand out the following ones: i) the balance-of-payments constraint on economic growth, ii) fiscal vulnerability, iii) the weakness of its financial intermediation system plus its limited development banking, and iv) its poor investment performance. All these result in a low and volatile rate of economic growth, and an inability to generate enough jobs to reduce its vast poverty. It is to be hoped that the policy responses to address the crisis are accompanied, sooner rather than later, by initiatives to help lay foundations for stronger long-term economic and social development in Mexico. So far, the fiscal budget for 2010 shows a shift in policy orientation, moving away from providing additional expansionary impulses to domestic activity and adopting instead a strategy of fiscal prudence or, as is now said, of fiscal consolidation. This shift was actually evident already in the last months of 2009 when, in fact some cuts in public expenditure were put in place. Thus the authorized fiscal deficit for 2010 is equivalent to 1% of GDP; a proportion much smaller than the 2.3% of GDP registered the previous year. In fact, in the first half of 2010 a number of taxes have been augmented this year (the VAT was raised from 15% to 16% for example) coupled with cuts in public expenditure. This orientation, this commitment to preserve Mexico´s long tradition of fiscal prudence reveals the opposition of the current administration to carry out -what they see as an excessive- expansion of the fiscal deficit and of public debt; most likely on the grounds that such action could imperil the financial and price stability of the Mexican economy.

An additional argument in that line is that given that the Mexican economy is already gaining momentum in the first half of 2010 –pari passu with the US economy- it is no longer necessary to provide fiscal stimulus. However, it may be safely argued that, first

of all, the rate of expansion of the Mexican economy is still insufficient to merely recover the ground lost in 2009 when it collapsed (-6.5%). In fact, private investment in Mexico has fallen systematically for six quarters (III-2008 to IV-2009) and although it increased in the first quarter of 2010, it is most likely that it declines once more in the second quarter! In addition, it is far from clear that the US and the world economy are already firmly cemented in a path of sustained and strong expansion. Thus there is the risk that the fiscal consolidation policy put in place this year may end up putting additional obstacles in Mexico´s road to a sustained and strong recovery. Such weary attitude must be extended to the analysis and prospects of the evolution of the el exchange rate. If it keeps appreciating in real term, investment in tradeable goods and services may be discouraged.

Finally on the political context and on a pragmatic nature, it will be important to build coalitions that allow Congress to identify and move forward with key initiatives that may be needed to put Mexico on track for a long-term, sustainable path of robust economic and social development. A most important one is fiscal reform, geared at increasing tax revenues, at reducing their dependence on oil revenues and thus their volatility, at increasing the efficiency and efficacy of public expenditure (current and investment). Last, but equally important, Mexico must move towards the implementation of fiscal policy based on a structural balance approach that introduces an automatic and countercyclical influence by the fiscal budget. This is a point where in the case of the Mexican economy, even the IMF has recently issued recommendations in that direction.

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Statistical Appendix

**Table 1: Mexico´s real GDP growth rates, 2008-2010,
(Changes over previous quarter, %)**

	2008				2009				2010
GDP growth 1/	I	II	III	IV	I	II	III	IV	I
Total GDP	1.3	-0.3	-0.2	-2.0	-6.8	0.3	2.4	1.9	-0.3
Private consumption	1.6	0.3	-1.2	-1.0	-6.5	1.0	1.7	0.2	-0.1
Public consumption	-1.9	1.3	0.1	0.9	1.8	-1.4	0.8	0.2	0.8
Private investment	0.7	1.6	-1.8	-6.5	-6.7	-4.1	-0.8	-2.2	5.9
Public investment	4.3	1.1	7.8	4.9	0.8	2.0	1.1	-0.3	-3.7
Exports of goods and services	4.3	0.6	-2.9	-15.2	-7.6	-0.9	8.4	7.5	7.0
Imports of goods and services	2.6	1.5	0.6	-15.6	-12.9	-1.9	13.0	3.6	3.5

Notes and sources: This table updates and extends the one presented in Ros 2010, based on INEGI, Banco de Información Económica, Indicadores de coyuntura.