BANCO DE MÉXICO

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Press Release

Monetary Policy Statement

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Banco de México's Governing Board decided to raise the target for the overnight interbank interest rate by 25 basis points to 8.00%.

During the third quarter of 2018, the world economy continued to grow, albeit at a more moderate pace, with an increased divergence among different regions and countries. In contrast with the Eurozone, Japan and the U.K., which have grown below expectations, economic activity in the U.S. grew at a relatively high rate, partly in response to the fiscal stimulus implemented. Under such an environment, global inflation remained on an upward trend; nevertheless, such trend has moderated with significant differences among countries. International oil prices have fallen considerably, due basically to supply factors. As expected, in November the Federal Reserve left the target range for the federal funds rate unchanged and reiterated its forecast of increasing it gradually. Forecasts for world economic growth for 2018 and 2019 have been revised slightly downwards due to the intensification of international trade disputes and to a further tightening of financial conditions, while considerable risks in the short and medium run have increased. In this environment, in recent weeks, international financial markets underwent episodes of volatility, and the prices of emerging economies' assets posted negative results, differentiated according to each country's macroeconomic fundamentals and idiosyncratic factors.

Since the last monetary policy decision, the Mexican peso depreciated significantly. In addition to the aforementioned external factors, the peso exchange rate was also affected by the announcement about the intention of cancelling the New Mexico City International Airport project and, in general, by markets' concerns regarding both the incoming administration's policies and some legislative initiatives. This led several rating agencies to downgrade the country's sovereign risk outlook from stable to negative. In turn, sovereign risk premia and medium- and long-term interest rates in Mexico registered sizable increases, way above those observed in other emerging market economies, reflecting the large increase in the different risk premia investors demand for holding domestic assets. This environment entails significant medium and long term risks that could affect the country's macroeconomic conditions, its growth potential and the economy's price formation process. For this reason, it is particularly relevant that, in addition to following a prudent and robust monetary policy, measures to foster greater productivity and an environment of confidence and certainty for investors are adopted, public finances are consolidated sustainably, and both transparency and accountability of public policies are strengthened.

The latest information suggests that during the third quarter of 2018, economic activity in Mexico expanded, after having contracted during the second quarter. Slack conditions in the economy are estimated to have tightened slightly with respect to the previous quarter, although they remain less tight than those observed at the beginning of the year. From a cyclical perspective, the balance of risks for growth continues biased to the downside and has deteriorated at the margin, due mainly to both the complex external environment faced by the Mexican economy and the abovementioned domestic uncertainty factors.

In October, inflation registered 4.90%, reflecting the increments in energy prices that have prevailed since June, mainly those of gasoline and LP gas. Such price increases stem from the dynamics of their international references and, in the case of gasolines, from the reduction in fiscal incentives associated with their domestic prices. This has contributed to keep non-core inflation high for a long period. Moreover, the referred shocks have affected core inflation due to their indirect effects on production costs. Other factors have also contributed to the persistence exhibited by core inflation. In particular, the core subindex has exhibited a high degree of resistance to decline, even increasing from 3.67% in September to 3.73% in October. In this context, expectations for headline inflation for the end of 2018 drawn from surveys have been revised from 4.50% to 4.61% during the same period, while those for the end of 2019 continue at around the same level. Expectations for core inflation for the end of 2018 increased from 3.53 to 3.59% during the same months and those for the end of 2019 remained practically unchanged. Expectations for headline inflation for the medium and long terms remain around 3.50%. On the other hand, information from market instruments suggests a considerable increase in inflationary risks in the medium- and long-terms.

As already highlighted, inflation faces significant risks related to the possible adoption of policies that could structurally affect the economy's price formation process. The most relevant is that the peso exchange rate may continue to be subject to pressures stemming from higher external interest rates and other external and domestic factors. Should the economy require real exchange rate adjustments as well as higher medium- and long-term interest rates, Banco de México will contribute to adjust the economy in an orderly manner, trying to avoid second-round effects on the economy's price formation process. On the other hand, inflation might be affected if pressures on energy prices persist or agricultural product prices increase; if there is an escalation of protectionist and compensatory measures worldwide; and, if there is a deterioration of public finances. Given the magnitude of the observed shocks and the level of inflation, there is also the risk of second-round effects affecting the price formation process. Additionally, if wage negotiations are not consistent with productivity gains, pressures on the economy could arise. Considering all of the above, the balance of risks to the forecasted trajectory of inflation has deteriorated and exhibits a significant upward bias, in an environment of high uncertainty.

To guide its monetary policy actions, Banco de México's Governing Board follows closely the development of inflation vis-à-vis its anticipated trajectory, taking into account the monetary policy stance adopted and the time frame in which monetary policy operates, as well as available information on all inflation determinants and on medium- and long-term inflation expectations, including the balance of risks for such factors. Monetary policy must also respond prudently if for any reason the uncertainty faced by the Mexican economy increases considerably. In this context, and considering that the balance of risks for inflation is biased upwards and that it has deteriorated significantly, Banco de México's Governing Board has decided by majority to raise the target for the overnight interbank interest by 25 basis points to 8.00%. One member voted for increasing the rate by 50 basis points. Considering the challenges that have been faced to consolidate a low and stable inflation, as well as the risks that the economy's price formation process is subject to, the Governing Board will take the necessary actions, specifically, maintaining or possibly strengthening the current monetary policy stance, so that headline inflation converges to Banco de México's target within monetary policy's period of influence.

Banco de México's Governing Board will maintain a prudent monetary policy stance and, under the current environment of uncertainty, will follow closely the potential pass-through of exchange rate fluctuations to prices, the monetary policy stance relative to that of the U.S. under an adverse external environment, and the conditions of slack in the Mexican economy. In the presence and possible persistence of factors that, by their nature, involve risks to both inflation and inflation expectations, monetary policy will be adjusted in a timely and robust manner to achieve the convergence of inflation to its 3% target and to strengthen the anchoring of medium- and long-term inflation expectations so that they attain such target.