

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 to 7.75%.

Available data suggests that the world economy increased its growth rate during the second quarter of 2018. However, there are signs of divergence among the main advanced economies. In the U.S., economic activity is expected to grow at a stronger pace, partly in response to the fiscal stimulus implemented, which, under conditions of reduced slack in the economy, may lead to greater inflationary pressures. As expected, in June the Federal Reserve raised the target range for the federal funds rate by 25 basis points, and reiterated its forecast that such range will continue to increase gradually and its expectation that inflation will be near its symmetric 2% target in the medium term. Although growth forecasts for the world economy for 2018 and 2019 remain practically unchanged, uncertainty in the short term and downside risks in the medium term have increased. Among these risks, the intensification of protectionist trade measures, a possible tightening of financial conditions generated by inflationary surprises, and the escalation of certain geopolitical risks stand out.

Under this environment, the U.S. dollar strengthened against most currencies, while risk aversion increased worldwide. Trade-related tensions and other geopolitical factors have also contributed to these developments. All of the above has caused a reallocation of investment portfolio towards safer assets. In this context, the currencies of most emerging economies depreciated significantly and exhibited higher levels of volatility. As for Mexico, since the last monetary policy decision, the peso depreciated further and also registered greater volatility. This behavior was influenced by both the aforementioned adverse external environment and other factors, such as the lack of agreement in the NAFTA renegotiation process and uncertainty associated with the country's forthcoming election. Interest rates in Mexico rose, especially those for short tenors.

During the first quarter of 2018, economic activity in Mexico continued gaining strength, growing at a rate even higher than that observed in the previous quarter. These developments caused some tightening in the economy's slack conditions. Although, in line with expectations, available information for the second quarter suggests a slowdown of economic activity, forecasts for the year remain unchanged. Given the uncertainty caused by the complex environment faced by the economy, Banco de México's Governing Board considers the balance of risks for growth maintains its bias to the downside.

The Mexican economy is now in a better position to cope with adverse scenarios due to the central bank's monetary policy stance adopted to keep medium- and long-term inflation expectations anchored and to the attainment of the fiscal objectives and the financial system's resilience. Nevertheless, the economy is expected to continue facing a complex environment, in both the external and domestic fronts. For this reason, it is particularly relevant that, in addition to following a prudent and robust monetary policy, measures to foster greater productivity are adopted, as well as a sustainable consolidation of the public finances.

Annual headline inflation continued to decrease, from 4.55% in April to 4.51% in May. Core inflation fell from 3.71% to 3.69% during the same period as a result of both monetary policy actions and the fading

of shocks that had an adverse effect on it last year. Non-core inflation fell from 7.07% to 6.99% during the same period, mostly due to reductions in the prices of agricultural products, which were partly offset by increases in gasoline and LP gas prices. Headline inflation expectations for the end of 2018 were revised from 3.98% in April to 3.94% in May, while those for the medium and long terms remained around 3.50%.

The decline in inflation during the first five months of 2018 is consistent with its convergence to the target as forecasted by Banco de México in its latest Quarterly Report. Nevertheless, some of the upside risks to inflation identified by the Central Bank have started to materialize. In particular, the peso exchange rate has depreciated even further, while the prices of gasoline and LP gas have been under pressure in line with increases in their international references. To the extent that these pressures persist, they could adversely affect the rate at which inflation declines. As for the tariffs imposed by the U.S. and the equivalent measures announced recently by Mexico, their effect on inflation is expected to be limited and short-lived. Considering all of the above, the risk of inflation converging to its target at a slower rate than that forecasted has increased, and therefore the attainment of the 3% target could be delayed if the monetary policy stance is not adjusted.

The aforementioned scenario continues to be subject to risks and to a high degree of uncertainty. Among the upside risks to inflation are that the peso exchange rate continues to be under pressure due to an environment of higher external interest rates and U.S. dollar strength, and uncertainty associated with both the NAFTA renegotiation and Mexico's elections. In the event of a scenario in which the real exchange rate would need to adjust, Banco de México will make sure it is done in an orderly manner, and with no second-round effects on the economy's price formation process. The risk of additional upward pressures on some energy product prices or of shocks on agriculture product prices also persists. Also, given the economy's position in the current business cycle, the behavior of unit labor costs could exert pressure on inflation. As for downside risks, the peso could appreciate if NAFTA negotiations turn out to be favorable. Summing up, since the last monetary policy decision, the balance of risks to the forecasted trajectory of inflation has deteriorated and remains biased upwards, 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-a-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 to such factors. Given that some inflationary risks have started to materialize and that the balance of risks for inflation has worsened and might affect the convergence of inflation to its target, Banco de México's Governing Board has voted unanimously to raise the target for the overnight interbank interest rate to 7.75%.

Looking ahead, the Governing Board will maintain a prudent monetary policy stance and will continue to follow closely the potential pass-through of exchange rate fluctuations to prices, the monetary policy stance relative to that of the U.S., 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 attain the convergence of inflation to its 3% target, and to firmly anchor medium- and long-term inflation expectations so that they attain such target.