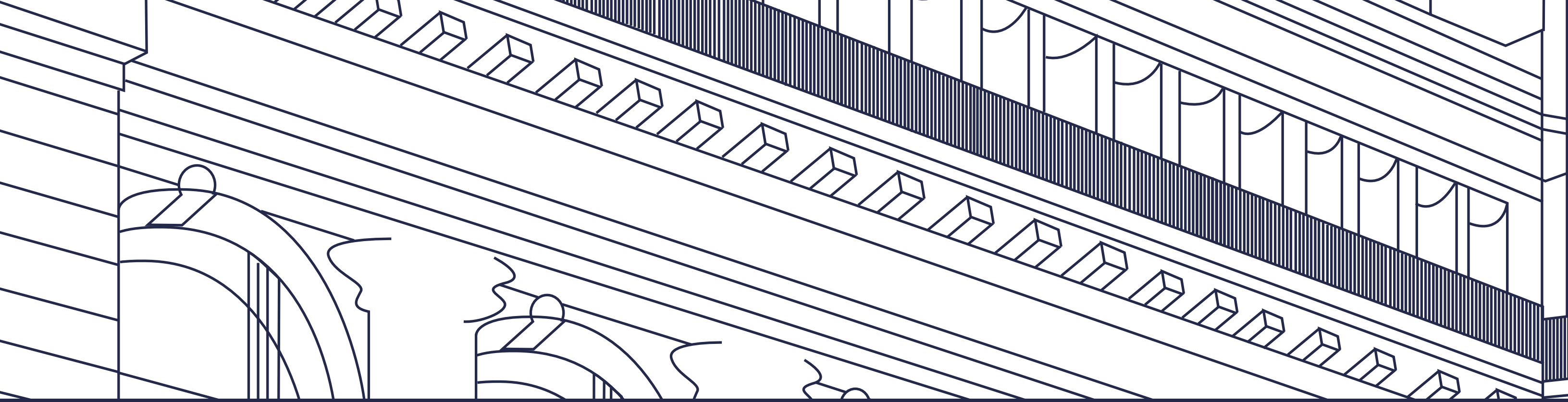

BANCO DE MÉXICO

Minutes number 61

Meeting of Banco de México's Governing Board on the occasion of the monetary policy decision announced on August 2, 2018

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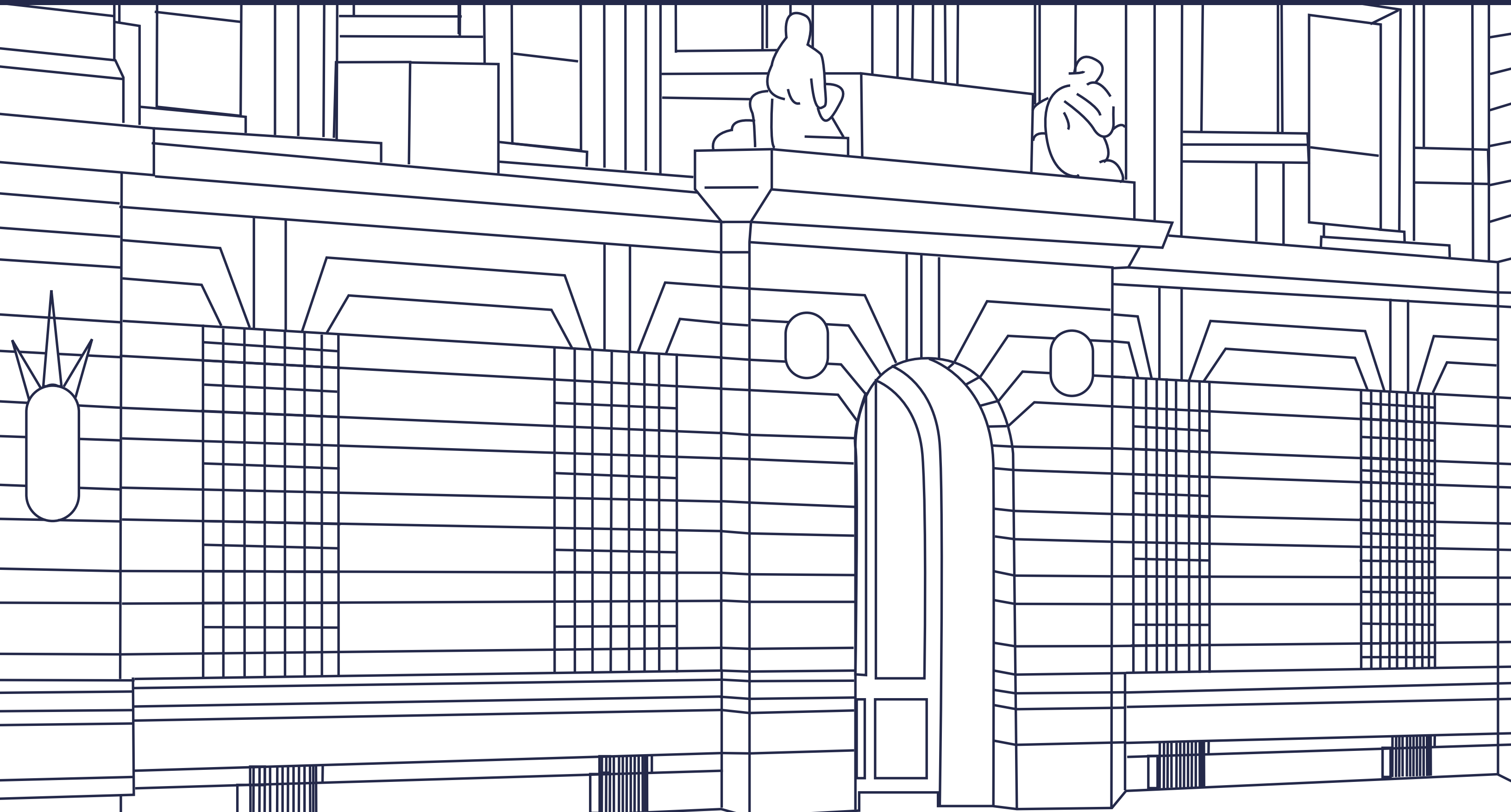

FOREWARNING
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1. PLACE, DATE, AND PARTICIPANTS

1.1. Place: Av. Cinco de Mayo Street no.2, 5th Floor, Col. Centro, Mexico City

1.2. Date of Governing Board meeting: August 1, 2018

1.3. Participants:

Alejandro Díaz de León-Carrillo, Governor

Roberto Del Cueto-Legaspi, Deputy Governor

Irene Espinosa-Cantellano, Deputy Governor

Javier Eduardo Guzmán-Calafell, Deputy Governor

Manuel Ramos-Francia, Deputy Governor

Miguel Messmacher-Linartas, Undersecretary of Finance and Public Credit

Fernando Luis Corvera-Caraza, Secretary of the Governing Board

Prior to this meeting, preliminary work by Banco de México's staff analyzing the economic and financial environment, together with the developments in inflation and the determinants and outlook for inflation, was conducted and presented to the Governing Board.

2. ANALYSIS AND RATIONALE BEHIND THE GOVERNING BOARD'S VOTING

This section summarizes the views expressed by the members of the Governing Board regarding the monetary policy decision.

All members highlighted that available data for the second quarter of 2018 suggest that the world economy continued to grow at a relatively fast pace. One member noted that it grew above potential during the first half of the year. Nevertheless, all members pointed out that there is an increasing divergence in growth among countries and regions. Most members stated that prospects for a solid growth rate of the world economy are maintained for 2018, while one member added that this scenario also prevails for 2019. However, all members agreed that the world economy's performance is subject to uncertainty and that risks to the downside for world economic growth have increased even in the short term and, to a larger extent, in the medium term. All members considered the following as the most relevant risks to the world economy: i) an escalation of trade disputes; ii) a possible tightening of financial conditions; and, iii) the materialization of geopolitical risks.

Regarding the first of these risks, some members mentioned that, recently, the threat of protectionism has increased in some countries. The same members highlighted that the U.S. has adopted some of these measures, announcing the possibility of even imposing additional tariffs. This has led to retaliatory measures by the affected countries. Particularly, one of the members warned about the possibility of the U.S. imposing additional tariffs on Chinese exports as well as trade barriers on automotive imports. All members emphasized that international trade flows are already showing the effects from these protectionist measures. In this regard, one member pointed out that a downward trend can already be observed in the emerging countries' trade volume, particularly in Asia and Latin America, as well as in the Purchasing Managers' Indexes (PMIs) of these regions. Another member stated that in the Eurozone and Asia there has been a decline in export manufacturing orders. The same member noted that some recent studies indicate that protectionist measures of this sort could significantly affect international investment and capital flows, particularly if they have a negative effect on confidence levels. In this context, some members stated that the possibility of escalating trade tensions is far from fading, despite the fact that, in recent days, U.S. and European Union representatives agreed to keep the tariff system that rules their bilateral trade unchanged, and even expressed the view of engaging in further liberalization.

As for the second risk, most members made reference to a possible tightening of global financial conditions due to a faster-than-expected normalization of U.S. monetary policy in a context of elevated debt levels worldwide, which even exceed those observed prior to the global financial crisis. In this environment, one member noted that this risk has increased, given the U.S. economy's position in the current business cycle and the adoption of an expansionary fiscal policy.

As for the third risk, one member pointed out that geopolitical tensions in the Middle East and other regions persist, and that there are no signs of them mitigating. Another member explained that, although the tensions associated with North Korea have apparently diminished, those related to Iran and to the effects of the U.S. economic blockade to this country, have increased. The same member added that despite the low probability of this type of risks, they could have significant implications for the prices of some commodities and for global risk appetite.

In addition to the above mentioned risks, some members included other factors that could affect the world economy's performance negatively. One member pointed out that the probability of a slowdown in U.S. growth is another risk to world economic growth. Some members noted that an economic slowdown in the U.S. may ensue given that the current business cycle is in an advanced stage. One member even mentioned the possibility of an economic recession in this country in the next years, and highlighted that such recession would be worsened by the deteriorated conditions of its public finances. Another member pointed out that the development of oil prices could have a negative impact on the growth rate of world economic activity. The same member added that, although the recovery of oil prices from their lowest levels in 2016 has partly been reverted in recent months, they may reach levels above those expected by markets if there are disruptions in the supply for oil. Finally, some members pointed out that the uncertainty related to elections in both advanced and emerging countries as well as to the terms and conditions of Brexit, may also have a negative effect on confidence levels and, in turn, on global investment and growth.

Regarding world inflation, some members mentioned that in advanced economies inflation continues to converge gradually to central banks' targets. One member stated that the strengthening of labor markets, as well as the increases in fuel prices, have led to slight rises in price levels worldwide. In this regard, the same member expressed that, towards the end of 2018, world inflation is expected to near 2%, stating that this process will be slower in certain regions than in others. The same member highlighted that the balance of risks to inflation in the short term is starting to deteriorate. The same member also pointed out that several risks to inflation in the medium term are expected to continue, underlining among these the persistence of an upward trend in fuel prices and the problems that certain emerging economies may have due to external or fiscal imbalances.

In regards to the performance of advanced economies, some members stated that several of them may have even reached the peak of their business cycle. Most members noted that U.S. economic activity grew at faster rate during the second quarter, partly in response to the fiscal stimulus adopted. Another member pointed out that this performance reflected the growth of most aggregate demand components. Another member mentioned that the increasing domestic demand is also due to the low levels of unemployment. In this regard, some members added that the latter have reached several-decade minimum levels in this country. In this regard, another member added that U.S labor market conditions remain tight and highlighted that wages and earnings, as well as the labor cost index, are on an upward trend. Some members stated that this environment of reduced slack may exert greater pressures on inflation. In line with the above, some members noted that the labor market conditions have been reflected in an upward trend of inflation and its expectations, mostly those for short- and medium-terms. As for growth forecasts, some members pointed out that timely indicators suggest that, in the U.S., GDP will continue growing at a high rate for the remainder of the year. One of the members stated that given both the current U.S. business cycle and the timing of the fiscal stimulus, the U.S. economy is expected to continue growing at a robust rate, not only for the remainder of 2018, but also during 2019. In this context, one member noted that, indeed, U.S. growth forecasts have been revised upwards, although, as some members mentioned above, there is the possibility of a deceleration in subsequent years. As for other advanced economies, most members highlighted that, in contrast with the U.S. economic dynamism, most recent data on economic activity in the Eurozone, United Kingdom and Japan point to a deceleration. Some members stated that growth forecasts for these three economies have been revised downwards. One member noted that these revisions reflect the negative surprises observed for economic activity at the beginning of 2018.

As for monetary policy in advanced economies, one member pointed out that, in general terms, monetary policy expectations in these economies exhibited only a few adjustments. The same member added that, although central banks have warned about the risks associated with the increasing protectionism worldwide, economic activity in this group of countries has been growing. Delving into the case of the U.S., most members highlighted that, as expected, the Federal Reserve kept the target range for the federal funds rate unchanged in its August meeting and reiterated its forecast of increasing it gradually. Some members pointed out that the forecast of two additional 25 basis points (bps) raises for the remainder of the year prevails. One member emphasized that the U.S. Federal Reserve has been facing the current economic environment in that country without major problems, by raising its reference rate gradually and through its forward guidance on monetary policy. Most members mentioned certain factors that might heighten inflationary pressures and affect the trajectory of interest rates in the U.S., such as labor market tightness, fiscal stimulus measures, and the protectionist policies announced. Another member highlighted that the yield curve of Treasury bonds is relatively flat, which apparently reflects, on the one hand, the expectation of gradual increases in short-term interest rates and, on the other hand, that the conditions that led to a low term premia have prevailed. The same member concluded that monetary policy normalization in the short term is currently subject to greater risks and to an environment of higher uncertainty, albeit being planned and announced as a gradual and smooth process. The same member added that, in the long run, there seem to persist conditions in markets that imply a low inflation rate.

Regarding monetary policy in other advanced economies, one member mentioned that the European Central Bank kept its reference rates unchanged, partly due to a weaker-than-expected economic performance and to the fact that the level of inflation is below the central bank target, which suggests that this institution has adopted a slightly more accommodative policy stance than expected. Regarding the Bank of Japan, the same member highlighted that it also kept its reference rate unchanged and committed to maintain a highly accommodative monetary policy for a longer period, by controlling the yield curve and introducing guidance on the likely path of interest rates. As for the Bank of England, the same member pointed out that, despite its favorable development, inflation remains above the 2% target in the United Kingdom, adding that, given the strong wage pressures, inflation expectations have remained at the highest level in the last four years. In this context, the same member pointed out that, in its next meeting, the Bank of England is expected to raise its target rate by 25 bps, to 0.75%. In this regard, some members concluded that a gradual withdrawal of the monetary stimulus in these countries continues to be expected. One member stated such process is foreseen to be faster in the U.S. than in other advanced economies.

As for emerging economies, one member noted that the forecast of moderate economic activity growth rates is maintained for this year and 2019, which means that these economies would accumulate four consecutive years of increasing GDP growth. Nevertheless, some members mentioned that the forecasts to growth for these economies were revised downwards. One member pointed out that, as for Asian economies, this was due to the contraction of trade flows in recent months. In relation to the Chinese economy, the same member noted that it has undergone a gradual deceleration, while another member added that uncertainty about this economy has increased, albeit from a still robust growth level. One member highlighted that the growth forecast for oil-exporting countries has increased slightly. In this context, some members pointed out that there is also divergence in growth rates of emerging economies. As for inflation in these economies, one member added that, in most cases, incoming data shows that inflation remains below the set targets; however, in some cases, they have been affected by the depreciation of their local currencies and, in other cases, by the rise in fuel prices. The same member noted that, in order to cope with this situation, the respective central banks have opted for a more cautious rhetoric and are expected to adopt a more restrictive stance in their next monetary policy decisions.

Most members pointed out that international financial markets exhibited episodes of volatility in recent weeks. Some members added that risk aversion has increased and that a high sensitivity to the escalation of trade tensions between the U.S. and other countries has been observed. Some members explained that this has caused an outflow of foreign capital from emerging economies. In this context, most members highlighted that asset prices in these economies exhibited negative returns, particularly those from Asian countries. In this regard, some members emphasized the case of China. In contrast, one of the members stated that most financial assets in advanced economies exhibited marginal changes. In this regard, another member pointed out that yields on U.S. 2-year Treasury bonds neared 2.70% and increased by around 140 bps from September to date. The same member added that those of 10- and 30-year T-bonds are at 3.00% and 3.13%, exhibiting increases of around 95 and 45 bps, respectively, during the same period. Most members highlighted the strengthening of the U.S. dollar. One of the members stated that the latter is associated with the expectation of a higher growth of U.S. aggregate demand relative to other advanced economies, partly as a result of the fiscal stimulus in that country. Another member noted that the monetary policy normalization process of the U.S. Federal Reserve has also implied a depreciation of emerging economies' currencies of between 1% and 4%. Looking ahead, one member pointed out that the U.S. dollar is expected to continue appreciating in real terms for the following quarters. The same member also mentioned that U.S. monetary conditions are tightening in two ways: through the increase in short-term interest rates, and through the nominal appreciation of the U.S. dollar, which, in turn, has led to a certain tightening of financial conditions. As for other asset and primary commodity prices, one member stated that stock prices of the automotive sector fell significantly given the possibility of the U.S. imposing new tariffs on automobile imports, while the prices of industrial metals have undergone a downward adjustment given the possible weakening of economic activity and the subsequent lower demand for commodities. In this regard, another member added that the prices of commodities are not expected to increase significantly in the near future, and that even the oil futures curve does not show signs of oil prices increasing sharply in the short term and that they show a significant amount of contango.

Looking ahead, most members added that risks are perceived in the short term, such as those previously described for world economic growth, which may continue generating volatility in international financial markets. Some members noted that, in this environment, there could be greater increases in interest rates and an additional strengthening of the U.S. dollar, as well as a significant decline in appetite for risk and capital outflows from emerging economies. One of the members added that the aforementioned could intensify if a more adverse environment for international trade materializes. In regards to China, another member referred to the possible effect of the fiscal and monetary easing recently announced by this country on financial markets. The same member pointed out that, although the Chinese authorities have stated that these policies are aimed at avoiding the effects arising from the trade tensions and other external sources of uncertainty on domestic demand, they may exert additional pressures on their currency and elevate the risks associated with the increasing indebtedness in China.

All members of the Governing Board noted that timely indicators suggest that during the second quarter of 2018 Mexico's economic activity contracted as compared to the previous quarter. In this regard, one member pointed out there appears to be evidence of such a slowdown on both supply and demand indicators. On the aggregate demand side, most members mentioned that there was a reversion in the dynamism exhibited by investment in the previous quarter and a weakening of exports, while private consumption showed a positive evolution. One member stated that the behavior of aggregate demand reflects the continuing adjustment of the economy to an environment of high uncertainty, a decreasing availability of external funding, and of a depreciation of the real exchange rate. Some members explained that the growth of investment decreased both in the component of construction, due to the fading effects of the reconstruction efforts after the earthquakes of 2017, as well as in imported machinery and equipment. One member reiterated that such behavior is mainly due to the persisting environment of uncertainty arising from both domestic and external factors. The same member pointed out that manufacturing exports could be affected in part by the weaker rate of growth of world trade and particularly by its effect on exports to countries other than the U.S. In regards to production, some members mentioned the contraction of the primary sector, while most members noted that the secondary sector continues to exhibit a lack of dynamism while the tertiary sector is showing signs of decelerating. As for the slower growth rate of the industrial sector, some members stated that it is associated with a negative trend in the construction sector. In this regard, one member added that it is also associated to the deceleration in manufacturing production.

Most members pointed out that in 2018 GDP growth is anticipated to fall to the lower part of the estimated range (2 to 3%), as specified in the latest Quarterly Report. Most members highlighted that this forecast is due to the weakness exhibited during the second quarter of the year. One member added that it also reflects the outlook that investment will remain weak in the following quarters. Another member noted that, taking into account that the first half of the year has ended, this adjustment of half a percentage point in the forecast to growth is significant, and that it implied an adjustment to this member's outlook for growth and inflation for the next months. Notwithstanding the above, most members pointed out that the forecast of a stronger growth for 2019 prevails, although some members mentioned that an environment of higher uncertainty is expected for that year. In this regard, one of the members stated that, under current conditions, it is difficult to make an assessment of the evolution of economic activity during the second half of 2018 and in 2019.

Most members noted that, given the uncertainty generated by the complex environment faced by the Mexican economy, the balance of risks for growth maintains a bias to the downside. Beside the aforementioned global risks, most members mentioned the uncertainty associated with the North America Free Trade Agreement (NAFTA) renegotiation and the outlook for the U.S.-Mexico bilateral relation. In this regard, some members pointed out that, despite the recent signs of a positive outcome, the risks of a prolonged NAFTA renegotiation or an unfavorable outcome cannot be dismissed, which can continue to have an effect on domestic demand, particularly on investment. One member mentioned as an additional risk the possibility that oil production remains significantly below the levels programmed for the remaining of 2018. Most members highlighted the uncertainty associated with the strategies, policies and plans of the incoming administration. In this regard, one member stated that the absence of details about the actions that the new administration will implement in different areas also entails risks to domestic demand during the second half of 2018 and in 2019. The same member also emphasized the possibility of a reduction of total public spending during the second half of this year, as has been the case in previous election years. Among the medium- and long-term risks to potential growth, another member noted the possible modification of the fiscal policy stance by the incoming administration, as well as the deterioration of Mexico's conditions of access to international trade. Finally, one member highlighted the uncertainty regarding the necessary measures to increase the productivity of the country and its adequate use of productive factors.

Most members pointed out that slack conditions in the Mexican economy are estimated to have eased and that forecasts to growth would imply output gaps that are wider than those previously expected for the following quarters. In this regard, one of the members stated that the economy is anticipated to grow even below potential during the next quarters and that the output gap will near zero in 2019. The same member emphasized that these forecasts imply that slack conditions would ease at a faster pace than expected, which could have significant consequences on the path of core inflation in the next months. Most members noted that labor market indicators remain tight. In this regard, one of the members highlighted that the national unemployment rate apparently stabilized at around 3.4%, a figure below the nonaccelerating inflation rate of unemployment (NAIRU) estimate. Another member pointed out that the latest data indicates a lower growth of formal employment and an increase in the unemployment rate, although it is too early to draw conclusions from these figures. Some members noted that the indicators of slack conditions do not reflect demand-related pressures on inflation. Another member emphasized that, although wage indicators have exhibited moderate increases, they could be subject to pressures in view of the absence of slack in the labor market. The same member also stated that, for this reason, wage revisions must be thoroughly assessed in order to fully identify their effects on the economy's price formation process. The same member added that, in this context, the alternatives proposed for revising various wage indicators should consider productivity gains and do not entail generalized cost pressures on the economy.

As for headline inflation, all members agreed that after the fall observed at the beginning of the year, it increased in June. Most members mentioned that in the first half of July 2018 inflation reached 4.85%, after having posted 4.65% in June and 4.51% in May. All members considered that this increase is explained mainly by the growth in the non-core inflation component, due to the upward adjustment in the prices of gasolines and L.P. gas. All members noted that the indirect effects of the price increases of these products have also had an impact on core inflation. One member highlighted that fundamental core inflation does not suggest any cyclical pressures on prices. Most members stated that in recent months headline inflation has been affected by the aforementioned shocks. One member pointed out that, in a more adverse environment, and with considerable elements of domestic uncertainty, some of the risks to the upside for inflation have materialized. In this regard, the same member mentioned that the Mexican peso exchange rate has been subject to episodes of volatility, despite its recent appreciation, and that non-core inflation has been subject to the energy-product shocks mentioned above.

As for non-core inflation, some members pointed out that it continued to increase, reaching 8.15% during the first half of July, after having posted 7.79% in June and 6.99% in May. In this regard, one member emphasized that energy prices have escalated above expectations, due mainly to the reduction in the fiscal stimuli applied to these products, as well as to the upward adjustment in their international references. Another member added that the contribution of energy products to the rise in inflation during the first half of July was above that registered in January 2017. As for core inflation, most members mentioned that it reached 3.64% during the first half of July, after having posted 3.62% in June and 3.69% in May. Some members noted that the development of core inflation has been in line with forecasts, exhibiting a downward trend during the entire year. One member emphasized that core inflation is the component that responds more clearly to the monetary policy stance. Another member considered that core inflation has declined at a slower rate than expected. Finally, one member mentioned that there are several additional risks to be considered regarding the recent developments in inflation and its components. The same member mentioned that in the first half of July, the percentage of components of the CPI basket with annualized monthly increases below or equal to 3% decreased to levels below the 50% reference for core inflation for the first time in several months. The same member added that the analysis of inflation dynamics considering frequency and time (wavelets) suggests that inflation's trend component has decreased very gradually, for both headline and core inflation.

Most members mentioned that headline inflation expectations for the end of 2018 were adjusted from 4.00% in June to 4.25% in July, whereas those for the end of 2019 remained around 3.60% and those for the medium and long terms remained around 3.50%. Most members emphasized that medium- and long-term inflation expectations continue above the target. In this regard, some members mentioned that the latter has been taking place for a long period. Some members noted that core inflation expectations for the end of 2018 increased from 3.54% in May's survey to 3.60% in that of July. As for the spread between nominal and real government security yields, some members pointed out that these have shown an upturn as a reflection of the increase in inflation risk premia, although one member considered that such premia have remained at relatively stable levels.

Regarding the foreseen trajectory for headline inflation, most members agreed that the change in relative prices stemming from the increase in energy prices affects the expected trajectory for headline inflation for the next twelve months, although this effect is estimated to be of a transitory nature. One member noted that inflation is expected to return to a downward trend in August, which would continue during the rest of 2018 and in 2019. As for core inflation, most members expect it will continue falling in the time frame in which monetary policy operates. Some members considered that attaining the inflation target during the period in which monetary policy exerts an influence will be difficult. One member mentioned that, in general terms, the speed at which headline and core inflation are declining appears to be too slow to attain the target within the time frame expected by Banco de México. Nevertheless, the same member noted that considering the latest information on economic activity, the economy's cyclical conditions will probably loosen further, a situation that could in turn make headline and core inflation fall more rapidly in the next quarters. The same member stated that, in the absence of additional supply-related shocks or of episodes of volatility that could affect the exchange rate, this scenario is what, in this member's opinion, makes feasible the convergence of inflation to its target within the expected time frame. The same member mentioned, nevertheless, that even in such a scenario, there is a high risk of inflation not converging to its target within the anticipated time frame.

Most members agreed that the balance of risks for the expected trajectory of inflation continues biased to the upside, in an environment of high uncertainty. One member mentioned that such balance did not deteriorate since the last monetary policy decision, although another member said that the prevailing uncertain environment makes its assessment difficult. The majority of members stated that among the main risks to the upside are that the peso exchange rate continues to be subject to external pressures such as the higher foreign interest rates and the U.S. dollar strength, and to factors of uncertainty that persist in both the domestic and external fronts, such as the NAFTA renegotiation. In this regard, one member also noted the still important possibility of a negative NAFTA outcome, as mentioned before, stating, however, that this risk has decreased. The same member also pointed out that the inflation's high current levels could generate hysteresis in the economy's price formation process. In this context, the same member noted that there is the possibility of facing a cyclical stage in which inflation persistently remains above its target, while the economy decelerates sharply. Another member mentioned that the risk of shocks to one or several of the items that compose the non-core inflation price basket is always present. In this regard, some members pointed out that the risk of further increases in the prices of some energy products or of agricultural products persists. Some members highlighted that a factor to consider are the effects of the possible changes in the incoming administration's economic policy. One member noted that among these measures could be a change in the policy for setting minimum wages. The same member stated that the tighter conditions in the labor market could generate risks to prices, although acknowledging that no demand-related pressures on inflation are anticipated and that the risks from the demand side apparently have decreased. Another member mentioned that the revision of nominal contractual wages, which is now at 5.6%, could begin to translate into increases in unit labor costs. Another member noted the risk of a deterioration in the fiscal position, which is structurally very vulnerable. The same member also warned of the possibility of an adverse inflationary surprise in the United States, despite considerations of a structural flattening of the Phillips curve in that country, which could have serious consequences for international financial markets. The same member also mentioned that a change in sentiment in these markets towards Mexico cannot be ruled out, and that the recent cases of several emerging economies –such as South Africa, Turkey, Brazil and Argentina– reveal how suddenly these changes can take place. Lastly, some members considered that there is the risk of U.S. trade policy actions leading to an escalation of protectionist and countervailing measures that could affect inflation negatively. As for the risks to the downside, some members highlighted a possible appreciation of the Mexican peso if the NAFTA renegotiations turn out to be favorable.

All members pointed out that since the last monetary policy decision, the Mexican peso appreciated and exhibited lower volatility. Some members noted that of the main emerging economies, the Mexican peso was the currency that appreciated the most. Most members agreed that such results were partly the consequence of the lesser levels of uncertainty since Mexico's presidential and legislative elections and as a result of a more optimistic outlook regarding the North America Free Trade Agreement (NAFTA) renegotiation and of the raise of 25 bps in Banco de México's monetary policy target rate announced in June. Some members added that the recent behavior of the exchange rate was also the result of investors' anticipating that Mexico will continue to have fiscal and monetary policy stances that contribute to an orderly adjustment of the Mexican economy and financial markets. Some members noted that, in this context, an improvement in the operating conditions of the exchange market has been observed. In particular, this members expressed that there has been greater liquidity and depth in this market, as well as an increase in net long derivatives positions on the Mexican peso. Most members indicated that this more favorable environment has also been reflected in the behavior of the prices of other assets. Some members mentioned that both short and long-term interest rates decreased moderately. One member stated that the latter has led to a slight steepening of the yield curve. Another member highlighted that an improvement in bond market operating conditions has also been observed, as well as capital flows from foreign investors to assets denominated in Mexican pesos, mainly to medium-term instruments. Some mentioned that sovereign risk indicators improved. One of the members specified that domestic financial markets have exhibited a favorable performance. On the other hand, most members noted that, looking head, there are risk factors that could affect domestic financial markets, particularly, the Mexican peso exchange rate. Among such risks they included the uncertainty surrounding NAFTA renegotiations, the higher levels of external interest rates, surprises regarding the process of normalization of monetary policy in the U.S., and, the worldwide escalation of protectionist trade measures. One member added also the uncertainty among investors regarding the economic package to be presented to Mexico's Congress by the incoming federal administration.

One member indicated that the recent behavior of financial markets highlights the importance of having a sound management of macroeconomic policy. Some members stated that the economy is expected to continue facing a complex environment, both in 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 and public finances are consolidated sustainably. One member pointed out that this strategy would reduce the probability of having to face a sudden recomposition of portfolios and capital outflows. Some members mentioned that over the next months one crucial element for preserving a robust macroeconomic policy will be the actions regarding public finances that the incoming administration will announce and implement. One member specified that, in the short term, possible doubts regarding the consistency between some of the initiatives presented by the incoming administration and strengthening the fiscal position should be clarified. The same member mentioned that it will also be important to take actions to ensure the soundness of public finances in the long term, in light of the possible pressures arising from public spending in items such as pension payment obligations, health spending, and the financial cost of federal government debt. In this member's opinion, spending in state-owned productive enterprises' investment that the new administration is considering should also be added to the aforementioned. Another member mentioned that some of the members of the newly elected president's economic team have announced that a responsible fiscal policy will be maintained in order to continue preserving sound macroeconomic fundamentals. The same member added that the aforementioned is a necessary condition so that Banco de México can fully meet its constitutional mandate. Most members pointed out the relevance of raising productivity levels and, in turn, the Mexican economy's growth potential, which, according to one of the members, stands currently around 2.5%. Most members mentioned that in order to achieve this, it is important to improve the rule of law and reduce public insecurity levels, corruption, and impunity. One member stressed that the magnitude of such a challenge requires building on the already attained achievements and adopting the required measures, both on the economic and institutional fronts, to make progress in that direction. The same member also pointed out that raising investment levels is also necessary, since as a share of GDP the latter has fallen to its lowest level in three years, and almost 1 percentage point below that observed in 2008. In this regard, the same member mentioned that it is necessary to give certainty to private investors as to the actions that the incoming administration will adopt in key areas and assess carefully how to create room for the recovery of public investment.

All members pointed out that the most relevant factor to consider for the monetary policy decision is that the effects of the changes in relative prices on headline inflation are forecasted to be temporary. Most members also stated that medium- and long-term inflation expectations have remained stable. Most members also added the forecast that slack conditions in the economy will continue easing, which reduces the possibility of pressures stemming from aggregate demand. Considering the aforementioned, most members emphasized that core inflation continues on a downward trend and is expected to continue falling. Another member highlighted that, under the scenarios foreseen for Mexico's economy, the current monetary policy stance is consistent with a convergence of headline inflation to the 3% target in the time frame in which monetary policy operates fully. One member added that Banco de México should continue with the same current policy stance as long as inflation does not follow a clear downward trend, particularly of its core component. Most members also agreed that, given the current economic environment, it is important to follow a prudent monetary policy stance. One member pointed out that this is essential in a context where major risks persist. Another member added that there are no historical precedents for some of these risks and that they may materialize anytime, and even simultaneously. In this regard, one member stated that, in the case of an adverse environment that requires an adjustment of the real exchange rate, previsions must be taken to ensure that medium- and long-term inflation expectations are not affected and that no second-round effects on in the economy's price formation process emerge. In this regard, some members pointed out that, in general terms, the monetary policy stance must prevent any additional inflationary pressures from contaminating the economy's price formation process and from putting at risk the convergence of headline inflation to its target. In this regard, one member pointed out that monetary policy faces a situation of inflationary pressures above those expected. The same member mentioned that, however, these pressures are the result of supply shocks, in the absence of demand-related pressures on prices, with core inflation following a path consistent with forecasts, and without evidence of second-round effects on inflation. The same member stated that although in these circumstances an immediate monetary policy response is not justified, a prudent stance must be maintained, since under an uncertain environment, with a balance of risks for inflation to the upside, and where it will be apparently difficult to achieve the inflation target during the period of influence of monetary policy, there is a high risk of second round effects, including a de-anchoring of long-term inflation expectations. In this context, some members mentioned that additional rises of the target rate cannot be ruled out, while one member highlighted that Banco de México should clearly indicate this possibility in its communications.

Furthermore, one member delved into the factors to consider for conducting Mexico's monetary policy. The same member mentioned that the current levels of short-term rates implies that their spreads in relation to those of the U.S. remain at prudently high levels, although the spread between Mexico and U.S. inflation has narrowed. The same member considered that the aforementioned situation is appropriate since the spread of term premia between both countries has remained relatively stable, and there is also the persisting possibility of volatility episodes or shocks that could result in a depreciation of the real exchange rate. The same member also added that monetary conditions have tightened further, not only due to the present level of interest rates, but also to the appreciation of the Mexican peso exchange rate. The same member also expressed concern because inflation has been slow in converging to Banco de México's target than as previously expected. The same member emphasized that this is taking place in an environment where economic activity is decelerating. The same member also mentioned that apparently there is certain degree of economic inertia that would be consistent with the forecast that long-term inflation expectations will remain at 3.5% instead of 3%. The same member noted that this could be due to the presence of different channels that generate inflation persistence and make inflation exhibit a strong resistance to the downside as well as to the need for Banco de México to strengthen the credibility of its 3% target. The same member pointed out that the prevailing uncertainty may represent a hindrance to achieving the convergence of inflation to its target, despite Banco de México's prudent and consistent conduction of monetary policy. The same member also expressed concern about the possibility of a situation where inflation is persistently above its target while simultaneously there is a sharp slowdown of economic growth, even to below potential levels. The same member stated that, in this context, monetary policy becomes less effective since one of the most important channels through which it operates is that of aggregate demand. The same member highlighted that the aforementioned situation may prevent inflation, particularly its core component, from converging to the 3% target during the expected time period.

Some members pointed out that, given that monetary policy is implemented within an inflation-forecast-targeting framework, the governing board must explain clearly and with detail the reasons for possible deviations of inflation from its target. The same members agreed that in the event of supply shocks on prices, it will generally be possible to explain credibly the deviation of inflation from the forecasted trajectory, the absence of a monetary policy response, and Banco de México's commitment to attaining the inflation target. One member stated that even in the presence of shocks that would justify a change in the monetary policy stance, for instance, when there is evidence or a risk of second-round effects on prices, postponing the attainment of the inflation target can be justified, as long as the monetary policy response to these shocks is deemed appropriate, and consistent with the attainment of the inflation target, although in a reasonably longer period. Another member explained that it is important to communicate the time frame in which inflation is expected to reach its target, as well as provide guidance on how Banco de México responds to different types of shocks in order to re-optimizing its monetary policy stance so that it is consistent with the fulfillment of the target in the referred time frame.

All members agreed that the message of Banco de México should be that of its commitment to reach the inflation target. The members stated that, given that headline inflation is being affected by the fluctuations in the relative prices of products corresponding to its non-core component, due attention must be paid to the behavior of core inflation, especially because it is the component that responds the most to monetary policy.

3. MONETARY POLICY DECISION

As stated in the monetary policy statement released August 2 of 2018, in order 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. Given the Mexican economy's recent developments and, in particular, that the shocks that have affected inflation recently are of a transitory nature, and considering that core inflation is expected to continue on a downward trend, Banco de México's Governing Board has voted unanimously to maintain the target for the overnight interbank interest rate unchanged at 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 achieve the convergence of inflation to its 3% target and to firmly anchor medium- and long-term inflation expectations so that they attain such target.

4. VOTING

Members voting in favor of this decision:
Alejandro Díaz de León Carrillo, Roberto Del Cueto Legaspi, Irene Espinosa Cantellano, Javier Eduardo Guzmán Calafell and Manuel Ramos Francia voted in favor of maintaining the target rate unchanged at 7.75%.

ANNEX

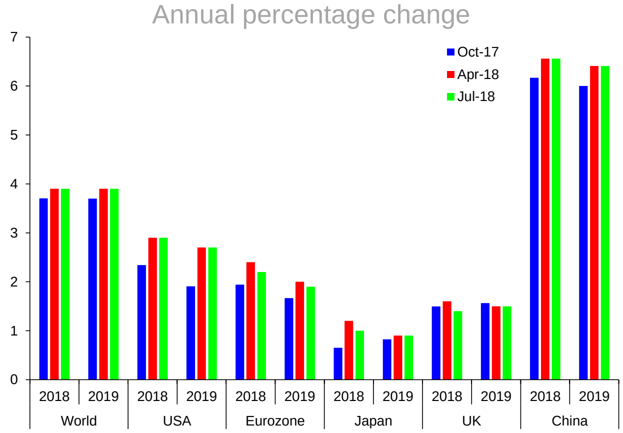
The information in this section was prepared for this meeting by the staff of Banco de México's General Directorate of Economic Research and General Directorate of Central Bank Operations and Payment Systems. It does not necessarily reflect the considerations of the members of the Governing Board as to the monetary policy decision.

A.1. External conditions

A.1.1. World economic activity

Available data suggest that the world economy continued to grow at a relatively fast pace. However, there is an increasing divergence in the performance of the main advanced economies. The U.S. economy grew at a faster rate during the second quarter of the year, while those of the Eurozone, Japan, and the U.K. did so at a lower-than-expected rate. Although domestic demand continued to expand in most economies, international trade decelerated and business confidence started to reflect the uncertainty associated to tariff-related measures. This uncertainty has increased the risks to the global economy in the short term and, to a larger extent, in the medium term (Chart 1). There is also the risk of a sudden tightening of financial conditions and of an escalation of geopolitical tensions.

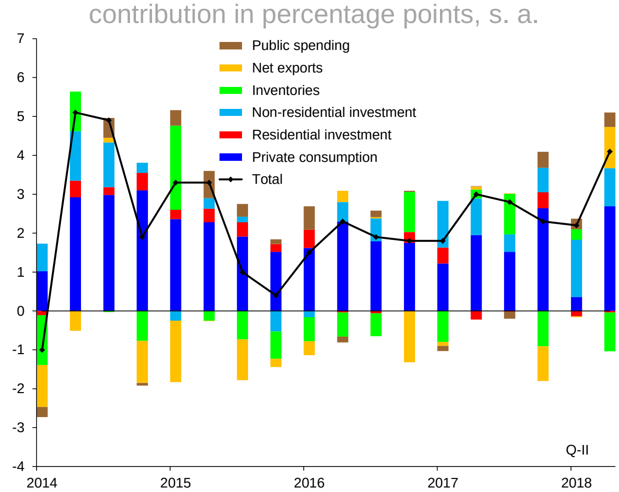
Chart 1
GDP Growth Forecasts for 2018 and 2019
Annual percentage change



Source: IMF.

In the U.S., after having posted a growth rate of 2.2% during the first quarter of the year, GDP grew at an annualized quarterly rate of 4.1% during the second quarter (Chart 2). Job creation and the higher levels of consumer confidence continued to fuel consumer spending. Net exports had a larger contribution to growth, mainly through the strong increase in agricultural exports, possibly in anticipation of the coming into effect of the Chinese tariffs on these items. Business investment continued to expand, while residential investment continued to grow at a moderate rate, vis-à-vis the strong rebound exhibited at the end of last year. In this environment, although the U.S. fiscal stimulus is expected to boost economic activity in 2018 and 2019, a significant downturn is anticipated in the medium term, as this stimulus gradually fades away. The aforementioned, together with uncertainty related to U.S. trade policy measures, has heightened the risks to the economic outlook for the U.S. itself and for other advanced and emerging economies.

Chart 2
USA: Real GDP and Components
Annualized quarterly percentage change and contribution in percentage points, s. a.



s. a. / Seasonally adjusted figures.
Source: BEA.

U.S. industrial production grew 0.6% in June, after having fallen 0.5% in May. This rebound was mainly due to the recovery of manufacturing production, which grew 0.8% in June, after having contracted in the previous month due to an accident in an auto parts plant. Mining production sustained the expansion that has been observed since the end of 2016. This was partially offset by the weakening of electricity and gas supply services, which decreased for the second consecutive month. Purchasing Managers' Indexes (PMIs) suggest that manufacturing activity will continue to grow during the third quarter, despite the dollar strength and the escalated risks to trade.

U.S. labor market conditions continued to tighten during the second quarter. In particular, 213,000 new jobs were created in June, an increase that was above the rate needed to keep pace with the growing labor force. The unemployment rate registered 4%, around 0.5 percentage points below the natural unemployment rate.[1] Quit and vacancy rates continued to increase, in tandem with the growing difficulties to cover available jobs. In this context, wage growth has been recovering.

In the Eurozone, GDP continued to grow at a moderate rate of 1.4% in annualized terms, a rate marginally lower than that observed during the first quarter of the year. These weak results could be explained partly by the presence of short-lived factors, among which were labor strikes in France, as well as, possibly, a lower growth of net exports. In contrast, available indicators suggest that private consumption continued to be driven by the favorable labor market conditions, while investment continued growing, in response to the higher profits of businesses and to accommodative financial conditions. In this environment, the unemployment rate fell to 8.3% in June, while wage growth increased, although at differing rates across countries. Nevertheless, looking ahead, the balance of risks to the region's growth has deteriorated due to the persisting uncertainty regarding the region's trade relations with both the U.S. and the United Kingdom.

In Japan, available indicators of consumption, equipment investment, and foreign trade are consistent with a moderate rate of growth exhibited in the second quarter of the year, after having contracted 0.6% during the first quarter mainly due to transitory factors. In this environment, in May, the unemployment rate reached its lowest level observed since 1992. Nevertheless, forward-looking indicators such as the Purchasing Managers' Indexes (PMIs) continued to fall in July, reflecting expectations of a lower external demand and the greater risks related to the imposition of U.S. tariffs on foreign exports.

Most emerging economies continued growing at a higher rate during the second quarter of the year, albeit with differences, reflecting the asymmetric effects of higher commodity prices and tighter financial conditions. The growth of the Chinese economy slowed down slightly during the second quarter, under an environment where the balance of risks to growth in that country deteriorated due to the lower growth rate of credit and the uncertainty associated with the escalation of trade disputes with the U.S. This situation could also have a negative effect on other Asian economies due to the high level of integration of the region's supply chains.

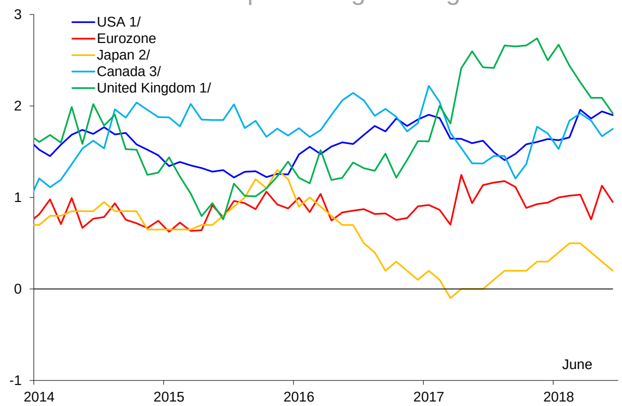
In general, the international prices of commodities decreased in recent weeks. On the one hand, after having increased as a result of falling oil production in Libya and Venezuela and uncertainty associated with sanctions imposed by the U.S. on crude oil exports from Iran, oil prices fell sharply, due to the possibility of Saudi Arabia and Russia raising their production levels and the U.S. using its strategic oil reserves to supply the market. The prices of industrial metals fell significantly due to the growing trade tensions between the U.S. and China and their potential impact on the economic growth of that Asian country. Finally, the prices of grains exhibited an erratic behavior due to both the unfavorable weather conditions and the tariffs imposed by China on several grains from the U.S.

A.1.2. Monetary policy and international financial markets

The reduced slack in the labor markets of advanced economies and the higher prices of food and energy have contributed to the gradual increase of inflation, albeit with significant differences across countries (Chart 3). In the U.S., inflation rose as some transitory factors that had maintained it at low levels during the last year faded out, particularly regarding telecommunication fares. In the Eurozone and Japan, core inflation and inflation expectations remain low, despite the fact that the reduced slack in their labor markets has been reflected in higher wage levels.

[1] The Congressional Budget Office (CBO) estimate for the natural unemployment rate for the second quarter is of 4.6%, while the Federal Reserve's most recent estimate for the long-term unemployment rate is 4.5%.

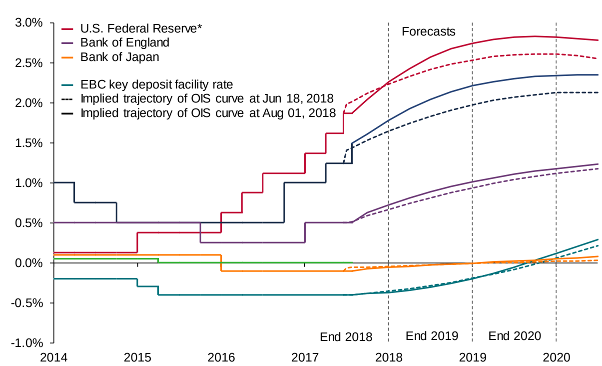
Chart 3
Selected Advanced Economies: Core Inflation
Annual percentage change



1/ Corresponds to the Consumer Price Index (CPI).
2/ Excludes fresh foods, energy, and the direct effect of the consumption tax increase.
3/ Excludes food, energy, and the effect of adjustments on indirect taxes (CPI-XFET).
Source: Haver Analytics, BEA, Eurostat, and Statistics Bureau.

In this environment, the central banks of the major advanced economies are expected to continue undergoing a gradual process towards implementing a more neutral monetary policy stance, although a greater divergence is anticipated in the pace at which each one of them could adjust their respective policies. The U.S. Federal Reserve, the Bank of England, and the Bank of Canada are expected to continue raising their respective reference rates in the coming months, while the European Central Bank and the Bank of Japan are expected to be more cautious as to the normalization process of their respective monetary policies (Chart 4).

Chart 4
Target Rates and Implied Trajectory in OIS Curves[1/]
Percent



1/ OIS: Fixed floating interest rate swap where the fixed interest rate is the effective overnight reference rate.
* In the case of the U.S. observed reference rate, the average interest rate of the federal funds target range is used (1.75%-2.00%).
Source: Bloomberg.

In its July meeting, as expected, the Federal Reserve kept the target range for the federal funds rate unchanged at between 1.75 and 2%, and reiterated its intention of increasing it gradually and in a manner consistent with sustained economic growth, tighter labor market conditions, and the convergence of inflation to the symmetric 2% target. In this context, market indicators almost fully price in that the Fed will raise its target rate by 25 basis points (bps) in its September meeting, and reflect the possibility of an additional 25 bps raise before the end of the year.

In its July meeting, as expected, the Bank of Canada raised its reference rate by 25 bps, to 1.5%. This central bank pointed out that the economy continues to operate near its full capacity and reiterated that it will continue increasing its reference rate gradually to keep inflation near its target. The Bank of Canada is thus expected to raise its key interest rate to 1.75% before the end of 2018.

In its August meeting, the Bank of England raised its reference rate by 0.25 percentage points, to 0.75%. In its press release, the Monetary Policy Committee pointed out the need for a further tightening of its monetary policy stance in the following years to ensure that inflation will return to its 2% target. Nevertheless, this central bank reiterated that it will continue raising such rates gradually and in a limited fashion, as long as the country's economic developments continue being consistent with economic forecasts. This central bank raised its growth forecast for the remainder of 2018 and for 2019, while it continues expecting inflation to be above its target, at least until 2020. Additionally, it reiterated that the economic outlook might be affected by the response of economic agents to the results of the Brexit negotiations.

In its June meeting, the European Central Bank (ECB) kept its key deposit facility rate and its forward guidance unchanged, by stating that interest rates will not vary at least until the Summer of 2019, or until necessary to ensure that inflation converges sustainably to its target. The ECB also pointed out that it will continue to buy assets for a monthly amount of 30,000 million euros until the end of September and that, subject to incoming economic figures, it is expecting to reduce these purchases to 15,000 million euros from late September to December 2018, when this program is anticipated to conclude. It also stated that, despite the high uncertainty over global trade, available information indicates that the region has been growing at a high and generalized rate. The ECB pointed out that, although inflation has remained weak, pressures on costs have increased due to the tightening of the European labor markets and the high utilization rates of capacity, reflecting its confidence that inflation will continue converging to its target. Monetary policy expectations implied by market instruments continue to anticipate that the first increase of the key interest rate will take place in the third quarter of 2019.

Finally, the Bank of Japan announced that it will maintain a highly accommodative monetary policy stance for as long as is necessary to reach its price stability target. This institution kept its short-term reference rate unchanged at -0.1% and its long-term rate indexed to its 10-year bond at 0%. The Bank of Japan emphasized that such rates will be kept at those levels for a long time. This central bank modified some aspects of its asset purchase program and of its yield curve control policy to improve their sustainability in the long run and to mitigate any negative effects they could have on Japan's markets.

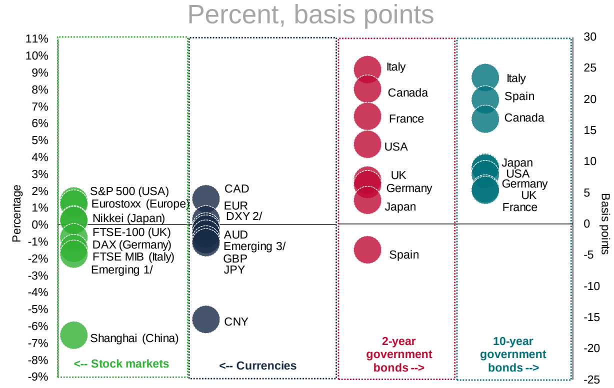
In emerging economies, headline inflation increased further due to factors such as the recent depreciation of their currencies, the rise in energy prices, and the lower slack in the economy. In most countries, however, headline inflation remained below the target of their respective central banks. The Philippines, Indonesia, and the Czech Republic raised their monetary policy target rates, while other central banks are expected to adopt a tighter policy stance in the coming months if the balance of risks to inflation deteriorates further.

In the specific case of China, although the reference rate was kept unchanged, its central bank cut the reserve requirements for commercial banks and increased the access to medium-term loans in an effort to promote the granting of credit to small and medium enterprises in order to face a potential economic slowdown in that country. The Chinese authorities also announced a fiscal stimulus package to offset the negative effects of uncertainty caused by external factors on economic activity.

In this context, international financial markets underwent episodes of volatility and became highly sensitive to the heightened trade tensions between the U.S. and other countries and its implications for global economic growth. As a result, the assets of emerging markets, as well as those that are more sensitive to an environment of higher protectionism, posted negative returns, particularly in the Asian region. In this regard, the fall of the Chinese stock market indexes and the depreciation of the renminbi stand out. Auto industry stock prices also fell significantly in light of the possibility that the U.S. imposes tariffs on vehicle imports, while the prices of industrial metals were adjusted downwards given the possibility of a weakening of economic activity and the consequent lower demand for commodities.

In advanced economies, both stock market indexes and exchange rates exhibited only a few variations, although U.S. stock markets remained on an upward trend driven by the strong dynamism of economic activity and the solid profits generated by companies during the second quarter. Such profits reflected, in part, the effects of the recent fiscal reform in that country (Chart 5). Debt instruments exhibited slight changes. In the U.S., short-term interest rates continued to increase more than long-term ones, thus contributing to a further flattening of the yield curve and raising concerns among investors about the economic cycle's maturity.

Chart 5
Change in Selected Financial Indicators
(June 18 – August 1, 2018)
Percent, basis points



1/ MSCI Emerging Markets Index (includes 24 countries).
2/ DXY: Weighted average of the nominal exchange rate of the six main world-traded currencies (calculated by Intercontinental Exchange, ICE) with the following weights: EUR (57.6%), JPY (13.6%), GBP (11.9%), CAD (9.1%), SEK (4.2%), and CHF (3.6%).
3/ J.P. Morgan Index constructed from a weighted average of the nominal exchange rate of emerging economies' currencies with the following weights: TRY (8.3%), RUB (8.3%), HUF (8.3%), ZAR (8.3%), BRL (11.1%), MXN (11.1%), CLP (11.1%), CNH (11.1%), INR (11.1%), and SGD (11.1%).
Source: Bloomberg and ICE.

In emerging economies, the prices of financial assets fell due to the persisting trade tensions and to idiosyncratic factors. Assets from Argentina, Turkey, and the Asian emerging economies were particularly affected. A continuing reduction in capital flows to these economies was observed, although accumulated flows during the year remain positive.

Looking ahead, risk factors persist that may lead to new volatility in financial markets. In recent weeks, protectionist trade measures escalated. If these persist, they could lead to a sharp adjustment in financial markets and to a deceleration of international trade and investment, therefore posing a risk for the cycle's current stage of expansion. Another risk is the possibility of monetary policy normalization in advanced economies taking place at a more rapid pace than expected by financial markets. The high valuation of some financial assets, the high leverage position of households and businesses in certain countries, and several geopolitical factors continue being risk factors as well.

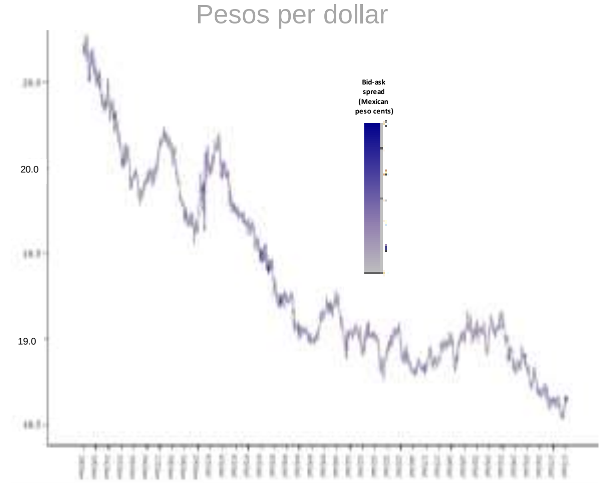
A.2. Current situation of the Mexican economy

A.2.1. Mexican markets

In the weeks after Banco de México's last monetary policy statement, the Mexican peso exchange rate against the U.S. dollar appreciated by around 10.7% (Chart 6), standing out as the currency that performed the best against the U.S. dollar during the period. The peso totally reverted its depreciation trend accumulated in the last months by appreciating 6.1% so far this year (Chart 7). This behavior was observed after Mexico's presidential and legislative elections and as a result of a more optimistic outlook regarding the North America Free Trade Agreement (NAFTA) renegotiation. The 25 bps raise in Banco de México's monetary policy target rate in June also contributed to the appreciation of the peso exchange rate.

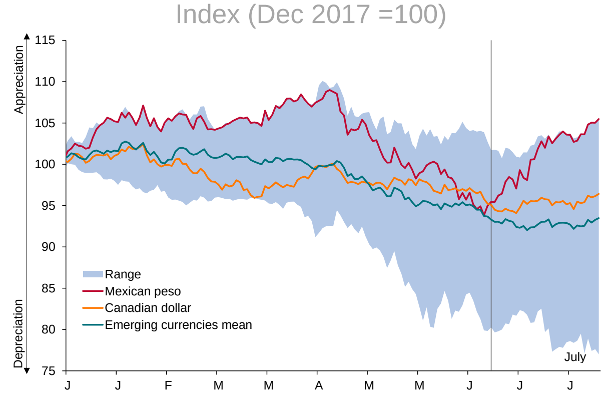
In this context, foreign exchange market-operating conditions, including liquidity and market depth, improved slightly vis-à-vis those observed during June (Chart 8). The implied volatility of peso-dollar exchange rate options decreased significantly, particularly in shorter-than-3 month tenors (Chart 9). This led to an increase in net long derivatives positions on the Mexican peso, mainly among foreign investors with short-term investment horizons (Chart 10). As for exchange rate expectations, forecasters from various financial institutions modified their projections from 18.95 to 19.00 pesos per dollar for the end of 2018, and from 18.62 to 18.80 pesos per dollar for the end of 2019.

Chart 6
Mexican Peso and Bid-ask Spreads of its Intraday Quotes
Pesos per dollar



Source: Prepared by Banco de México with Reuters data.

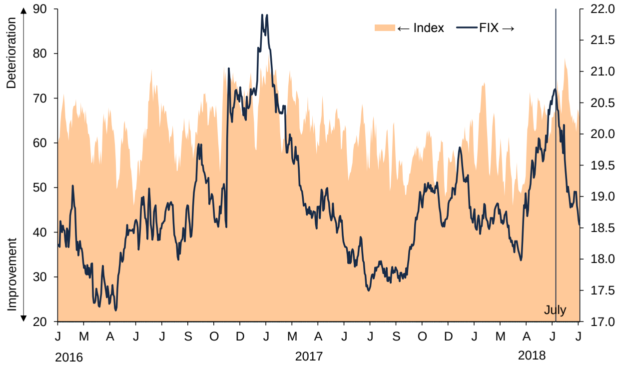
Chart 7
Accumulated Index of Selected Emerging Currencies and Mexican Peso in 2018
Index (Dec 2017 =100)



Note: Currencies' mean and range of the following emerging countries: Peru, Turkey, Philippines, Poland, Hungary, South Korea, Indonesia, South Africa, Russia, Brazil, Colombia, and Chile. The black vertical line represents Banco de México's last monetary policy decision.
Source: Prepared by Banco de México with Bloomberg data.

Chart 8
Mexican Foreign Exchange Market Operating Conditions and Peso-dollar Exchange Rate

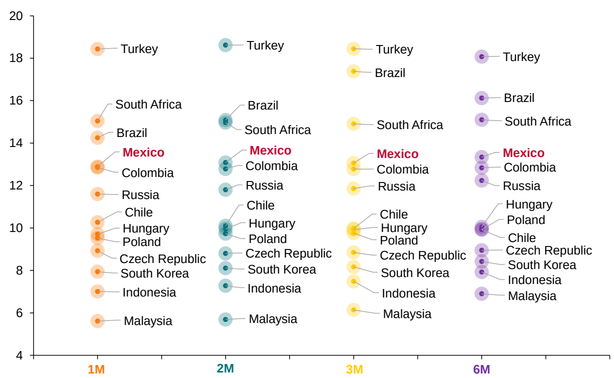
Index (5-day moving average), pesos per dollar



Note: Index calculated using the mean, volatility, skewness, kurtosis, bid-ask spread and mean of simple differentials all of them related to quotes of intraday operations, and the total traded volume. After obtaining this data, the percentiles since 2011 are calculated and the average of the 7 percentiles for each day is considered. The black vertical line represents Banco de México's last monetary policy decision.
Source: Prepared by Banco de México with Reuters data.

Chart 9
Implied Volatility of Selected Emerging Currencies-USD Options at Different Maturities (July 30, 2018)

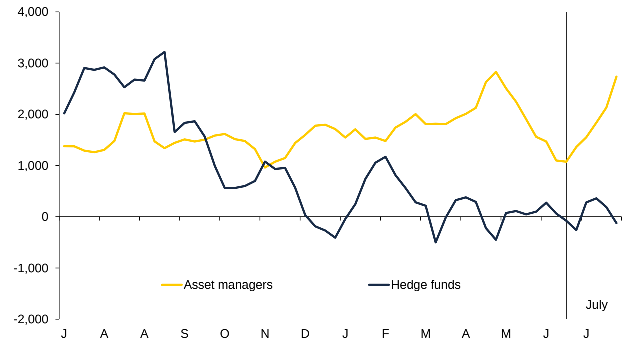
Percent



Source: Bloomberg.

Chart 10
Mexican Peso Net Futures Position in Chicago Mercantile Exchange by Investor Type

Millions of dollars

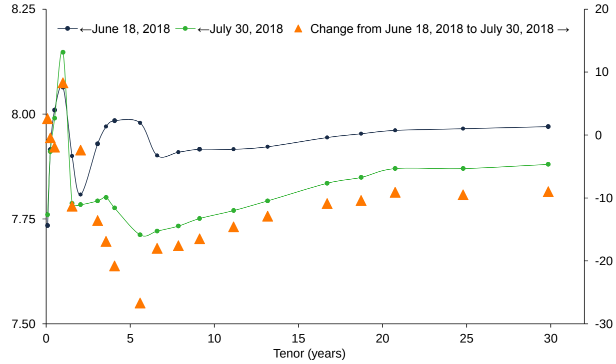


Note: The black vertical line represents Banco de México's last monetary policy decision.
Source: Prepared by Banco de México with data from the Commodity Futures Trading Commission (CFTC).

Since the previous monetary policy statement, the yield curve of government securities had a positive performance, with interest rates of shorter-term instruments registering the most significant decreases (of up to 27 bps; Chart 11). It is worth noting that the adjustment of interest rates in the Mexican market took place in an environment where operating conditions in the bond market remained stable. During this period, capital inflows from foreign investors to peso-denominated assets stood out, particularly those directed to medium term instruments (Chart 12).

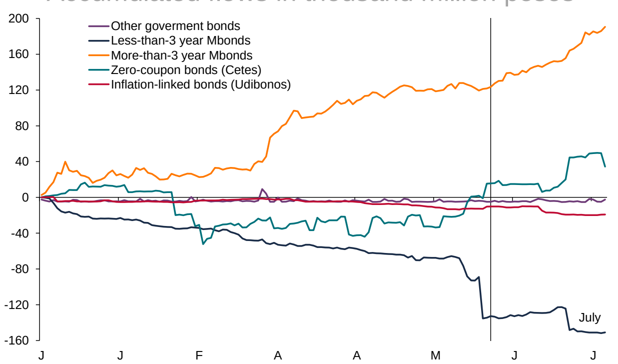
Finally, expectations for the target rate implied in the interest rate swap yield curve were 7.76% for Banco de México's August monetary policy decision and 8.02% for the end of the year (Chart 13). The consensus among forecasters is that the central bank will leave the target rate unchanged in its August policy decision, anticipating that it will close the year at 7.75%.

Chart 11
Government Bond Yield Curve
Percent, basis points



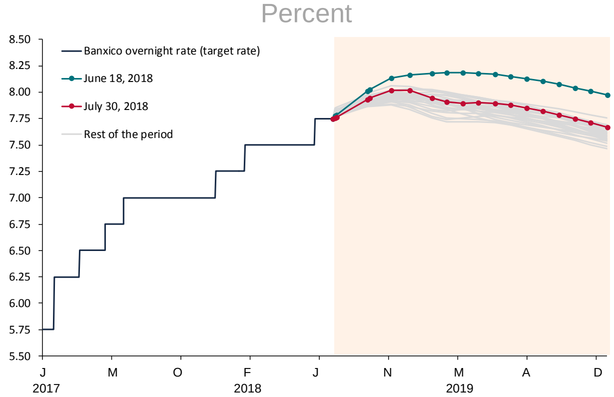
Source: PIP.

Chart 12
Foreign Investors' Flows in Mexican Government Securities in 2018
Accumulated flows in thousand million pesos



Note: The black vertical line represents Banco de México's last monetary policy decision.
Source: Prepared by Banco de México with Indeval data.

Chart 13
Banxico Overnight Interest Rate Implied in 28-day TIIE IRS Curve
Percent

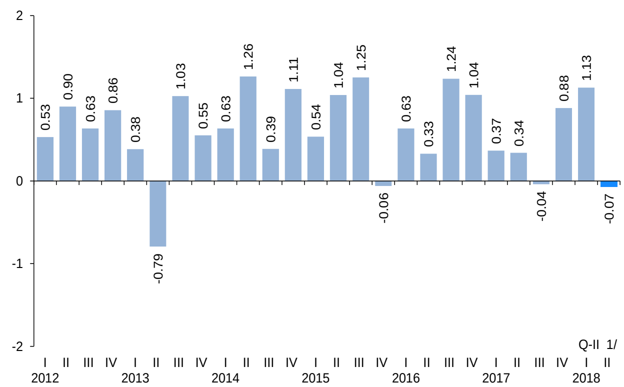


Source: Prepared by Banco de México with PIP data.

A.2.2. Economic activity and determinants of inflation

According to INEGI´s GDP timely estimate, Mexico's economic activity contracted during the second quarter of 2018, in contrast with the rebound observed during the last quarter of 2017 and first quarter of 2018 (Chart 14). This result is partly the reflection of both the reversion in the dynamism exhibited by investment, particularly that related to construction, and a weakening of exports. Private consumption, in contrast, remained on a positive trend.

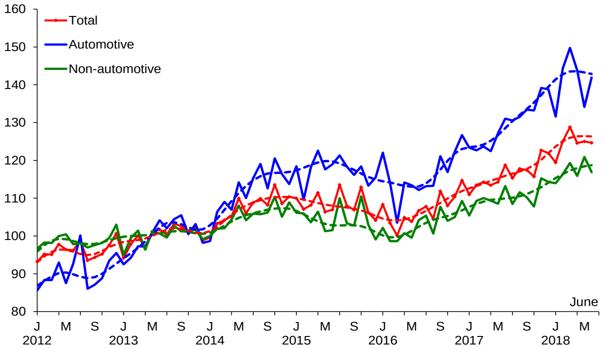
Chart 14
Gross Domestic Product
Quarterly percentage change, s. a.



s. a. / Seasonally adjusted figures.
1/ The figure corresponding to the second quarter of 2018 refers to INEGI's GDP quarterly timely estimate.
Source: Mexico's National Accounts System (SCNM, for its acronym in Spanish), INEGI.

During the April-June 2018 period, manufacturing exports exhibited a certain slowdown vis-à-vis the previous quarter, mainly as a reflection of the contraction of automobile exports, while non-automobile exports followed an upward trend (Chart 15). By destination, exports to the U.S. continued to grow, albeit at a lower rate, while those to the rest of the world exhibited an incipient negative trend. As for domestic demand, despite private consumption's fall in April (as revealed by its monthly indicator), it remained on a positive trend. More timely indicators of consumption, although of less coverage, exhibited a mixed behavior. In particular, in May, revenues of retail stores maintained the dynamism they had been exhibiting since the beginning of the year. In contrast, the lack of vigor in the sales of light vehicles persisted up to the end of the second quarter of 2018. Between March and April 2018, investment slowed down, in contrast with the recovery observed at the end of 2017 and beginning of 2018, in response to both the fading recovery that construction had exhibited in the previous months, and the incipient trend change of spending in machinery and equipment.

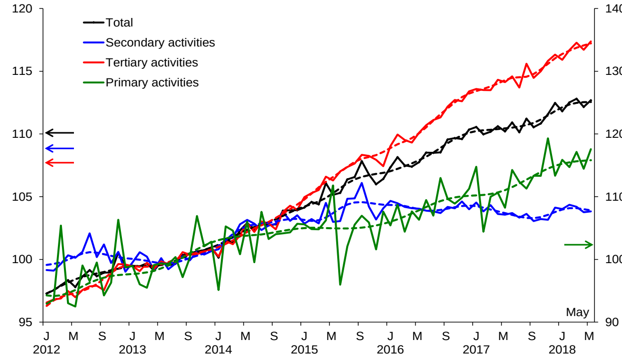
Chart 15
Total Manufacturing Exports
Indices 2013 = 100, s. a.



s. a. / Seasonally adjusted series and trend series. The former is represented by a solid line and the latter by a dotted line.
Source: Prepared by Banco de México with data from the Tax Administration Service (SAT, for its acronym in Spanish), the Ministry of the Economy (SE, for its acronym in Spanish), Banco de México, the National Institute of Statistics and Geography (INEGI, for its acronym in Spanish), Mexico's Merchandise Trade Balance, and National System of Statistical and Geographical Information (SNIEG).

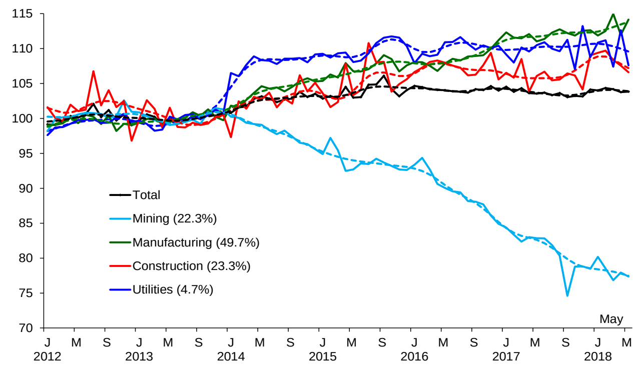
As for production, during the second quarter of 2018, secondary activities continued showing weak results, after the uptick observed at the end of 2017 and beginning of 2018, while primary activities exhibited a strong contraction and tertiary activities slowed down, as compared to the dynamism observed in the previous quarters (Chart 16). Regarding industrial activity, during the April – May 2018 period, mining continued on a negative trend, while the rebound observed in construction between December 2017 and February 2018 reverted (Chart 17). In contrast, manufacturing production exhibited an incipient recovery. As for the services sector, the slowdown observed reflected mainly the weak results of its components of wholesale and retail trade; arts, entertainment and recreation; and other services (except public administration), while those of transportation and warehousing; information and cultural industries; finance and insurance; real estate and rental and leasing; public administration; professional, scientific and technical services; and, management of companies and enterprises, continued growing.

Chart 16
Global Index of Economic Activity
Indices 2013 = 100, s. a.



s. a. / Seasonally adjusted and trend series. The former is represented by a solid line and the latter by a dotted line.
Source: Mexico's National Accounts System (SCNM, for its acronym in Spanish), INEGI.

Chart 17
Industrial Activity
Indices 2013 = 100, s. a.

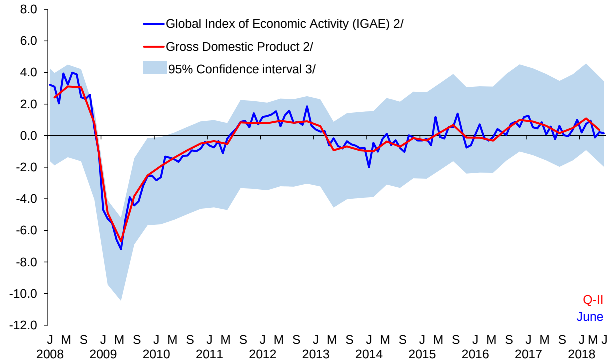


s. a. / Seasonally adjusted series and trend series. The former is represented by a solid line and the latter by a dotted line.
Source: PEMEX and Mexico's National Accounts System (SCNM, for its acronym in Spanish), INEGI.

As for the economy's cyclical position, several indicators of slack conditions suggest that these loosened during the second quarter of 2018. In particular, as a result of the contraction in GDP observed during the April – June period, the positive output gap measure that excludes the oil sector, narrowed, and ended up close to zero (Chart 18). Regarding labor market conditions, both the urban and national unemployment rates remained at low levels (Chart 19). The number of IMSS-insured jobs continued on an upward trajectory, albeit at a moderate rate of growth. According to available information from the first quarter of 2018, unit labor costs in real terms for the overall economy exhibited a level similar to that of the last quarter of 2017, while in May, those of the manufacturing sector remained on an upward trend.

Chart 18
Output Gap Estimates [1/] Excluding Oil Industry [4/]

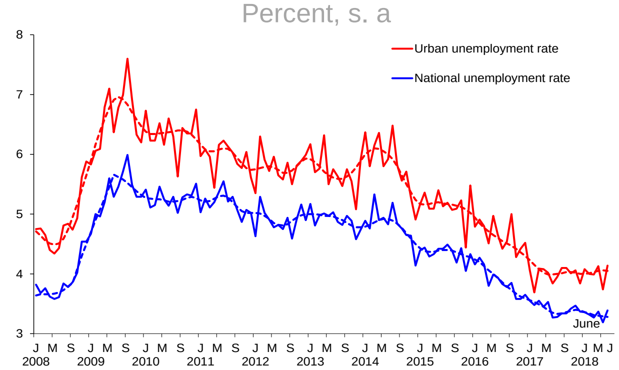
Potential output percentages, s. a.



s. a. / Seasonally-adjusted figures.
1/ Output gap estimated with a tail-corrected Hodrick-Prescott filter; see Banco de México (2009), "Inflation Report (April-June 2009)", p.74.
2/ Second quarter of 2018 GDP figures; IGAE figures up to June 2018 consistent with GDP figures.
3/ Output gap confidence interval calculated with a method of unobserved components.
4/ Excludes both oil and gas extraction, support activities for mining, and petroleum and coal products' manufacturing.
Source: Prepared by Banco de México with data from INEGI.

Chart 19
National Unemployment Rate and Urban Unemployment Rate

Percent, s. a



s. a. / Seasonally-adjusted and trend series. The former is represented by a solid line and the latter by a dotted line.
Source: National Survey of Occupations and Employment (ENOE, for its acronym in Spanish), INEGI.

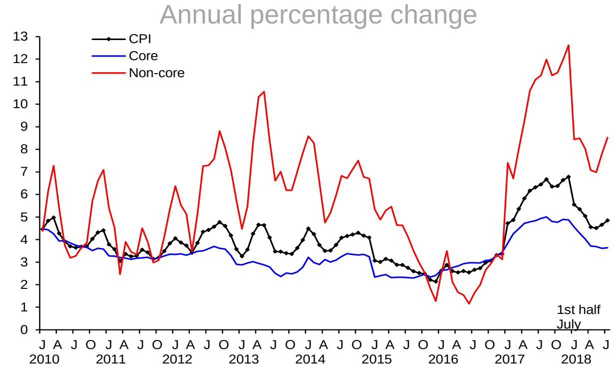
At the end of the second quarter of 2018, the real annual growth rate of financing to the private non-financial sector continued to increase, as compared to the end of 2017. This was mainly the result of the higher growth rate of domestic financing to companies, particularly large companies, while lending to SMEs continued to grow moderately. Credit to households continued to grow at low rates, although higher than those observed at the end of 2017. The aforementioned took place in a context where the costs of financing reached levels above those observed on average during 2017 and, in general, did not exhibit significant changes vis-à-vis the previous quarter. Business and housing delinquency rates have remained stable and at low levels, except those related to consumer lending. The latter continue at relatively high levels, although there are signs that they have stopped deteriorating. This suggests the absence of demand pressures on the loanable funds market.

A.2.3. Developments in inflation and inflation outlook

During the first half of July, the annual rate of headline inflation rose to 4.85%, after having posted a rate of 4.51% in May and of 4.65% in July. These increases were associated with the materialization of some risks to the upside that had been previously mentioned, as a result of higher-than-expected rises in the prices of energy-related products, which led to significant increases in non-core inflation (Chart 20 and Table 1).

Chart 20
Consumer Price Index

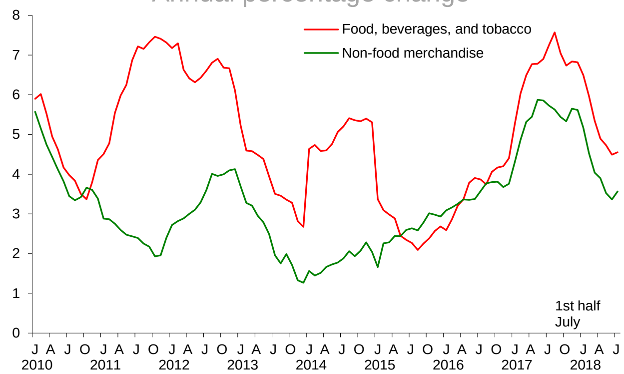
Annual percentage change



Source: Banco de México and INEGI.

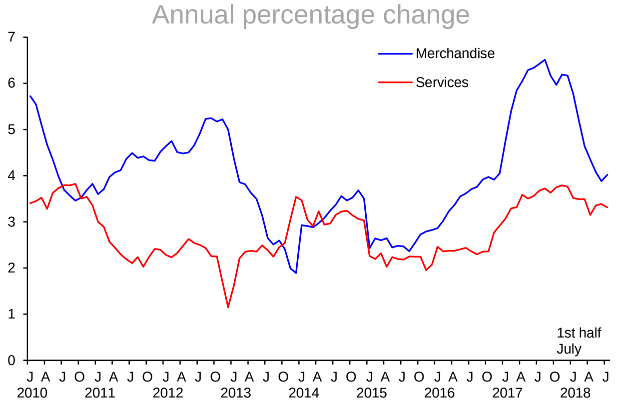
Annual core inflation reached 3.69% in May and 3.62% in June. This fall was caused mainly by the decline in the annual rate of change of merchandise prices. During the first half of July, annual core inflation reached 3.64%. The fact that core inflation stopped declining in that month is associated in part with the indirect effects of the increases in energy prices. During the first half of July, the annual rate of change of merchandise prices exhibited a rebound, which was slightly more noticeable in the case of non-food items (Chart 21 and Chart 22). The annual growth rate of the price sub-index of services exhibited a moderate decline (Chart 22 and Table 1).

Chart 21
Merchandise Core Price Subindex
Annual percentage change



Source: Banco de México and INEGI.

Chart 22
Merchandise and Services Core Price Subindex
Annual percentage change

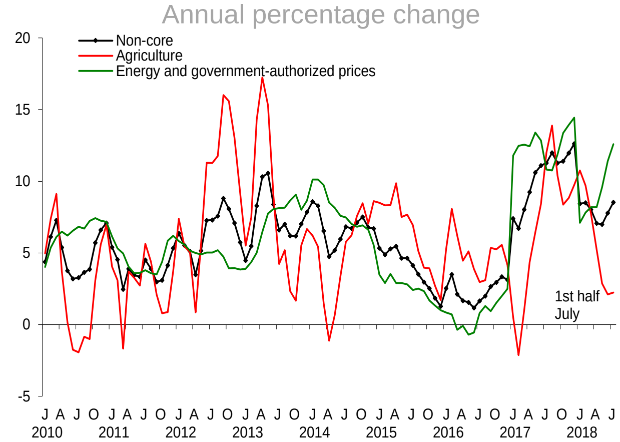


Source: Banco de México and INEGI.

Annual non-core inflation increased further, reaching 6.99% in May, 7.79% in June, and 8.52% in the first half of July. The high annual growth rate of energy prices, mainly those of L.P. gas and gasoline, were the most relevant in this regard. These results were partially offset by the low inflation levels of the price sub-index of agricultural products (Chart 23 and Table 1).

The medians for short-term inflation expectations from Banco de México's Survey of Private Sector Forecasters, increased between May and June. In this regard, the rise in the median for headline inflation expectations for the end of 2018 is noteworthy, after recent inflation figures, particularly those related to its non-core component, were above private sector forecasters' expectations. Hence, the medians for headline inflation expectations for the end of 2018 and 2019 were adjusted upwards from 3.94% to 4.25% for the end of 2018 and from 3.55% to 3.60% for the end of 2019. In contrast, the medians for expectations for the following 12 months from these surveys, both relative to the month in which data is collected and to the subsequent month, were adjusted downwards, from 3.90% to 3.85% and from 3.90% to 3.80%, respectively. The medians for medium- and long-term inflation expectations remained stable at around 3.5%. As for inflation expectations implied in quoted market prices of long-term money market instruments (drawn from 10-year government bonds), these remained unchanged, at levels close to 3.5%. The inflation risk premia increased during the same period.

Chart 23
Non-core Price Subindex
Annual percentage change



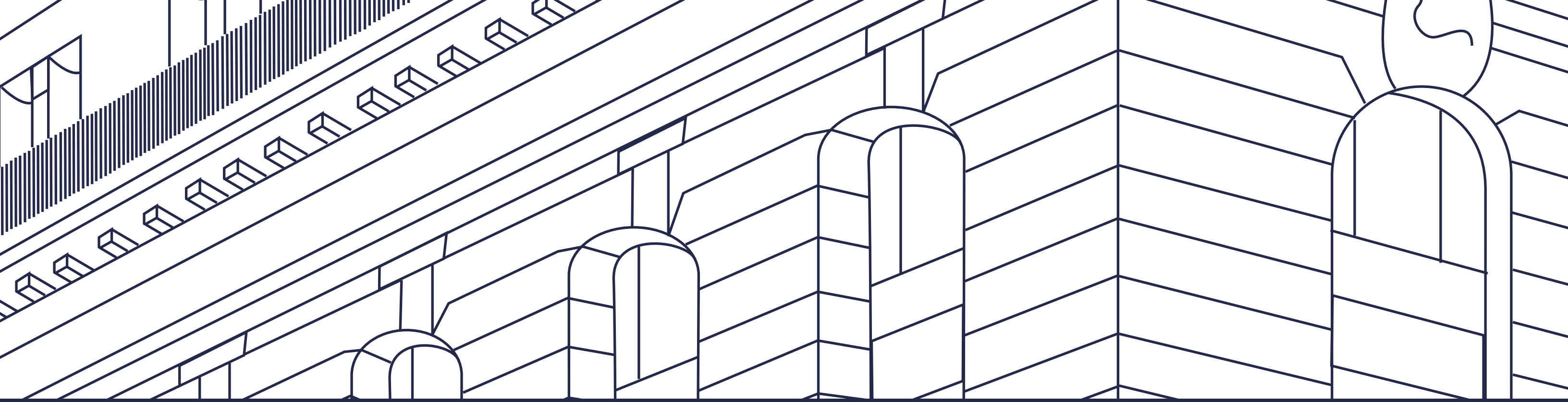
Source: Banco de México and INEGI.

Given that the prices of energy-related products have increased more than expected, especially those of gasoline and L.P. gas, the expected trajectory for headline inflation could be affected for the next 12 months, although this effect is estimated to be of a transitory nature. In contrast, core inflation is foreseen to remain on a downward trend. Among the upside risks to inflation are; first, pressures on the peso exchange rate due to an environment of higher external interest rates and U.S. dollar strength and to persisting uncertainty in both the external and domestic fronts, such as the NAFTA renegotiation; second, additional upward pressures on some energy prices or increases in agricultural prices; and, third, that the trade policy measures adopted by the U.S. generate an escalation of protectionist and countervailing actions that could negatively affect the behavior of inflation. As for downside risks, the peso could appreciate if NAFTA negotiations turn out to be favorable.

Table 1
Consumer Price Index and Components
Annual percentage change

Item	December 2017	May 2018	June 2018	1st half July 2018
CPI	6.77	4.51	4.65	4.85
Core	4.87	3.69	3.62	3.64
Merchandise	6.17	4.07	3.88	4.02
Food, beverages, and tobacco	6.82	4.73	4.49	4.55
Non-food merchandise	5.62	3.52	3.36	3.57
Services	3.76	3.36	3.38	3.31
Housing	2.65	2.57	2.60	2.61
Education (tuitions)	4.74	4.82	4.81	4.81
Other services	4.63	3.73	3.76	3.58
Non-core	12.62	6.99	7.79	8.52
Agriculture	9.75	2.87	2.11	2.23
Fruits and vegetables	18.60	-0.87	-1.40	0.67
Meats, poultry, fish, and eggs	4.50	5.14	4.24	3.21
Energy and government-authorized prices	14.44	9.59	11.40	12.59
Energy goods	17.69	12.37	15.22	17.16
Government-authorized prices	8.36	4.53	4.48	4.39

Source: INEGI



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