BANCO DE MÉXICO®

Minutes number 69

Meeting of Banco de México's Governing Board on the occasion of the monetary policy decision announced on August 15, 2019

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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 14, 2019.

1.3. Participants:

Alejandro Díaz de León-Carrillo, Governor.
Irene Espinosa-Cantellano, Deputy Governor.
Gerardo Esquivel-Hernández, Deputy Governor.
Javier Eduardo Guzmán-Calafell, Deputy Governor.
Jonathan Ernest Heath-Constable, Deputy Governor.
Arturo Herrera-Gutiérrez, Secretary of Finance and Public Credit.
Gabriel Yorio-González, Undersecretary of Finance and Public Credit.
Elías Villanueva-Ochoa, 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 (see annex).

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

All members noted that during the second quarter of the year the world economy decelerated, reflecting the lower growth of the main advanced and emerging economies. In this sense, most members added that this deceleration has been widespread and greater than anticipated. The majority mentioned that there were tensions between the U.S. and other economies, related both to trade as well as to issues associated with migration, technology and exchange rate policy. They emphasized that the areas most affected by this environment are world trade, manufacturing production, investment and business confidence, and that the outlook for growth for the world economy for 2019 and 2020 has been revised downwards once more.

Most members highlighted that risks to global growth have increased and thus the balance of risks has deteriorated. The majority highlighted that among the main risks those that stand out are: i) an escalation of trade disputes; ii) a disorderly Brexit; and, iii) political and geopolitical risks. As an additional risk, one member also considered episodes of financial stress in emerging economies, while another added the possibility of a sharp slowdown of the Chinese economy.

Delving into advanced economies, one member mentioned that in the United States industrial production, exports as well as imports have remained relatively stagnant since late 2018. He/she added that this has already started to be reflected in job creation, although this indicator still remains at satisfactory levels. Another member considered that economic activity in that country has started to be affected by the escalation of trade tensions, especially in manufacturing activity and in corporate investment. Some members pointed out that different indicators suggest the possibility of an economic deceleration which, in an extreme case, could become a recession. Regarding the euro area, one member indicated that GDP growth in the first semester has been lower than in previous years and that business confidence indicators and the Purchasing Managers' Index (PMI) continued to worsen, highlighting the case of Germany.

Most members noted the absence of widespread inflationary pressures worldwide and pointed out that this has been partly a consequence of the weakening of economic activity and of lower commodity prices, highlighting one of them, the case of energy products. Most members mentioned that as to the main advanced economies, both headline and core inflation continue to be below their respective central banks' targets. In this regard, one member emphasized that such indicators are expected to remain below their target levels for a prolonged period. In this sense, most members added that inflation expectations remain weak and have even deteriorated in some of these economies. One member stated that differences between goods' and services' inflation continue to be present, with the latter sector continuing to expand, and thus strengthening the labor market. He/she added that this situation has been characterized by an absence of inflationary pressures, despite the increases observed in recent wage revisions. The same member analyzed the different factors that have kept inflation structurally low and with a lesser response to the lower labor slack in advanced economies. In

this respect, he/she mentioned technological change and the incorporation of countries with an abundant labor force into globalization, arguing that this has contributed to greater productivity gains and to more competitive markets and, thus, to lower inflationary pressures. Regarding inflation in emerging economies, another member mentioned that the absence of inflationary pressures is evidenced by the downward trend followed by core inflation in these economies.

All members noted that, given an environment of greater uncertainty, global economic slowdown and lower inflationary pressures –in most cases at levels below their targets– a large number of central banks have adopted more accommodative monetary policy stances. One member highlighted that some central banks have cut their reference rates in magnitudes even greater than expected and other member emphasized the major change in the direction followed by monetary policy worldwide over the last eight months. Most members mentioned that central banks in advanced economies are assessing the possibility of implementing additional non-conventional measures. As for the US Federal Reserve, all members indicated that in its July meeting it cut its target range for the federal funds rate by 25 basis points (bps) and brought forward the end of its balance sheet reduction. One member highlighted that this occurred under conditions of greater uncertainty. Some members underlined that in its communications the US Federal Reserve made it clear that this adjustment does not imply the beginning of an easing cycle, although the possibility of future adjustments, if required, was not ruled out. One member added that market expectations continue to differ from the statements by some Federal Reserve officials, and another member emphasized that despite the strength of the economy and the labor market, the Federal Reserve cut its rates in a preventive way. In this sense, one member pointed out that markets envisage a further reduction of 50 and 25 basis points in 2019 and 2020, respectively. Meanwhile, all members mentioned that although the European Central Bank left its policy rate unchanged, it modified its forward guidance about the trajectory of interest rates towards a more accommodative policy stance and announced that it would consider additional monetary easing measures. Some members mentioned that various emerging economies have also adopted monetary policy easing measures, emphasizing the cases of Brazil, Chile, Russia, South Korea and India among a large list of countries. One member considered that the central banks of emerging economies that have not modified their interest rates, have tightened their monetary policy stances in relative terms. Another member argued that the observed cuts have generated concern among analysts regarding the beginning of a possible currency war.

Most members mentioned the presence of volatility episodes in international financial markets, associated with US-China tensions and with the greater-than-anticipated deceleration of some economies. One member pointed out that risk aversion sentiment and the search for safe haven assets over the last weeks led to significant falls in stock markets, a reduction in bond yields in advanced economies, which reached historically low levels, and to a widespread appreciation of the US dollar. Another member mentioned the decrease in interest rates for all maturities, both in advanced and emerging economies. Another member stressed that, given the outlook of a greater monetary policy easing, risk premia of most countries remained unchanged or decreased. Another member mentioned that in the case of the U.S., considerable downward adjustments have been observed in the yield curve of Treasury bonds in all maturities. In addition, he/she argued that the recent performance of markets, given the escalating trade tensions, has had considerable impacts, especially across countries and regions integrated to world trade and with episodes of volatility in emerging markets. As to capital flows to these economies, some members emphasized that, although investment flows to their debt markets continue registering inflows, stock markets have been accumulating outflows for 16 consecutive weeks. One member stressed the negative implications of outflows from the equity market for the valuation of currencies and other assets of these economies.

Most members pointed out that risks that could affect global financial markets persist. In addition to the risks to global growth mentioned above, one member highlighted the possibility of periods of political instability in Italy, and other countries. In this regard, another member stressed that, given the intensification or materialization of some of these risks, the main economies' central banks may be expected to take action to improve global financial conditions, just as it has happened during 2019. Therefore, he/she considered that, despite the global uncertainty, the balance of risks for global financial markets remains stable. In contrast, another member indicated that the foreseen scenario of a greater loosening in financing conditions implies the risk of monetary stimulus measures being of a lesser magnitude than anticipated or insufficient to contain

a greater-than-expected deceleration of economic activity. He/she also mentioned the greater challenges to financial stability that could result from a longer period of global monetary policy easing.

As for emerging economies, one member indicated that these are also subject to different idiosyncratic risk factors and that, in some cases, for example in Mexico, such factors have reinforced the impact of the lower growth trend worldwide, as well as the uncertainty that has hindered investment. He/she pointed out that the current environment affects these economies in two ways. On the one hand, he/she mentioned the slowdown of world trade and lower commodity prices, which imply a deterioration in the terms of trade and give rise to lower economic growth and lower inflationary pressures. On the other hand, he/she stated that such economies can be affected by episodes of portfolio rebalancing towards lower-risk assets, thus putting pressure on their currencies, risk premia and interest rates. As a consequence, the environment they face is complex and uncertain.

All members mentioned that the latest information suggests that during the second quarter of 2019, the stagnation that economic activity in Mexico had been showing in the previous quarters continued. One member specified that the GDP flash estimate for this quarter registered its first negative annual rate since late 2009 and that the average quarterly rate of the last five quarters is 0.04%. Some members specified that the deceleration was greater than anticipated. One member pointed out that it was greater than that suggested by the weak global economy and another member added that it is worrisome that this has taken place in a context where the US economy is growing above potential. One member mentioned that timely indicators suggest the possibility of a downward revision to the quarterly growth figures for the second quarter of the year. He/she stressed the weakening of the economic cycle, given that different indicators estimated by INEGI, such as the Coincident and Leading Composite Indicators System (SICCA, for its acronym in Spanish) and the Coincident Indicator of the Cyclical Indicators System (SIC, for its acronym in Spanish) reached their lowest level in May 2019, and noted that this weakening applies to most components of these indicators, which is consistent with a situation of recession. He/she added that during the last nine months the negative gap widened with respect to its long-term trend, which is also consistent with of the existence of a recession.

All members emphasized that stagnation of economic activity reflects a greater weakness in most components of aggregate demand, standing out among those the slowdown of consumption and lackluster investment. In the same vein, one member mentioned the delays in government spending. Regarding the weakness of consumption, another member highlighted that the average annual percentage change has been 4.3% in 2016, 3.1% in 2017, and 2.3% in 2018, and that the latest data corresponding to May 2019 was 0%. He/she specified that consumption of durable goods already registers negative annual changes. Another member added that the trend-cycle measure of the private consumption index seems to have reached an inflection point at the end of the previous year, without reversing its downward trend since then. Another indicated that this weakness has taken place despite the fact that remittances and the wage bill continue growing. As to investment, most members mentioned that both public and private investment continue to exhibit a downward trajectory. One member specified that its different components show clear negative trends since mid-2018. In this respect, most members highlighted the sharp fall in construction and mentioned the decline in purchases of imported machinery and equipment. One of them pointed out that, with seasonally adjusted data, investment in construction is at levels unseen since early 2006. Regarding external demand, most members stated that manufacturing exports performed better in the second quarter of the year, as compared to the previous one. One member pointed out that this is explained by the dynamism of the US economy and another member stated that this is taking place despite the slowdown of world trade.

From a medium-term perspective, one member mentioned his/her concern over the secular slowdown in the growth rate of private consumption that has been observed since 2016. In the same way, he/she indicated that private investment has remained stagnant during the same period and that in the last months it is already following a negative trend. He/she indicated that the cost of financing to households and firms has been growing constantly since 2016 and that the growth rate of credit granted by commercial banks has declined since then. He/she pointed out that, although consumption and investment respond to different factors, interest rates are a key factor in their evolution. The same member considered that this shows that the transmission mechanism of a tight monetary policy implies costs and that the risks associated with maintaining a high

interest rate for a long period should not be minimized. Another member expressed that the evolution of investment is a reason for concern. He/she pointed out that after having been stagnant from mid-2015 to mid-2018, investment is increasingly showing a marked downward trend, recently reaching levels similar to those observed in July 2014. He/she added that this performance, which affects potential growth, partly derives from the strong decline in public investment. He/she added that private investment has been curbed by the high uncertainty prevailing in the country, due partly to external factors, but apparently, to a greater extent, to the insufficient clarity of certain public policies and a domestic environment that is generally perceived as unfavorable for investment. In this respect, he/she noted that over three quarters of private sector analysts surveyed by Banco de México consider that the current juncture is not favorable for investment, and that the main obstacles to growth are attributed to domestic economic conditions, as well as to governance problems, some of which are the uncertainty over the political situation, and the problems of public insecurity and absence of rule of law. He/she added that, in contrast, the relevance given by analysts to monetary policy is much lower.

On the supply side, most members mentioned the weakness of the industrial and services' sectors. One member emphasized that the Global Economic Activity Indicator (IGAE, for its acronym in Spanish) shows that deceleration is already present in all sectors. Delving into industrial activity, he/she indicated that it shows a negative trend since mid-2018, which already allows for speaking of a recession in this sector. Some members emphasized the contraction of primary activities, while one member pointed out that construction has fallen more rapidly in the last months.

All members mentioned that growth expectations for this year have been adjusted to the downside. Some members highlighted that the median of analysts' expectations has declined and that in most recent surveys it lies at 0.6%. On the other hand, most members indicated that it is possible to estimate that GDP growth in 2019 will lie with a high probability in a range below the one foreseen in the Quarterly Report January – March 2019. Regarding growth expectations for 2020, some members noted that these have also been adjusted to the downside. One of them specified that the most optimistic scenario now points to growth below 2%. One member mentioned that timely information allows to anticipate that investment will continue declining. Another member noted that indicators of demand for money for transactional purposes, along with the slope of the yield curve, suggest that the probability of economic contraction in the next two quarters has reached levels similar to those observed during previous episodes of significant falls in output.

All members indicated that, in an environment of significant uncertainty, the balance of risks for growth remains biased to the downside. One member indicated that this bias has increased with respect to previous decisions. Some members pointed out that growth is subject to both external and domestic risks. Among external risks, in addition to the global risks previously described, some members mentioned the possibility of delays in the ratification of USMCA. One of them added the risk of new US threats to impose tariffs on Mexico or complications in the bilateral relationship between these two countries. Another member mentioned the risk of a deceleration in the U.S. in the next years and noted that this scenario stresses the urgency to correct the domestic factors that inhibit growth. As for domestic risks, most members highlighted the persistence of an environment of uncertainty that has affected private investment, and which has stemmed from the public policy decisions taken by the new administration and by concerns over insecurity and corruption. Another member highlighted a greater reduction of public revenues. Finally, one member emphasized the risk of maintaining an overly restrictive monetary policy stance.

Most members mentioned that slack conditions in the economy continued to loosen, even more than anticipated, thus the negative output gap widened. As to the labor market, one member argued that it has presented a lower rate of job creation, thus the unemployment gaps have eased somewhat with respect to the levels reached in 2018. In this regard, another member noted that sluggish economic activity has been reflected in the behavior of the labor market and, more clearly, in formal employment. This member mentioned that, although the number of IMSS-insured workers has increased over the last year, the increment with respect to the previous year went down by over 40% between July 2018 and July 2019. He/she added that the unemployment rate has increased moderately, albeit accompanied by greater informal employment and by increases in the underemployment rate. He/she added that, despite the weakening of the labor market, the most recent indicators continue showing adjustments in earnings above productivity, which

could be impacting employment. He/she specified that the impact on formal employment has been particularly large in the Northern border free zone, where the minimum wage increased considerably. Finally, he/she stated that the downward adjustment in growth expectations for 2019 and 2020 strengthens expectations that during this period a negative output gap will continue to be observed, albeit lower than estimated, considering the probable decline of potential growth. Meanwhile, another member noted that the risk of a widening of economic slack conditions persists.

Most members mentioned that between June and July, headline inflation fell from 3.95% to 3.78%. The majority indicated that this evolution was due mainly to a decline in the non-core component, since the core component has continued to exhibit persistence. One member noted that annual inflation has been showing a clear downward trend since September 2018 and that since then it has declined over 120 basis points. Such member argued that an indicator showing that inflation is not only decreasing, but also that the price formation process has remained under control, is that headline inflation accumulated so far this year is only 0.65%, the third lowest figure for a similar period this century. He/she stated that the trajectory of has been better than forecasted in previous months both by the Central Bank and by analysts. He/she added that in the latter case, in December they expected accumulated headline inflation as of July to amount to 1.19%. Nevertheless, it has been barely above half that figure. He/she stressed that despite that, analysts adjusted their inflation expectations to the upside and currently expect inflation to close the year at 3.66%. He/she stated that if their month-to-month inflation expectations remained at the level they had in December, their expected inflation for the end of 2019 would be 3.17%. He/she mentioned that the upward adjustment of inflation expectations is surprising, given that inflation has been below expectations and various inflationary risks have decreased.

As for the non-core component, most members stressed that it declined from 4.19% in June to 3.64% in July. They added that this dynamics especially reflected the lower increases in energy prices, as well as in fruits and vegetable prices, while the growth rate of livestock products' prices rose at the margin. One member highlighted that non-core inflation accumulated during the first seven months of the year was -3.82%, the lowest figure in the last 20 years. As for core inflation, most members noted that it has remained persistent around 3.8%. In this context, some members emphasized that it has remained at relatively high levels. They added that it should be acknowledged that it still does not show a trajectory visibly converging to the 3% target. In this respect, one of them mentioned that its persistence in the last 16 months is noteworthy, considering the weakening of economic activity and the evolution of the exchange rate, which, although having undergone fluctuations, has slightly depreciated during that period. In this regard, some members agreed that its evolution seems to be determined by supply shocks, driven by the behavior of wages, food prices, and, until recently, energy prices. One of them highlighted that in the last two Quarterly Reports, average core inflation forecasts for the third quarter of 2019 were 3.4 and 3.6%, respectively, and that for July, the data came in at 3.82%, having remained around that level for a long period. Finally, another member noted that core and non-core inflation are already within the variability interval of plus/minus one percentage point around 3%.

Most members mentioned that inflation expectations at different terms drawn from surveys and financial markets have remained relatively stable, although at levels above the 3% target. In this regard, one member highlighted that this is observed for both headline and core inflation and despite a significant downward adjustment of economic growth forecasts. He/she added that breakeven inflation drawn form market instruments has decreased, although it continues to suggest the persistence of upward risks for medium- and long-term inflation. In this regard, another member pointed out that exogenous factors that impact the non-core component, which will probably pick up to their historic averages, might explain why the inflation risk premium is still at relatively high levels. One member noted that it cannot be ruled out that the pessimistic tone of recent communiqués may be one the reasons behind the recent increase in inflation expectations.

Most members noted that, Banco de México's baseline scenario for headline inflation may improve to some degree, mainly due to lower pressures on non-core inflation. One member stated that, despite the volatility of the latter, given the world economic deceleration there are likely to be lower pressures on the prices of energy products and, consequently, on non-core inflation. As for the outlook for core inflation, the majority of members noted that it is expected to start decreasing given the dissipation of the shock arising from energy product prices. One member explained that, in contrast to what

happened in 2017 and 2018, such prices are no longer a key factor in light of the government's new price policy and the decrease of international oil prices observed in recent months. Most members highlighted that the downward trend of core inflation would be influenced by the greater slack in the economy. One member mentioned that the dissipation of shocks on the relative prices of food products would also contribute to lower core inflation. Another member added that such subindex will also be influenced by the effects of wages, which have a lagged impact. In this regard, one member argued that the effect of wage pressures is conditioned to firms' profit margins and to each market's intrinsic features. He/she stated that, the greater the slack in the economy and the stronger the competition in each sector, the lower the possibilities of a firm passing through its labor cost increases to consumer prices and that, so far, evidence reveals that contagion has been limited and that these pressures are starting to fade. One member considered that core inflation is expected to remain on a downward trend towards the 3% target within the forecast horizon. Another member expressed that, in his/her opinion, the outlook for headline and core inflation implies small upward adjustments to both of their future trajectories, although it does not modify them significantly. Some members mentioned that headline inflation will probably be at levels relatively close to the 3% target towards the end of the year. One member pointed out that, although it is still the case that headline inflation is expected to converge to the target, in a context of core inflation under control, this scenario would materialize if non-core inflation remains below its long-term average, and the peso exchange rate shows a relatively favorable behavior. Nevertheless, one of the members emphasized that there is the risk of meeting the target in a non-optimal way, that is, on the basis of a significant decline in non-core inflation, which is the most volatile one, and persistence of the core component, which, in his/her opinion, is the most relevant one.

As to upside risks for inflation, the majority of members mentioned the possibility of core inflation continuing to show persistence. One member pointed out that it is worrisome that the growth rates of both food merchandise and services prices remain at levels close to 4% and that, in some subcategories, such as services other than housing and education, they lie at around 5%. He/she added that, despite the greater slack in the economy, core inflation may remain at high levels. Most members noted the risk of the peso exchange rate coming under pressure stemming from external or domestic factors. In this regard, some members mentioned the possibility of volatility episodes putting pressure on the peso exchange rate, due to events such as a downgrading of the sovereign rating and Pemex's loss of investment grade status by a second rating agency, as well as a deterioration of Mexico's relationships with its North American trade partners. One member added that the risk of the peso depreciating is partly associated with investors' concerns regarding several public policies. Another member considered that the risk of greater inflation due to a depreciation of the exchange rate is bounded. He/she argued that the pass-through of exchange rate fluctuations to prices is relatively low, noting that it is practically insignificant for economies with inflation-targeting regimes, an independent central bank, and a flexible exchange rate regime.

Most members mentioned as an upside risk the threat by the United States to impose tariffs on Mexican imports and the adoption of compensatory measures, although they considered that this risk has dissipated somewhat. The majority of members added the risk that energy prices revert their trend or that agricultural and livestock product prices increase. One member pointed out the possibility of non-core inflation registering a reversion to its historical values, which are significantly higher than the current ones. Another member highlighted that it is also important to consider that such component is volatile. Most members mentioned as a risk weak public finances. In particular, one member explained that these may suffer pressures stemming from the development of economic activity, Pemex´s situation and international oil prices, among other factors. The majority of members mentioned as a risk that, given the magnitude of various wage revisions, cost-related pressures arise, insofar as such revisions exceed productivity gains. In this regard, one member considered that available evidence so far points to a very insignificant impact of minimum wage increases on inflation and that this is evidenced by both the inflation observed at the border zone, which is far below the national average, as well as the headline inflation in the rest of the country so far this year. Finally, some members also added the escalation of protectionist measures worldwide.

As to downside risks, most members mentioned the possibility that the peso exchange rate may appreciate due to the greater financial slack worldwide, or in case greater certainty arises regarding the trade relation with the United States.

The majority noted that lower rates of change in the prices of certain goods included in the non-core subindex, as observed in the case of energy goods due to the greater weakness exhibited by the world economy, would also contribute to reduce core inflation. The majority of members added the possibility that slack conditions widen more than anticipated, which would have an impact on the behavior of core inflation.

In this context, most members agreed that high uncertainty continues to persist regarding the risks that might affect inflation. One member noted that risks have decreased substantially as compared to those present in December 2018, due to a significant improvement of global financial conditions, to the decrease in international commodity prices, and to the expectation that prices of energy products in Mexico will remain stable. He/she added that slack conditions have increased drastically and considered that the balance of risks for growth is strongly biased to the downside. Another member pointed out that in his/her opinion, the balance of risks for inflation is now slightly tilted to the downside, particularly in regards to the expected trajectory within the time frame in which monetary policy operates. One member considered that, despite the recent reduction of headline inflation and its forecasts, high risks and a considerable degree of uncertainty persist, which makes it difficult to establish the balance of risks. Another member expressed that the balance of risks for inflation continues biased to the upside, although this has occurred in an environment where there is greater uncertainty as to the pressures in different directions that will be exerted on inflation by its determinants, in particular, the peso exchange rate and the country's economic activity. Another member underlined the persistence of a high degree of uncertainty about inflation risks. He/she highlighted the greater importance that the widening of the slack in the economy has gained as a downside risk and, as an upside risk, the possible presence of some risk factors that would affect domestic financial markets and the peso exchange rate, such as the imposition of tariffs or the downgrading of credit ratings.

Most members highlighted that domestic financial markets have reflected the effects of both lower interest rates for all terms in the major advanced economies and episodes of volatility, thus stressing that, while the peso exchange rate fluctuated during these episodes, interest rates on government securities have decreased, including longer term ones. The majority noted that this behavior is in line with that observed in other emerging markets. Delving into interest rates, the majority of members highlighted that the yield curve in Mexico is inverted and that such inversion has increased. In this regard, some members emphasized that this contrasts with what is observed for most advanced and emerging economies where the yield curve has a positive slope. One member argued that the inversion of the yield curve reflects concerns about the economic deceleration. Another member added that interest rates of government bonds are at their lowest levels of the year, with the decline in ten-year yields standing out. In this regard, one member considered that it is important to analyze the yield curve behavior. Such member pointed out that long-term interest rates can be decomposed into: i) short-term interest rate expectations, which are associated with the monetary policy stance, which, in turn, is related to the economy's cyclical position and to other inflationary pressures; and, ii) a term premium that rewards investors for inflationary, duration and liquidity risks, among others. The same member noted that nominal and real yield curves are currently inverted vis-à-vis the overnight interbank rate, underlining that both the component of short-term interest rate expectations and the term premium have exhibited significant reductions over the last months. As to the peso exchange rate, another member stated that it has appreciated vis-à-vis the levels observed at the end of 2018, in contrast with the depreciation registered by most currencies of emerging economies. He/she attributed this behavior to both the tight monetary policy stance as well as other domestic factors, among which the fulfillment so far of fiscal commitments by the current administration stands out. In this regard, one member highlighted that the peso exchange rate has exhibited volatility associated with episodes of escalation of trade tensions, different idiosyncratic factors, and even contagion from other emerging economies, such as China and Argentina. Another member noted that the Mexican peso depreciated since Banco de México's last monetary policy decision, in line with the evolution observed in other emerging currencies, despite Mexico's favorable interest rate spread. Most members mentioned the deterioration of credit risk premia, while some added the higher domestic financial market stress. One member pointed out that the indicators of Pemex's credit risk are showing a higher risk premium, due to the strong deterioration of its fundamentals. As to the stock market, the majority of members stated that it fell significantly. One member argued that among the determinants of the performance of such market, interest rates offered by short-term fixed income

instruments should be considered, since they are an alternative to riskier equity instruments. Some members mentioned that the fall observed in the stock market was due to lower economic activity and to local uncertainty factors. One member underlined that the accumulated flow in equity instruments from foreign investors remains positive during the year, while such flow is practically null in the case of government instruments. Furthermore, another member pointed out that there was a marginal outflow in the positions of the external sector in government securities, despite the wide relative monetary stance and the maturity restructuring towards long-term positions.

Regarding the risks that may affect the performance of financial assets in Mexico, all members mentioned that uncertainty persists with respect to the credit rating outlook for both Pemex's debt and Mexico's sovereign debt. Most members also pointed out the uncertainty regarding the bilateral relationship between Mexico and the United States. With regards to the risk of credit rating revisions, one member argued that, despite the fact that several instruments already include such revisions, their materialization may increase markets' volatility and reduce the financing capacity of the economy. In this regard, another member stated that it is important to address the factors that gave rise to such revisions, avoid an additional downgrading of credit ratings, and seek to improve the current ratings in order to contribute to an orderly adjustment of domestic financial markets and to preserve the elements that allow them to remain as an attractive investment destination. Finally, one member considered that the measures taken by several central banks of the major economies mitigate the external risks. He/she added that, in his/her opinion, several domestic risks associated with public policies have faded away throughout the year.

Most members agreed that Pemex's situation is still a risk factor. They stated that Pemex's business plan announced in mid-July has failed to reestablish confidence in its financial outlook due to doubts regarding the viability of increasing crude oil production. One member added the impossibility to reach adequate oil reserve replacement levels as set out in the plan. Another member mentioned that such rescue program demands, in the short- and medium-terms, the continued and essential support of the federal government, which is in an overly constrained fiscal position. He/she considered that it would be desirable to resume bidding rounds with public-private partnerships, as well as oil auctions. He/she also highlighted that analysts have stated that the proposed business plan does not include an explicit strategic plan that considers the international oil demand environment within the framework of the foreseen economic deceleration nor the increasing use of renewable energies. Most members pointed out that the increase of Pemex's default premia observed in previous months has not reversed and that markets continue to discount an additional downgrading of Pemex's credit rating. One member added that the above may generate forced sales of Pemex's debt and, in general, turmoil in domestic financial markets. The majority of members considered that Pemex's situation may affect public finances and Mexico's sovereign debt rating. Nevertheless, another member argued that the indirect impact on the financial cost of the sovereign debt has been limited so far. He/she added that, although it cannot be ruled out that Pemex may lose its investment grade relatively soon, this should not necessarily give rise to disorderly adjustments in markets, taking into account that an important segment of the market already discounts this possibility.

Most members mentioned that the current environment continues to pose significant medium- and long-term risks that could affect the country's macroeconomic conditions, its capacity to grow, and the economy's price formation process. In this regard, they highlighted that, in addition to a prudent and firm monetary policy, it is particularly important to adopt measures that foster an environment of confidence and certainty for investment and higher productivity, and that public finances are consolidated in a sustainable manner. In this context, they noted that addressing the deterioration of both the sovereign's and Pemex's credit ratings and achieving the fiscal targets for 2019 is necessary, and added that it is also important that the Economic Package for 2020 generates confidence. The majority of members stated that strengthening the rule of law, tackling corruption, and fighting insecurity are equally imperative. Finally, one member pointed out the need to increase productivity through the adoption of new technologies and the strengthening of human capital.

Most members warned that the perception of weak public finances persists. In particular, one member underlined that, to date, budgetary revenues fall short with respect to the programmed and that this situation may worsen in the following three years due to the financial support granted to Pemex, which will

imply a reduction of fiscal revenues, while at the same time oil revenues might also be lower. Most members highlighted that the aforementioned may represent a challenge for public finances given that the shortfalls in resources will need to be offset with expenditure cuts, greater capacity to raise revenue, and, in 2019, with the use of resources from the Budgetary Revenues Stabilization Fund (FEIP, for its acronym in Spanish). Some members mentioned that the authorities recently announced a set of measures aimed at boosting economic activity. One member noted that these measures do not necessarily involve injecting additional resources to the economy, while another member emphasized that, although such measures may help to improve the situation, it is essential that fiscal policy fulfills the goals announced for the primary balance. He/she pointed out that if doubts regarding the strength of public finances worsen there would be greater uncertainty, with a negative impact on economic activity. As for the use of part of the resources of the FEIP, some members considered that it is important to keep in mind the challenges arising from this decision in an environment characterized by significant risks. Such members warned about the weakness of investors' confidence on the Mexican economy. One member noted that among other decisions of the new administration that have contributed to this situation are the cancellation of the New Mexico City International Airport (NAIM, for its acronym in Spanish), the suspension of bidding rounds with public-private partnership, and the beginning of international arbitration processes related with gas pipelines. Such measures, in addition to public insecurity and the absence of rule of law, reduce the country's level of competitiveness and undermine the legal certainty to the trade relations between Mexico and its trading partners in North America, which could contribute to the delay in the ratification and implementation of the USMCA. Another member highlighted that, although the complicated external environment has affected the performance of emerging economies overall, it is important to consider that the perception of risk in the case of Mexico has been greater, in general, thus reflecting the simultaneous effect of idiosyncratic factors. In this regard, he/she underlined the weakening of some indicators, such as: i) the Credit Default Swap (CDS) premium, which has been more unfavorable in Mexico than in other emerging economies with similar or even lower credit ratings; and, ii) the Mexican Stock Exchange index expressed in US dollars, which from mid-2018 to date has exhibited one of the worst performances among this group of economies. Such member added that during the last months, the main rating agencies have downgraded the sovereign debt credit rating or its outlook.

As for Mexico's monetary policy, most members stated that, considering that headline inflation has decreased as foreseen by Banco de México, that slack conditions in the economy have widened more than expected, and the recent behavior of external and domestic yield curves, lowering the target for Mexico's overnight interbank interest rate by 25 basis points to 8% is appropriate. The majority considered that this adjustment is consistent with the convergence of headline inflation to the 3% target within the time frame in which monetary policy operates.

One member added that the fact that the risks faced by the economy have not increased recently provides margin to lower the policy rate. He/she noted that, since May 2017, policy rate adjustments in Mexico have been synchronized with those carried out by the US Federal Reserve, in such a way as to keeping a spread in Mexican and US rates of around 575 basis points and that such spread represented the tightest relative monetary policy stance since early 2008. The same member added that such monetary policy stance was restrictive enough to fight the inflation increase observed during 2017-2018 and the risks that inflation faced. He/she considered that, given the latest conditions regarding the path of inflation, economic growth, and financial stability risks, widening this spread cannot be justified. He/she added that, considering the recent cut in interest rates by the US Federal Reserve, the interest rate spread between both countries has widened to 600 basis points, thus intensifying Mexico's monetary policy restrictive stance relative to that of the United States. Such member stated that, in real terms, the policy rate is at its highest levels in eleven years, adding that this level, in a moment in which the economy is close to a recession and headline inflation being below the upper limit of the variability interval and with a trajectory of convergence to the 3% target, reflects that the current monetary policy stance is highly restrictive, not only in relation to other economies but also in absolute terms. He/she pointed out that one of the reasons why Banco de Mexico has maintained a tight policy stance is that it has sought to keep a prudent and cautious stance given the many external and domestic risks the Mexican economy has faced. He/she mentioned that, despite the above, the Governing Board should also take into account in its decision-making the effects of the behavior of

economic activity. He/she emphasized that, for Banco de México it is extremely important to seek price stability, and that this is monetary policy's best contribution to the country's development given its limitations to stimulate the potential growth of the economy. However, he/she acknowledged that, at a time when the economy is on the edge of a recession, maintaining a tight policy stance for a long time is not advisable. Such member added that, in other words, this Central Bank will continue to procure the stability of the peso's purchasing power, but not at any price. Another member emphasized that for various reasons both monetary and fiscal policy face important limitations to stimulate the economy under current circumstances. He/she pointed out that to reach such objective it is necessary to tackle the fundamental causes of the current weakness, that is, a situation of uncertainty and insufficient clarity of public policies in diverse areas, which does not generate appropriate conditions for investment, in addition to actions that directly hinder private investment.

One member considered that the most important risk for domestic financial markets nowadays is maintaining an overly tight monetary policy stance. He/she argued that, although high interest rates are typically considered to contribute to an environment of greater stability, keeping interest rates high for a long period could contribute to generate unbalances and may have a negative effect on markets. As an example of the above, such member mentioned the negative slope that Mexico's yield curve currently registers, as a result of short-term interest rates being highly sensitive to adjustments to the policy rate. In this regard, he/she compared the recent experience of Colombia and Mexico, stating that both countries share a similar target and have similar levels of inflation and have kept their policy rates unchanged in 2019; however, in Colombia the policy rate is lower and lies at 4.25%, while its economy is expanding at higher rates of around 3%, which indicates that Mexico's monetary policy stance is highly restrictive. One member argued that, although several advanced and emerging economies have eased their monetary policies, in contrast to what can be observed for Mexico, in almost all of these countries inflation lies at levels close to or even below the target.

This same member stated that the policy rate should be left unchanged, arguing that: i) although the 3% inflation target refers to the behavior of headline inflation; given the volatility of the non-core component, to accurately assess inflationary pressures on the economy as well as the sustainability of the trajectory of inflation, it is essential that at the same time the behavior of the core component be analyzed carefully; ii) despite the significant downward adjustment of economic growth forecasts, both headline and core inflation expectations for all terms remain above Banco de México's expectations and the 3% target, highlighting that the latter is a point target rather than a +/- 1% interval around such figure; iii) the lack of credibility of Banco de México's inflation forecasts, stemming partly from core inflation remaining above projections; iv) the positive effect on the peso exchange rate of the widening interest rate spread between Mexico and the United States was more than offset by several domestic and external economic and political shocks; v) uncertainty persists as to different aspects of public policies and the deterioration of economic fundamentals, which has been reflected in a higher country risk perception and demand a cautious stance; vi) more information is needed on the main elements of the fiscal policy for 2020, as it is an essential input for monetary policy implementation. He/she considered that, under an environment of uncertainty as the current one, prioritizing the trustworthiness of Banco de México's messages is of paramount importance since, under the above mentioned circumstances, the potential for confusion and for adverse effects generated by surprises in the implementation of monetary policy increases. Nevertheless, the same member noted that monetary policy's margins for maneuver may widen in the short term if, as expected, headline inflation continues to decrease and core inflation starts to follow a downward trend in the next weeks, a solid fiscal package is announced for 2020, and if no significant shocks occur.

One member pointed out that, on this occasion, the monetary policy statement plays a particularly crucial role since the policy rate had not been lowered in five years and a wide segment of the market was not anticipating a downward adjustment in this decision, thus an adequate message is important to avoid generating uncertainty and affecting monetary policy's effectiveness. He/she added that this requires caution and acting with prudence. Likewise, such member pointed out that this monetary policy action must not be interpreted as the start of an easing cycle, since future monetary policy decisions will depend on the development of inflation vis-à-vis its forecasted trajectory. Another member mentioned that a decrease in the policy rate together with an adequate message by Banco de México may send a

signal of certainty and confidence. Such member added that this is possible if the monetary policy statement highlights the substantial reduction of inflationary risks throughout the year, the better-than-expected behavior of inflation, and that inflation is expected to converge to the target. This would confirm that inflation is controlled, which allows for monetary policy easing in order to attain the convergence of inflation to its target in an effective way with the lowest costs for economic activity. One member stated that, even after considering this downward adjustment in the reference rate, the monetary policy stance in both relative and absolute terms remains restrictive, and an analysis of the underlying risk factors leads to the conclusion that an accommodative cycle should begin.

One member mentioned that the widening slack conditions in the economy, along with an external environment where the outlook of lower interest rates and lackluster growth expectations has been taking hold, points to an environment of lower inflationary pressures within the time frame in which monetary policy operates. He/she added that, nevertheless, there are other elements that continue to influence Mexico's economy and price formation process and have contributed to make core inflation remain above the 3% target and to show resistance to decline, and that this situation suggests that Banco de México should act gradually and follow closely the available information on the economy's cyclical position, and on all inflation determinants as well as on their balance of risks.

Most members highlighted that in the foreseeable future all factors and elements that have an impact on both inflation and its outlook should be followed, and the necessary actions be taken, so that the policy rate is consistent with the orderly convergence of headline inflation to Banco de México's target within the time frame in which monetary policy operates.

3. MONETARY POLICY DECISION

To guide its monetary policy actions, Banco de México's Governing Board follows closely the development of inflation vis-à-vis its forecasted trajectory, taking into account the monetary policy stance and the time frame in which monetary policy operates. In this process, it uses available information on all inflation determinants as well as on medium- and long-term inflation expectations, including the balance of risks for such factors. Monetary policy must also respond prudently if for any reason the uncertainty faced by the economy increases significantly. In this context, considering that headline inflation has decreased as foreseen by Banco de México, the greater than expected widening in the amount of slack in the economy, and the recent behavior of the external and domestic yield curves at various terms, Banco de México's Governing Board decided by majority to lower the target for the overnight interbank interest rate by 25 basis points to 8.00%, considering that under the current environment such level is consistent with the convergence of headline inflation to the central bank's target within the time frame in which monetary policy operates. One member voted to maintain the target at 8.25%. In order to consolidate a low and stable inflation, in an environment in which price formation and slack conditions in the economy are subject to risks, the Governing Board will continue to follow closely all factors and elements of uncertainty that have an impact on inflation and its outlook, and will take the required actions based on incoming information so that the policy rate is consistent with the orderly convergence of headline inflation to Banco de México's target within the time frame in which monetary policy operates. Banco de México's Governing Board will maintain a prudent monetary policy stance and, under the current environment of uncertainty, will follow closely the potential pass-through of exchange rate fluctuations to prices, Mexico's monetary policy stance relative to that of the U.S.-in an external environment that it is still subject to risks- and the behavior of slack conditions and cost-related pressures in the economy. In the presence and possible persistence of factors that, by their nature, involve risks to both inflation and its expectations, monetary policy will be adjusted in a timely and firm manner to achieve the convergence of inflation to its 3% target and to strengthen the anchoring of medium- and long-term inflation expectations so that they attain such target.

4. VOTING

Alejandro Díaz de León-Carrillo, Irene Espinosa-Cantellano, Gerardo Esquivel-Hernández, and Jonathan Ernest Heath-Constable voted in favor of lowering the target for the overnight interbank rate to 8.00%.

Javier Eduardo Guzmán-Calafell voted in favor of maintaining the target for the overnight interbank rate at 8.25%.

5. DISSENTING VOTES

Vote. Javier Eduardo Guzmán-Calafell

In my judgment, the combined effect of several factors makes monetary policy easing inadequate. First, although headline inflation has decreased, its core component, which reflects inflationary pressures more accurately, has remained high for a long period and does not show signs of decreasing. Second, at the moment there is no information on fiscal policy for 2020, a fundamental input for monetary policy implementation. Third, lowering the policy rate implies surprising the markets, which creates the risk of an adverse reaction and of making the central bank's communication policy confusing. In an environment of high external and domestic uncertainty, where the perception of country-risk has increased significantly, the central bank must be extremely cautious given the risk of financial market turmoil. For these reasons, I believe it is preferable to keep the policy rate unchanged and simultaneously signal that as some uncertainty factors dissipate and a more favorable balance of risks is attained, which is a likely scenario, the central bank would have more solid bases to take advantage of the consequent margins of maneuver, even in the very short term.

ANNEX

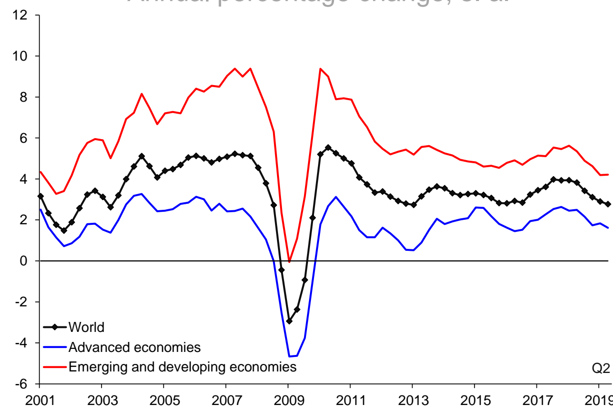
The information in this Annex was prepared for this meeting by the staff of Banco de México's General Directorate of Economic Research and General Directorate of Central Bank Operations. It does not necessarily reflect the considerations of the members of the Governing Board as to the monetary policy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

A.1. External conditions

A.1.1. World economic activity

World economic activity decelerated during the second quarter of the year due to a moderation of growth in the main advanced and emerging economies (Chart 1). In addition, concerns about the effects of tensions between the United States and other economies, not only related to trade but also those associated with technology, migration, and, more recently, to exchange rate policy, have intensified the decline in business confidence, the weakness of investment, and the slowdown of manufacturing. As a result, growth expectations for the world economy were revised downwards once more. Headline and core inflation in the advanced economies have remained at low levels and below their central bank targets. In this context, a large number of central banks have adopted more accommodative monetary policy stances. Global financial markets exhibited high volatility due to the trade tensions between the United States and China and the greater than expected slowdown of some economies. In this environment, the risks faced by the global economy have increased, among which the following stand out: an escalation of trade disputes, a disorderly Brexit, and the deterioration of some political and geopolitical risks stand out. For this reason, the balance of risks for world economic activity is considered to have deteriorated.

Chart 1
World GDP Growth
Annual percentage change, s. a.

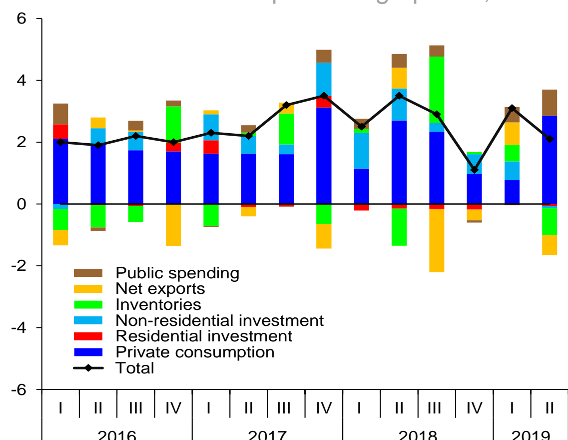


s. a. / Seasonally adjusted figures.
Note: GDP calculations for Q2 2019 include estimates for some countries. The sample of countries used in the calculations accounts for 85.6% of world GDP measured by purchasing power parity.
Source: Prepared by Banco de México with data from Haver Analytics, J.P. Morgan and International Monetary Fund (IMF).

In the United States, economic activity decelerated during the second quarter of the year, growing at a seasonally adjusted annual quarterly rate of 2.1%, after having grown 3.1% during the first quarter. The fall in the growth rate occurred despite the higher contribution of public spending to growth and the rebound of private consumption driven by the still high levels of consumer confidence and the strength of the labor market. Thus, the weakness of economic activity is associated with the greater sluggishness exhibited by business fixed investment, the strong inventory decumulation, and the negative contribution of net exports (Chart 2).

US industrial production continued to exhibit lack of vigor in July, by falling 0.2% at a monthly rate after having recovered slightly in May and June. This contraction was mainly due to lower mining activity, especially in in oil extraction and refining, as well as to the fall in manufacturing, which can be associated with lower growth in world demand. The decline in manufacturing activity is consistent with the evolution of the manufacturing sector Purchasing Managers Index (PMI), which registered in July its lowest level in almost a decade. Thus, in an environment of growing tensions between the United States and other economies, the weakness of such sector is expected to persist.

Chart 2
United States: Real GDP and Components
Annualized quarterly percentage change and contributions in percentage points, s. a.



s. a. / Seasonally adjusted figures.
Source: Bureau of Economic Analysis (BEA), Blue Chip January 2019, and Federal Reserve Bank of Atlanta.

The US labor market continued to strengthen in July, although at a more moderate rate than in previous months. In particular, job creation in the non-farm sector went down from 193,000 new jobs in June to 164,000 in July, still above the level necessary to absorb the growth of the labor force. The unemployment rate rose slightly from 3.6% in June to 3.7% in July, although it remains close to its lowest level in the last 50 years. In this environment, average hourly wages continued to increase, albeit at a slightly more moderate rate.

In the euro area, GDP growth moderated during the second quarter of the year, registering a seasonally adjusted annual rate of 0.8%, after having increased by 1.8% during the first quarter, due to the fading of transitory adverse factors. Private consumption remained strong, driven by the increase in employment, the high levels of consumer confidence, and more accommodative financial conditions. Nevertheless, exports and investment remained weak, due to the lower global dynamism. Industrial activity in Germany fell further, while in other economies of the region it appears to be stabilizing. In this environment, the labor market continued to strengthen, with unemployment decreasing from 7.6 to 7.5% between March and June.

The Japanese economy continued growing at high rates during the second quarter. In particular, Japan's GDP grew at a seasonally adjusted annual rate of 1.8%, after having done so by 2.8% during the first quarter, in both cases driven by temporary factors. The growth of business fixed investment picked up significantly, while private consumer spending was partly driven by the higher number of holidays and by the preemptive purchases in anticipation of the VAT increase that is expected in October. On the other hand, the historical political tensions between Japan and South Korea spread to the trade arena in the form of restrictions to some Japanese exports used by the South Korean technology industry and a wave of protests against Japanese business establishments taking place in the latter country.

In most emerging economies, indicators suggest that economic activity continued to remain weak during the second quarter due to both idiosyncratic factors and the weakening of international trade. In particular, the Chinese economy continued losing dynamism during the second quarter of the year, while in July indicators of investment, retail sales and industrial production continued to show a gradual slowdown of that economy. European emerging economies have been affected by the fall in external demand and by idiosyncratic factors, while some of the main Latin American economies have grown below expectations, partly attributable to idiosyncratic factors as well.

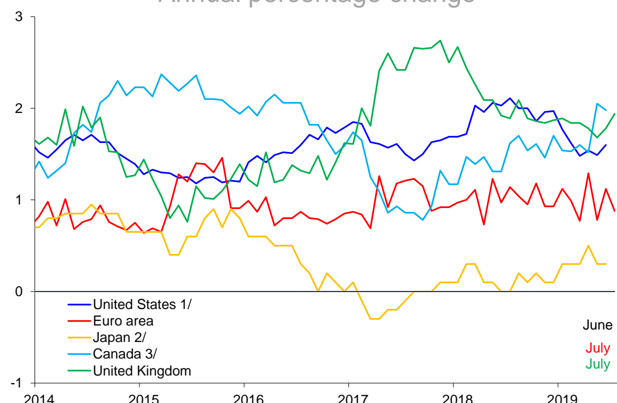
International commodity prices followed a downward trend during the last weeks. In particular, oil prices decreased due to the escalation of trade tensions between the United States and China, after having recovered during part of June and July after the agreement to extend cuts in oil production quotas among members of the Organization of Petroleum Exporting Countries (OPEC) and some of the main oil-producing countries, as well as the intensification of geopolitical tensions in the Middle East and the reduction of US crude oil inventories. Industrial metal prices fell as a result of the deceleration of world industrial activity and escalating trade tensions between the United States and China. In contrast, gold prices have risen significantly reflecting the increasing risk aversion in global financial markets, reaching their highest level in six years. Finally, grain prices fell due to the higher volumes of grain harvest, particularly in Europe; to better weather conditions in the United States; and, to a fall in US grain exports to China given the escalating tensions between both countries.

A.1.2. Monetary policy and international financial markets

Headline and core inflation in the major advanced economies have remained at low levels and below their central banks' targets. Inflation expectations

drawn from surveys and market instruments have also remained at low levels. Particularly, in the United States, core inflation has been below 2% since the beginning of the year, while in the euro area and Japan it has not trended upwards significantly (Chart 3). In most emerging economies, headline inflation fell due to the lower energy products and food merchandise prices, remaining below their central banks' targets in various cases.

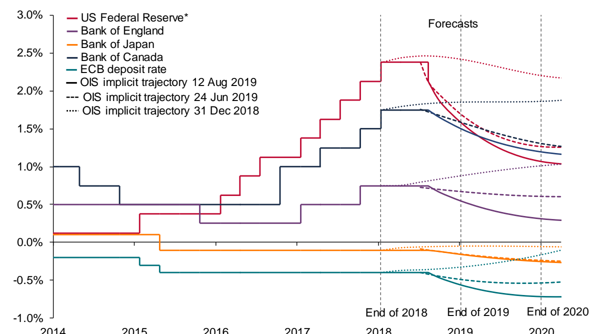
Chart 3
Selected Advanced Economies: Core Inflation
Annual percentage change



1/ Refers to the Personal Consumption Expenditure (PCE) deflator index.
2/ Excludes fresh food, energy, and the direct effect of the consumption tax increase.
3/ Excludes food, energy, and the effect of adjustments on indirect taxes (CPIX).
Source: Haver Analytics, BEA, Statistical Office of the European Union (Eurostat), and Statistics Bureau (Japan).

In this context, the central banks of several economies have started to adopt more accommodative monetary policy stances given the low levels of inflation, lower growth expectations and the greater risks faced by the world economy. Expectations that many central banks will continue cutting their reference rates have also strengthened (Chart 4).

Chart 4
Reference Rates and Implied Trajectories in OIS Curves1/
Percentage



1/ OIS: Fixed floating interest rate swap where the fixed interest rate is the effective overnight reference rate.
* In the case of the US observed reference rate, the average interest rate of the federal funds target range is used (2.00% - 2.25%).
Source: Bloomberg.

In its July meeting, as anticipated, the US Federal Reserve cut the target range for the federal funds rate by 25 basis points (bps) to 2.00-2.25%, the first target rate decrease since the financial crisis of 2008. In its policy statement, this central bank mentioned that, in light of the implications of global developments for the economic outlook as well as muted inflation pressures, it decided to lower the target range for the federal funds rate. The Fed highlighted that such action supports the view of a sustained expansion of economic activity, and inflation near its symmetric 2% target, although uncertainties about this scenario prevail. The Fed also announced that it will conclude the reduction of its securities holdings in August, two months earlier than mentioned in its March meeting. In this regard, the Federal Open Market Committee (FOMC) emphasized that, in determining the path to be followed by monetary policy, it will continue monitoring the available information and will take the appropriate measures to keep a sustained economic expansion, a strong labor market, and inflation levels around its target. In his press conference, the Federal Reserve Chairman highlighted that the reduction in the federal funds rate does not represent the beginning of a series of cuts but rather a mid-cycle adjustment. However, he insisted that the possibility of additional reductions is not ruled out. In this regard, market instruments are anticipating four 25 basis point-adjustments during the rest of 2019 and in 2020.

In its July meeting, the European Central Bank (ECB) left its policy rates unchanged. Nevertheless, the ECB modified its forward guidance regarding the trajectory of monetary policy by pointing out that its

key interest rates will remain at their present or lower levels at least throughout the first half of 2020. In that meeting, it also emphasized the need for keeping a highly accommodative monetary policy stance for a long period as inflation rates and expectations have been persistently below levels that consistent with its target and highlighted its commitment to symmetry in attaining the inflation target. This central bank is also analyzing additional monetary policy measures, including ways to reinforce its forward guidance on policy rates, actions to reduce the impact of negative interest rates, such as the design of a tiered system for banks' reserve requirements, and options for implementing a new asset purchase program.

In its July meeting, the Bank of Japan left its policy interest rates unchanged, reaffirming that it will keep them at extremely low levels until at least the spring of 2020. In its Outlook for Economic Activity and Prices Report of July, this central bank acknowledged that external risks to growth have increased due to the climate of greater protectionism and emphasized that it will not hesitate to adopt a more flexible monetary policy stance if the convergence of inflation to its target is put at risk.

In its July meeting, the Bank of Canada left its policy interest rate unchanged at 1.75%. In its message, this central bank mentioned that available figures for the second quarter suggest that economic activity recovered given the rebound in oil production and the fading of transitory factors. However, it highlighted that the effects of escalating trade and geopolitical tensions on both trade and investment have been greater than expected. In this environment, the Bank of Canada pointed out that risks for growth are biased to the downside, while those of a higher inflation have increased given that the greater trade disputes may be reflected in supply shocks. Considering the above, this central bank argued that its accommodative monetary policy stance continues being appropriate and underlined that it will closely follow the development of oil markets and trade policies worldwide.

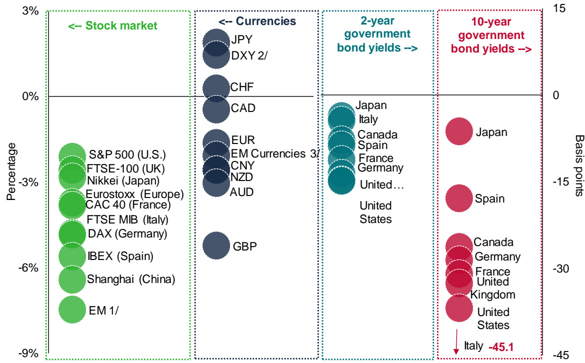
In its August meeting, the Bank of England left its policy rate at 0.75% and did not modify the size of its stock of corporate and UK government bond purchases. The Bank of England reaffirmed that it will adjust its monetary policy stance in whichever direction is necessary if, as a result of the Brexit negotiations, substantial changes in growth and inflation expectations were to be observed. It pointed out that, under the assumption of an orderly Brexit, the most appropriate monetary policy stance to reach the 2% target in a sustained manner will be that of a gradual and limited increase in its policy rate. Nevertheless, the Bank of England warned that such adjustment will depend on Brexit conditions and their impact on aggregate supply and demand and on the exchange rate. This central bank revised downwards its growth projections for 2019 and 2020, mainly reflecting the greater uncertainty about Brexit.

Other central banks of advanced economies, such as the Reserve Bank of Australia and the Reserve Bank of New Zealand, also eased their monetary policy stances, leaving their policy rates at historically low levels.

In emerging economies, several central banks adopted more accommodative monetary policy stances, including those of Saudi Arabia, Brazil, Costa Rica, United Arab Emirates, the Philippines, Hong Kong, India, Indonesia, Paraguay, Russia, South Africa, Thailand, and Ukraine. The case of the Bank of Turkey stood out, which surprised financial markets by cutting its reference rate by 425 basis points in July, in an environment where inflation has been below what this central bank had expected.

During practically the entire month of July, international financial markets continued to be supported by the more accommodative monetary policy stances of several central banks. In particular, the stock markets of the major economies reached historically high levels. Nevertheless, at the beginning of August, the announcement of new tariffs on Chinese imports by the United States, as well as the labeling by US authorities of China as an exchange rate manipulator, following the yuan depreciation, increased uncertainty in financial markets again. This trend intensified given the greater than expected slowdown exhibited by some economies, the uncertainty generated in the electoral process of Argentina, and political tensions in Hong Kong. The preceding was reflected in a reshuffling of investment portfolios towards lower-risk assets. Thus, in advanced economies the main stock markets fell and interest rates decreased to historically low levels. In addition, most yield curves flattened, and some even inverted, which may be reflecting the lower economic growth outlook, the lower levels of inflation, and the search for yield in an environment where a high percentage of fixed-income securities of this group of countries are traded at negative interest rates. Finally, stock exchange markets registered significant appreciations of safe haven currencies, such as the US dollar, the Swiss franc, and the Japanese yen (Chart 5).

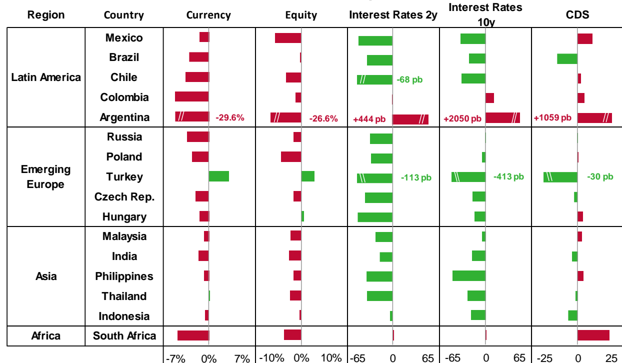
Chart 5
Change in Selected Financial Indicators (June 24, 2019 – August 12, 2019)
Percent, basis points



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.

As to emerging economies, investment inflows to these countries have exhibited a mixed behavior since Banco de México's previous monetary policy decision. While debt markets registered stable capital inflows over most of the period, stock markets continued registering outflows. Nevertheless, in the latest weeks both have exhibited outflows. In this context, at the end of period, interest rates of government securities decreased significantly, exchange rates depreciated, and stock market indexes fell (Chart 6).

Chart 6
Emerging Economies: Financial Assets Performance from June 24 to August 12, 2019
Percent, basis points



Note: Interest rates correspond to interest rate swaps for 2-year/10-year maturities. In the case of Argentina, rates in US dollars are used since they are the most liquid ones and those that reflect more adequately the performance of the fixed income market in that country.
Source: Bloomberg.

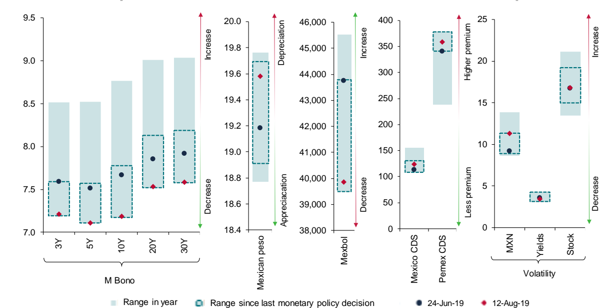
Looking ahead, market participants are expected to remain attentive to the evolution of several risk factors that may lead to higher volatility and to a deterioration of international financial market conditions. Among those that stand out are the possibility of an intensification of tensions between the United States and other economies; a sharper deceleration of economic activity in a context where the scope of action of central banks is limited; an intensification of negative idiosyncratic events in emerging economies, as well as a possible contagion among its financial assets; and, an escalation of geopolitical tensions worldwide, mainly in the Middle East and Asia.

A.2. Current situation of the Mexican economy

A.2.1. Mexican markets

Since Banco de Mexico's previous monetary policy decision to date, the prices of financial assets in Mexico reflected the effects of both the lower interest rates at all terms in advanced economies and episodes of volatility. Thus, the peso/dollar exchange rate depreciated 2.04% during the period, closing at 19.60 pesos per US dollar (Chart 7). Forward outright trading conditions for the peso implied in FX spot options remained relatively stable, although at deteriorated levels when compared to other emerging economies (Chart 8).

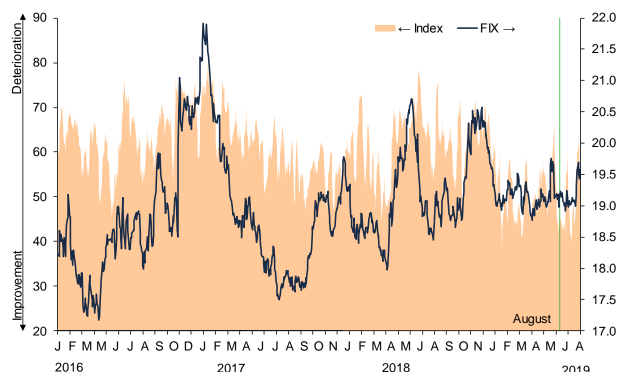
Chart 7
Mexican Markets' Performance and Trading Conditions
Percent, pesos/US dollar, index and basis points



Note: For the Mexican peso volatility, the levels implied in 1-month exchange rate options are considered. For the interest rate, a Garch model (1,1) of daily fluctuations in all the curve since 2007 is considered. For exchange rate volatility, the Vimex published by MexDer is considered.
Source: Prepared by Banco de México with Bloomberg and Proveedora Integral de Precios (PIP) data.

Chart 8
Mexican Foreign Exchange Market Trading Conditions

Index (5-day moving average) and pesos/US dollar

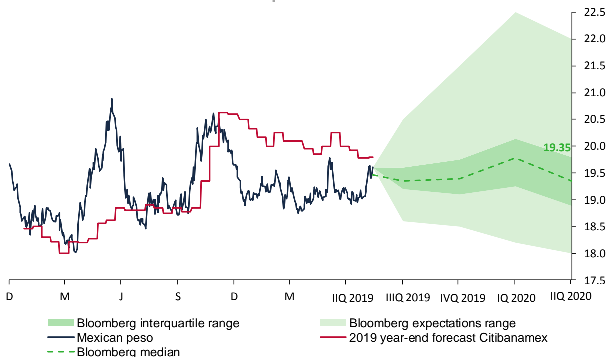


Note: Index calculated using the mean, volatility, skewness, kurtosis, bid-ask spread and mean of simple differentials, all of them related to quotes of intraday operations, and the total traded volume. After obtaining this data, the percentiles since 2011 are calculated and the average of the 7 percentiles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

Peso exchange rate expectations by forecasters from several financial institutions were adjusted downwards from 19.90 to 19.80 pesos per US dollar for the end of 2019 and from 20.23 to 20.00 pesos per US dollar for the end of 2020 (Chart 9).

Chart 9
Analysts' Mexican Peso Exchange Rate Expectations for Each End of Quarter

Pesos per US dollar

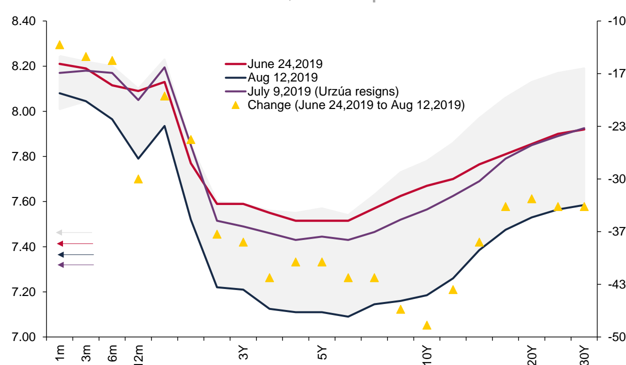


Note: The black vertical line represents Banco de México's latest monetary policy decision.
Source: Bloomberg and Citibanamex survey.

Interest rates of government securities decreased by up to 49 basis points, mainly for the short and medium terms (Chart 10). This decrease was again associated with the adjustments observed in most debt markets worldwide driven by expectations that the central banks of the main advanced economies will adopt even more accommodative monetary policy stances. The preceding occurred in a context of low trading volume and in which trading conditions deteriorated during certain days of the period (Chart 11).

Chart 10
Nominal Yield on Government Securities

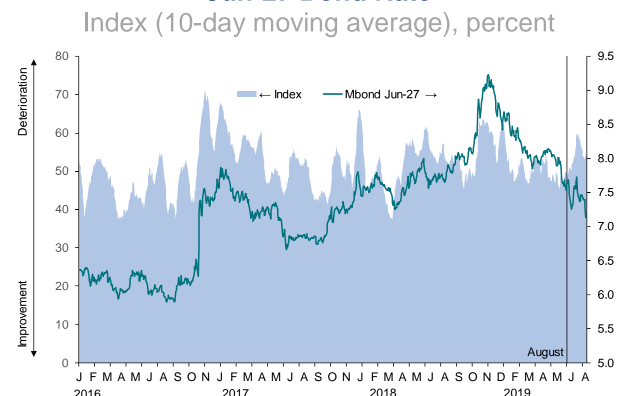
Percent, basis points



Source: PIP.

Chart 11
Mexican Government Debt Market Trading Conditions and Jun-27 Bond Rate

Index (10-day moving average), percent

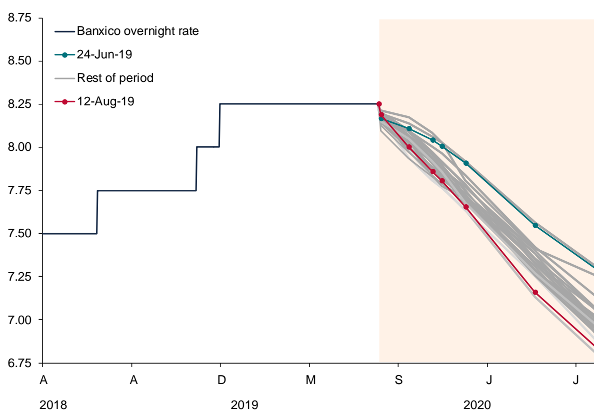


Note: Index calculated with the changes in bonds' interest rates, volatility of events, bid-ask spread, the average of the differences in quotes of intra-day operations, and the daily interbank and customer traded volume. Considering the aforementioned, percentiles since 2016 and the average of percentiles for every day are calculated. The vertical line represents the date of Banco de México's latest monetary policy decision.
Source: Calculated by Banco de México with data from Bloomberg, PIP and brokerage firms.

As to expectations regarding the path of the monetary policy target rate implied in the yield curve structure, these were adjusted downwards vis-à-vis the levels observed in the previous period (Chart 12). In this regard, both expectations of private sector analysts surveyed by Citibanamex and those implied by market instruments do not anticipate changes to the target rate for the monetary policy decision of August, although in the days prior to the monetary policy decision some analysts adjusted their expectations to a cut in August. For the end of 2019,

both expectations implied in market rates and the median of the latest survey among forecasters anticipate a 50 bp cut in the policy rate.

Chart 12
Banxico Overnight Interbank Rate Implied in TIIE IRS Curve
Percent



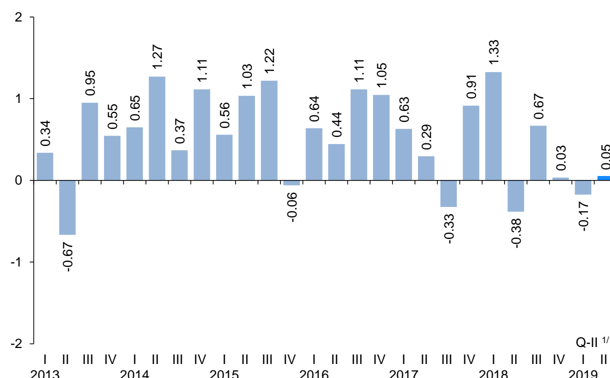
Source: Banco de México with Bloomberg data.

A.2.2. Economic activity in Mexico

According to INEGI's GDP flash estimate, during the second quarter of 2019, the stagnation that Mexico's economic activity has been registering in the previous quarters continued (Chart 13). Such behavior was due to the greater weakness of several components of aggregate demand, in a context of marked uncertainty stemming from both domestic and external factors. In particular, gross fixed investment continued showing an unfavorable performance, while private consumption remained weak. In contrast, manufacturing exports recovered.

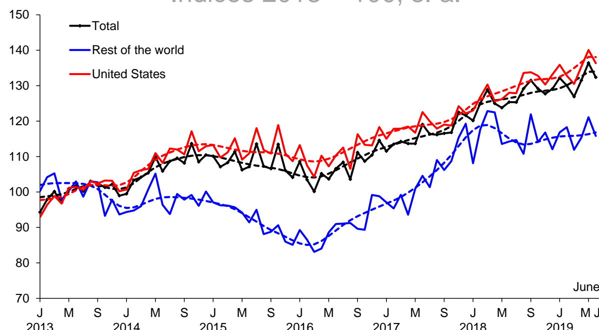
As for external demand, despite the weakening of world trade and the escalation of trade tensions, during the second quarter of 2019 manufacturing exports recovered relative to the deceleration displayed in the previous two quarters. In particular, exports to the United States continued trending upwards, while those to the rest of the world registered a slight recovery vis-à-vis the levels observed during most of 2018 and early 2019 (Chart 14). By type of commodity, automotive exports continued exhibiting a positive trajectory, while the rest of manufactures decelerated slightly towards the end of the period.

Chart 13
Gross Domestic Product
Quarterly percentage change, s. a.



s. a. Seasonally adjusted figures.
1/ Figures for the second quarter of 2019 correspond to INEGI's GDP quarterly flash estimate.
Source: Mexico's National Accounts System (SCNM, for its acronym in Spanish), INEGI.

Chart 14
Total Manufacturing Exports
Indices 2013 = 100, s. a.



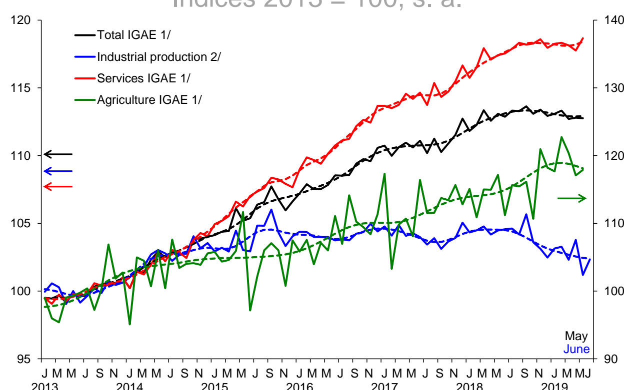
s. a. / Seasonally adjusted series and trend series based on data in nominal USD. The former is represented by a solid line and the latter by a dotted line.
Source: Prepared by Banco de México with data from the Tax Administration Service (SAT, for its acronym in Spanish), the Ministry of the Economy (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 the National System of Statistical and Geographical Information (SNIEG, for its acronym in Spanish).

As for domestic demand, according to its monthly indicator, during April-May 2019 the weakness that private consumption has been showing since the end of 2018 continued. This reflected the lackluster performance that services consumption has been exhibiting since late 2018, as well as the stagnation of the consumption of goods, which is largely explained by the unfavorable behavior of consumption of imported goods. More timely indicators of consumption, albeit of less coverage, exhibited a relatively weak performance during the second quarter of 2019. In particular, although retailers' earnings recovered moderately, the sales of

manufacturing industries that are more correlated with the consumption of domestically produced goods remained at a standstill. In turn, sales of light vehicles continued on a negative trend. Regarding gross fixed investment, the negative trend it has been following since early 2018 became more evident, even reaching its lowest level since August 2014. Indeed, both investment in construction and in imported machinery and equipment contracted significantly during April-May.

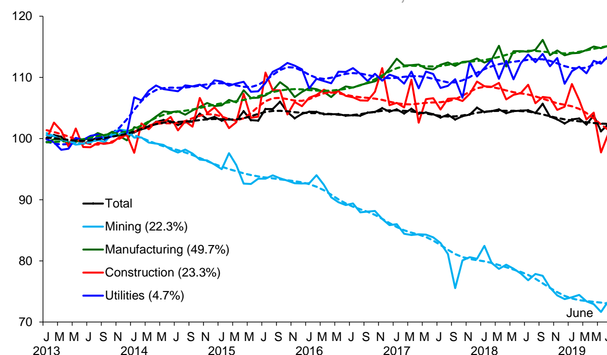
As for production, the latest information suggests that the lackluster growth of Mexico's economic activity during the second quarter of 2019 may be associated with the weakness of secondary activities as well as with the contraction of primary activities, while services showed a moderate recovery (Chart 15). Within industrial activity, the downward trajectory of construction followed since the early part of 2018 further intensified, while mining continued trending downwards (Chart 16). Manufacturing exhibited a certain recovery vis-à-vis the deceleration it had registered during the second half of 2018 and early 2019. The behavior of services during April-May was mainly explained by the positive contribution of the items of transportation, warehousing and information; accommodation and food services; and arts, entertainment and other services (except public administration). In contrast, there was a decline in the items of retail and wholesale trade; professional, scientific and technical services; and administrative and support and waste and management and remediation services.

Chart 15
Indicators 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.
1/ Figures up to May 2019.
2/ Monthly Industrial Activity Indicator figures up to June 2019.
Source: Mexico's National Accounts System (SCNM, for its acronym in Spanish), INEGI.

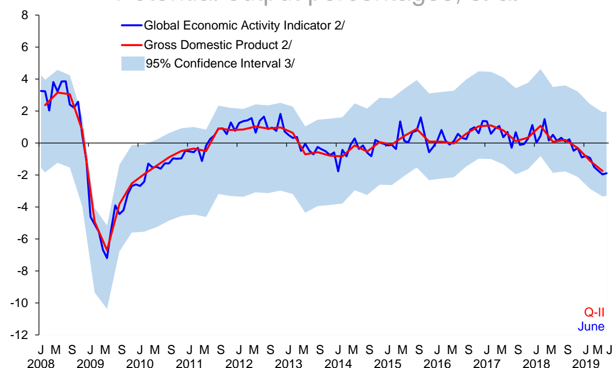
Chart 16
Industrial Activity 1/
Indices 2013 = 100, s. a.



s. a. / Seasonally adjusted and trend series. The former is represented by a solid line and the latter by a dotted line.
1/ Figures in parentheses correspond to its share in the total in 2013.
Source: Mexico's National Accounts System (SCNM, for its acronym in Spanish), INEGI.

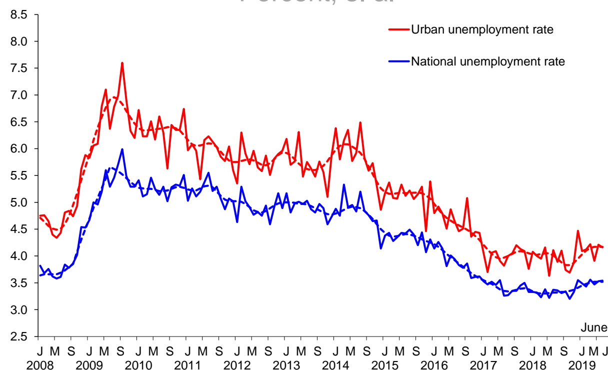
As to the economy's cyclical position, during the second quarter of 2019 slack conditions in the economy continued to loosen even more than expected, widening the negative output gap (Chart 17). As to labor market conditions, both national and urban employment rates continued at levels above those reported during most of 2018 (Chart 18). The deceleration in the growth rate of the number of IMSS-insured jobs also persisted. Given the behavior of productivity and real average earnings, unit labor costs in the overall economy remained at a level similar to that reported in the previous quarter. At the beginning of the second quarter of 2019, manufacturing unit labor costs continued on a positive trajectory, reaching relatively high levels (Chart 19).

Chart 17
Output Gap Estimates [1/] Excluding Oil Industry [4/]
Potential output percentages, s. a.



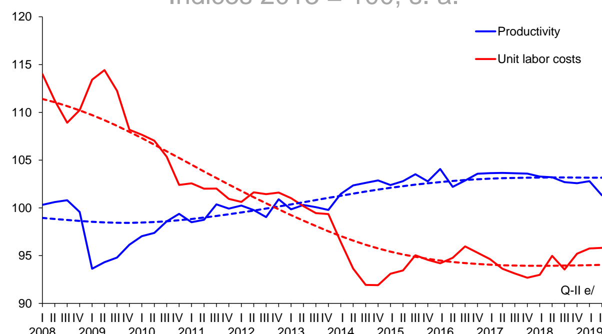
s. a. / Calculations based on seasonally adjusted figures.
1/ Output gap estimated with a tail-corrected Hodrick-Prescott filter; see Banco de México (2009), "Inflation Report (April-June 2009)", p.74.
2/ GDP figures up to the second quarter of 2019 and of IGAE implicit up to June, consistent with timely 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 INEGI data.

Chart 18
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.

Chart 19
Global Indicator of Labor Productivity (IGPLE, for its acronym in Spanish) and Unit Labor Costs [1/]
Indices 2013 = 100, s. a.



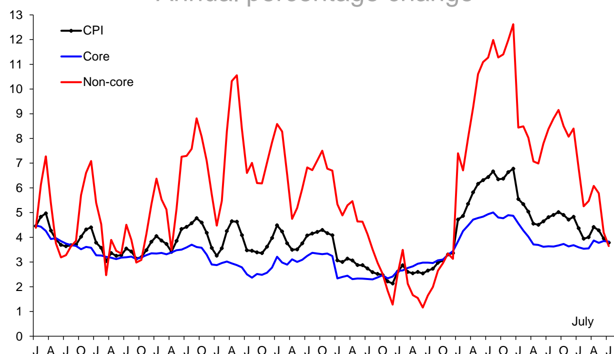
s. a. / Seasonally adjusted and trend series. The former is represented by a solid line and the latter by a dotted line. Trend series estimated by Banco de México.
1/ Productivity based on hours worked.
e/ Figures for the second quarter of 2019 are estimates of Banco de México based on SCN-INEGI's GDP flash indicator.
Source: IGPLE published by INEGI. Unit labor costs prepared by Banco de México with INEGI data.

In June 2019, domestic financing to the private non-financial sector displayed an annual growth rate in real terms lower than that observed during the first quarter of the year. As for its components, credit to private firms slowed down due mainly to the lower pace of growth of bank credit. In turn, housing credit continued showing a high dynamism, while consumer credit kept expanding at a low growth rate. With regards to interest rates, those related to firm financing did not change significantly at the margin, although they remain at high levels. Mortgage interest rates have remained stable since the second quarter of 2017, while those of credit cards continue trending upwards and those related to personal loans have increased at the margin. Regarding portfolio quality, firms and mortgage delinquency rates remained at low levels, while those related to consumption did not register significant changes, although they remain at high levels.

A.2.3. Developments in inflation and inflation outlook

Between June and July 2019, annual headline inflation decreased from 3.95 to 3.78%, showing a downward trend (Chart 20 and Table 1). Between June and July 2019, annual headline inflation went down from 3.95 to 3.78%, continuing to trend downwards vis-à-vis the high levels registered in 2017 (Chart 20 and Table 1). The reduction in annual headline inflation between these two months was mainly due to the reduction that non-core inflation has continued to exhibit.

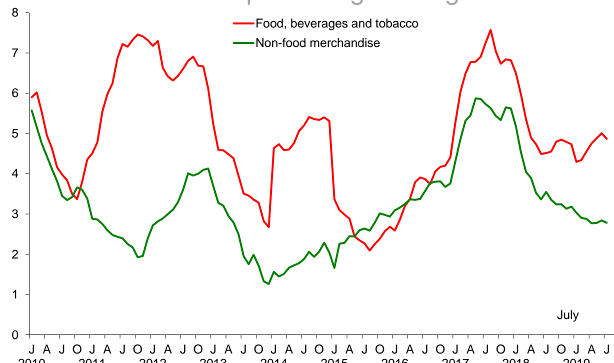
Chart 20
Consumer Price Index
Annual percentage change



Source: Banco de México and INEGI.

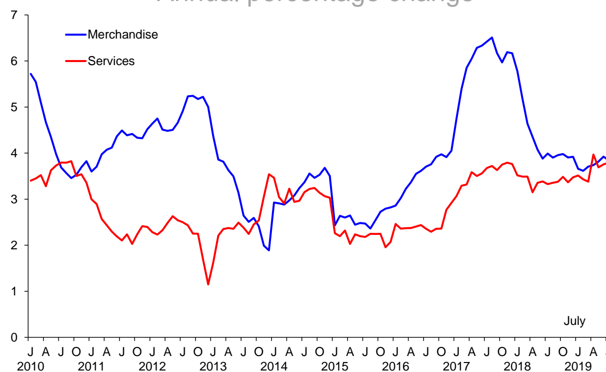
In June and July 2019, annual core inflation was 3.85 and 3.82%, respectively, maintaining its persistence at levels around 3.80%. Within this component, the high annual rates of change of food merchandise prices –though these have decreased at the margin– (Chart 21) and services (Chart 22) continue to stand out. Indeed, although decreases in the annual rates of change of the prices of some services are beginning to be observed, this is not a generalized pattern and several services are still growing at annual rates above 5%. In contrast, the annual rates of change of non-food merchandise prices remain at relatively stable levels below 3%.

Chart 21
Merchandise Core Price Subindex
Annual percentage change



Source: Banco de México and INEGI.

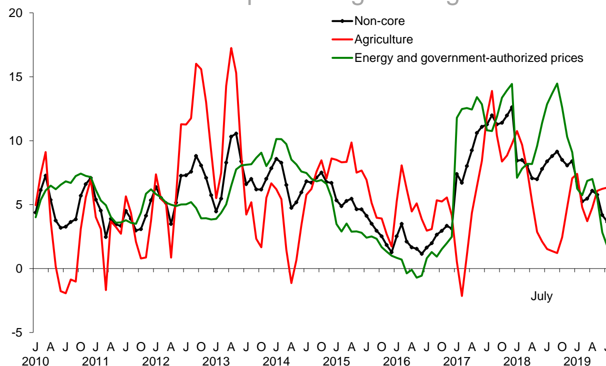
Chart 22
Merchandise and Services Core Price Subindex
Annual percentage change



Source: Banco de México and INEGI.

Annual non-core inflation remained on a downward trend, going from 4.19 to 3.64% between June and July 2019 (Chart 23 and Table 1). This result is largely associated with a decline in the growth rate of energy goods prices. In particular, of the 17 basis points by which annual headline inflation decreased, 16 can be accounted for by the lower contribution of gasoline and L.P. gas prices. Although the annual growth rates of fruit and vegetable prices have also fallen, those of livestock product prices continue to increase.

Chart 23
Non-core Price Subindex
Annual percentage change



Source: Banco de México and INEGI.

The medians for short-term inflation expectations drawn from Banco de México's Survey of Private Sector Forecasters remained relatively stable, although some exhibited adjustments. Between May and July, the median of headline inflation expectations for the end of 2019 was adjusted downwards from 3.75 to 3.65%, while that for the core component increased from 3.60 to 3.66%. At the same time, the medians for headline and core inflation for the end of 2020 remained at 3.60 and 3.40%, respectively. Thus, implied non-core inflation

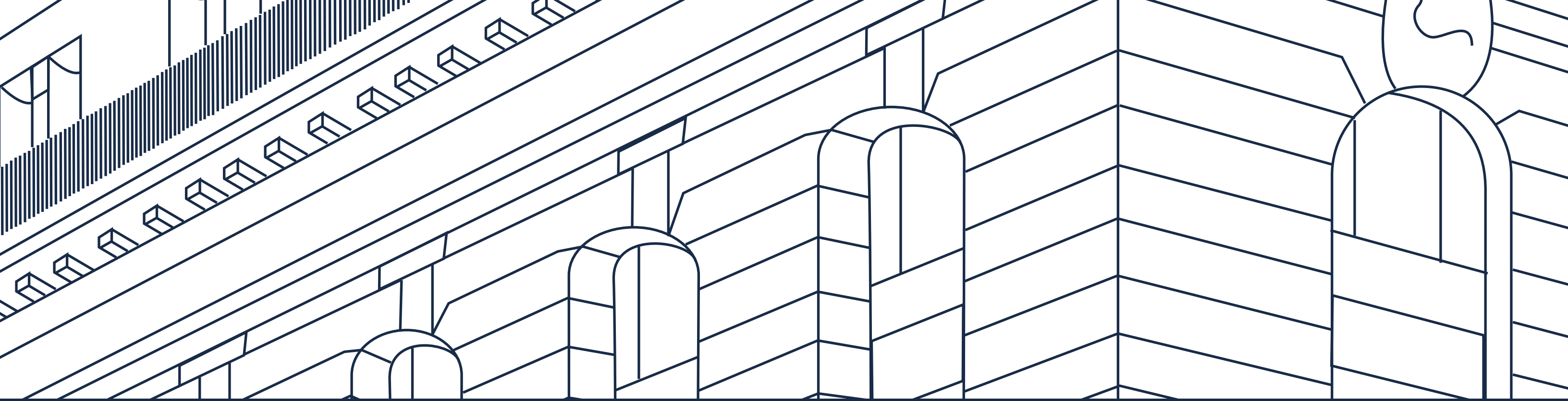
expectations for the end of 2019 adjusted downwards from 4.24 to 3.76%, while those for the end of 2020 remained at around 4.35%. As to the medians of headline and core inflation for the medium-term (next four years), these decreased from 3.54 to 3.50% and from 3.48 to 3.41% between May and July, respectively, while those of headline and core inflation expectations for the longer term (five to eight years) remained at 3.50 and 3.40%, respectively. Thus, expectations for both headline and core inflation remain at levels above the 3% inflation target. Finally, inflation expectations implicit in long-term market instruments (drawn from 10-year government bonds) decreased slightly between May and July, although they remained at levels close to 3.50%, while the inflation risk premium also decreased marginally.

As for risks to inflation, the following stand out. To the upside, that core inflation continues to show persistence. Also, there is the possibility that the peso exchange rate comes under pressure stemming from external or domestic factors. Additional risks are the threat by the United States to impose tariffs on Mexican imports and the adoption of compensatory measures, although these risks have dissipated somewhat; that energy prices revert their trend or that agricultural and livestock product prices exhibit increases; weak public finances; and, that global protectionist measures escalate. In addition, given the magnitude of several wage revisions, that cost-related pressures arise, insofar as such revisions exceed productivity gains. Regarding downside risks, the peso exchange rate may appreciate, possibly associated with a context of more accommodative monetary policy stances and lower interest rates worldwide, or in case greater certainty arises regarding the trade relation with the United States. Another downside risk is that the prices of certain goods included in the non-core subindex register lower rates of change, as observed in the case of energy goods, due to the greater weakness exhibited by the world economy, which would also contribute to reduce core inflation. In addition, that slack conditions widen more than anticipated, which would impact the behavior of core inflation. Given the aforementioned, high uncertainty still persists regarding the risks that might affect inflation.

Table 1
Consumer Price Index and Components
Annual percentage change

Item	May 2019	June 2019	July 2019
CPI	**4.28**	**3.95**	**3.78**
Core	**3.77**	**3.85**	**3.82**
Merchandise	**3.82**	**3.92**	**3.85**
Food, beverages and tobacco	4.88	5.01	4.87
Non-food merchandise	2.78	2.84	2.78
Services	**3.69**	**3.75**	**3.79**
Housing	2.83	2.84	2.86
Education (tuitions)	4.86	4.86	4.91
Other services	4.30	4.39	4.40
Non-core	**5.78**	**4.19**	**3.64**
Agriculture	**6.08**	**6.23**	**6.33**
Fruits and vegetables	11.26	9.32	5.61
Meats, poultry, fish and eggs	3.29	4.89	7.06
Energy and government-authorized prices	**5.50**	**2.83**	**1.73**
Energy products	6.51	2.51	0.76
Government-authorized prices	3.64	3.74	4.04

Source: INEGI.



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