BANCO DE MÉXICO®

Minutes number 93

Meeting of Banco de México's Governing Board on the occasion of the monetary policy decision announced on June 23, 2022

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FOREWARNING
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1. PLACE, DATE AND PARTICIPANTS

1.1. Place: Meeting held by virtual means.

1.2. Date of Governing Board meeting: June 22, 2022.

1.3. Participants:

Victoria Rodríguez, Governor.
Galia Borja, Deputy Governor.
Irene Espinosa, Deputy Governor.
Gerardo Esquivel, Deputy Governor.
Jonathan Heath, Deputy Governor.
Rogelio Eduardo Ramírez, Secretary of Finance and Public Credit.
Gabriel Yorio, Undersecretary of Finance and Public Credit.
Elías Villanueva, Secretary of the Governing Board.

Prior to this meeting, preliminary work by Banco de México's staff analyzing the economic and financial environment as well as 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

International environment

Most members stated that available indicators suggest that global economic activity slowed down during the second quarter, affected mainly by mobility restrictions in China and the repercussions of the military conflict. One member added that it was also affected by the tightening of financial conditions. **Another** member said that performance remains heterogeneous among countries and sectors. He/she noted that in the United States, the reduction of fiscal and monetary stimuli has started to affect some GDP components, such as residential investment, although consumption continues to show dynamism. **One** member indicated that said economy continues to recover, albeit with a reduction in consumer confidence and a weakening of growth expectations. Meanwhile, **some** members mentioned that labor markets in advanced economies continue functioning strongly, with increases in wages and in the number of vacancies.

Most members noted that the outlook for global economic growth was revised downwards. One member mentioned that the conflict in Ukraine, the partial shutdown of activities in China and less lax financial conditions contributed to that revision. He/she pointed out that, nevertheless, an expansion of close to 3% is still expected for 2022 and 2023. **Most members agreed that the outlook is uncertain. Some** members stated that among global risks, those associated with the pandemic, the persistence of inflationary pressures, the intensification of geopolitical tensions and greater adjustments in economic, monetary and financial conditions, stand out. **One** member warned about the increasing likelihood of a pronounced slowdown, and even a recession, in the United States. **Another** member indicated that the contraction of the Chinese economy expected for the second quarter of the year may have implications for global demand. **Most members noted that the balance of risks for global economic activity is biased to the downside.**

All members highlighted the high levels that world inflation has registered. Most members mentioned that in some cases, levels unseen in decades have been registered. They also noted that inflation continued to be pressured by the persistence of bottlenecks, the effects of the geopolitical conflict and the recovery of demand. Likewise, they emphasized the high commodity prices, especially of food and energy products. One member added the boost to spending from fiscal and monetary stimuli provided in response to the pandemic. **Some** members highlighted that a more generalized increase in prices is observed. **Most members stated that, in the United States, CPI inflation reached 8.6% in May. One** member noted that core inflation declined marginally. **Some** members highlighted that in the euro area inflation rose to 8.1% in May and **some** members indicated that, in this context, global short-term inflation expectations continued increasing. **One** member pointed out that inflation convergence towards central banks' targets continues to be expected for the end of 2023 and early 2024. **Another** member warned about the possibility of tighter labor market conditions. **One** member considered that the environment for inflation remains very complex and with a high degree of uncertainty.

All members said that a large number of central banks have continued raising their reference rates. Some members detailed that such actions have the aim of moderating aggregate spending. **All members mentioned that in its latest monetary policy decision, the Federal Reserve raised the target range for the federal funds rate by 75 basis points and anticipated future adjustments. Most members added that such an increase had not been observed since 1994. Some** members pointed out that it was larger than expected. **Most members added that, based on financial market data, the federal funds rate is expected to reach levels above 3.5%. One** member noted that such level is above the neutral range. He/she highlighted that the European Central Bank left the reference rate unchanged in June and announced that it would increase it by 25 basis points in each of its next two decisions. **Some** members mentioned that emerging economies also continued raising their reference rates. **One** member elaborated that, in most cases, the ex-ante real interest rate is still below its neutral level. He/she noted that, within this group, only Brazil, Chile and Mexico have positive ex-ante real interest rates. He/she added that, although in the first two cases the inflation rate is above 10%, Mexico stands out as one of the Latin American countries with the lowest annual inflation rate. **Another** member stated that a more accelerated reduction of monetary stimulus worldwide is still expected.

All members noted that in this context, global financial conditions tightened further. Most members noted that the dollar strengthened, interest rates increased, especially at the shorter-term nodes, and equity indices registered losses, in a context of risk aversion. Regarding financial markets of emerging economies, **some** members noted that they presented a negative performance, with adverse effects on their currencies. **One** member also mentioned the negative impact observed in stock markets and risk premia as measured by CDS premia. **Some** members stated that yield curves flattened. **One** member added that outflows were registered in fixed-income and equity assets, mainly from China and other Asian economies. **Some** members mentioned that a more abrupt than expected monetary normalization processes could lead to further tightening and greater volatility in global financial conditions. **One** member pointed out that this could lead to capital outflows from emerging economies.

Economic activity in Mexico

Most members agreed that the economic recovery is expected to continue in the second quarter of 2022. Some members indicated that this is already being observed in certain timely indicators. **One** member stated that the recovery would be supported by the improved performance of tertiary activities.

On the supply side, most members noted that industrial production continued recovering in April, given the favorable performance of the manufacturing sector. Some members added that industrial activity was driven by several of its components, although they specified that construction continues to show sluggishness. **Some** members highlighted that the negative effects on the automotive industry have diminished. **One** member pointed out that the capacity utilization rate in the manufacturing sector registered historical highs. He/she noted that in June there were fewer technical shutdowns in assembly plants, although the production of light vehicles has not yet regained its pre-pandemic levels. **Some** members emphasized that the recovery of services continues to show heterogeneity. **One** member noted a marginal moderation in retail activities and a greater dynamism in leisure, lodging and food preparation services.

On the demand side, most members underlined that consumption continues to recover. They detailed that various determinants of consumption remain at high levels, such as consumer confidence, the total wage bill, and remittances. Some members highlighted that for nine consecutive months the monthly indicator of private consumption has been showing small increases. **One** member pointed out that its growth has been driven mainly by the consumption of services and non-durable goods. **Another** member emphasized that consumption of goods and services has already surpassed pre-pandemic levels. **Some** members added that leading indicators, such as ANTAD (*Asociación Nacional De Tiendas De Autoservicio y Departamentales*, for its acronym in Spanish) sales, and credit and debit card spending, suggest that private consumption continued to improve in the second quarter. **Most members highlighted that investment showed an improvement in March, driven by the component of machinery and equipment other than for transportation. However, they pointed out that investment continues to show sluggishness, particularly investment in construction. One**

member mentioned the lag observed in both the construction and the transportation equipment components of investment.

Regarding the external sector, most members highlighted the good performance of non-automotive manufacturing exports. One member detailed that this was due to increases in both volume and price. **Another** member highlighted the impact of problems on the supply of microprocessors on automotive exports in April. **One** member noted that non-oil imports have shown a significant upward trend, especially those of capital goods, while intermediate and consumer goods' imports kept a positive trend, which has increased the trade deficit.

Most members agreed that various labor market indicators have continued to improve, although the recovery remains incomplete. They also noted that unemployment, underemployment and labor participation rates, as well as employment in IMSS-insured jobs, have continued to show progress. One member pointed out that this is particularly true for the northern region of the country and within the manufacturing industry. **Another** member indicated that in April, the national and urban unemployment rates were at low levels, in an environment in which the labor participation rate and the employment-to-working-age-population ratio continued approaching their pre-pandemic levels. **One** member added that some experimental indicators of vacancy levels show that these maintain a good pace of growth. In this context, **some** members noted that nominal wage revisions for IMSS-insured workers registered an annual increase of 11%, a new maximum, while wage revisions in the private sector registered an 8.2% increase. However, they emphasized that certain labor market indicators, such as employment levels, show weakness and remain below their pre-pandemic levels. **One** member noted that the number of inactive workers among the working-age population remains above the level observed before the pandemic. **Another** member added that relative to its trend level, the number of IMSS-insured workers has also shown weakness.

Most members pointed out that slack conditions in the economy have decreased. They stated that these are expected to continue decreasing gradually. However, **one** member stated that Mexico's GDP is still lagging with respect to both the trend and the absolute level that prevailed prior to the pandemic. He/she added that some services, such as lodging, food preparation and leisure, still register levels of activity below their pre-pandemic levels. He/she stressed that there is still room for the economy to grow as some services continue to recover and some manufacturing industries regain the use of their installed capacity, without necessarily creating additional inflationary pressures.

Some members agreed that the environment for economic recovery remains uncertain. **One** member said that, given the uncertainty regarding the evolution of the pandemic, the persistence of supply chain disruptions and inflationary pressures, and the expectation of a further tightening of monetary conditions, a complex global economic environment prevails, which keeps the balance of risks for economic growth biased to the downside.

Inflation in Mexico

Most members mentioned that in the first fortnight of June, headline and core inflation registered annual variations of 7.88 and 7.47%, respectively, and remained at elevated levels. One member highlighted that most of the CPI components have accelerated their growth. He/she detailed that monthly inflation in May surpassed analysts' expectations and for the third consecutive year was positive whereas typically it used to be negative. **Another** member noted that inflation is well above the target and that pressures at the margin, measured by standardized monthly changes, persisted during May and June. **Some** members noted that certain indicators of central tendency reflect generalized pressures. **One** member detailed that in the first fortnight of June, 45% of the items in the CPI basket showed seasonally adjusted monthly variations above 10%.

Regarding the different shocks that have affected inflation, **this member** indicated that the combination of the shocks derived from the pandemic and those associated with the military conflict, maintains an extremely complex environment and with a high degree of uncertainty. He/she added that inflation is suffering from the depth, simultaneity and longer duration of shocks. He/she considered that it is being affected by global factors and is particularly pressured by increases in international food references. Meanwhile, **another** member said that, although inflation in Mexico is part of a global phenomenon, it also stands out for being relatively contained and at a lower level than in other similar emerging economies as well as in advanced economies. He/she indicated that this is due to a less lax monetary policy stance, the absence of inflationary pressures on the demand side and the Federal Government's fuel price policy. **One** member mentioned that despite this pricing policy and a flexible and resilient exchange rate, which has allowed the economy to absorb part of the external inflation pass-through, a generalized inflationary phenomenon is being confronted, with inflation rates unseen in over 20 years and which have shown resistance to decline.

Most members noted that core inflation responded mainly to inflationary pressures from abroad on energy and food prices, and to higher production costs. One member added the pressures related to the recovery of domestic consumption. In this context, **some** members highlighted that the core component maintains an ongoing sequence of increases since December 2020. **Most members highlighted the increase in food commodity prices, associated with the phenomenon of global commodity inflation. One** member pointed out that this sub-index registers a double-digit inflation and highlighted, in particular, the effect on wheat and dairy products' prices. **Another** member pointed out that the price increases of these commodities affect lower-income households to a greater extent, as they allocate a higher proportion of spending to consumption of such goods. **One** member indicated that if the food merchandise component were excluded from core inflation, as in other countries, the annual change in core inflation would still be above the inflation target, but at a much lower level. He/she added that this reflects that pressures on food services and non-food merchandise are lower than those on food merchandise. **Some** members mentioned inflationary pressures in the services component. **One** member considered it concerning that services inflation, which to a greater extent reflects domestic pressures, has maintained an upward trend for more than a year and is located above the target for headline inflation.

Most members indicated that non-core inflation remains at high levels. Some members highlighted the pressures on agricultural and livestock products. **With respect to inflation in energy prices, most members pointed out that it has remained relatively subdued by the policies set by the Federal Government. One** member added that, because of the gasoline price subsidy, no multiplicative effects on other prices are observed.

Most members mentioned that inflation expectations for 2022 and 2023 increased considerably again. One member noted that inflation expectations for both years are well above the inflation target. **Another** member indicated that although inflation expectations for the end of 2022 and for the subsequent 12 months continue at high levels, the former remained close to their level observed during the previous month and the latter decreased at the margin. **One** member considered that short-term expectations have increased since June 2021 and stated that, in his/her opinion, they will surely continue to be revised upwards.

Most members pointed out that medium- and long-term headline inflation expectations increased slightly and remain at levels above the target. Some members indicated that the increase in long-term expectations is an alert regarding the beginning of an expectations' unanchoring process, which is important to revert. **Some** members added that these expectations had remained stable for a long period. **One** member emphasized that long-term expectations for core inflation have remained stable. **Most members stated that expectations drawn from market instruments continued adjusting upwards. One** member specified that the ones for the average of 6-to-10 years still remain at low levels, although they have shown steady increases over the course of several months.

Most members stated that given the greater-than-anticipated inflationary pressures, inflation forecasts have been revised upwards once again. They pointed out that inflation convergence to the 3% target is still expected to be attained during the first quarter of 2024. One member noted that forecasts for the next four quarters already exceed market expectations. **Another** member pointed out that the seasonally adjusted annualized quarterly change is expected to lie above 10% in the second quarter of 2022, its highest value during this period of high inflation. He/she mentioned that the increase in inflation registered in most CPI components in recent months has generated doubts over when the inflection point could be reached. He/she noted that, recently, inflation was anticipated to peak between April and May, and to start declining beginning in June. He/she added that currently it is expected to reach its peak in August or September and headline and core inflations are estimated to begin declining in the fourth quarter of 2022. He/she underlined that the headline inflation forecast for said quarter was revised upwards by over 100 basis points. He/she pointed out that recurring forecast adjustments are due to a continuous accumulation of unanticipated shocks, which has been a problem during the last couple of years in Mexico and in other countries.

Among upward risks to inflation, most members mentioned external inflationary pressures

associated with the pandemic, greater pressures on agricultural and livestock product prices and on energy prices due to the ongoing geopolitical conflict and cost-related pressures. Some members highlighted the labor costs. **One** member pointed out that although a wage-price spiral cannot be confirmed, firms can be expected to pass through part of their higher labor costs onto final consumers, in response to the growing demand. **Another** member considered that the cost increase could be reflecting the all-time highs registered in capacity utilization in the manufacturing sector. **Some** members emphasized as a risk that core inflation persist at high levels and a depreciation of the exchange rate. **Most members mentioned that there is high uncertainty regarding the time it will take for the effects of these shocks to start to fade, and added that the occurrence or the intensification of additional disturbances cannot be ruled out.** Among downward risks, **some** members pointed to the possibility that the Policy Program to Fight Inflation and High Prices (PACIC, for its acronym in Spanish) will have a greater-than-anticipated effect, while **one** member stated that its impact would be marginal and would be mainly associated with the gasoline subsidy. He/she underlined that the viability of this measure will depend on whether it can be financed without affecting the fiscal balance. **Another** member mentioned, among downward risks, the following: i) a decline in the intensity of the military conflict; ii) an improvement in supply chains; and iii) a greater-than-expected effect from the negative output gap. **One** member stated that the withdrawal of fiscal and monetary stimuli at the global level would contribute to mitigate inflationary pressures worldwide and, consequently, domestic ones. **Another** member stressed that it is worrying that conjunctural risks, such as climate-related factors, logistical problems and input costs, showed a greater deterioration than that perceived during previous inflation episodes, which suggests a concurrence of risks greater than previously observed. **Most members considered that the balance of risks for the expected inflation trajectory within the forecast horizon is significantly biased to the upside.**

Macrofinancial environment

Most members emphasized that the negative behavior of domestic financial markets was in line with that observed at the global level. They highlighted that the exchange rate showed an orderly performance, while **one** member considered that its trading conditions deteriorated somewhat at the margin. **Some** members recognized that the exchange rate depreciated slightly. However, they pointed out its resilience, given the country's sound macroeconomic fundamentals and the broad volatility-adjusted interest rate spread relative to the United States. **One** member added that its favorable behavior is also due to lower idiosyncratic risks relative to other economies in the region. **Another** member noted that so far this year the Mexican peso has appreciated slightly. **One** member pointed out that forward-looking indicators for the Mexican peso show improvements both according to market metrics and analysts' expectations.

Most members pointed out that short- and long-term interest rates increased. Some members highlighted the flattening of the yield curve. **One** member stated that its slope is at low levels, in line with the international trend. He/she added that the real yield curve has declined, especially for shorter terms. He/she indicated that foreign capital inflows to *Bonos* and *Udibonos* in search of yield and shelter from high inflation levels will continue. **Another** member highlighted that default premia increased given the environment of higher risk aversion. **Some** members pointed out that the stock market registered a decline of more than 2%.

One member expressed the need, in this context of high risks and high uncertainty, for the economies characterized by a high degree of financial and commercial integration with the rest of the world, and that are exposed to external shocks, to maintain a solid macroeconomic policy stance at all times. He/she pointed out that, within the scope of Banco de México's attributions, this implies pursuing low and stable inflation and safeguarding the strength of the financial system. He/she underlined that the relative monetary policy stance is appropriate, which along with solid macroeconomic fundamentals, such as fiscal discipline and sustainable external accounts, allows the economy to face possible negative external shocks.

Monetary policy

The Governing Board evaluated the magnitude and diversity of the shocks that have affected inflation and its determinants, along with the risk of contamination of medium- and long-term inflation expectations and of the price formation process. Most members also considered the increasing challenges for monetary policy, stemming from the ongoing tightening of global financial conditions, the environment of significant uncertainty and inflationary pressures associated with the geopolitical conflict and with new cases of COVID-19 in

China, as well as the possibility of greater negative effects on inflation. Based on these considerations, all members voted for raising the target for the overnight interbank interest rate by 75 basis points to 7.75%. Most members emphasized that, with this action, the monetary policy stance adjusts to the trajectory required for inflation to converge to its 3% target within the forecast horizon.

The Governing Board expressed that it will thoroughly monitor inflationary pressures as well as all factors that have an incidence on the foreseen path for inflation and its expectations. The latter, in order to set a policy rate that is consistent at all times both with the orderly and sustained convergence of inflation to the target, as well as with an adequate adjustment of the economy and financial markets. The Board added that for the following monetary policy decisions, it intends to continue increasing the reference rate and will evaluate taking the same forceful measures if required.

One member considered that the recent monetary policy decision of the Federal Reserve and the recent volatility in global financial markets lead to a proportional response in order to preserve the relative monetary policy stance, promoting stability in domestic markets. Likewise, he/she considered that looking forward, the absolute stance will be increasingly important and the relative stance will be less so. He/she argued that this is because, first, the current decision places the real interest rate above the level considered as neutral, and second, there is enough space for an eventual reduction of the spread between the reference rates in Mexico and in the US. He/she emphasized the importance of a gradual transition to a moderately restrictive absolute stance in order to prevent the current inflationary phenomenon from generating second-round effects on the price formation process, but stressed also the importance of avoiding an excessive tightening. He/she pointed out that the real interest rate, which for Mexico is among the highest in the world, affects different variables, such as credit, investment and durable goods' consumption. He/she forewarned that it is necessary to avoid an excessive tightening, which may result counterproductive even to preserve macroeconomic and financial stability, and therefore, to control inflation. He/she considered that the increase observed in emerging economies' risk premia is associated with the deterioration in their economic outlook and in their public finances, which partly derives from monetary tightening and reflects the limits of monetary policy to preserve macroeconomic stability in emerging economies. He/she mentioned, as additional reasons, that the inflation rebound is caused by global factors and thus an excessive tightening in Mexico would bring little gains in terms of controlling domestic inflation, and that unlike other countries that provided ample fiscal and monetary stimuli, Mexico does not register an out-of-control growth of aggregate demand. He/she mentioned that during the following quarter, there may be conditions to begin dissociating from the pace of the Federal Reserve's rate increases, given that: i) the volatility adjusted interest rate spread relative to the United States is among the highest in the emerging economies and is at all-time highs; ii) from a medium-term perspective, the Mexican peso stands out for its sound performance and low volatility, which reflects solid macroeconomic fundamentals; iii) Mexico began its normalization process earlier and is closer to the zone considered as restrictive; iv) unlike other emerging economies and the United States, Mexico does not face demand- or labor market-related inflationary pressures; and v) inflation in Mexico is less distant from its target, as compared to other countries.

Another member mentioned that given the deterioration in the balance of risks and the persistence of high inflation levels, this decision, rather than a change in the pace, will give the necessary boost to attain an interest rate trajectory consistent with the convergence of inflation to its target. He/she underlined that, although the monetary policy adjustments that have been implemented allow the relative position with the United States to be solid, given the recent, larger than expected increase in the reference rate of the United States, and given tighter financial conditions worldwide, as well as an increase of perceived risk aversion, the relative monetary policy stance must be thoroughly monitored, while inflationary pressures persist. In this regard, he/she mentioned that the shocks associated with the armed conflict continue affecting commodity prices, while the resurgence of COVID-19 cases in China and the subsequent restrictions to mobility continue affecting the reestablishment of supply chains, and it remains unclear if they could be lifted in the short-term. He/she considered that it is inevitable to act forcefully to address the inflationary pressures that are perceived in the convergence trajectory of inflation to its target and which have caused a deterioration in the inflation forecasts, although the period of convergence remains constant. He/she underlined that given the lag at which monetary policy operates, the ex-ante real interest rate may need to lie above the upper threshold of the range for the neutral rate for the stance to be more effective. He/she added that looking ahead, it is necessary to carefully assess if another increase of a similar magnitude is necessary which would ensure the anchoring of inflation expectations, allow the ex-ante real rate to adjust more efficiently as compared to the expected inflation trajectory and prevent the emergence of second-round effects on price formation. He/she indicated that the actions taken, complemented with the adequate use of communication tools, have been more effective, and that it is important that this continues, especially in periods of high uncertainty, given that an orderly adjustment of financial markets is necessary in view of Banco de México's decisions.

One member stated that Mexico is currently facing an even more complex inflation environment. He/she forewarned that, since the last monetary policy decision, the expected inflation trajectory at year end has been revised by over 100 basis points, that the balance of risks to inflation maintains a considerable upward bias, and that the possibility that inflationary shocks will be longer-lasting, that they will intensify or that new shocks will emerge, cannot be ruled out. He/she considered that in this environment, a faster rate of tightening is urgently required to achieve a restrictive monetary policy stance. He/she added that the effects of the pandemic on world inflation, a greater international monetary tightening and the deterioration of inflation expectations, call for maintaining this rate of tightening at least during the following monetary policy decision. He/she mentioned four factors to be considered in fighting inflation. The first factor is to take the monetary stance to a restrictive region. He/she point out that although the current hiking cycle began in June 2021, inflation expectations increased, so that the monetary policy stance is barely in the lower part of the neutral range. He/she mentioned that, after the 75 bp increase, it would reach the upper threshold of the neutral range, and, given a new possible upward revision in the expectations, this increase will not be sufficient to reach a restrictive monetary policy stance. Thus, an adjustment of a similar magnitude will be necessary in the next decision. He/she emphasized that the cyclical conditions become secondary and no effort must be spared in controlling inflation. Second, he/she noted that a necessary but not sufficient condition for inflation to decline in Mexico, is that it declines in the United States. He/she expressed that inflation in the United States reached very high levels, which pushed the Federal Reserve to increase its reference rate by 75bp. He/she pointed out that Mexico's relative monetary policy stance has been enough to confront the episodes of higher volatility. Therefore, he/she considered that the Federal Reserve's increase must be matched, in order to maintain the interest rate spread between the two countries. Third, the support, albeit marginal, of other efforts to reduce inflation, such as the PACIC and especially the fiscal stimulus to the price of gasoline. The fourth is characterized by a combination of patience and luck. Patience in waiting for the current shocks to dissipate and luck for new shocks not to emerge. He/she sustained that the expected inflection point in the headline and core inflation trends during the fourth quarter does not depend exclusively on Banco de México, thus it is important to remain cautious. He/she expressed the opinion that the current challenges demand a communication policy that is free of ambiguities, with precise qualitative and quantitative information about the future policy actions. Furthermore, he/she pointed out that, given that the monetary tightening works mainly through the expectations channel, it is important to have and effective communication. This opens the discussion to improve the communication strategy towards a more robust framework. He/she pointed out that some pioneering central banks have a forward guidance in which, in addition to the inflation and growth forecasts, they publish the reference rates' trajectory, which is consistent with the inflation forecast. He/she considered that such communication policy could strengthen the monetary policy transmission. The above assuming that said trajectory would not imply a commitment regarding future decisions, but rather only a guide over its possible course. He/she noted that an explanation could be added on how this path could be changed in response to a number of events. He/she argued that measures of this kind should be thoroughly analyzed and, if implemented, it should be done in a cautious manner.

Another member recalled that from the beginning of the current cycle, it was pointed out that the challenge was for inflationary pressures, which at the time where considered to be transitory and generated by supply shocks, not to affect price formation and the anchoring of expectations. He/she added that the relevance of expectations, especially those for longer terms, in monetary policy transmission, was highlighted, and that these could be affected by persistent and high levels of inflation, even in the absence of demand pressures. He/she added that it was emphasized that the central bank's credibility helps to maintain expectations anchored and contributes to a more efficient monetary policy. He/she pointed out that twelve months later, there are high levels of inflation, unseen in more than 20 years, a generalized inflationary phenomenon which affects a large number of goods and services, and which has shown resistance to decline despite the adjustments in the monetary policy stance, and the most concerning, the beginning of the unanchoring of medium- and long-term expectations. He/she highlighted that all of this has taken place despite two factors that have contributed to reduce additional inflationary pressures: a flexible and resilient exchange rate, which has allowed the economy to absorb part of the pass-through of external inflation, and the energy price policy implemented by the Federal Government to limit their increase in real terms. He/she considered that it is essential to take firm and forceful actions to restore confidence in the commitment to convergence to the target within the forecast horizon. He/she considered it necessary to take the reference rate to restrictive territory, and that increasing the rate of adjustment of monetary policy cannot be postponed. He/she argued that regarding the expectations channel, there are studies that show that, even in the face of supply shocks, reference rate increases contribute to mitigate the effects on long-term expectations. He/she added that in the face of inflationary pressures from abroad, a 75 bp increase would also reinforce the exchange rate channel. He/she considered it fundamental that communication allows the anticipation of the more restrictive monetary conditions needed to achieve the convergence of inflation to the target, given the growing risks to price stability. He/she expressed that only with the proposed increase and anticipating more restrictive monetary conditions can the central bank's commitment to its constitutional mandate be endorsed and the anchoring of inflation expectations guaranteed. He/she argued that the way to induce lower interest rates in the future, as well as an expansion of financing and credit, to the benefit of economic activity and employment, is precisely by raising the reference rate in a timely and sufficient manner, and by avoiding more severe rate increases in the future. He/she warned that, if this is not done, the social cost in terms of production and employment will undoubtedly be much higher. He/she stated that the main current challenge is the high level of inflation.

One member considered that monetary policy in Mexico has continued to face a highly complex environment. Given the high social and economic costs derived from inflation, and given that these affect the most vulnerable population to a greater extent, it is essential to act with the necessary determination to achieve low and stable inflation. He/she argued that the confluence of factors, such as those associated with the pandemic and the geopolitical conflict, among others, has led to a generalized inflationary shock of great magnitude, which could have long-term effects on the dynamics of inflation in Mexico and he/she added that, in such an environment, the possibility of price formation contamination may increase. He/she warned that an unanchoring of inflation expectations, mainly of those for longer terms, would make convergence to the target more difficult. He/she pointed out that international monetary and financial conditions are in circumstances unseen in several decades, especially in terms of the Federal Reserve's pace of monetary tightening, which could have significant repercussions on global and domestic financial markets, including the exchange rate, and could make it difficult to control inflation in Mexico. In view of the deteriorating environment, it is necessary to strengthen the monetary policy stance and confirm the commitment that the necessary actions will be taken so that inflation expectations remain anchored and a deterioration of the price formation process is avoided. He/she expressed that, at the present juncture, there must not be any doubt about the central bank's determination to achieve the convergence of inflation to the target within the forecast horizon. This, considering that it is important to address the described scenario in a decisive manner, in order to comply with Banco de México's obligation with the Mexican population. He/she stated that, looking ahead, the evolution of all inflation determinants should continue to be considered, including inflation expectations, especially longer-term ones, slack conditions and the evolution of financial markets as well as the relative monetary policy stance. He/she considered that in the next monetary policy decisions, Banco de México should continue the cycle of reference rate increases, assessing whether it is necessary to take the same forceful measures based on the outlook for inflation and its expectations. All of the above, in order for Banco de México to adopt the necessary actions to comply with its constitutional mandate of maintaining low and stable inflation.

3. MONETARY POLICY DECISION

The Governing Board evaluated the magnitude and diversity of the shocks that have affected inflation and its determinants, along with the risk of contamination of medium- and long-term inflation expectations and of the price formation process. It also considered the increasing challenges for monetary policy stemming from the ongoing tightening of global financial conditions, the environment of significant uncertainty, and inflationary pressures associated with the geopolitical conflict and with the resurgence of COVID-19 cases in China, as well as the possibility of greater effects on inflation. Based on these considerations, and with the presence of all its members, the Board decided unanimously to raise the target for the overnight interbank interest rate, on this occasion, by 75 basis points to 7.75%. With this action, the monetary policy stance adjusts to the trajectory required for inflation to converge to its 3% target within the forecast horizon.

The Board will monitor thoroughly inflationary pressures as well as all factors that have an incidence on the foreseen path for inflation and its expectations. This, in order to set a policy rate that is consistent at all times with the trajectory needed to facilitate the orderly and sustained convergence of headline inflation to the 3% target within the time frame in which monetary policy operates as well as an adequate adjustment of the economy and financial markets. For the next policy decisions, the Board intends to continue raising the reference rate and will evaluate taking the same forceful measures if conditions so require.

4. VOTING

Victoria Rodríguez, Galia Borja, Irene Espinosa, Gerardo Esquivel and Jonathan Heath voted in favor of increasing the target for the overnight interbank interest rate by 75 basis points to 7.75%.

ANNEX

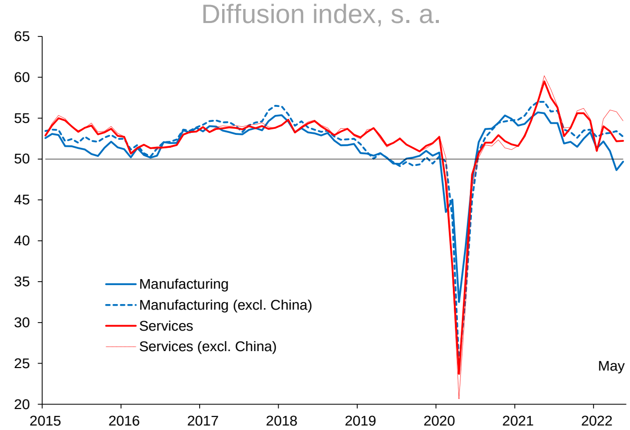
The information in this Annex was prepared for this meeting by the staff of Banco de México's Directorate General of Economic Research and Directorate General of Central Bank Operations. It does not necessarily reflect the considerations of the members of the Governing Board as to the monetary policy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

A.1. External conditions

A.1.1. World economic activity

Available indicators suggest that global economic activity slowed down during the second quarter of 2022 (Chart 1), as a result of the military conflict in Ukraine, mobility restrictions in China due to the resurgence of COVID-19 cases towards the end of the first quarter, and the tightening of financial conditions worldwide. Heterogeneity across countries is expected to have increased during the second quarter, as some of the main advanced economies are expected to recover from the first quarter, while some of the main emerging economies, like China and Russia, are foreseen to contract. World inflation continued increasing, in some cases reaching its highest levels in decades, pressured by the persistence of bottlenecks, the recovery of demand, and the high levels of food and energy prices. In this environment, a large number of central banks continued raising their reference rates, while expectations of a faster reduction of monetary stimulus worldwide have continued to increase. Financial conditions tightened further, interest rates rose and the dollar strengthened, in a context of risk aversion. Among global risks to growth, those associated with the evolution of the pandemic, the persistence of inflationary pressures, the escalation of geopolitical tensions, and the further adjustments of economic, monetary and financial conditions stand out.

Chart 1
Global: Purchasing Managers' Index: Production Component
Diffusion index, s. a.



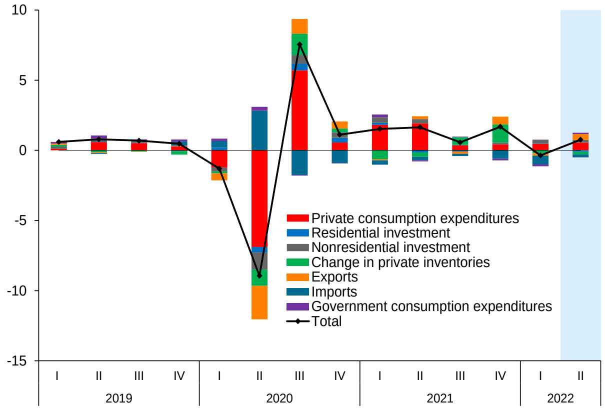
s. a. / Seasonally adjusted figures.
Source: IHS Markit.

In the United States, after having contracted during the first quarter of the year at a seasonally adjusted quarterly rate of 0.4%, available indicators suggest that economic activity registered a moderate recovery during the second quarter (Chart 2).[1] Although economic activity has been supported by consumption and by a lower negative contribution of net exports, investment in machinery and equipment has moderated and residential investment has weakened. Even though private consumption appears to have continued contributing positively to growth during the second quarter, it faces greater risks due to tighter financial conditions and weaker consumer confidence.

US industrial production moderated its pace of expansion by growing at a monthly rate of 0.2% in May, after having grown 1.4% in April. This weakening reflected a lower growth in gas and electricity generation activities, as well as a slight contraction of manufacturing activity. In contrast, mining recovered at a faster rate, supported by oil and gas drilling and production. The Manufacturing Purchasing Managers' Index suggests that the sector's expansion will continue facing supply shortages and higher production costs.

[1] Expressed as a seasonally adjusted quarterly annualized rate, US GDP grew at a rate of -1.5% during the first quarter of 2022.

Chart 2
US Real GDP and Components
Quarterly percentage rate and contribution in percentage points, s. a.



s. a. / Seasonally adjusted figures.
Note: The shaded area refers to Blue Chip Economic indicators of June 2022.
Source: BEA, and Blue Chip Economic Indicators of June 2022.

The US labor market continued to improve in May, thus remaining under tight conditions. The non-farm payroll increased by 390 thousand jobs in May, after having grown by 436 thousand jobs in April. This mainly reflected growth of leisure, hospitality, education and professional services. In May, the unemployment rate remained at 3.6% for a third consecutive month, in a context in which labor participation increased. The vacancy rate remains high and wage growth remains at high levels.

In the euro area, available indicators suggest that economic activity has continued growing at a slow rate throughout the second quarter of 2022, after having expanded at a seasonally adjusted quarterly rate of 0.6% in the first quarter.[2] The weakness of economic activity continued being attributed to bottlenecks, the increase in energy and food prices, and the impact of Russia and Ukraine's military conflict on trade and production. The unemployment rate remained unchanged in April (as compared to the previous month), at a level of 6.8%. The latest Purchasing Managers' Indices point to a continued recovery in services in light of the easing of restrictions to deal with COVID-19 cases, on the one hand, and, to a slower pace of growth of manufacturing activity stemming from the lower growth of China and the conflict between Russia and Ukraine, on the other.

In Japan, available information suggests a rebound of economic activity during the second quarter of 2022, after having contracted at a seasonally adjusted quarterly rate of -0.1% during the first quarter.[3] This was due to the growth of domestic demand, mainly attributed to higher household consumption and business investment. External demand remained weak, as a result of disruptions in supply chains. In this environment, the unemployment rate decreased from 2.6% in March to 2.5% in April. Purchasing Managers' Indices suggest a rebound in services and a slower pace of expansion in the manufacturing sector due to the continued disruptions in production chains.

In the main emerging economies, available indicators suggest a slower pace of growth during the second quarter of the year, although with a marked heterogeneity across countries and regions, depending on the relevance of commodities in their external sector, as well as on their level of exposure to distortions in supply chains and the evolution of the pandemic. In China, available indicators point to a strong contraction during the second quarter as a result of mobility restrictions determined by the country's zero-COVID policy.[4] While these restrictions were mostly lifted at the beginning of June, several cities reinstated some of them by mid-month. In other emerging economies, Purchasing Managers' Indices remain in expansion territory, suggesting that the weakening of China has not significantly affected growth in other regions. In Emerging Europe, available indicators suggest a sharp contraction in Russia as a result of the geopolitical conflict and the economic sanctions imposed on that country.

International commodity prices registered a mixed behavior since Mexico's previous monetary policy decision, remaining at high levels and exhibiting volatility. Oil prices rose during most of the period, driven by factors such as the European Union's agreement to phase out Russian oil imports, expectations of a recovery of oil demand in China, and the beginning of the summer season in the United States. These factors succeeded in largely offsetting the downward pressures generated by the Organization of the Petroleum Exporting Countries and allied countries (OPEC+) decision to increase their production targets in July and August. In the

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[2] In annualized terms, euro area GDP registered a quarter-on-quarter seasonally adjusted variation of 2.5% during the first quarter of 2022.

[3] In annualized terms, Japan's GDP registered a quarter-on-quarter seasonally adjusted variation of -0.5 during the first quarter of 2022.

[4] In annualized terms, China's GDP grew at a rate of 4.8% during the first quarter of 2022.

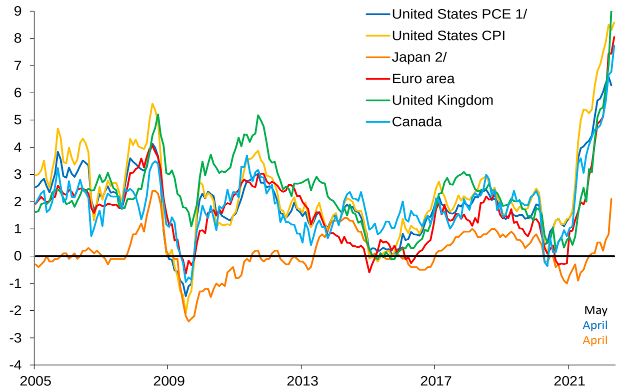
United States, the price of natural gas increased due to the rise in exports and the increased demand by electricity generators at the beginning of summer. In the European market, natural gas prices trended downwards during most of May, although in subsequent weeks they increased due to interruptions in natural gas pipeline supply from Russia. Industrial metal prices overall trended upwards during the second half of May and early June in response to the partial easing of lockdown measures to contain COVID-19 cases in China. However, the recent resurgence of COVID-19 cases in cities such as Beijing and Shanghai has renewed the risks for economic recovery in that country and exerted downward pressure on the prices of these metals. Grain prices have decreased since Mexico's previous monetary policy decision due to diplomatic efforts to restore food and fertilizer shipping routes from Ukraine and Russia, as well as lingering concerns about global economic slowdown leading to a lower demand for grains. Nevertheless, these prices remain at relatively high levels due to uncertainty stemming from the military conflict between Russia and Ukraine.

A.1.2. Monetary policy and international financial markets

Inflation continued increasing worldwide, reaching its highest levels in four decades in some cases, driven by greater and worsening inflationary pressures, among which those related to energy and food prices stand out. Inflation developments are associated with the recovery of demand and persistent bottlenecks, along with the greater pressures on commodity prices partly stemming from the invasion of Ukraine.

In most major advanced economies, headline and core inflation continued increasing (Chart 3), remaining above their central banks' targets. In the United States, after having declined in April to a level of 8.3%, CPI's annual rate of change rose to 8.6% in May, reflecting an increase in food inflation from 9.4 to 10.1% and in energy inflation from 30.3 to 34.6%. Core inflation decreased marginally from 6.2 to 6.0%. Short-term inflation expectations for the main advanced economies drawn from surveys continued being revised upwards, while long-term ones have remained relatively stable.

Chart 3
Selected Advanced Economies: Headline Inflation
Annual percentage change

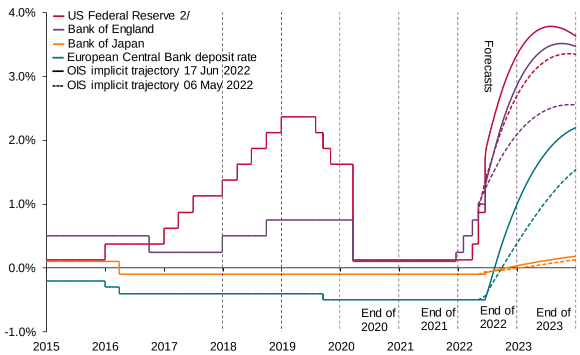


1/ The personal consumption expenditure deflator is used.
2/ Excludes fresh food. This series does not exclude the effect of the increase in the consumption tax in May 2014 and October 2019 nor the effect of the free daycare and preschool program in October 2019.
Source: Bureau of Economic Analysis, Bureau of Labor Statistics, Eurostat, Bank of Japan, Statistics Canada, Office of National Statistics.

Headline inflation continued rising in most of the main emerging economies, remaining above their central banks' targets, although in some cases it moderated slightly. This increase has resulted from an increase in energy and food prices as well as in the core component, in a context of high commodity prices and persistent disruptions in supply chains due to the geopolitical conflict in Eastern Europe and the strict lockdown measures imposed in China.

In this context, the central banks of most major advanced economies have continued reducing their monetary stimulus, with some even accelerating the process. The central banks of the United States, the United Kingdom, Canada, Australia, New Zealand and South Korea continued raising their interest rates. In the United States and Australia, reference rates were raised more than in previous decisions. The Swiss central bank surprised markets by increasing its rate by 50 basis points for the first time since 2007. The European Central Bank stated that it intends to raise its rates in its July and September meetings. Regarding asset purchase programs, most central banks continued gradually reducing their asset holdings. The European Central Bank announced that it will conclude its asset purchase program on July 1, while the Bank of Japan continued purchasing certain assets. The greater inflationary pressures worldwide and the upward risks to inflation have led to expectations of an accelerated reduction of monetary stimulus by the central banks of the main advanced economies through interest rate increases and a reduction in the size of their balance sheets. Thus, the expected trajectories for reference interest rates drawn from financial instruments foresee once again a faster pace of increases in most major advanced economies than previously expected (Chart 4).

Chart 4
Reference Rates and Trajectories Implied in OIS Curves[1/]
Percent



1/ OIS: Fixed floating interest rate swap where the fixed interest rate is associated to the effective overnight reference rate.
2/ For the observed reference rate of the US, the average interest rate of the target range of the federal funds rate (1.50% - 1.75%) is used.
Source: Banco de México with data from Bloomberg,

Among the recent monetary policy decisions of the main advanced economies' central banks, the following stand out:

i) At its June meeting, the Federal Reserve raised the target range for the federal funds rate by 75 basis points, the greatest increase since 1994, to 1.50-1.75%, and reiterated that it anticipates successive increases in the target rate would be appropriate. In this regard, the chairman pointed out that the pace of said adjustments will continue to depend on incoming data and the evolution of the economic outlook. He added that a 75-basis point increase is unusually large, that adjustments of this magnitude are not expected to be common, although he stated that a 50 or 75 basis point increase seems more likely at their next meeting. Regarding the Federal Reserve's balance sheet, the Federal Open Market Committee (FOMC) announced it will continue reducing its holdings of Treasury securities, agency debt, and mortgage-backed securities, as outlined in the Plans to Reduce the Size of the Federal Reserve's Balance Sheet published in May. Meanwhile, the FOMC's median for headline inflation expectations was revised upwards for 2022, from 4.3 in March to 5.2% in June, and downwards for 2023, from 2.7 to 2.6%, and for 2024, from 2.3 to 2.2%. As for core inflation, medians were revised upward, from 4.1 to 4.3% for 2022 and from 2.6 to 2.7% for 2023, while for 2024 it remained unchanged at 2.3%. The medians for growth expectations were revised downward to 1.7% in 2022 and 2023 and to 1.9% in 2024, while unemployment expectations were revised upward for all years, rising from 3.7% in 2022 to 4.1% in 2024. As for expectations regarding the reference interest rate, the medians increased from 1.9 to 3.4% for 2022, from 2.8 to 3.8% for 2023, from 2.8 to 3.4% for 2024, and from 2.4 to 2.5% for the long term. In this context, the expected trajectory for the federal funds rate implied by financial instruments was revised upwards once again during the reported period and reflects, according the latest available information, an increase in the interest rate at the end of 2022 similar to that expected in June by the median of the Committee's expectations.

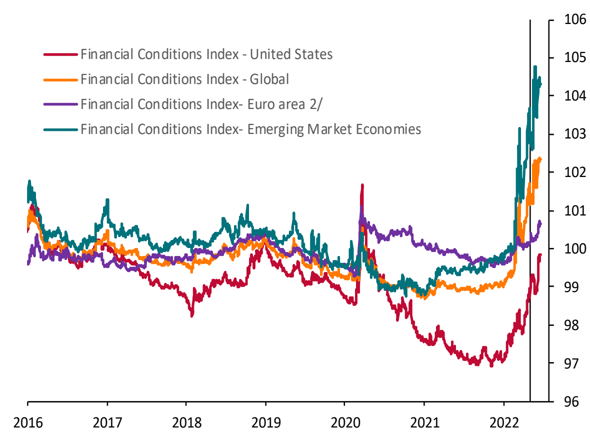
ii) At its June meeting, the European Central Bank left its refinancing, key lending and key deposit rates unchanged at 0.0, 0.25 and -0.5%, respectively. Nevertheless, it announced that the Governing Council intends to raise these rates by 25 basis points at its July meeting and expects to increase them again in September, noting that the magnitude of the upward adjustment will depend on medium-term inflation expectations, and that, if the inflation outlook deteriorates, a larger increase would be appropriate. After September, it anticipates further gradual and sustained increases in interest rates, stating that the pace of adjustment will depend on data and its assessment on the evolution of inflation in the medium term. Regarding its Asset Purchase Program (APP), it announced its conclusion on July 1, 2022, in line with previous expectations of concluding asset purchases in the third quarter of the year. It also mentioned that the Governing Council intends to continue reinvesting, in full, principal payments on securities purchased under the program maturing over an extended period after the date on which the interest rate increase begins and for as long as necessary to maintain ample liquidity conditions and an appropriate monetary policy stance. Regarding its Pandemic Emergency Purchase Program (PEPP), it reiterated its intention to reinvest, at least until the end of 2024, the principal payments on maturing securities. It also mentioned that throughout its monetary policy normalization process, the Governing Council will maintain optionality, data dependence, gradualism, and flexibility in the conduction of monetary policy. To address potential fragmentation risks that could contribute to an uneven transmission of monetary policy normalization across jurisdictions within the monetary union, in a subsequent unscheduled meeting on June 15, the Council decided that it will apply flexibility in reinvesting overdue reimbursements of the PEPP portfolio and will request to accelerate the creation of a new anti-fragmentation tool for the European market.

iii) At its June meeting, the Bank of Japan left its reference rate unchanged at -0.1% and its long-term interest rate target (indexed to its 10-year bond) at around 0%. It restated that it expects interest rates to remain at their current levels or even lower. As part of its curve control strategy, it also clarified that it will offer to buy 10-year government bonds at 0.25% every business day through fixed-rate purchase operations, unless it is highly likely that no bids are received. It also left its guidelines regarding purchases of assets other than government bonds unchanged.

Since Mexico's previous monetary policy decision, a large number of central banks in major emerging economies continued raising their reference interest rates. These included Mexico, Chile, Peru, Brazil, Hungary, the Czech Republic, Poland, Israel, India and South Africa. The Philippines increased its interest rate for the first time since the beginning of the pandemic, and Ukraine announced its first increase since the beginning of the conflict with Russia, raising it by 150 basis points to 25.0%. It is worth noting that the Russian central bank continued lowering its interest rate, announcing a 300-basis point and an additional 150-basis point cut to 9.5%. China announced a 15-basis point cut in its 5-year loan prime rate (LPR) in May.

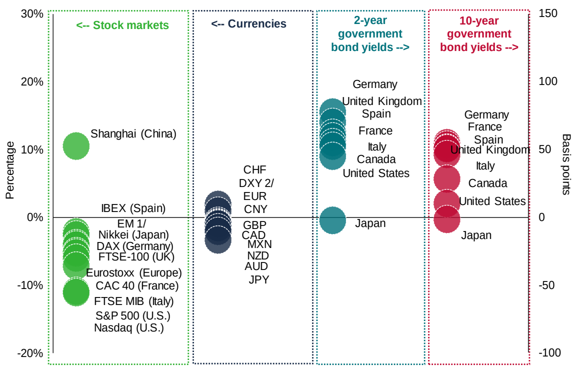
International financial markets recently registered greater volatility, after it had decreased during most of May and early June. This occurred in an environment in which, despite higher optimism due to the decrease in COVID-19 cases and the easing of mobility restrictions in China, concerns regarding the high levels of inflation and uncertainty about the rate of withdrawal of monetary stimulus by major advanced economies and its impact on economic activity, as well as the evolution of geopolitical tensions and the pandemic, continued. In this context, financial conditions tightened further during the period, although with some heterogeneity across countries and asset classes (Chart 5). In particular, stock markets in most main advanced and emerging economies exhibited a negative behavior since Mexico's previous monetary policy decision, given that, despite the gains registered in the first half of the period, indices have fallen in recent weeks. In foreign exchange markets, after having weakened during the second half of May against most currencies of advanced economies, the US dollar resumed its appreciation trend in response to expectations regarding the withdrawal of monetary stimulus and the recent inflation figures in the United States. The currencies of emerging economies overall appreciated in May, and have partially reversed this trend in recent weeks. In most major advanced economies, short- and long-term government bond interest rates increased due to expectations of a continued withdrawal of monetary stimulus (Chart 6). In most emerging economies, long-term interest rates exhibited a mixed behavior (Chart 7). In this context, since Mexico's previous monetary policy decision, there have been capital outflows from emerging economies in both fixed income and equity markets, although this trend reversed recently in the equity markets of some Asian and Latin American economies.

Chart 5
Financial Conditions Index[1/]
Units



1/ The financial conditions index is constructed considering the effect of five variables on economic activity: the reference interest rate, the 10-year government bond, the spread of investment-grade bonds over the government debt bond with equivalent maturity, the ratio of a stock index with 10-year average earnings per share and the trade-weighted exchange rate. Emerging economies include Brazil, Chile, China, Czech Republic, Hungary, India, Indonesia, Israel, Malaysia, Mexico, Philippines, Poland, Romania, South Korea, South Africa, Thailand, and Turkey. The global sample includes G10 countries and emerging economies.
2/ In the case of emerging economies, the financial conditions index considers the CDS as the credit spread component and includes the debt-weighted exchange rate. The vertical black line indicates the last scheduled meeting of Banco de México's Monetary Policy Committee.
Source: Prepared by Banco de México with Bloomberg and Goldman Sachs data.

Chart 6
Change in Selected Financial Indicators from May 6, 2022 to June 17, 2022
Percent; basis points



1/ The MSCI Emerging Markets Index consists of 24 countries.
2/ DXY: a weighted average estimated by the Intercontinental Exchange (ICE) of the nominal exchange rate of the main six currencies operated globally with the following weights: EUR 57.6%, JPY: 13.6%, GBP: 11.9%, CAD: 9.1%, SEK: 4.2%, and CHF: 3.6%.
Source: Bloomberg and ICE.

Chart 7
Selected Emerging Economies: Financial Assets Performance since May 9, 2022
Percent, basis points

Region	Country	Currencies	Equity markets	Interest rates 2Y	Interest rates 10Y	CDS
Latin America	Mexico	0.65%	-2.12%	66	-7	14
	Brazil	0.14%	-3.32%	24	16	38
	Chile	-0.79%	6.81%	-4	-29	0
	Colombia	4.62%	-3.80%	73	66	-13
	Peru	2.68%	-3.27%	-11	-36	-7
Emerging Europe	Russia	19.92%	-0.52%	-395	-380	5,347
	Poland	0.37%	-2.18%	146	91	13
	Turkey	-14.91%	2.58%	340	-343	135
	Czech Republic	0.91%	-0.27%	90	79	-4
	Hungary	-5.01%	-4.68%	122	111	39
Asia	China	0.63%	10.36%	-5	1	-2
	Malaysia	-0.35%	-6.97%	-25	-14	-2
	India	-0.67%	-5.27%	23	-4	8
	Philippines	-3.00%	-6.30%	8	30	-6
	Thailand	-1.96%	-2.82%	-1	-36	0
	Indonesia	-1.89%	0.96%	-2	23	-2
Africa	South Africa	1.00%	-0.47%	17	15	13

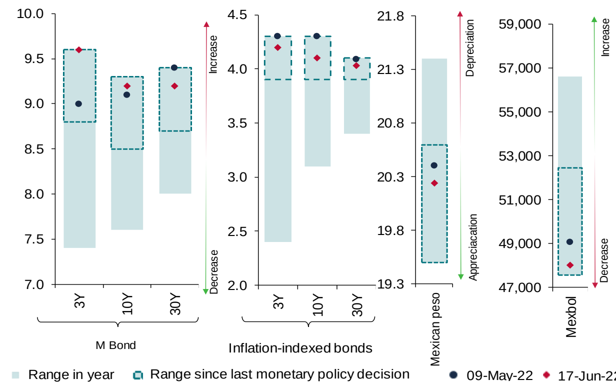
Note: An upward adjustment indicates currency appreciation. Interest rates correspond to swap rates at th3 specified terms, except for Hungary, where government securities with 3-year maturities were used as a reference. For the Philippines, a 2-year swap rate was used, and for Russia, a 2-year and 3-year swap rate was used.
Source: Bloomberg.

A.2. Current situation of the Mexican economy

A.2.1. Mexican markets

In the international context described above, in domestic financial markets, the exchange rate maintained an orderly behavior, while short- and medium-term interest rates increased. Thus, the yield curve behaved similarly to that of other fixed income markets at a global level, in a period characterized by greater volatility derived from the 75-basis point adjustment of the Federal Reserve's target range for the federal funds rate (Chart 8).

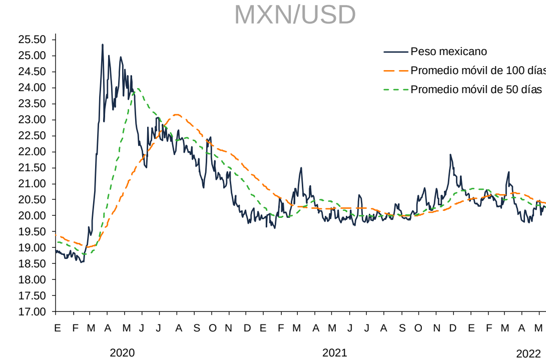
Chart 8
Mexican Markets' Performance
Percent, MXN/USD and index



Source: Prepared by Banco de México.

The Mexican peso fluctuated in a range of one peso and 6 cents, between 19.53 and 20.59 pesos per dollar, ending the period with an appreciation of 0.65% (Chart 9). This occurred in a context in which both spot and future trading conditions slightly deteriorated.

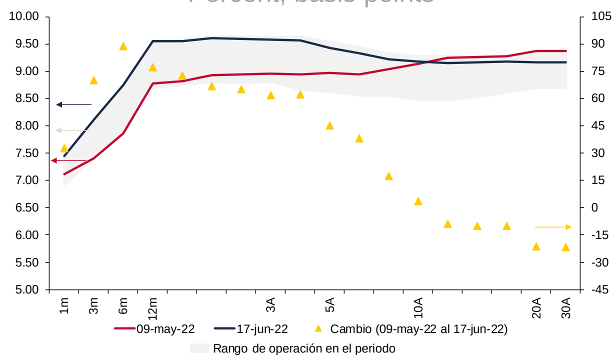
Chart 9
Mexican Peso Exchange Rate with Moving Averages
MXN/USD



Source: Prepared by Banco de México.

The yield curve on government securities flattened, in line with the behavior of other yield curves worldwide (Chart 10), with increases of up to 73 basis points in short- and medium-term interest rates and decreases of up to 22 basis points in longer-term ones, in line with expectations of a more restrictive monetary policy stance by Banco de México. The yield curve on real interest rate instruments also registered decreases of up to 59 basis points for the short term and up to 21 basis points for the long term. In this context, breakeven inflation registered movements of between -21 and 69 basis points for all terms (Chart 11). These adjustments took place in an environment in which trading conditions deteriorated during the period covering the monetary policy decision.

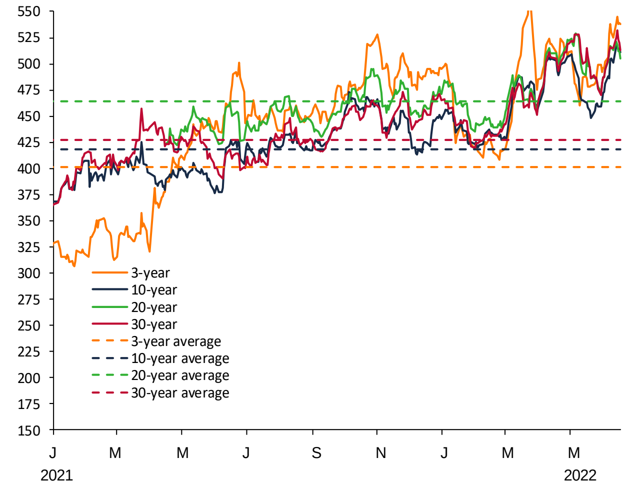
Chart 10
Nominal Yield Curve of Government Securities
Percent, basis points



Note: The chart does not include bonds maturing in December 2021 and June 2022. CETES with similar maturities are considered.
Source: PIP.

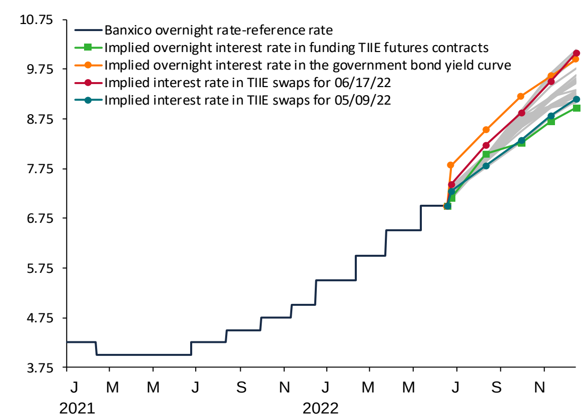
Regarding expectations for the trajectory of the monetary policy reference rate, information implied by the Interbank Equilibrium Interest Rate (TIIE, for its Spanish acronym) swaps curve incorporates an increase of 93 basis points for the June decision and an additional 76 basis points for the August decision, while for the end of 2022 it points to a reference rate close to 10.37% (Chart 12). Most forecasters surveyed by Citibanamex anticipate the reference rate to increase by 75 basis points to 7.75% in the June decision, while for the end of 2022 a rate of 9.00% is expected.

Chart 11
Breakeven Inflation in Government Securities' Yields
Basis points



Source: PIP.

Chart 12
Interbank Funding Rate Implied in TIIE Swaps
Percent



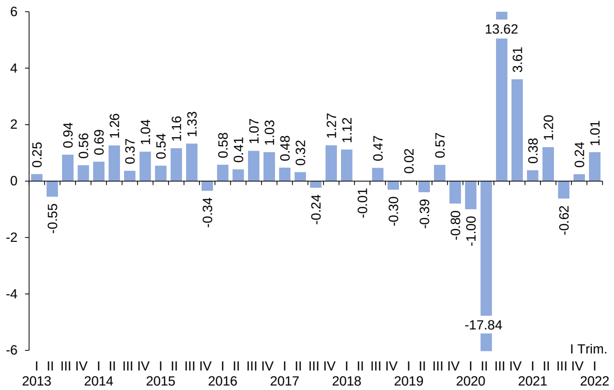
Source: Prepared by Banco de México with Bloomberg data.

A.2.2. Economic activity in Mexico

After having reactivated during the first quarter of 2022, economic activity is expected to have continued recovering in the second quarter (Chart 13). However, high uncertainty regarding the future evolution of the pandemic, disruptions in global supply chains, and the global economic environment prevails.

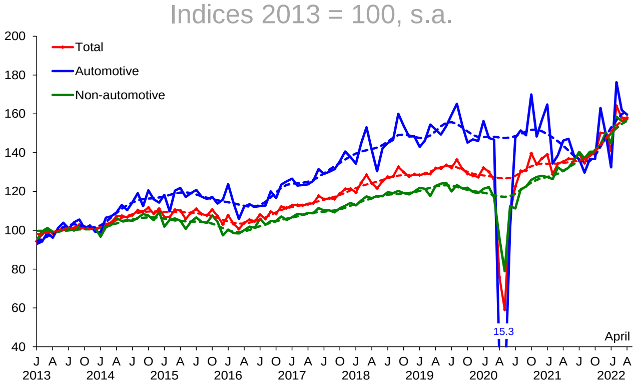
Regarding external demand, in April the value of automotive exports fell at the margin, while that of the rest of the manufacturing exports continued increasing (Chart 14).[5] By destination, manufacturing exports to the United States stagnated, while shipments to the rest of the world contracted.

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



s. a. / Seasonally adjusted figures.
Source: Mexico's System on National Accounts (SCNM, for its Spanish acronym), INEGI.

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

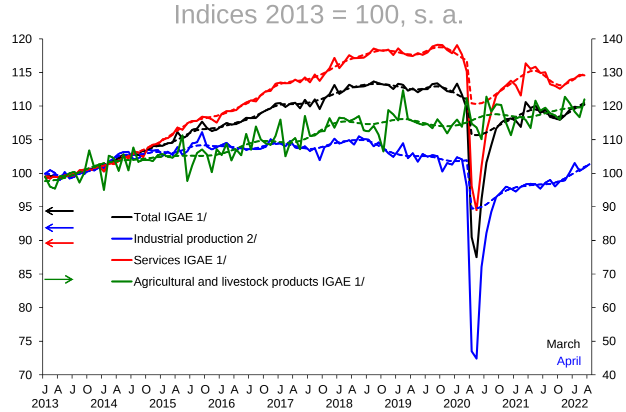


s. a. / Seasonally adjusted series and trend series based on data in nominal US dollars. The former is represented by a solid line and the latter by a dotted line
Source: Prepared by Banco de México with data from the Tax Administration Service (SAT, for its Spanish acronym), the Ministry of the Economy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

On the domestic demand side, based on its monthly indicator, private consumption continued showing dynamism in March, accumulating nine months with increases at the margin and being above is February 2020 level. The consumption of both goods and services trended upwards. Meanwhile, in March, gross fixed investment reversed the decline observed in the previous month and was above its pre-pandemic level. Investment spending on construction partially reversed February's decline, while machinery and equipment continued trending upwards.

On the production side, industrial activity continued reactivating at the beginning of the second quarter of 2022 (Chart 15) mainly as a result of the dynamism of the manufacturing sector and a moderate reactivation of the construction sector (Chart 16), albeit the latter remains at low levels. Despite having increased at the margin, mining remained sluggish. Meanwhile, at the end of the first quarter, tertiary activities halted their recovery. This reflected the performance at the margin of trade and of professional, corporate and business support services, as well as of educational and health services. In contrast, the rest of the items registered monthly increases.

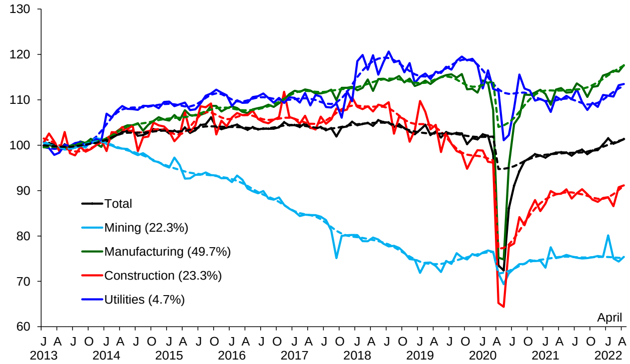
Chart 15
Global Indicator of Economic Activity
Indices 2013 = 100, s. a.



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 March 2022
2/ Figures up to April 2022 from the Monthly Indicator of Industrial Activity.
Source: Mexico's System of National Accounts (SCNM, for its Spanish acronym), INEGI.

[5] Refers to the value of merchandise exports in current dollars. This value differs from that reported for goods exports in Mexico's System of National Accounts, since the latter represents value added, measured in constant pesos.

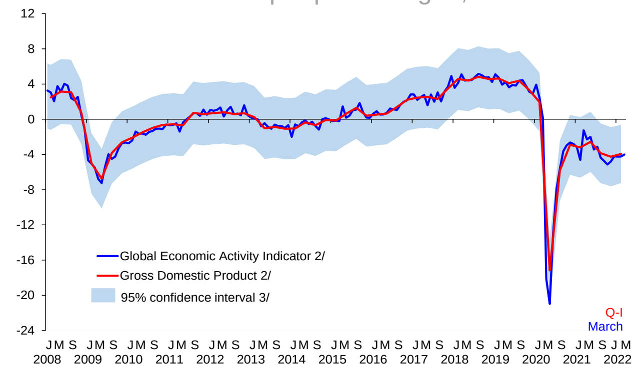
Chart 16
Industrial Activity1/
Indices 2013 = 100, s. a.



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 parenthesis correspond to their share in the total in 2013.
Source: Mexico's System of National Accounts (SCNM, for its Spanish acronym), INEGI.

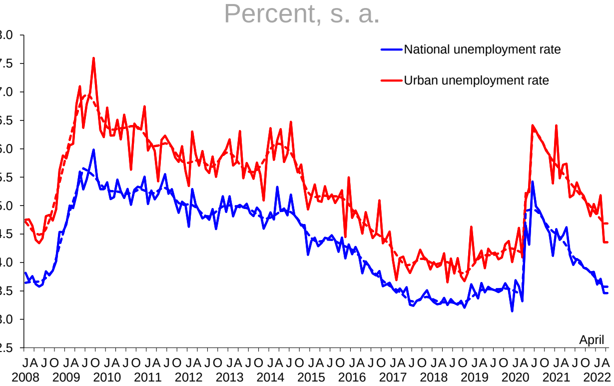
Regarding the cyclical position of the economy, the estimated output gap reduced its slack at the end of the first quarter of the year (Chart 17). During the second quarter, economic slack is expected to have continued to diminish gradually. In April, several labor market indicators showed an improvement. In particular, both national and urban unemployment rates decreased in relation to March, with the former being at its lowest recorded level since January 2005 and the latter being at levels similar to those observed prior to the health emergency (Chart 18). This took place in a context in which the labor participation rate and the employment rate among the working age population grew at the margin. Meanwhile, with seasonally adjusted figures, the net creation of IMSS-insured jobs continued trending upwards in April and May 2022. Finally, in April, unit labor costs in the manufacturing sector accumulated three months with monthly increases, remaining above the levels registered prior to the health emergency (Chart 19).

Chart 17
Output Gap Estimates1/
Excluding Oil Industry4/
Potential output percentages, s. a.



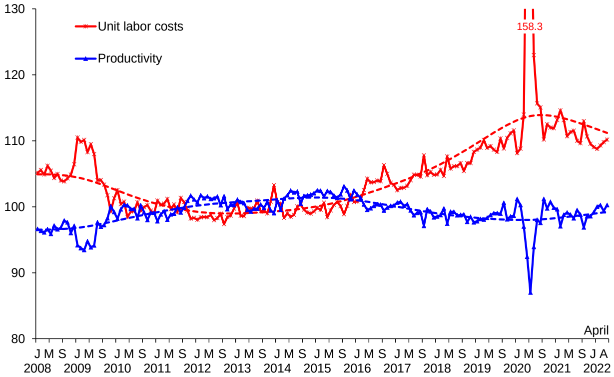
s. a. / Calculations based on seasonally adjusted figures.
1/ Output gap estimated with a tail-corrected Hodrick-Prescott filter; see Banco de México (2009), "Inflation Report, April-June 2009", p.74.
2/ GDP figures up to the first quarter of 2022 and IGAE up to March 2022.
3/ Output gap confidence interval calculated with a method of unobserved components.
4/ Excludes both oil and gas extraction, support services for mining, and petroleum and coal products' manufacturing.
Source: Prepared by Banco de México with INEGI data.

Chart 18
National and Urban Unemployment Rates
Percent, s. a.



s.a. / Seasonally adjusted series and trend series. The former is represented by a solid line and the latter by a dotted line.
Source: Prepared by Banco de México with data from ENOE, ETOE (from April to June 2020), and ENOE new edition (ENOE[N]) from July to date.

Chart 19
Productivity and Unit Labor Costs in the Manufacturing Sector[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/ Productivity based on hours worked.
Source: Prepared by Banco de México with seasonally adjusted data of the Monthly Manufacturing Industry Survey and industrial activity indicators of Mexico's System of National Accounts (Sistema de Cuentas Nacionales de México, SCNM), INEGI.

In April 2022, domestic financing to firms continued moderating its annual rate of contraction in real terms. Within it, bank credit to firms continued its gradual recovery, which began in the last quarter of 2021 and has been reflected in increases in the balance of credit in the last two quarters. This, in a context in which corporate credit demand continued recovering, while lending conditions remained tight compared to those at the beginning of the pandemic, although these have been easing for smaller firms since the second half of 2021. Net corporate debt issuance in the domestic market was negative during the first four months of this year. As for credit to households, commercial bank housing portfolios regained dynamism in March and April. In turn, outstanding bank consumer credit registered a positive real annual variation for the fourth consecutive month, mainly as a result of the sustained dynamism of payroll credit and credit card portfolios. This has taken place in a context in which household demand for credit has been gradually recovering. Household lending conditions remained stable, while consumer credit conditions eased during the first quarter of the year.

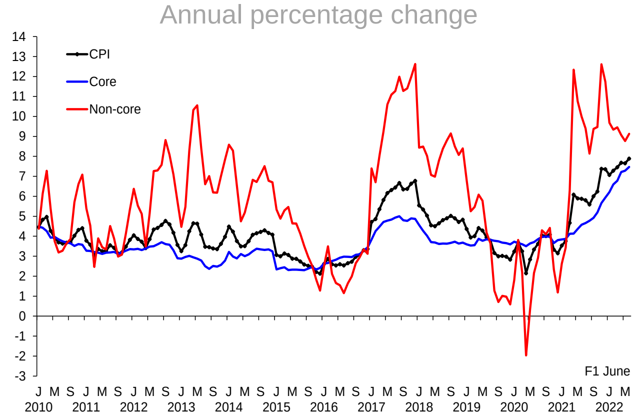
Interest rates on bank credit to firms have followed the dynamics of the overnight interbank interest rate. During the first quarter of 2022, corporate credit intermediation margins narrowed, and therefore are generally at levels lower than those observed prior to the pandemic. At the same time, mortgage loan interest rates remained at levels around their historical lows. Meanwhile, in February 2022 credit card interest rates registered a level similar to that observed during the fourth quarter of 2021, while personal credit rates increased. Regarding portfolio quality, in April 2022, corporate and housing loan delinquency rates declined and remained at low levels. Lastly, consumer portfolio delinquency rates also declined, remaining at levels lower than those registered prior to the onset of the pandemic, although they continue to be high.

A.2.3. Development of inflation and inflation outlook

Between April and the first half of June 2022, annual headline inflation increased and remained at high levels, going from 7.68 to 7.88% (Chart 20 and Table 1). Inflation continued being pressured by the effects of the pandemic shocks that have not faded, in addition to more recent ones associated with the military conflict between Russia and Ukraine. This caused core inflation to continue trending upwards and non-core inflation to remain at high levels and with a resistance to decline.

Chart 20

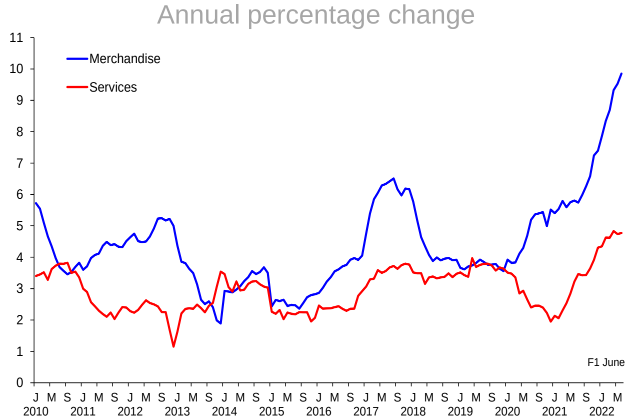
Consumer Price Index
Annual percentage change



Source: Banco de México and INEGI.

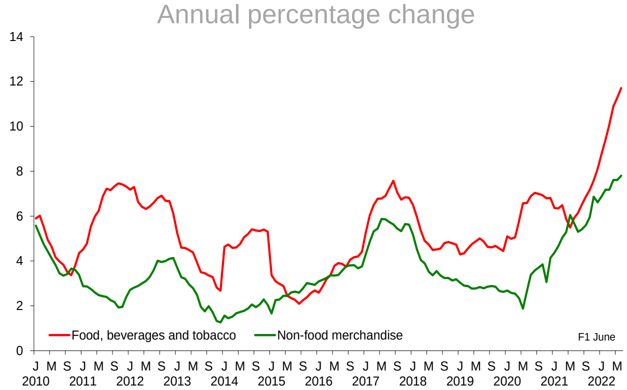
Annual core inflation increased from 7.22 to 7.47% between April and the first half of June 2022. This component continued to reflect the pressures affecting both merchandise and services prices. In the case of merchandise, its annual inflation increased from 9.33 to 9.85% during the aforementioned periods (Chart 21), driven by disruptions in production and distribution chains, higher international energy and food prices and, in general, higher production costs. During the same period, annual food merchandise inflation rose from 10.88 to 11.71%, while non-food merchandise inflation increased from 7.61 to 7.80% (Chart 22). Annual service inflation went from 4.83 to 4.77% on the same dates. High levels of inflation in services, especially those other than housing and education, reflect an increase in pent up demand and higher business operating costs. In this regard, it is worth noting that increases in energy and food prices have also exerted pressure on inflation of certain services, such as transportation and food.

Chart 21
Merchandise and Services Core Price Sub-index
Annual percentage change



Source: Banco de México and INEGI.

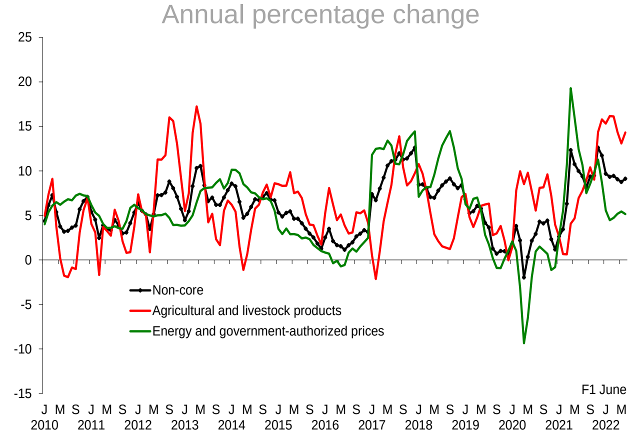
Chart 22
Merchandise Core Price Sub-index
Annual percentage change



Source: Banco de México and INEGI.

Between April and May 2022, annual non-core inflation shifted from 9.07 to 9.13% (Chart 23 and Table 1). Within it, annual inflation of agricultural and livestock products was 14.36 and 14.31% on the aforementioned dates. Inflation of fruits and vegetables, as well as of livestock products, remained at high levels, pressured by the increase in the price of production inputs, such as fertilizers and grains, which has further worsened since the geopolitical conflict. Meanwhile, annual energy inflation decreased from 5.91 to 5.84% between the aforementioned periods.

Chart 23
Non-core Price Sub-index
Annual percentage change



Source: Banco de México and INEGI.

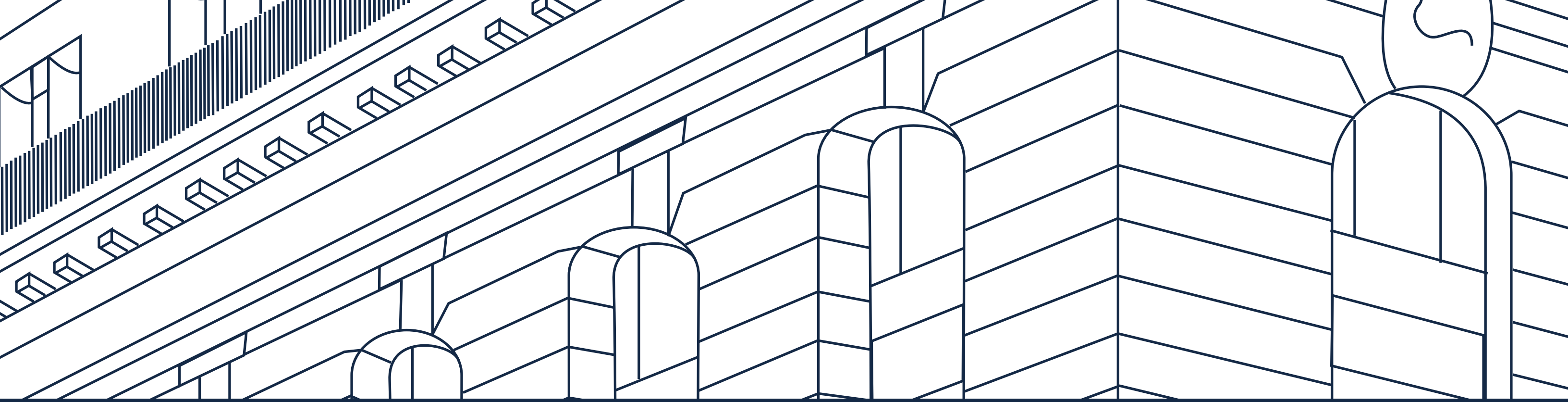
Regarding inflation expectations from the survey conducted by Banco de México among private sector forecasters, from April to May the median for headline inflation for the end of 2022 increased from 6.75 to 6.81%, while that for the core component rose from 6.00 to 6.38%. At the same time, the median of headline inflation expectations at the end of 2023 was revised upwards from 4.13 to 4.34%, while that for core inflation was revised from 4.00 to 4.14%. The median of headline inflation expectations for the medium term increased from 3.76 to 3.80%, while that for core inflation remained at 3.70%. Likewise, the median of headline inflation expectations for the long term (5 to 8 years) increased from 3.55 to 3.60% and for core inflation remained stable at 3.50%. Finally, breakeven inflation exhibited volatility. Within it, expectations implied by market instruments continued rising, while the inflation risk premium remains at elevated levels.

In view of greater-than-anticipated pressures on inflation, the forecast for headline inflation was revised upward until the third quarter of 2023 and that for core inflation was adjusted upward for the entire horizon, although convergence to the 3% target is still expected to be reached in the first quarter of 2024. These projections are subject to risks. On the upside: i) persistence of core inflation at high levels; ii) external inflationary pressures associated with the pandemic; iii) greater pressures on agricultural and livestock product prices and on energy prices due to the ongoing geopolitical conflict; iv) exchange rate depreciation; and v) cost-related pressures. On the downside: i) a decline in the intensity of the geopolitical conflict; ii) a better functioning of supply chains; iii) a greater-than-expected effect from the negative output gap; and iv) a larger-than-anticipated effect from the Policy Program to Fight Inflation and High Prices. The balance of risks for the trajectory of inflation within the forecast horizon is biased significantly to the upside.

Table 1
Consumer Price Index and Components
Annual percentage change

Item	April 2022	May 2022	1st fortnight June 2022
CPI	**7.68**	**7.65**	**7.88**
Core	**7.22**	**7.28**	**7.47**
Merchandise	**9.33**	**9.53**	**9.85**
Food, beverages and tobacco	10.88	11.27	11.71
Non-food merchandise	7.61	7.61	7.80
Services	**4.83**	**4.74**	**4.77**
Housing	2.76	2.84	2.97
Education (tuitions)	3.18	3.24	3.31
Other services	7.01	6.71	6.64
Non-core	**9.07**	**8.77**	**9.13**
Agricultural and livestock products	**14.36**	**13.08**	**14.31**
Fruits and vegetables	15.84	12.88	13.29
Livestock products	13.21	13.24	15.12
Energy and government-authorized prices	**5.18**	**5.44**	**5.15**
Energy products	5.91	6.30	5.84
Government-authorized prices	3.40	3.41	3.51

Source: INEGI.



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