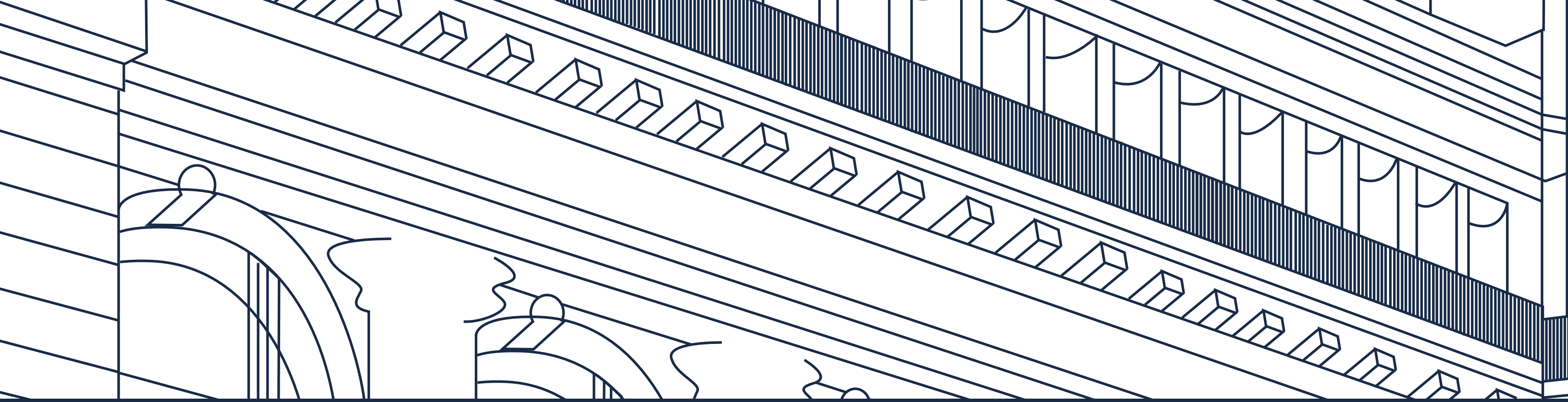

BANCO DE MÉXICO®

Minutes number 67

Meeting of Banco de México's Governing Board on the occasion of the monetary policy decision announced on May 16, 2019

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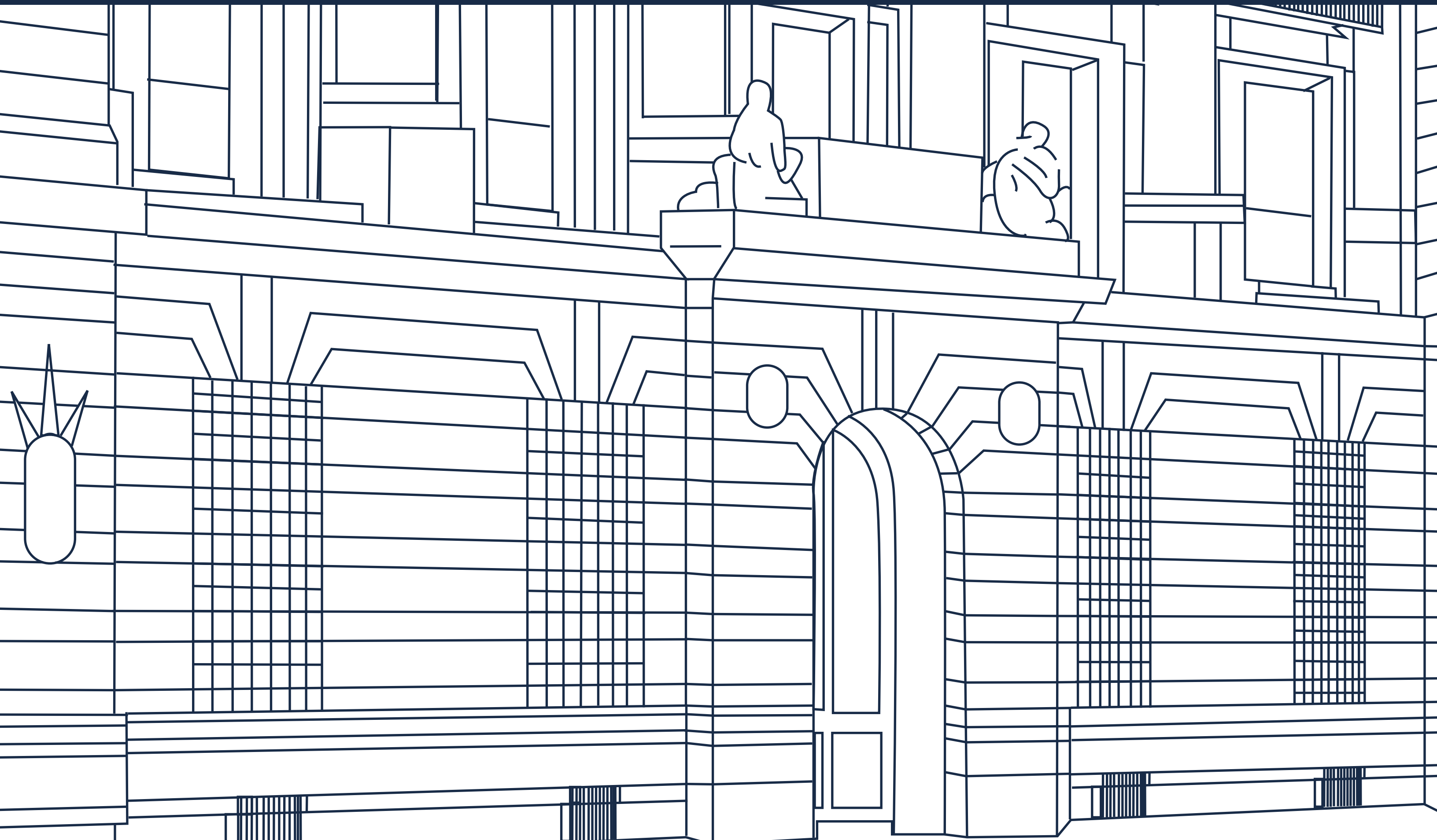

FOREWARNING
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1. PLACE, DATE, AND PARTICIPANTS

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

1.2. Date of Governing Board meeting: May 15, 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
Carlos Manuel Urzúa-Macías, Secretary of Finance and Public Credit.
Arturo Herrera-Gutiérrez, 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

Most members agreed that since the second half of 2018 world economic activity has exhibited a downward trend, although it recovered moderately during the first quarter of 2019 in some economies, such as the U.S., the U.K, the euro area and China, largely associated with transitory factors. In particular, some members claimed that this recovery was a result of the fiscal and monetary stimuli in such countries. As for growth expectations, most members noted that these are still being revised downwards. One member mentioned that the International Monetary Fund's forecasts for 2019 decreased in a generalized manner, and another one pointed out that the probability of new downward revisions for this year and the next one apparently has increased. In this context, most members agreed that the outlook for investment has deteriorated and business climate worldwide has worsened. One member stated that some analysts expect a gradual deceleration in global economic activity and a low risk of recession. He/she added that given the more adverse environment for world trade, manufacturing has been one of the most affected sectors and that, on the demand side, investment has been affected by the impact of this environment on global value chains. In contrast, he/she stated that services, which is a more labor intensive sector and is less exposed to global trade, has continued to expand in the major economies, supporting consumption and the labor market. The same member highlighted that two factors have led to a reallocation of resources from manufacturing to services: one medium- and long-term factor, associated with a greater trade integration and specialization, and a more recent one, related to technological change and its use in the services sector.

Most members indicated that the balance of risks to global growth remains biased to the downside. Among the risks that still persist the majority mentioned the escalation of trade tensions between the U.S. and its trade partners. In this respect, most members warned that the recent announcements of protectionist measures between China and the U.S. affected investors' sentiment, thus reversing the optimism that had conveyed stability to global markets. They also considered that this could lead to a sharper economic deceleration. Most members added the following risks: i) a more prolonged weakening of some of the major economies than expected; ii) new episodes of volatility in international financial markets; and iii) the intensification of certain political and geopolitical risks. Regarding the latter, some members stressed the possibility of a disorderly Brexit process, and one of them added the tensions generated by North Korea and conflicts in the Persian Gulf. Such member warned that this could deteriorate consumer confidence, discourage investment, weaken further the lack of dynamism of global growth, increase the volatility in markets and worsen global financial conditions. In this respect, another member stated that the financial channels could magnify the economic slowdown.

As to the evolution of labor markets in advanced economies, one member highlighted the high levels of job creation and the historically low levels of the unemployment gaps. In the same line, he/she emphasized the contrast between the high levels of consumer confidence and the fast deterioration of business climate observed since mid-2018. In the case of the U.S., another member argued that its anticipated deceleration reflects the fading of the fiscal stimulus and its protectionist trade policy. Some members mentioned that such policy could lead to a greater-than-anticipated deceleration. One member underlined that the probability of a recession in the U.S. taking place in the following twelve months has decreased, albeit from relatively high levels. However, the same member mentioned his/her concern about the performance of some financial indicators being similar to those observed in the months prior to past recessions. In contrast, another member noted that, although the yield curve of Treasury bonds has inverted in certain tranches, the lower term premium suggests that such performance points more to a deceleration rather than a recession.

Most members highlighted the lower dynamism in emerging economies, although stating that some of these have slightly rebounded recently. One member pointed out that the tightening of global financial conditions affected to a greater extent the more vulnerable economies. Another member mentioned that economic activity in China seems to be responding favorably to the implemented stimuli and stressed that the Chinese authorities have expressed their intention to use the policy tools at their disposal to attain an orderly adjustment of their economy. However, he/she added that there is still the risk that these actions turn out to be insufficient and that shocks occur that could contribute to a greater-than-anticipated slowdown of the economy. Regarding the outlook for emerging economies, some members anticipate a decreasing growth trend. One member specified that this will be more evident in Asian economies, which already show signs of weakness after having exhibited a positive performance in early 2019. Another member stressed that emerging economies that are more open to world trade face considerable challenges to boost investment. In addition, he/she noted that in some economies, idiosyncratic factors have increased the uncertainty regarding the economic outlook and have hindered investment. Some of the downward risks for growth of emerging economies that he/she highlighted are: i) the deterioration or persistence of trade tensions; ii) that these give rise to a greater deceleration of the Chinese economy and to lower commodity prices; iii) that, with the aim of attaining quantitative targets for the bilateral deficits of larger economies, trade opportunities for other economies are restrained; and iv) that a restructuring of investment portfolios towards lower-risk assets is observed. The same member pointed out that the environment for these economies has become more uncertain and that their performance will be determined by idiosyncratic factors and by the soundness of their macroeconomic foundations.

Most members mentioned that global inflationary pressures remain at moderate levels, some of them pointing out the downward pressures associated to a lower global demand, although the majority acknowledged that increases caused by higher energy prices have also been observed. In the same vein, most members mentioned that although headline inflation has rebounded due to the above, core inflation has decreased in several economies, in some cases due to transitory factors and methodological changes. The majority clarified that in the U.S., the euro area and Japan, core inflation lies below their central banks' targets. In this sense, one member added that in many developed countries inflation expectations for the end of 2019 have been adjusted downwards, below such targets. Most members noted that although labor markets in advanced economies continue to exhibit strength and certain wage increases, no inflationary pressures have been detected so far. One member considered that the performance of labor markets could contribute to attain their inflation targets, but he/she also stated that this is still subject to uncertainty, given the moderate increases in labor costs and the risks for global economic activity. However, he/she warned that an unexpected rebound in inflation cannot be ruled out, as a result of a greater pass-through of wage increases or of import tariffs on prices. Another member underlined that in advanced economies a number of factors have kept inflationary pressures structurally low, such as the difficulty for firms to pass on cost pressures associated with wage-related increases to goods and services' prices. He/she pointed out that technological change and globalization have allowed the fragmentation of production processes according to the comparative advantages and to the cost structure in different countries and regions. He/she added that this has generated productivity gains and more competitive markets, making more difficult for firms to increase their prices. Finally, he/she underlined that the future performance of inflation will largely depend on the persistence or weakening of these factors, and that although inflation in advanced economies is expected to remain low, this scenario is not free of upside risks. Regarding inflation in emerging economies, one member stated that it followed a slight upward trend, but also pointed out that core inflation remained relatively stable, once the effects of the exchange rate depreciation dissipated and due to a lower global demand.

All members noted that given the environment of lower inflationary pressures and of lower world economic dynamism, expectations that the central banks of the major economies will follow a more accommodative monetary policy strategy have strengthened. Nevertheless, one member underlined that the risk of monetary policy surprises cannot be ruled out. All members mentioned that in its May meeting the US Federal Reserve left the target range for the federal funds rate unchanged, and reiterated its message that it would be patient in making adjustments to the range. One of them added that the Fed has also adopted a strategy that relies more on the most recent information and without a predetermined direction or bias. Another member pointed out that market variables are no longer incorporating increases in the federal funds rate in 2019.

Regarding international financial markets, most members stated that the outlook of lower interest rates in advanced economies led to an easing of global financial conditions, to greater risk appetite, and to a better performance of emerging economies' assets and currencies. One of them highlighted the gains that have been observed in the main economies' stock indices, the decline in government and corporate bond interest rates, and the pause in the strengthening of the US dollar. Some members noted the greater capital flows to emerging economies and one pointed out that these were channeled particularly to fixed income assets and, to a lesser extent, to stock markets, reflecting the higher uncertainty about economic activity worldwide and in emerging economies. Most members pointed out that, more recently, markets were affected by the escalation of trade tensions. Some members commented that in this juncture investors sought refuge in lower risk assets, and one of them highlighted the moderation in capital flows to emerging economies, as compared to the beginning of the year, and even registering outflows of equity assets in recent weeks. The same member warned that political and geopolitical risks could aggravate global financial conditions. In this regard, another member noted that the recent negative performance of financial markets could persist or even worsen, given the resurfacing of different political and geopolitical tensions. If the above materializes, it would have an adverse effect particularly on emerging economies. In addition, he/she warned that, if upward monetary policy surprises materialize in the main advanced economies, it would surely lead to sharp adjustments in international financial markets. Nevertheless, one member pointed out that the escalating trade tensions have not reversed the improvement in global financial conditions, and that due to the above and to expectations of a continued monetary policy easing, the risks to economic activity and international markets remain biased to the downside.

All members said that timely information suggests that the weak performance that the Mexican economy had been exhibiting since the previous quarter intensified during the first quarter of 2019, due to both external and domestic factors, some of which are transitory. Most members noted that, according to timely estimates, using seasonally adjusted figures, GDP contracted 0.2% during the first quarter of the year, and some members specified that such weakening was greater than anticipated. Most members indicated that transitory factors affected economic activity. In this regard, some of them mentioned the fuel distribution problems, the blocking of railways, the strikes in northern Mexico, and the delays at border crossings. Given the above, one of the members deemed that the recent growth figures are likely to overestimate the weakness of economic activity. Another member mentioned that the economic cycle measured by INEGI's Coincident and Leading Composite Indicators System (SICCA, for its acronym in Spanish) points to an upward phase covering 119 consecutive months at the end of the first quarter of 2019. The same member added that although this phase has been the longest in Mexican history since 1980, it has also been characterized by the slowest growth. He/she mentioned that its current stage points to a temporary stagnation, without signaling yet the beginning of a recession. Another member stated that the Coincident Indicator of INEGI's Cyclical Indicators System (SIC, for its acronym in Spanish) has lay below its long-term trend for 7 consecutive months, registering even more prolonged negative contributions in certain indicators related to employment and economic activity.

With regard to economic activity from the demand side, most members noted that manufacturing exports have decelerated. Some noted that this has been associated with the negative impact on global trade. They stressed that the decline in growth expectations of US industrial production for 2019 implies a lower dynamism of external demand for Mexico. One member warned that the slow growth of non-oil exports has taken place despite certain dynamism in the US economy and a very favorable real exchange rate. Specifically, he/she highlighted the deceleration of automotive exports. As for domestic demand, most members emphasized the persistent lack of dynamism of investment and the recent slowdown of consumption. One member noted that investment is expected to have continued decelerating after the rebound observed in January.

Another member commented that a cause of concern is that private investment has remained practically stagnant since 2016 and that, since then, the cost of financing to firms has increased and the growth rate of bank lending to firms, particularly to small- and medium-size firms, has declined. The same member added that it is also worrisome that a secular slowdown in private consumption has been observed since 2016, while the growth rate of credit to households has declined considerably, which has been accompanied by a significant increase in the costs of such credits. In this regard, he/she indicated that it is no coincidence that the slowdown in consumption and the stagnation of investment have coincided with a period in which the real interest rate has increased significantly, given that, although consumption and investment respond to different determinants, interest rates are a key factor in their evolution. He/she pointed out that the above shows that the monetary policy transmission mechanism is functioning through channels that affect real variables. Another member stressed that the weakness of investment has continued for approximately four years, due to several factors, such as the fall in public investment, fundamentally explained by the strategy adopted to strengthen public finances, and an environment of persisting uncertainty. He/she specified that the stagnation of investment has not responded to the adopted monetary policy stance, since such stagnation began when the reference rate was at 3%. He/she added that recent surveys among entrepreneurs and analysts do not assign a major role to monetary policy as an explanatory factor of low growth rates. On the other hand, one member warned that, given different transitory and idiosyncratic factors, it is foreseeable that GDP components on the expenditure side will continue exhibiting negative growth rates or rates very close to zero in the first quarter. On the supply side, most members emphasized that in the first quarter of the year contractions were observed in the industrial and services components. As to industrial production, one member stressed that data up to March show a downward trend in three out of its four main components, along with a stagnation of the manufacturing industry. Another member stressed that the significant contraction in construction is a cause of concern, while another one added that the persistent fall in oil production is also worrisome.

Most members noted that given the GDP figures at the beginning of 2019, growth expectations for the year have deteriorated. One member noted that growth expectations for 2019 by private sector specialists surveyed by Banco de México have been decreasing constantly for more than a year. Nevertheless, some members indicated that a recovery in the growth rate is expected starting from the second quarter. One of them pointed out that this could be driven by consumption, given the higher real wages, the real increase in credit for consumption and the increase in the purchasing power of remittances. He/she commented that positive, albeit marginal, contributions of private investment and exports are foreseen. Likewise, he/she pointed out that, in this scenario, along with the implementation of the priority programs of the new administration, a new phase of growth is likely to begin. Regarding growth expectations for 2020, another member pointed out that these have been adjusted downwards from April 2018 to April 2019. However, most members noted that in recent months such expectations have recovered somewhat. In this regard, another member mentioned that this seems to reflect an arithmetic effect, as there are no elements that lead to assume a more optimistic view.

All members pointed out that the balance of risks for growth has become more uncertain and that it continues biased to the downside, as a result of external and domestic factors. Among the former, in addition to the already described global risks, most members added the possibility of obstacles in the ratification process of the trade agreement reached in North America, other actions that can affect trade in the region and the risk that the US authorities include Mexico in the list of countries subject to trade retaliations. One member considered that, if the ratification of the aforementioned agreement is delayed, the investment outlook could become more complicated. Another member added among external risks the decline in the growth rate of manufacturing production in the U.S. and the potential implications of the fall in the Purchasing Managers' Indices in both that country and worldwide. Among domestic risk factors, most members highlighted the risk of additional reductions in oil production, which may negatively affect public revenues. One member added the uncertainty regarding the direction of public policies in different sectors, which has contributed to maintain an adverse environment for investment. Another member pointed out that greater uncertainty, apart from undermining private investment, may also curb consumption. The same member also added the following downward risks to growth: i) the possibility of a downgrading of Pemex's credit rating, coupled with a reduction in the country's risk rating; ii) a further delay in the implementation of the new government's priority programs; iii) that the new government's austerity program leads to a greater inactivity of government than anticipated; iv) that the real exchange rate appreciates and discourages non-oil exports; v) that the growth of family remittances starts to fade; and; vi) that the increase in the purchasing power driven by the recent wage increases dwindles due to the difficulty to abate inflation. As to medium-term downward risks, such member noted the possibility of a recession in the United States.

Some members argued that there are upside risks to growth, such as the significant increase in consumer confidence that has persisted for several months, the increase in the total wage bill, the start of new social programs aimed at segments of the population with a high marginal propensity to consume, and a more favorable performance of remittances. One member added the following risk factors: i) a greater-than-expected dynamism of the US economy, an early ratification of the new trade agreement in North America as well as an elimination of trade tariff and non-tariff barriers imposed by US authorities on Mexico; ii) a greater–than-expected upturn of private investment due to positive signals from the government; iii) an early start-up of the new public investment projects, coupled with a higher-than-expected return; and iv) the possibility of a higher-than-anticipated rebound effect resulting from a low base of comparison.

Most members mentioned that the economy's slack conditions loosened towards the end of 2018 and early 2019. One member pointed out that they remain at a neutral level, while another member noted that they are expected to widen in the following quarters. One member stated that, considering the current real GDP forecasts for the next two years, it is reasonable to anticipate a negative output gap, although below the one derived from statistical estimates, given the probable decline in the country's growth potential over the last years. Such member highlighted the paradox that, in an environment of economic weakness, there have been increases in different indicators of wage pressures, such as contractual wages, IMSS-insured workers' wages, and unit labor costs in the manufacturing sector. He/she stated that the upward trend of the latter has become more evident since late 2018, due to wage increases being above labor productivity. The same member argued that the natural outcome of this combination of trends has been a fall in formal employment, an increase in informal labor, and a rise in the unemployment rate, which has probably been softened by the higher levels of employment in the informal sector. He/she added that, naturally, the contraction of employment has been more marked in certain regions of the country, such as the northern border zone, where greater wage adjustments have been observed, even showing a sharp contrast with the neighboring municipalities that have not been affected by such adjustments.

As for the path of headline inflation, most members mentioned its decline at the beginning of the year. One member highlighted the unusually low monthly inflation in January, due to the VAT reduction in the border zone. Another member emphasized that after accumulating 44 basis points in the first three months, it was the lowest inflation for a first quarter since Mexico's Consumer Price Index (INPC, for its acronym in Spanish) exists. Such member added that, in February, the annual inflation rate lay marginally below the upper limit of the variability range for the first time since December 2016. One member emphasized that inflation showed a clear downward trend between September and February, although it rebounded in March and April. The same member added that cumulative inflation from December to April has been the second lowest since 2000, as compared with the same period in previous years. Another member pointed out that core inflation, which reflects more accurately inflationary pressures, registered a higher growth during January-April of this year than in the same period of the previous year and the second highest figure in the last 5 years. All members underlined that headline inflation rose from 4.00% to 4.41% between March and April. Most members noted that the latter figure is higher than expected and one member further stated that headline inflation lay again above the upper limit of the variability range. Another member highlighted that inflation was affected by the impact of major adjustments stemming from the peso exchange rate and from significant pressures on the non-core inflation component. One member pointed out that the possibility of headline inflation turning out higher during the second quarter of the year vis-à-vis the first quarter, was expected given the change in weights from the update of the CPI's base year adopted in mid-2018 and due to comparison base effects.

Most members noted that the recent rise in headline inflation was due to increases in its two components, pointing out that the core inflation component contributed in greater measure to such an increase. As to this latter component, most members emphasized that it remains at high levels and recently rose further than expected, going from 3.55% in March to 3.87% in April. One member added that this was the highest annual rate in the last 13 months. Some members pointed out that the behavior of core inflation was due to the variation of food merchandise prices, which continues to increase, while that of services prices rebounded recently. One member explained that the prices of food merchandise, education and services other than housing and education have grown at rates near or above 5%. Most members mentioned that services prices were influenced by the calendar effect, given that the Easter holiday this year took place in April, while in 2018 it did so in March. Nevertheless, they noted that, even after eliminating this effect, services prices register an increase. One member underlined that this effect is transitory and that he/she expects that it would start to revert starting from the third quarter of the year. Another member added that services other than tourism are not registering price increases as significant, although their growth rate has not decreased either. Such member pointed out that the rise in food merchandise prices is worrisome. He/she stated that, although INEGI reported that food merchandise inflation was 4.75% in April, Coneval estimated that the cost of the basic food basket used to measure extreme poverty, increased 6% in the same period. In this regard, such member further stated that preserving the population's purchasing power and protecting the poorest sectors of the population should be the priority. One member said that the trend of core inflation showing a weak connection between the price dynamics and the economy's cyclical position is of concern. Another member highlighted that several measures to track trend core inflation show persistence or even an upward trend. Such member added that, given the deceleration of economic activity, no demand pressures on prices are observed at this moment and that this, in addition to the performance of the peso exchange rate, suggests that the recent path of core inflation is explained mainly by supply shocks, stemming from the indirect impact of food and energy prices, and by the behavior of wages, together with a certain degree of inertia of core inflation. One member pointed out that it is too soon to draw conclusions about the persistence of core inflation since it cannot be ruled out that it may be due to the confluence of supply shocks that will eventually fade away. As for non-core inflation, most members mentioned that it increased from 5.47% to 6.08% from March to April, partly reflecting that since the second fortnight of February 2019, the downward path in the rate of change of energy prices reverted.

As for inflation expectations, most members stated that those for short- and medium-term headline inflation increased recently. Some members noted that this was due to the recent increase of headline inflation and of some of its components. Nevertheless, one member considered that inflation expectations for the end of 2019 have been decreasing after rebounding at the end of 2018, from a median of 3.90% in November to one of 3.60% in March and of 3.70% in April. Another member explained that, between February and April, the median for headline inflation expectations for 2020 remained at 3.60%. As for headline inflation expectations for the long term, most members expressed that they remained unchanged. As for core inflation expectations, most members pointed out that those for the short and medium terms increased. One member added that, between February and April, the median of such expectations for the end of 2019 and for 2020 increased from 3.50% to 3.56% and from 3.48% to 3.50%, respectively. One member considered that the median of those corresponding to the end of 2019 has not changed significantly over the last months and remains relatively stable at around 3.50%. Another member warned that long-term core inflation expectations have been converging to those of headline inflation in the last years. In sum, most members stated that all inflation expectations are clearly above the 3% permanent target, with one member specifying that this situation has been observed for a long period. Some members underlined that analysts' inflation expectations for all terms remain above those projected by Banco de México. As for information drawn from market instruments, most members pointed out that, after having followed a downward trend, the medium- and long-term inflationary risk premium recently increased and remains at high levels. One member considered that this points to a new increase of inflationary risks in the medium and long terms.

Some members mentioned that the increases in headline and core inflation and the evolution of their determinants could lead to revisions to their foreseen paths. One member highlighted that the future paths have become more uncertain. Another member noted that although headline inflation is foreseen to resume a downward trend in the second half of 2019, its convergence to the 3% target is expected to be slower than anticipated, adding that this target appears to be difficult to attain during the first half of 2020. In contrast, another member pointed out that, in the absence of other shocks, it is feasible to be very close to the 3% target towards the first half of 2020, given that the recent developments in inflation have been according to or even better than what was foreseen. In this regard, such member pointed out that average annual headline inflation during the first quarter of 2019 was in line with the forecast of the last Quarterly Report.

As for inflation risks, most members highlighted the possibility that the peso exchange rate comes under pressure from external or domestic factors. The majority added that inflation could be affected if additional pressures on energy prices or on agricultural and livestock product prices arise, if an escalation of protectionist and compensatory measures worldwide materializes, or in case public finances deteriorate. Moreover, most members agreed that, given the magnitude of the increases to the minimum wage, in addition to their possible direct impact, there is the risk that these bring about high wage revisions in a variety of sectors. Some members expressed that a possible source of wage pressures are the labor commitments subscribed within the framework of the United States-Mexico-Canada Agreement (USMCA). Some members underlined that wage revisions in some sectors have already exceeded productivity gains, which could give rise to cost pressures and affect formal employment. Some members mentioned that available information suggests that wage revisions may be putting pressure on core inflation, mainly through prices of labor-intensive goods and services. One member considered that although based on available information it is too early to assess the lighthouse effect that minimum wage increases may have on other wages and, subsequently, on the price level, it is important to monitor the economy's absorption capacity to ensure that such increases do not generate additional inflationary pressures. The same member stated that it is difficult to analyze this phenomenon due to the characteristics of the labor market where minimum wage increases mostly impact the low income deciles and the informal sector of the economy. He/she warned that the analysis is further complicated by the extraordinary increase in the minimum wage level in the country's northern border zone, which could impinge upon contractual wage negotiations for firms not only at the border zone but also in the rest of the country. He/she also highlighted that the increase of tourist services prices is of concern since, due to their labor intensive nature, they are more exposed to wage increases, and that such price increases may be the result of an undesirable pass-through effect. Another member emphasized that, up to now, there is no evidence that increases in the minimum wage, both at the national level and in the border zone, have translated into significant inflationary pressures. He/she noted that, in the case of the northern border zone, where such pressures may have been greater, inflation has been even lower than in the rest of the country.

Some members added the risk that the persistence shown by core inflation could lead to a greater resistance to decline of medium- and long-term inflation expectations. One member stated that the recent dynamics of core inflation implies the materialization of some of the upwards risks that had been mentioned on previous occasions. Finally, some members highlighted the risk that the widening of economic slack does not translate into lesser pressures on inflation, given the factors that have been putting upward pressure on core inflation. As for downside risks, the same members mentioned the possibility that the prices of certain goods included in the non-core subindex could register lower variations and that economic slack could widen more than expected. One member considered that, in his/her opinion, such balance is relatively stable. The same member argued that risks have decreased as compared to those at the beginning of the year, due to the fact that the improvement of global financial conditions implies lower pressures on the peso exchange rate and, eventually, on inflation, among other factors. He/she added that stable energy product prices are expected on account of the price setting policy of the new administration. Most members pointed out that, although there has been an intensification of certain downside risk factors, like the greater slack in the economy, there are other factors that could make inflation remain at high levels and, therefore, deviate from its foreseen path, given the factors that have restrained core inflation from decreasing. Thus, most members agreed that, in an environment of high uncertainty, it is deemed that the balance of risks for inflation relative to its forecasted trajectory remains biased to the upside.

As for domestic financial markets, most members pointed out that the Mexican peso appreciated compared to the levels observed during the last monetary policy decision, although it has exhibited higher volatility. Some members mentioned that trading conditions in the foreign exchange market point to an orderly functioning of such market. Most members stated that Mexico's relatively high interest rate spreads with respect to other economies have contributed to the positive performance of the peso. Regarding interest rates, the majority noted that these recently increased, mainly those for the medium and long terms, which was associated with the escalation of the trade tensions that affected international financial markets. Some members added that the higher-than-expected inflation figures also contributed to such increase. Notwithstanding the above, one member highlighted that trading conditions in the fixed income market are at adequate levels. Another member pointed out that the stock market exhibited a marginal increase during this period. Some members delved into the performance of domestic financial markets and analyzed their development throughout a longer period, particularly since the last quarter of 2018. One member argued that it is useful to divide the analysis into two periods. During the first period, from October to the first half of December 2018, the peso depreciated significantly, while interest rates on government bonds, risk premia, and the stock market index exhibited a negative performance. Such member emphasized that this was due to a generalized strengthening of the US dollar given the outlook of a further tightening of monetary policy in the United States as well as the natural higher uncertainty present at the beginning of a new federal administration, and to some controversial public policy decisions. He/she mentioned that, during the second period, extending from the second week of December 2018 to date, the Mexican peso has been one of the best performing currencies. He/she added that interest rates on government bonds and risk premia decreased, while the stock market resumed a positive trend. He/she noted that this improvement was due partly to the aforementioned international factors and also to the fact that the natural uncertainty associated with the beginning of a new federal administration has been fading as some key decisions have been taken. Among these, he/she highlighted the USMCA, the fiscal discipline included in the Economic Package for 2019, the successful negotiation with the bond holders of the New Mexico City International Airport, and the fight to deter fuel theft. He/she considered that all of these factors appear to have contributed to restore, at least partially, an environment of greater confidence and certainty. Therefore, this member noted that the risks for domestic financial markets have been decreasing. Another member pointed out that these markets have exhibited a positive performance despite the uncertainty associated with the announcement of new public policy measures. Most members agreed that risks prevail which may affect the performance of domestic financial markets, and highlighted the uncertainty regarding the external environment and the risks regarding the credit outlook of both Pemex and the overall Mexican economy. One member underlined the uncertainty and the risk factors still prevailing have domestic assets trading at a discount or with an additional risk premium relative to their behavior in the last years or with respect to their current credit ratings.

The majority of the members warned that the current environment continues to pose significant medium- and long-term risks that could affect the country's macroeconomic conditions, its growth capacity and the economy's price formation process. Most members stressed that it is particularly important, in addition to maintaining a prudent and firm monetary policy, to promote the adoption of measures to foster an environment of confidence and certainty for investment and higher productivity, and to consolidate public finances in a sustainable way. One member noted the importance of promoting the adoption of new technologies, strengthening human capital, reducing opportunity gaps and generating the necessary incentives for growth and development. In this context, the majority mentioned that it is particularly relevant that the fiscal targets of the Economic Package for 2019 are met and that strengthening the rule of law, tackling corruption and fighting insecurity are imperative. Delving deeper into public finances, one member noted that there is a growing concern about a shortfall in public revenues, due mainly to lower oil revenues. He/she warned that this problem could worsen due to the economic slowdown and to lower tax revenues derived from the support measures for Pemex. In addition, he/she stressed that during the current fiscal year, various factors could put pressure on public finances, among which the following stand out: i) expectations of lower revenues, without considering the decrease in fiscal revenues due to the support provided to Pemex; ii) the need to reduce Pemex's expenditures; and iii) the increase in the cost of the public debt, which could even increase further during the rest of the year subject to the behavior of the sovereign risk and the inflation premium. Finally, such member warned that public spending has been reallocated in detriment of public investment, and that together with the lack of vigor of private investment, this has adverse effects not only on economic activity in the short term but also in the medium and long run by affecting productivity and the economy's growth potential. Another member mentioned that meeting the fiscal targets implies in the short term addressing in a timely manner the pressures stemming from the developments in oil production, the measures to support Pemex, and from a lower than expected economic growth. In this regard, most members pointed out the concern about the persisting reduction in oil production, which has led to lower-than-budgeted oil revenues, leaving the federal government with less room for maneuver to implement its priority projects and meet its fiscal targets for 2019 and 2020.

Delving into Pemex's situation, most members mentioned that the federal government's efforts to support this state-owned company, such as the recent agreements to lessen its tax burden and refinance its debt, although they point in the right direction, it is necessary to solve the company's structural problems. Such members added that this company has structural problems and that it is essential not only that it submits a credible and functional business plan, which does not jeopardize the federal government's fragile fiscal balance, but also that it offers a permanent solution. In this context, the majority highlighted that its credit rating is a risk factor for domestic financial markets and for the country's economy. One member underlined that it is important that the actions that are adopted contribute to generate confidence and to anchor more effectively the outlook for the Mexican economy. Another member noted that according to experts, returns on projects involving oil exploration and production are far higher than those involving oil refining. The same member added that neither Pemex nor the federal government have the resources to make the necessary investments. He/she argued that it is also necessary to promote private investment in this sector as well as to offer legal certainty to private companies' contracts and to improve Pemex's corporate governance. Some members mentioned the risks associated with the decision to build the oil refinery in Dos Bocas. One member pointed out that the federal government has had to adjust public spending for 2019, which could compromise physical investment in Pemex. Finally, another member underlined that markets' questioning regarding the institution's solvency, the strength of public finances and their possible impact on the economy, will continue as long as Pemex does not have a business model that opens the perspective of a recovery of crude oil production and of a financially viable institution in the long run.

In addition, one member highlighted that in the last years the economy and price formation have faced considerable shocks, both external and domestic, and that for this reason both fiscal and monetary policies had to be strengthened. Such member stated that having a sound macroeconomic policy contributes to an orderly adjustment of the economy and to the attainment of the inflation target, and provides the necessary room to adopt the required actions to foster greater certainty and confidence. In this regard, the same member expressed that is necessary to avoid that economic deceleration occurs with the adoption of policies that could affect the economy's price formation, keeping inflation under pressure and above its target.

All members considered that the current monetary policy stance is consistent with the convergence of inflation to its target within the time frame in which monetary policy operates. Nevertheless, most members expressed their concern about the persistence exhibited by core inflation. One member stated that the recent increase in core inflation reflects the challenges to consolidate its convergence to 3%. Another member mentioned that expectations of the US Federal Reserve adopting a more accommodative monetary policy stance relieves the pressure to synchronize Mexico's monetary policy with that of the U.S., providing greater room for maneuver to Banco de México. Such member added that this allows the central bank to focus on its main goal of maintaining price stability and also meet its additional objectives related with financial stability, and even center its attention on how the economy positions itself in the business cycle. In this regard, such member pointed out that monetary policy can influence the business cycle only around the long-term growth trend, but it cannot influence the trend itself. He/she considered that monetary policy's most important contribution to a country's economic development is to guarantee price stability, which is a necessary condition for sustained economic growth, but which is far from being a sufficient condition.

The majority of members agreed that the evolution of inflation expectations is an important factor to consider for monetary policy conduction. One member pointed out that despite the tight monetary policy, analysts estimate that core inflation will not decline considerably in the next two years, anticipating a path significantly above Banco de México's forecasts. Such member mentioned that given the decline in inflation in early 2019, inflation expectations for the end of the year were adjusted downwards, and several analysts foresaw that Banco de México would start a cycle of monetary policy easing. However, just as the central bank had warned at the time, it was not clear that such downward trend could be sustained in the short term, as proven by the recent increase in inflation. Moreover, he/she also highlighted that the monetary policy stance does not depend only on the behavior of a single variable. The same member underlined that although the growth in the annual inflation rate in April should not have been surprising, most analysts did not anticipate it and ended up revising upwards their expectations for the end of 2019. He/she considered that the latter suggests that a shift towards a more accommodative message in the previous monetary policy statement would have been very premature. However, he/she emphasized that the anticipated increase in headline inflation for the second quarter of the year is a temporary phenomenon that might fade away as long as the current monetary policy stance is maintained long enough to ensure that observed inflation and its expectations converge clearly to inflation's permanent target, as has been forecasted.

One member mentioned that the increase in long-term core inflation expectations is difficult to explain in a context where inflation has been decreasing, short-term inflation expectations have remained relatively stable and the risks to inflation have diminished. In this regard, he/she argued that the tone of the monetary policy statement is an economic policy tool and that, when private agents have imperfect information on the state of the economy, they use the information provided by the central bank to update their beliefs about such state. He/she argued that the tone of the central bank's communications may constitute a mechanism for coordinating or confirming private agents' beliefs. He/she considered that the tone of the last three monetary policy statements has been relatively pessimistic and has highlighted the potential upward risks to inflation, which might be one of the reasons behind the recent increases in short- and long-term inflation expectations. Another member argued that the behavior of such expectations is not related with a pessimistic message by the central bank regarding the path of inflation, given that the forecasts published are based on objective criteria and, up to the last Quarterly Report, they estimated that inflation would converge to its target in the first half of 2020.

Most members noted that the current environment poses a complex outlook and dilemmas for monetary policy. They argued that, although the weakening of economic activity and the widening of economic slack should mitigate inflationary pressures, there are still significant risks that could increase inflation. Some members expressed that the central bank should monitor the evolution of the economy so that the tight monetary policy does not continue for too long. One of them warned that this could generate greater economic slack, lead to an excessive appreciation of the real exchange rate and to downward pressures on export activity, and attract volatile capital flows, which, in the long run, could increase the instability and vulnerability in the foreign exchange market. He/she mentioned that, in view of a stable balance of risks for inflation, the upward cycle of interest rates should be thought of as concluded, unless extraordinary events occur. Nevertheless, he/she acknowledged that it is important for Banco de México to send a clear signal of prudence and commitment to complying with its main mandate. He/she stated that for the monetary policy decision to contribute to attain the inflation target and to maintain financial stability, the tone of the monetary policy statement should be more neutral than that of previous ones, thus contributing to anchor inflation expectations. He/she stressed that inflation has behaved accordingly to the central bank's projections, that the inflation target is expected to be attained in the near future, and that inflation risks have diminished. Another member argued that it is key for the monetary policy statement to emphasize that, despite the weakening of economic activity, the balance of risks to inflation has deteriorated in an environment of significant domestic and external uncertainty. Most members warned about the risks of easing the monetary policy stance too early, in an environment where: i) headline and core inflation have increased; and ii) the future path of these indicators considers additional pressures and has become more uncertain. One member mentioned that this could lead to higher volatility in domestic financial markets, undo the progress achieved in granting higher real wages and even foster a less favorable macroeconomic environment for sustained economic growth. Another member pointed out that although the negative output gap forecast should contribute to ease inflationary pressures, there is the risk that supply shocks on inflation and, specifically, the trends that are being observed in wages, lead to a de-anchoring of long-term inflation expectations, especially in an environment of increases in short-term headline inflation expectations and of a persisting upward trend in long-term core inflation expectations. He/she emphasized the risk of core inflation following an inertial behavior and also added the importance of exercising extreme caution in light of the challenges that might arise in a situation of high domestic and external uncertainty. Some members noted that under these circumstances, an easing of the monetary policy stance or a premature message in this direction would validate the above mentioned inflation expectations, would call into question the commitment to the inflation target and would affect the central bank's credibility. One member pointed out that this could even affect economic activity negatively, as it would be reflected in upward adjustments of long-term interest rates. Some members added that the current monetary policy stance should be maintained for as long as it is required to guarantee the convergence of inflation, and one of them stressed that this is the only way for inflation expectations to begin decreasing. Most members indicated that the central bank should be prepared to respond to the extent that is required to attain such convergence and considered that, given the environment of both external and domestic uncertainty, Banco de México should maintain a firm and cautious policy stance.

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 as well as available information on all inflation determinants and on medium- and long-term inflation expectations, including the balance of risks for such factors. Monetary policy must respond prudently if for any reason the uncertainty faced by the economy increases considerably. Although headline and core inflation have increased, these developments are considered to be transitory and the current monetary policy stance consistent with the convergence of inflation to its target within the time frame in which monetary policy operates. For this reason, Banco de México's Governing Board decided unanimously to leave the target for the overnight interbank interest rate unchanged at 8.25%. Considering the risks to consolidate a low and stable inflation as well as those the economy's price formation is subject to, the Governing Board will continue to follow closely all factors and elements of uncertainty that have an impact on both inflation and its outlook, and will take the necessary actions so that the reference rate is kept at a level consistent with the convergence of headline inflation to Banco de México's target within the period 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 inflation 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, Javier Eduardo Guzmán-Calafell and Jonathan Ernest Heath-Constable voted in favor of leaving the target for the overnight interbank interest rate unchanged at 8.25%.

5. DISSENTING VOTES

Against the Monetary Policy Statement (press release). Gerardo Esquivel-Hernández

Although I agreed with the decision to keep the target interest rate level constant, I do not agree with the press release that informs about such decision. Specifically, I differ on both the restrictive tone that characterizes it as well as the conclusion reached with respect to the balance of risks to inflation. This is based on the fact that inflation observed throughout 2019 has behaved in line with (or even more favorably) than what was expected in late 2018. I consider that the recent change in the monetary policy stance of several developed countries as well as the marked deceleration of Mexico's economic activity allowed for releasing a monetary policy statement with a more neutral tone. I am particularly concerned that inflation expectations and inflation risk premia are increasing despite the relatively favorable behavior of inflation in 2019. It is not totally unlikely that such expectations are being affected by the central bank's communication. I also differ with the emphasis given to the minimum wage increase as an upward risk to inflation. After five months of this increase, there is no convincing evidence that this is in fact occurring.

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 and Payment Systems. It does not necessarily reflect the considerations of the members of the Governing Board as to the monetary policy decision.

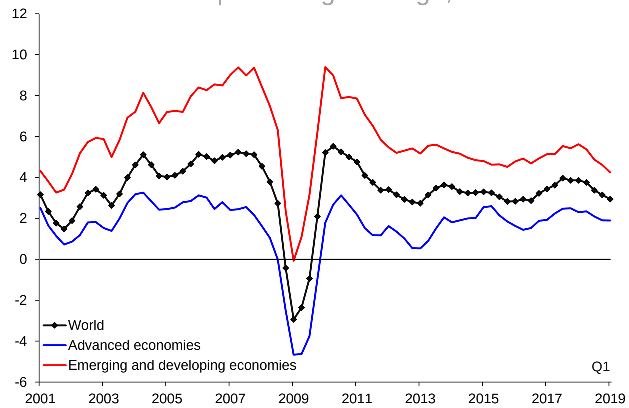
A.1. External conditions

A.1.1. World economic activity

Since the second half of 2018, world economic activity has exhibited a decelerating trend, although a moderate recovery was observed during the first quarter of 2019 in some of the major economies such as the United States, the United Kingdom, the euro area and China, largely associated with short-run factors (Chart 1). Although certain risks to world economic growth decreased due to, among other factors, stronger expectations that the central banks of the major economies will adopt a more accommodative monetary policy stance and China's announcement of new fiscal and monetary stimuli measures, the balance of risks for the global economy continues biased to the downside. Among the risks that stand out are the effects of the recent escalation of trade tensions between the U.S. and China and the possibility that these tensions spread to other regions; the possibility that some of the major economies continue to exhibit lackluster growth; new episodes of volatility in international financial markets; and the intensification of certain political and geopolitical risks.

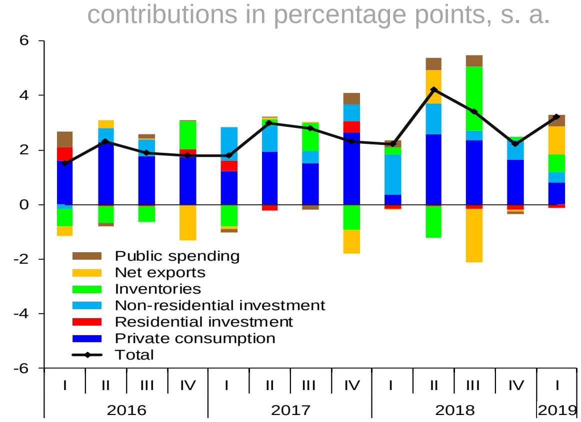
In the United States, during the first quarter of 2019, economic activity grew at a seasonally adjusted annualized quarterly rate of 3.2%, after having registered a rate of 2.2% during the fourth quarter of 2018 (Chart 2). This rebound was due to the strong growth of net exports and inventory investment. In contrast, the growth of domestic demand moderated, reflecting the slowdown of private consumption spending and business' fixed investment, although the latest indicators point to a recovery of these components during the second quarter of the year. For the medium term, expectations that US economic growth will moderate remain as the effects of the fiscal stimuli implemented in that country in December 2017 fade away.

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



s. a. / Seasonally adjusted figures.
Note: GDP calculations for Q1 2019 include estimates for some countries. The sample of countries used in the calculations accounts for 85.5% of world GDP measured by purchasing power parity.
Source: Prepared by Banco de México with data from Haver Analytics and International Monetary Fund (IMF).

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



s. a. / Seasonally adjusted figures.
Source: Bureau of Economic Analysis (BEA).

Industrial production in the United States contracted at a monthly rate of 0.5% in April, after having grown 0.2% in March. This decline was associated with the monthly fall of 3.5% in electricity and gas production as well as the 0.5% contraction in manufacturing. In particular, the poor performance of manufacturing production has been practically generalized, reflecting the effects of a weaker global demand, the appreciation of the US dollar, and the slowing down of domestic demand in that country. In addition, forward-looking indicators, such as the component of new orders of the Purchasing Managers Index (PMI), continue to suggest that the weakness of manufacturing production may continue in the short run.

The US labor market tightened further at the beginning of 2019. In March and April, 226,000 new jobs were created on average, figure above the one required to meet the growth of the labor force. The US unemployment rate decreased again, from 3.8% in February to 3.6% in April, reaching its lowest level in nearly five decades. Indicators such as job openings and initial unemployment claims also suggest a further tightening of the labor market. In this context, wages continued registering certain growth.

In the euro area, GDP growth recovered slowly by increasing from a seasonally adjusted annualized quarterly rate of 0.9% during the fourth quarter of 2018 to one of 1.5% during the first quarter of this year, reflecting the relative strength of domestic demand, which was driven by the high levels of consumer confidence, the accommodative monetary conditions, and fiscal stimuli. The above mentioned offset the weakness of external demand and the more prolonged than expected negative effects of idiosyncratic factors in some of the region’s economies and sectors. Nevertheless, forward-looking indicators, such as the PMI and business confidence suggest that the weakness of certain economies may extend into the second quarter. Despite the latter, the labor market remained tight. Indeed, the unemployment rate decreased from 7.8% in February to 7.7% in March.

In Japan, indicators available on first quarter of 2019 of retail sales, capital orders, industrial production and imports suggest a weakening of domestic demand. Certain forward-looking indicators suggest that economic activity will continue being relatively weak during the second quarter. In this context, the labor market continued to remain tight as reflected by the unemployment rate, which increased from 2.3% in February to 2.5% in March, due mainly to an increase in the number of quits while the rate of new job openings in relation to that of employment applications remained at its highest levels in the last 46 years.

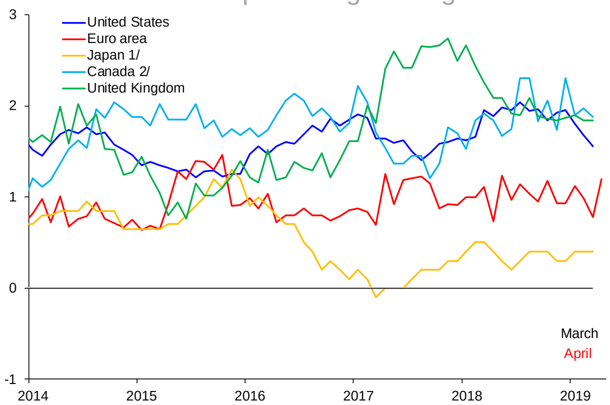
In emerging economies, economic activity has shown a heterogeneous performance during the first quarter of the year. On the one hand, the growth rate of the Chinese economy recovered, reflecting the effects of the stimulus measures adopted since the end of 2018, among which the tax cuts and greater spending in infrastructure stand out. On the other hand, other emerging economies, such as Russia, Hungary, Romania, India, Taiwan, and South Africa, continued to grow at a slower rate and some of them even contracted.

International prices of commodities exhibited different trends during the last weeks. On the one hand, in most of April, crude oil prices increased as a result of several factors, such as the previously agreed cuts in oil production quotas among OPEC member countries; the fall in oil production in Iran, Libya and Venezuela due to the escalation of internal and external conflicts in these countries; and the announcement by the United States on imposing again sanctions to Iranian crude oil sales starting in May. However, towards late April, crude oil prices decreased due to the guarantees of certain producers, particularly Saudi Arabia, that they would raise their production if an unbalance in the supply of crude oil was observed. The escalation of trade tensions between the United States and China in May also contributed to the downward adjustment of crude oil prices. On the other hand, industrial metal prices fell, given the uncertainty in financial markets and the outlook of a lower dynamism in global economic activity. Finally, grain prices fell as a result of an increase in supply worldwide, given the better-than-expected performance of winter crops and favorable climate conditions.

A.1.2. Monetary policy and international financial markets

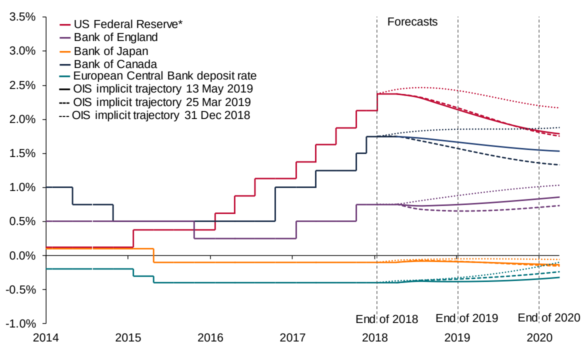
Although headline inflation in most advanced economies rebounded due to the increase in energy prices, core inflation decreased in many of them (Chart 3). In the United States, core inflation measured by the personal consumption expenditure deflator (PCE) moderated from an annual rate of 1.7% in February to 1.6% in March, partly due to decreases associated with transitory factors and methodological changes that affected relevant items, such as clothing and certain financial services. In the euro area, core inflation increased due to the arithmetic calendar effect caused by the change of month in the Easter holiday between 2018 and 2019 on the prices of certain tourist packages, while in Japan this increase was partly due to the introduction of new models of domestic appliances. In both regions, both inflation and inflation expectations drawn from financial instruments remain considerably below their central banks’ targets. In this environment, expectations that the central banks of major advanced economies will adopt a more accommodative monetary policy have strengthened (Chart 4). In most emerging economies, inflation remained close to their respective central banks’ targets and, in some cases, even below them.

Chart 3
Selected Advanced Economies: Core Inflation
Annual percentage change



1/ Excludes fresh food, energy, and the direct effect of the consumption tax increase.
2/ Excludes food, energy, and the effect of adjustments on indirect taxes (CPI-XFET).
Source: Haver Analytics, BEA, Statistical Office of the European Union (Eurostat), and Statistics Bureau (Japan).

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



1/ OIS: Fixed floating interest rate swap where the fixed interest rate is the effective overnight reference rate.
* In the case of the US observed reference rate, the average interest rate of the federal funds target range is used (2.25% - 2.50%).
Source: Bloomberg.

In its May meeting, the US Federal Reserve left the target range for the federal funds rate unchanged at 2.25-2.5%. In its statement, the Federal Open Market Committee (FOMC) expressed that, although GDP growth during the first quarter was higher than expected, both private consumer spending and gross fixed investment decelerated. It also noted that inflation, both headline and core, decreased and is below its 2% target, while reiterating that it will be patient in making future adjustments to the policy rate. On the other hand, although recently most of its members have expressed their concern about the low levels of inflation, the Fed's Chairman considered that the recent decrease of this indicator is apparently temporary and that, for this reason, the current monetary policy stance is still appropriate and that, for the time being, there are no clear bases to determine the path that the federal funds rate will follow. In this context, the federal funds rate futures continue to suggest a cut of 25 basis points in the reference rate in 2019 and an additional one in 2020.

In its April meeting, the European Central Bank (ECB) left its benchmark rate unchanged at 0%, its key deposit facility rate at -0.4% and its key marginal lending facility rate at 0.25%. As to its forward guidance, the ECB reiterated that key interest rates will remain at the current levels at least until the end of 2019. This central bank confirmed that it will continue reinvesting its balance securities for an extended period of time, past the date of an eventual increase of its key interest rates, while pointing out that the details on the precise terms of the targeted longer-term refinancing operations (TLTRO-III) will be communicated in the following monetary policy meetings. Additionally, the ECB has reiterated that it has sufficient instruments to attain its objectives, while it will also analyze the need to implement measures to mitigate the adverse effects that the negative interest rates may have on banking intermediation.

In its April meeting, the Bank of Japan left its short-term policy interest rate unchanged at -0.1% and its long-term interest rate (indexed to its 10-year bond) at 0%. Additionally, this central bank modified its policy rate forward guidance, pointing out that it will not achieve its 2% inflation target before March 2022 and that it will keep short- and long-term interest rates at extremely low levels until at least the spring of 2020.

In its April meeting, the Bank of Canada left its policy interest rate unchanged at 1.75%. It also reaffirmed the message regarding the expected path of that rate by pointing out that the current conditions suggest that the target rate will remain below its neutral level, which was revised downwards by 25 basis points, leaving it at a range of 2.25%-3.25%. This central bank also adjusted its growth estimates for 2019 to the downside, highlighting that it will follow closely the development of household spending, oil markets, and trade policies worldwide. In this context, market instruments are reflecting the outlook that there will not be any rate adjustments in the following two years.

In its May meeting, the Bank of England left its base rate (Bank rate) unchanged at 0.75%, highlighting that economic activity has been stronger than previously anticipated, driven by the strength of consumption and higher inventory accumulation, which appears to have offset the weakness of fixed investment stemming from the higher uncertainty regarding Brexit. In its latest inflation report, this central bank raised its growth projections from 1.2 to 1.5% for 2019, from 1.5 to 1.6% for 2020, and from 1.9 to 2% for 2021, due mostly to expectations of less restrictive financial conditions. As to its monetary policy, the Bank of England reiterated that, although the monetary policy stance of a gradual and limited increase of the reference rate continues to be appropriate, it will be adjusted in whichever direction is necessary. In particular, it highlighted that this adjustment will depend on the conditions of the Brexit and its consequent impact on aggregate supply and demand and on the pound sterling exchange rate.

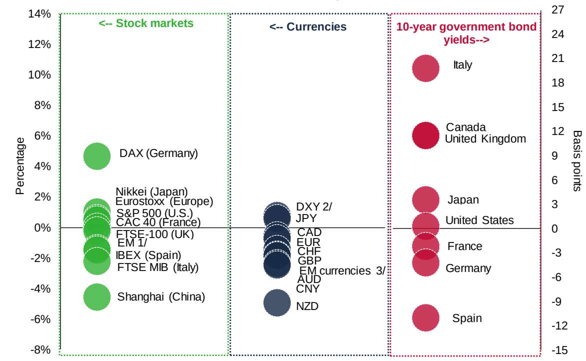
In most emerging economies, central banks refrained from modifying their monetary policy stances, although with certain exceptions. On the one hand, the People's Bank of China adopted measures to ease its financial conditions by reducing the reserve requirements of banking institutions and by injecting liquidity through open market operations. On the other hand, the central banks of India, Malaysia, and the Philippines cut their policy rates.

During April, financial markets performed positively, driven mostly by expectations that the main central banks will adopt a more accommodative monetary policy in the foreseeable future. Additionally, some risk factors associated with concerns about an abrupt deceleration of the Chinese economy and a disorderly Brexit moderated.

Notwithstanding the above, during the first fortnight of May, financial markets reverted the good performance they had exhibited since late March, due mainly to the escalation of trade tensions between the United States and China, which was reflected in the reciprocal announcements of tariff increases on several products by these two countries. In addition, certain geopolitical risks have resurfaced, particularly those related with missile tests by North Korea and the continuation of the Iran nuclear deal.

Thus, since Banco de Mexico's past monetary policy meeting, stock indices in several countries posted mixed results, with the fall of the Chinese stock exchanges standing out. The interest rates of government bonds in advanced economies registered minor changes, while the US dollar appreciated against most currencies, driven by higher interest rates than in other countries, the relatively improved performance of the US economy as well as the search for safe haven assets after the escalation of trade tensions between the United States and China (Chart 5).

Graph 5
Change in Selected Financial Indicators (March 25, 2019 – May 13, 2019)
Percent, basis points



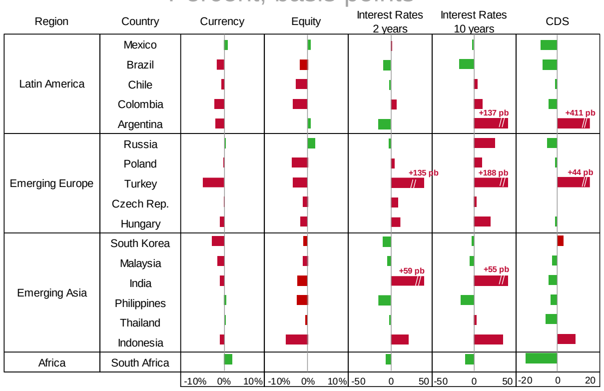
1/ MSCI Emerging Markets Index (includes 24 countries).
2/ DXY: Weighted average of the nominal exchange rate of the six main world-traded currencies (calculated by Intercontinental Exchange, ICE) with the following weights: EUR (57.6%), JPY (13.6%), GBP (11.9%), CAD (9.1%), SEK (4.2%), and CHF (3.6%).
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.

Overall, the assets of emerging economies registered losses as aversion for riskier assets increased (Chart 6). Certain economies, Argentina and Turkey in particular, continued to be affected by idiosyncratic factors, as reflected by the depreciation of their currencies, the rises in their interest rates and by the increment in their default risk.

In this context, significant uncertainty factors persist that may trigger a higher volatility in international financial markets and a further deterioration of growth expectations worldwide. Among the factors that stand out are: the possibility of a more pronounced deceleration of economic activity; a greater deterioration of US-China bilateral relations; the risk of trade tensions spreading to other regions; a disorderly Brexit; a less gradual normalization of monetary policy than expected; and an escalation of political and geopolitical risks.

Chart 6
Emerging Economies: Financial Assets Performance since March 25, 2019

Percent, basis points



Note: Interest rates correspond to interest rate swaps for 2-year/10-year maturities, respectively. 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.

A.2. Current situation of the Mexican economy

A.2.1. Mexican markets

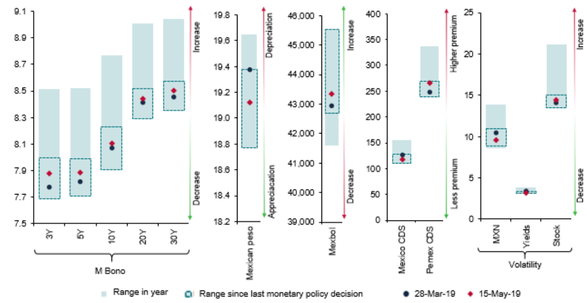
Since Banco de Mexico's latest monetary policy decision, the prices of financial assets in Mexico exhibited a mixed performance by asset class. On the one hand, the peso exchange rate appreciated 1.32% against the US dollar, reaching 19.12 pesos per US dollar in a context of relatively stable trading conditions. On the other hand, interest rates on government securities increased by up to 32 basis points, mainly on short- and medium-term instruments. Finally, the stock market had a marginal increase of 0.92% during the period, although it stood out that its main index posted a negative streak between late April and the first weeks of May.

Thus, the Mexican peso was one of the currencies that registered the best performance relative to other emerging economies' currencies. These results are basically explained by Mexico's tighter monetary policy relative to that of the other central banks. Nevertheless, volatility increased during the period, associated with greater risk aversion worldwide caused by the uncertainty regarding trade negotiations between the U.S. and China.

Orderly trading conditions continued to prevail in the foreign exchange market, which registered adequate levels of liquidity and depth (Chart 7). Similarly, forward-looking conditions implied by exchange rate options (FX options), measured using volatility and depreciation bias, also registered an improvement vis-à-vis those observed some months ago (Chart 8).

Chart 7
Mexican Markets' Performance and Trading Conditions

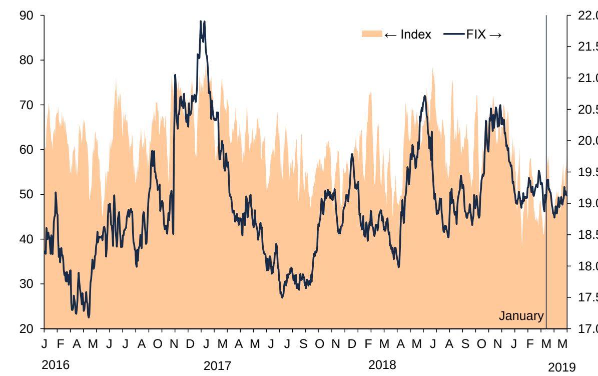
Percent, pesos/US dollar, index and basis points



Note: For the Mexican peso volatility, the levels implied in 1-month exchange rate options are considered. For interest rate volatility, 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

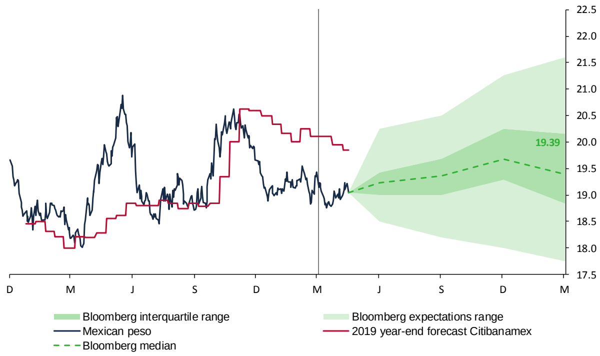
Index (5-day moving average) and pesos/US dollar



Note: Index calculated using the mean, volatility, skewness, kurtosis, bid-ask spread and mean of simple differentials across quotes, 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 the date of Banco de México's latest monetary policy decision.
Source: Prepared by Banco de México with Reuters data.

Finally, exchange rate expectations by several financial institutions' analysts for the end of 2019 were adjusted downwards, from 20.10 to 19.85 pesos per US dollar, while those for the end of 2020 were adjusted from 20.15 to 20.00 pesos per US dollar (Chart 9).

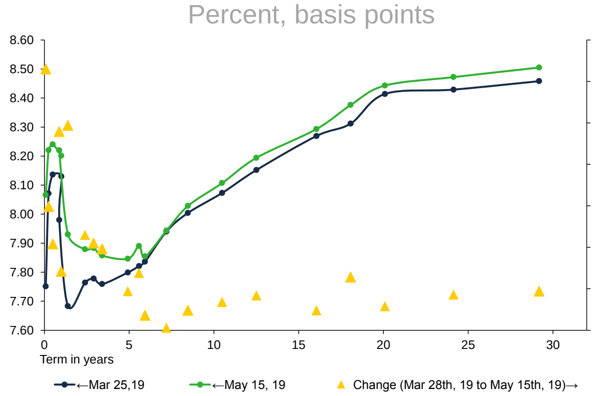
Chart 9
Analysts' Mexican Peso Exchange Rate Expectations for Each Quarter End
Pesos per US dollar



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

Interest rates on government securities increased up to 32 basis points, mainly for the short and medium terms (Chart 10). This negative performance partly reflected the higher trade uncertainty in international markets, which in turn led to greater risk aversion. However, the changes observed in the yield curve of government securities were also associated with Mexico's recent inflation figures as well as with markets' reaction to Banco de México's monetary policy statement of March, which was interpreted as having a more restrictive tone than anticipated by the market. All of the above occurred in a context where trading conditions in this market remained stable throughout the analyzed period (Chart 11).

Chart 10
Nominal Yield on Government Securities
Percent, basis points



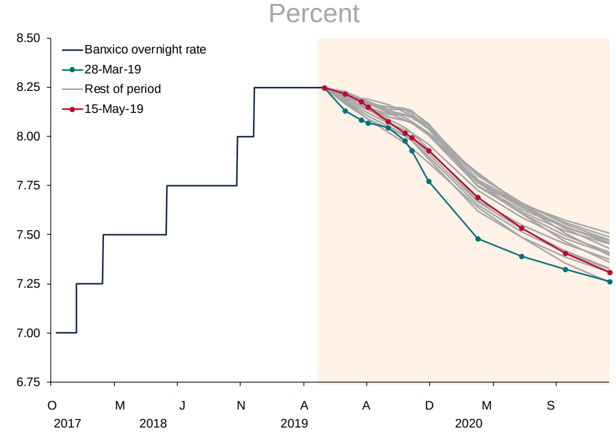
Source: PIP.

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, all of these 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 upwards vis-à-vis the levels of the previous period (Chart 12). In this regard, markets are not anticipating adjustments to the target rate in the monetary decision of May, in line with expectations of private sector analysts surveyed by Citibanamex. As for expectations for the target rate for the end of 2019, markets anticipate that it will end the year at 8.00%, in line with the median of economists.

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

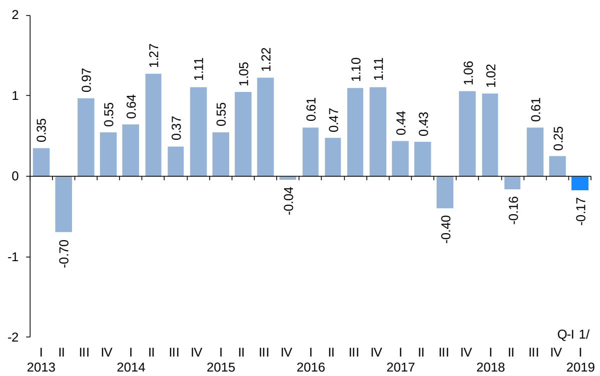


Source: Banco de México with Bloomberg data.

A.2.2. Economic activity in Mexico

According to INEGI's GDP flash estimate, during the first quarter of 2019 Mexico's economic activity contracted vis-à-vis the last quarter of 2018, thus aggravating the weakness the Mexican economy has been exhibiting since the previous quarter (Chart 13). Such performance was due to both a moderation in global economic growth as well as to a further deterioration of domestic demand, deepened by certain transitory factors that took place during the quarter, such as the fuel distribution problems, the blocking of railways in Michoacán, and the labor conflicts in Matamoros.

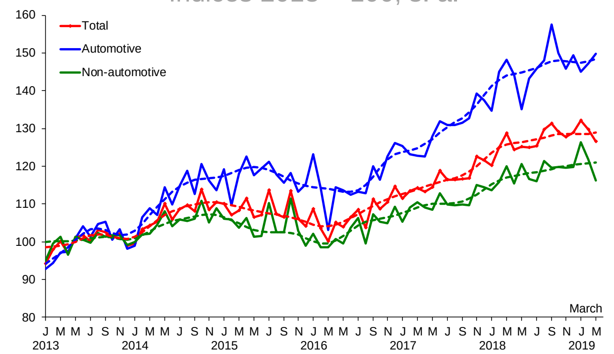
Chart 13
Gross Domestic Product
Quarterly percentage change, s. a.



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

As to the performance of external demand, during the last part of the first quarter of 2019, manufacturing exports decelerated, in a context where world trade is undergoing a loss of dynamism and trade tensions persist. In particular, declines were observed in February and March, mainly due to the contraction of non-automotive exports, although automotive exports exhibited a lack of vigor (Chart 14). By destination, exports to both the United States and the rest of the world continued registering weak results.

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

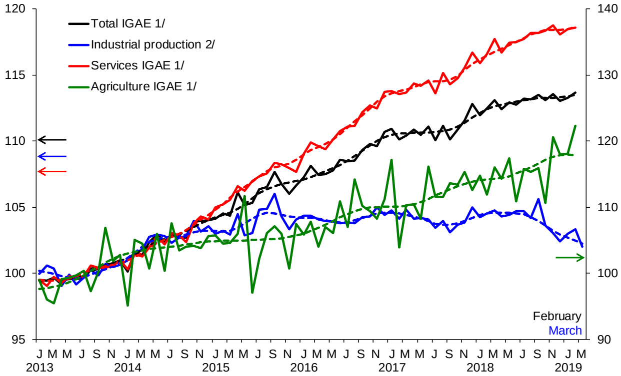


s. a. / Seasonally adjusted series and trend series based on data in nominal USD. The former is represented by a solid line and the latter by a dotted line.
Source: Prepared by Banco de México with data from the Tax Administration Service (SAT, for its acronym in Spanish), the Ministry of the Economy (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, in the early part of 2019 private consumption decelerated vis-à-vis the dynamism observed throughout most of 2018. In particular, services consumption grew at a lower rate, which may be associated with the temporary impact of gasoline supply problems on some sectors, such as those of transportation, accommodation and food services. Timely indicators of consumption, albeit of less coverage, such as those of manufacturing sales in the domestic market –which are highly correlated with the consumption of nationally produced goods– and earnings of retailers have exhibited an incipient recovery, as compared to the weak performance observed during the second half of 2018. In contrast, sales of light vehicles continued showing weakness. In February 2019, gross fixed investment partially reversed the rebound observed during the previous month. Therefore, it continues to exhibit weakness, particularly in relation to machinery and equipment.

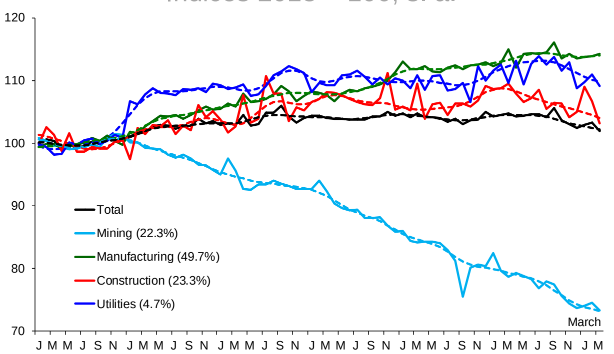
As for production, the decline of economic activity during the first quarter of 2019, reflected the contraction of both secondary and tertiary activities, thus making more evident the weak performance that industrial activity has been exhibiting for several years and interrupting the dynamism services showed in 2018 (Chart 15). In particular, manufacturing continued to exhibit lack of vigor, while construction spending continued on the same negative trend observed during most of 2018 (Chart 16). In turn, mining continued trending downwards, despite the apparent stabilization of the oil production platform towards the end of the first quarter of 2019. The deceleration of tertiary activities can be associated with a slight weakness of domestic demand, partly stemming from the above mentioned transitory factors. In particular, during January and February 2019, several services that are more closely related to consumption –such as those of arts, entertainment and recreation; accommodation and food services; and transportation and warehousing and information– exhibited a weak performance.

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 February 2019.
2/ Figures up to March 2019 of the Monthly Indicator of Industrial Activity.
Source: Mexico's National Accounts System (SCNM, for its acronym in Spanish), INEGI.

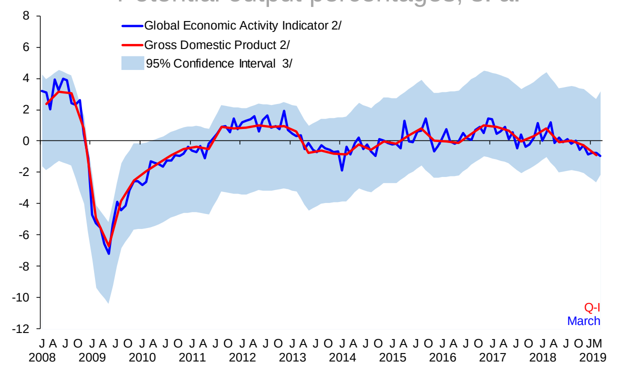
Chart 16
Industrial Activity
Indices 2013 = 100, s. a.



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

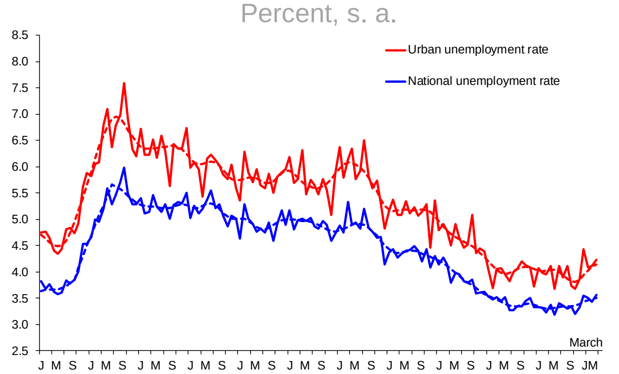
As for the economy's cyclical position, slack conditions are deemed to have eased towards the end of 2018 and during the first quarter of 2019 (Chart 17). As to the evolution of the labor market, during January-March 2019 both the national and urban unemployment rates where at levels above those of the fourth quarter of 2018, trending slightly upwards (Chart 18). The growth rate of the number of IMSS-insured jobs continued to slow down. In particular, in March 2019, this indicator registered its first fall at a monthly rate with seasonally adjusted data since 2009. On the other hand, at the beginning of 2019, unit labor costs in the manufacturing industry continued trending upwards, reflecting mostly the increases in real average earnings, that in several sectors, exceeded productivity gains (Chart 19).

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



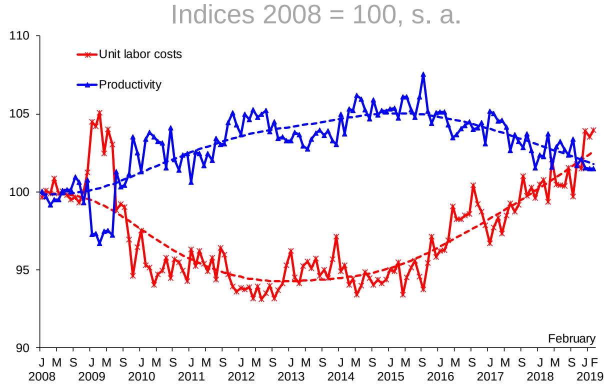
s. a. / Seasonally adjusted figures.
1/ Output gap estimated with a tail-corrected Hodrick-Prescott filter; see Banco de México (2009), "Inflation Report (April-June 2009)", p.74.
2/ GDP flash figures up to the first quarter of 2019; IGAE figures up to March 2019, consistent with timely figures.
3/ Output 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
Manufacturing Productivity and Unit Labor Costs [1/]
Indices 2008 = 100, s. a.



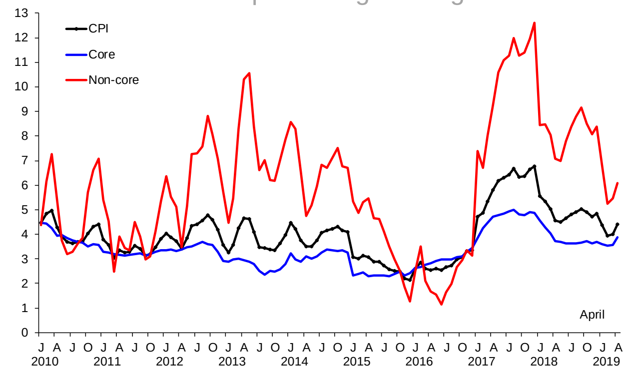
s. a. / Seasonally adjusted and trend series. The former is represented by a solid line and the latter by a dotted line.
1/ Productivity based on hours worked.
Source: Prepared by Banco de México with seasonally adjusted data from the Monthly Manufacturing Survey and industrial activity indices of INEGI's Mexican National Accounts' System (*Sistema de Cuentas Nacionales de México*).

During the first quarter of 2019, domestic financing to the non-financial private sector displayed a growth rate higher than that registered at the end of the previous year, which points to an incipient change in its growth trend as compared to the deceleration observed during the second half of 2018. Regarding its components, financing to private firms continued growing at the same pace than the previous quarter, while lending to households had a higher real annual growth rate than in the previous quarter. As for interest rates, those related to firm financing did not change significantly vis-à-vis the previous quarter. In turn, interest rates of housing credit have remained stable since the second quarter of 2017, whereas the interest rates of the consumer credit segment have remained practically unchanged during the same period, with the exception of those of credit cards, which have increased. With regards to portfolio quality, firms and mortgage delinquency rates remained at low levels, while those related to consumption have followed a downward trend since August 2018, although they remain at high levels.

A.2.3. Developments in inflation and inflation outlook

Between March and April 2019, annual headline inflation rose from 4.00 to 4.41%, largely due to core inflation increases, although non-core inflation also rose (Chart 20 and Table 1). Indeed, of the 41 basis point-increase that annual headline inflation registered during this period, core inflation accounts for 25 basis points and non-core inflation for 16 basis points.

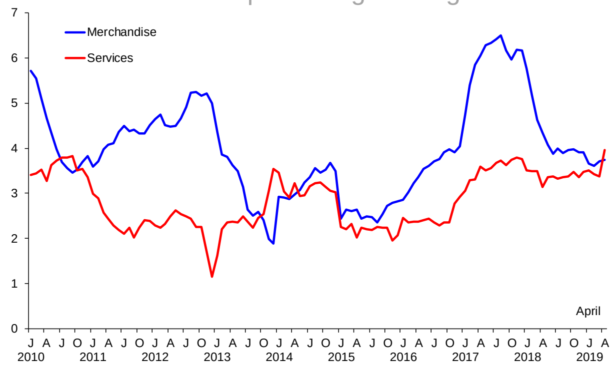
Chart 20
Consumer Price Index
Annual percentage change



Source: Banco de México and INEGI.

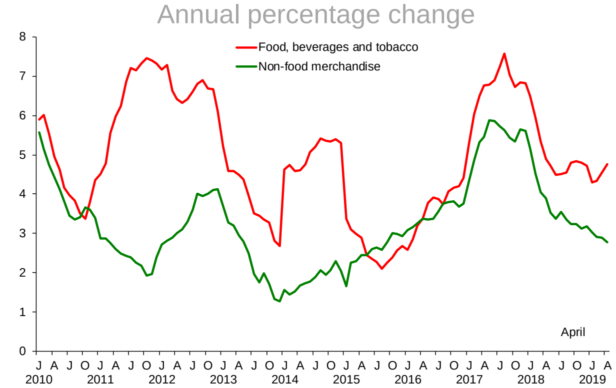
Annual core inflation rose from 3.55% in March to 3.87% in April. Thus, this indicator continues exhibiting resistance to decline, while risks associated to its behavior prevail. The latter in relation to some inputs, such as commodity prices and wage increases, which might generate cost-related pressures. During this period, the annual rate of change of merchandise prices rose slightly (Chart 21), although its components exhibited mixed results (Chart 22). On the one hand, the annual rate of change of food merchandise prices continued to increase, while that of non-food merchandise prices kept on decreasing. In turn, the annual rate of change of services prices rose during the above mentioned months, partly influenced by a calendar effect, given that this year Easter took place in April, while in 2018 it did so in March. Nevertheless, even after eliminating this effect, the annual variation of services prices would be registering an increase, in addition to the fact that prices of several food, transportation, and entertainment services have been exhibiting annual rates of change of above 5% and, in some cases, at increasingly higher rates. Thus, core inflation has remained at high levels and has recently increased further.

Chart 21
Merchandise and Services Core Price Subindex
Annual percentage change



Source: Banco de México and INEGI.

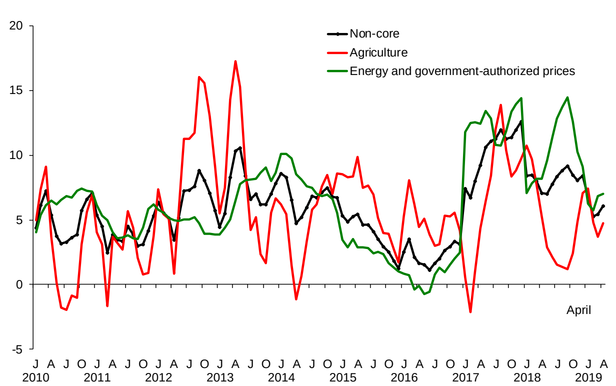
Chart 22
Merchandise Core Price Subindex
Annual percentage change



Source: Banco de México and INEGI.

As to annual non-core inflation, it increased from 5.47 to 6.08% between March and April. This result is associated mainly with the higher rates of change in the prices of several agricultural and livestock products as well as in energy products, such as L.P. gas and electricity (Chart 23 and Table 1).

Chart 23
Non-core Price Subindex
Annual percentage change



Source: Banco de México and INEGI.

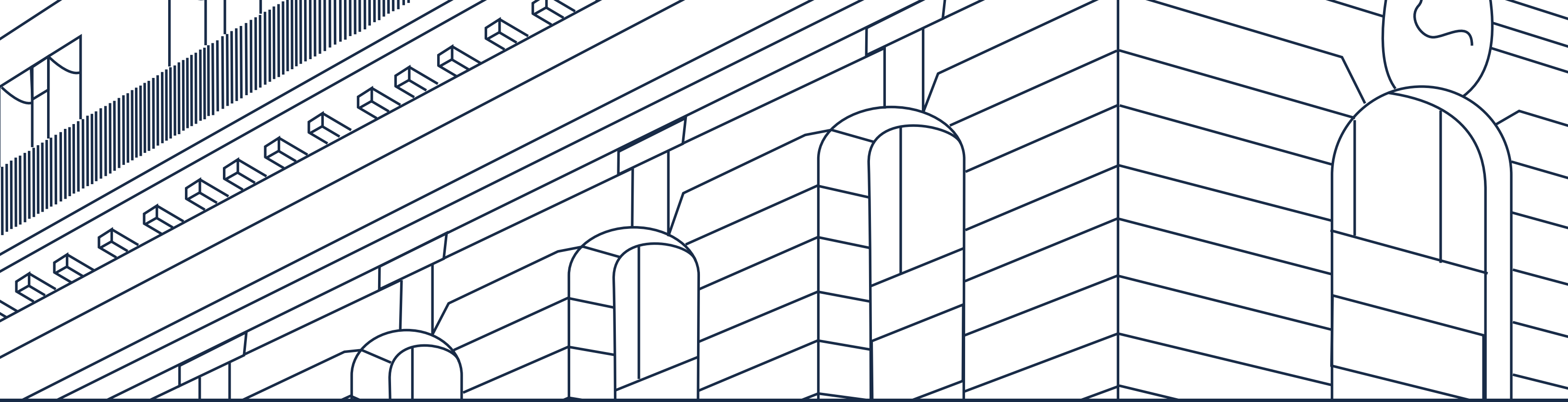
The medians for short-term inflation expectations drawn from Banco de México's Survey of Professional Forecasters exhibited mixed adjustments. In particular, it stands out that, between February and April, the median of headline expectations for the end of 2019 was adjusted upwards from 3.65 to 3.70%, while that for the end of 2020 remained at 3.60%. At the same time, the medians for core inflation for the end of 2019 and for 2020 increased by 6 and 2 basis points to 3.56 and 3.50%, respectively. The aforementioned led implied non-core inflation expectations for the end of 2019 and for 2020 to move from 4.11 to 4.13% and from 3.97 to 3.91%, respectively. The median of headline inflation expectations for the medium term (next four years) rose from 3.50 to 3.55%, while that for the longer terms (next five to eight years) remained stable at 3.50%. It should be noted that the median of medium- and long-term core inflation expectations remained at 3.50 and 3.40%, respectively, the latter having been at 3.30% during most of 2018. Thus, both headline and core inflation expectations remain clearly above the 3% headline inflation target. Finally, inflation expectations implicit in long-term market instruments (drawn from 10-year government bonds) remained at levels close to 3.50%, while the inflation risk premium increased slightly.

The evolution of inflation is subject to risks. Among those standing out to the upside are that the peso exchange rate comes under pressure stemming from external or domestic factors; that additional pressures on energy prices or on agricultural and livestock product prices arise, especially in those prices where their international references have been under upward pressure; that an escalation of protectionist and compensatory measures worldwide materializes or in case public finances deteriorate. Moreover, given the magnitude of the increases to the minimum wage, in addition to their possible direct impact, there is the risk that these bring about high wage revisions in several sectors. In fact, in some sectors such increases have exceeded productivity gains, which could give rise to cost pressures, thus affecting formal employment and contributing to keep core inflation at high levels and preventing the increased slack in the economy from translating into lesser inflationary pressures. In this sense, the persistence shown by core inflation could lead to a greater resistance to decline of medium- and long-term inflation expectations. As for those risks standing out to the downside are that the prices of certain goods included in the non-core subindex register lower variations or that economic slack widens more than expected. Thus, although there has been an intensification of certain downside risk factors, such as the greater slack in the economy, there are others that could make inflation remain at high levels and, therefore, make it deviate from its foreseen path, given the factors that have restrained core inflation from decreasing. For this reason, in an environment of high uncertainty, it is deemed that the balance of risks for inflation relative to its forecasted trajectory still remains to the upside.

Table 1
Consumer Price Index and Components
Annual percentage change

Item	February 2019	March 2019	April 2019
CPI	**3.94**	**4.00**	**4.41**
Core	**3.54**	**3.55**	**3.87**
Merchandise	**3.61**	**3.71**	**3.74**
Food, beverages and tobacco	4.34	4.56	4.75
Non-food merchandise	2.90	2.88	2.77
Services	**3.43**	**3.38**	**3.97**
Housing	2.62	2.68	2.78
Education (tuitions)	4.84	4.84	4.84
Other services	4.02	3.79	4.98
Non-core	**5.25**	**5.47**	**6.08**
Agriculture	**4.80**	**3.70**	**4.77**
Fruits and vegetables	10.68	9.65	10.19
Meats, poultry, fish and eggs	0.77	-0.21	1.38
Energy and government-authorized prices	**5.73**	**6.86**	**7.01**
Energy products	6.57	8.15	8.58
Government-authorized prices	3.43	3.45	3.52

Source: INEGI.



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