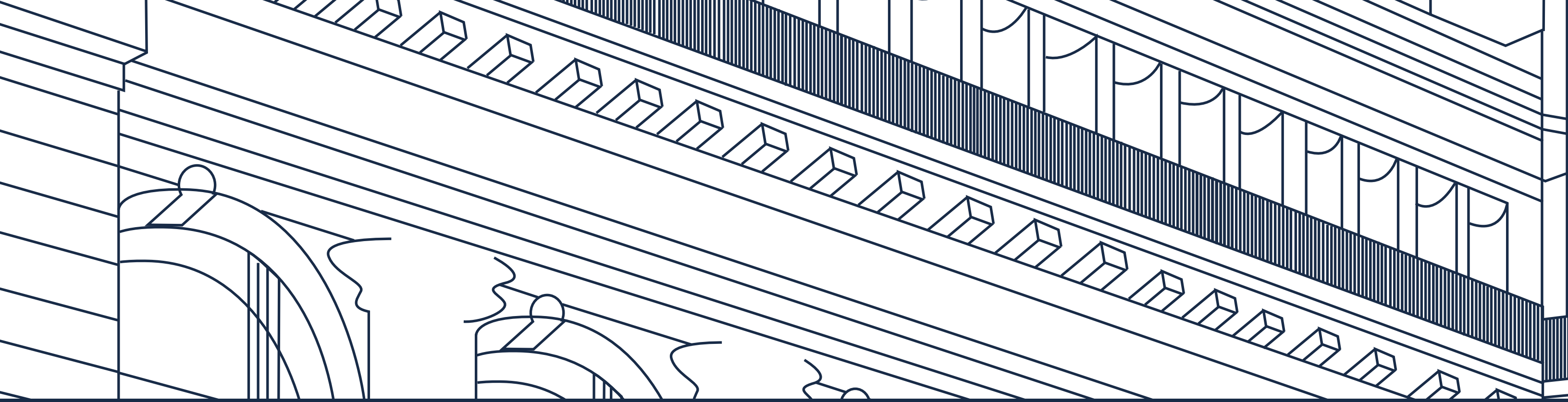

BANCO DE MÉXICO®

Minutes number 66

Meeting of Banco de México's Governing Board on the occasion of the monetary policy decision announced on March 28, 2019

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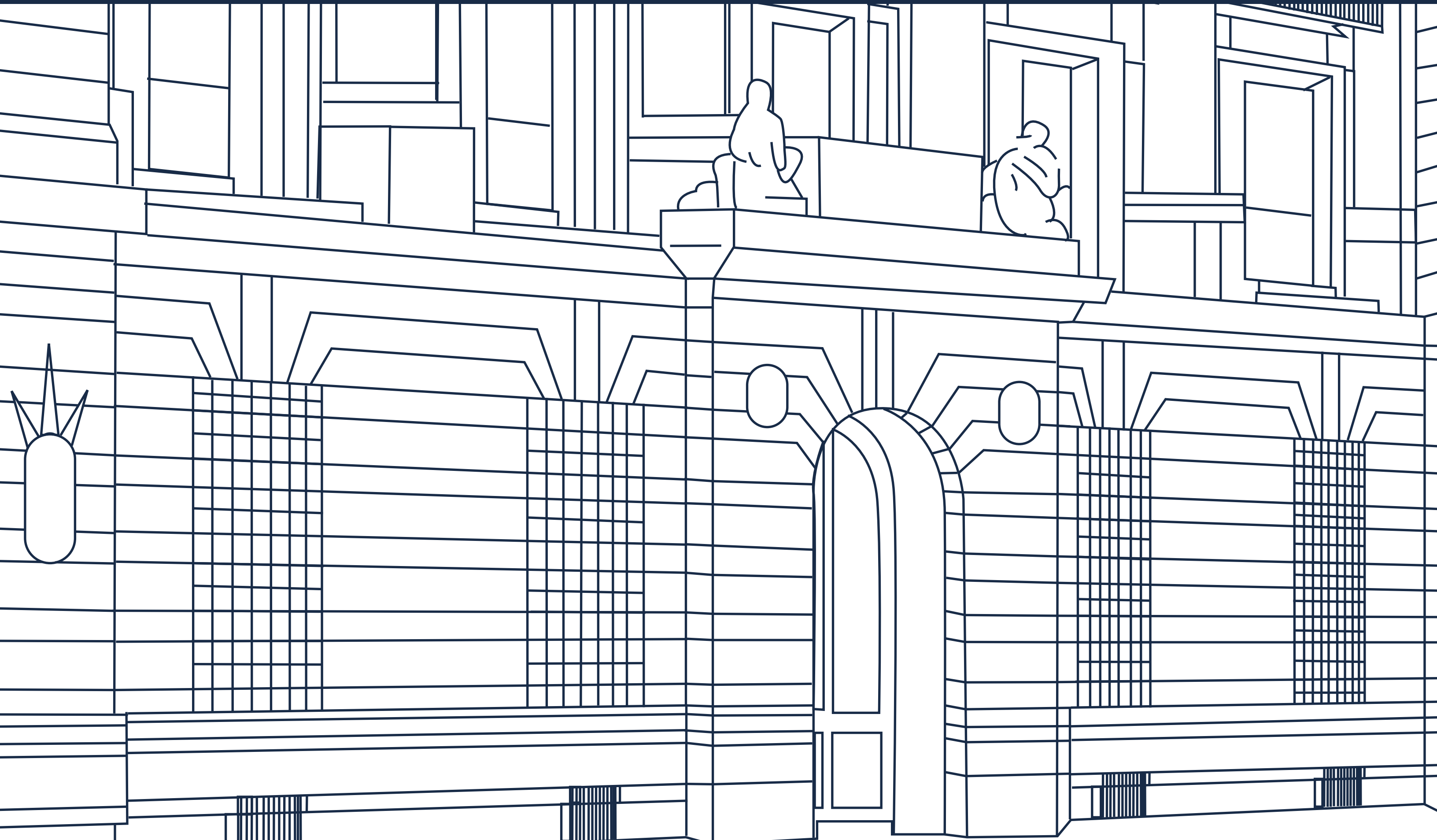

FOREWARNING
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1. PLACE, DATE, AND PARTICIPANTS

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

1.2. Date of Governing Board meeting: March 27, 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

All members agreed that available indicators suggest that the weakening of world economic activity during the second half of 2018 continued during the early part of 2019, with a lower dynamism in most advanced and some emerging economies. In this context, some members stated that among the main factors of this deceleration are the trade tensions and the implementation of tariff measures between the U.S. and China, which have affected global trade and investment. One member called attention to persistent political and idiosyncratic factors. Another member pointed out that the deceleration of the global economy has been greater than anticipated. Most of the members acknowledged that such an environment has led to the decline in world growth expectations for 2019, one member adding that growth projections for 2020 have also been revised downwards. In this regard, some members noted that different timely and leading indicators continue showing weakness, which signals a significant deceleration in several regions of the world. However, some members claimed that it is possible to expect a certain rebound in the following quarters, insofar as the transitory factors that have affected the dynamism of some economies continue to dissipate and the stimulus measures announced in several economies begin to take effect.

All members stated that the balance of risks to global growth remains biased to the downside and one pointed out that, despite the apparent moderation of some risk factors over the last weeks, other factors have intensified considerably. The majority agreed that among the main risks, the following stand out: i) an escalation of trade disputes between the U.S. and China; ii) a disorderly Brexit process; iii) a lower-than-anticipated growth of the Chinese economy; iv) a sharper-than-expected deceleration in some economies due to idiosyncratic factors; and, v) political and geopolitical tensions. Regarding the first of these risks, one member warned that, although negotiations appear to be heading towards reaching an agreement, the risk of setbacks or episodes of intensification of the tensions between both countries has not disappeared. The same member added that tariff barriers —greater than those registered prior to the conflict — could be observed, even if an agreement between both economies is reached. As to the second risk, he/she mentioned that the probability of a scenario without a mutually convenient agreement between the U.K. and the European Union has apparently increased in the last days.

Most members mentioned the lower dynamism in advanced economies, especially in the euro area and, to a lesser extent, in the U.S. One member delved into the fact that, although this group of countries continue having differences in their cyclical positions and in their inflationary gaps, the negative effects of trade disputes have contributed to a synchronized deceleration. Some members pointed out that the economic slowdown in the euro area has been greater than expected, and affected by idiosyncratic factors. One of them mentioned the case of Italy, which is already in recession, and of Germany, where manufacturing production has even started to show signs of contraction. One member considered that although some idiosyncratic factors that affected the euro area have already dissipated, the lower growth of external demand continues to affect the region's dynamism. As for the deceleration of the US economy, another member stated that it was intensified by the fading of the transitory effects of the pro-cyclical fiscal stimulus adopted by that country. Another member mentioned that industrial production and exports seem to be suffering from the effects of the trade tensions and the global economic weakness, while the fiscal deficit has widened further.

Most members stated that growth expectations for advanced economies have decreased. One of them stressed that, although the deceleration is widespread, reductions to growth forecasts vary, given that they have been considerable in the euro area, while in Japan and in the U.S. they have been of a smaller magnitude. However, most members emphasized that several financial indicators point to a higher probability of recession in the U.S. over the next 12 months. One member explained that although there are certain signals of a gradual recovery of private spending in the U.S., it is expected to grow at a lower rate than that registered during the previous quarter.

As to emerging economies, most members mentioned the lower dynamism displayed by some of them, especially China, where the economic slowdown has been greater than anticipated. Nevertheless, some members considered that this slowdown could moderate as a result of the adopted fiscal and monetary stimuli. One of the members pointed out that the People’s Bank of China mentioned that there was still room to cut its reserve requirements, in an effort to generate more market liquidity, and that this could contribute to raise global growth towards the second half of 2019. Some members stated that such stimuli are limited by China’s own structural problems, such as the transition towards a more moderate growth as well as the vulnerabilities that prevail in that country, such as the high levels of public and private indebtedness. Regarding growth prospects for emerging economies, one member argued that a certain divergence among them persists, given that, although countries such as Argentina and Turkey are anticipated to continue contracting in the first half of the year, others like Brazil and India are anticipated to continue recovering. Another member pointed out that in an environment where lesser pressures from external markets are foreseen, the performance of emerging economies will be determined, to a large extent, by idiosyncratic risk factors and by the soundness of their macroeconomic fundamentals.

All members emphasized that inflationary pressures have decreased worldwide, partly due to the decline in economic growth. Some members added that this has also been the result of lower prices of some commodities. Most members noted a continuous tightening in the labor markets of advanced economies. Some of them specified that wage growth has been accelerating and unemployment continues to decline. One of them added that, in certain cases, the unemployment rate has reached multiannual minimum levels. Most members specified that, despite the above, headline inflation in these countries is below their respective central bank targets, and one member pointed out that it has been declining. Another member mentioned that there are few pressures on prices associated with the labor market. When analyzing the evolution of inflation in advanced economies from a long-term perspective, one member warned that lower inflationary pressures reflect both the effects of the recent economic deceleration and the presence of other factors that have kept inflation structurally low. In particular, he/she considered that technological changes and globalization have allowed the fragmentation of the production processes for both goods and services according to the comparative advantages of different countries and regions. Such member added that this allowed the incorporation of the abundant workforce from Asia and Eastern Europe into the global economy and stressed that all of this has contributed to greater market competition, reducing the possibility of firms increasing their prices. He/she noted that the continued presence or weakening of these structural factors will be highly relevant for the future evolution of inflation. With regards to inflation in emerging economies, some members agreed that it declined due to the fall in energy and food prices, the fading of the effect of the depreciation of their currencies, and to the lower dynamism worldwide. One member pointed out that in some of these economies, headline inflation was close to their central banks’ targets, and in others it was even below such targets.

All members mentioned that the described external environment has consolidated expectations that the main central banks will not tighten monetary conditions in the foreseeable future. Regarding the US Federal Reserve, they stated that in its policy decision of March, it left the target range for the federal funds rate unchanged and reaffirmed its message that it will be patient in making future adjustments. In this regard, most members stressed that the median of the Federal Open Market Committee projections suggests there will be no increases in the federal funds target range in 2019. One member underlined the adjustment in the target range’s expected trajectory by the members of the

Federal Open Market Committee, from two increases this year to none. Another member mentioned that markets are beginning to consider the possibility of the next adjustment being to the downside. Most members underlined the Federal Reserve's announcement of shrinking the rate of reduction of its securities holdings starting in May and concluding such process in September 2019. One member added that the central banks of Canada, the euro area, England and Japan did not adjust their policy rates in their March meetings either, and that they emphasized that the economic deceleration has been greater than expected. He/she added that, as a consequence of the latter, market variables are discounting that there will be no additional increases during the year in the policy rate of several of these countries.

Most members agreed that during the first months of 2019, financial markets in developed countries performed favorably, in light of expectations that the central banks of the main advanced economies will not tighten monetary conditions in the foreseeable future. One member added that the apparent decline in trade tensions between the U.S. and China as well as the measures announced by the Chinese government to address the deceleration of its economy also contributed to this development. Another member noted that financial conditions improved despite the international uncertainty, which entails the risk of an additional fall in economic activity. Some members stated that the main stock market indices registered gains, that government bond interest rates decreased, that there was a compression of corporate bond spreads and that risk appetite increased. Some members noted that the US yield curve inverted. One member specified that the latter was notorious in its shorter terms. Another member mentioned that this behavior, which was also observed in Canada, has been present in all the recent previous recessions in the U.S., since it anticipates problems to finance medium- and long-term projects and therefore informs us about a possible credit channel that can contribute decisively to the economic deceleration.

As to financial markets of emerging economies, most members pointed out that these have also had a favorable performance, following the Federal Reserve's announcement of a more cautious policy stance. One member specified that interest rates in most of these countries decreased and some mentioned the improved performance of their currencies. Most members mentioned that improved financial conditions have encouraged capital flows to emerging economies, while some members also attributed such flows, in part, to the significant interest rate spreads some of these economies have with respect to US rates.

Most members indicated that, in the foreseeable future, although financial stress on emerging economies has diminished, the perceived risks to global economic growth could affect international financial markets and therefore the possibility of new episodes of financial volatility persists. Some members added the risk of surprises to the upside in the Federal Reserve's monetary policy in view of possible unexpected increases in inflation. One of them argued that the implications of a slower normalization process should be seen with caution given that, although such process can ease pressures on domestic financial markets, at the same time it points to a lower expansion of the world economy, it extends the challenges to financial stability stemming from the persistence of low interest rates, and reduces monetary policy's margin of response in the event of a weakening of economic activity.

Most members noted that economic activity in Mexico decelerated at the end of 2018 and in early 2019. One member indicated that this was more marked at the end of 2018. Another member mentioned that although GDP growth in the fourth quarter was positive, it is a cause of concern that both public and private investment have declined for three consecutive quarters, that exports have fallen for two consecutive quarters and that consumption has decreased in two out of the last three quarters. He/she added that the sum of the components of aggregate demand exhibited a contraction.

In this context, most members mentioned that available information suggests that in early 2019 economic activity continued exhibiting low growth, although some of them specified that it has maintained a positive trajectory. Most members mentioned that the country's economic performance was a consequence of the slowdown of the world economy, of some weakness in domestic demand, and of some transitory factors, such as the fuel distribution problems and the blocking of railways, which could have affected growth during the first quarter of the year. In this respect, another member clarified that there was no major spillover to other activities so that overall economic activity exhibited a slight increase in January. With regard to economic activity from the demand side, another member noted that both external and domestic demand seem to continue losing dynamism. Regarding external demand, some members mentioned that exports continue following an upward trend. However, some members warned that automotive exports to the U.S. remain weak. As for domestic demand, most members considered that consumption shows some deceleration and that investment continues on a negative trend. One of them elaborated that this is due especially to the weakness in purchases of machinery and equipment. In this context, he/she added that according to economic analysts interviewed by Banco de México, the current juncture's investment climate is going through a bad moment. As for the performance of productive activities, some members mentioned that in January the Global Index of Economic Activity (IGAE) grew at a lower-than-anticipated monthly rate. With respect to industrial production, most members noted that it has shown weakness and, in particular, that manufacturing continues to show sluggishness and that mining remains on a downward trajectory. One member specified that within the mining sector, the decline in oil production is noteworthy. Another member mentioned that construction rebounded significantly during the first month of the year. Some members highlighted that the services sector has also decelerated. One member added that this behavior was observed in sectors that were most affected by the fuel distribution problems.

Some members argued that it is yet to be seen if the observed economic deceleration is temporary. One member stated that it is not clear yet whether the lower dynamism is caused by the adjustment that always occurs at the beginning of a new administration or if it is a phenomenon associated with a new phase of the business cycle. The same member warned about the performance of the components of the Coincident Indicator of INEGI's Cyclical Indicators System, which have shown declines for several consecutive months, which points to the beginning of a downward phase in the economic cycle. Such member argued that some of these components, such as the IGAE, the urban unemployment rate or the permanent IMSS-insured workers, have had a negative contribution for at least ten consecutive months. To put this into perspective, he/she added that the level of the coincident indicator in December 2018 was one of the lowest in the last 10 years and that the last time these levels were observed —with a downward trend— was in November 2008, at the onset of the last recession in Mexico. In the same vein, such member added that the inverted yield curve in Mexico anticipates the possibility of recession.

In this sense, most members noted that in light of the deceleration in Mexico, both Banco de México as well as private sector analysts and multilateral entities have revised downwards their growth expectations for 2019. One of the members mentioned that given the lower global dynamism, especially in the U.S., a certain deceleration of foreign trade and, in consequence, a lower demand for Mexican exports, will continue to be observed. Some members highlighted that precisely exports have been one of the country's main growth drivers over the last 25 years. As to the dynamism of domestic demand, one member stated that consumption is anticipated to continue weakening. However, another member noted that, given the decline in growth expectations, the increase in consumer confidence, which is at historical highs, is striking. In addition, some members commented that signs of an economic recovery starting from the second quarter of 2019 are to be expected, once the transitory factors that have affected economic activity dissipate. One of them noted that, considering that the beginning of a new administration is always complex for circumstantial reasons and not necessarily for structural ones, the performance of public spending in the next months will be key for said economic recovery and to subsequently boost private investment.

All members agreed that the balance of risks for growth remains biased to the downside. One member pointed out that this bias is observed in both the short- and medium-term horizons. In addition to the global risks described above, most members mentioned other downward risks for growth of domestic nature, among which the following stand out: i) that the current environment of uncertainty that has kept investment at low levels, and that may lead to lower levels of consumer expenditure, persists or deteriorates; ii) that a downgrading in the credit rating of State-owned productive companies or of the sovereign itself materializes; iii) that public spending is exercised with a longer delay than would normally occur at the beginning of an administration; iv) risks stemming from the ratification process of the new free-trade agreement with the U.S. and Canada; and v) the possibility of a slower-than-expected recovery in oil production. Regarding the first risk, some members explained that the uncertainty originated by the lack of clarity on several public policies may hinder the recovery of private investment and consumption. In this context, one member added that the uncertainty could also make consumers reduce their spending for precautionary reasons, while another pointed out that the main action to strengthen economic activity in the current scenario is the creation of conditions of confidence that promote an upturn of investment. To the above mentioned risks, one member added the possibility of tax revenues decreasing in relation to their projections, which may limit the performance of public spending; that the recent stagnation of automotive exports to the U.S. persists; and that the real exchange rate appreciates, thus discouraging non-oil exports. Another member pointed out that an additional risk is that the effects of the transitory factors that have affected the economy turn out to be greater than expected or that this type of events occur again. Finally, some members mentioned that several risks to medium-term growth persist, including the possibility of a recession in the U.S.

As to the upward risks for growth, one member noted a greater-than-expected dynamism of the US economy; the approval and implementation of the new North America free trade agreement; a better performance of one or several components of GDP from the spending side; the possibility of a greater-than-expected rebound effect arising from a low base of comparison; and greater-than-expected returns on the government's new investment projects. In this context, another member stated that there are at least three factors that could contribute to an economic growth rate that would not be as low as might be anticipated: i) the increase in consumer confidence; ii) the positive effect in consumption that the new social programs focused on segments of the population, such as elder adults and young people, with a high propensity to consume, may have; and iii) the slight 3% increase in the real wage of IMSS-insured workers. Similarly, the same member mentioned that an escalation of trade tensions between China and the U.S. may benefit Mexico, as a result of the natural redirectioning of certain bilateral trade flows between those countries.

Most members considered that slack conditions in the economy loosened towards the end of 2018 and in the early part of 2019, and some members highlighted that this confirms the existence of a negative output gap. Nevertheless, one member pointed out that, excluding oil production, the latest output gap indicators remained neutral and that, although labor market indicators continue exhibiting tightness, they appear to have loosened at the margin. Another member noted that such conditions were still tight at the end of 2018 and stated that, in the current situation, an accurate assessment of the economy's business cycle stage is complex due to: i) the fact that the recent evolution of the economy may have been affected by transitory factors; ii) that, given the decline in investment and the unfavorable evolution of productivity, that the economy's growth potential is probably contracting, which further complicates the estimation of the output gap; and, iii) that, regardless of the recent increases in the unemployment rate, such rate continues to be below its long-term levels. Finally, most members stated that, considering the forecasts for growth, slack conditions in the economy are expected to widen in the following quarters. Some members noted that this would lead to a negative output gap.

All members mentioned that between January and the first half of March 2019, annual headline inflation decreased from 4.37 to 3.95%. Most members highlighted that, since the first half of February, it remained within the range of variability around the 3% target, and one member noted that this is the first time this occurs since December 2016. The same member pointed out that, during the last six fortnights, inflation fell by 105 basis points. However, he/she argued that it is unclear whether this path is sustainable in the long term. In this regard, another member noted that, although it has improved at the margin, the reading for the first half of March was slightly above that of February. One member added that headline inflation has been affected by significant adjustments stemming from both the exchange rate and from pressures to non-core inflation, particularly energy prices. Another member argued that latest figures point to a significant fall in inflation and reveal a behavior consistent with the forecast trajectory of convergence to the target in the time frame in which monetary policy operates. The same member pointed out that the average of the last six figures of annualized headline and core inflation suggests that price increases have grown at decreasing rates. He/she added that inflation seems to be converging to the target faster than expected and that it is exhibiting a significantly better path than that described in the forecasts published in Banco de México's Quarterly Reports of the third and fourth quarters of 2018. One member considered that the recent decline in inflation is explained by the fall in non-core inflation, and that it has been accompanied by worrisome elements. He/she highlighted among these the considerable persistence of core inflation; the fact that it has exceeded the central bank's projections, in a context of frequent upward revisions of its future trajectory; short-, medium- and long-term inflation expectations above the central bank's forecasts and above the 3% target; long-term core inflation expectations at the highest levels that have been recorded, and gradually getting closer to those for headline inflation, which could imply a deeper entrenchment of expectations at levels above the target; and estimates of compensation for inflationary expectations and inflationary risk implied by market instruments which are still at relatively high levels.

Most members agreed that the reduction in headline inflation was mainly due to the fall in non-core inflation from 6.81% in January to 5.39% in the first half of March. Such members pointed out that this component decreased by 385 basis points in the last six fortnights. Some members noted that this decrease was a reflection of the lower increases in energy and in agricultural and livestock product prices. Nevertheless, some members stated that some of the favorable shocks that have led to the fall in non-core inflation have started to revert recently. In particular, the prices of energy goods rose during the second half of February, reflecting the increase in their international references.

As to core inflation, most members noted that it decreased from 3.60 to 3.51% between January and the first half of March 2019. As to the dynamics of its components, most members mentioned that inflation of certain services remains high. Similarly, some members pointed out that food merchandise inflation has increased. Most members agreed that core inflation's resistance to decline is worrisome. Some members underlined that for the last eleven months, the cumulative fall in core inflation has been of barely two tenths of a percentage point. One member underlined that core inflation has remained above 3.5% for 53 consecutive fortnights and that it has shown a basically lateral behavior over the last eleven months. Nevertheless, one member considered that core inflation has broken through the 3.6% floor observed during several consecutive months and has apparently started a downward phase consistent with the forecasts of convergence to the target.

Regarding inflation expectations, most members mentioned that, between January and February, the median of headline inflation expectations for the end of 2019 and for 2020 fell from 3.80 to 3.65% and from 3.71 to 3.60%, respectively. Some members pointed out that the median of expectations for 2019 is above Banco de México's forecast for the end of the year. As to core inflation expectations, most members pointed out that, between January and February, their median for 2019 remained at 3.50% and that for 2020 increased slightly from 3.45 to 3.48%. Additionally, some members described as mixed the behavior of inflation expectations drawn from surveys. However, one member stated that it is worth mentioning that considering the aforementioned decline in expectations, a change in trend of these indicators has occurred given that, between May and November 2018, headline and core inflation expectations had been increasing constantly and significantly. Regarding medium and long-term inflation expectations, most members highlighted that those corresponding to headline inflation continue above the permanent target of 3%, at levels around 3.50%. Regarding medium-term core inflation expectations, such members stated that these increased from 3.42% to 3.50%, while those for the long term remained at 3.40%, after having been at 3.30% during most of 2018. Some members emphasized that the latter are at historically high levels. As for information drawn from market instruments, most members pointed out that although the medium- and long-term inflationary risk premium decreased, it still remains at high levels. In this regard, one member pointed out that this premium implied in the 10-year bond has continued to decrease as stress in debt markets has faded. Another member said that although some risk premia have increased, those that are more closely linked to monetary conditions have been decreasing.

As to the outlook for headline inflation, most members considered that it is feasible that it will converge to the 3% target towards the first half of 2020, although some members noted that an upturn in inflation is anticipated in the coming months due to a higher trajectory for energy prices. Some members pointed out that the above is also due to a low base of comparison in the previous year and that this trend should begin to reverse in June. One of the members added that this means that the perception of favorable developments in inflation in the short term will fade rapidly. However, another member stated that, if the observed path continues, the inflation target may be reached within the timeframe in which monetary policy operates.

As to the forecasts for non-core inflation, some members mentioned that, despite its recent decline, some of its components, particularly energy prices, are expected to exert upward pressure on this subindex in the following months. In this regard, one member explained that the decline in non-core inflation resulted from a reduction in the growth rates of agricultural and livestock product prices and of energy prices. The same member added that the former are highly volatile, while the latter are very likely to increase in the following months due to their seasonality. In this context, the same member argued that it is foreseeable that non-core inflation increases. Another member indicated that, from March 2020 core inflation is anticipated to decrease in view of expectations of a more appreciated peso exchange rate. Some members added that this component would also be subject to downward pressures as a result of greater slack.

As for upward risks to inflation, most members highlighted the possibility that the peso exchange rate is pressured by external or domestic factors. One member added that, in his/her opinion, this continues to represent one of the main risks for inflation. Most members pointed out that inflation could also 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. One member noted that the latter risk is important, because one of the fundamental pillars of price stability is having sustainable public finances, and emphasized that their deterioration could increase medium and long-term inflation expectations. In this regard, another member pointed out that public finances could weaken given the fall in oil production and the weakening of economic activity. Additionally, most members agreed that, given the magnitude of the minimum wage increases, in addition to their possible direct impact, there is also the risk that these bring about wage revisions that exceed productivity gains and give rise to cost pressures, affecting formal employment and prices. One member estimated that the materialization of these pressures would imply a greater resistance of core inflation to decline or even additional pressures on this subindex. Some members pointed out that this year wage growth appears to be accelerating. In this regard, some members emphasized that the significant increase in the minimum wage level in the country's border zone has raised the possibility of observing a lighthouse effect, that is, that the 100% increase affects also contractual wage demands for those salaries that are above the minimum wage. One of the members added that this effect might be observed in firms both at the border zone as well as in the rest of the country. Another member stressed that, up to now, there is no evidence that increases in the minimum wage level have led to significant inflationary pressures. He/she argued that in the case of the northern border, where these pressures could have been higher due to the greater increase in the minimum wage level, available information does not suggest an inflationary pattern different from that of the rest of the country. In this regard, another member argued that the new policy of improving the purchasing power of minimum wages is praiseworthy and necessary, but acknowledged that, for this policy to be functional, it must be implemented within a plausible horizon, in order to assess it and ensure that the economy can absorb such increases without generating inflationary pressures. Some members argued that, in order to raise the purchasing power of wages in a sustained manner, the role of other public policies must be considered, such as fostering competition in the markets for those goods and services with a high share in the consumption basket of the low-income population.

Most members pointed out that the persistence exhibited by core inflation could lead to a greater resistance to decline of long-term inflation expectations. In this regard, one member expressed concern about the persistence of such subindex at levels above the target, and within this subindex, about the annual rate of change of services prices other than housing and education continuing at high levels. As for downside risks, some members mentioned the possibility of observing lower price variations in the prices of certain goods included in the non-core subindex or a greater-than-foreseen widening of slack conditions. In sum, the majority of the members agreed that although there has been an intensification of some of the downside risk factors, there continue to be others that might put upward pressure on inflation in greater magnitude and make it deviate from its foreseen path, therefore they highlighted that there still persists an upward bias in the balance of risk to inflation with respect to its forecast trajectory. One member stated that the balance of risks for inflation is relatively stable, and that several of the risk factors for inflation have been easing in recent weeks.

Most members pointed out that, since the last monetary policy decision, financial assets in Mexico have exhibited a positive performance reflecting both the more favorable conditions that have prevailed in international financial markets as well as Mexico's monetary policy stance relative to that of other economies. Regarding the performance of the Mexican peso, one member noted that it appreciated slightly during this period, with an improvement in the measures of depth and volatility of the foreign exchange market. Some members considered that the Mexican peso has remained relatively stable since the end of December 2018. In this context, one member mentioned that the Mexican peso has reversed the losses observed at the end of 2018 and that the current low levels of volatility had not been observed since, at least, 2014. Another member highlighted that this behavior is noteworthy and reflects certain calmness despite the uncertainty associated with the change of administration and the start of a government with novel policies. One member emphasized that the performance of domestic markets was mixed, pointing out in this regard, that, although the Mexican peso had appreciated during part of the period since the monetary policy decision of February, such trend was recently reversed in view of concerns regarding the weakening of the world economy, thus the peso underwent a slight depreciation.

As to interest rates, most members mentioned that those of government securities decreased significantly during the period and that trading conditions in this market improved. One member pointed out that inflows to the fixed income market from foreign investors have continued, although in lesser magnitude than in previous months. In regards to Mexico's stock market, the same member underlined that this market fell, as a reflection of the latest quarterly results, which showed a deceleration of revenue growth and profit margins, stating that this might have been further influenced by the downward revisions in growth forecasts for the Mexican economy. As to sovereign risk premia, most members highlighted that they remained at high levels similar to those observed in the latest monetary policy decision while one member stated that they registered a decrease. Some members mentioned that the current levels of such premia are higher than those of other economies with a credit rating similar or even lower, than that of Mexico. In this regard, most members stressed that the presence of risk factors and uncertainty associated with the Mexican economy has led to an additional discount or risk premium for domestic assets.

Most members stated that risk factors persist that could affect the performance of domestic financial markets, among which Pemex's financial situation, its future economic viability and the implications this could have on its credit rating stand out. Such members noted that a deterioration in the credit rating of the state-owned company could lead to a revision in the rating of the country's sovereign debt, reducing the availability of financial resources for the economy and possibly causing episodes of volatility in Mexican financial assets as well as significant adjustments in investment portfolios. In this regard, one member warned that Pemex's debt accounts for a significant share in the portfolio of several institutional investors dedicated to emerging economies, which have exposure to a wide range of Mexican assets. Another member pointed out the nervousness of investors given the potential loss of Pemex's investment grade and the possible revision of the country's sovereign rating. In this context, all members considered that Pemex's financial challenges are a risk factor for the country's macroeconomic stability, as a deterioration of its credit rating could increase not only the cost of the country's sovereign debt, but also that of the private sector debt. One member added that the latter would affect businesses and households, making public and private investment more expensive, affecting overall spending as well. The same member considered that this could lead to a downturn in economic activity and, eventually, to a deterioration in the credit portfolio of commercial banks.

In this regard, most members highlighted the possible announcement of support measures for Pemex by the federal government. Some members agreed that the support could improve the company's short-term outlook, but most members pointed out that it should primarily address structural problems, strengthening its medium- and long-term capacity to generate value by means of a credible and functional business plan. One member argued that the measures announced so far to repair the company's financial position, although relevant, have been considered insufficient by the markets. This member indicated that, unless Pemex adopts a business model that allows a sustained recovery of its oil production capacity and that guarantees its financial viability without affecting the perspectives for solid public finances in the long run, such actions might be counterproductive, because they would probably not avoid a rating cut for Pemex, they would increase the vulnerability of public finances and they would affect the sovereign's risk. Another member mentioned that the proposal of using part of the funds from the Budget Revenue Stabilization Fund (*Fondo de Estabilización de los Ingresos Presupuestales*, FEIP) to grant a one-time financial support to Pemex as well as allowing the use of this fund as a countercyclical fiscal policy tool can have positive effects, but also entails risks. This member noted that the effectiveness of the support will not only depend on the amount, but on the destination of the resources. Finally, most members agreed that the support to be granted to Pemex should not affect the fiscal balance, in order to avoid an impact on Mexico's sovereign risk.

Most members emphasized the importance of sound public finances, so that together with a prudent monetary policy, a solid macroeconomic stance is maintained allowing the economy to face adverse scenarios. Such members also pointed out the importance of achieving the goal established in the 2019 Economic Package of a primary surplus of 1% of GDP. One member noted that, since the last monetary policy decision, concerns regarding insufficient public revenues relative to the projections in the Federal Income Law have increased. He/she mentioned that this could be the result of lower tax collection as a consequence of lower economic growth than forecast in the 2019 Economic Package, or from a greater-than-expected decline in the oil production platform.

Some members considered that the current environment continues to pose significant risks in the medium and long terms, which could affect the country's macroeconomic conditions, its growth potential and the economy's price formation process. Some members mentioned that, for this reason, it is necessary to adopt economic policy measures that foster an environment of confidence and certainty for investment, promote higher productivity, adequate resource allocation, competition, technological progress and human capital formation, and that also narrow opportunity gaps. Such members emphasized that, in order to achieve the abovementioned, it is necessary to strengthen institutions, to enforce the rule of law, to effectively fight corruption and to bring down insecurity. One member mentioned that, in particular, it is crucial to try to avoid the combination of an economic deceleration with the adoption of certain policies that might generate higher levels of inflation and maintain it above the target. He/she also pointed out that, in the presence of different adverse shocks, the Mexican economy has had to adjust to a lesser availability of external financial resources. Such member stated that this has required a significant depreciation of the real exchange rate and a further strengthening of macroeconomic policy. The same member considered that in order for this adjustment to be orderly and with the least possible impact on GDP, the exchange rate has to function as an adjustment variable and inflation must remain contained and near its target. He/she concluded that, for this reason, both monetary and fiscal policies had to be reinforced.

All members agreed 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. One member added that the foreseen trends of headline, core and non-core inflation seem to be the result of the credibility of Banco de México's decisions and of the functioning of monetary policy's transmission channels. Some members argued that the expectations of monetary policies in advanced economies more relaxed than previously anticipated increases the room for maneuver for monetary policy conduction in Mexico. Nevertheless, one member mentioned that although the moderation of expectations regarding monetary normalization in advanced economies diminishes the risks for monetary policy in Mexico, it does not change significantly the inflationary scenario faced by the Mexican economy.

Most members mentioned that slack conditions in the economy are foreseen to widen over the next quarters. In this regard, one member noted that Banco de México should monitor that the tight monetary policy does not remain in place for too long, in case the economy's slack conditions continue to widen. He/she considered that, otherwise, there is the risk of generating an over-adjustment of economic activity. In line with the above, such member argued that the recent behavior of total investment is concerning, since this variable has stagnated over the last years and has fallen in recent months. The same member warned that it is evident that this behavior cannot be decoupled from the high real interest rate levels prevailing in Mexico, since the policy interest rate is at its highest levels of the last 10 years. Such member added that, although the high interest rates contributed significantly to financial stability and to diminish inflationary pressures, partly due to an increase in capital inflows and to an appreciation of the Mexican peso, the prevalence of these interest rates at high levels could eventually contribute to generate undesired downward pressures on economic activity —especially in the export sector— and also to attract too-volatile capital inflows, which could increase the instability and vulnerability of the foreign exchange market in the long term. Such member concluded that, in this environment, the balance of risks for growth is clearly biased to the downside, while that for inflation is stable and, for this reason, unless something extraordinary occurs, the upward cycle of interest rates should be thought of as concluded. The same member underlined that the necessary room to begin a downward adjustment in the policy rate could be created in the near future, given that he/she considers that the level of such rate is consistent with the convergence of inflation to its target, and depending on how inflation behaves in the next weeks. Another member warned that if the current monetary policy is relaxed too soon, significant increases in volatility could be observed in domestic financial markets and this could have an impact on financial stability. While the same member agreed on the need to measure the negative consequences of maintaining a tight monetary policy for too long, he/she stressed the importance of considering the scope and limitations of monetary policy. The same member explained that monetary policy has only one instrument: the policy interest rate which aims to achieve a single objective, price stability. Such member emphasized that the latter is a necessary condition to achieve sustained growth in economic activity, but it is far from being a sufficient condition. He/she stressed that when monetary policy is used to attain two objectives, such as to contribute to improve public finances or to try to boost economic growth in the short term, it loses its effectiveness and there's the risk of not achieving any of the objectives at all. Such member mentioned that monetary policy can influence the cyclical behavior of the economy around its growth trend in the long term, but not the trend itself. The same member argued that, for this reason, the most important and solid contribution that monetary policy can make to the healthy economic development of the country is to seek price stability. The same member also stressed the importance of taking into consideration the natural lag with which monetary policy operates and in which it can effectively contribute to the commitment to price stability.

Most members expressed their concern about the persistence exhibited by core inflation. One member pointed out that such concern stems from the fact that the current monetary policy has been restrictive since early 2018, with an ex-ante real interest rate above its neutral level and that it is this component that should respond most to monetary policy actions. Another member added that its evolution should be a focus of attention for the central bank, given the degree of interrelation between inflation and its expectations. One member underlined that despite the tight monetary policy, the path of inflation foreseen by economic analysts is markedly above Banco de México's forecast. He/she argued that core inflation expectations for 2019 and 2020 suggest that core inflation will remain at its current levels, that is, analysts expect core inflation will not decrease in the next two years. He/she expressed that the fact that long-term expectations are at 3.50% might be of concern. However, he/she argued that, considering that such expectations are "adaptive", they could decrease in the medium term when inflation converges to its target. Another member noted that the increase in medium and long-term core inflation expectations is a cause of unease for the central bank. One member stressed that given the persistence of a situation of high uncertainty and upside risks to inflation, monetary policy must continue to emphasize prudence and the strengthening of its credibility. He/she indicated that in this sense, economic analysts' generalized forecasts of an easing of monetary policy in Mexico in a context in which short and long- term inflation expectations are above the 3% target are surprising. He/she highlighted that this suggests that the evolution of the reference rates drawn from analysts' surveys and from market instruments is not consistent, in their view, with the convergence of inflation to the target for the first half of 2020. He/she stated that, given the macroeconomic environment that is currently foreseen, achieving this will require a firm monetary policy to be in place for a prolonged period. Likewise, this and another member agreed that the behavior of inflation expectations described above reflects lack of credibility regarding the 3% target.

Most members mentioned that a prudent and firm monetary policy must be maintained in order to attain the convergence of inflation to its target in the time frame in which monetary policy operates and to promote the converge of inflation expectations to 3%. Some members stressed the above given the persistence of an environment of high uncertainty and of upward risks for inflation. One member pointed out that the contribution of persistence to core inflation is asymmetrical, that is, it increases more when inflation rises and persists for a long time when inflation decreases. He/she highlighted that, for this reason, it is essential to have patience when implementing a tight monetary policy in the periods after inflation increased significantly. Most members agreed that Banco de México must communicate a clear signal of prudence and commitment to its price stability mandate. Such members pointed out that the central bank will continue following closely the evolution of inflation, its determinants and its expectations and will adjust its monetary policy stance if necessary.

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. In this context, considering that the recent developments in inflation and its main determinants have not changed significantly with respect to their foreseen path, that the cyclical position of the economy has loosened somewhat, and that the current monetary policy stance is consistent with the convergence of inflation to its target, 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 low and stable inflation as well as those the economy's price formation is subject to, the Governing Board 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 time frame in which monetary policy operates.

Banco de México's Governing Board will maintain a prudent monetary policy stance and, under the current environment of uncertainty, will follow closely the potential pass-through of exchange rate fluctuations to prices, Mexico's monetary policy stance relative to that of the U.S. —in an external environment that it is still subject to risks — and the behavior of slack conditions in the Mexican economy. In the presence and possible persistence of factors that, by their nature, involve risks to both inflation and inflation expectations, monetary policy will be adjusted in a timely and 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. In regards to the first issue, I consider that the recent evolution of the different indicators of inflation in Mexico described in such document as well as the policy changes announced recently by the Federal Reserve and the European Central Bank, opened up the space for a press release with a more neutral tone. In regards to the second issue, I consider that the downside risks to inflation due to both a perspective for conditions of greater slack in the Mexican economy as well as a foreseeable worldwide economic deceleration, are high enough as to balance the potential upward risks that are identified in the document. It is worth adding that, in my assessment, the concerns about the potential impact on inflation of the increase in the minimum wage level or of a possible exchange rate pass-through, are smaller than as reflected in the monetary policy statement.

ANNEX

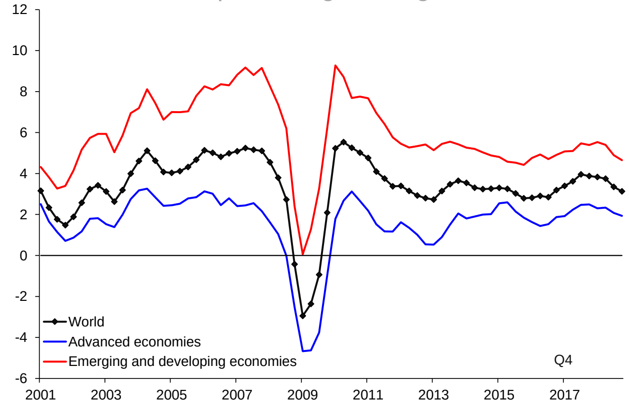
The information in this Annex was prepared for this meeting by the staff of Banco de México's General Directorate of Economic Research and General Directorate of Central Bank Operations and Payment Systems. It does not necessarily reflect the considerations of the members of the Governing Board as to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

A.1. External conditions

A.1.1. World economic activity

The weakening of world economic activity observed during the second half of 2018 (Chart 1) continued in the early part of 2019, as evidenced by a lower dynamism in most advanced and some emerging economies, such as the euro area, China, and, to a lesser extent, the United States. Indeed, indicators of manufacturing activity, capital goods orders and retail sales point to a lower world growth rate in the early part of the year. This has led to a downward revision of global growth expectations for 2019, although there are certain factors that could support an increase in growth in the second half of 2019, such as the economic stimuli in China; a partial improvement in financial markets; the fading of some idiosyncratic factors in the euro area; and a gradual stabilization in emerging economies, like Argentina and Turkey. Nevertheless, risks to global growth persist. Among those that stand out are a sharper deceleration of the euro area, Chinese and US economies than previously foreseen; uncertainty regarding trade disputes between the U.S. and China; a disorderly Brexit process; a lower-than-expected growth of the Chinese economy; and an escalation of political and geopolitical turmoil in different regions.

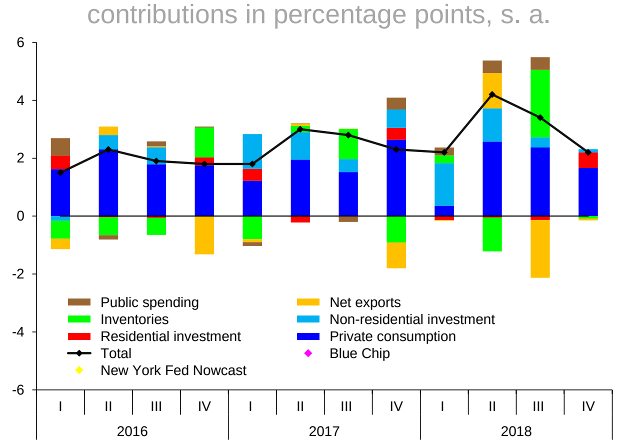
Chart 1
World GDP Growth
Annual percentage change, s. a.



s. a. / Seasonally adjusted figures.
Note: GDP calculations for Q4 2018 include estimates for some countries. The sample of countries used in the calculations accounts for 84.6% of world GDP measured by purchasing power parity.
Source: Prepared by Banco de México with data from Haver Analytics, J.P. Morgan and International Monetary Fund.

In the U.S., available indicators of domestic demand point to a deceleration of economic activity during the first quarter of the year, with GDP forecasts pointing to an annualized quarterly growth rate below 2%, after having grown 2.2% in the fourth quarter of 2018 (Chart 2). Although retail sales picked up significantly in January, after having fallen markedly at the end of last year, private consumer spending is expected to grow at a more moderate rate during the first quarter of 2019relative to the fourth quarter of 2018. On the other hand, shipments and capital goods orders suggest that non-residential investment may continue displaying weakness. Industrial production and exports also appear to be enduring the negative effects of the increasing trade disputes and the weakening of global growth.

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



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

In the U.S., industrial production remained practically unchanged in February, after having contracted at a monthly rate of 0.1% in January. This was due to the diverging behavior of its main components. On the one hand, the unusually low temperatures in February in several regions of the country explain the strong rebound of 3.6% in utilities. In contrast, manufacturing production contracted for the second consecutive month (monthly rates of -0.3% and -0.4% in January and February, respectively), reflecting the weakening of global demand, the appreciation of the US dollar, and a moderation of domestic demand in this country. In addition, mining contracted 0.2% due to the fall in the exploration and drilling of oil wells. The component of new orders of the manufacturing sector Purchasing Managers' Index (PMI), which had exhibited relative strength up until January, suggests that manufacturing production may weaken further over the next months.

The US labor market remained tight in early 2019. Although the monthly average growth of the non-farm payroll slowed down at the beginning of this year, as compared to the levels observed in 2018, the number of new jobs created remains above the increase in the labor force. The unemployment rate decreased once more, from 4.0% in January to 3.8% in February, a figure considerably below the estimated long-term level. This decline is explained partly by the return of federal employees who had been classified as unemployed during the partial government shutdown in the U.S. The increase in labor participation rates along with data on other indicators, such as job openings and quit rates, suggest a further tightening of the labor market. In this context, an increase in wage growth was observed.

In the euro area, economic activity continued to be affected by transitory factors. In particular, although for the region as a whole industrial production recovered in January, in Germany, it contracted again mostly due to a new downturn in vehicle production, which may be associated with a strike in an auto-parts factory. As for forward-looking indicators available up to March, the production item of the composite PMI reversed in this month most of the increase registered in February, mainly reflecting a fall in the manufacturing sector, while the component of manufacturing production of the IFO survey once again declined.

In Japan, available indicators of retail sales, capital goods orders, industrial production, and exports for the first quarter of the year point to a deterioration of domestic and external demand. The manufacturing sector's PMI continued to decrease, registering levels consistent with a contraction. Regardless of the latter, the unemployment rate remained near its lowest level of the last 25 years.

In emerging economies, available indicators as of the first quarter of the year show some stabilization of economic activity, after the weakening observed in the fourth quarter, though with heterogeneity among countries. In particular, indicators of Chinese industrial production, imports, and gross fixed investment show that this economy might be reducing its rate of deceleration in response to the introduction of a series of fiscal and financial stimuli. In the foreseeable future, greater economic activity is expected in both India and in a significant number of Latin American countries, while Russia and several Asian and European emerging countries are estimated to exhibit a lower dynamism.

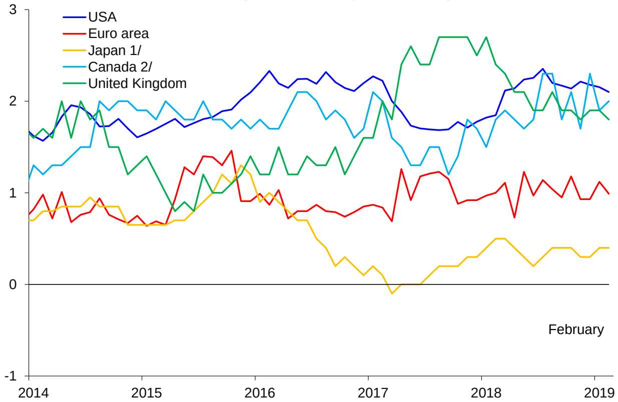
International prices of commodities have generally trended upwards over the last weeks. In particular, crude oil prices continued to recover mainly due to the fulfillment of oil production cuts by OPEC members and to the unexpected interruptions of oil production in Venezuela. Similarly, the prices of industrial metals have increased in recent weeks due to the improved outlook for the Chinese economy after the announcement of greater stimulus measures by the authorities of this country, and to progress in China's trade negotiation with the U.S. In contrast, grain prices, particularly wheat prices, fell due to signs of a larger world supply.

A.1.2. Monetary policy and financial international markets

In major advanced economies, headline inflation continued to decrease in the early part of 2019 due mainly to the lower energy prices observed in relation to the previous year, while core inflation has remained relatively stable (Chart 3). In the U.S., headline inflation as measured by the Consumer Price Index (CPI) decreased from 1.9% in December to 1.5% in February, while its core component went from 2.2 to 2.1%. The latter was due largely to a fall in the prices of certain medicines and of used cars. Additionally, inflation measured by the personal consumption expenditure deflator (PCE) has remained slightly below the Federal Reserve target, given that the possible effects of the imposition of trade tariffs on the price level may have been offset by the appreciation of the US dollar. In the euro area and Japan, core inflation remained at low levels and below their central banks' targets. Inflation expectations implied by market variables remain low in most advanced countries, suggesting that inflationary pressures are contained.

Chart 3
Selected Advanced Economies: Core Inflation

Annual percentage change

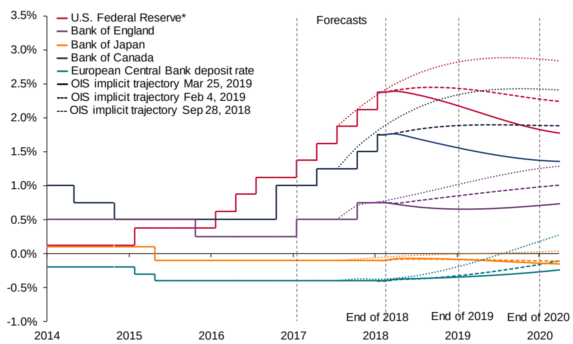


1/ Excludes fresh food, energy, and the direct effect of the consumption tax increase.
2/ Excludes food, energy, and the effect of adjustments on indirect taxes (CPI-XFET).
Source: Haver Analytics, BEA, Eurostat, and Statistics Bureau.

In an environment of a deteriorating outlook for global growth and of low inflation, expectations that the major central banks will not tighten monetary conditions in the foreseeable future have consolidated (Chart 4).

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 March 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, notwithstanding the strong labor market, available information points to a deceleration of economic activity in the early part of the year, vis-à-vis the still solid growth observed during the fourth quarter. Consistent with the above statement, the Fed adjusted downwards its growth expectations for 2019 and 2020 from 2.3 to 2.1%, and from 2 to 1.9%, respectively. Similarly, the median of its inflation forecasts went from 1.9 to 1.8% in 2019, and from 2.1 to 2% in 2020 and 2021, respectively. The FOMC also reiterated that it will be patient in making future adjustments to the target range. This is consistent with an expected slower trajectory of interest rate increases than previously anticipated. Indeed, the FOMC members adjusted their expectations of number of increases to the target range for 2019 from two in their forecasts of December to none in those of March, while leaving expectations of one increase of 25 basis points in 2020 unchanged. The federal funds rate futures even suggest one cut of 25 basis points in the reference rate for 2019 and another for 2020. The Fed also announced significant changes in the strategy for the normalization of its balance sheet, which consist in reducing the rate of decrease of its balance starting in May and concluding such process in September 2019.

In its March 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%. Additionally, the BCE revised downwards its growth and inflation forecasts for 2019 and 2020 and adjusted its forward guidance, pointing out that the key interest rates will remain at the current levels at least until the end of 2019 and not until summer, as it had been mentioning in its previous statements. The ECB also announced a new program of longer-term refinancing operations (LTRO) to help preserve favorable bank lending conditions and a better transmission of monetary policy. It also confirmed its intention to continue reinvesting its balance securities for an extended period of time, past the date when it starts raising its key interest rates.

In its March 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%. It also reiterated that it will continue with a highly accommodative monetary policy, keeping interest rates at low levels for as long as needed to reach its price stability target of 2%, highlighting that it will take into consideration the uncertainty on the development of economic activity and inflation, including the effects of the consumption tax increase programmed for the end of 2019. Although its statement noted that world economic conditions have worsened, which has lead in turn to a deterioration of Japanese exports and industrial production, it restated its outlook that domestic demand will continue its positive trend.

In its March meeting, the Bank of Canada left its policy interest rate unchanged at 1.75%. It pointed out that the global economy weakened more than anticipated in January and that it expects that this will lead to a lower growth of the Canadian economy during the first half of the year, vis-à-vis previous expectations. In this environment, the Bank of Canada modified its message regarding the expected path of its policy interest rate by stating that the current conditions indicate that the target rate will remain below its neutral level, as compared to previous statements where it noted that target rates should continue rising towards their neutral level in order to reach the inflation target. Finally, this central bank mentioned that it will follow the development of household spending, oil markets, and trade policies worldwide.

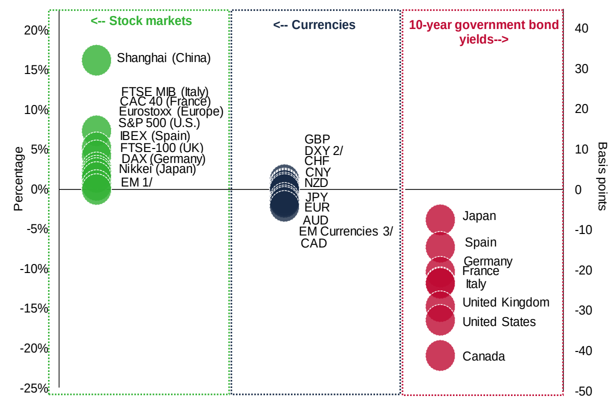
In its March meeting, the Bank of England left its base rate (Bank rate) unchanged at 0.75%. In its statement, the Monetary Policy Committee pointed out that available figures on economic activity had been mixed, emphasizing that, although the labor market has continued strengthening, surveys reflect that economic activity has continued to deteriorate, as originally anticipated in its economic forecasts published in February. Nevertheless, this central bank stressed that the uncertainty as to the conditions for the United Kingdom's withdrawal from the European Union (Brexit) has complicated the interpretation of recent economic figures. Regarding monetary policy, the Bank of England reiterated that it will adjust it in the direction that is required, depending on the balance of effects of Brexit on demand, supply and the exchange rate. It also highlighted that, if the path of economy activity is smooth and free of shocks associated with the new trade arrangements between the European Union and the United Kingdom, it would be expecting a gradual and limited increase of its reference rate.

In most emerging economies, inflation continued following a downward trend, mainly reflecting the decline in energy and food prices relative to the previous year as well as in global demand. In several cases, inflation was below the target of their respective central banks. Nevertheless, in particular cases, such as Russia and Argentina, measured inflation rebounded due to certain adjustments in taxes and subsidies. In this environment of lower risks to inflation, most central banks of emerging economies left their policy interest rates unchanged. In the specific case of India, its central bank cut its policy rate, pointing out that the negative output gap has widened.

International financial markets exhibited a favorable behavior, given expectations that the major central banks would be more cautious in adjusting their monetary policies and, consequently, keeping interest rates at lower levels than expected some months ago. Investors' concerns regarding certain risk factors have also diminished. In particular, there is the perception of a higher possibility of a trade agreement between the U.S. and China. In addition, the announcement of both fiscal and monetary measures by the Chinese authorities diminished concerns about this economy undergoing a sharper deceleration.

In advanced economies, stock market indices registered overall gains, the yield spreads on corporate bonds compressed, and interest rates of government bonds decreased (Chart 5). In foreign exchange markets (FX markets), the US dollar appreciated slightly against the currencies of other advanced economies, driven partly by the improved performance of the US economy relative to that of other advanced economies and by their interest rate differentials.

Chart 5
Change in Selected Financial Indicators (February 4, 2019 – March 22, 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.

In emerging economies, asset prices exhibited a diverging behavior and were highly sensitive to the monetary policies of advanced economies, to China's economic figures, to the trade negotiations between the U.S. and China, and to some idiosyncratic factors (Chart 6).

Chart 6
Emerging Economies: Financial Assets Performance between February 1, 2019 and March 25, 2019
Percent, basis points

Region	Country	Currencies	Equity markets	Interest rates 2Y	Interest rates 10Y	CDS
Latin America	Mexico	0.45%	-2.37%	-43	-53	-8
	Brazil	-5.40%	-4.29%	19	34	10
	Chile	-4.28%	-4.76%	-21	-23	2
	Colombia	-1.35%	9.50%	-18	-23	-10
	Argentina	-13.15%	-9.38%	104	86	185
Emerging Europe	Russia	2.17%	-0.96%	-88	-48	-5
	Poland	-1.33%	-1.49%	1	-12	-1
	Turkey	-6.56%	-3.51%	31	279	100
	Czech Republic	-1.38%	2.68%	0	10	-1
	Hungary	-0.86%	1.54%	-5	-15	-1
Asia	South Korea	-1.35%	-2.66%	-12	-21	-2
	Malaysia	0.64%	-2.04%	-9	-6	-13
	India	3.25%	3.67%	-84	-60	-18
	Philippines	-0.56%	-3.45%	-24	-30	-9
	Thailand	-0.98%	-1.54%	2	-8	3
	Indonesia	-1.72%	-1.95%	-44	-42	-19
Africa	South Africa	-7.37%	2.66%	4	4	24

Note: Interest rates correspond to interest rate swaps for 2-year/10-year maturities. In the case of Argentina, considering low liquidity and in order to reflect the performance of the fixed income market adequately, rates in US dollars are used.
Source: Bloomberg.

Going forward, investors are expected to remain cautious and attentive to the evolution of several risk factors that are still latent worldwide. Among those that stand out are the outcome of trade negotiations between the U.S. and its trade partners; the risk of a sharper deceleration of the world economy; and the negotiations regarding Brexit. In addition to the above, there is the possibility of an escalation of idiosyncratic and geopolitical events in different regions.

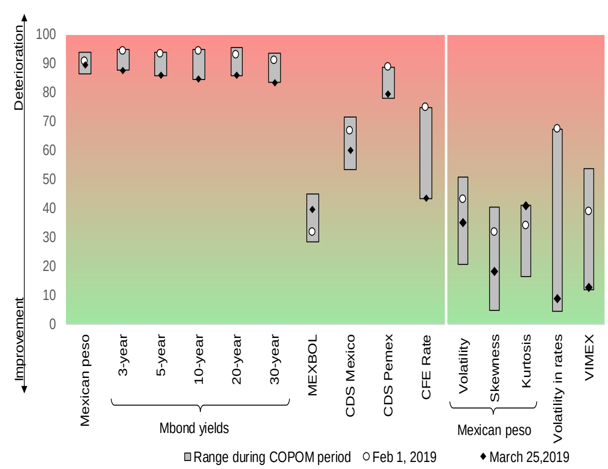
A.2. Current situation of the Mexican economy

A.2.1. Mexican markets

In the weeks after Banco de Mexico's latest monetary policy decision, the prices of financial assets in Mexico exhibited a relatively positive performance (Chart 7). Among the factors behind these results, the outlook that the main central banks of developed economies will continue with a much more gradual than previously expected normalization of their monetary policies, as well as Mexico's monetary policy stance relative to that of other economies are noteworthy. Nevertheless, it is important to point out that the period between monetary policy decisions in Mexico was not exempt from some episodes of volatility generated by news about the credit rating of Mexico's sovereign debt as well as of Pemex's. In this regard, the announcement that the credit outlook of both Mexico and Pemex was being revised from stable to negative by the S&P rating agency, and the publication of a document by Moody's stating that the announced support measures for Pemex by the Federal Government are negative for Mexico's sovereign rating. In this context, some risk factors and the uncertainty associated with the Mexican economy have led to an additional discount or risk premium for domestic assets.

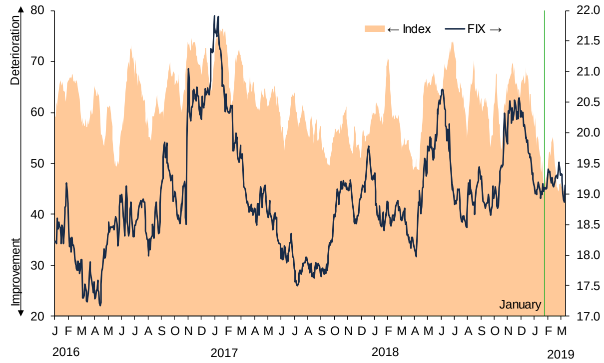
Despite the aforementioned, the peso exchange rate appreciated by 0.5% during the reference period. Trading conditions in the foreign exchange market improved, as compared to the previous period (Chart 8). Similarly, forward-looking conditions implied by exchange rate options (FX options), measured using volatility and depreciation bias in the short term, improved. Finally, exchange rate expectations by several financial institutions' forecasters for the end of 2019 were adjusted downwards, from 20.33 to 20.10 pesos per US dollar, while those for the end of 2020 were adjusted upwards, from 20.00 to 20.15 pesos per US dollar (Chart 9).

Chart 7
Mexican Markets' Performance and Trading Conditions
Pesos per US dollar



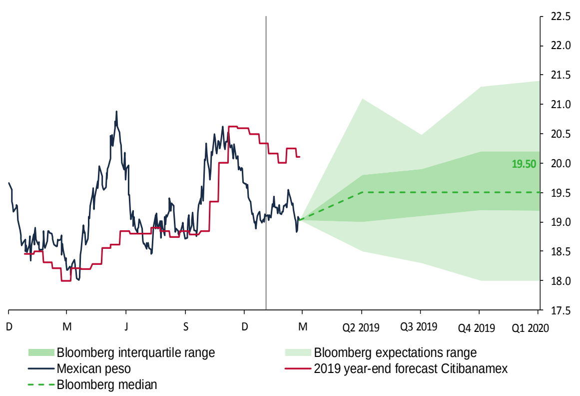
Note: The percentile distribution with levels as of 2007 is considered, except for the Federal Electricity Commission (CFE, for its acronym in Spanish) bond, where the 10-year bond is considered since its issuance; and for the CPI, where the inverse distribution of the levels is used. For the Mexican peso's exchange rate volatility, skewness and kurtosis, the levels implied in 1-month exchange rate options are considered. For the interest rate volatility, a Garch model (1,1) is used.
Source: Calculated by Banco de México with Bloomberg and PIP data.

Chart 8
Mexican Foreign Exchange Market Trading Conditions
Index (10-day moving average)



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

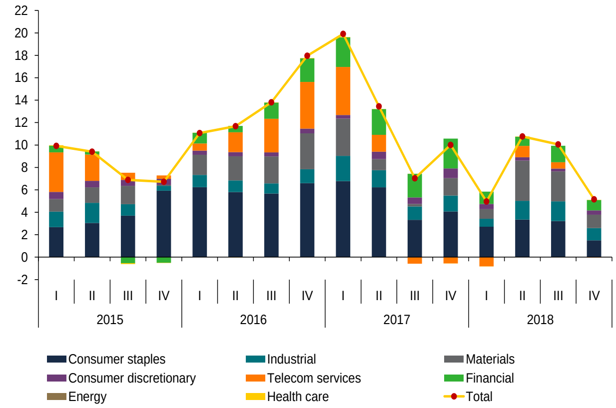
Chart 9
Analysts' Mexican Peso Exchange Rate Expectations for Each End of Quarter
Pesos per US dollar



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

The revision of economic growth forecasts for Mexico by several private sector forecasters and multilateral organizations apparently had a negative impact on the Mexican stock exchange (BMV, for its acronym in Spanish), whose main benchmark index (known as IPC) fell by 2.4% during the reference period. Indeed, the BMV's latest quarterly financial results indicate a deceleration of revenue growth and profit margins for the main Mexican firms listed (Chart 10).

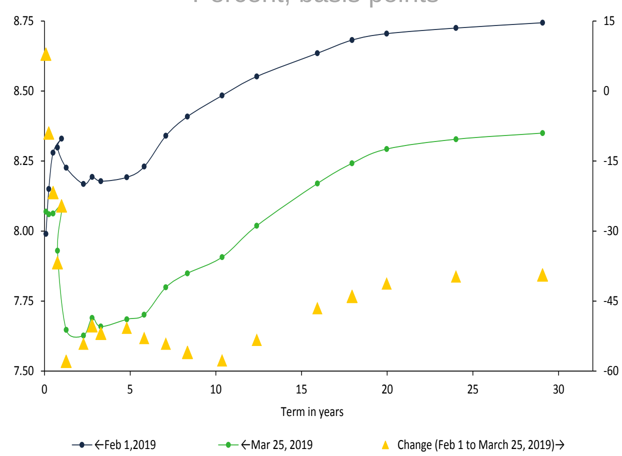
Chart 10
Annual Revenue Growth of Firms Listed in the BMV Mexican Stock Exchange
Percent



Source: Prepared by Banco de México with Bloomberg data.

Interest rates of government securities with more-than-one year maturities decreased between 37 and 58 basis points (Chart 11). These reductions took place in a context in which trading conditions in that market remained stable throughout the analyzed period (Chart 12).

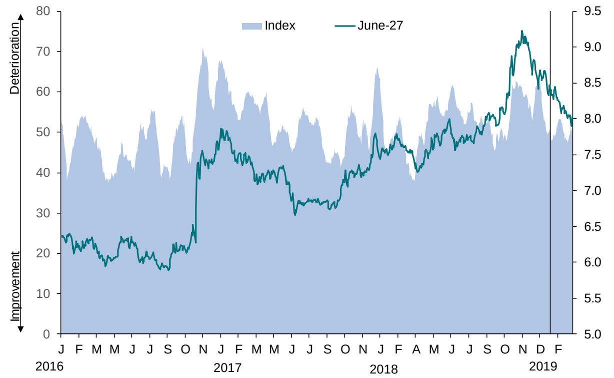
Chart 11
Nominal Yield on Government Securities
Percent, basis points



Source: PIP.

Chart 12
Index of Mexican Government Debt Market Trading Conditions

Index (10-day moving average), percent

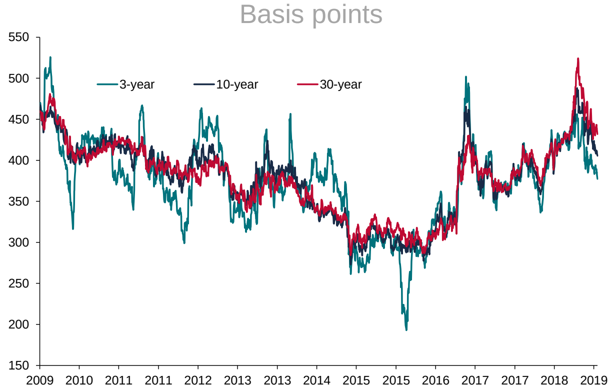


Note: Index calculated with the changes in bonds' interest rates, volatility of events, bid-ask spread, the average of the differences in quotes of intra-day operations, and the daily interbank and customer traded volume. Considering the aforementioned, percentiles since 2016 and the average of percentiles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

The real yield curve decreased between 23 and 34 basis points for their different terms. Thus, both inflation compensation and inflation risk premia implied in the spreads of nominal and real rates of market instruments decreased between 15 and 34 basis points, remaining, on average, at levels of 413 basis points (Chart 13). Expectations regarding the level of the monetary policy target rate implied in the yield curve structure were adjusted downwards vis-à-vis the levels of the previous period (Chart 14). Nonetheless, markets are not anticipating adjustments to the target rate in the monetary policy decision of March, in line with expectations of forecasters surveyed by Citibanamex. As for expectations for the target rate for the end of 2019, markets anticipate that it will end the year at 7.65%, while the median of forecasters is 8.00%.

Chart 13
Inflation Compensation and Inflationary Risk Implied in Government Securities' Yield Curve

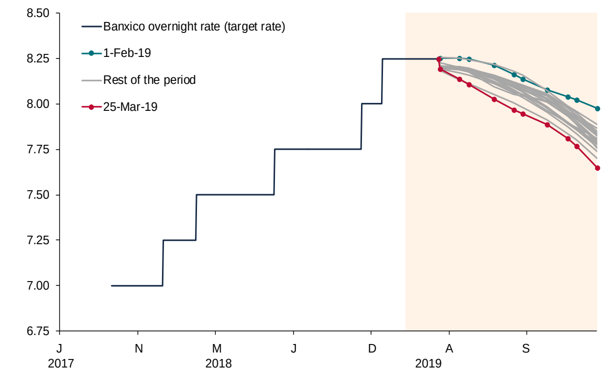
Basis points



Source: Prepared by Banco de México with Bloomberg data.

Chart 14
Banxico Overnight Interbank Rate Implied in TIIE IRS Curve

Percent



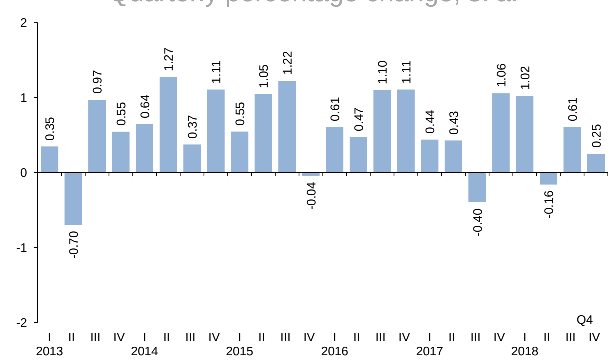
Source: Banco de México with PIP data.

A.2.2. Economic activity in Mexico

During the fourth quarter of 2018, Mexico's economic activity decelerated significantly as compared to the third quarter (Chart 15). Available information suggests that in the early part of 2019 economic activity continued registering low growth, as a result of the slowdown of the world economy, some weakness in domestic demand, and certain transitory factors.

Chart 15
Gross Domestic Product

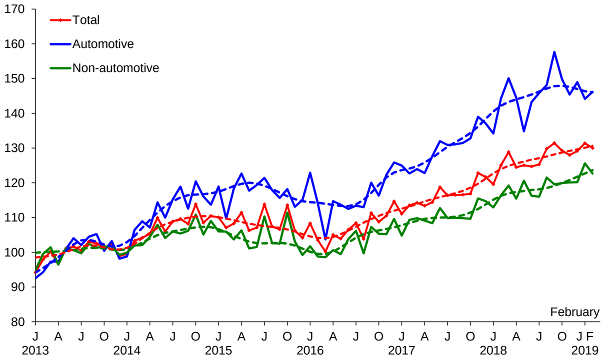
Quarterly percentage change, s. a.



1/ Figures for the fourth quarter of 2018 correspond to INEGI's GDP quarterly flash estimate.
Source: Mexico's National Accounts System (SCNM, for its acronym in Spanish), INEGI.

During January and February 2018, manufacturing exports remained on a positive trend due to the performance of non-automotive exports, while automotive exports displayed a slight downward path (Chart 16). By destination, exports to the U.S. continued trending upwards, although at a lower growth rate, while those to the rest of the world slightly recovered.

Chart 16
Total Manufacturing Exports
Index 2013 = 100, s. a.

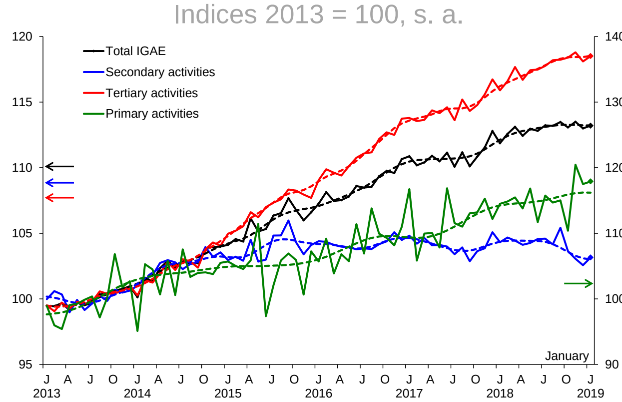


s. a. / Seasonally adjusted series and trend series based on data in nominal USD. The former is represented by a solid line and the latter by a dotted line.
Source: Prepared by Banco de México with data from the Tax Administration Service (SAT, for its acronym in Spanish), the Ministry of the Economy (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, private consumption decelerated at the end of 2018 vis-à-vis the growth rate observed in previous months. This downturn reflected the weakness of consumption of goods and a certain loss of dynamism in the consumption of services. Timely indicators of consumption, albeit of less coverage, suggest that the lower dynamism of private consumption may continue in the early part of 2019. Indeed, at the beginning of 2019, retail stores revenues, domestic sales of manufacturing industries, as well as sales of light vehicles continued on a downward path. At the end of 2018, the negative trend that gross fixed investment —both in machinery and equipment as well as in construction — had been exhibiting since the early part of 2018 steepened, keeping investment at low levels.

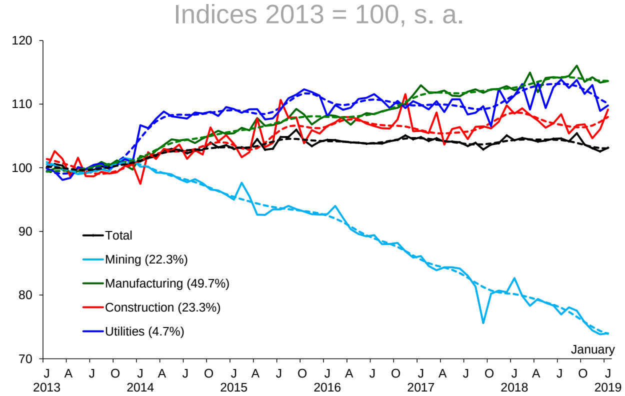
As for production, despite the improvement registered in January 2019, industrial activity continued exhibiting a weak performance, while services slightly decelerated (Chart 17). In particular, although construction rebounded in the first month of 2019, manufacturing continued to show lack of vigor and mining activities remained on a downward trend (Chart 18). On the other hand, the evolution of services at the beginning of the year might be related to the weak results of different services more related with consumption, such as those of entertainment and recreation; temporary accommodation and food services; and those linked with transportation and information industries, which might have been affected by different transitory factors. In contrast, the items professional, scientific and technical services; management of companies and enterprises; administrative and support, waste management and remediation services; finance and insurance and real estate and rental and leasing; wholesale trade and retail trade; and public administration contributed positively to this sector.

Chart 17
Global Index of Economic Activity
Indices 2013 = 100, s. a.



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

Chart 18
Industrial Activity
Indices 2013 = 100, s. a.

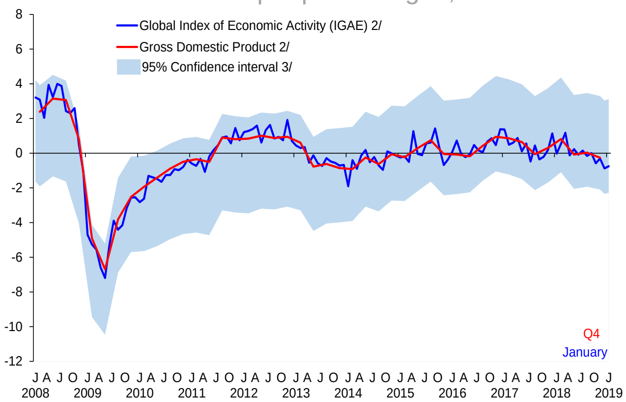


s. a. / Seasonally adjusted and trend series. The former is represented by a solid line and the latter by a dotted line.
Source: Mexico's National Accounts System (SCNM, for its acronym in Spanish), INEGI.

As for the economy's cyclical position, slack conditions are deemed to have eased towards the end of 2018 and the early part of 2019, (Chart 19). As to the labor market, in January and February both the national and urban unemployment were at levels above those of the fourth quarter of 2018 (Chart 20). Although in the early part of 2019 the number of IMSS-insured jobs continued exhibiting a positive trend, its growth rate has lost dynamism since mid-2018. At the beginning of 2019, unit labor costs in the manufacturing industry maintained an upward trend (Chart 21).

Chart 19
Output Gap Estimates [1/]
Excluding Oil Industry [4/]

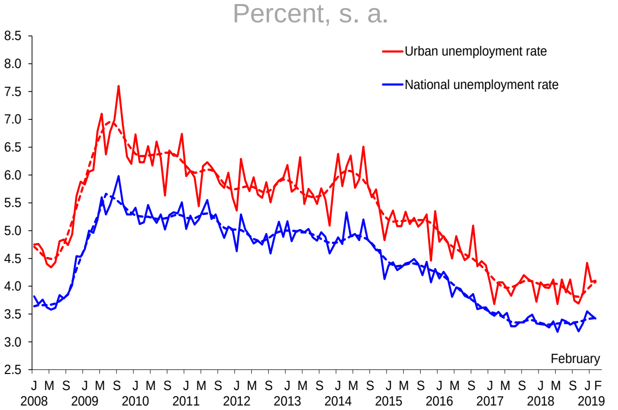
Potential output percentages, s. a.



s. a. / Seasonally adjusted figures.
1/ Output gap estimated with a tail-corrected Hodrick-Prescott filter; see Banco de México (2009), "Quarterly Report (April-June 2009)", p.74.
2/ GDP flash figures up to the fourth quarter of 2018; IGAE figures up to January 2019.
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 20
National Unemployment Rate and Urban Unemployment Rate

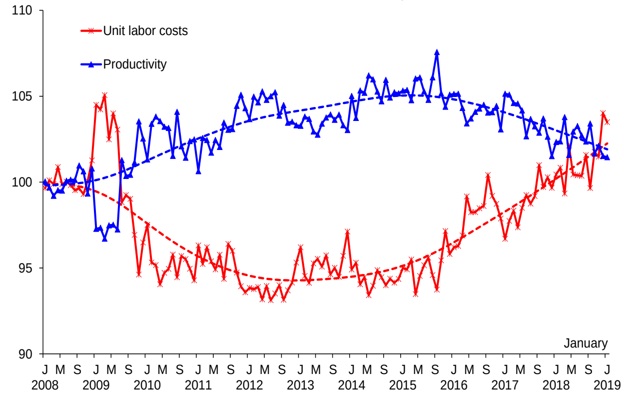
Percent, s. a.



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 21
Manufacturing Productivity and Unit Labor Costs [1/]

Indices 2008 = 100, s. a.



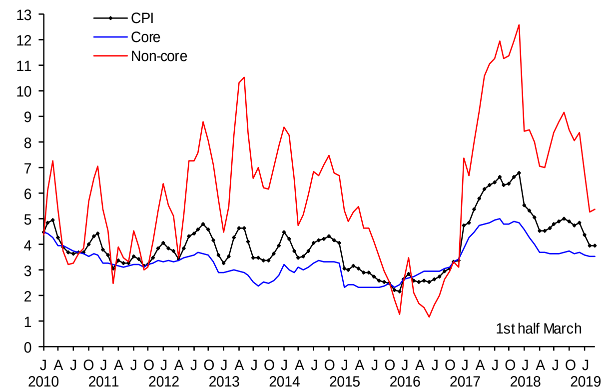
s. a. / Seasonally adjusted and trend series. The former is represented by a solid line and the latter by a dotted line.
1/ Productivity based on hours worked.
Source: Prepared by Banco de México with seasonally adjusted data from the Monthly Manufacturing Survey and industrial activity indices of INEGI's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

In January 2019, domestic financing to the private sector seemed to have ended the decelerating trend that began to be observed since the second half of 2018, and which was noticed mainly in the growth rate of firms financing, while lending to households grew at a relatively lower and stable pace. Regarding interest rates, those related to firms financing have continued to respond to the reference interest rate and thus, although they did not change at the margin, they are at the highest levels registered since the second quarter of 2009. Meanwhile, interest rates of housing credit have remained stable since the second quarter of 2017, whereas in the segment of consumer credit interest rates have remained practically unchanged, with the exception of those of credit cards, which have trended upwards since December 2015. 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 continue being at high levels.

A.2.3. Developments in inflation and inflation outlook

Between January and the first two weeks of March 2019, annual headline inflation decreased from 4.37 to 3.95%. This result was mainly due to the reduction of non-core inflation, while core inflation continued to exhibit resistance to decline (Chart 22 and Table 1). Nevertheless, some of the favorable shocks that have led to the fall in non-core inflation have recently started to revert. In particular, during the second half of February, new increases in energy prices were registered.

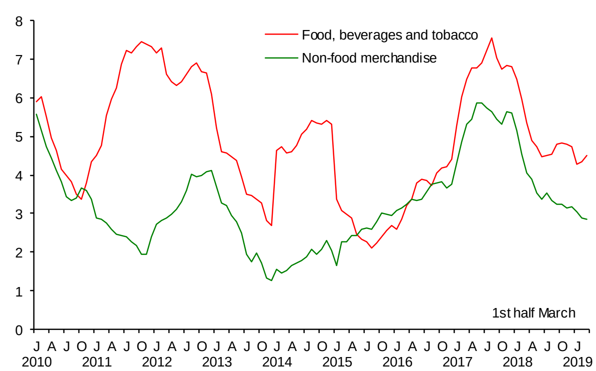
Chart 22
Consumer Price Index
Annual percentage change



Source: Banco de México and INEGI.

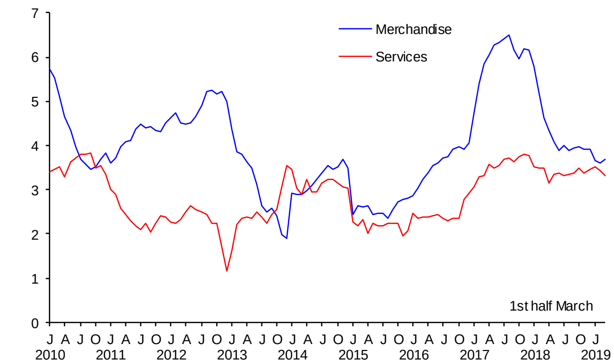
As for annual core inflation, it went from 3.60 to 3.51% between January and the first two weeks of March 2019. Although the annual rate of change of non-food merchandise prices continued trending downwards, that of food merchandise prices has been increasing since February (Chart 23). At the same time, the annual rate of change of services prices decreased due to the lower increases in the prices of tourist services and telecommunications (Chart 24). Nevertheless, the prices of some services continued to exhibit high annual rates of change and do not show a clear downward trend.

Chart 23
Merchandise Core Price Subindex
Annual percentage change



Source: Banco de México and INEGI.

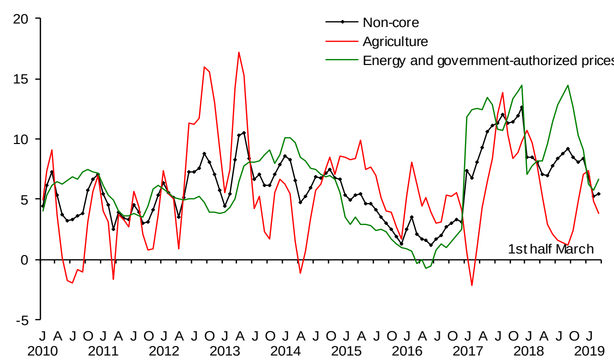
Chart 24
Merchandise and Services Core Price Subindex
Annual percentage change



Source: Banco de México and INEGI.

Moreover, annual non-core inflation fell from 6.81 to 5.39% between January and the first two weeks of March 2019. This reduction was due mainly to the lower increases in agricultural products and energy prices, although the latter reversed to an upward trend in the last two weeks of February (Chart 25 and Table 1), especially gasoline and LP gas prices, which reflected the increase in their corresponding international references.

Chart 25
Non-core Price Subindex
Annual percentage change



Source: Banco de México and INEGI.

The medians for short-term inflation expectations drawn from surveys exhibited mixed adjustments. Regarding those from Banco de México's Survey of Private Sector Forecasters, between January and February the medians of end-of-year headline inflation expectations for 2019 and 2020 were revised downwards, from 3.80 to 3.65% and from 3.71 to 3.60%, respectively. This decrease is explained by a reduction in implied non-core inflation expectations (from 4.73 to 4.11% and from 4.51 to 3.97%, respectively), given that the medians of core inflation expectations for 2019 remained unchanged at 3.50% and those for 2020 rose from 3.45 to 3.48%. The medians of headline inflation expectations for the following 12 months —relative to the month in which data is collected and to the subsequent month — increased from 3.98 to 4.17% and from 3.98 to 4.10%, respectively. The median of headline inflation expectations for the medium term (next four years) declined from 3.53 to 3.50%. The median for the longer term (next five to eight years) remained stable at around 3.50%. Nevertheless, it is worth noting that the median of medium-term core inflation expectations was adjusted upwards to 3.50%, while that for the longer term remained at levels close to 3.40%, after being at 3.30% during most of 2018. Thus, both headline and core inflation expectations remain above the 3.00% headline inflation target. Finally, inflation expectations implicit in market prices of long-term money market instruments (drawn from 10-year government bonds) remained at levels close to 3.5%, while the inflation risk premium decreased, although it remains at relatively high levels.

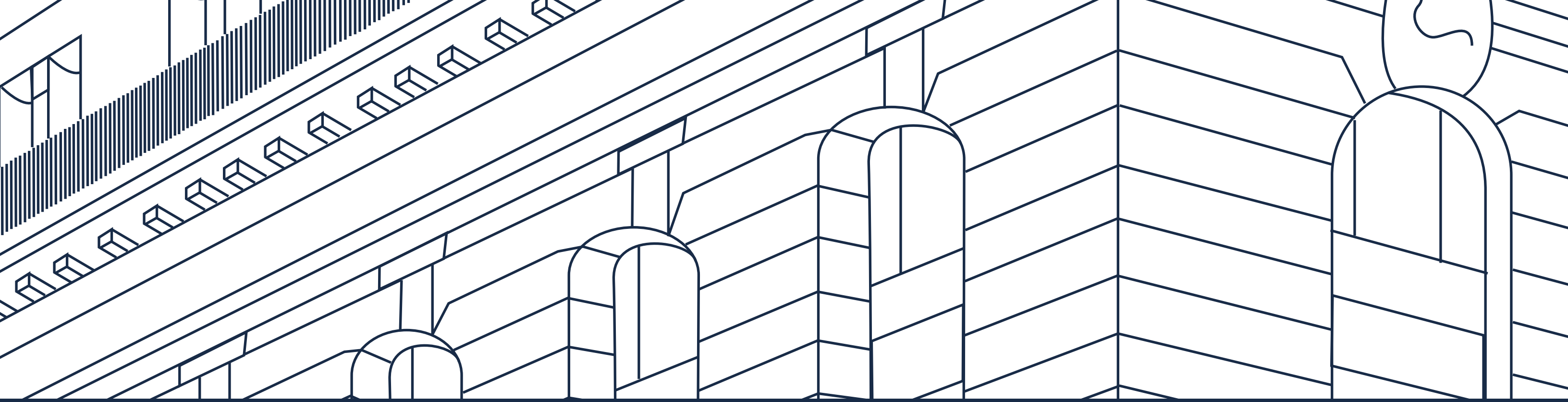
Considering the monetary policy stance and the timeframe in which it operates, as well as available data on inflation determinants, including the current economic environment and the economy's business cycle phase, forecasts for annual headline inflation continue to anticipate that it will reach levels close to Banco de México's target during the first half of 2020. Similarly, annual core inflation is expected to be at levels around 3% in the first half of 2020.

The abovementioned forecasts are subject to risks within the timeframe in which monetary policy operates. Among such risks, the following stand out. To the upside: that the peso exchange rate is pressured by external and domestic factors; that more pressures are observed on energy prices or new increases on agricultural and livestock product prices; that an escalation of protectionist and compensatory measures worldwide materializes; that public finances deteriorate; and, considering the magnitude of the recent minimum wage increases, there is also the risk that these bring about wage revisions that exceed productivity gains and give rise to cost pressures, affecting formal employment and prices; and that the persistence shown by core inflation also gives rise to a greater resistance of long-term inflation expectations to decline. To the downside: that certain goods included in the non-core subindex exhibit lower price variations; and, that slack conditions widen more than foreseen. Altogether, although there has been an intensification of some downside risk factors, there are still others that might put upward pressure on inflation in greater magnitude and make it deviate from its foreseen path. For this reason, the balance of risks for the forecasted trajectory for inflation still remains to the upside, in an environment of marked uncertainty.

Table 1
Consumer Price Index and Components
Annual percentage change

Item	January 2019	February 2019	1st half March 2019
CPI	**4.37**	**3.94**	**3.95**
Core	**3.60**	**3.54**	**3.51**
Merchandise	**3.66**	**3.61**	**3.68**
Food, beverages and tobacco	4.30	4.34	4.52
Non-food merchandise	3.03	2.90	2.86
Services	**3.51**	**3.43**	**3.31**
Housing	2.59	2.62	2.66
Education (tuitions)	4.68	4.84	4.84
Other services	4.28	4.02	3.67
Non-core	**6.81**	**5.25**	**5.39**
Agriculture	**7.41**	**4.80**	**3.80**
Fruits and vegetables	13.23	10.68	10.21
Meats, poultry, fish and eggs	1.95	0.77	-0.33
Energy and government-authorized prices	**6.26**	**5.73**	**6.70**
Energy products	7.36	6.57	7.94
Government-authorized prices	**3.45**	**3.43**	3.36

Source: INEGI.



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