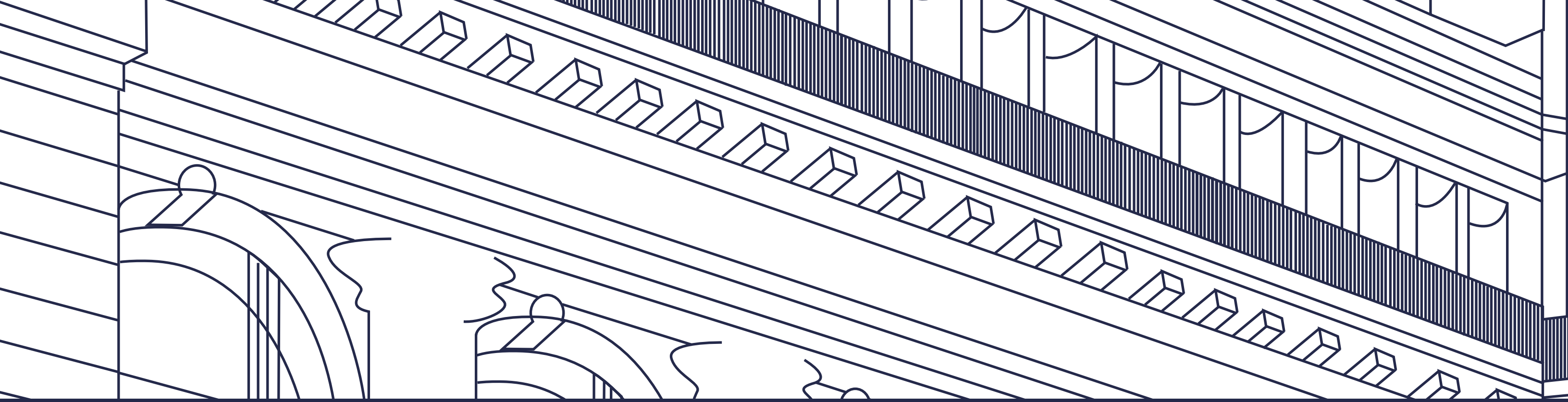

BANCO DE MÉXICO

Minutes number 60

Meeting of Banco de México's Governing Board on the occasion of the monetary policy decision announced on June 21, 2018

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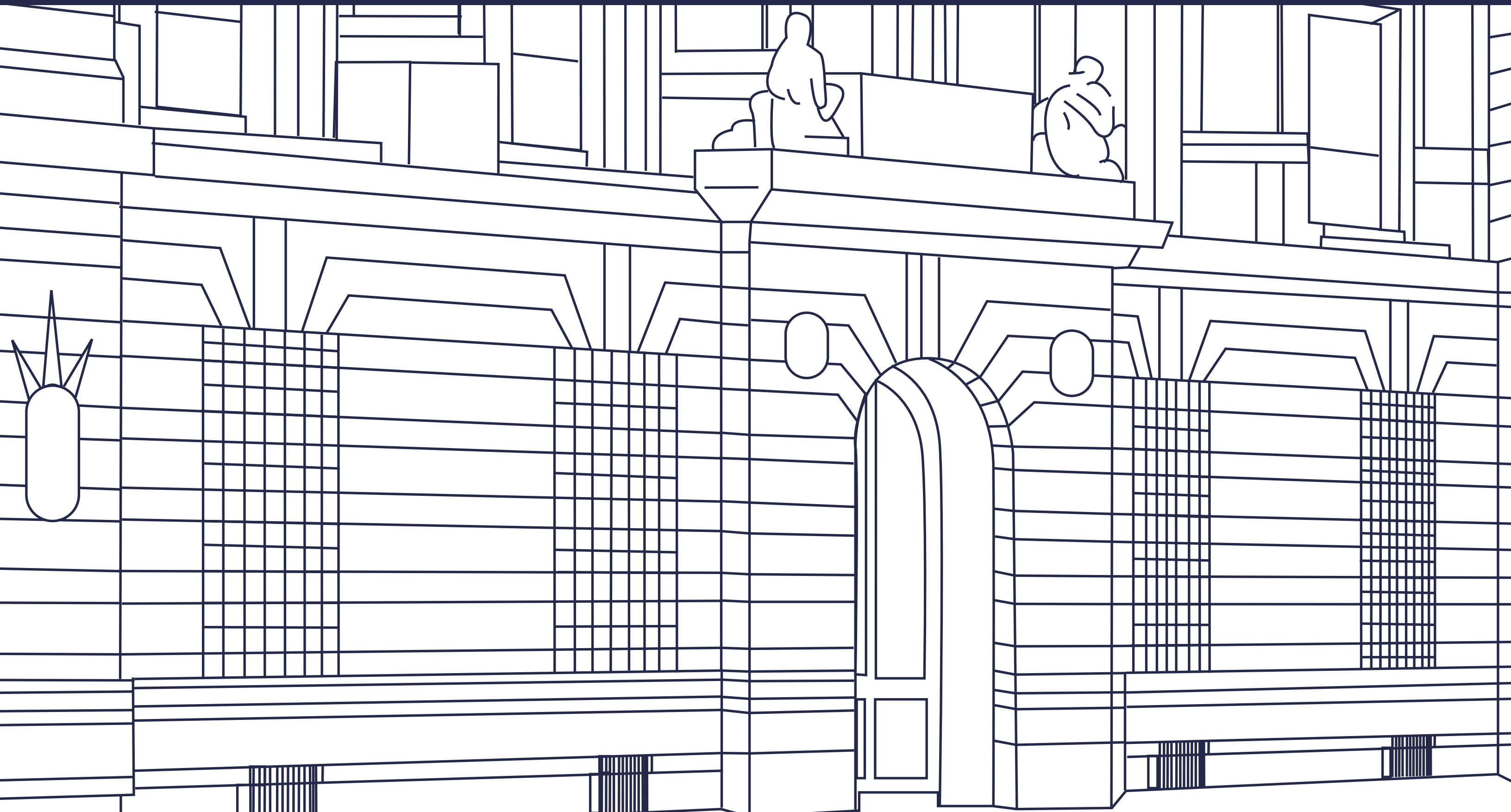

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1. PLACE, DATE, AND PARTICIPANTS

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

1.2. Date of Governing Board meeting: June 20, 2018

1.3. Participants:

Alejandro Díaz de León-Carrillo, Governor

Roberto Del Cueto-Legaspi, Deputy Governor

Irene Espinosa-Cantellano, Deputy Governor

Javier Eduardo Guzmán-Calafell, Deputy Governor

Manuel Ramos-Francia, Deputy Governor

José Antonio González-Anaya, Secretary of Finance and Public Credit

Miguel Messmacher-Linartas, Undersecretary of Finance and Public Credit

Fernando Luis Corvera-Caraza, Secretary of the Governing Board

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

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

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

All members highlighted that, according to available data, the world economy increased its growth rate during the second quarter of 2018. Some members pointed out that this increase was the result of higher growth in advanced economies. One member noted that this was due to temporary factors that faded out and had affected the dynamism of some of these economies at the beginning of the year. Nevertheless, most members highlighted that economic growth among advanced economies has started to show signs of divergence, emphasizing that, in contrast with the United States, where a stronger upswing in economic activity is expected, the rest of the advanced economies have exhibited signs of lesser dynamism.

Most members pointed out that the forecasts for world economic growth for 2018 and 2019 have remained practically unchanged. One member stated that growth rates are expected to be higher than those for 2017 and to be above potential. Notwithstanding the above, most members mentioned that both uncertainty in the short run, and medium run downside risks to world economic growth, have increased. Such members pointed to three risks that stand out: i) the intensification of protectionist trade measures; ii) a possible tightening of financial conditions caused by a faster pace of normalization of monetary policy by the Federal Reserve, in case of inflationary surprises in the United States; and, iii) the escalation of certain geopolitical risks. Some members added that the protectionist actions adopted by the United States have led to retaliatory trade measures by other countries, and that the possible escalation of these could have significant effects on global trade and investment. One member pointed out that these events could significantly reduce international trade flows, even in countries not directly involved. In this regard, the same member highlighted that, according to recent estimates, increases in tariff barriers to levels authorized by the WTO, could result in a reduction of world trade similar to that observed in 2008-2009, affecting to a larger extent emerging and developing regions. This member stated that this is particularly relevant in view of the importance of international flows of merchandises and services for world growth. In this regard, another member noted that growth figures for world trade volume already show a clear reversion.

Regarding geopolitical risks, one member argued that such episodes could have a negative effect not only on economic activity of the regions involved, but also on the world economy, mainly through its effect on investment. This member also added that although the world's geopolitical situation apparently has improved after the recent meeting between the Presidents of the United States and North Korea, tensions in other fronts persist and are at risk of intensifying. Additionally, this member stated that, on top of these challenges, there are those related to election processes and to political developments in different countries, both advanced and emerging.

Another member added that world economic growth is forecasted to decrease in the medium term, in so far as slack conditions worldwide become tighter, investment and trade moderate, the effects of the U.S. tax reform fade out, the economic stimulus generated by China dissipates, and financing conditions grow tighter.

As for world inflation, most members pointed out that there is also some divergence in the behavior of inflation and its expectations in advanced economies. The majority emphasized that inflation has increased in the United States, while some added that inflation remains at low levels in other advanced economies. As for the balance of risks to world inflation, one member pointed out that it remains relatively stable in the short-term, albeit with mixed signs. Some members mentioned that one of the main risks to world inflation is the intensification of trade tensions among some of the major world economies. One member added that other risk factors to inflation persist, including: i) a faster rate of increase of U.S. inflation; ii) a continuation of the upward trend in the prices of commodities; and, iii) problems in some emerging economies that have external or fiscal imbalances.

Regarding economic activity, most members pointed out that the outlook for the U.S. economy has strengthened. Some members highlighted the upswing in U.S. growth during the second quarter of 2018, driven by the recovery of private consumption, pointing out that these results are consistent with the increased levels of consumer confidence and disposable income. One member added that fixed investment has exhibited a strong recovery as well. Another member stated that the U.S. economy has undergone an atypical cycle, characterized by a gradual and widespread recovery, which has narrowed the output gap and led to historically low levels of unemployment. In this context, most members emphasized that the labor market has continued to strengthen and that slack conditions have tightened. Most members noted that U.S. economic activity is expected to grow at a strong pace in 2018 and 2019, and one member stated that the environment is more uncertain for the medium and long terms.

As for other advanced economies, most members noted that in contrast with the United States, the Eurozone has grown at a slower pace during the second quarter of the year, and doubts persist as to the soundness of its recovery. One member mentioned that this has occurred in an environment where political tension in Italy and Spain has intensified and concerns about the possibility of additional protectionist measures have increased. Regarding Japan, another member mentioned that expectations for the Japanese economy's growth this year have been revised slightly downwards.

As to inflation in the major advanced economies, most members pointed out that in the case of the United States inflation and inflation expectations have already started to increase. These members argued that the fiscal stimulus adopted, in the context of reduced slack in the economy, particularly in the labor market, might lead to greater pressures on wages and prices. One member added that the possible impact of protectionist measures and the recovery of the prices of fuels and other commodities could also contribute to an uptick in inflation. In this regard, one member pointed out that financial markets suggest that the balance of risks to inflation is somewhat biased upwards. In this regard, all members emphasized that there is a risk that inflationary surprises may arise in the United States. Another member stated that inflation has not only increased in the United States, but also in Canada, in contrast with that of Japan and the Eurozone, where it remains weak and below their central banks' targets.

Most members stated that, given the divergence in the behavior of both economic activity and inflation among the major advanced economies, the observed and expected trajectories of monetary policy have also exhibited some divergence. One member pointed out that, in view of expectations of a generalized increase in inflation, monetary policy in some advanced economies is foreseen to turn less accommodative. Nevertheless, the same member noted that this process will be faster in the United States than in other countries. Elaborating on the case of the United States, most members pointed out that, as expected, in its June decision, the Federal Reserve raised the target range for the federal funds rate by 25 basis points, to between 1.75 and 2.00%. One member stated that the language in its FOMC statement points to a faster process of monetary policy normalization. Most members highlighted that this committee increased its median forecasts for the expected trajectory of the federal funds rate for the end of 2018 and for 2019, and thus is expecting two additional increases of 25 basis points each for the rest of the year. One member noted that the forecast for the reference rate for the end of 2019 is already above the Federal Reserve's long-run estimate. The same member emphasized that the Federal Reserve raised its projections for economic growth for 2018, for inflation for 2018 and 2019, and lowered those for unemployment for 2018, 2019, and 2020. Some members emphasized that the Federal Reserve reiterated its expectation that inflation will be near its symmetric 2% target in the medium term. In this context, most members concluded that the expected path is consistent with a scenario of gradual adjustments in the federal funds rate. One member pointed out that the scenario of higher inflation in the U.S. is being adjusted by the Federal Reserve with no distress, and that the baseline scenario for inflation in that country does not consider adverse inflationary shocks. However, all members highlighted that, given the possibility of inflationary surprises, the risk that the Federal Reserve may follow a faster-than-expected normalization of its monetary policy persists. One member mentioned that there is a higher probability of this event given the increase of both inflation and inflation expectations. The same member also pointed out that said normalization process is not expected to be accompanied by excessive volatility. Regarding the monetary policy of other advanced economies, one member pointed out that, given the moderate growth of inflation in the Eurozone, the European Central Bank kept its reference rate unchanged, stating that it is expecting to keep it at the current level until at least the summer of 2019 or until necessary. Another member stated that in view of these messages, markets incorporated a delay in the expected date for increases in the Eurozone reference rates until the fall of 2019. One member highlighted that the Bank of England and the Bank of Japan also kept their reference rates unchanged. Nevertheless, the same member pointed out that the Bank of England is expected to tighten its stance later this year, while the Bank of Japan is expected to continue with a highly accommodative stance possibly until 2020. In this context, one member estimated that, in general terms, the U.S. dollar is expected to follow an appreciation trend in the following quarters and that the spreads in both the levels and expected trajectories of interest rates between the United States and other advanced economies will be higher and probably more volatile.

As to emerging economies, one member stated that these continue to grow at a fast pace, although exhibiting downside risks. The same member highlighted that the Chinese economy is gradually slowing down due to its position in the business cycle. However, this member stated that the slowdown could be greater as a result of the elimination of tax benefits and the escalation of a possible trade war. This member also pointed out that the scenario for inflation among emerging economies is also heterogeneous and that the recent depreciation of some currencies and the increase in the prices of commodities have heightened the risk of higher inflation in these economies. The same member pointed out that while some emerging countries have loosened their monetary policy stances, Argentina, Indonesia, Romania, and Turkey have adopted tighter monetary policy stances, due to their position in the business cycle and inflationary pressures.

Most members highlighted that the world economic environment described above has led to greater volatility in international financial markets and to interest rate increases. In particular, one of the members pointed out that interest rates of U.S. 2-year Treasury bonds have hit levels above 2.5% and also registered an increase of over 120 basis points since September, while 10- to 30-year Treasury bonds have yields of 2.9% and 3.0%, corresponding to increases of over 80 and 35 basis points, respectively, during the same period. In this context, most members noted that there has been a generalized strengthening of the dollar and greater risk aversion worldwide. Such members pointed out that all of the above has caused a reallocation of investment portfolios towards safer assets. In this regard, one member added that episodes of a strengthening of fixed-income assets have been observed in the United States, while another member added that concerns about overvalued assets persist, particularly those of emerging economies, as well as about the growing use of complex derivatives, which have contributed to further adjustments in financial markets. In this regard, most members noted that capital outflows have been observed, particularly of fixed income assets from emerging economies and, in some cases, this situation has been intensified by idiosyncratic factors. In this context, most members stated that the currencies of most emerging economies depreciated significantly and exhibited greater volatility. One of the members expressed that the adjustment in emerging markets has also been significant in equity instruments and even in sovereign risk indicators. In this regard, the same member pointed out that, in a context of lower search for yield, these countries will face tighter financial conditions. Another member argued that this scenario is expected to have adverse effects on the economic performance of these countries and, more markedly, on those economies where high levels of both public and private indebtedness, among other vulnerabilities, persist.

All members stated that in the first quarter of 2018 economic activity in Mexico continued gaining strength, growing at a rate even higher than that observed in the previous quarter, although most members noted that some timely indicators suggest a slight slowdown during the second quarter. One member added that economic growth during the first quarter was apparently influenced by transitory factors, such the impact of the reconstruction efforts after the earthquakes of September 2017, which affected both industrial production and investment figures. The same member added that the recent strengthening of investment may also be the result of capital goods imports being brought forward due to the uncertainty related to the renegotiation of the North American Free Trade Agreement (NAFTA) and, in general, to the escalation of protectionist trends in the world. This member added that aggregate demand generally increases in the months prior to presidential elections. Most members highlighted that consumption and exports continued to increase, although exports exhibited a slight moderation in April. Some members stated that investment is apparently slowing down. On the supply side, most members noted that services continued growing strongly, while industrial production weakened due to an incipient adjustment in the trend of construction observed since April, as well as a slight lack of dynamism in manufacturing. One member added that this occurred after the upswing of investment in the previous months, mainly driven by the rebound in construction. Regarding low-frequency developments in economic activity, one member pointed out that in recent years the economy has been subject to a lower availability of external funds and to a high degree of uncertainty, which have led to a significant depreciation of the real exchange rate. The same member added that external demand has been adjusting in response to the significant change in relative prices and to an environment of higher real interest rates. The same member also added that this has led to the following trends in the adjustment process: i) a high dynamism in exports; ii) a slight moderation in consumption; and, iii) a tendency for weak investment.

Most members noted that the forecasts for growth for this year and for 2019, published in Banco de México's Quarterly Report, remain unchanged. One member noted that the Mexican economy is expected to slow down in the following months as the factors that influenced economic activity temporarily at the beginning of 2018 fade out. This and another member added that the aforementioned slowdown will also be influenced by a slower rate of growth of spending in the second semester; a relatively slight negative effect of the recent imposition of tariffs on imports from Mexico by the United States and Mexico's response; and, an additional reduction in the oil production platform.

Given the uncertainty caused by the complex environment faced by the Mexican economy, most members considered that the balance of risks to growth continues to be biased downwards. Some members estimated that this balance has deteriorated and one member pointed out that, although risk factors in general terms are the same that have been observed since some months ago, several of them indicate a more challenging outlook. Among such risk factors, most members pointed out the aforementioned global risks, as well as uncertainty associated to the lack of agreement in the NAFTA negotiations and to the country's electoral and post-electoral processes. As to the last two factors, some members noted the possibility that they may lead to the postponement of investment projects or to the reduction of consumer spending. Most members pointed out the possible consequences on economic activity of an environment of uncertainty related to the electoral process, to institutional weakness, as well as to crime and public insecurity. Regarding these two last phenomena, one of the members stated that they constitute challenges to the monopoly of the use of force by the State and have intensified lately, even in Mexico City, which may suggest that such phenomena are no longer geographically isolated. Another member argued that the growing public insecurity has already affected the country's productive activity. The same member mentioned as an additional risk factor the possibility of future adjustments in the fiscal stance that may deteriorate the perception of sovereign risk. Some members added the possibility of volatility episodes in financial markets. One member also mentioned the worsening of volatility in domestic financial markets, especially in the foreign exchange market, while another member referred to the implications of the recent U.S. fiscal reform.

Most members highlighted that the recent performance of economic activity caused a slight tightening in slack conditions. One of the members pointed out that this tightening has been observed mainly in the labor market. The same member added that some wage indicators have started to increase. These indicators, the member also pointed out, should be monitored in order to thoroughly identify their role in the price formation process. Moreover, another member considered that the labor market situation exhibits no significant changes. The same member noted that, in April, the domestic unemployment rate posted figures similar to those observed since mid-2017. This member stated that, indeed, this market continues to exhibit tight conditions, which are consistent with an output gap close to zero, as suggested by most available indicators. This member added that the deterioration of real wages observed during 2017 apparently has ended, although no excessive wage pressures are observed. Some members pointed out that growth is expected to run close to potential for the rest of 2018 and for 2019, thus maintaining the output gap close to zero. One of the members mentioned that this would imply that, starting from a level moderately above zero, the output gap will gradually converge to zero in the following quarters. The same member added that this is reflected in both the recent and expected development of a broad set of cyclical indicators of the economy as well as in the output gap excluding the oil sector, which, from this member's standpoint, is the correct way to evaluate the economy's current position in the business cycle.

All members agreed that annual headline inflation continued to decrease, from 4.55% in April to 4.51% in May. Some members pointed out that in May headline inflation moderated the rate at which it had been falling since January. Most members noted that core inflation fell from 3.71% in April to 3.69% in May. Some members attributed this behavior partly to the monetary policy actions implemented recently and to the fading out of the shocks that affected it last year. Moreover, some members pointed out that this decrease occurred despite the increases in the prices of services caused by a calendar effect. One member added that this situation contrasts with the decline in the prices of merchandises. As for non-core inflation, most members noted that this component also fell, from 7.07 to 6.99% during the same period. One member stated that this was due to reductions in the prices of agricultural products. However, most members pointed out that these price reductions were partially offset by increases in the prices of gasolines and L.P. gas.

Most members stated that between April and May 2018 headline inflation expectations drawn from surveys remained relatively stable for all terms. Some members specified that those for the end of 2018 and 2019 remained around 4.0 and 3.6%, respectively. One of the members added that expectations for the following twelve months decreased from 4.01 to 3.90%. Regarding headline inflation expectations, another member stated that short-term expectations increased slightly and that they are above Banco de México's forecasts. In regards to core inflation expectations, the same member pointed out that those for the end of 2018 and 2019 remained at the same levels of 3.54 and 3.36%, respectively. As for medium- and long-term expectations, most members stated that they remain stable at a level of 3.5%. Some members emphasized that, in this context, expectations are above Banco de México's forecasts and the 3% target. Regarding the spreads between nominal and real yields of government securities that correspond to a compensation for inflation and for inflation risk premia, most members pointed out that these spreads have increased. One of the members stated that this suggests greater concern of markets regarding the behavior of medium- and long-term inflation. In this regard, another member noted that the inflation risk premia has been increasing at the margin, while another member highlighted that inflation expectations drawn from market instruments have remained practically unchanged.

Some members agreed that the decline in inflation during the first five months of 2018 is consistent with its convergence to the target as forecasted by Banco de México in its latest Quarterly Report. Nevertheless, the majority expressed that some of the upside risks to inflation identified by the Central Bank have started to materialize. It stated that, in particular, the peso exchange rate has depreciated even further, while the prices of gasoline and L.P. gas have been under pressure, in line with increases in their international references. One member pointed out that the outlook of prolonged NAFTA negotiations could imply a level of the exchange rate above that expected for the rest of the year. Most members noted the effect that the tariffs imposed on some products and inputs from the United States could also have, although it is estimated that their impact on inflation would be limited and short-lived. Nevertheless, one member stated that such impact could be greater as more products subject to tariff-related measures are added to the list. Regarding the nature of these events, one member pointed out that, in some cases, they consist of changes in relative prices that have a short term effect on inflation, while in other cases, such as the depreciation of the peso, the inflationary impact could be more long-lived. One member recalled that the inflation forecast included in the latest Quarterly Report was prepared expecting an orderly behavior of the exchange rate, a significant reduction of non-core inflation, and the absence of cyclical pressures on inflation. All members considered that if the aforementioned pressures on inflation persist, these will affect the rate at which inflation declines. Taking the above into account, most members highlighted that the risk to inflation converging to its target at a slower rate than previously expected has increased. Some members pointed out that inflation may not attain the 3% target during 2019.

Most members agreed that the balance of risks to the forecasted trajectory of inflation has worsened since the last monetary policy decision and remains biased to the upside, in an environment of high uncertainty. Among the main upward risks to inflation are that the peso exchange rate continues to be under pressure due to an environment of higher external interest rates and U.S. dollar strength, and to uncertainty associated with both the NAFTA renegotiation and this year´s electoral process. Some members mentioned that the uncertainty associated with the post-electoral process could also affect the exchange rate. One member added that there is the risk that the exchange rate depreciation becomes permanent and that the exchange rate continues being subject to depreciation pressures. The same member also mentioned that this would imply risks in at least two aspects: i) that the passthrough of exchange rate fluctuations to consumer prices also becomes permanent; and, ii) that the passthrough per unit of depreciation increases. In the same direction, this member was concerned that the passthrough to the prices of services may become positive, when it is currently close to zero. Another member pointed out that increases in the prices of the non-core component basket cannot be ruled out, due to their high volatility. In this regard, some members highlighted that the risk of continuous upward pressures in the prices of certain energy-related goods or shocks to agricultural prices persists. Some members mentioned the risk of changes to the gasoline price-smoothing policy, while one member specified that this could generate greater volatility and lead to a change in the seasonality of inflation. Most members mentioned that, considering the current position of the economy in the business cycle, demand-related pressures could arise, particularly through the behavior of unit labor costs. In this regard, one member mentioned that lower potential growth could lead to greater inflationary pressures, even in a scenario where aggregate demand would grow at a relatively low rate. This member also stated that lower potential growth could also reduce producers' margin to absorb any supply-related shocks. The same member mentioned that private sector analysts forecasts of inflation, and Banco de México's own forecasts of inflation, do not consider the possibility of a significant increase in the minimum wage. The same member mentioned that if said increases do not reflect labor productivity gains, it could significantly affect the economy's price determination process. In addition, this member pointed out that the high structural vulnerability of public finances in Mexico is also a risk for inflation, and the same member also stated as a risk the fact that long-term inflation expectations are around 3.5%, and that they show a high degree of persistence and hysteresis. The same member also stated that the latter situation is reflected in excessive long-term interest rates, which implies significant costs for the population. Finally, most members pointed out that given the U.S. foreign trade policy actions, the risk of inflationary pressures generated by the escalation of protectionist and countervailing measures has increased. As for downside risks to inflation, some members highlighted a possible appreciation of the Mexican peso if NAFTA negotiations turn out to be favorable.

The majority of members stated that since the last monetary policy decision, the Mexican peso depreciated further and its volatility rose. One member noted that the peso was one of the currencies of emerging economies that exhibited a greater depreciation, while another member pointed out that, in the margin, the peso appreciated slightly. Most members agreed that this behavior was influenced by the abovementioned external and domestic shocks and risks. One member pointed out that the implied volatility in exchange rate options exhibited overall increases in all maturities and remains high as compared to the levels observed in other emerging economies' currencies, particularly for expiration dates close to July 1, when elections in Mexico will take place. In this context, most members stated that operating conditions in the foreign exchange market deteriorated, although one member considered that they remain at adequate levels. Most members mentioned that there was a reduction in derivative positions betting on an appreciation of the Mexican peso. Some members clarified that the latter was mainly observed among foreign investors with a short-term investment horizon. Regarding interest rates, most members expressed that these have increased, especially those for shorter terms. In this regard, one member mentioned that the yield curve has flattened considerably. Some members noted that the long-term interest rate spread between Mexico and the U.S. has recently widened.

Looking forward, most members agreed that in the next months, domestic financial markets, and the peso exchange rate in particular, will continue to be affected by a complex international environment. One member pointed out that although analysts expect the exchange rate to appreciate considerably after having depreciated markedly, there is a high degree of uncertainty regarding such expectation. The same member mentioned that the prices of Mexican assets are apparently incorporating with some probability the materialization of a new shock on the real exchange rate. Another member stated that, at first, pressures on domestic financial markets might diminish or increase depending on the economic message of the presidential election's winner and, later on, depending on how this message is translated into concrete decisions when the incoming administration takes office. The same member mentioned that during this process it will be crucial to have in mind both the risks generated by a very complex external environment and by an economy with a high degree of openness to foreign capital flows like Mexico's.

Regarding macroeconomic policy, some members pointed out that the shocks that have affected the Mexican economy have exerted pressure on both the real exchange rate and real interest rates. In this context, most members emphasized that the monetary policy adopted to keep medium- and long-term expectations anchored, together with the attainment of the fiscal measures and the financial systems' resilience, have contributed to place the economy in a better position to face adverse scenarios, like the abovementioned. In this regard, one member highlighted the importance of having a fiscal and monetary policy stance that contributes to generate the conditions for an orderly adjustment of the economy and of financial markets, and to continue working to consolidate the resilience of the domestic financial system. The same member added that such actions would reduce the probability of having to face portfolio reallocations and capital outflows. Another member mentioned that in an adverse environment like the one currently faced by the Mexican economy, the optimal macroeconomic response would be to adjust both fiscal and monetary policies. However, as mentioned by the same member, monetary policy would be the one that, to a great extent, would have to face the referred shocks and risks, given that, currently, for different reasons, a fiscal adjustment is very unlikely. The same member mentioned that public finances are subject to different sources of vulnerability and that these could be intensified in the near future given that the winner of the forthcoming elections, regardless of who it is, will try to fulfill his campaign promises, which could exert additional pressures on public finances. Another member emphasized that for Banco de México to be able to fulfill completely its constitutional mandate of ensuring price stability, it is imperative that responsible and sustainable fiscal policy be implemented. Some members emphasized the importance of fighting and reducing corruption and impunity and, in general terms, of improving the effective exercise of the rule of law. One member explained that institutional weakness is a burden for investment and growth, and that it affects both through different channels. The same member also added that this has already been reflected in total factor productivity remaining stagnant and even falling since several decades ago. Another member added that according to private sector analysts, among the most important factors that might jeopardize economic growth, as drawn from Banco de México's surveys, are the increase in problems related with governance, such as political uncertainty, public insecurity, corruption, impunity, and lack of rule of law.

As for monetary policy, all members pointed out that it is important to realize that some risks to inflation have already materialized and that the balance of risks to inflation worsened, which could affect inflation's convergence to its 3% target. All members cautioned that monetary policy faces a more adverse scenario and with greater uncertainty. In this regard, one member specified that a distinction has to be made between risk, which is quantifiable, and uncertainty, which is not. The same member added that a robust monetary policy implies that a central bank averse to risk and uncertainty would need to act under a pessimistic scenario in terms of the variables it might consider uncertain, such as the behavior of the exchange rate. Another member stated that, given the current level of uncertainty, monetary policy can face surprises in one direction or another and that Banco de México must be prepared to respond in whichever scenario. Some members noted that, in an uncertain environment, the monetary policy stance is relevant for the adjustment in financial markets, including the exchange rate market, to take place in an orderly manner. In this regard, one of the members mentioned that, in case the Mexican economy faces a scenario in which the real exchange rate would need to be adjusted, it is important to prevent medium- and long-term inflation expectations from being affected and possible second-round effects on the economy's price formation process. One of the members mentioned that a moderately-tight monetary policy has contained the decompression of the term premia and has led to a flattening of the yield curve, which confirms that this monetary policy stance has been adequate. However, the same member noted, the inflationary risk premia has increased and, because of this, monetary policy needs to be further adjusted. The same member added that the risk-taking channel of monetary policy has operated intensively and effectively in the last years. This member argued that this channel depends on the spread between U.S. and Mexico's short-term interest rates, the evolution of which has contributed to improve the operating conditions in the foreign exchange market and has curbed the long-term interest rate spread, a spread that has recently increased. The same member noted that monetary policy must take into account that a narrowing of the short-term interest rate spread is not convenient.

Most members highlighted the need to maintain a prudent monetary policy. One member pointed out that Banco de México has been communicating that it is convenient to act in such a way and considered that adjusting the central bank's reference rate is consistent with such policy guidance. Another member added that it is necessary to act prudently and cautiously to raise confidence in the economy, mainly in a context in which several shocks are taking place simultaneously that might affect the economic environment and outlook. All members agreed that, under a more adverse scenario, a monetary policy response is essential to prevent inflation expectations from de-anchoring and other second-round effects from taking place, and to ensure the convergence of inflation to its target. Some members pointed out that this is particularly relevant given the economy's current position in the business cycle and the absence of slack. One member mentioned that by adding elements to make monetary policy decisions more transparent and accountable, such as publishing the inflation forecasts, it is imperative for the central bank to explain and act in the event that those forecasts might not be met. The same member added that otherwise, the central bank would face a high reputational risk. Some members mentioned that in an environment as the one described above, additional increases in the next monetary policy meetings cannot be ruled out. One member added that Banco de México's future forward guidance would need to be adjusted to reflect that further increases in the reference rate might be required. Finally, all members considered that the Governing Board must continue monitoring the development of inflation and its determinants, so that, if needed, monetary policy can act in a timely and decisive manner that allows the attainment of the central bank objectives.

3. MONETARY POLICY DECISION

To guide its monetary policy actions, Banco de México's Governing Board follows closely the development of inflation vis-a-vis its anticipated trajectory, taking into account the monetary policy stance adopted and the time frame in which monetary policy operates, as well as available information on all inflation determinants and on medium- and long-term inflation expectations, including the balance of risks to such factors. Given that some inflationary risks have started to materialize and the balance of risks to inflation has worsened and might affect the convergence of inflation to its target, Banco de México's Governing Board has voted unanimously to raise the target for the overnight interbank interest rate to 7.75%.

Looking ahead, the Governing Board will maintain a prudent monetary policy stance and will continue to follow closely the potential pass-through of exchange rate fluctuations to prices, the monetary policy stance relative to that of the U.S., and the conditions of slack in the Mexican economy. In the presence and possible persistence of factors that, by their nature, involve risks to both inflation and inflation expectations, monetary policy will be adjusted in a timely and robust manner to attain the convergence of inflation to its 3% target, and to firmly anchor medium- and long-term inflation expectations so that they attain such target.

4. VOTING

Members voting in favor of this decision: Alejandro Díaz de León Carrillo, Roberto Del Cueto Legaspi, Irene Espinosa Cantellano, Javier Eduardo Guzmán Calafell and Manuel Ramos Francia voted in favor of raising the target rate by 25 basis points to 7.75%.

ANNEX

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

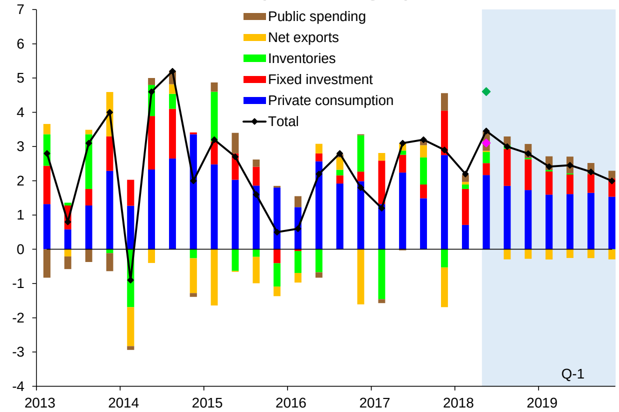
A.1. External conditions

A.1.1. World economic activity

Available indicators suggest that the world economy increased its rate of growth during the second quarter of 2018, reflecting the fading out of the factors that temporarily affected the growth of some of the major advanced economies at the beginning of 2018. However, economic activity in the main advanced economies has started to show signs of divergence: a strong recovery in U.S. economic activity is expected for the second quarter, while in the other advanced economies the recovery seems to be weaker than was anticipated some months ago. Emerging economies have also exhibited differing rates of expansion. Under such an environment, although the outlook for recovery in world economic activity for 2018 and 2019 remains practically unchanged, in the short term uncertainty has increased, while medium-term downward risks have worsened. Among such risks are the intensification of protectionist measures –which could affect the expansion cycle of trade and investment– a possible tightening of financial conditions arising from inflation surprises, and the escalation of geopolitical risks in various regions.

In the U.S., demand indicators suggest a strong pick up of GDP growth during the second quarter of 2018. This is evidenced by the significant recovery of private consumption in April and the evolution of purchase orders for capital goods and other leading indicators, which point to the continuing upturn in business investment that has been observed since the end of 2017 (Chart 1). The outlook for U.S. economic growth in the short term is backed by household confidence and the positive dynamics of employment and income, as well as by the continuing growth of external demand, financial conditions that are still accommodative, and the effects of the tax reform approved by the U.S. Congress at the end of 2017. These factors, under conditions of reduced slack in the economy, may lead to greater inflationary pressures.

Chart 1
USA: Real GDP and Components
Annualized quarterly percentage change and contribution in percentage points, s. a.



s. a. / Seasonally adjusted data.
Note: The diamonds in pink and green refer to the Federal Reserve Banks of New York and Atlanta forecasts for Q2 2018 GDP, respectively.
Source: BEA, Blue Chip, and Federal Reserve Banks of Atlanta and New York.

U.S. industrial production fell at a monthly rate of 0.1% in May, partly due to transitory factors. Indeed, the decrease in manufacturing production largely reflected the 6.5% contraction in vehicle and auto parts production, caused by a fire in an auto parts plant. This was partially offset by the growth of electricity and gas distribution and mining production, which kept the upward trend that has been observed since the end of 2016. Looking ahead, certain leading indicators, such as the NY Empire State Manufacturing Index, point to an upswing in manufacturing activity in June.

U.S. labor market conditions continued to strengthen during the second quarter. The non-farm payroll increased by around 200,000 monthly jobs on average during the first five months of 2018, a rate of increase above that needed to keep pace with the growing labor force. These developments led to an additional reduction in the unemployment rate, down to 3.8% in May, its lowest level in nearly two decades. Under these conditions, wage growth has been picking up moderately.

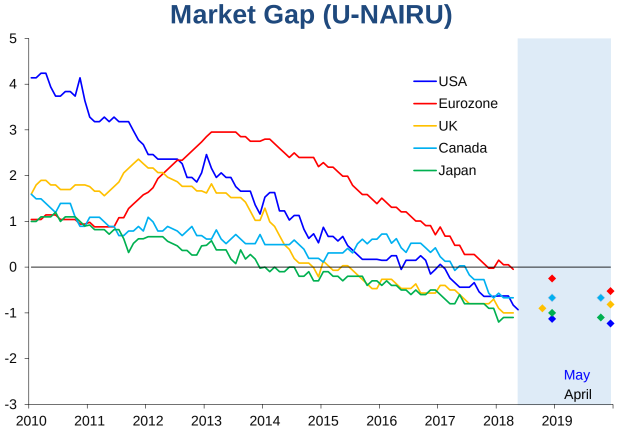
Available information on the Eurozone points to a moderate rebound in growth during the second quarter, albeit at a still moderate pace, after having grown at an annualized rate of only 1.5% during the first quarter. Although the rebound in domestic demand is expected to be further driven by employment growth, high confidence levels and financial conditions that are still accommodative, concerns have been raised as to whether the region can continue growing at a rate above potential. In this regard, both industrial production and Purchasing Manager's Indexes have exhibited weak results in the last months.

In Japan, available indicators on trade, consumption and equipment investment are consistent with a moderate growth during the second quarter of 2018, after economic activity slowed down to an annualized rate of 0.6% during the first quarter. Nevertheless, the weakness of Japan's Purchasing Managers Indexes suggests that, looking ahead, growth could be below that expected a few months ago.

In the U.K, available information points to a recovery of economic activity during the second quarter of 2018. Particularly, U.K. consumption recovered as the transitory factors that affected it at the beginning of the year have faded out. Nevertheless, industrial production has continued to deteriorate, in line with a moderation of external demand.

Growth in advanced economies has continued to be reflected in the strengthening of labor markets. Unemployment rates have continued to decrease, company surveys suggest a growing labor shortage, and wages have been recovering gradually (Chart 2).

Chart 2
Selected Advanced Economies: Labor Market Gap (U-NAIRU)



Note: The source of NAIRU data is the OECD, except for USA figures, which are drawn from the CBO. Expectations are drawn from the Consensus Forecast, except those for the USA, which are obtained from the U.S. Federal Reserve.
Source: Haver Analytics, FRED, CBO, Consensus Forecast, and OECD.

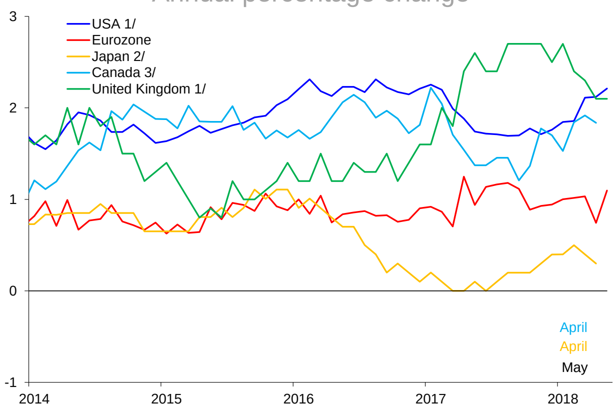
Emerging economies continued to grow throughout 2018, albeit at different rates between regions. While the Asian region has grown above potential, driven by the higher demand from China, economic activity in the European emerging economies grew at a more moderate rate due to the overall weakness exhibited by the Eurozone. Emerging economies are facing greater downside risks to growth, due to the possibility that the U.S. may impose more tariffs on their exports and the possibility that global financial conditions become tighter.

In the last weeks, commodities' international references exhibited a mixed behavior. On the one hand, after the upward trend exhibited at the beginning of 2018, oil prices decreased, due to signs suggesting that U.S. oil production may reach new historical highs, as well as recent concerns that the Organization of Petroleum Exporting Countries (OPEC) and other crude oil producers may reach an agreement to raise crude oil production. Prices of grains also fell due to an improvement in weather conditions. In contrast, the prices of industrial metals continued to increase after the hike registered as a result of the U.S. announcing the imposition of tariffs on steel and aluminum and of the fears of a strike in the world's largest copper-producing mine in Chile.

A.1.2. Monetary policy and international financial markets

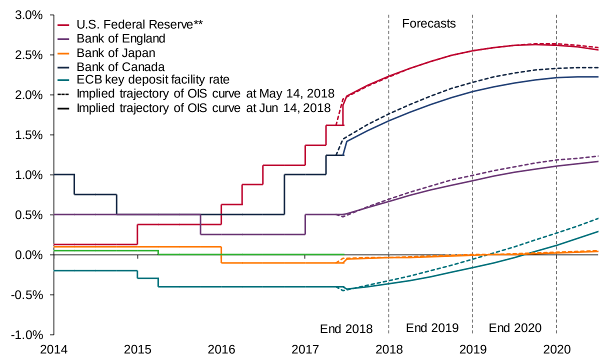
In the context described above, inflation in advanced economies has followed a gradual upward trend since the end of 2017, although with some differences among countries. In the U.S. and Canada, inflation has exhibited a generalized increase, while in the Eurozone and Japan it has continued to advance slowly and has remained below the central banks' targets (Chart 3). In this environment, the central banks of the major advanced economies are expected to continue with their gradual process of adopting a more neutral monetary policy stance, although a greater divergence in the pace at which these institutions could adjust their monetary policies is anticipated. In particular, the Federal Reserve is expected to keep raising the federal funds rate in the following months, while other central banks, particularly the European Central Bank and the Bank of Japan, are expected to be more cautious as to the normalization of their respective monetary policies and could possibly keep a highly accommodative policy stance in the foreseeable future (Chart 4).

Chart 3
Selected Advanced Economies: Core Inflation
Annual percentage change



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

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



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

As expected, in June the Federal Reserve raised the federal funds target range by 25 basis points (bps), leaving it between 1.75 and 2%. In its last monetary policy statement, it pointed out that economic activity in the U.S. has continued to grow at a strong pace. It also mentioned that additional gradual raises in its reference rate would be consistent with a scenario of sustained economic activity growth, a strong labor market, and headline and core inflation close to its symmetric 2% target. The FOMC members raised their growth and inflation forecasts for 2018 and also lowered their unemployment rate estimation, expecting that it will remain below its long-term level in the next three years. The Federal Reserve continued to describe monetary conditions as accommodative, but omitted its expectation that the reference rate will remain below its neutral level for some time. This is consistent with the upward revision in its median forecast, which now has the federal funds rate above the long-term rate in 2019. In this regard, the median estimates for the federal funds rate incorporate 2 additional 25 basis points increases by the Federal Reserve for the rest of 2018 - forecasting an additional raise above the expected in its FOMC meeting of March - and 3 more in 2019. Similarly, the federal funds rate futures almost completely incorporate two increases in the target rate for the rest of 2018.

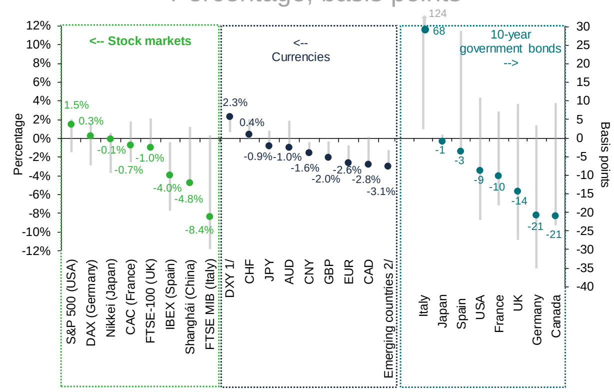
In its June meeting, the European Central Bank (ECB) kept its reference rate unchanged. However, it modified its forward guidance by stating that interest rates will remain unchanged at least until the summer of 2019 or until necessary to ensure that inflation remains in line with its expected sustained adjustment towards the target. The ECB also pointed out that it will continue to buy assets for a monthly amount of 30,000 million euros until the end of September and that, depending on economic results, it is expecting to reduce these purchases to 15,000 million euros from late September to December 2018, when this program is foreseen to conclude. The ECB also stated that, although risks to the region's growth are balanced, uncertainty has increased due to the implementation of protectionist policies around the world and persistent volatility in financial markets. In response to the ECB statement, monetary policy expectations implicit in market-based instruments changed so that the expected date for the first raise in the reference rate was delayed from the first quarter of 2019 to the third or fourth quarter of the same year.

In its June meeting, the Bank of Japan kept its short-term deposit rate unchanged at -0.1%, its long-term government bonds target rate at 0%, while leaving the volume of its asset purchase program unchanged as well. This central bank gave a positive assessment of the Japanese economy, emphasizing the growth of exports, investment and domestic consumption. However, it acknowledged that inflation remains low and reiterated the need for an in-depth analysis of the factors that have prevented inflation from rising, and of maintaining the monetary stimulus to attain the convergence of inflation to the 2% target.

In many emerging economies, inflation remained relatively low and, in some cases, even below their central bank targets. Nevertheless, in an environment in which slack conditions have continued to decrease, commodity prices have risen and the currencies of these economies have depreciated, the risk of higher levels of inflation and pressures for more central banks to adopt less accommodative monetary policy stances have increased. In this regard, the central banks of India, Indonesia and Turkey recently raised their reference rates.

In the last weeks, global financial markets exhibited periods of greater volatility and an environment of lower risk appetite due to the escalation of certain risk factors. Trade tensions between the U.S. and its main trade partners intensified after the U.S. government imposed tariffs on steel and aluminum imports from Mexico, Canada and the European Union, as well as on several products from China. Furthermore, political changes in Spain and Italy affected the performance of markets in the region. This caused a reallocation of foreign investment portfolios towards safer assets –which was reflected in the fall of several stock market indexes, particularly European ones– an unfavorable behavior of corporate bond markets, and in an appreciation of the dollar against other major currencies. Despite the faster pace of growth of economic activity and the gradual increase in inflation in advanced economies, the flight to quality led to a decrease in government bond yields of the main advanced economies, except those of Italy, which rose significantly (Chart 5). It is worth noting that, despite a risk aversion environment, U.S. stock markets remained on an upward trend, reaching, in some cases, new historically high levels. This appears to reflect the persistent optimism regarding the dynamism of the U.S. economy, despite the presence of various trade-related and geopolitical risks.

Chart 5
Change in Selected Financial Indicators (May 14 – June 15, 2018)
Percentage, basis points

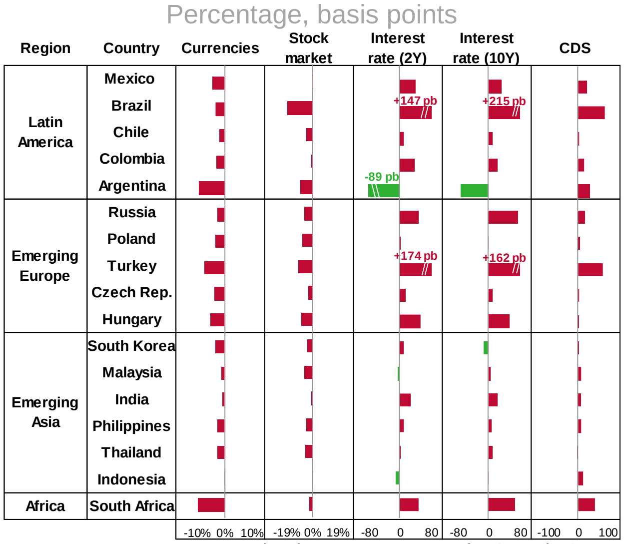


1/ DXY: Weighted average of the nominal exchange rate of the six main world-traded currencies (calculated by Intercontinental Exchange, ICE) with the following weights: EUR (57.6%), JPY (13.6%), GBP (11.9%), CAD (9.1%), SEK (4.2%), and CHF (3.6%).
2/ J.P. Morgan Index constructed from a weighted average 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.

As for the financial markets of certain emerging economies, some of them registered capital outflows. Especially affected were those countries with large current account deficits and considerable short-term financing requirements. As a result, the currencies of various emerging economies depreciated significantly and exhibited greater volatility, particularly the Argentine peso, the Turkish lira and the South African rand, while yields increased in a generalized manner and stock markets fell (Chart 6). In this context, some central banks continued to intervene in their foreign exchange markets with the intention of mitigating adverse fluctuations in such markets. In this sense, the central banks of Argentina, Brazil and Indonesia intervened in their foreign exchange markets. Some of these countries, including India, Indonesia and Turkey, adjusted their monetary policy stances by raising their reference rates.

Chart 6
Performance of Selected Emerging Market Assets (May 14, 2018 –To Date)

Percentage, basis points



Note: Interest rates correspond to interest rate swaps for 2- and 10-year terms, except for Indonesia, where 1-year and 5-year interest rates are used for 2- and 10-year interest rates, respectively, since those maturities are not available in the market.
Source: Bloomberg.

Looking ahead, risk factors persist that could generate more volatility in markets. Particularly, an escalation of protectionist policies could lead to a slowdown in international trade and investment, which could pose a risk for the current expansion cycle. Another risk is the possibility that the pace of monetary policy normalization in advanced economies occurs more rapidly than expected by financial markets. The high valuation of certain financial assets and the high leverage of households and businesses in certain advanced countries, as well as geopolitical instability in several regions, continue being risk factors as well.

A.2. Current situation of the Mexican economy

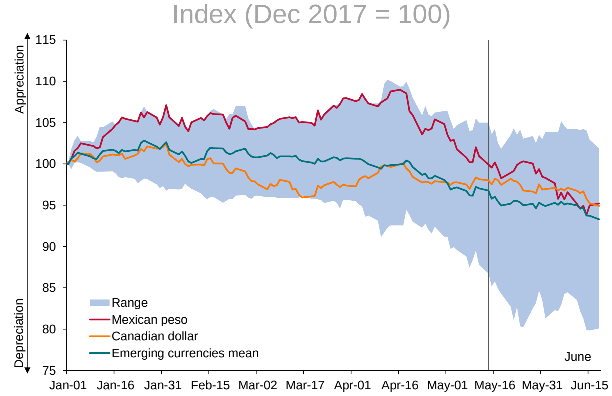
A.2.1. Mexican markets

In the weeks following Banco de México's last monetary policy statement, the Mexican peso exhibited volatility and depreciated against the U.S. dollar by around 4.5% (Chart 7). This result was mainly associated with a more negative market sentiment towards emerging economies' financial markets in general, in an environment of increased uncertainty regarding the implementation of protectionist trade policies worldwide and facing the possibility that the Federal Reserve may speed up the pace of normalization of its monetary policy stance. In the case of Mexico, uncertainty related to the North American Free Trade Agreement (NAFTA) renegotiations and to the country's upcoming election also contributed to the negative performance of the peso exchange rate.

On June 15, the peso/dollar exchange rate reached a peak of 20.96 pesos per dollar, level unseen since January 2017. Foreign exchange market-operating conditions worsened once more: higher bid/ask spreads, lower market depth, and smaller trade operating volumes were observed (Chart 8). Forward-looking operating conditions as measured, for instance, by the implied volatility in exchange rate options, also deteriorated (Chart 9).

Chart 7
Accumulated Index of Selected Emerging Currencies and Mexican Peso in 2018

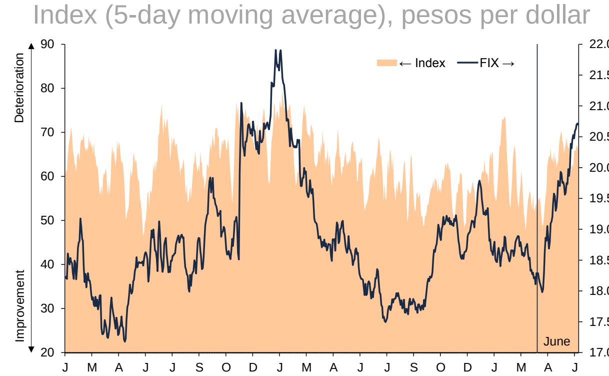
Index (Dec 2017 = 100)



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

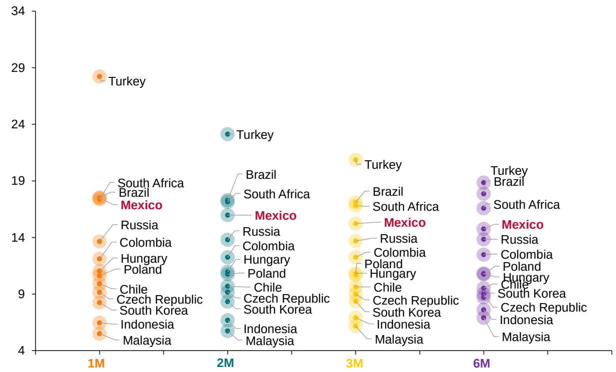
Chart 8
Mexican Foreign Exchange Market Operating Conditions Index and Peso-dollar Exchange Rate

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



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

Chart 9
Latest Level of Implied Volatility in Selected Emerging Currencies-USD Options (Different Maturities)
Percentage

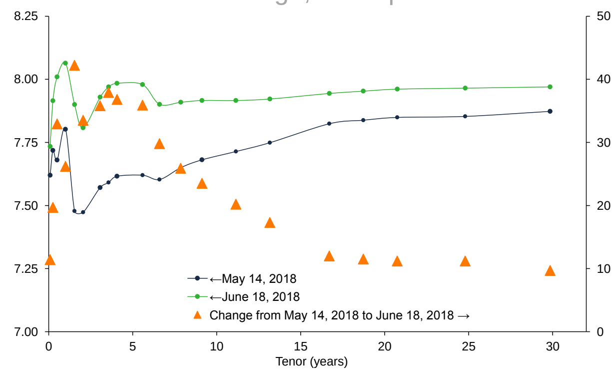


Source: Bloomberg.

Since the previous monetary policy statement, the yield curve of government securities posted negative results that led to overall increases of up to 42 basis points (bps) (Chart 10), being the interest rates of instruments with shorter maturities the ones to exhibit the greater increases. Thus, the slope of the yield curve, measured by the spread between 30- and 3-year bonds, flattened by around 28 basis points (bps), down to a level of 0 basis points (bps), which had not been seen since June 2007 (Chart 11). The adjustment of interest rates of the Mexican government bond market occurred in an environment where operating conditions remained relatively stable.

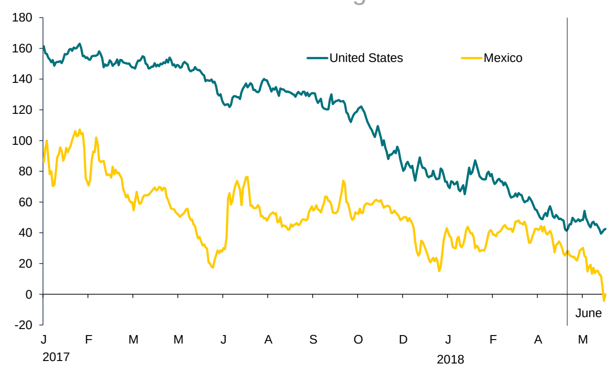
Finally, monetary policy target rate expectations implicit in the interest rate swap yield curve registered 7.67% for June's decision, 7.82% for August, and 8.16% for the end of the year (Chart 12). The consensus among forecasters is that Banco de México will raise the target rate by 25 bps in its next monetary policy decision.

Chart 10
Government Bond Yield Curve
Percentage, basis points



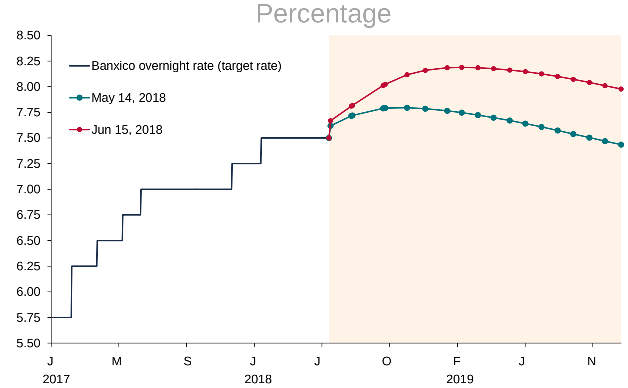
Source: PIP.

Chart 11
Slope of Yield Curve Measured through the Spread between Mexico-US Government Bonds' Nominal Rate with 30- and 3-year Maturities
Percentage



Source: PIP.

Chart 12
Banxico Overnight Interest Rate Implied in 28-day TIIE IRS Curve
Percentage

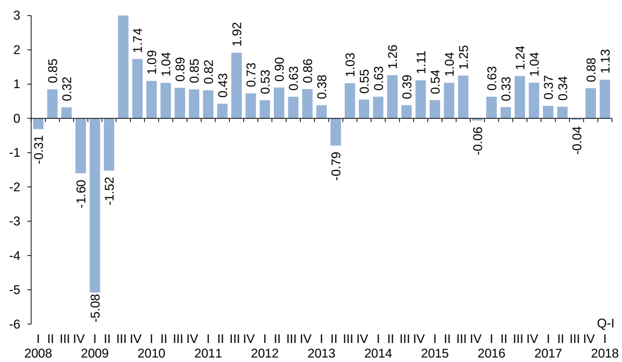


Source: Banco de México with PIP data.

A.2.2. Economic activity and determinants of inflation

During the first quarter of 2018, economic activity in Mexico continued to gain strength, even growing at a rate higher than that observed in the previous quarter (Chart 13). Manufacturing exports and private consumption continued to show significant dynamism, while investment rebounded. Nevertheless, timely indicators for the second quarter suggest a certain slowdown of economic activity.

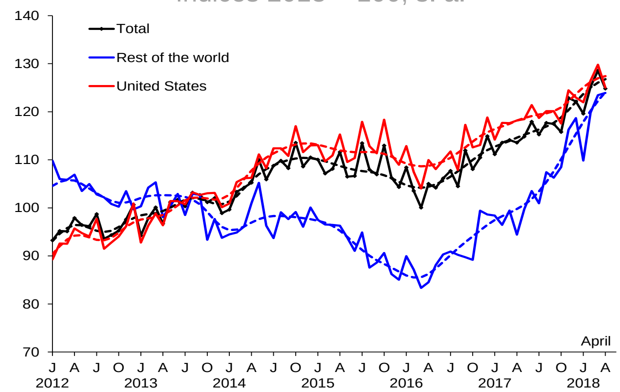
Chart 13
Gross Domestic Product
Quarterly percentage change, s. a.



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

Although both automobile and non-automobile exports followed an upward trend in the first quarter of 2018, in April they contracted, mainly reflecting the fall in Mexican exports to the U.S., as exports to the rest of the world mantained their dynamism (Chart 14). In regards to the development of domestic demand, according to its monthly indicator, in the first quarter of 2018, private consumption continued to improve, driven mainly by the consumption of goods. Indicators of consumption that are preliminary, although of less coverage, include retail stores' revenues, which exhibited a positive trend, as well as the sales of light vehicles, which remained weak. Moreover, in the first quarter, investment recovered slightly as a result of the rebound of business spending in machinery and equipment, as well as the upswing in construction that began at the end of 2017. Nevertheless, the contraction of this economic aggregate in March originated by the fall in construction spending indicates that the recovery observed at the beginning of the year may have been temporary.

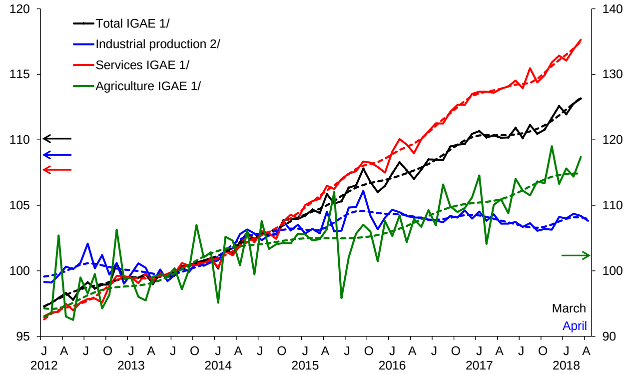
Chart 14
Total Manufacturing Exports
Indices 2013 = 100, s. a.



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

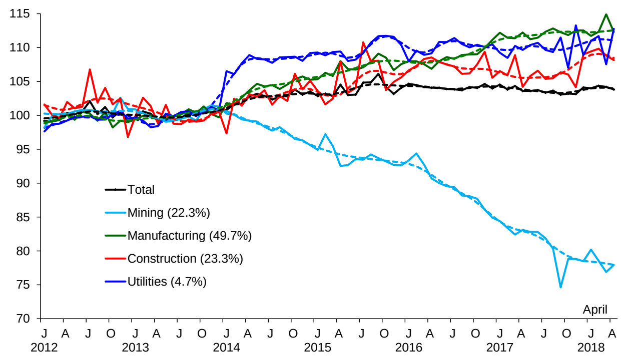
On the production side, during the first quarter of 2018 growth of economic activity was driven by the dynamism of tertiary activities and the rebound of industrial activity, although the latter exhibited a certain loss of dynamism at the beginning of the second quarter (Chart 15). The items that mainly contributed to the positive performance of the services sector during the first quarter were trade; educational services, health care and social assistance; transportation; information and cultural industries; and, public administration. The development of industrial activity in the same period reflected the favorable trend in manufacturing and construction. Nevertheless, at the beginning of the second quarter, these two sectors once more posted weak results. As for mining, during the January – April 2018 period, it continued to follow a negative trend, remaining at considerably low levels (Chart 16).

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



s. a. / Seasonally adjusted and trend series. The former is represented by a solid line and the latter by a dotted line.
1/ Figures up to March 2018.
2/ Monthly industrial activity index. Figures up to April 2018.
Source: Mexico's National Accounts System (SCNM, for its acronym in Spanish), INEGI.

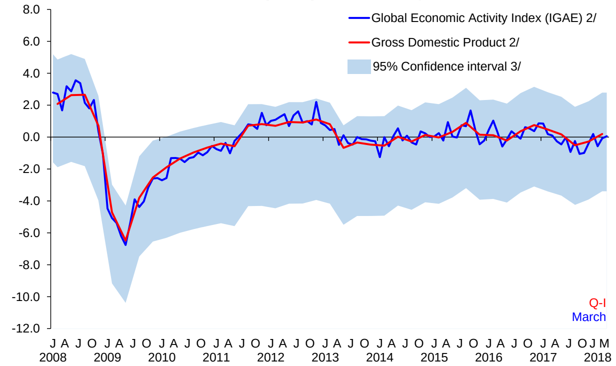
Chart 16
Industrial Activity
Indices 2013 = 100, s. a.



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

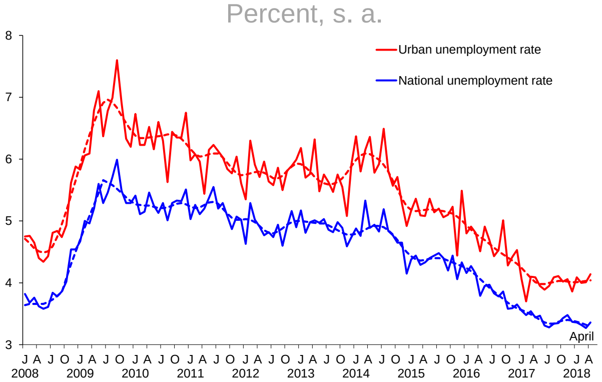
As to the economy's position in the business cycle, several indicators suggest that in the first quarter of 2018 slack conditions exhibited a tightening. In particular, the positive output gap (excluding the oil sector) widened (Chart 17). In turn, the urban unemployment rate continued its downward trend, while the national unemployment rate remained at historically low levels (Chart 18). Furthermore, the number of IMSS-insured jobs continued its positive trend. Given the behavior of productivity and inflation, during the first quarter of 2018 overall labor costs in real terms registered levels similar to those observed in the last quarter of 2017 (Chart 19).

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



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

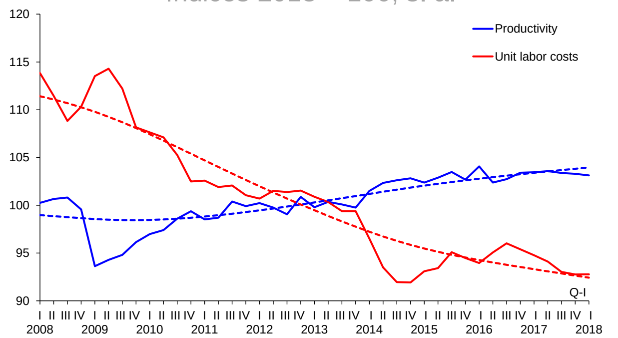
Chart 18
National Unemployment Rate and Urban Unemployment Rate
Percent, s. a.



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

Chart 19
Global Index of Labor Productivity (IGPLE, for its acronym in Spanish) and Unit Labor Costs[1/]

Indices 2013 = 100, s. a.



s. a. / Seasonally-adjusted and trend series. The former is represented by a solid line and the latter by a dotted line. Trend series estimated by Banco de México.

1/ Productivity based on hours worked.

Source: IGPLE published by INEGI. Unit labor costs prepared by Banco de México with data from INEGI.

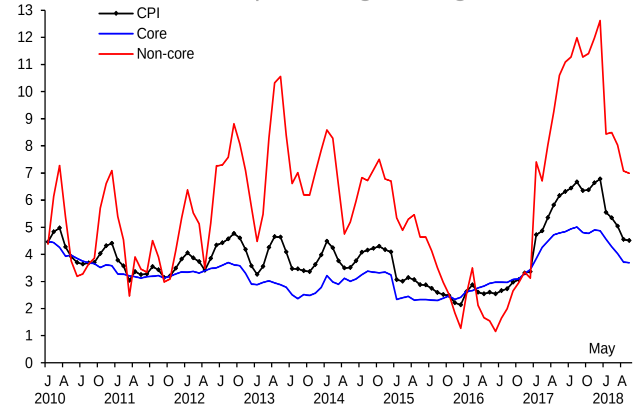
Up to April 2018, domestic financing to the private non-financial sector exhibited higher growth in real annual terms, as compared to the end of 2017. This outcome is mostly due to the sustained dynamism of financing to large companies and, to a lesser degree, to the incipient recovery of household credit. External financing continued to grow at a slow pace. The costs of financing reached higher levels vis-à-vis those observed on average during 2017, albeit not showing significant changes in recent months. Delinquency rates have remained at low and stable levels, except those related to consumer lending, which continue to remain at relatively high levels, although they have shown some signs of having stopped the deterioration they had been undergoing since the end of 2016. Evidence suggests that lending markets are not facing any demand-related pressures.

A.2.3. Developments in inflation and inflation outlook

Between April and May 2018, annual headline inflation continued to decrease, from 4.55% to 4.51%. This was caused by the lower annual price variations in both its core and non-core components (Chart 20 and Table 1).

Chart 20
Consumer Price Index

Annual percentage change

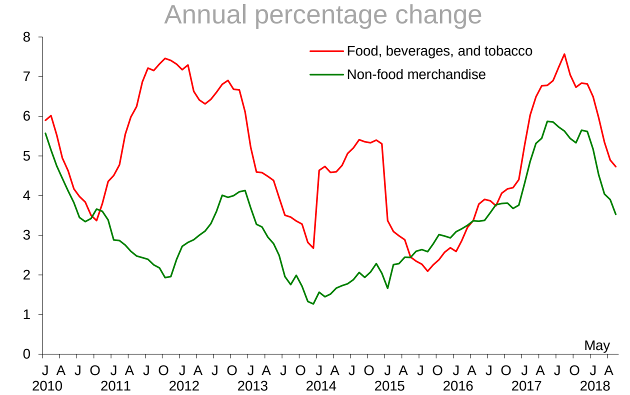


Source: Banco de México and INEGI.

Annual core inflation fell from 3.71% in April to 3.69% in May 2018, as a result of both monetary policy actions and the fading of shocks that had an adverse effect on it last year. The prices of merchandises, particularly of non-food items, continued posting lower annual variations (Chart 21 and Chart 22). In contrast, the annual growth rate of the services price sub-index exhibited a marginal increase associated with the effect of the annual price variation of tourism services, which decreased significantly in April due to the calendar effect originated by the starting date of the Easter holiday (Chart 22 and Table 1).

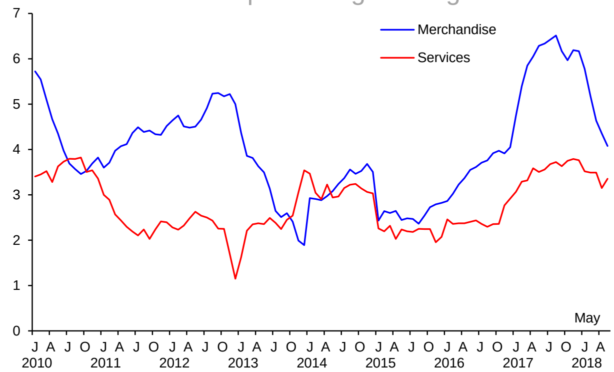
Chart 21
Merchandise Core Price Subindex

Annual percentage change



Source: Banco de México and INEGI.

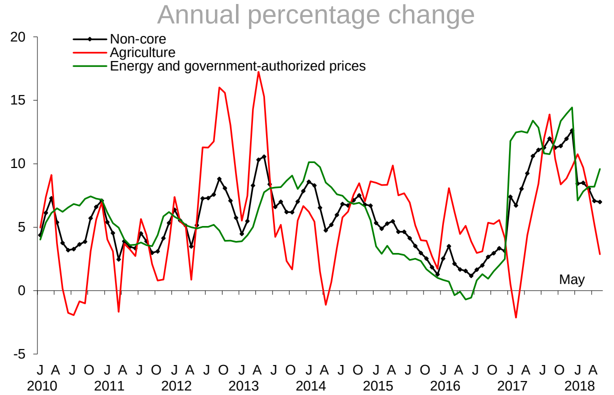
Chart 22
Merchandise and Services Core Price Subindex
Annual percentage change



Source: Banco de México and INEGI.

Annual non-core inflation fell from 7.07% to 6.99% during the same months. In this regard, the reduction in the prices of agricultural products are particularly relevant. These were partially offset by increases in the prices of fuel and LP gas (Chart 23 and Table 1).

Chart 23
Non-core Price Subindex
Annual percentage change



Source: Banco de México and INEGI.

The short-term median inflation expectations reported by Banco de México's survey of private sector forecasters decreased slightly between April and May. In particular, the medians for headline inflation expectations for the end of 2018 and 2019 were adjusted downwards from 3.98 to 3.94%, and from 3.58 to 3.55%, respectively. The median expectations for the following 12 months from these surveys, both relative to the month in which data is collected and to the subsequent month, were adjusted downwards, from 4.01% to 3.90% and from 3.98% to 3.90%, respectively. The medians for medium- and long-term inflation expectations remained stable at around 3.5%. As for inflation expectations implied by quoted market prices of long-term money market instruments (drawn from 10-year government bonds), these continued to remain at levels close to 3.5%.

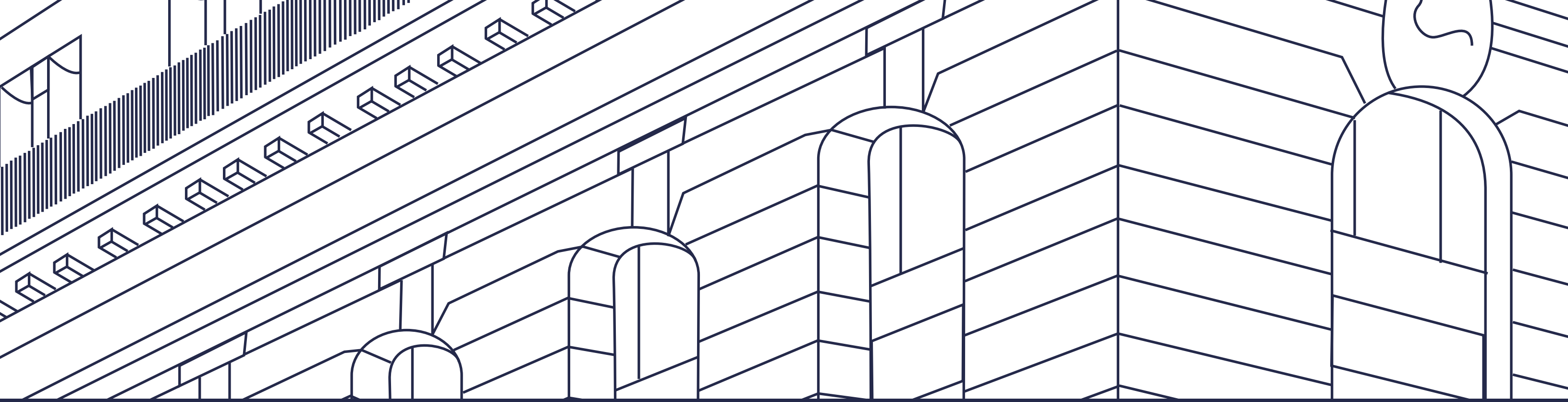
The decline in inflation during the first five months of 2018 is consistent with its convergence to the target as forecasted by Banco de México in its latest Quarterly Report. Nevertheless, some of the risks to inflation identified by the Central Bank have started to materialize, the peso exchange rate has depreciated even further, while the prices of gasoline and L.P. gas have been under pressure, in line with increases in their international references. On the other hand, the tariffs imposed by the U.S. and the equivalent measures announced recently by Mexico are expected to have a limited and short-lived effect on inflation.

In particular, among the upside risks to inflation are that the peso exchange rate continues to be under pressure due to an environment of higher external interest rates and U.S. dollar strength, and uncertainty associated with both the NAFTA renegotiation process and Mexico's forthcoming elections. Likewise, that shocks to agricultural product prices and upward pressures on some energy product prices materialize. Also, given the economy's current position in the business cycle, the behavior of unit labor costs could exert pressure on inflation. As for downside risks, the peso could appreciate if NAFTA negotiations turn out to be favorable.

Table 1
Consumer Price Index and Components
Annual percentage change

Item	December 2017	March 2018	April 2018	May 2018
CPI	6.77	5.04	4.55	4.51
Core	4.87	4.02	3.71	3.69
Merchandise	6.17	4.64	4.35	4.07
Food, beverages, and tobacco	6.82	5.35	4.90	4.73
Non-food merchandise	5.62	4.04	3.90	3.52
Services	3.76	3.49	3.15	3.36
Housing	2.65	2.54	2.56	2.57
Education (tuitions)	4.74	4.84	4.84	4.82
Other services	4.63	4.07	3.24	3.73
Non-core	12.62	8.03	7.07	6.99
Agriculture	9.75	7.74	5.24	2.87
Fruits and vegetables	18.60	8.82	4.07	-0.87
Meats, poultry, fish, and eggs	4.50	7.12	5.94	5.14
Energy and government-authorized prices	14.44	8.19	8.18	9.59
Energy goods	17.69	8.85	9.12	12.37
Government-authorized prices	8.36	6.85	6.36	4.53

Source: INEGI.



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Document published on July 5, 2018