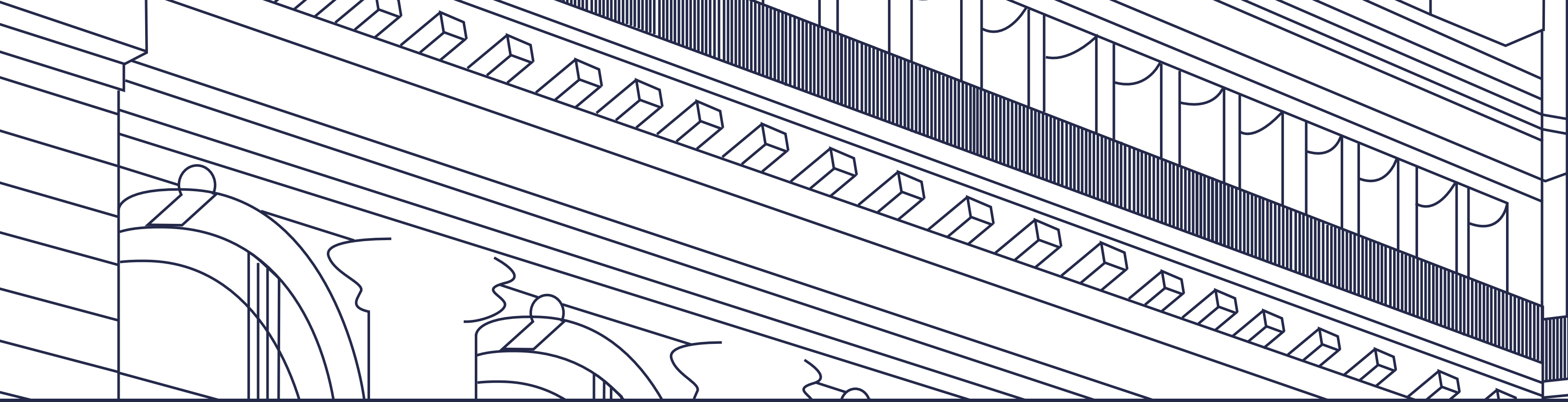

BANCO DE MÉXICO®

Minutes number 72

Meeting of Banco de México's Governing Board on the occasion of the monetary policy decision announced on December 19, 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: December 18, 2019

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

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

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

Most members of the Governing Board pointed out that during the fourth quarter of the year the world economy continued to decelerate. In this respect, one member noted that this was the result of the weakness of advanced economies, given that growth in emerging economies remained stable during said period. Some members added that in 2019 the international environment has been characterized by high uncertainty. One member mentioned that the extended trade war between the United States and China has been the biggest obstacle to world economic growth. Some members commented that the impact of trade tensions have propitiated a decline in global trade, investment, manufacturing production and business confidence. One member mentioned that the strongest impact has been observed in more open economies that export to the U.S. and China.

Most members mentioned that the main advanced economies have continued to slow down. One of them specified that the US economy is an exception, an economy which is going through its longest cycle of expansion on record. Another member pointed out that trade-related uncertainty has affected economic activity in the Euro area, Japan and the U.S. He/she mentioned that in the U.S. the weakness of investment stands out, although in general the impact has been of a lesser magnitude. Meanwhile, some members pointed out that private consumption and services have expanded in advanced economies. One member highlighted that the services' sector is the main source of employment and that it has contributed to maintain the unemployment gaps at historically low levels. In this context, most members considered that these economies' labor markets have continued to show strength. As for emerging economies, one member stated that available indicators point to a not so favorable behavior, due to idiosyncratic factors associated to outbreaks of sociopolitical instability, especially in Latin America.

Regarding the growth outlook, most members pointed out that it has been revised downwards. One member considered that investment is expected to remain weak, given that it tends to be more sensitive to an environment of high uncertainty compared to an environment of low interest rates. He/she added that looser financial conditions, rather than generating greater capital accumulation, would lead to an increase in businesses and households' leverage, which could increase financial vulnerabilities, especially in the less regulated segments. Another member pointed out that in recent weeks, certain timely indicators have started to suggest a possible change of trend. In this regard, most members agreed that the growth rate of the world economy is anticipated to begin rebounding starting from early 2020. One member specified that this forecast is based on expectations that, along with the expected stimulus provided by the implemented policy measures, global economic activity will be supported by the gradual fading of the impact of certain factors that have affected it. He/she added that the economic recovery would be gradual, while another member specified that it would be heterogeneous across regions.

Most members noted that some risks to the global economy have moderated recently, in light of the preliminary trade agreement reached between China and the U.S., and the election results in the United Kingdom. Similarly, one member mentioned that the additional agreement among the governments of Mexico, the United States and Canada has also contributed to improve the business climate. Most members stressed that risks to the global economy persist, which are associated to: i) trade tensions; ii) political and geopolitical factors; and, iii) a greater-than-anticipated deceleration in key economies. One member mentioned surprises in the monetary field as an additional risk. Regarding the first of the referred risks, some members considered that in view of the upcoming US electoral process it is difficult to guarantee that the negotiations between the U.S. and China will not suffer any setbacks. With respect to the second risk, some members noted that, although elections in the U.K. lowered the uncertainty, details are still missing about the United Kingdom's exit strategy from the European Union. In this context, most members agreed that the balance of risks for world economic activity remains biased to the downside, although one of them mentioned that given the described events, the balance of risks has improved since the last monetary policy decision, and also from a medium-term perspective.

Most members pointed out that both headline and core inflation in the main advanced economies remain at low levels, below the targets of their respective central banks. Some members noted that, despite the tightening in labor markets, the impact on wages and inflation has been moderate in said economies. With respect to emerging economies, some members highlighted that in a considerable number of these, headline inflation is below target. One member added that in most cases, core inflation continues trending downwards. Another member mentioned that in some cases, slight price level increases have been observed. In this regard, he/she emphasized the increase in commodity prices. Finally, he/she added that the balance of risks to global inflation remains biased to the downside.

All members pointed out that the central banks of the main advanced economies maintained accommodative policy stances. One member added that certain monetary authorities have urged their respective governments to adopt complementary policies that boost economic growth. Most members noted that in its December meeting, the US Federal Reserve left the target range for the federal funds rate unchanged, and highlighted that such range is appropriate to achieve its goals. They added that, according to that central bank's communication, prior to increasing the policy rate, an increase in inflation would have to be observed. They stated that the median of the projections by the members of the Federal Open Market Committee does not indicate further adjustments for 2020, whereas market expectations anticipate only one additional cut for the next year. In this respect, one member highlighted that economic analysts do not expect changes either in the federal funds' rate during 2020. As to emerging economies, some members stated that a number of central banks continued easing their monetary policies. One member mentioned that Brazil recently lowered its policy rate by 50 basis points, leading to a total downward adjustment of 200-basis points during the year. Finally, the majority of members agreed that accommodative monetary policy stances at the global level will continue during the next year.

Most members stated that the recent moderation in some of the abovementioned risks to the global economy, along with signs of stabilization in certain leading indicators have led to a greater risk appetite in international financial markets. They added that the accommodative monetary policy stances have also contributed to the favorable performance of said markets. In this regard, one member argued that these have incorporated an environment of low interest rates throughout the yield curve. Another one pointed out that, although there have been episodes of volatility, these have been temporary and more improvements than setbacks have been observed. Some members mentioned that stock indices have registered generalized gains, reaching historic highs. Regarding fixed income instruments, some members stated that government bond interest rates declined. One stressed that around 30% of all fixed income instruments in circulation in developed economies exhibit negative returns, especially in the Euro area and Japan. He/she pointed out that the US Treasury bonds' yield curve exhibited a slightly positive slope. With respect to emerging economies, some mentioned that financial assets exhibited volatility, especially in Latin America as a result of idiosyncratic factors. In this context, one mentioned that the aforementioned region had a negative performance in the foreign exchange and bond markets. He/she specified that in the case of emerging economies the results were mixed. He/she underlined that although flows to fixed income assets were negative in the last four weeks, equity assets registered moderate inflows in said period. Some members pointed out that the improvement in international financial markets has benefitted emerging economies. One member emphasized that the flows of funds to these economies have continued to accumulate during the year and that in most cases risk premia have declined. In this regard, he/she considered that the balance of risks for financial markets has improved since the last monetary policy decision, as well as from a medium-term perspective. Another member warned that, although the observed improvement suggests a more favorable global environment, a sudden tightening stemming from the materialization of certain risks cannot be ruled out.

All members mentioned that although information available for the fourth quarter of 2019 is limited, the weakness that has been observed for several quarters in Mexico's economic activity is expected to persist, and they agreed that the economy remains stagnant. One member pointed out that an accurate reading of economic activity is complicated not only because of the limited information available, but also due to the effects of the temporary factors that have affected the automotive sector. Another member added that the stagnation has been due to: i) an external environment that has not been favorable, given that US manufacturing production contracted during the last year; ii) that at the beginning of each new administration's six-year term a deceleration is observed associated with slow public spending; and, iii) a tight monetary policy that has affected consumption and investment. He/she considered that the latter is particularly relevant in an environment in which the real yield of government bonds is even above the expected real rate of return of many productive investment projects.

Regarding aggregate demand, one member mentioned that the weakness of its components persists. Some members underlined the deceleration of consumption and the negative trend in investment. One member emphasized that public investment continues to reflect the lack of resources and that private investment has been affected for a number of years by the uncertainty regarding the trade relations in North America and by other domestic factors. He/she added that the weakness of investment in machinery and equipment and in construction has intensified. He/she also specified that non-residential investment has maintained a declining trend since early 2015. With regards to external demand, most members pointed out that manufacturing exports lost dynamism, and that they were affected by strikes in the US automotive sector, although one member considered that exports maintained a positive trend.

On the supply side, most members underlined the negative performance of the industrial sector. Some members detailed that in October it contracted once again. One member added that this confirmed the negative trend that this indicator has been exhibiting. Within industrial production, most members highlighted the loss of dynamism in manufacturing production as well as the weakness in mining and construction. Regarding manufacturing production, one member specified that in October it registered a significant fall, although it is expected to be transitory. Regarding construction, most members stressed that its decline intensified during the year. One member detailed that mining seems to have started to stabilize after having exhibited a negative trend for several years. Finally, another member added that the services sector continues to decelerate.

As to the labor market, most members highlighted the decrease in the growth rate of formal employment. One member specified that in November 2019, 345 thousand formal jobs were created, with an annual growth of 1.7%, figures below those of the previous year, of 688 thousand jobs and a 3.5% growth. One member mentioned that during 2019 formal job creation is expected to register its lowest level since 2009. He/she also emphasized the higher employment in the informal sector and an increase in underemployment. He/she mentioned that the accumulated change since 2012 of the percentage of economically active population that works less than 35 hours a week increased by a factor of almost four during the period 2018-2019. One member added that a slight increase in the unemployment rate was also observed. Some members considered that the evolution of the labor market has reflected the weakness of the economy, although some of them maintained that it has also reflected the trajectory of wages. In particular, one member mentioned that there is information which suggests that the wage policy has started to limit formal job creation, which may also weaken economic activity. He/she specified that such distortions will become more evident as a result of the 20% increase in the minimum wage starting 2020, which is the largest increase in the last 44 years. Another member added that the experience of the northern border free zone clearly shows that wage increases that are inconsistent with the development of productivity negatively affect employment. He/she added that the upward trend in unit labor costs has continued, as a consequence of both larger real remunerations and a labor productivity that has registered consecutive annual contractions over the last 6 quarters.

Most members agreed that the stagnation of economic activity has implied that the negative slack conditions have widened with respect to those observed in the previous quarter. One member noted that such widening has been greater than previously foreseen. Another member considered that its magnitude is a reason for concern and estimated that the current negative output gap is by far the largest since the 2009 global crisis. Another member noted that the growth outlook for 2019 and 2020 imply negative output gaps in both years similar to those estimated in the latest Quarterly Report. One member specified that given the economy's cyclical position, exogenous cost pressures, salary pressures among them, could hamper the recovery of employment and production as well as the narrowing of the negative output gap.

Most members mentioned that the growth outlook is in line with that published in the Quarterly Report July – September 2019. With respect to the outlook for 2020, most members indicated that a moderate recovery is expected. One member mentioned that the recovery is possible for several reasons: i) a low comparison base; ii) the public administration is more prepared to operate; iii) the USMCA ratification is imminent; and, iv) a low probability that the negative shocks observed in 2019 occur again. Some members maintained that a slight recovery of private consumption is estimated, boosted by consumer confidence, income from remittances, and the wage bill. One member expressed that investment is foreseen to remain weak, both in construction and in imported machinery and equipment. He/she added that a slight recovery in tertiary activities is anticipated. However, he/she stated that industrial production would maintain an unfavorable evolution, particularly in construction and mining.

Most members noted that in an environment of marked uncertainty the balance of risks for growth remains biased to the downside. One considered that said balance has been deteriorating throughout the year, and another member pointed out that this has occurred despite a certain improvement in the environment. Some members maintained that the growth remains subject to both external and domestic risks. In addition to the above described global risks, one member added expectations of a slight improvement in the global economy as an upside risk. He/she considered that among domestic risks the possibility of monetary policy remaining tight for a long period stands out.

Most members mentioned that there are risks associated to the ratification of the USMCA in the U.S. and Canada. Some members warned that the final part of the legislative ratification is still pending in said countries. However, most members acknowledged that the uncertainty associated to such process has diminished and agreed that the USMCA ratification could improve the investment outlook. Nonetheless, one member noted that non-trivial challenges to its implementation are anticipated, and therefore it is not evident that said agreement will reactivate private investment in the short run. In this context, another member mentioned that this agreement is a necessary but not a sufficient condition for a strengthening of confidence that is compatible with a solid expansion of investment. Most members stressed that to reach this goal, other domestic uncertainty factors need to be mitigated, such as those related to governance, legal certainty, insecurity and those related to the country' economic and political situation. One member asserted that the implications of the behavior of investment in recent years for potential growth are even more worrisome, a situation that is accentuated considering the level, orientation and high concentration of public investment, as well as the possibility that the recent stagnation of total factor productivity persists or even that a negative trend in this variable is observed, in the absence of a public policy package that may contribute to reverse such trend. Meanwhile, another member added that it is unlikely that the National Infrastructure Investment Agreement of the Private Sector could reverse the weakness of investment, given that the resources intended for these projects are lower than the annual average observed in the last five years. He/she added that the restructuring of spending approved in the 2020 Federal Budget poses significant risks to the country's potential growth, given that resources are reallocated from strategic sectors, such as the electrical sector, the airport sector, and the highway infrastructure sector, to projects with uncertain profitability. Another member mentioned the possible reductions in public revenue as an additional risk to growth.

Among upward risks to growth, one member stated that the foundations of private consumption, such as remittances, the real wage bill and consumer confidence remain strong. He/she also noted that the fiscal policy objective will be a lower surplus, which will allow for a higher public spending. He/she mentioned that the factors that typically tend to cause a deceleration at the beginning of each new government's six-year term will no longer be present and stated that the National Infrastructure and Housing Programs will start functioning next year. Similarly, some members pointed out that it is possible that a less restrictive monetary policy contributes to a recovery of the economy. One of them mentioned that investment and consumption would gradually recover.

Most members stated that in November headline inflation was 2.97%, lying around the point target. One member mentioned that headline inflation has decreased at a greater-than-anticipated rate. Most members stressed that the decline in headline inflation was determined by a significant reduction in the non-core component. In this regard, all noted that the annual rate of change of this component was particularly low, reaching 0.98% in November. On the other hand, most members mentioned that core inflation exhibited slight reductions, laying at 3.65%, a pattern that one member emphasized has been observed since early 2018.

Delving into the evolution of non-core inflation, all members considered that it has remained at historically low levels. In this regard, most members highlighted the reduction in the rates of change of energy prices and agricultural and livestock products' prices. As to core inflation, most members emphasized that it has exhibited persistence. One member pointed out that it has declined at a rate lower than expected at the beginning of the year. Another member considered that it has remained on the same decreasing trend observed since June of this year. Some members attributed the slow reduction of core inflation to the high rates of change of services' prices. One member underlined that throughout the year, the price-related pressures of the services other than housing and food merchandise have been associated, in his/her opinion, to the indirect effects of the energy price increases in 2018 and to the wage increases since early 2019. Meanwhile, another member considered that the different determinants of core inflation have performed favorably during the year. Specifically, he/she mentioned the exchange rate appreciation, the low levels of inflation of energy and agricultural and livestock products' prices, along with a negative output gap.

The majority of members pointed out that short-term inflation expectations have moderated, while those for the longer term remain above 3%. One member noted that expectations for headline inflation for the end of 2019 decreased from 3.00 to 2.94% and those for 2020 rose slightly from 3.46 to 3.5%. Another member noted that, based on the latest information and prior to the decision on minimum wages, expectations for headline and core inflation for 2020 and for the long term were 3.5 and 3.4%, respectively. He/she added that such expectations could partially incorporate the said adjustment to the minimum wage, but that it will be necessary to wait for the next surveys to determine if they show an additional adjustment. One member mentioned that short-term inflation expectations from surveys have followed the latest information and that breakeven inflation and inflationary risk implied in fixed income instruments has remained relatively stable.

As for inflation forecasts, most members estimated that headline inflation expectations for the end of 2019 could be below the forecasts of the Quarterly Report July-September 2019. One member mentioned that he/she foresees that it will close below target, and be the second lowest annual inflation of the current century. In this regard, the majority stated that this behavior would respond to the outstandingly favorable performance of non-core inflation during 2019. Some members emphasized that such performance is not expected to continue much longer. One member pointed out that, with an average of almost 6% since January 2001, when the inflation targeting regime was formally adopted, it would be difficult to expect that non-core inflation continues registering such low figures for a long time. In this regard, he/she considered that, in said context, assessing the behavior of inflation based on the headline price index entails serious limitations. Another member argued that it is wrong to assume that non-core inflation will once again show its previous levels and volatility since the new policy on energy prices reduces the volatility of this component by design. He/she pointed out that, given this policy, it is not right to assume that non-core inflation will mechanically rebound and that this assumption led to overestimations of headline inflation in 2019. He/she added that such was the case of estimates by economic forecasters and by Banco de México itself, which, in May of this year adjusted upwards its inflation estimates for the fourth quarter of 2019, from 3.4% to 3.7%, while, in early August, economic forecasters had estimated inflation to be at 3.66% for the end of 2019. He/she mentioned that these estimates contrast significantly with the figure estimated for the end of the year. Regarding the core inflation outlook, some members stated that it is expected to continue declining in December, although one member pointed out that doubts persist as to the pace at which it would decrease.

For 2020, the majority of members considered that headline and core inflation will reflect both the conditions of greater slack in the economy as well as the cost pressures that could stem from the minimum wage increase, which could raise them to moderately higher levels than those anticipated in the last Quarterly Report. One member stated that although it is difficult to anticipate which would be the end result of the interaction between the aforementioned factors, since it is uncommon for the economy to face labor cost pressures during the low phase of the economic cycle, core inflation is expected to be subject to moderate pressures. Some members pointed out that with the announced minimum wage increase, one of the upward risks for inflation materialized, which will make it difficult to attain the 3% target in 2020 as anticipated. One member underlined that a transitory seasonal rebound in inflation in the following months is expected. Another member considered that several determinants that have a delayed impact on core inflation have had a favorable behavior during the year, and, thus, this component is foreseen to continue decreasing in the following months and headline inflation to continue at levels close to the target in the next year.

As for upward risks to inflation, most members mentioned the possibility of core inflation continuing to show persistence and that the recent minimum wage increase leads to wage revisions that exceed productivity gains in different segments of the employed population and that this generates cost-related pressures, affecting formal employment and prices. In this regard, such members argued that the effect on inflation of the minimum wage increase is expected to be moderate. One member noted that research on the lighthouse effect of the minimum wage concludes that the impact should be marginal. Another member stated that it is not clear that minimum wage increases significantly affect inflation and that evidence on the minimum wage increase in the border area this year confirms it. He/she explained that inflation in the northern region in 2019 is the lowest in the country - 2.24% in November – and that it is even lower in the border area, despite the fact that the minimum wage in nominal terms in this region doubled in 2019. He/she added that something similar can be said about the rest of the country where, despite the increase of over 16% in the minimum wage, observed inflation in 2019 will be significantly below the target. He/she noted that a wage increase may not be inflationary because: i) it affects a relatively small segment of workers and the wage bill, and ii) domestic labor markets probably operate with distortions that have generated a gap between wage and labor productivity, so that such increases can be absorbed through adjustments in profit margins. He/she pointed out that the wage increase represents a negative supply shock, whose possible impact on prices is, in any case, transitory, and that the optimal response is not to tighten monetary conditions that would worsen the negative effect of the shock. Another member noted that wage increases should be supported by productivity gains, otherwise inflationary risks intensify with the introduction of distortions in the price formation processes and formal employment is negatively affected. He/she added that, given the magnitude of the wage increase, it is foreseeable that a significant number of micro and small enterprises, which group the largest number of workers earning the minimum wage, will have to pass-through such adjustments to the prices of their products, cut their number of employees, or, in the worst case, abandon formality. He/she noted that the recent announcement would represent the second considerable and consecutive increase to the minimum wage and that it is a factor to which the central bank should remain attentive.

Most members added as an upward risk to inflation that that the peso exchange rate comes under pressure from external or domestic factors, although the easing of certain external tensions and progress in the ratification of the USMCA have reduced this risk. One member argued that a possible rebound in the exchange rate does not represent a great risk because the peso has appreciated and multiple studies have shown that the pass-through of foreign exchange adjustments to prices is not significant in economies with a flexible exchange rate, a prudent fiscal policy and a central bank with high credibility. He/she also mentioned that given the risk of exchange rate pressures, monetary policy must not strengthen such variable as a factor to contain inflation, because doing so weakens its function as a variable to prevent imbalances in the balance of payments. The majority added the threat of tariffs by the United States and the adoption of compensatory measures, although this risk has diminished more noticeably after a new trade agreement was reached. In this regard, one member emphasized, that even if the ratification of the USMCA is achieved next year, it should not be forgotten that this agreement does not oblige the US Executive to refrain from establishing tariffs or other unilateral trade restrictions, which could represent new price shocks. In addition, most members mentioned the risks of public finances deteriorating or of increases in agricultural, livestock product or energy prices being greater than expected, which could make non-core inflation revert to higher levels. One member highlighted that, although energy prices are administered by the government and do not automatically reflect the evolution of their international references, increases in the latter generate pressures on public finances, which indirectly impact the dynamics of domestic prices through different channels. Finally, one member added the possibility that a temporary seasonal rebound in inflation in the coming months shows a greater persistence and that economic slack continues to have no clear impact on inflation.

As for downside risks, most members mentioned: i) a greater appreciation of the peso exchange rate, which could be associated with a context of greater risk appetite in international financial markets or with the final steps towards ratifying the trade agreement with the United States and Canada; ii) a widening of slack conditions or their impact on core inflation being greater than foreseen; and iii) that the prices of certain goods included in the non-core subindex register lower rates of change. One member added a lower pass-through of the minimum wage increase to prices, given the expected slack conditions, and that the favorable behavior of producer prices leads to a decline of the core component. He/she pointed out that the producer price inflation is close to zero and that several studies indicate a correspondence with consumer prices after a certain lag. In this context, the majority pointed out that uncertainty still persists as to the risks that could make inflation deviate from the trajectory described previously. One member noted that this balance of risks applies to an inflation trajectory adjusted upwards as a result of the materialization of one of its risks. Another stated that, in his/her opinion, the balance is uncertain for the long term and symmetrical in the short term. One member mentioned that the referred balance has become slightly upward-biased. Another member considered that inflation risks have decreased significantly during the year. He/she mentioned that not only the external environment is much more favorable, but that the domestic factors that generated more uncertainty have been resolved favorably.

Most members agreed that, although domestic financial markets underwent episodes of volatility associated with social developments in some Latin American countries, financial assets in Mexico and the peso exchange rate recently exhibited a positive behavior. Some members pointed out that the agreement to approve the USMCA together with the monetary policy stance have contributed to such results. The majority mentioned that long-term interest rates decreased. One member added that real interest rates have also decreased. He/she argued that, given the complex environment, the sound macroeconomic and monetary policy stances have been fundamental in making the nominal and real yield curves, especially in their longer maturities, adjust downwards in an orderly manner. He/she noted that both short-term interest rate expectations and term premia have decreased in recent months. The majority of members noted that the Mexican peso appreciated, although some members stressed that episodes of volatility were observed. One member highlighted that the Mexican peso performed better than other Latin American currencies, some of which have been more exposed to political and social risks, either directly or by contagion. Another member emphasized that the stock market registered gains, accumulating a positive annual return close to 6.5%. As for risk premia, some members underlined the reduction in the CDS premium. One member argued that, despite such reduction, the level of the premium implies that the market continues discounting a downgrade of the sovereign rating.

Some members mentioned that, despite the favorable evolution of the external environment, risks persist that may affect the performance of domestic financial assets. As for external risks, they highlighted the possibility of shocks, including for instance, the contagion from emerging economies, mainly from Latin America, or those associated with the electoral process in the United States. As for domestic risks, they mentioned the uncertainty about Pemex's credit rating. One member pointed out that significant challenges persist that are still pending solution. He/she underlined the potential implication, both for public finances and the sovereign credit rating, of the loss of Pemex’s investment grade, while another mentioned that expectations of a downgrade are still latent. One member argued that the balance of risks for financial markets has improved throughout the year, due to a more favorable external environment and to the resolution of domestic uncertainty factors. He/she noted that, in that period, interest rates for terms greater than three years decreased around 200 basis points, the peso appreciated around 4%, and Mexico's CDS decreased 75 basis points. He/she stressed that fiscal discipline was maintained throughout the year, a preliminary trade agreement was reached with the US Congress, and Pemex's rating has been maintained. As to the latter, he/she pointed out that Pemex’s CDS premium has decreased significantly due to the support of the Federal Government, the refinancing and debt repurchase operations, and the increase in crude oil production.

The majority of members mentioned that the current environment continues to pose risks that may affect the country’s macroeconomic conditions, its ability to grow, and the economy’s price formation process. In this regard, they highlighted that it is particularly important that, in addition to a prudent and firm monetary policy, measures to foster an environment of confidence and certainty for investment and higher productivity are adopted, and that public finances are consolidated in a sustainable way. In this context, they stated that strengthening the credit rating outlook for the sovereign and Pemex's debt, as well as achieving the fiscal targets for 2019 and the goals set in the 2020 Economic Package are necessary. They also pointed out that strengthening the rule of law, tackling corruption, and fighting insecurity are equally imperative. One member added that increasing productivity through the adoption of new technologies and human capital investment is also important. Another member underlined that all these measures would prevent a further deterioration of potential growth. One member highlighted that, based on the opinion of business owners and economic forecasters, among the obstacles to economic activity in Mexico, the factors related to governance problems (public insecurity, political instability, impunity and corruption) and uncertainty in domestic economic conditions stand out. In this regard, another member stated that the main action that could be taken to stimulate economic activity is the implementation of public policy measures that generate economic certainty and encourage investment.

Delving into Pemex's financial situation, one member pointed out that one rating agency, whose position will be crucial in defining the future of Pemex's investment grade, has reiterated the negative outlook on the company's rating, based on the one corresponding to the sovereign debt, the deterioration of Pemex's credit profile, and its perception that Pemex's investment expenditures will be insufficient to replenish its crude oil reserves in 2019 and 2020. Another member mentioned that attention remains focused on validating the company's capacity to increase its production, and that its continuing dependence on the Federal Government's budget support is unsustainable. Regarding public finances, some members highlighted that the goals for 2020 are based on optimistic assumptions and that considering the use of resources from the Budget Revenue Stabilization Fund (FEIP, for its acronym in Spanish) this year, the funds to deal with contingencies will be reduced considerably. One member added that the primary surplus has been achieved through underspending and through the use of resources from the FEIP. He/she stated that using extraordinary resources to face income shortfalls in the absence of unforeseen shocks does not address the structural problems. He/she added that fiscal pressures are expected to continue increasing due to the upward trend in pension spending by the Federal Government. Another member stressed that, at the beginning of the year, there were fears about the Federal Government not complying with fiscal discipline; however, to date, results show that fiscal discipline was maintained. One member warned that challenges for public finances over the medium and long terms should be considered and that, in this context, the announcement that the tax authorities are considering a tax reform is of great relevance.

Regarding the monetary policy decision, considering the lower levels registered by headline inflation, its outlook within the timeframe in which monetary policy operates, the more ample slack in the economy, as well as the recent behavior of external and domestic yield curves, Banco de México's Governing Board decided by majority to lower the target for the overnight interbank interest rate by 25 basis points to 7.25%.

Similarly, one member added two other reasons for lowering the policy rate: i) that the monetary signal and its effect on the cost of financing must be consistent with a real rate of return, which is following a downward trend due to the economy's cyclical conditions and that maintaining a disparity between these rates for a long period would generate distortions in investment decisions; and, ii) that a monetary policy easing would contribute, albeit modestly, to an economic recovery for the following year.

The same member elaborated on the importance of the relative and absolute monetary policy stances given that they summarize the multiple factors that must be considered in the monetary policy decision. He/she mentioned that the former is essential in the case of small and open economies, as it reflects the degree of tightness in terms of the global monetary conditions and of the differences between domestic and external inflation. He/she added that, from a risk appetite perspective, such stance also measures if the level of relative tightness allows to compensate investors for risk premia. He/she expressed that accommodative monetary policies worldwide, in particular that of the Federal Reserve, and the increase in risk appetite, provide a margin of maneuver for Mexico's relative monetary policy.

As to the absolute monetary policy stance, said member explained that it considers the inflation target and the neutral rate. When the level of monetary tightness is compared in these terms, the conditions of the economy's real rate vis-à-vis its equilibrium level are implicitly assessed. Furthermore, leaving the policy rate in the restrictive segment, above the neutral rate, as the current absolute policy stance suggests, communicates to society the firm intention of consistently attaining the inflation target. In sum, the relative and absolute policy stances allow to calibrate the direction and magnitude of the adjustments in the policy rate. Moreover, their assessment suggests that the monetary policy stance is tighter than necessary.

Therefore, if the expected convergence of inflation to its target is confirmed, the same member mentioned that a greater monetary policy easing might be considered. Said member argued that the possibility of inflation being above the foreseen trajectory would affect Banco de México's credibility, which reaffirms the need for gradually adjusting the policy rate within the restrictive range.

In this regard, he/she stated that the speed of these adjustments should consider its effect on the expectations of economic agents. He/she mentioned that firms and analysts make conjectures about future monetary policy actions, which affect their inflation expectations. In determining the speed of adjustment, Banco de México must minimize the costs to its credibility in case that inflation deviates from the anticipated trajectory. He pointed out that, in the context of a weak economy with a materialization of negative risks, a greater than necessary monetary policy easing would imply a higher cost for the central bank's credibility and the formation of inflation expectations, as compared to a lower than necessary easing.

He/she emphasized that, in this case, a conservative behavior strengthens the perception of commitment to the inflation target, and to the central bank's independence, in addition to highlighting that Banco de México's decisions are based on an objective view and supported by technical elements. He added that an advantage associated with a cautious monetary policy is that it moderates financial market expectations about the actions of the central bank, and allows an orderly evolution of interest rates with lower costs for the economy.

Finally, the same member suggested that the fact that monetary policy is in a rate-cutting cycle that is subject to the evolution of inflation, its expectations and balance of risks, be included in the guidance of the monetary policy statement. He/she considered that this would acknowledge that the policy rate has been lowered on four consecutive occasions and that the expected trajectory of inflation has been better than anticipated under multiple scenarios. Including the above into the statement would convey a clearer and more credible message, which would be in line with maintaining a restrictive policy stance in absolute and relative terms for as long as necessary, but not as restrictive as the current one.

One member considered that a 25-basis point adjustment to the policy rate is insufficient to acknowledge the progress attained in the macroeconomic realm and in mitigating risks in the last months, and that this would mean remaining behind the curve already anticipated by the market. In particular, he/she made reference to inflation being below target, the exchange rate being at levels below 19 pesos per US dollar, and the fiscal policy being conducted prudently. The same member added that all of the aforementioned has taken place in a context of null growth. He/she stated that previous communications have mentioned that monetary policy decisions will be taken based on available data and considered that the current conditions allow for a greater monetary policy adjustment. He/she added that this is possibly the last opportunity to make an adjustment of a greater magnitude. The same member mentioned that monetary policy must contribute to improve the overall economy's performance, and that this does not imply putting at risk the central bank's main mandate. He/she mentioned that not doing it this way would be unwise and unjustified. The same member pointed out that the tight monetary policy has affected consumption and investment, in an environment in which the real yield of government bonds is above the expected real rate of return of many productive investment projects. He/she indicated that a too-high interest rate incentivizes savings by increasing the yield of bonds and also raises the cost of credit. That both channels hamper consumption and investment and, therefore, growth. Also, that a high interest rate affects public finances directly by increasing the public debt's financial cost and indirectly through its negative effect on growth and tax collection. He/she mentioned that the deterioration of public finances and the lower growth generated by the high interest rates tend to increase delinquency rates and make public debt less attractive, which leads to higher risk premia. Said member indicated that, for this reason, a too-high interest rate, which in principle seeks to shield us from some risks, might paradoxically become a destabilizing factor.

The majority of members pointed out that given the outlook of high uncertainty that still prevails, maintaining a prudent monetary policy is necessary. Such members mentioned that monetary policy must be adjusted gradually and mainly respond to the evolution of inflation relative to its foreseen trajectory, and incorporate all information available on the economy's current situation and characteristics, in such a way as to allow headline inflation to converge to its target in an orderly and sustained manner. They added that significant domestic and external risks prevail. Such members were also concerned about medium- and long-term inflation expectations remaining above the 3% target.

One member considered that since the last policy decision, monetary policy faces a more complex situation, given that the current environment is characterized by factors that have differentiated effects on inflation. On the one hand, slack conditions have widened and the balance of risks for growth is biased to the downside, while headline inflation is at target; and, on the other hand, the risk of a greater than expected increase to the minimum wage materialized. Another member mentioned that, on this occasion, two additional factors had to be considered. First, a lesser uncertainty stemming from external factors such as the USMCA. Said member pointed out that the latter shows how strengthening confidence can increase the margin of maneuver for monetary policy. He/she added that this highlights the importance of dissipating the domestic sources of concern, due to both their direct impact on the economy and the fact that it would allow a more flexible implementation of the different economic policy instruments. In this regard, he/she pointed out that monetary policy's capacity to respond will be very limited if domestic uncertainty does not decrease significantly. Second, he/she highlighted the outlook of an upward adjustment in the trajectory of inflation, a risk that has materialized via wages and that apparently is the core component's main source of persistence.

Another member mentioned that the process of monetary policy easing is determined period after period depending on the trajectory of headline inflation and its components towards the target. In particular, the assessment must take into consideration the following factors: the possible rebound of inflation due to the core component's persistence; the potential reversion of the non-core component; the probable rebound of the economy in 2020; and, the evolution of domestic and external risks. One member pointed out that the risks faced by the economy are not only those derived from its cyclical position. There are other challenges and risk factors, external and domestic, which affect the economy, the price formation process, and inflation. He/she mentioned that the setting of the monetary policy stance must not only foster that the projections for headline inflation remain around the target within the forecast horizon, but also take into consideration: i) an external environment characterized by low growth, with obstacles to investment, and low inflationary pressures and interest rates, and, at the margin, by a greater risk appetite; ii) a considerable widening of slack conditions in the economy; iii) the recent decline of headline inflation as a result of non-core inflation being atypically low; iv) core inflation's resistance to decline and whose behavior will be determined by the combination of a greater amount of slack in the economy and the direct and indirect effects generated by the minimum wage increase; and, v) the need to foster appropriate conditions in the fixed income market and in short-term interest rates. As to the latter consideration he/she mentioned that the behavior of interest rates must ensure an orderly adjustment of the economy; be in line with the behavior of the domestic and external yield curve, and with risk premia; maintain the attractiveness of domestic fixed income markets, generate confidence and consider global monetary conditions; and, propitiate that the yield curve incorporates short-term interest rate expectations that are consistent with the central bank's objectives in the timeframe in which monetary policy operates. He/she emphasized that the latter suggests the convenience of adjusting the monetary policy stance gradually under the current environment. He/she added that in this process it is necessary to identify, in the best possible way, the economy's conditions, the risks it faces, as well as the possible vulnerabilities that could materialize.

Another member mentioned that a monetary policy easing of more than 25 basis points would not be convenient, as it would probably validate the inflationary impact of the minimum wage adjustments, which would justify having long-term inflation expectations above the target. He/she added that an action of this sort with a view to stimulate economic growth, would be difficult to reconcile with the theoretical and empirical evidence of economic growth determinants, and does not consider the opinion of business people or analysts on the factors that are hampering the growth of the Mexican economy. It would also leave aside evidence on interest rates having a modest impact on economic growth, even in the short term. For all of the above reasons, an action like the one described would certainly be perceived as being incompatible with the central bank's mandate. He/she added that monetary policy must strive for the convergence of inflation to its target without imposing excessive costs to the economy while, at the same time, preventing inflation expectations from becoming unanchored. He/she mentioned that the argument that Banco de México must adjust its monetary policy stance in view of a wide nominal interest rate spread with other economies, does not consider the need for including other risk factors into the analysis, such as the exchange rate volatility. Once the latter is considered, the spread decreases significantly.

Another member highlighted that the monetary policy statement must continue to communicate that in an environment characterized by high risks and great uncertainty, future monetary policy will depend mainly on the evolution of inflation and on its deviations from the foreseen trajectory.

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 forecasts, taking into account the monetary policy stance and the time frame in which monetary policy operates. In this process, it uses available information on all inflation determinants as well as on medium- and long-term inflation expectations, including the balance of risks for such factors. Monetary policy must also act prudently if for any reason the uncertainty faced by the economy increases significantly. In this context, considering the lower levels registered by headline inflation, its outlook within the time frame in which monetary policy operates, the more ample slack in the economy, as well as the recent behavior of external and domestic yield curves, Banco de México's Governing Board decided by majority to lower the target for the overnight interbank interest rate by 25 basis points to 7.25%. One member voted for lowering the target to 7.00%. In order to consolidate a low and stable inflation, in an environment in which price formation and slack conditions in the economy are subject to risks, the Governing Board will continue to follow closely all factors and elements of uncertainty that have an impact on inflation and its outlook, and will take the required actions based on incoming information so that the policy rate is consistent with the orderly and sustained 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 relative monetary policy stance in an external environment that it is still subject to risks, and the behavior of slack conditions and cost-related pressures in the economy. In the presence and possible persistence of factors that, by their nature, involve risks to both inflation and its expectations, monetary policy will be adjusted in a timely and firm manner to achieve an orderly and sustained 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, Javier Eduardo Guzmán-Calafell, and Jonathan Ernest Heath-Constable voted in favor of lowering the overnight interbank interest rate by 25 basis points to a level of 7.25%.

Gerardo Esquivel-Hernández voted in favor of lowering the overnight interbank interest rate by 50 basis points to a level of 7.00%.

5. DISSENTING OPINIONS/VOTES

Gerardo Esquivel-Hernández

I believe that the economic juncture in which the decision was taken was probably one of the last favorable opportunities in this cycle to make a more decisive monetary policy adjustment. In my opinion, lowering the policy rate by only 25 basis points is insufficient to acknowledge the progress attained in reducing inflation and in mitigating inflationary risks over the last months. An adjustment of this magnitude simply means remaining behind the curve already anticipated by the market. On numerous occasions it has been said that monetary policy decisions will be taken based on facts and observed figures. I believe that the combination of an exchange rate close to 19 pesos per US dollar, an annual inflation below target, the significant reduction of external and domestic risks, and null economic growth could fully justify opting for a more decisive policy action. The alleged inflationary risk attributed to the minimum wage is in fact very low. This year's evidence, both in the northern border as well as in the rest of the country, suggests it. Overestimating this risk may end up influencing inflation expectations and becoming a self-fulfilling prophecy.

ANNEX

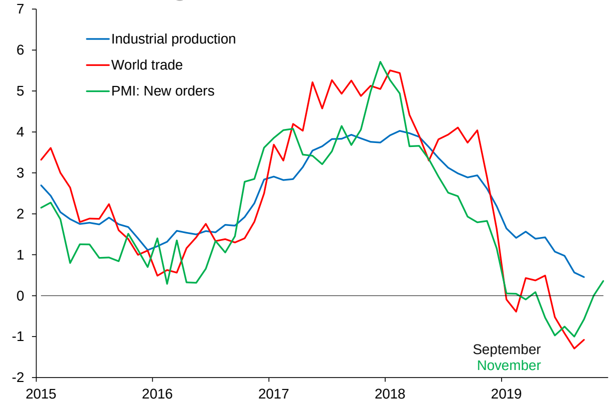
The information in this Annex was prepared for this meeting by the staff of Banco de México's General Directorate of Economic Research and General Directorate of Central Bank Operations. It does not necessarily reflect the considerations of the members of the Governing Board as to the monetary policy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

A.1. External conditions

A.1.1. World economic activity

During the fourth quarter of 2019, in light of the uncertainty at a global level that continued to affect business confidence, the world economy seems to have continued to decelerate, while its growth outlook has been revised downwards. Although the risks that the global economy faces have subsided recently due to the agreements on trade-related issues reached between the United States and some of its main partners, especially China, as well as by the election results in the United Kingdom, and signs of stabilization in certain leading indicators (Chart 1), the balance of risks for world economic activity remains biased to the downside. In particular, the possibility of additional bouts of uncertainty that could negatively affect the outlook for global economic growth, and which may be related to a new escalation of trade tensions or with social and political uncertainty in several regions of the world, persists. The above has taken place in an environment where headline and core inflation remain at low levels and below their respective central banks' targets. In this context, those institutions have maintained accommodative monetary policy stances.

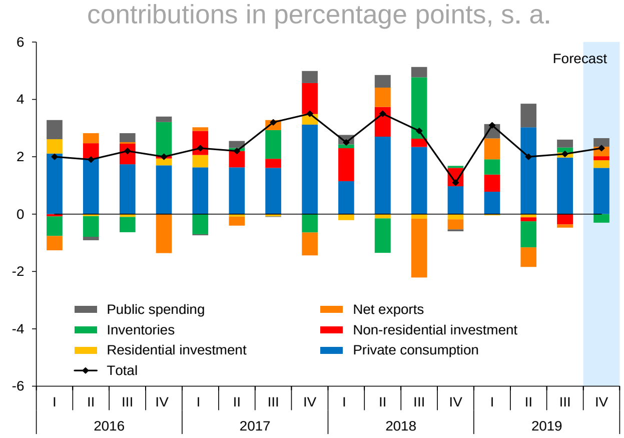
Chart 1
Global Activity Indicators
Annual percentage change of 3-month moving average and deviation from 50, s. a.



s. a. / Seasonally adjusted figures.
Source: CPB Netherlands and Markit.

In the United States, available information suggests that GDP growth during the fourth quarter may be slightly below the average observed in the previous three quarters (Chart 2). In particular, private consumption appears to be slowing down, after having remained strong throughout the year, whereas non-residential investment is expected to continue exhibiting weakness. In contrast, residential investment is expected to continue growing at a modest rate, while recent data suggest a positive contribution to growth from net exports due to the large drop in imports. Finally, public spending is expected to continue supporting short-term growth, although this stimulus would start to fade throughout 2020.

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

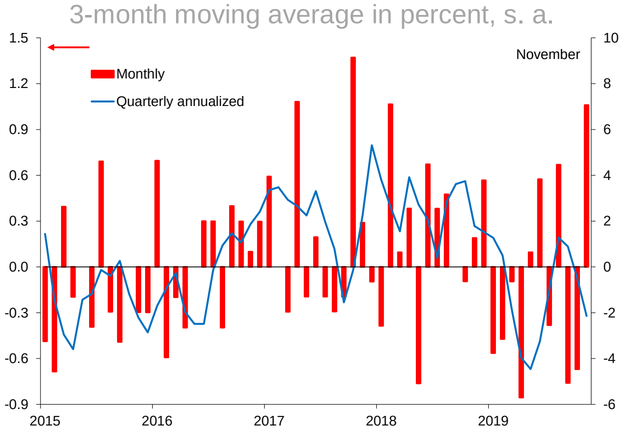


s. a. / Seasonally adjusted figures.
Note: Figures for the fourth quarter correspond to GDP Now estimates of December 17, 2019.Source: Bureau of Economic Analysis (BEA) and Federal Reserve Bank of Atlanta.

US industrial production recovered in November, growing at a monthly rate of 1.1%, after having contracted 0.9 and 0.4% in October and September, respectively. This expansion was partly due to the rebound of manufacturing production, largely attributed in turn to the recovery of automotive production after the labor conflict in this sector was settled (Chart 3). Excluding motor vehicles and auto parts, the US Federal Reserve estimates that manufacturing production grew 0.3%. Certain leading indicators, such as the Purchasing Managers' Index (PMI), point to a certain stabilization of this sector at the end of the fourth quarter.

In this environment, the US labor market continued showing signs of strength. In particular, the non-farm payroll grew at a faster rate in November, increasing by 156,000 and 266,000 new jobs in October and November, respectively. Although this was partly due to the normalization of labor conditions in the automotive sector, the growth of employment was generalized. In turn, the unemployment rate decreased from 3.6 to 3.5%, once more reaching its lowest levels since the end of 1969. In this context, wages continued to grow at a moderate rate.

Chart 3
USA: Manufacturing Production
Monthly change and annualized quarterly change of 3-month moving average in percent, s. a.



s. a. / Seasonally adjusted figures.
Source: US Federal Reserve.

In the euro area, available indicators suggest that during the fourth quarter of the year economic growth would continue to be weak, mainly reflecting the lack of vigor of international trade, in an environment of persistent uncertainty that has been affecting manufacturing activity and investment spending in the region. In particular, retail sale indicators available for October appear to show a moderation of consumption during that period. In addition, although the Composite Purchasing Managers' Index showed signs of stabilization in November, its level suggests that manufacturing growth may remain weak. Despite the above described environment, the unemployment rate decreased from 7.6% in September to 7.5% in October.

In Japan, GDP growth during the third quarter was revised upwards from 0.2 to 1.8%, reflecting the strong growth of private consumption in anticipation to the VAT increase. In October, the entry into force of this rate increase contributed to the highest contraction in retail sales of the last 10 years. Despite the apparent weakening of economic activity at the beginning of the fourth quarter, the unemployment rate remained at 2.4% in October. In this context, the Japanese authorities announced a fiscal stimulus package of around 2% of GDP that is expected to boost economic activity in 2020 and 2021.

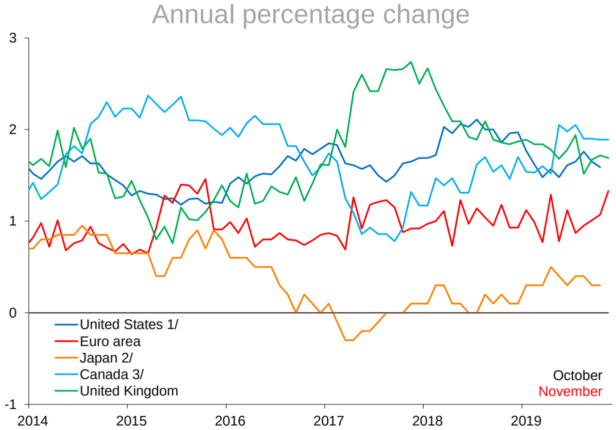
In emerging economies, available information indicates that most of them continued registering moderate growth rates during the fourth quarter of the year. In China, economic activity indicators, such as retail sales and industrial production, recovered slightly in November. Nevertheless, economic activity is expected to continue its trend towards a gradual deceleration in the medium term due to the economy's high leverage and to the trade conflicts with the United States. As for Latin America, social and political tensions have started to be reflected in a decline in growth expectations for the region and in a high volatility in its financial markets.

International commodity prices registered a mixed behavior during the last weeks. International crude oil prices registered a high volatility between mid-November and early December due to the uncertainty regarding the trade tensions between China and the United and news on US oil production levels. Nevertheless, in the last days, oil prices trended upwards, lying close to their highest levels of the year. This was due to a fall in crude oil extraction by some Organization of Petroleum Exporting Countries (OPEC), particularly Iran and Angola, the extension of the oil production cut agreement between OPEC and its allies, and the fall in US crude oil inventories. Grain prices followed a slight upward trend given growing expectations that China will increase its purchases of US grains, following the provisions of the preliminary agreement reached between both countries, and delays in US summer harvests. Finally, industrial metal prices followed a downward trend due to the sharp fall in zinc, nickel, and copper prices stemming from the significant deceleration of the world manufacturing sector.

A.1.2. Monetary policy and international financial markets

Headline and core inflation of the main advanced economies have remained at low levels and below their respective central banks' targets, despite the continuing tightness of their labor markets (Chart 4). Similarly, inflation expectations drawn from surveys and from market instruments have remained at low levels. In the United States, headline inflation, as measured by the personal consumption expenditure deflator, remained below the US Federal Reserve's 2% target, while core inflation decreased in October partly due to the effect of the methodological change for measuring clothing and apparel prices. In the euro area, headline and core inflation increased slightly in November. In Japan, both remained at very low levels in October. In most emerging economies, inflation remained in line or below their central banks' targets, although in certain Asian economies, particularly China and India, headline inflation continued to increase due to the effects of the higher prices of pork.

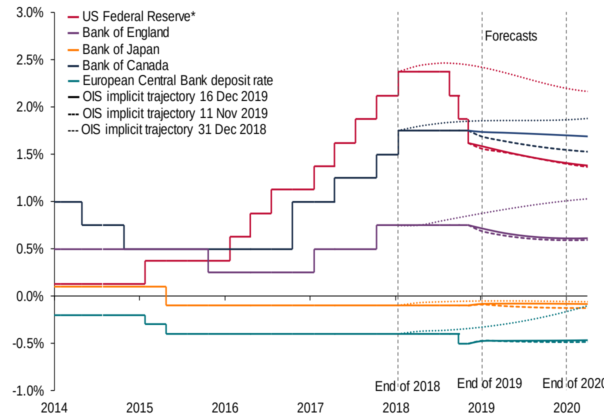
Chart 4
Selected Advanced Economies: Core Inflation
Annual percentage change



1/ Refers to the Personal Consumption Expenditures Price Index (PCE).
2/ Excludes fresh food, energy, and the direct effect of the consumption tax increase of 2014.
3/ Excludes food, energy, and the effect of adjustments on indirect taxes (CPIX).
Source: Haver Analytics, BEA, Statistical Office of the European Union (Eurostat), and Statistics Bureau (Japan).

In this context of low growth forecasts, of inflation persistently below the main central banks' targets, and of high risks for the global economy, the major central banks have maintained accommodative monetary policies (Chart 5).

Chart 5
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 (1.50% - 1.75%).
Source: Bloomberg.

In its December meeting, as anticipated, the US Federal Reserve left the target range for the federal funds rate unchanged at 1.5-1.75%. In its statement, this central bank reiterated that the current monetary policy stance is appropriate to ensure a sustained growth of economic activity, sound labor conditions, and inflation close to its 2% symmetric target, and eliminated the reference to uncertainty regarding said scenario. The medians of the Fed's projections on the federal funds rate suggest that this rate would remain unchanged in 2020 and would increase by 25 basis points in 2021, contrasting with the implied path of the federal funds rate futures, which continues to reflect the expectation of an additional cut in 2020. This central bank reiterated that, in determining its future actions, it will take into consideration the implications of available information, including the development of global economic activity and low inflationary pressures. In this regard, the Chairman of the US Federal Reserve pointed out that, in order to support a raise in the federal funds rate, inflation would need to increase significantly and persistently.

In its December meeting, as expected, the European Central Bank (ECB) left unchanged its monetary policy stance. As to its forward guidance, this central bank reiterated that Monetary Policy Committee members anticipate that rates remain at their current levels or below them until inflation robustly converges to a level sufficiently close to but below 2%. In addition, in her first press conference, the ECB President highlighted that although inflation is moderate and growth is weak, there are signs of a certain stabilization of economic activity. She also pointed out that this central bank will start revising its monetary policy strategy in January and that such revision will probably last until the end of 2020.

The Bank of Japan did not modify its monetary policy stance in its December meeting. In said meeting it reiterated that it will leave interest rates at their current or lower levels until it is certain that the 2% inflation target is not at risk. The Bank of Japan Chairman highlighted that, although the external and domestic environment has improved slightly, risks to inflation and economic activity remain biased to the downside and thus monetary policy maintains an accommodative stance. He also pointed out that although a cut in reference rates remains an alternative, the costs and benefits of this option must be assessed.

The Bank of Canada left its policy interest rate unchanged at 1.75% in its December meeting. In its statement, this central bank mentioned that economic growth decelerated during the third quarter, although it highlighted the sound growth rate of investment spending. This central bank identified trade conflicts and their associated uncertainty as the main sources of risk for its economic outlook and pointed out that future decisions on the path of the reference interest rate will be determined by its assessment of the adverse effect that such conflicts may have on the components of external demand that have largely explained the strength of Canada's economy, such as consumption and the housing sector.

In its December meeting, the Bank of England left its policy rate at 0.75% and did not modify the size of its government bond purchases. Two members once again voted in favor of cutting the policy rate by 25 basis points. The Monetary Policy Committee highlighted the improvement in the economic outlook. In particular, it pointed out that consumer and business confidence may recover in the short term given the lower uncertainty regarding the United Kingdom's exit process from the European Union and the recent preliminary trade agreement between the United States and China. In this context, this central bank reiterated that its monetary policy stance will depend on the course followed by the economy, which will be influenced by the United Kingdom's exit process from the European Union and by the outlook for the world economy.

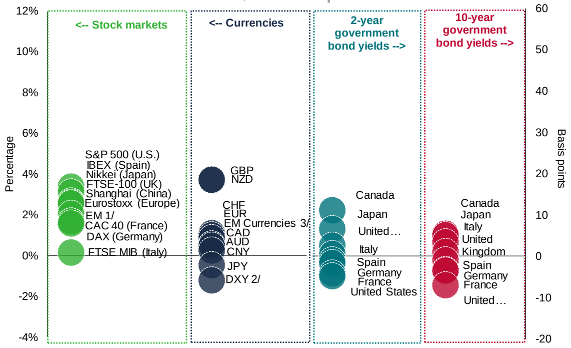
In emerging economies, some central banks have continued to ease their monetary policy stances. In particular, the People's Bank of China cut the 7-day reverse repo rate from 2.55 to 2.50% for the first time since October 2015, while it lowered the one-year Loan Prime Rate (LPR) from 4.20 to 4.15% and the 5-year LPR from 4.85 to 4.80%. Expectations that this central bank will continue to gradually ease its monetary policy stance in order to boost economic activity strengthened. Other central banks, such as those of Brazil, Turkey and Russia, also lowered their reference interest rates. Some others implemented other type of measures to face the deterioration of their economies and the volatility of financial markets, associated, in several cases, with social conflicts. In this regard, Chile announced interventions in its foreign exchange market, while leaving its monetary policy rate unchanged.

As to financial markets, these exhibited a high sensitivity to the decline of certain risk factors, which has led to greater risk appetite among investors. Thus, during the last month, the financial markets of advanced economies exhibited moderate adjustments differentiated by asset class. Stock indexes registered slight gains; interest rates of government bonds showed limited mixed adjustments; and the US dollar depreciated slightly (Chart 6).

Financial assets of emerging economies registered a higher volatility, especially those of Latin America due to the presence of idiosyncratic factors. Inflows towards emerging economies' financial assets recovered, although capital inflows were concentrated in equity assets. In contrast, fixed income markets registered moderate outflows in the last weeks. The currencies of these economies fluctuated slightly, except for specific cases, such as the Chilean peso, which continued to exhibit a high volatility (Chart 7).

Chart 6
Change in Selected Financial Indicators from November 11, 2019 to December 16, 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.

Chart 7
Emerging Economies: Financial Assets Performance from November 11, 2019 to December 16, 2019

Region	Country	Currencies	Equity markets	Interest rates 2Y	Interest rates 10Y	CDS
Latin America	Mexico	0.76%	1.71%	4	-6	-8
	Brazil	2.11%	4.31%	21	10	-19
	Chile	-0.21%	5.71%	25	9	1
	Colombia	-0.52%	-0.47%	-4	0	-3
	Argentina	0.03%	12.40%	-816	-252	-914
Emerging Europe	Russia	2.32%	1.51%	-8	17	-19
	Poland	1.32%	-3.99%	-7	-23	-7
	Turkey	-1.31%	7.76%	-99	-9	-30
	Czech Republic	1.30%	1.36%	0	-1	-5
	Hungary	2.55%	5.96%	0	-9	-3
Asia	South Korea	-0.48%	2.07%	-18	-32	-3
	Malaysia	0.03%	-2.41%	-2	3	-2
	India	0.65%	1.47%	6	11	1
	Philippines	0.43%	-3.84%	0	0	-1
	Thailand	0.36%	-4.46%	-7	-13	-2
	Indonesia	0.41%	1.02%	17	35	-5
Africa	South Africa	3.59%	1.02%	-21	-19	-11

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

Several risk factors persist, such as a greater-than-expected weakening of global economic activity; a new escalation of trade tensions between the United States and its main trade partners; uncertainty regarding the condition for the United Kingdom's exit from the European Union, although this decreased after the recent election results in that country; the possible impeachment of the US President; higher social and political uncertainty in several Latin American countries; and, an escalation of geopolitical tensions in the Middle East, among others.

A.2. Current situation of the Mexican economy

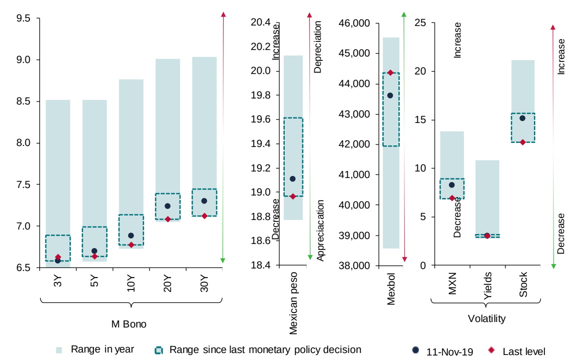
A.2.1. Mexican markets

Since Banco de Mexico's previous monetary policy decision, the prices of financial assets in Mexico exhibited a positive behavior, although some episodes of sharp volatility, mostly related with social events in some Latin American countries, were observed during the period (Chart 8).

In particular, the peso/dollar exchange rate fluctuated in a broad range of 18.90-19.66 pesos per US dollar, closing the period at 18.94 pesos per US dollar, appreciating by 0.76%. In turn, forward-looking trading conditions for the peso exchange rate implied in FX options continued to evolve favorably. Indeed, the implied volatility of one-month options reached the minimum levels of the last six years. For its part, the median of peso exchange rate expectations by forecasters from several financial institutions for the end of 2019 were adjusted downwards from 19.75 to 19.60 pesos per US dollar, while those for the end of 2020 were slightly adjusted from 20.07 to 20.05 pesos per US dollar (Chart 9).

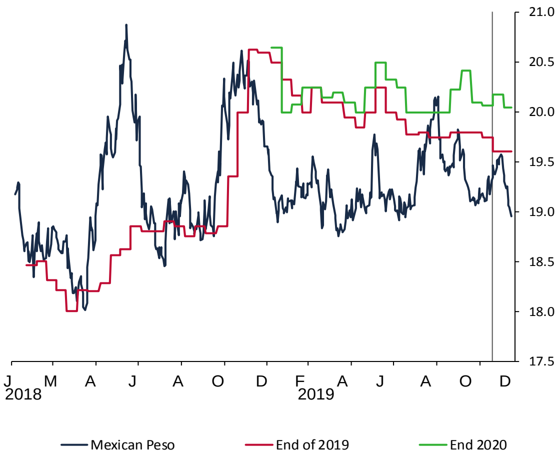
Chart 8
Mexican Markets' Performance and Trading Conditions

Percent, pesos/US dollar, index and basis points



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

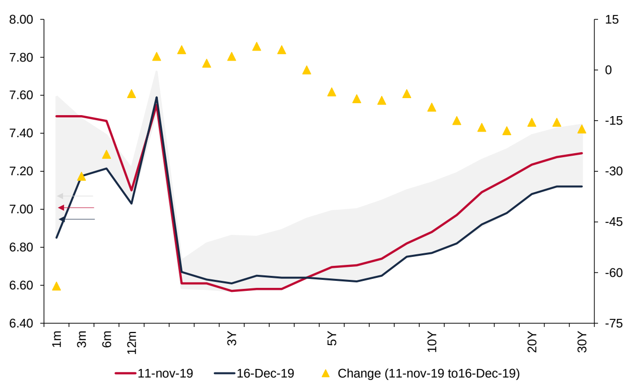
Chart 9
Analysts' Mexican Peso Exchange Rate Expectations
Pesos per US dollar



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

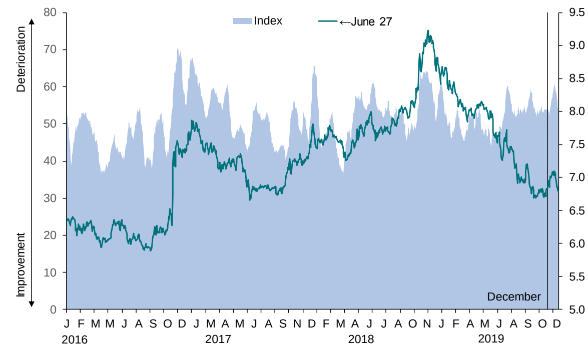
Interest rates of government securities registered mixed and moderate fluctuations, with increases of up to 7 basis points in the 1 to 3-year nodes and decreases in the rest of the curve (Chart 10). It is worth noting that, although these adjustments occurred in a context where trading conditions remained stable, the trading volume decreased due to seasonal reasons (Chart 11).

Chart 10
Nominal Yield on Government Securities
Percent, basis points



Source: PIP.

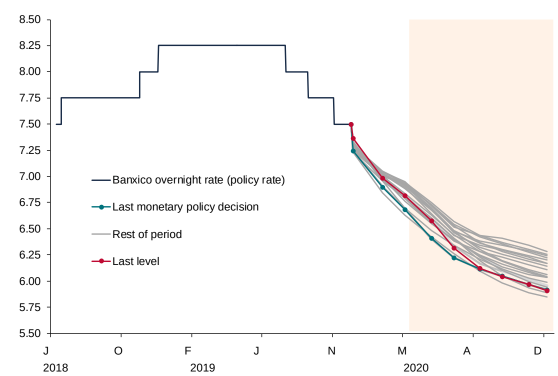
Chart 11
Mexican Government Debt Market Trading Conditions and Jun-27 Bond Rate
Index (10-day moving average), percent



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

As to expectations regarding the path of the monetary policy target rate, information implied in the TIIE (Interbank Equilibrium Interest Rate) swap curve considers a 25-basis point cut, placing the funding rate at levels of 7.25% by the end of the year (Chart 12), in line with the median forecasts of private sector forecasters surveyed by Citibanamex. For the end of 2020, market variables incorporate rates of around 6.00%, while the median of said survey among forecasters remained at 6.50%.

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

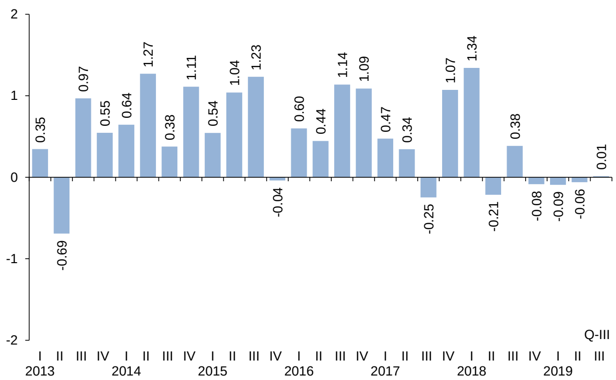


Source: Prepared by Banco de México with Bloomberg data.

A.2.2. Economic activity in Mexico

According to latest revised GDP data, during the third quarter of 2019 economic activity remained stagnant (Chart 13). Such behavior reflected the unfavorable performance exhibited by investment and the slowdown of exports, while private consumption recovered slightly. Although available information for the fourth quarter of 2019 is limited, the weakness of economic activity is expected to persist during said quarter.

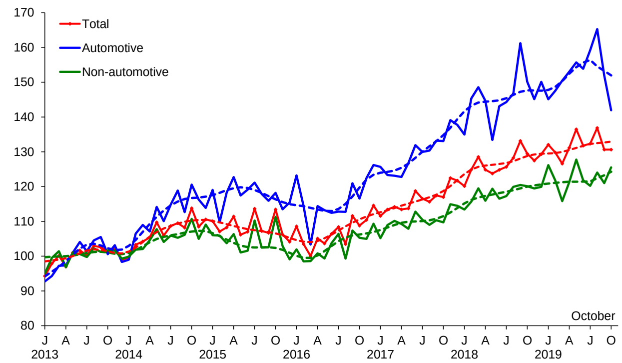
Chart 13
Gross Domestic Product
Quarterly percentage change, s. a.



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

As for external demand, at the beginning of the fourth quarter of 2019 manufacturing exports continued to slow down (Chart 14). Such evolution was due to the downturn of automotive exports, consistent with the fall in Mexico's automotive production originated by changes in the automotive production lines of several auto assembly plants and the effects of strikes in this sector in the United States. In particular, such fall is explained by the lower exports to the United States, given that those to the rest of the world recovered slightly. This decrease was offset by the positive path followed by non-automotive manufacturing exports, which were bolstered by exports to the United States, given that those to the rest of the world continued trending downwards.

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

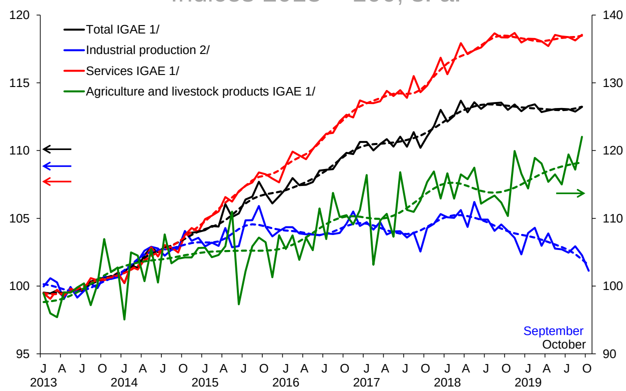


s. a. / Seasonally adjusted series and trend series based on data in nominal USD. The former is represented by a solid line and the latter by a dotted line.
Source: Prepared by Banco de México with data from the Tax Administration Service (SAT, for its acronym in Spanish), the Ministry of the Economy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

As for domestic demand, according to its monthly indicator, at the end of the third quarter of 2019 private consumption registered a slight recovery vis-à-vis the weakness observed at the end of 2018 and the beginning of 2019. Such rebound is mainly explained by the recovery of consumption of imported goods, given that consumption of domestic goods and services remained weak. More timely indicators of consumption, albeit of less coverage, such as retailer's earnings and sales of manufacturing industries that are more correlated with domestic consumption, remain on a positive trend. In contrast, sales of light vehicles have continued trending downwards. In September 2019 the decreasing trend followed by gross fixed investment since early 2018 continued to intensify. The unfavorable performance of investment in construction persisted, while investment in machinery and equipment remained weak, albeit recovering slightly at the margin.

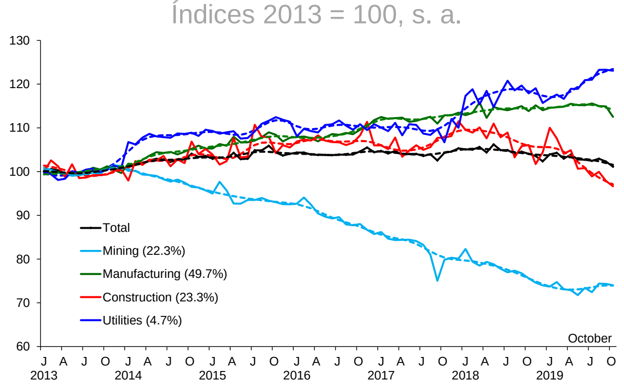
As for production, the stagnation of economic activity during the third quarter of 2019 reflected the unfavorable performance of secondary activities and the lackluster growth of tertiary activities, although the latter slightly recovered towards the end of said period (Chart 15), largely driven by the positive contribution of transportation and warehousing; finance and insurance; and, of real estate, rental and leasing. As for industrial activity, it continued to perform poorly at the beginning of the fourth quarter of 2019. In particular, the downward trajectory followed by construction intensified further, while manufactures decreased significantly, mainly due to the contraction of transport equipment. In contrast, mining, quarrying, and oil and gas extraction remained relatively stable (Chart 16).

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

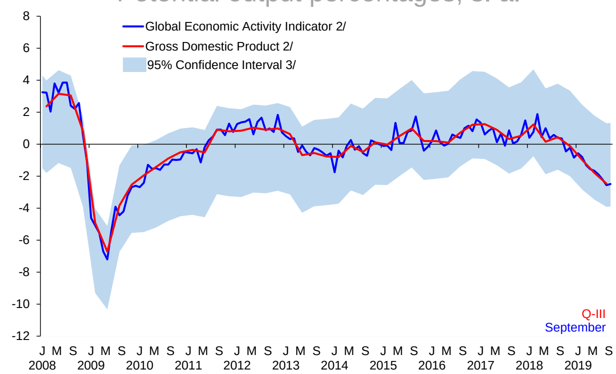
Chart 16
Industrial Activity[1/]
Índices 2013 = 100, s. a.



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

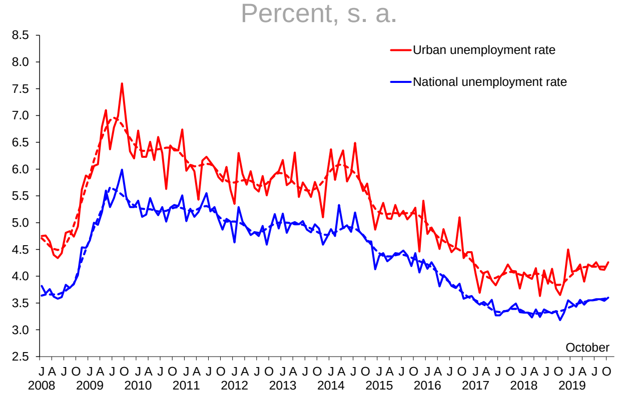
As to the economy's cyclical position, slack conditions are estimated to have widened during the third quarter of 2019, due to the stagnation of economic activity. In particular, output gap estimates, both based on total GDP and on GDP excluding the oil sector, displayed more negative levels than in the previous quarter (Chart 17). Available information for the fourth quarter suggests that during that period a widening of negative slack conditions might be observed with respect to the previous quarter. As to labor market conditions, both national and urban unemployment rates remained at levels above those registered in 2018 (Chart 18), while IMSS-insured jobs continued to grow at a sluggish pace. As a result of the behavior of productivity and real average earnings, unit labor costs in the overall economy continued trending upwards during the third quarter of 2019 (Chart 19), while manufacturing unit labor costs remained at relatively high levels.

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



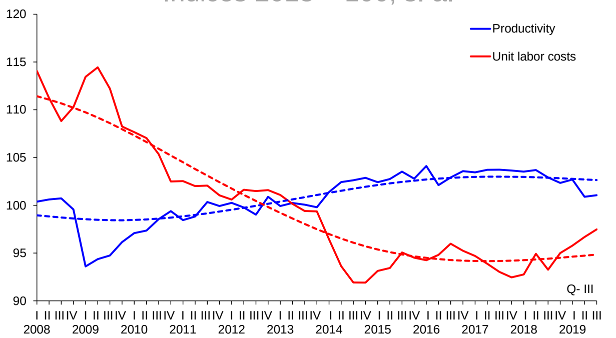
s. a. / Calculations based on seasonally adjusted figures.
1/ Output gap estimated with a tail-corrected Hodrick-Prescott filter; see Banco de México (2009), "Inflation Report (April-June 2009)", p.74.
2/ GDP figures up to the third quarter of 2019 and of IGAE up to September 2019.
3/ Output gap confidence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



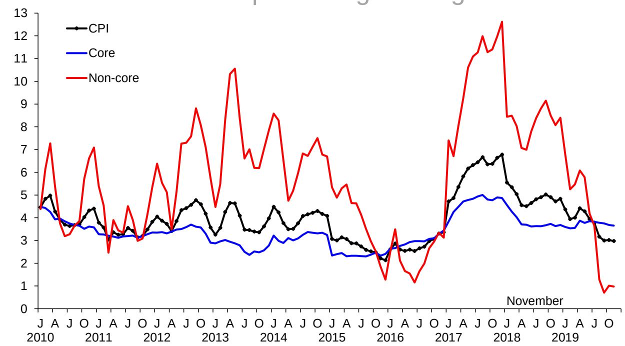
s. a. / Seasonally adjusted and trend series. The former is represented by a solid line and the latter by a dotted line. Trend series estimated by Banco de México.
1/ Productivity based on hours worked.
Source: IGPLE published by INEGI. Unit labor costs prepared by Banco de México with INEGI data.

In October 2019, domestic financing to the private sector continued to slow down. Within it, the deceleration that financing to private firms has been registering since the second half of 2018 further intensified, in turn due to the lower growth of bank credit and to the contraction of debt issuance,. As to the household segment, mortgages maintained the dynamism they have been exhibiting throughout the year, whereas consumer credit continued registering a low growth rate. As for interest rates, those of firm financing decreased, in line with the reduction of the overnight funding interest rate. Interest rates of mortgages, on the other hand, have remained stable since the second quarter of 2017, while in the segment of consumer credit those of credit cards and personal loans continued following an upward trend. With regards to portfolio quality, firm and mortgage delinquency rates remained at low levels, while those related to consumption did not register significant changes, although they continue being at high levels.

A.2.3. Development of inflation and inflation outlook

Between October and November 2019, annual headline inflation decreased slightly, from 3.02 to 2.97% (Chart 20 and Table 1).

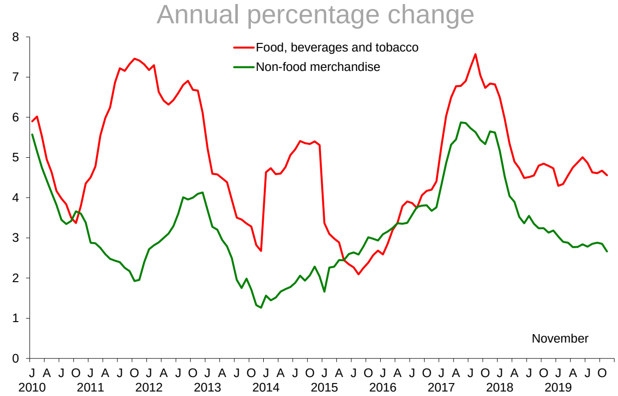
Chart 20
Consumer Price Index
Annual percentage change



Source: Banco de México and INEGI.

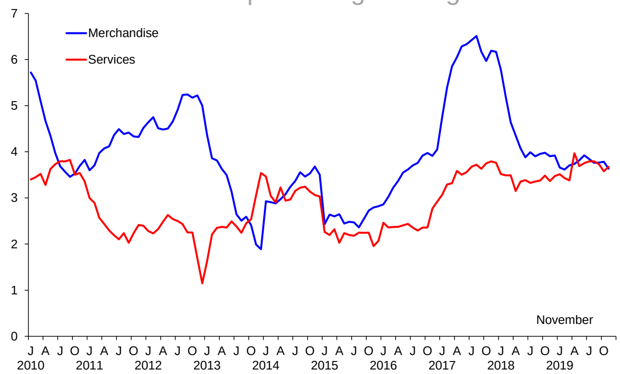
In particular, annual core inflation decreased from 3.68 to 3.65% between October and November 2019. Within this component, the annual rate of change of food merchandise prices fell from 4.67 to 4.56% in said period. As for non-food merchandise prices, its annual rate of change continued to decrease, reaching 2.66% in November (Chart 21). In contrast, the annual rate of change of services prices rose from 3.58 to 3.67% between October and November (Chart 22), mainly due to increases in certain tourist and food and beverage services prices.

Chart 21
Merchandise Core Price Subindex
Annual percentage change



Source: Banco de México and INEGI.

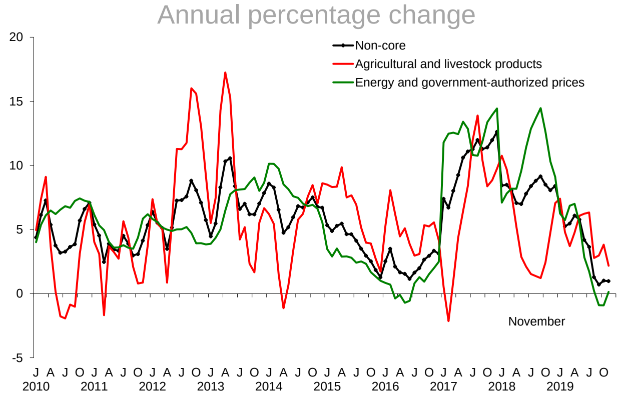
Chart 22
Merchandise and Services Core Price Subindex
Annual percentage change



Source: Banco de México and INEGI.

Annual non-core inflation decreased from 1.01 to 0.98% between October and November 2019 (Chart 23 and Table 1). This was due to a reduction in the annual rate of change of fruit and vegetable prices, which was offset by increases in the annual rates of change of livestock product, energy and government-authorized prices.

Chart 23
Non-core Price Subindex
Annual percentage change



Source: Banco de México and INEGI.

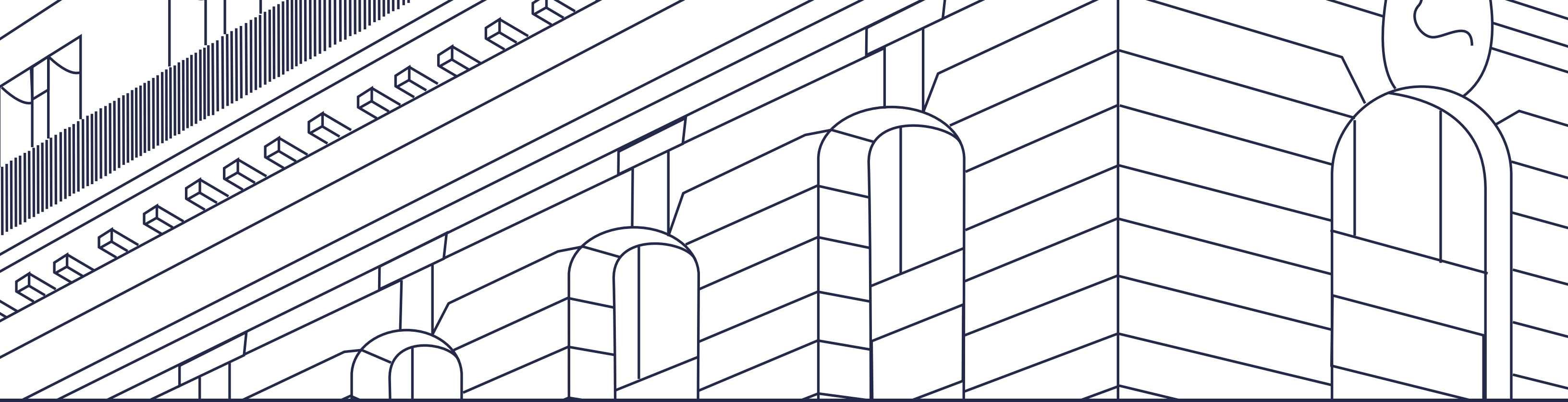
The medians for short-term headline inflation expectations drawn from Banco de México's Survey of Private Sector Forecasters registered decreases between the October and December surveys. In particular, the median of expectations for the end of 2019 decreased from 3.00 to 2.94%. This mainly reflected the reduction from 1.07 to 0.85% in implied non-core inflation expectations, given that the median for core inflation expectations was adjusted slightly from 3.60 to 3.58%. For its part, the median of expectations for headline inflation for the end of 2020 decreased from 3.50 to 3.46%, which is explained by the downward revision of the non-core component from 3.81 to 3.69%, given that the core component increased from 3.38 to 3.40%. As to the medians for headline and core inflation expectations for the medium term (next four years), they remained unchanged at 3.50% and 3.46%, respectively, while headline and core inflation expectations for the longer term (five to eight years) remained at 3.50 and 3.40%, respectively. Thus, expectations for both headline and core inflation for the medium and long terms remain above the 3% headline inflation target. Finally, long-term inflation expectations (average of 6 to 10 years) implied in long-term market instruments decreased slightly between October and November and remain close to 3%, while the inflation risk premium (calculated on the basis of 1-10 average inflation expectations) increased slightly from 0.18 to 0.21% during the same period.

Regarding risks to inflation, those to the upside are: core inflation's persistence; that the recent minimum wage increase leads to wage revisions that exceed productivity gains in different segments of the employed population and that this generates cost-related pressures, thus affecting formal employment and prices; that the peso exchange rate comes under pressure from external or domestic factors, although the easing of certain external tensions and progress in ratifying the USMCA have reduced such risk; possible tariff and compensatory measures, although this risk has diminished; that public finances deteriorate; and, in this same regard, that there are greater-than-expected increases in agricultural and livestock product or energy prices. As for downside risks: a greater appreciation of the peso exchange rate, which could be associated with a context of greater risk appetite in international financial markets or with the final steps towards ratifying the trade agreement with the United States and Canada; a widening of slack conditions or their impact on core inflation being greater than foreseen; and, that the prices of certain goods included in the non-core subindex register lower rates of change. In this context, uncertainty still persists regarding the risks that could make inflation deviate from its expected trajectory.

Table 1
Consumer Price Index and Components
Annual percentage change

Item	September 2019	October 2019	November 2019
CPI	**3.00**	**3.02**	**2.97**
Core	**3.75**	**3.68**	**3.65**
Merchandise	**3.77**	**3.78**	**3.63**
Food, beverages and tobacco	4.61	4.67	4.56
Non-food merchandise	2.88	2.85	2.66
Services	**3.73**	**3.58**	**3.67**
Housing	2.89	2.93	2.88
Education (tuitions)	4.73	4.73	4.73
Other services	4.28	3.91	4.16
Non-core	**0.71**	**1.01**	**0.98**
Agricultural and livestock products	**2.98**	**3.82**	**2.18**
Fruits and vegetables	0.71	2.36	-1.48
Livestock products	4.86	5.02	5.38
Energy and government-authorized prices	**-0.90**	**-0.91**	**0.14**
Energy products	-3.09	-3.20	-1.80
Government-authorized prices	4.35	4.78	5.09

Source: INEGI.



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