



BANCO DE MÉXICO®

## Minutes number 71

**Meeting of Banco de México's Governing Board on the occasion of  
the monetary policy decision announced on November 14, 2019**

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## 1. PLACE, DATE, AND PARTICIPANTS

**1.1 Place:** Av. Cinco de Mayo Street no. 2, 5<sup>th</sup> floor, Col. Centro, Mexico City.

**1.2. Date of Governing Board meeting:** November 13, 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 third quarter of the year the world economy continued to decelerate. Some members added that this was mainly the result of trade tensions, primarily between the United States and China. In this regard, one member mentioned the imposition of tariffs between these countries, as well as restrictions to trade in technology and to investment, while another member added that other idiosyncratic factors have also contributed to the economic slowdown. One member specified the latter has had a differentiated impact across countries, depending on their degree of openness and the overall state of their economies.

The majority of members mentioned that the adverse global environment has contributed to a decline in

world trade, in investment and in business confidence as well as in manufacturing production. One member stated that indicators of global manufacturing activity suggest that it could be reaching an inflection point, which would limit the impact of potential negative effects on world trade and on activity in the services' sector. However, he/she added that the possible strengthening of the manufacturing industry is still uncertain.

Most members mentioned that the main advanced economies have decelerated, which has been salient in the industrial sector, and has been mainly motivated by the abovementioned trade disputes. One member highlighted the fragility of aggregate demand in the euro area and Japan, and its strong dependence on world trade. Likewise, he/she mentioned that the United States has also been affected by trade disputes, but to a lesser degree. He/she added that in advanced economies, the services sector has performed better, thus supporting the labor market. In this regard, another member considered that labor markets in these economies continue to perform strongly, with low unemployment rates, which has allowed consumption and the services sector to be less affected by the economic slowdown. Regarding emerging economies, one member noted that some of them have been subject to risk factors of an idiosyncratic and political nature, and associated to public policies, which have reinforced the trend of lower growth and uncertainty and have hindered investment. Another member mentioned that emerging economies have shown some recovery, which could more than offset the weakening trajectory of advanced economies. Considering the above, he/she stated that the latest information suggests a stabilization of global economic growth by the end of 2019.

With respect to the growth outlook, most members pointed out that it has continued to be adjusted to the downside. One member delved into the fact that, although an outlook of low interest rates has consolidated for a long time, investment tends to be more sensitive to an environment of high economic uncertainty. He/she added that, for that reason, it is likely that investment will remain weak and that looser financial conditions will support households' spending and lead to greater leverage, rather than encouraging an increase in capital accumulation.

Most members noted that trade tensions between the U.S. and China have eased, and that the probability of a disorderly exit of the United Kingdom from the European Union has diminished. One

member pointed out that in the U.S. there is a lower probability of additional tariffs on imports of vehicles and vehicle parts from the European Union, among others economies. Another member considered that the favorable evolution of trade tensions, as well as the more accommodative stances adopted by the main central banks have mitigated the perception of risk for global economic activity. Nevertheless, most members emphasized that risks to the global economy persist, associated to trade tensions and geopolitical factors as well as political and social uncertainty in different countries. One member pointed out that emerging economies are facing considerable challenges, such as a greater-than-anticipated deceleration, both at a global level and in some of these countries, particularly in China, where the authorities' efforts to implement countercyclical measures could be insufficient. Another member mentioned that the global economic situation poses significant macroeconomic policy challenges. He/she stated that the room for maneuver for fiscal policy is limited, and that it is worrying that global indebtedness has reached historic highs. Finally, he/she argued that increasing the debt burden would imply adding more financial vulnerabilities to the world economy and could represent a major obstacle for sustainable growth. In this context, most members agreed that the balance of risks to world economic activity remains biased to the downside.

Considering the weak economic environment, most members underlined that global inflation pressures have diminished. One member indicated that the indirect effects of the lower energy prices have also contributed to the above. In the case of the main advanced economies, most members mentioned that headline and core inflation remain below their central banks' targets. One member added that inflation expectations for this group of economies have also been at levels below such targets. Most members agreed that these developments in inflation have taken place despite the upturn in wages, associated with the relative strength of the labor market. One member added that inflation in various emerging economies is also at levels below their respective targets. Finally, one member considered that the balance of risks for world inflation remains biased to the downside.

The majority of members pointed out that some central banks of the main advanced economies have taken measures to relax monetary conditions in recent months. One member highlighted that the contribution of additional stimuli to address the economic slowdown is increasingly smaller. All members underlined that in its October meeting, the

US Federal Reserve cut the target range for the federal funds rate by 25 basis points. Most added that, with this decision, a 75 basis point decrease has accumulated this year. They highlighted that the Federal Reserve communication indicates that the attained range is appropriate, considering the risks faced by the US economy and that, therefore, no further adjustments are expected in the short term. One member highlighted that the adjustment in the federal funds rate was made despite the fact that inflation is at its symmetrical 2% target and despite the strength of economic activity and of the labor market, given that, in his/her opinion, the Federal Reserve considers that uncertainty is high. In addition, another member stated that, given the referred adjustment, the US Treasury bonds' yield curve is no longer inverted, even in its shorter segments. For the euro area, Japan and the United Kingdom, most members noted that the central banks of these countries have declared that they will maintain accommodative monetary policy stances until they reach their respective inflation targets. One member underlined that the European Central Bank increased its monetary stimulus considerably in September. Some members pointed out that the Bank of Japan stated that it could even reduce its interest rate in case it was necessary. As for emerging economies, another member expressed that most central banks have eased their monetary policies during the year. He/she mentioned that some of these have lowered their interest rates to a greater degree than the Federal Reserve, as Brazil (150 basis points), Chile (100bp), India (135bp) and Indonesia (100bp).

Most members agreed that global financial markets exhibited lower volatility, due mainly to the mitigation of the above mentioned global risks. In addition, they indicated that the accommodative monetary policy stances in the main advanced economies have contributed to a better performance of such markets in recent weeks. Some members mentioned that, in view of a lower risk aversion, stock markets have recorded gains. One member noted that these have reached historic highs. Another member added that since the last monetary policy decision, advanced economies' interest rates increased moderately and the US dollar registered a generalized depreciation. Most members pointed out that during the last weeks capital flows to emerging economies exhibited a positive trend, both to fixed income and equity markets, and that the currencies of these economies appreciated against the US dollar and their risk premia decreased. One member mentioned that both in advanced and emerging economies, financial markets anticipate an environment of low interest

rates and that over 30% of fixed income instruments exhibit negative returns. However, he/she noted that volatility episodes have been observed during the periods in which different risk factors have intensified. In this context, most members indicated that financial markets could be affected by the prevailing risks to the global economy. Some members argued that these could, to a greater extent, affect emerging markets. One member pointed out that the negative effect of the materialization of such risks on financial markets should not be overestimated, given that the central banks of the main economies would seek to improve global financial conditions via more accommodative monetary policy stances. Some members considered that the risks to international financial markets have subsided, and one of them mentioned that the balance of risks to global financial markets remains neutral.

All members pointed out that latest information on the third quarter of 2019 shows that the stagnation that economic activity in Mexico has been exhibiting for several quarters continues. Most members agreed that there has been practically no economic growth during a year and a half. Some members added that in the third quarter growth was marginal. One member specified that the economy grew 0.1%, while in the annual comparison a 0.4% contraction was observed. Some members highlighted that economic activity is decelerating at a faster-than-anticipated pace. One member added that if the figures for the third quarter are confirmed, the first annual contraction since 2009 would be registered, along with the first desynchronization of the Mexican economy in 25 years with respect to the US economic cycle. Some members pointed out that such contraction would have its origins in the uncertainty related to domestic factors, such as governance problems and public expenditure below the programmed, and to external factors, such as the USMCA ratification process.

Regarding aggregate demand, most members highlighted the weakening of consumption and the lack of dynamism of investment. Delving into the evolution of consumption, one member added that it has decelerated despite the continuous increase in remittances and in the total wage bill in real terms. Another member added that the weakness of consumption is evident in durable goods, while retail sales have registered sustained growth, which could be related to the expansion and creation of some social programs. As for investment, he/she highlighted that, after having followed a clear negative trend during the year, August figures were

positive, albeit still insufficient to consider that there has been a change of trend. Another member specified that public investment has been contracting for several years and continues to bear the adjustment of public finances, while private investment has been affected by the uncertainty related to the trade relationship in North America and other domestic factors since late 2016. As for external demand, most members indicated that manufacturing exports lost dynamism, although some members pointed out that automotive manufactures destined to the U.S. partially offset the referred fall.

On the supply side, most members mentioned the weakness exhibited by the industrial sector, in particular construction and mining. One member pointed out that the weakness in the mining sector was due to lower oil production. Meanwhile, another member highlighted that industrial activity started to rebound in August and seems to have stopped falling after reaching a minimum in July. He/she added that this behavior is accounted for by a better performance of mining, which finally appears to have started reverting the negative trend it had shown for many years, and because manufactures have continued to grow, showing greater resilience against an adverse environment. With respect to tertiary activities, most members noted their stagnation throughout 2019, which is a cause for concern. In this regard, one member highlighted that, in the past, these activities have contributed significantly to economic growth. Another member indicated that tertiary activities are the largest sector of the economy and added that most of their components have weakened, although activities such as transportation, trade and recreation are starting to show a slight recovery. One member noted that only primary activities performed favorably.

Regarding the labor market, most members stressed the strong decline in the pace of formal job creation during the year. In this respect, one member noted that as of October 2019 the growth rate of annual formal employments was 1.68%, which is below the 3.74% registered last year. Some members mentioned that the unemployment rate has risen moderately. However, one member added that this has been accompanied by higher rates of underemployment and informal sector employment. He/she argued that, in addition to the lack of dynamism, the labor market is characterized by the creation of job posts that are, to a large extent, of low quality or that cannot meet the workers' needs. Some members noted that the performance of the

labor market reflected the weakness of the economy. One member added that it has also reflected a trajectory of wages that has been incompatible with the evolution of productivity.

Most members agreed that the stagnation of economic activity has implied the widening of slack conditions in the economy at a faster rate than foreseen. Some members noted that the negative output gap is expected to continue widening throughout next year.

Most members mentioned that, based on the most recent data, expected GDP growth for the present and next year will be lower than that published in the Quarterly Report April – June 2019. Similarly, one member pointed out that specialists surveyed by the central bank once again revised their growth expectations downwards for the current and following years. With respect to growth in 2019, one member indicated that the economy would not grow in the last quarter of the year and another one added that, therefore, a delay is anticipated in the recovery foreseen for such quarter. Another member noted that this would partly be due to factors such as strikes and technical shutdowns that would affect the performance of the automotive industry during the fourth quarter of the year. Meanwhile, another member estimated that economic activity will tend to improve moderately starting next year, despite the current stagnation due to the statistical comparison basis, which will be more evident in certain sectors of the industry, for instance, in construction. In the same vein, he/she mentioned that 2020 will be a leap year, and therefore there will be an extra day to produce goods and services, as compared to the previous year. Finally, another member highlighted that the weakness of gross fixed investment has had considerable implications for the evolution of the economy's capital stock and that its growth rate is estimated to intensify in 2019 the downward trend it has been showing over the last years, with the consequent risks for potential growth.

Most members noted that in an environment of marked uncertainty, the balance of risks to growth continues biased to the downside. One member considered that such balance has deteriorated significantly given the unfavorable dynamics of the services sector and emphasized that one of the most important risks that economic activity faces is the continuation of very restrictive monetary policy stance for too long, because it operates through channels that affect real variables, such as consumption and investment. Some members stated that growth is subject to both external and domestic

risks. Among external risks, besides the global risks described above, one member mentioned the threat of tariffs by the United States on Mexico, and delays in the USMCA ratification. Another member added that manufacturing exports could be affected by the evolution of industrial production and of the automotive sector in both the United States and the rest of the world. With regards to domestic risks, some members mentioned the situation of Pemex and of public finances. Regarding the latter, one member highlighted the risk of a reduction in public revenues and internal factors that affect confidence and the outlook for the Mexican economy. Another member added the negative effect of maintaining very high interest rates on public finances. One member mentioned various upward risks to growth: i) the possibility of the USMCA being ratified in the short term, which would improve the certainty outlook for investment; and ii) a better implementation of public policies. Finally, he/she added that the negative factors that affected the economic performance in 2019 are not likely to occur again, such as the difficulties caused by the fuel shortages, the strikes in Tamaulipas, the railroad blockages, and the suspension of important infrastructure projects.

Most members mentioned that headline inflation has remained stable, and that in October it was 3.02% and thus lies around the point target. The majority stressed that this performance is due to the fact that non-core inflation has remained at low levels, lying at 1.01% in October, while core inflation has remained at higher levels, although it has shown a slight decline to 3.68% in such period. One member considered that headline inflation has declined at a faster-than-anticipated pace.

Regarding non-core inflation, most members indicated that it is at historically low levels and pointed out that in recent months some downward risks have materialized in this subindex. Some members highlighted the lower rates of change of energy and agricultural and livestock product prices. One stressed that these have recently shown the lowest levels on record. However, most members highlighted that non-core inflation is subject to a high degree of volatility.

With respect to core inflation, most members agreed that it has continued to show persistence. One member pointed out that it has remained at around 3.8% for over 9 months. Another member expressed that within the core component there are greater pressures on the prices of services other than housing and on food merchandise, partly due to the

indirect effects of the energy price increases during the second half of last year and of wage increases since the start of this year, which also have a lagged effect. One member added that, given the negative output gap, an exchange rate that has remained most of the year at more appreciated levels than at the end of 2018, energy prices with negative annual growth and agricultural product prices with moderate growth, wages are the variable that seems to be contributing, to a larger extent, to core inflation's persistence. He/she pointed out that econometric exercises lead to the same conclusion. Meanwhile, some members mentioned that core inflation has recently shown slightly lower readings. One member noted that in October it declined for the fourth consecutive month. Some members considered that the fall of core inflation is essentially explained by the lower growth of services prices.

Most members indicated that short-term inflation expectations drawn from surveys have followed the latest data, while longer term expectations have remained relatively stable, albeit at levels above 3%. Some members detailed that in October headline inflation expectations for year-end 2019 decreased to 3%. One member added that for 2020 and for the medium and long terms they stood at 3.5%. Some members mentioned that compensation for inflation and inflationary risk implied in fixed income instruments has continued to decrease. One of them specified that break-even inflation is at its lowest level of the year.

Regarding inflation forecasts, most members mentioned that the recent behavior of the factors that affect the foreseen trajectory of headline inflation suggests that it may lie slightly below the trajectory set forth in the previous Quarterly Report. One member pointed out that at the end of the year inflation is likely to be below the target. Meanwhile, another member stated that, on balance, the latest data on inflation and the expected trajectory of different economic variables do not significantly alter the outlook for the performance of headline and core inflation for the following months. One member indicated that, despite expectations of headline inflation converging to its target, the trajectory depends on core inflation's persistence easing and on non-core inflation converging to levels close to the inflation target. Some members emphasized that a slight increase in headline inflation is expected in the first quarter of next year, as a consequence of the comparison base, calendar effects and seasonality. One mentioned that it is foreseen that inflation will return to levels of around 3% starting in the second quarter of 2020.

Regarding the outlook for core inflation, one member outlined that its performance in the following quarters will depend on the interaction between the indirect effects of the energy price and wage increases, with the effects of the greater slack in the economy. He/she pointed out that core inflation is estimated to follow a gradual declining trajectory towards 3% within the forecast horizon, slightly above that anticipated in the last Quarterly Report. One member considered that there are two factors that make it possible to anticipate a greater reduction in the core component. On the one hand, the moving average of the annualized monthly changes of this indicator remains at low levels of 3.3%. On the other hand, fundamental core inflation, that is, the one that is more closely associated to the economic cycle, was only 3.38% in October. With respect to non-core inflation, another member indicated that this component is expected to rebound to levels much closer to 3%.

In relation to upward risks to inflation, most members mentioned the possibility of core inflation continuing to show persistence. Some members added that this could occur despite the greater slack in the economy. In this respect, one member detailed that risks to core inflation's trajectory are evident when considering that close to 70% of the basket of the item that includes services other than housing and education, excluding tourism, continues to show annualized monthly growth rates above 4%. In this context, some members expressed their concern about the persistence of headline and core inflation expectations above the central bank forecast for 2020 and for the long term.

Most members added the following risks: i) wage increases above productivity gains, and that this generates cost pressures. Some mentioned that there is uncertainty associated with the new adjustments to the minimum wage in 2020: ii) that the peso exchange rate comes under pressure from both external and domestic factors; iii) the threat of tariffs by the United States and that compensatory measures are adopted, although they considered that this risk has diminished; iv) that public finances deteriorate; and, v) increases in agricultural, livestock or energy prices greater than expected. In addition, some members pointed out the risk that non-core inflation registers a reversal to its historic values.

One member mentioned the composition of observed inflation as a risk to its trajectory. He/she indicated that currently its components do not correspond to a long-term equilibrium, given that

non-core inflation is abnormally low and core inflation is high.

As for downward risks, most members mentioned the following: i) a possible appreciation of the peso exchange rate, which could likely be associated with a context of greater risk appetite in international financial markets or in case the trade agreement with the United States and Canada is ratified; ii) that slack conditions widen more than expected or that their impact on core inflation is greater than foreseen; in this regard, one member indicated that, given that a negative output gap is observed, no demand-related inflation pressures are anticipated; and, iii) the possibility that the prices of certain goods included in the non-core subindex register lower rates of change. Some members pointed out as a possible indicator of lower inflationary pressures the fact that the producer price index was 0.6% in October as compared to the same month of the previous year, noting that this rate is the lowest observed since August 2015.

In this context, most members agreed that uncertainty still persists regarding the risks that could make inflation deviate from its foreseen trajectory. One member considered that, although the balance of risks is more balanced in the short term, in a longer-term perspective it could become uncertain due to the above mentioned dynamics of the headline inflation components. Another member mentioned that although the balance of risks is complex, in his/her opinion, it continues biased to the upside. One member estimated that risks to inflation have subsided considerably during this year, associated with better global financial conditions and with the above mentioned downward risks. Therefore, he/she considered that the balance of risks to inflation remains neutral.

Most members agreed that financial markets in Mexico performed favorably, in line with the improvement in global financial conditions. They indicated that government bond yields declined for all terms. One member specified that stronger decreases were observed in certain short-term segments, and another one indicated that interest rates have remained at their lowest levels of the year. One member added that the recomposition towards longer term assets in foreign investors' portfolio continued. Another member stated that nominal and real yield curves are inverted in their shortest tranches. He/she added that, after breaking down long-term interest rates into short-term interest rate expectations and term premia, it is found that both components have declined in recent months.

He/she argued that maintaining a prudent macroeconomic policy stance has been crucial for yield curves, both nominal and real, especially in their long end, to be adjusting in an orderly manner and to the downside, in a context of a slowdown of economic activity, looser global financial conditions, and idiosyncratic risks. All members noted that the peso exchange rate appreciated slightly. One member stressed that such appreciation occurred in a context of better market trading conditions. Another member highlighted that the Mexican peso has performed better than other Latin-American economies' currencies, which he/she associated partly to the fact that the short-term interest rate in Mexico is higher. One member added that the exchange rate has maintained a favorable outlook in light of the possible ratification of the USMCA. Some members mentioned that the stock market recorded slight gains. As for risk premia, most members emphasized that these decreased. One member stated that the Credit Default Swap (CDS) premium has decreased, both for the sovereign and Pemex's debt, as both of these were at their lowest levels of the year. Another member emphasized that despite this reduction, the level of the sovereign CDS premium suggests that markets are still discounting a downgrade of Mexico's credit rating, given that said CDS level is above those of other countries with a similar or even lower credit rating.

Most members agreed that risks persist, which could affect the performance of financial assets in Mexico. Among these risks is a possible downgrade of the sovereign and Pemex's ratings. In this sense, one member claimed that, given the strong presence of foreign investors, the country is exposed to a reversal of capital flows and to an increase of the country risk premium. Another member pointed out that economic growth rates consistently below expectations are a risk to domestic financial markets. One member considered that, although risks for domestic financial markets have diminished, an important risk faced by these markets currently is the continuation of an overly-tight monetary policy for a prolonged period. He/she stated that an interest rate that is too high, in addition to affecting growth and public finances, contributes to maintain the exchange rate appreciated, which not only affects net exports, but also attracts speculative capital, which could increase the country's financial vulnerabilities. He/she stated that it is possible that a very high interest rate, which in principle would seek to protect the economy from certain risks, could, paradoxically, end up being an additional destabilizing factor.



Most members mentioned that the current environment continues to pose significant risks that could affect the country's macroeconomic conditions, its ability to grow, and the economy's price formation process. In this regard, they emphasized 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 underlined that it is necessary to strengthen the credit rating outlook for the sovereign and Pemex's debt, as well as to achieve the fiscal targets for 2019 and the goals set in the 2020 Economic Package. Likewise, they also pointed that strengthening the rule of law, tackling corruption, and fighting insecurity are equally imperative. One member added that it is important to increase productivity by adopting new technologies and investing in human capital. Another member mentioned that such measures would prevent potential growth from further deteriorating. Delving into Pemex's financial situation, the majority of members acknowledged that efforts for refinancing the company's external liabilities have had a favorable impact, as recognized by markets. They also mentioned that during the third quarter Pemex registered a positive cash flow and that oil production ceased to fall. One member added that the state-owned company has improved its financial profile in the short and medium terms. Some members stated that due to the above, the price of debt instruments stabilized and the premium on its CDS decreased. One member specified that in addition to the latter, the significant channeling of resources by the federal government contributed to reduce Pemex's 5-year CDS by 100 basis points over the last weeks and thus the possibility of a downgrade is significantly lower than it was a few months ago. Nevertheless, the majority warned about Pemex's business plan continuing to be a cause of concern for the rating agencies.

One member expressed that the state-owned company's financial results as of the third quarter of this year show that it is still premature to consider that the structural problems that have prevented it from being profitable have been overcome. He/she also mentioned that the International Monetary Fund (IMF) noted that the business plan of the company must be revised. Another member pointed out that there is skepticism about Pemex's ability to meet its production and reserve replacement goals. He/she asserted that one of the rating agencies, whose stance is decisive for maintaining the company's investment grade, has pointed out that the

company's investment levels are far below those that, in its opinion, are required to increase production and reserves. Some members indicated that given the above, markets seem to continue discounting that Pemex will lose its investment grade. Faced with this scenario, such members warned that this company could require additional support from the Federal Government, which would exert greater pressure on public finances, which already face the challenge of achieving the revenues projected for next year, in an environment in which economic activity may be lower than originally forecasted. One member pointed out that, given the aforementioned, the sovereign credit rating may also be affected.

Delving into the state of public finances, one member mentioned that according to the IMF, the weakness of public revenues can lead to pressures and that, in the absence of additional measures to raise revenues or reduce spending, it estimates that a fiscal gap of between 0.5 and 1.5% of GDP will appear over the next five years. On the other hand, another member mentioned that fiscal policy has remained prudent and that the proposal for 2020 is cautious and responsible by presenting a primary surplus of 0.7% of GDP. Finally, the majority added that, judging from the opinion of business people and analysts, among the obstacles for economic activity in Mexico those that stand out are factors related to problems of insecurity, the rule of law, corruption and the lack of clarity in some public policies. One member pointed out that the percentage of companies that report having been victims of a crime continued to increase, and that the cost of credit is clearly higher for companies in those states with higher crime rates.

In relation to the monetary policy decision, considering that the lower levels recorded by headline inflation, as well as the ample slack conditions in the economy and the recent behavior of the external and domestic yield curves allow for decreasing the policy rate, the majority considered adequate to reduce by 25-basis points the overnight interbank interest rate to a level of 7.50%.

Most members highlighted that given the high uncertainty outlook faced by inflation, monetary policy must remain prudent. They stated that the monetary policy stance must be adjusted gradually, incorporate available information, respond to the economy's conditions, and allow for an orderly and sustained convergence of inflation to the target. One member argued that the level of the attained rate allows for gradually decreasing the level of monetary

restriction, according to the economy's conditions, and facilitates the efficient convergence of inflation to its target in the time frame in which monetary policy operates. Another member mentioned that the outlook has become more complex as GDP growth has turned out to be lower than anticipated, while core inflation and inflation expectations continue to show persistence, and an environment of high uncertainty prevails around factors that could affect inflation, even in the short term, such as the wage policy and Pemex's situation. In this context, he/she asserted that while any room for maneuver that is available should be used to ease the monetary policy stance, this should be done with caution given the risks faced by the economy.

One member pointed out that it is necessary to determine the best balance for the monetary position that considers i) an external environment of lower inflationary pressures and interest rates; ii) a headline inflation around its target, a persistent core inflation and an atypically low non-core inflation; iii) a widening of economic slack; and iv) the need for aligning short-term interest rates to procure an orderly adjustment of the economy; that is in tune with the yield curve and the risk premia; that contributes to maintain the attractiveness of domestic markets; and that helps the yield curve incorporate short-term interest rate expectations that are consistent with the central bank objectives. The same member considered that the above suggests that, under the current environment, the monetary policy stance should be adapted gradually. He/she added that in such process it is necessary to identify, in the best possible manner, the economy's conditions, the risks that it faces, as well as possible vulnerabilities that might arise.

Some members highlighted that the monetary policy stance is very restrictive, considering both the domestic situation as well as its position relative to other countries, and that therefore the policy rate should be adjusted by 50 basis points. As for the domestic situation such members argued that economic slack has increased significantly and that inflation is at the central bank's target.

One of them considered that the adjustment in the interest rate in Mexico is lagging very much behind with respect to the current conditions in the country and in the world. He/she pointed out that from September 2018 to October 2019 inflation decreased by 200 basis points, while the policy rate is at the same level as in September last year. In this context, he/she considered that a reduction of only 25 basis points to the policy rate would be minimizing

the important fall registered by inflation in the last year. He/she also argued that it would obviate other factors that have changed significantly during said period: the deceleration of the global economy, the relaxation of monetary policies of advanced and emerging economies, as well as the decline in some internal risks associated with Pemex and public finances. He/she also mentioned that Mexico is the investment grade emerging market country with the highest real rate in the world, and that it is the only country in Latin America that simultaneously has inflation close to its target together with a tight monetary policy position. He/she considered such stance atypical, in addition to unjustifiable and insensitive to the current circumstances. He/she considered such stance inexplicable given that already headline inflation is at its objective and the output gap is at its most negative level since the 2009 crisis. He/she mentioned that it might widen if the interest rate remains too high. Finally, he/she warned that the monetary policy stance might be contributing to an over-adjustment of the economy in an effort to keep inflation low, which is already at its target level, and considered that monetary policy operates through channels that affect real variables, such as consumption and investment, and thus maintaining a very tight monetary policy stance for a long period constitutes a risk to economic activity, public finances and financial stability.

Given the prospects of a more negative output gap, another member pointed out that although monetary policy is not the most effective instrument to induce a recovery, its transmission mechanisms, especially the interest rate, credit and asset price channels, do influence, albeit modestly, aggregate demand. Such member added that the primary goal of a 3% inflation should be pursued at the lowest possible cost. He/she mentioned that the policy rate is over the upper bound of the estimation range for the neutral rate, even after incorporating risk premia. He/she also considered that since the economic cycle is in its low phase, the monetary policy stance must be reduced in absolute terms, although a tight monetary policy stance is still required in order for core inflation to converge to 3% levels. However, he/she noted that it is not appropriate to maintain the current levels of monetary tightening, which are higher than those observed in other episodes where inflation was higher, the output gap was positive, and the balance of financial and global risks was less favorable.

One member pointed out that the current economic weakness cannot be overcome with monetary policy measures, as its margins of maneuver are narrow, since the level of the policy rate is a reflection of the

risks faced. In this regard, he/she noted that interest rate spreads with other economies decrease considerably when the foreign exchange risk is incorporated. He/she added that the evidence suggests that the impact of interest rates on economic activity is relatively modest and that countercyclical policies do not address the main cause of stagnation: an environment of uncertainty and not conducive to investment. Such member underlined that an imprudent easing of monetary policy, by constituting an additional source of uncertainty, would have an effect opposite to the one intended, and that the risks are particularly high in economies as open as Mexico's. He/she argued that monetary policy is not a substitute for the economic and institutional measures needed to foster investment and increase productivity. Another member pointed out that although economic activity is slowing down at a faster pace than anticipated and slack conditions have widened, the challenges faced by the economy, the price formation process and inflation are not only those that stem from the economy's cyclical position. He/she emphasized that there are multiple challenges and risk factors, both external and domestic, which have an impact on the economy and inflation.

As for the monetary policy stance relative to other countries, some members pointed out that Mexico's interest rate spread with respect to the United States is at its highest levels in recent history and considered that a reduction of 25 basis points would keep such spread unchanged. Such members argued that the relative monetary policy stance is high when taking into consideration that the external and domestic risks faced by the economy have decreased and monetary policy has eased globally. One of them mentioned that the spread between Mexico and US interest rates is the second highest among emerging and advanced economies. Another member stated that keeping interest rate spreads constant gives a double false impression: on the one hand, it makes it seem that Mexico is responding mechanically to the Federal Reserve's actions. On the other hand, it suggests that there has not been a significant change in the country's economic and financial conditions, which sends a misleading message about the balance of risks faced. All members pointed to the notion that while the Federal Reserve's actions are a factor that is considered by Banco de México, they are not a determinant for monetary policy decisions. One of them added that, from previous decisions, it is possible to observe that Banco de México responds by assessing a wide range of factors that might influence inflation. Another member highlighted that the monetary

policy stance should not be tied to monetary conditions relative to other economies which respond to a different context.

As for monetary policy communication, one member mentioned that Banco de México's communication policy must be transparent, concise, and easy to understand, so that the general public has an understanding that the central bank actions have as a priority to guarantee the convergence of inflation to the target. He/she added that the above prevents distortions in inflation expectations that could compromise such convergence, as well as incorrect expectations regarding monetary policy intentions. He/she mentioned that communication should emphasize that a strategy of gradual and prudent adjustments in the absolute and relative monetary policy stance will be followed, which will strengthen consistency with the economic cycle and with future expectations. He/she indicated that this strategy must take into account the level of uncertainty and the lag with which monetary policy operates. Such member added that the forward guidance on the monetary adjustment cycle should be subject to what the margins of absolute and relative monetary policy stances suggest, as well as to incoming data and unexpected events. He/she mentioned that this strategy should facilitate the understanding of monetary policy actions and improve their effectiveness. Another member stressed the importance of an adequate and objective communication by the central bank. He/she also underlined that the tone of the communiqué should highlight the decrease in both inflation and its risks. He/she pointed out that this would send a message of certainty and confidence and confirm that the central bank can ease monetary policy without compromising its mandate and with the lowest possible costs for the Mexican economy. The majority of members concluded that under the current environment of high uncertainty it must be communicated that monetary policy will adjust prudently, contributing to an orderly and sustained convergence of headline inflation to its target.

### **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 that the lower levels registered by headline inflation, the ample slack in the economy, as well as the recent behavior of external and domestic yield curves allow for decreasing the policy rate, Banco de México's Governing Board decided by majority to lower the target for the overnight interbank interest rate by 25 basis points to 7.50%. Two members voted for lowering the target to 7.25%. 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 the convergence of inflation to its 3% target and to strengthen the anchoring of medium- and long-term inflation expectations so that they attain such target.

#### **4. VOTING**

Alejandro Díaz de León-Carrillo, Irene Espinosa-Cantellano, and Javier Eduardo Guzmán-Calafell voted in favor of lowering the overnight interbank interest rate by 25 basis points to a level of 7.50%.

Gerardo Esquivel- Hernández and Jonathan Ernest Heath-Constable voted in favor of lowering the overnight interbank interest rate by 50 basis points to a level of 7.25%.

#### **5. DISSENTING OPINIONS/VOTES**

**Vote.** Gerardo Esquivel- Hernández

Headline inflation has performed better than expected and will soon have been at figures very close to the inflation target for a full quarter. Indeed, accumulated inflation so far allows us to anticipate that annual year-end inflation will be less than 3%. Although core inflation is still at relatively high levels, its recent trend is clearly downward, and it is estimated to maintain this tendency in the coming months. On the other hand, the generalized reduction of interest rates in other economies, as well as the widening of the negative output gap and the reduction of certain domestic and external risks, opened up space for easing the country's relative monetary policy stance. It is worth remembering that Mexico is an atypical case since it is the only Latin American country that has inflation close to target and, simultaneously, maintains a tight monetary policy stance. For this reason, I believe that on this occasion it was possible and desirable to reduce the interest rate by 50 basis points, without jeopardizing or compromising Banco de México's fundamental mandate. Under the current economic conditions, a 25-basis point reduction is not enough and comes in too late.

**Vote.** Jonathan Ernest Heath-Constable

Headline inflation has reached the 3.0% point target, economic activity remains stagnant and forecasts indicate that the negative output gap will continue to widen. Monetary policy easing is being observed worldwide, as well as relatively stable financial markets and a moderation of domestic and external risks, which, nevertheless, are still latent. All of the aforementioned favors adopting a less tight policy stance.

I restate that maintaining a tight monetary policy stance is necessary to guarantee a core inflation consistent with the inflation target. However, the levels of tightness of the current policy stance are the highest in the past eleven years. In relative terms, despite the reductions in the policy rate, the monetary policy stance has not changed given that monetary policy easing has continued worldwide. In absolute terms, although there has been a reduction, we are still far above the upper limit of the estimates for the long-term neutral rate. Consequently, there is a wide margin of maneuver for the proposed reduction, even if considering that the balance of risks for inflation, despite being well-balanced in the short term, is uncertain in a longer time horizon.

## 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.

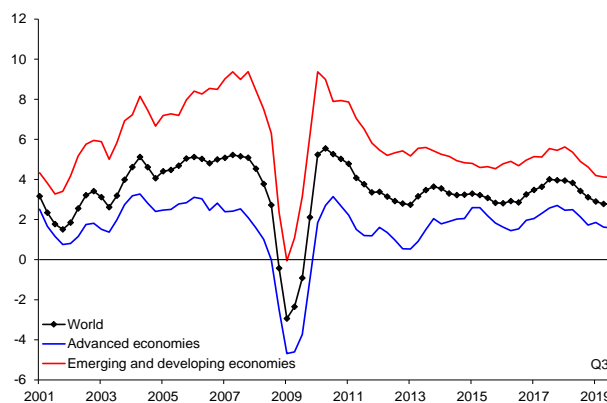
### A.1. External conditions

#### A.1.1. World economic activity

World economic growth continued to slowdown during the third quarter of 2019 (Chart 1). In particular, the prolonged trade tensions, greater geopolitical risks and several idiosyncratic factors continued to cause a deterioration of manufacturing activity, trade and investment, which led to a downward revision of global economic growth expectations for 2019 and 2020. For its part, headline and core inflations in the major economies remained at low levels and below their central banks' targets. In response to this environment, some of these institutions have eased monetary policy in the last months, while some countries have also adopted more fiscal stimuli.

Although world economic growth continues facing significant risks, some of these have been diminishing in the last weeks, supporting a recovery of international financial markets. In particular, tensions between the United States and China eased after the intention of signing a draft trade agreement between their governments was announced. In addition, a lower probability of a disorderly exit of the United Kingdom from the European Union is perceived, given that the British Parliament approved in principle the exit agreement negotiated between its First Minister and the European Union, albeit rejecting the proposed timetable. In turn, the European Commission approved an extension to January 31 to reach a final agreement with the U.K., in an environment where parliamentary elections will be taking place in December in this country. Despite the above described progress, a new escalation of trade tensions between the United States and China or greater adverse effects in the UK and euro area economies cannot be ruled out, given the high uncertainty about their future relationship, while at the same time several social and political risks persist in other countries.

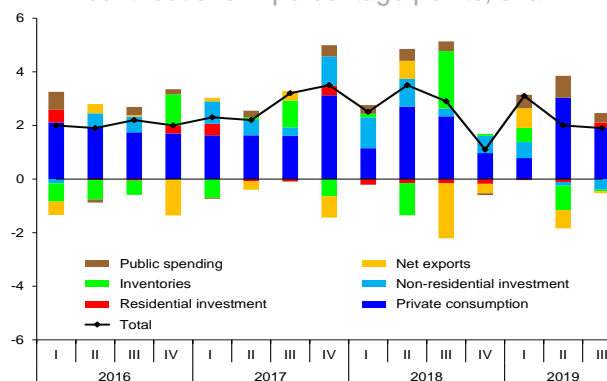
**Chart 1**  
**World GDP Growth**  
Annual percentage change, s. a.



s. a. / Seasonally adjusted figures.  
Note: GDP calculations for Q3 2019 include estimates for some countries. The sample of countries used in the calculations accounts for 85.6% of world GDP measured by purchasing power parity.  
Source: Prepared by Banco de México with data from Haver Analytics, J.P. Morgan and International Monetary Fund (IMF).

In the United States, the growth rate of GDP decelerated slightly, declining from a seasonally adjusted annual rate of 2.0% in the second quarter to 1.9% in the third quarter (Chart 2). The lower growth of economic activity was associated to the further weakening of business investment and of net exports, due largely to the escalation of trade tensions at the beginning of the period. In contrast, private consumption continues to be driven by the still solid growth of employment, higher disposable income and high household confidence, while residential investment registered an incipient recovery after exhibiting prolonged sluggishness, driven by lower mortgage interest rates.

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



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



US industrial production contracted in September at an annual rate of 0.4%, due to the decline exhibited by both the manufacturing sector, explained by transitory factors—and the mining sector explained by lower crude oil drilling and extraction—. In particular, the 0.5% decline of manufacturing production during that month partly reflected the sharp fall of the automotive sector, in turn associated to strikes in that sector. Nevertheless, the rest of manufacturing also exhibited a weak performance, given that production figures excluding vehicle and auto parts production fell by 0.2%. Although the manufacturing sector Purchasing Managers' Index (PMI) exhibited certain recovery in September and October, it continues to suggest weakness in said sector.

In this environment, the US labor market continued showing signs of strength. Although the growth of the non-farm payroll moderated, diminishing from an average of 188,000 jobs in the third quarter to 128,000 in October, it was largely due to transitory factors, such as the strike in the automotive sector and the fading of temporary hires in the public sector. In addition, such growth continued to be above the level necessary to offset the labor force expansion. For its part, the unemployment rate fell from 3.7% in August to 3.6% in October, in a context where the labor force participation rate continued to increase. Other labor market indicators, such as hire and quit rates, have continued to reflect the tight conditions in this market. In this context, wages have continued to increase at a moderate rate.

In the euro area, during the third quarter, GDP grew at a seasonally adjusted annual rate of 0.9%, similar to that observed in the second quarter. Available indicators suggest that economic growth continued to be driven by private consumption and residential investment, while net exports continued to have a negative contribution to adjustments in the economy (Chart 8). Indeed, the growth of private consumption has continued to show a relative strength stemming from the good performance of the labor market and the still high consumer confidence. The weakness of external demand has continued to affect manufacturing activity and business investment in this region. The composite Purchasing Managers' Index stabilized at low levels at the beginning of the fourth quarter, which may suggest that a moderate growth will prevail in the region for the remainder of the year. In this context, the unemployment rate remained at low levels, fluctuating around 7.5%.

In Japan, GDP growth decelerated significantly during the third quarter by registering an annualized

seasonally adjusted rate of 0.2%, after having grown 1.8% during the second quarter, due to the sharp deterioration of external demand. Consumer and business confidence indicators also continue to deteriorate, which, together with the increase in consumption taxes, may intensify the weakness of this economy. In this environment, although the pace of job creation has been decreasing, the labor market has remained relatively strong. In particular, although the unemployment rate rose from 2.2% in August to 2.4% in September, it remained below the long-term rate.

In most emerging economies, economic activity continued to grow at a moderate rate during the third quarter of the year. The weakening of China's annual growth rate stood out, declining from 6.2% in the second quarter to 6.0% in the third, the lowest growth rate registered since 1990. The Asian economies have continued to be affected by the deterioration of manufacturing activity worldwide. As for Latin America, its economies have grown less than expected due mainly to idiosyncratic factors.

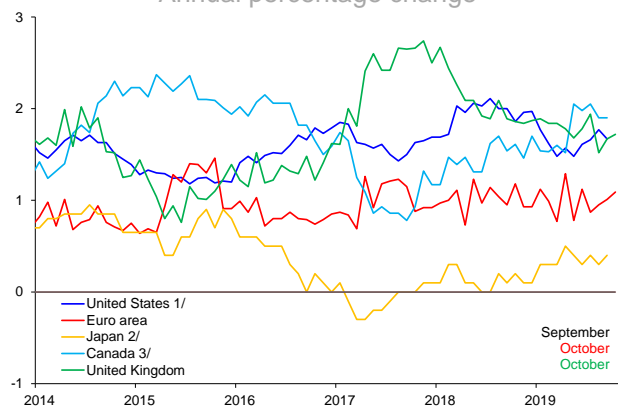
Most international commodity prices followed an upward trend in recent weeks. In particular, after decreasing at the end of September on account of the weakness of world economic activity and the rapid recovery of crude oil in Saudi Arabia after the attack to its main oil facilities, crude oil prices partially recovered. Such recovery can be associated to the progress in trade negotiations between the United States and China; the rising expectations that the Organization of Petroleum Exporting Countries (OPEC) and its allies will make an additional cut to the current production quotas; and the still solid US growth figures. Moreover, grain prices continued to follow an upward trend due to unfavorable climate conditions for crops and greater expectations of a trade agreement that involves the purchase by China of significant amounts of these goods from the United States. Finally, industrial metal prices exhibited a mixed behavior, with considerable increases in copper and aluminum prices and falls in iron and steel prices.

### **A.1.2. Monetary policy and international financial markets**

Headline and core inflation in the major advanced economies remained at relatively low levels and below their central banks' targets, despite the persisting tightening of labor markets and the fading of some transitory factors that had been exerting downward pressures on them (Chart 3). Similarly, inflation expectations drawn from surveys and

market instruments remain at low levels. In the United States, core inflation, as measured by the personal consumption expenditure deflator, decreased from 1.4 to 1.3% in September, remaining below the Federal Reserve target, while the core component declined from 1.8 to 1.7%. In the euro area and Japan, core inflation has remained low despite the low unemployment levels. In emerging economies, headline and core inflation intensified their negative trend and, in several cases, continued at levels below their central banks' targets.

**Chart 3**  
**Selected Advanced Economies: Core Inflation**  
 Annual percentage change



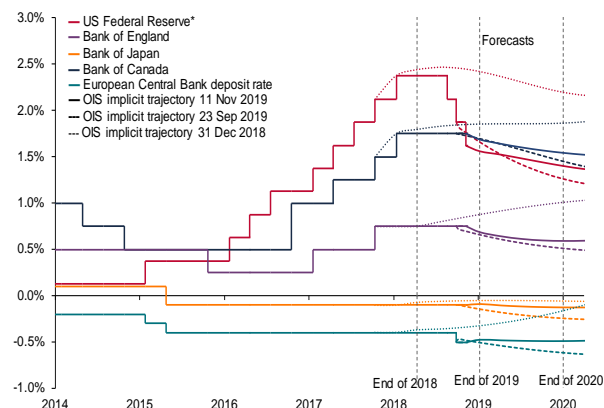
1/ Refers to the Personal Consumption Expenditures Price Index (PCE).  
 2/ Excludes fresh food, energy, and the direct effect of the consumption tax increase.  
 3/ Excludes food, energy, and the effect of adjustments on indirect taxes (CPIX).  
 Source: Haver Analytics, BEA, Statistical Office of the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

In this context, the central banks of a large number of economies have continued to adopt accommodative monetary policy stances, given low inflation levels, lower growth expectations, and greater risks to world economic activity. Nevertheless, adjustments were made to the expected policy stances that some of the main central banks may follow in the future, particularly in the case of the US Federal Reserve. In particular, the implied trajectory of reference interest rate futures of the main advanced economies suggest that the pace of reductions may be more gradual than was anticipated some weeks ago.

In its October meeting, as anticipated, the US Federal Reserve cut the target range for the federal funds rate by 25 basis points to 1.50-1.75%. The Fed Chairman stated that the Fed will continue to monitor the effects of its actions as well as incoming economic information, clarifying that the path to be followed by monetary policy is not on a preset course. He added that the current monetary policy

stance remains appropriate given the risk the economy faces and that only significant developments in economic conditions would modify said outlook, which was interpreted as a possible pause in the process of reduction of the federal funds rate. In this environment, the implied path in federal funds futures reflects expectations of only one additional cut in 2020.

**Chart 4**  
**Reference Rates and Implied Trajectories in OIS Curves<sup>1/</sup>**  
 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 October meeting, the European Central Bank (ECB) ratified the measures announced in its previous monetary policy meeting, which represented a significant change in its monetary policy stance. As to its forward guidance, the ECB highlighted that the Governing Council expects the key ECB interest rates to remain at their present or lower levels until inflation robustly converges to a level sufficiently close to, but below, 2%. As to its new asset purchase program, it also restated that it will run for as long as necessary to reinforce the accommodative impact of its policy rates, and to end shortly before it starts raising its policy interest rates.

The Bank of Japan did not modify its policy interest rates in its October meeting, although it adjusted its forward guidance for policy rates. In particular, in this meeting, it also pointed out that it will leave short- and long-term interest rates at their present or lower levels as long as it is necessary to be certain that the 2% inflation target is not at risk, which contrasts with the previous message that suggested that interest rates were to remain at low levels until the spring of 2020. The Bank of Japan also mentioned that it did

not cut its reference rates because it does not consider that the possibility of a setback in the achievement of its price stability target has increased. Nevertheless, it lowered its growth and inflation forecasts for the next three years.

The Bank of Canada left its policy interest rate unchanged at 1.75% in its October meeting, although it discussed the possibility of a cut to mitigate the downward risks that the Canadian economic outlook is facing. In its statement, this central bank mentioned that the Canadian economy is expected to decelerate in the second quarter of the year, anticipating a growth below potential as a reflection of the uncertainty associated with trade conflicts, adjustments to the energy sector and the fading of transitory factors that boosted productive activity in the second quarter. In addition, the Bank of Canada pointed out that, in determining its monetary policy stance, it will assess the possibility of the impact of the weakening of the world economy on Canada's economic activity spreading beyond investment and manufacturing. In this context, it stated that it will pay close attention to the elements that have supported growth, such as private consumption spending, the real estate sector, and fiscal policy.

In its November meeting, the Bank of England left its policy rate at 0.75% and did not modify the size of its government bond purchases, although two members voted in favor of cutting its interest rate. In its statement, it pointed out that the a no-deal exit of the United Kingdom from the European Union has decreased due to the recent agreement negotiated between both regions and the extension of the deadline to approve such agreement. Nevertheless, it highlighted that the risks for growth continue to be biased to the downside due to the uncertainty about the nature of this transition. In this environment, the Bank of England conditioned its monetary policy stance to the evolution of the Brexit, by pointing out that a gradual and limited tightening would be necessary in case the UK economy recovers according to projections and the risks that it is facing do not materialize.

In emerging economies, most central banks continued to ease their monetary policies, in an environment of low inflation and weak external and domestic economic activity, especially in those economies where inflation has been below their central bank targets, such as Saudi Arabia, Brazil, Chile, the Philippines, India, Thailand, Turkey, and Ukraine.

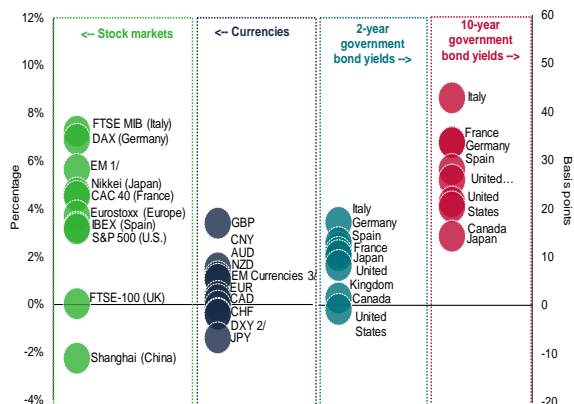
In the last weeks, international financial markets registered less volatility due to the partial fading of some risk factors, as previously mentioned. In addition, the monetary easing actions by some of the main central banks have contributed to improve market performance in the last weeks. This context led to a climate of lower risk aversion, reflected in gains in most stock indexes and in increases in most interest rates of advanced economies, particularly in longer-term bonds. There was a depreciation of safe-haven currencies, such as the Japanese yen, the Swiss franc, and the US dollar, while the rest of the advanced economies' currencies appreciated (Chart 5).

Similarly, in emerging economies, currencies appreciated and most stock indexes recovered (Chart 6). In this context, flows towards emerging economies' financial assets exhibited a positive trend. In particular, inflows towards fixed income assets were observed. As for equity markets, these moderated their outflow trend and even registered inflows in the last weeks. In some particular cases, financial markets were negatively affected by the presence of idiosyncratic factors, such as the case of Chile, where demonstrations related to social reform demands have taken place, and of Argentina, where the results of the general elections and the change in administration have generated uncertainty over the course of that country's economic policy

It should be noted that the relative recovery of markets in the last weeks may still be reversed due to the presence of several risk factors, such as a greater than expected weakening of global economic activity; increased uncertainty as to the future economic relationship between the United Kingdom and the European Union; a new escalation of trade tensions between the United States and its main trading partners; increased political and social tensions; and, growing geopolitical tensions in the Middle East, among others.



**Chart 5**  
**Change in Selected Financial Indicators**  
**from September 21, 2019 to November 11, 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 6**  
**Emerging Economies: Financial Assets**  
**Performance from September 23 to November 11, 2019**  
 Percent, basis points

Region	Country	Currencies	Equity markets	Interest rates 2Y	Interest rates 10Y	CDS
Latin America	Mexico	1.86%	0.13%	-21	4	-26
	Brazil	0.65%	3.39%	-47	-42	-14
	Chile	-5.02%	-8.43%	-16	33	6
	Colombia	3.02%	2.53%	38	37	-15
	Argentina	-4.85%	15.47%	1,873	250	994
Emerging Europe	Russia	-0.04%	6.32%	-64	-64	-10
	Poland	3.16%	4.07%	6	27	-5
	Turkey	-1.10%	3.10%	-278	-204	-66
	Czech Republic	1.84%	3.85%	24	34	-2
	Hungary	0.75%	5.49%	7	32	-8
Asia	South Korea	2.35%	1.55%	45	60	-1
	Malaysia	0.86%	0.96%	2	-1	-9
	India	-0.75%	3.21%	-17	4	-4
	Philippines	2.61%	1.80%	-13	-13	-10
	Thailand	0.50%	-0.04%	2	23	-3
	Indonesia	0.14%	-0.93%	-59	-34	-4
Africa	South Africa	0.04%	0.99%	17	27	-6

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.

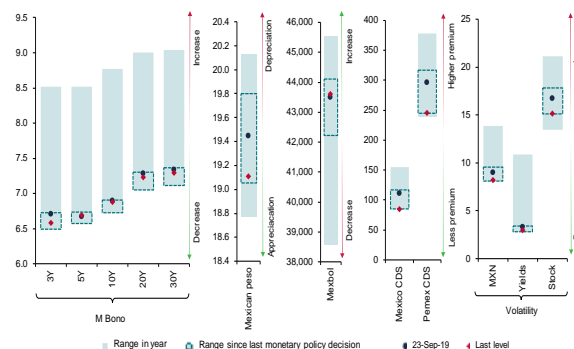
## A.2. Current situation of the Mexican economy

### 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, in line with its emerging peers (Chart 7). In particular, in the presence of episodes of volatility, the peso/dollar exchange rate fluctuated between 19.06 and 19.82 pesos per US dollar, standing at 19.12 pesos per US dollar at the end of the period, implying a 1.86% appreciation during the period. In turn, forward-looking trading conditions for the peso exchange rate implied in FX options remained stable (Chart 8). For its part, peso exchange rate expectations by forecasters from several financial institutions for the end of 2019 were adjusted slightly downwards from 19.80 to 19.75 pesos per US dollar, while those for the end of 2020 were adjusted upwards from 20.00 to 20.07 pesos per US dollar (Chart 9).

**Chart 7**  
**Mexican Markets' Performance and Trading Conditions**  
 Percent, pesos/US dollar, index and basis points

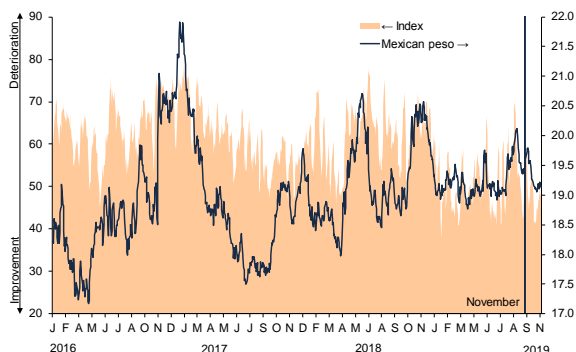
Percent, pesos/US dollar, index and basis points



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.

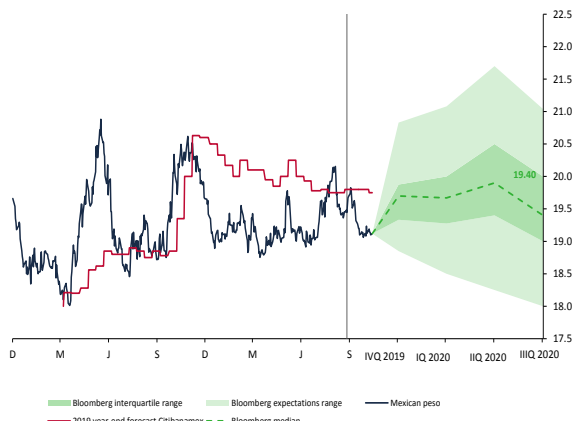
**Chart 8**  
**Mexican Foreign Exchange Market Trading**  
**Conditions**

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



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

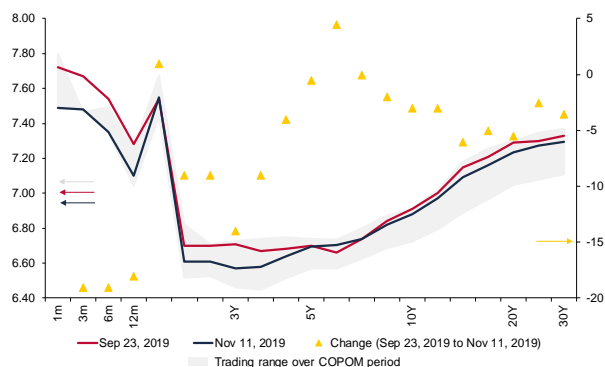
**Chart 9**  
**Analysts' Mexican Peso Exchange Rate**  
**Expectations for Each End of Quarter**  
 Pesos per US dollar



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

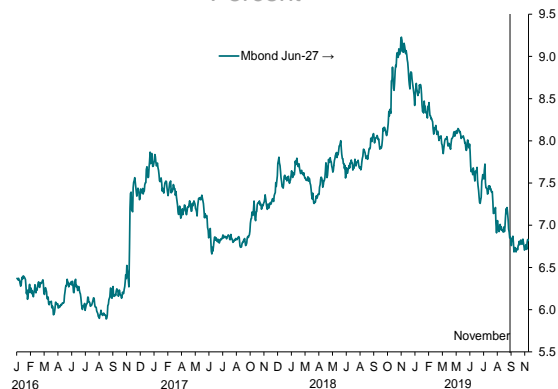
Interest rates of government securities continued to reflect the effects of the lower external interest rates. Thus, most of them decreased up to 15 basis points for terms over one year (Chart 10). It should be noted that interest rates of longer-term bonds accumulate decreases of over two percentage points from the highest level recorded at the end of the previous year (Chart 11).

**Chart 10**  
**Nominal Yield on Government Securities**  
 Percent, basis points



Source: PIP.

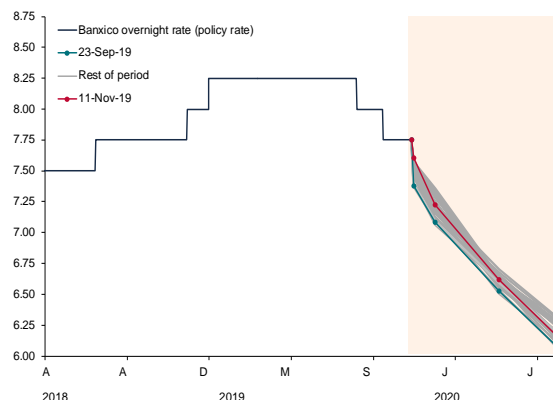
**Chart 11**  
**Bond Rate (Jun-27)**  
 Percent



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

As to expectations regarding the path of the monetary policy target rate, information implied in the TIIE (Interbank Equilibrium Interest Rate) swap curve considers that the funding rate will be at levels of 7.23% at the end of the year (Chart 12), practically in line with the median of private sector analysts surveyed by Citibanamex, which expects that it will be at 7.25%. As to the end of 2020, market variables incorporate rates slightly below 6%, while the median of said survey among forecasters was adjusted downwards from 6.75 to 6.50%.

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



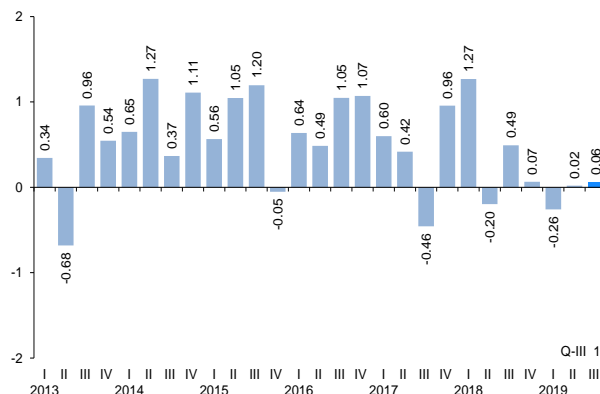
Source: Prepared by Banco de México with Bloomberg data.

### A.2.2. Economic activity in Mexico

INEGI's GDP flash estimate for the third quarter of 2019 shows that the stagnation that Mexico's economic activity has been registering for several quarters continues (Chart 13). Such behavior reflected the deceleration of exports, the weakness of private consumption, and the unfavorable performance that investment has maintained.

As for external demand, during the third quarter of 2019 manufacturing exports registered a deceleration vis-à-vis the previous quarter, in an environment where trade tensions and the weakening of world trade prevail. Such evolution was associated with the weakness of non-automotive exports, given that automotive exports continued to improve. By destination, manufacturing exports to the United States continued trending upwards, while those to the rest of the world continue to show the same lack of vigor observed since mid- 2018 (Chart 14).

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

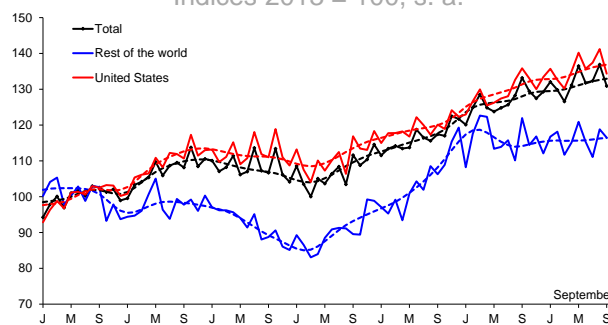


s. a. Seasonally adjusted figures.

1/ Figures for Q3-2019 refer to INEGI's GDP flash estimate.

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

**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.

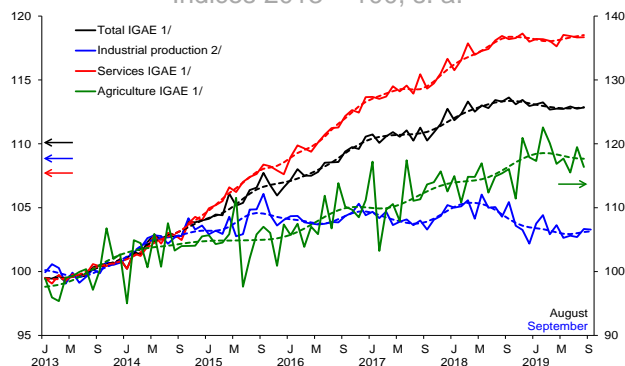
Source: Prepared by Banco de México with data from the Tax Administration Service (SAT, for its acronym in Spanish), the Ministry of the Economy (SE, for its acronym in Spanish), Banco de México, the National Institute of Statistics and Geography (INEGI, for its acronym in Spanish), Mexico's Merchandise 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, the weakness that private consumption has been exhibiting since the end of 2018, — explained by a lackluster performance of consumption of both goods and services— continued in the middle of the third quarter of 2019. More timely indicators of consumption, such as retailers' earnings and sales of manufacturing industries that are more correlated with the consumption of domestically produced goods, continued on a positive trend at the middle of the third quarter of the year. In contrast, sales of light vehicles continued trending downward. For its part, the unfavorable performance that gross fixed investment has been registering for several quarters continued. The negative trend that investment in

machinery and equipment has followed since the beginning of 2018 persisted while investment in construction remained weak, although slightly recovering in August.

As for production, according to the flash estimate, the incipient growth of Mexico's economic activity during the third quarter of 2019 reflected the lack of dynamism of industrial activity and the stagnation of tertiary activities, while primary activities reversed the contraction registered in the second quarter of this year (Chart 15). Within secondary activities, the downward trend followed by construction intensified, while manufacturing continued trending upwards, although with a certain loss of dynamism as compared to the previous quarter. Mining registered a slightly favorable change of trend that can be associated with the stabilization of the oil platform (Chart 16). For its part, services showed a negative change of trend towards the end of the quarter, as a result of the unfavorable evolution of finance and insurance and real estate, rental and leasing; retail trade; educational and health care and social assistance; accommodation and food services; public administration and arts, recreation and entertainment. In contrast, improvements were observed in wholesale trade; transportation and warehousing and professional, scientific, and technical services.

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



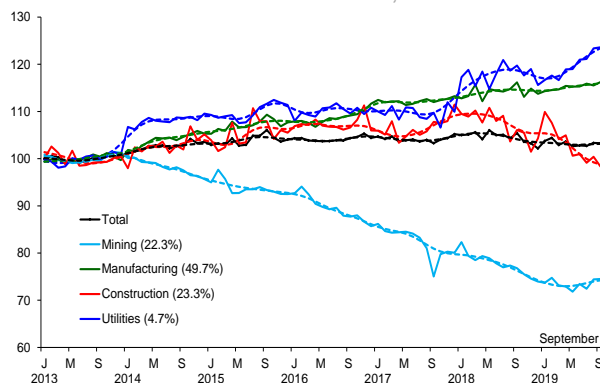
s. a. / Seasonally adjusted and trend series. The former is represented by a solid line and the latter by a dotted line.

1/ Figures up to August 2019.

2/ Monthly Industrial Activity Indicator figures up to September 2019.

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

**Chart 16**  
**Industrial Activity 1/**  
Indices 2013 = 100, s. a.



s. a. / Seasonally adjusted and trend series. The former is represented by a solid line and the latter by a dotted line.

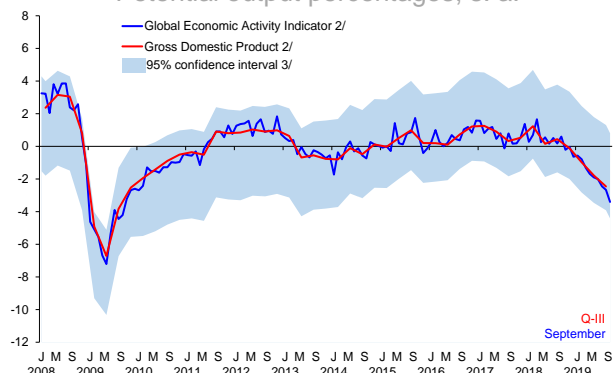
1/ Figures in parentheses correspond to its share in the total in 2013.

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

As to the economy's cyclical position, it is estimated that the negative slack conditions might have widened at a greater-than-anticipated pace during the third quarter of 2019. In particular, estimates of the output gap, based both on total GDP and on the one that excludes the oil sector, exhibited a greater negative gap than in the previous quarter (Chart 17). As to labor market conditions, both national and urban unemployment rates remained at levels above those reported during most of 2018 (Chart 18), while the number of IMSS-insured jobs continued to grow at a slower rate. At the middle of the third quarter of 2019 unit labor costs in the manufacturing sector remained at relatively high levels (Chart 19).

**Chart 17**  
**Output Gap Estimates <sup>1/</sup>**  
**Excluding Oil Industry <sup>4/</sup>**

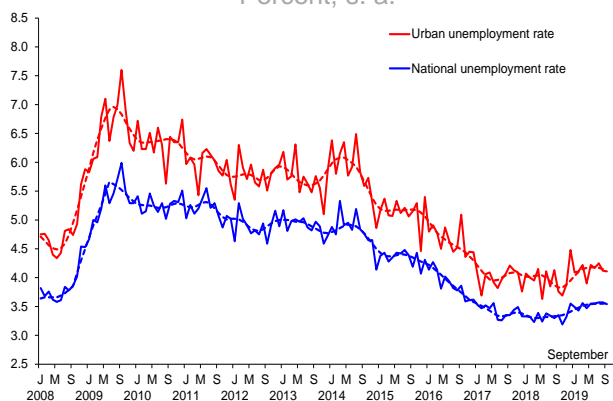
Potential output percentages, s. a.



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 second quarter of 2019 and of IGAE up to July 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**

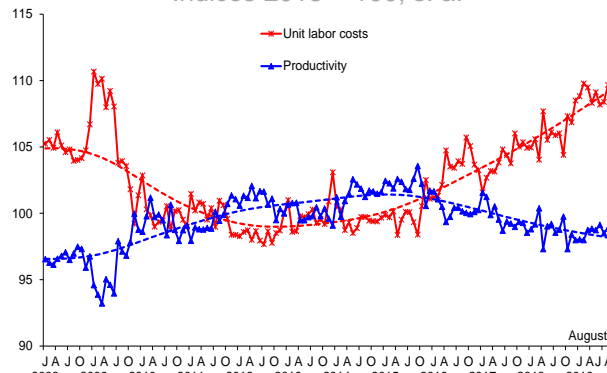
Percent, s. a.



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**  
**Productivity and Unit Labor Costs in the Manufacturing Sector <sup>1/</sup>**

Indices 2013 = 100, s. a.



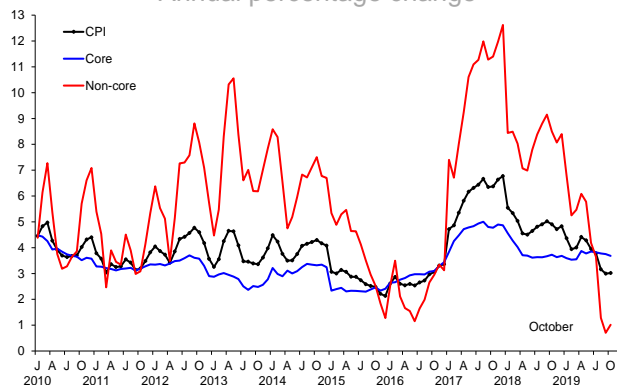
s. a. / Seasonally adjusted and trend series. The former is represented by a solid line and the latter by a dotted line.  
 1/ Productivity based on hours worked.  
 Source: Prepared by Banco de México with seasonally adjusted data from the Monthly Survey of the Manufacturing Industry and from industrial activity indicators from Mexico's National Accounts System, INEGI.

In September 2019, domestic financing to the private sector grew at an annual rate below that of the previous quarter. Within it, the slowdown of financing to private firms intensified, as explained by the lower net placement of domestic debt and the lower growth of bank credit. As to the household segment, mortgages continued registering a high dynamism, while consumer credit kept growing at a slow rate. As for interest rates, those related to firm financing decreased, in line with the reduction of the overnight interest rate, although they remain at high levels. Interest rates of mortgages have remained stable since the second quarter of 2017, whereas in the segment of consumer credit those of credit cards continue trending upwards. Regarding portfolio quality, firms and mortgage delinquency rates remained at low levels, while those related to consumption did not register significant changes, although they remain at high levels.

### A.2.3. Development of inflation and inflation outlook

Between September and October 2019, annual headline inflation remained practically unchanged registering 3.00 and 3.02%, respectively (Chart 20 and Table 1). This behavior reflected the fact that, although core inflation registered some reduction, non-core inflation increased, after exhibiting the lowest annual rate since June 2016 in September.

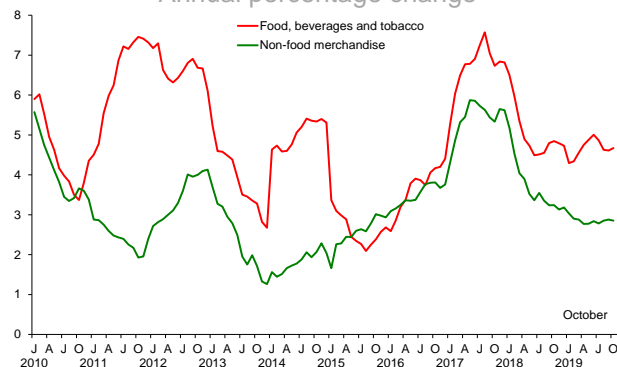
**Chart 20**  
**Consumer Price Index**  
 Annual percentage change



Source: Banco de México and INEGI.

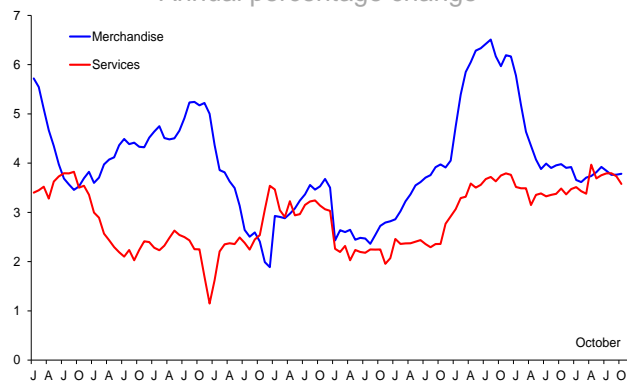
Annual core inflation decreased from 3.75 to 3.68% between September and October 2019, thus continuing to show persistence. Within this component, the annual rate of change of merchandise prices remained stable during this period, at 3.77 and 3.78%, respectively. In particular, the annual rate of change of food merchandise prices registered levels of 4.61 and 4.67%, while that of non-food merchandise prices has remained at levels below 3% (Chart 21). As to the annual rate of change of services prices, it decreased from 3.73 to 3.58% between September and October 2019, due mainly to the lower increases in tourist and certain food/beverage services prices, while other services continued registering rates above 5%.

**Chart 21**  
**Merchandise Core Price Subindex**  
 Annual percentage change



Source: Banco de México and INEGI.

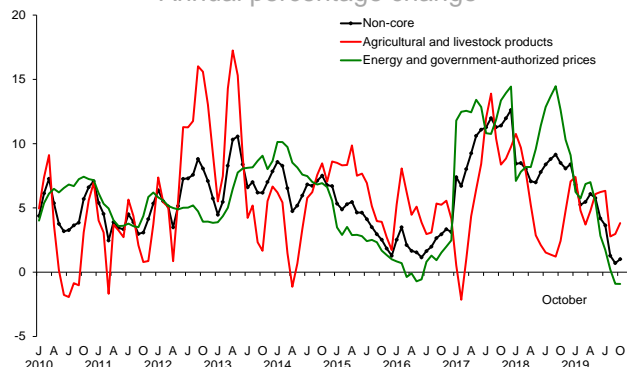
**Chart 22**  
**Merchandise and Services Core Price Subindex**  
 Annual percentage change



Source: Banco de México and INEGI.

As to annual non-core inflation, it increased from 0.71 to 1.01% between September and October 2019 (Chart 23 and Table 1). This result was due to an increase in the annual rate of change of agricultural and livestock product prices, which was partially offset by a decrease in that of energy prices.

**Chart 23**  
**Non-core Price Subindex**  
 Annual percentage change



Source: Banco de México and INEGI.

The medians for short-term inflation expectations drawn from Banco de México's Survey of Private Sector Forecasters exhibited decreases between September and October. Indeed, the medians for headline inflation expectations for the end of 2019 and 2020 decreased from 3.36 to 3.00% and from 3.56 to 3.50%, respectively. Such adjustments are mainly explained by a decrease in implied non-core expectations, which decreased from 2.46 to 1.07% for the end of 2019 and from 4.10 to 3.81% for the end of 2020. The medians for core inflation expectations for the end of 2019 and 2020 also decreased from 3.67 to 3.60% and from 3.40 to 3.38%, respectively. The medians for headline inflation expectations for the medium term (next four



years) remained unchanged at 3.50%, while those for core inflation decreased from 3.49 to 3.46%. As to the medians for headline and core inflation expectations for the longer term (five to eight years), these remained at 3.50 and 3.40%, respectively. Thus, expectations for both headline and core inflation 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 August and October and remain close to 3%, while the inflation risk premium (calculated on the basis of 1-10 year average inflation expectations) was also adjusted downwards, from 0.28 to 0.18% between August and October.

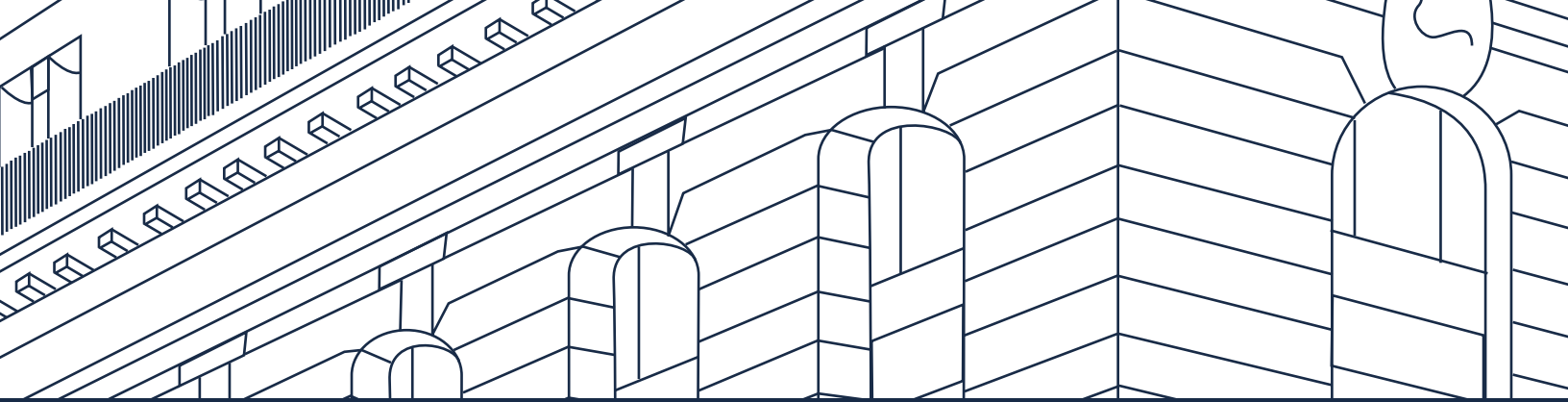
Regarding inflation risks, those to the upside are: that core inflation remains persistent; wage revisions that exceed productivity gains and generate cost-related pressures; that the peso exchange rate comes under

pressure from external or domestic factors; the threat of tariffs by the United States and that compensatory measures are adopted, although this risk has diminished; that public finances deteriorate; and, increases in agricultural, livestock or energy prices greater than anticipated. As for downside risks: an appreciation of the peso exchange rate, possibly associated with a context of greater appetite for risk in international financial markets or in case the trade agreement with the United States and Canada is ratified; a widening of slack conditions or that its impact on core inflation is 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 foreseen trajectory.

**Table 1**  
**Consumer Price Index and Components**  
Annual percentage change

Item	August 2019	September 2019	October 2019
<b>CPI</b>	<b>3.16</b>	<b>3.00</b>	<b>3.02</b>
<b>Core</b>	<b>3.78</b>	<b>3.75</b>	<b>3.68</b>
<b>Merchandise</b>	<b>3.76</b>	<b>3.77</b>	<b>3.78</b>
Food, beverages and tobacco	4.63	4.61	4.67
Non-food merchandise	2.85	2.88	2.85
<b>Services</b>	<b>3.79</b>	<b>3.73</b>	<b>3.58</b>
Housing	2.92	2.89	2.93
Education (tuitions)	4.66	4.73	4.73
Other services	4.40	4.28	3.91
<b>Non-core</b>	<b>1.28</b>	<b>0.71</b>	<b>1.01</b>
<b>Agricultural and livestock products</b>	<b>2.78</b>	<b>2.98</b>	<b>3.82</b>
Fruits and vegetables	-0.75	0.71	2.36
Livestock products	5.77	4.86	5.02
<b>Energy and government-authorized prices</b>	<b>0.20</b>	<b>-0.90</b>	<b>-0.91</b>
Energy products	-1.53	-3.09	-3.20
Government-authorized prices	4.30	4.35	4.78

Source: INEGI.



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