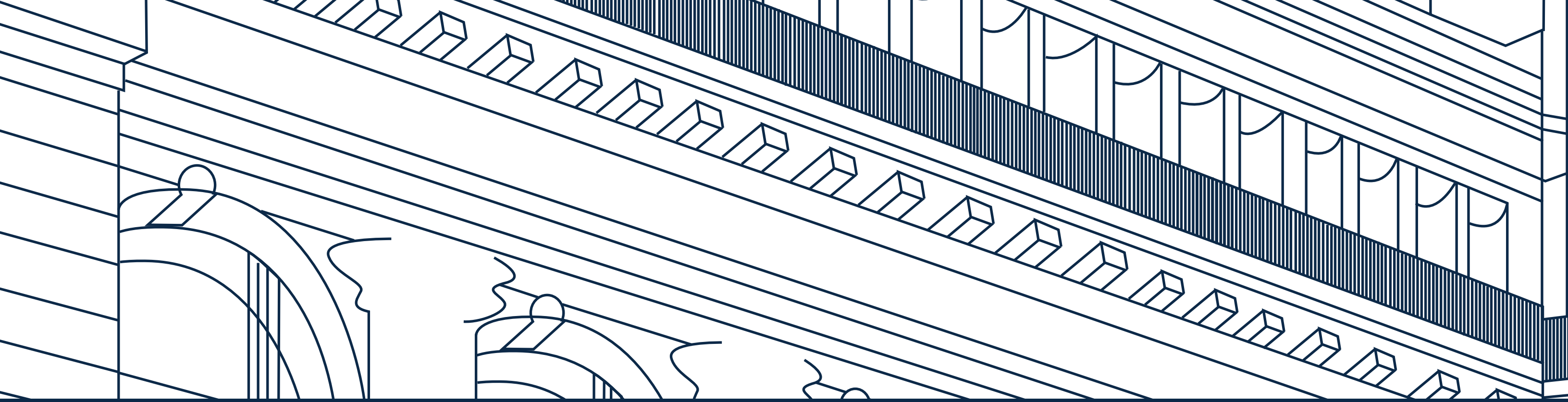

BANCO DE MÉXICO®

Minutes number 99

Meeting of Banco de México's Governing Board on the occasion of the monetary policy decision announced on March 30, 2023

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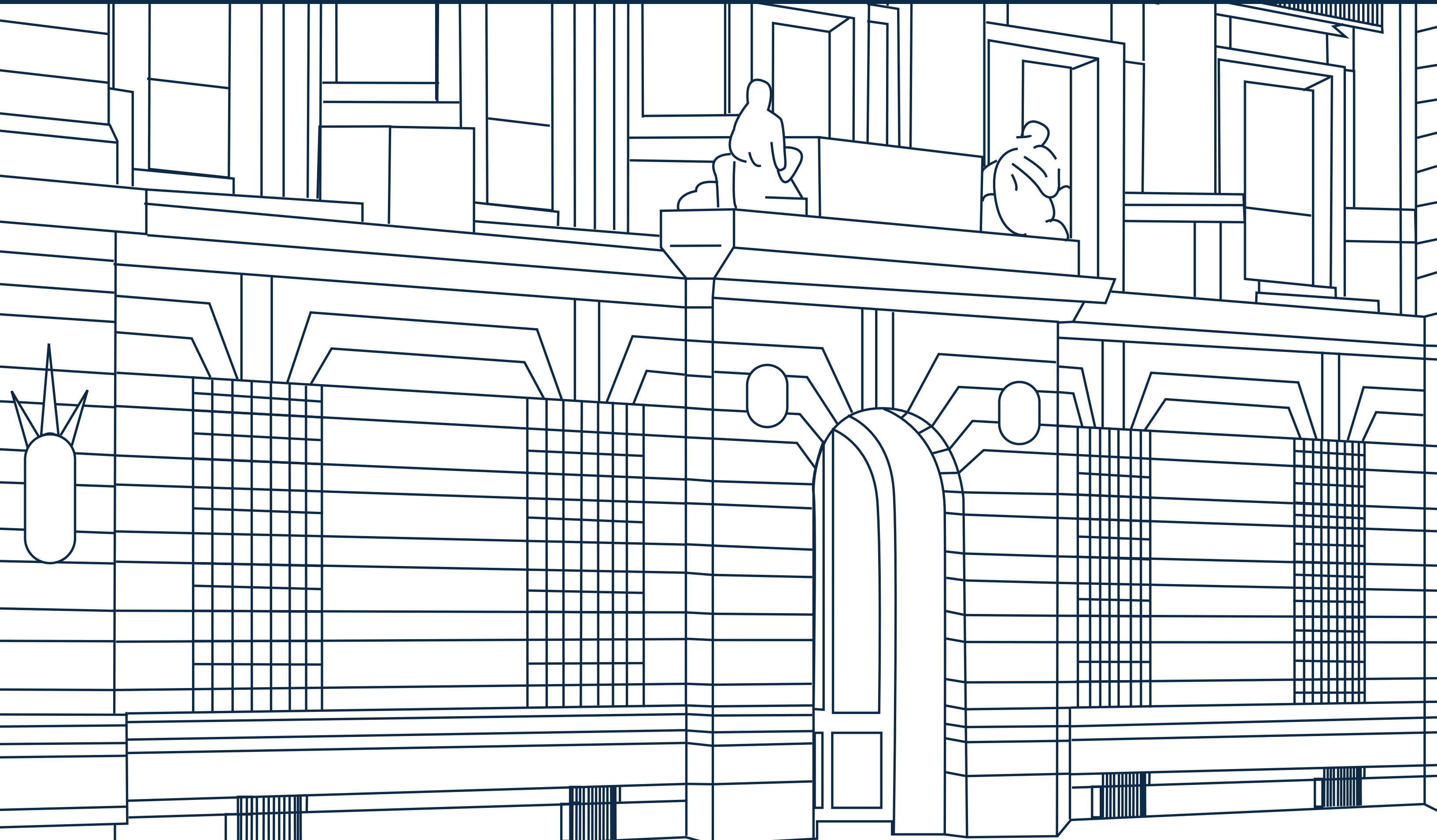

FOREWARNING

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1. PLACE, DATE AND PARTICIPANTS

1.1. Place: Meeting held by virtual means.

1.2. Date of Governing Board meeting: March 29, 2023.

1.3. Participants:

Victoria Rodríguez, Governor.
Galia Borja, Deputy Governor.
Irene Espinosa, Deputy Governor.
Jonathan Heath, Deputy Governor.
Omar Mejía, Deputy Governor.
Gabriel Yorio, Undersecretary of Finance and Public Credit.
Elías Villanueva, Secretary of the Governing Board.

Prior to this meeting, preliminary work by Banco de México's staff analyzing the economic and financial environment as well as 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

International environment

Most members highlighted that during the first quarter of the year, global economic activity recovered compared to the fourth quarter of 2022, showing greater dynamism than expected. They added that, in various economies, labor markets continued showing signs of tightening. One member pointed out that, in advanced economies, nominal wages continued increasing at relatively high rates, although in real terms these show negative annual variations.

Most members mentioned that in the weeks following the last monetary policy meeting, the global growth outlook for 2023 was revised slightly upwards. However, they noted it continued implying a deceleration. They indicated that the likelihood of a recession this year has diminished. One member added that forecasts for an economic recovery by 2024 are maintained. Among global risks, **another** member noted the worsening of geopolitical tensions and tighter financial conditions.

Most members mentioned that global inflation remains at high levels, although in a large number of economies, headline inflation continued decreasing. They attributed this reduction to lower commodity prices, particularly those of energy. One member added the lower sea freight costs and lesser pressures on global supply chains. **Another** member pointed out the fading, although moderate, of certain pressures on merchandise prices excluding those related to food and energy.

Most members warned that at the global level core inflation shows persistence. Some members noted that the core components' behavior is taking place in a context of economic expansion and a strong labor market. **Some** members highlighted the contribution of the services component to the persistence of core inflation. They considered that, given the resistance of the latter to decline, in most economies, convergence of inflation to their central banks' targets, foreseen for the end of 2024 and early 2025, remains uncertain.

One member reflected on the asymmetric effects that global shocks have had on the economic sectors during this episode. He/she pointed out that the services sector initially registered a contraction and a fall in relative prices, while the opposite was observed with merchandise. He/she highlighted that services are currently recovering and their prices have been subject to upward pressures, as opposed to merchandise prices, which have started to normalize, which explains why some inflationary pressures are common across different economies. He/she also considered that these adjustments are not perfectly synchronized, which continues to be a source of heterogeneity and pose challenges for monetary policy. In this context, he/she estimated that, in the absence of shocks of similar magnitude, it is feasible to return to patterns similar to those observed prior to the pandemic. However, he/she warned that the potential long-term effects of the shocks are uncertain and need to be monitored.

All members referred to the developments in the US and European banking systems since the second week of March, as well as to concerns about financial stability. One member highlighted that the latter was generated by the failure of certain regional commercial banks in the United States and the subsequent difficulties of a Swiss bank of global systemic importance. He/she pointed out that one of the US banks had high investments in long-term fixed-income securities and that the other affected banks had a high proportion of depositors with balances above the limit covered by deposit insurance. He/she considered that this, together with an inadequate risk management, had left these institutions in a vulnerable position. **Another** member pointed out that monetary tightening did not generate the problems of these institutions. He/she explained that the new financial conditions only exposed their vulnerabilities, as well as the need to strengthen supervision and compliance with risk management standards.

Most members highlighted that the financial authorities of the referred countries have implemented measures to strengthen confidence in their banking sectors, such as liquidity provision and increasing bank deposit insurance. They added that the authorities reported being prepared to use all their tools to maintain the soundness of their banking systems.

All members noted that developments in the US and European banking systems led to greater risk aversion and high volatility in international financial markets. Most members mentioned that, in this context, interest rates on mainly short-term government securities adjusted downwards and that the US dollar appreciated. Some members added that stock market indices fell. **One** member noted that emerging markets showed, in general, a negative performance, with exchange rate depreciations and higher risk premia. He/she added that the latter led to tighter financial conditions. **Another** member expressed his/her concern about additional events that could generate instability in the international financial system and, therefore, an increase in global risk aversion.

Some members pointed out that, in light of the greater uncertainty over financial stability, expectations on the monetary policy stances of several advanced economies, including the United States, exhibited volatility. **One** member indicated that, previously, during February and early March, these expectations had risen due to increased concerns about inflation. He/she pointed out that, in the case of the Federal Reserve, analysts and markets had incorporated an increase of 50 basis points for the March decision. He/she added that, subsequently, indeed, given the risks to financial stability, such expectations were abruptly adjusted downwards. He/she noted that markets and analysts even considered the possibility of a pause for the Federal Reserve's March decision.

Most members highlighted that, despite concerns about financial stability, several central banks in advanced economies continued raising their reference rates. All members stated that, at its March meeting, the Federal Reserve raised the target range for the federal funds rate by 25 basis points. Most members highlighted that this central bank anticipated that a further increase might be necessary. Some members pointed out that the monetary policy statement mentioned that events in the banking sector are likely to lead to tighter credit conditions, which will influence the evolution of economic activity, employment, and inflation. **One** member highlighted that this central bank's communication suggests that the hiking cycle is approaching its final stage. **Another** member underlined that its chairman stated that no cuts are foreseen in 2023. **Most members noted that markets expect a less restrictive policy stance for this year than that anticipated by the Federal Reserve. One** member pointed out that this disparity could represent a risk. **Another** member warned that the divergence between market expectations and central bank communication is a current global phenomenon.

Some members highlighted that monetary authorities, such as the European Central Bank and the Federal Reserve, stated that the appropriate tool to fight inflation is the reference rate, while liquidity facilities and other tools are appropriate to deal with financial stability problems. **Regarding this subject, most members agreed that monetary policy should indeed focus on pursuing low and stable inflation, while financial stability should be achieved through other tools. Some** members argued that it is not possible to address both inflationary and financial stability problems using the same tool. **One** member acknowledged that the insolvency of some US banks poses challenges to monetary policy. However, he/she pointed out that it would be wrong to use the reference rate to mitigate financial risks at the cost of fighting inflation. He/she considered it essential to communicate that the central banks' priority is price stability. **Another** member stated that financial stability, like price stability, is a public good that is essential for the wellbeing of society. He/she noted that the appropriate tools to achieve financial stability are: a) macroprudential supervision and regulation focused on containing the accumulation of vulnerabilities; b) timely identification of risk factors; c) coordination among financial authorities; and d) liquidity facilities that financial institutions can access during stress episodes. **One** member considered that disruptions to financial stability require caution in diagnosing and monitoring the problem, as well as in determining the required policy response.

Economic Activity in Mexico

Most members pointed out that the Mexican economy continued increasing, although at a

moderate pace. One member mentioned that it has shown resilience in light of a complex external environment. **Some** members stated that heterogeneity among sectors persists. **One** member added that, in January, seasonally adjusted Global Economic Activity Indicator (IGAE, for its acronym in Spanish) figures reflected a monthly fall in primary activities, while tertiary activities rebounded and secondary ones remained unchanged. **Another** member indicated that the economy is expected to continue growing moderately. **Some** members mentioned that slack conditions continue narrowing. **One** member noted that the output gap is currently not statistically different from zero. **Another** member stated that the economy's cyclical position remains at a level similar to that at the end of 2022.

Some members mentioned that industrial production stagnated at the beginning of the year. **Some** members noted that construction registered a decline during the same period. **One** member added that, although this sector had reactivated to some extent in December, it partially reversed such progress in January, and thus, from a medium-term perspective, it seems stagnant. He/she added that only the administration's major public infrastructure projects have driven forward the sector. Meanwhile, **another** member noted a certain reactivation of manufacturing production and electricity generation. He/she stated that the manufacturing sector excluding the transportation equipment subsector expanded, while the rest of manufacturing registered a contraction. He/she added that the transportation equipment subsector is still below its pre-pandemic levels. **Some** members indicated that the manufacturing subsectors most integrated to global production chains register greater dynamism, while those that are more domestically linked have exhibited sluggishness. As for the services sector, they pointed out that recently six of its nine subsectors have continued growing. However, **one** member stated that commercial activities, which had led growth in this sector, have somewhat decelerated.

On the demand side, most members highlighted the expansion of private consumption at the end of last year. They underlined the improvement in the consumption of services. Some members pointed out that timely indicators, such as consumer confidence, the wage bill and remittances, suggest that this dynamic continued during the first months of 2023. However, **one** member noted that consumption of non-durable goods has stagnated in its latest readings, while that of semi-durables and durables has contracted, mitigating the shift in consumption patterns observed since the pandemic. **Regarding investment, most members highlighted that it continues improving. Some** members noted that this is being supported by the machinery and equipment component. However, **one** member warned that investment is still behind its peak levels of mid-2018, although it is close to its pre-pandemic levels. **Another** member mentioned that investment in non-residential construction continues trending upwards and is above its February 2020 level, while residential construction has stagnated and is still below that level. **One** member stated that ensuring the conditions for the country to take full advantage of the reconfiguration of global production chains would give a greater boost to domestic production, helping to counteract the anticipated cyclical weakness in external demand. Regarding exports, **some** members noted that during the January-February period, manufacturing exports exhibited some weakness. **One** member noted that external demand has shown less dynamism and that the largest trade deficit on record for a January-February period was observed.

All members agreed that the labor market remains strong. Most members pointed out that conditions in this market are showing signs of tightening. They noted that the labor participation rate continued increasing, while unemployment remained at low levels. Some members stated that the unemployment rates are at historic lows. **One** member noted that employment has increased at a faster pace than the labor participation rate. **Another** member warned of a shortage of skilled labor in some regions of the country.

Most members highlighted the relatively high magnitude of wage revisions. One member pointed out that contractual wage revisions in private companies reached levels of 8.6%. He/she indicated that the annual wage growth of IMSS-insured workers has remained at levels above 11%. He/she added that the increase in the minimum wage explains a growing fraction of the increase in the IMSS-insured workers' average base salary. However, **another** member stated that wages do not seem to show an atypical behavior considering the evolution of their traditional determinants, such as inflation, labor market dynamics, and productivity growth. He/she also considered that the observed increase in wages rather obeys a recovery of real wages, which are barely 1.8% above what was registered in the last quarter of 2019.

Inflation in Mexico

All members considered that the inflation outlook remains complex and uncertain, although they acknowledged that some pressures are easing. Most members pointed out that external pressures have diminished. One

member recalled that in order to solve Mexico's inflationary problem external pressures must ease, although he/she underlined that this is not a sufficient condition. **Some** members mentioned that, at this point, domestic pressures are regarded as a challenge, especially those affecting services prices.

Most members noted that annual headline inflation has decreased due to the evolution of the non-core component, while core inflation has adjusted downwards gradually. Some members recalled that annual headline inflation had been declining since September 2022. **Most members mentioned that during the first fortnight of March, headline and core inflation registered 7.12% and 8.15%, respectively.**

Most members pointed out that core inflation continues showing persistence and remains at high levels. One member indicated that, although the core component has not yet shown a clear downward inflection point, last November it interrupted its upward trend and its figures have been in line with expectations. **Another** member stated that estimates in which the most recent monthly variations of this component are weighted, suggest that said component is close to following a downward trend. He/she added that supercore inflation as well as indicators more related to supply factors may have already reached their inflection point. **One** member pointed out that inflation more related to wages decreased at the margin. He/she mentioned that, within this indicator, six of the 36 CPI items that comprise it contributed with nearly 63% of its annual variation in the first fortnight of March, while the contribution of the remaining 30 items registered a marginal decrease. Therefore, he/she considered that the increase registered in this index has not been generalized. **Another** member indicated that there has been an improvement in producer prices, and therefore there is a lower pass-through of cost-related pressures to consumer prices.

All members mentioned that merchandise inflation continued decreasing. Most members highlighted, in particular, the reduction in food merchandise inflation. Some members considered that the seasonally adjusted monthly variations of merchandise prices are already showing a clear downward trend. **Some** members noted the reduction in the percentage of food merchandise items with double-digit seasonally adjusted annualized monthly variations**. One** member pointed out that, for the first time since the beginning of last year, the percentage of such food merchandise items showing annualized monthly price variations above 10% is below 50%, while that of non-food merchandise continues decreasing, and currently stands at around 13.6%. Regarding food merchandise components, **another** member underlined the lower annual variations in the prices of corn, wheat, and dairy products.

Most members highlighted the upward trend in annual services inflation. One member pointed out that, although the acceleration of services inflation is not excessive, the annual variation of this index is consolidating at high levels. **Some** members noted that inflation of services other than housing and education increased again during the first fortnight of March. **One** member pointed out that, considering seasonally adjusted monthly variations, a certain stabilization is observed in education and housing inflation, but inflation of the rest of services continues trending upwards. **Another** member noted that the price increases in some services could be one-off adjustments, as in the case of domestic services, higher education or other personal care services, but pointed out that it is necessary to remain vigilant, especially regarding inflation of services other than housing and education, because these increases are taking place in an environment where inflation has remained at elevated levels for two years. **Most members highlighted that the prices of various services have increased significantly due to the high cost of their inputs. Some** members added the increased labor costs. They mentioned the minimum wage and **one** member added the higher vacation benefits. **Another** member noted that recent service inflation figures also reflect the mitigation of the change in consumption patterns generated by the containment of the health emergency and the subsequent reopening of the economy. He/she pointed out that part of the behavior of this component is due to the recovery in the sector and reflects price increases that were probably postponed at the time due to weak demand. In this regard, he/she pointed out that services activity recently reached its pre-pandemic levels.

Most members mentioned that in the first fortnight of March, non-core inflation adjusted downwards, reaching 4.15%. They indicated that such reduction was due to decreases in its agricultural and livestock products and energy components.

Some members mentioned that, according to surveys, inflation expectations for 2023 and 2024 increased again. However, **some** members considered that short-term expectations have somewhat stabilized. **One** member pointed out that those for the next 12 months continued decreasing. **Most members mentioned that longer-term expectations remained relatively stable.** However, **one** member warned that inflation expectations for all terms remain elevated and above the central bank's target. Regarding inflation expectations drawn from market instruments, **another** member highlighted that breakeven inflation remains at high levels.

Most members mentioned that Banco de México's forecasts for headline and core inflation were revised marginally. They noted that inflation is still projected to converge to the target in the fourth quarter of 2024. One member pointed out that only for the first and second quarters of 2023 headline inflation forecasts were revised downwards and those corresponding to the core component were revised upwards. **Another** member noted that non-core inflation has been below forecasts. **One** member noted that forecasts over the planning horizon consider the gradual fading of the effects of the pandemic and the military conflict shocks, as well as the monetary policy actions that have been implemented.

Most members stated that, looking ahead, inflationary pressures are expected to continue decreasing. One member added that the reduction in merchandise inflation will become more noticeable and that services inflation will likely stabilize. He/she pointed out that the mitigation that has been observed in the global shocks that have affected some services prices will eventually be reflected in this component. He/she stated that, although international food prices have been decreasing for some months, only until March their annual variations became negative. In this context, he/she considered that, looking ahead, a more noticeable reduction in food merchandise and food services inflation could be observed. He/she stated that these two components accounted for 64% of the most recent inflation figure.

With respect to upward risks to inflation, most members mentioned the persistence of its core component at high levels. Some members noted the possibility of greater cost-related pressures. **One** member stated that insecurity continues affecting the high distribution costs. He/she considered that the narrowing slack conditions have made inflation more susceptible to new supply- and demand-related shocks. **Some** members pointed out the inflationary risk generated by the tight labor market. However, **some** members highlighted that, according to Banco de México estimates, a wage-price spiral is not being observed. **One** member added that the nearshoring phenomenon could increase the existing pressures in the real estate market. **Another** member pointed out that the turmoil in financial markets caused by the failure of some US banks could be a source of additional volatility in the foreign exchange market, which could represent a risk for inflation. **One** member added the possibility of pressures on energy or agriculture and livestock product prices. In this regard, **another** member stated that the forecasted inflation trajectories should be taken cautiously, because the non-core component, which is not susceptible to monetary policy actions, is assumed to behave favorably and below its historical average. As for downside risks, **one** member pointed to a greater-than-anticipated slowdown of the world economy. **Most members considered that the balance of risks for the trajectory of inflation within the forecast horizon remains biased to the upside.**

Macrofinancial environment

Most members pointed out that domestic financial markets registered high volatility, in view of the recent increase in global risk aversion derived from the described developments in international banking systems. One member mentioned the negative behavior of these markets. However, **another** indicated that markets have operated in an orderly manner despite the observed volatility. **Most members pointed out that the stock market registered falls. Some** members underlined the reduction in the value of the financial sector stocks. **One** member added the fall in those of the consumer discretionary sector.

Most members indicated that, after having appreciated, the Mexican peso registered volatility over the last weeks in response to the referred increase in risk aversion. Some members pointed out that, in view of increased risk aversion, the Mexican peso reversed part of the appreciation registered during the year. **One** member stated that the exchange rate adjustment occurred through a reduction in long positions and an increased demand for currency hedging in light of the risk of a greater depreciation, which were partially offset by increased positions on short- and medium-term government securities. **Another** member pointed out that the Mexican peso has accumulated an appreciation of over 6% during 2023. **One** member mentioned that since the beginning of the restrictive cycle, the bilateral real exchange rate with the United States has appreciated around 7%, while the multilateral trade-weighted one has appreciated around 15%, which could be reflecting tighter monetary conditions. **Another** member stated that during this period the nominal exchange rate reached levels unseen since 2017. He/she highlighted that, from a longer-term perspective, the national currency keeps standing out among the currencies of emerging economies. **One** member noted that foreign exchange market trading conditions have recently deteriorated. However, **another** member noted that these remained stable for most of the period. He/she added that, during this episode of volatility, no pressures were observed on either the peso-denominated funding market or the US dollar-denominated one. He/she underlined that the factors that have caused the Mexican peso to appreciate prevail, and therefore, in the absence of new risks, the peso is anticipated to exhibit more stability.

Most members pointed out that, since the previous monetary policy decision, interest rates on government securities in Mexico registered generalized increases. One member stated that, initially, with the 50-basis point increase in the reference rate of the February meeting, the yield curve adjusted significantly upwards. He/she added that, subsequently, said curve has adjusted slightly downwards, in line with the developments in fixed-income markets in the United States. **Another** member pointed out that interest rates in Mexico remain above the levels registered in the previous policy decision. **One** member stated that interest rates exhibited increases of 67 basis points in the short term and of 52 basis points in the long term. **Some** members indicated that default risk premia increased. **One** member mentioned that, despite this, capital inflows to the fixed-income market continued.

All members noted that developments in the US and European banking systems have had a limited impact on the domestic financial system. Most members highlighted that banking institutions in Mexico do not have direct credit or debt exposure to the affected foreign entities. They mentioned that Mexican banks exceed regulatory requirements of liquidity and capitalization. One member underlined that, in Mexico, unlike in the United States, all banks, regardless of their size, must comply with said requirements. **Another** member pointed out that the macroprudential policies implemented in Mexico over the last two decades have so far allowed the Mexican financial system to be sufficiently resilient to avoid contagions as well as to contain any signs of instability. Notwithstanding, he/she underlined that there will not be a complacent stance in the face of potential risks. **One** member added that the risk of potential losses for banks and brokerage firms due to interest rate increases has decreased. He/she mentioned that, although no liquidity problems are foreseen in the Mexican banking system, a temporary increase in the cost of financing cannot be ruled out.

All members highlighted that, looking ahead, Banco de México will remain attentive to the developments in international financial markets and to any likely impact on the domestic financial system. One member underlined that, due to its sound macroeconomic fundamentals, the Mexican economy is currently in a resilient position, given the challenging economic environment that all economies are facing. He/she mentioned that the Mexican economy is in better conditions than in the past to face the risks associated with an external juncture characterized by tight financial conditions derived from the monetary restriction cycle at the global level, as well as the challenges associated with the stability of the international financial system, which could lead to an even greater tightening of global financial conditions.

Some members indicated that the performing credit of commercial banks to firms and households has continued to expand, especially credit for consumption. **One** member also underlined the increase in mortgage lending. **Another** member pointed out that delinquency rates are at low and stable levels. **One** member stated that asset holdings, both by households and firms, continue to shift towards longer maturity ones, reflecting the higher yields offered by these instruments.

Monetary policy

The Governing Board evaluated the magnitude and diversity of the inflationary shocks and its determinants, along with the evolution of medium- and long-term inflation expectations and the price formation process. It considered the challenges stemming from the ongoing tightening of global financial conditions, the environment of uncertainty, the persistence of accumulated inflationary pressures and the possibility of greater effects on inflation, as well as the monetary policy stance already attained in this hiking cycle. Based on the above, and with the presence of all its members, the Board decided unanimously to raise the target for the overnight interbank interest rate by 25 basis points to 11.25%. With this action, it slows the pace of interest rate increases and the monetary policy stance adjusts to the trajectory required for inflation to converge to its 3% target within the forecast horizon.

The Board will thoroughly monitor inflationary pressures as well as all factors that have an incidence on the foreseen path for inflation and its expectations. The latter, in order to set a policy rate that is consistent at all times with both the orderly and sustained convergence of headline inflation to the 3% target within the time frame in which monetary policy operates as well as with an adequate adjustment of the economy and financial markets. For its upcoming decision, the Board will take into account the inflation outlook, considering the monetary policy stance already attained.

One member argued that, considering all the above, in this meeting a 25-basis point increase is appropriate, given: a) the inflation outlook; and b) the monetary policy stance already attained. Regarding the first element, he/she reiterated that assessing the inflation outlook overall involves analyzing the observed and expected behavior of inflation as well as its determinants. In this regard, he/she considered that this outlook, despite remaining complex, is less adverse than that observed during most of 2022. He/she pointed out that, since the previous monetary policy decision, in view of the evolution of the non-core component, the observed behavior of headline inflation has turned out lower than anticipated. He/she added that the performance of core inflation has been in line with forecasts. He/she underlined that, looking ahead, the expected trajectory of inflation is similar to that already anticipated during the previous monetary policy decision. He/she noted that, so far, no significant effects of the US and Swiss banking problems on the outlook for domestic inflation are perceived, although he/she acknowledged that the Board must remain vigilant over this issue. He/she underlined that, at the margin, a deterioration of inflation dynamics is not perceived, although he/she emphasized that they remain complex. He/she stated that this reinforces the alternative of a rate increase for this policy decision of lesser magnitude than that of February's, as mentioned in the previous policy statement. Regarding the second element, he/she restated that during this inflationary period Banco de México has acted in a timely and forceful manner. He/she pointed out that the reference rate has accumulated a 700-basis point increase and that, during the second half of 2022, a restrictive policy stance was attained, as required by the inflationary environment. Hence, he/she considered important to give relevance to the policy stance attained. This, considering that, to face a complex inflationary environment such as the present one, the central bank currently has an even more solid and robust stance than during the previous monetary policy decision. He/she argued that, considering the features of the inflation outlook mentioned above, the policy stance can be strengthened in lesser magnitude than as in the February meeting.

Another member considered that, despite the positive performance of inflation, domestic pressures persist, mainly in the core component and with an upward dynamic in the services sector. He/she listed three sources of domestic pressures: i) growth of consumption exceeding the expansion of economic activity; ii) increased cost-related pressures stemming from the labor market; and iii) high inflation expectations. In this environment, he/she deemed it necessary to strengthen the monetary policy stance, although at a slower pace, considering the restrictive level attained. He/she noted that the main risk continues being that inflation does not decrease at the pace necessary to achieve convergence within the planning horizon. He/she underlined that the policy statement should: i) acknowledge that, although there are signs of moderation in inflationary pressures and inflation is in line with forecasts, both inflation and its expectations are above target; ii) emphasize that the restrictive stance must be strengthened to bring core inflation down at the required pace and that, in the face of increasing domestic pressures, the trajectory of the services component will be key for the upcoming decisions; and iii) underline that the Mexican banking system is sound and acknowledge that turmoil in international financial markets could pose a greater challenge for monetary policymaking. Regarding forward guidance, he/she pointed out that the environment of high uncertainty calls for a cautious approach and favors a flexible policy stance. He/she pointed out that, based on current prospects, the reference to future increases may be omitted, emphasizing that monetary policy decisions will depend on the evolution of inflation determinants, the trajectories of inflation forecasted throughout the planning horizon, and on inflation expectations. He/she added that it should be pointed out that the monetary policy stance is expected to remain restrictive over the entire referred horizon. He/she also reflected on the urgent need to comprehensively assess the central bank communication policy. He/she highlighted the significant progress of recent years, from disclosing the Board members vote and publishing the updated forecasts for each monetary policy decision, to including the forward guidance in the central bank policy statements and publishing the full version of each of the member's interventions three years after the policy decision. He/she stated that all of the above points in the right direction of greater transparency and accountability. He/she emphasized that communication is as important as monetary policy decisions on the reference rate, and that both elements constitute a tool to attain an effective transmission of monetary policy. In his/her opinion, the fact that, for the second time in 18 months, last February's decision took by surprise all private sector analysts cannot go unnoticed. He/she considered that this should lead to an evaluation of the central bank communication policy, its implementation, and the results achieved, in order to move towards a communication strategy that places institutional messages at its heart. He/she argued that said strategy should define the role of the Board members in transmitting institutional messages, and provide specific rules that, while allowing diverse opinions to be shared, set the basis on which monetary policy effectiveness is maintained as the primary goal.

One member pointed out that, for this monetary policy decision, it is possible to continue with the monetary tightening as planned. He/she stated that the current context provides an opportunity to slow down the pace of reference rate increases and to consider the possibility of reaching the terminal rate of the current hiking cycle. He/she underlined that since the last monetary policy decision the inflation outlook improved at the margin, mainly due to lower external pressures, which is expected to lead to the materialization of a downward inflation trajectory. In this regard, he/she pointed out that different pressures on inflation justify implementing a restrictive monetary policy stance for a certain period. However, he/she sustained that it is time to focus on tackling domestic-related pressures, especially on services prices. He/she listed the factors that, in his/her opinion, will be key to determine the terminal interest rate: i) that inflation draws closer to its historical average, as in recent readings; ii) that core inflation consolidates a decreasing trend in its merchandise component and services inflation is contained; iii) that short- and medium-term expectations are more stable and gradually approach the target; iv) that the uncertainty associated with the balance of risks for inflation decreases, as it has done marginally; v) that incoming data validate the expected trajectory for inflation and that its forecast undergoes marginal revisions; and vi) that the restrictive level that has been attained is consistent with the complex nature of the current inflation phenomenon. He/she highlighted that the latter is possibly the most important factor. He/she estimated that during the upcoming monetary policy decision it will be determined whether the evolution of data allows to confirm the level of 11.25% as the terminal rate or if an additional adjustment is required. He/she stated that, once said level has been attained, during the next phase of the monetary cycle, the interest rate will need to remain fixed for a period of time enough to consolidate the convergence of inflation to the target. He/she considered that, during such phase, a restrictive monetary policy stance should be maintained with an ex-ante real interest rate of around 7%, considering that the reduction in expected inflation is reflected in increases in the ex-ante real interest rate. He/she stated that Banco de Mexico’s communication must be as explicit as possible, avoiding an insufficiently clear forward guidance; for this reason, he/she pointed out that the monetary policy statement should justify the decision clearly, as well as the future intentions, specifying that these do not represent a fixed commitment and that they are subject to incoming data. Finally, he/she underlined that it is necessary to convey that, with the proposed adjustment, the hiking cycle would be close to ending, depending on the evolution of incoming data.

Another member pointed out that headline inflation has decreased slowly and that the core component has shown greater persistence. With the proposed increase, he/she considered that the expected trajectory of inflation, as well as the associated balance of risks, are consistent with slowing the pace of interest rate increases. He/she highlighted three elements to consider for the conduct of monetary policy. First, he/she mentioned that the level of the monetary policy stance attained is historically high and that the ex-ante real interest rate is about to be almost twice the upper bound of the neutral range, which he/she estimated will be proportional to the observed inflation gap. He/she pointed out that said gap is anticipated to continue narrowing, while the ex-ante real interest rate is foreseen to increase insofar as inflation expectations ease. He/she stated that these expectations in the past have declined at a slower pace than the decrease in inflation, and that therefore it is reasonable to expect the real interest rate increase to not be excessive, although sufficient to maintain a significantly restrictive policy stance. He/she noted that, despite the recent episode of volatility, the real exchange rate continues acting restrictively on the economy, and thus overall monetary conditions have reached a level that supports the convergence of inflation. Second, he/she indicated that the monetary policy stance impacts the economy gradually. He/she reminded that the ex-ante real interest rate exceeded its range estimated as neutral six months ago, so monetary restriction can be expected to begin showing its effects more clearly during the second half of the year and reach them fully during 2024. Therefore, he/she pointed out the need to act cautiously so that the restrictive policy stance does not end up having an impact at times when the inflationary gap is not significant. Third, he/she underlined that effective central bank communication contributes to reduce some of these lags. He/she considered it relevant for communication to contribute to a better understanding of the central bank's reaction function for the rest of the year, in order to reduce market uncertainty over the interest rate's expected trajectory, so that the latter is consistent with the central bank's forecasts. He/she concluded that it is convenient to outline that, in the current conditions and in the absence of additional and significantly adverse shocks, the policy stance attained will allow to maintain inflation expectations anchored, will avoid second-round effects on price formation, and will be adequate for inflation to converge to the target within the forecast horizon, consistent with the constitutional mandate.

One member considered a 25-basis point increase in the reference rate appropriate, given that, although core inflation remains high, inflationary pressures have shown signs of mitigation, which are anticipated to be more noticeable over the following months. Likewise, he/she indicated that the degree of policy restraint already attained must be considered. He/she pointed out that, with this adjustment, the reference rate will have accumulated a 725-basis point increase, bringing the real short-term interest rate to a clearly restrictive level of approximately 6.5%. He/she stated that the monetary restriction has been reflected in different indicators, such as shorter-term inflation expectations, which have stabilized, and longer-term inflation expectations, which have remained anchored. He/she added that, given the tighter financial conditions, in view of the monetary tightening in Mexico and in other countries, the adjustment in the short-term real interest rate has been transmitted along the yield curve of real interest rates. Additionally, he/she highlighted the real exchange rate appreciation that has been observed since the start of the hiking cycle, and mentioned that this could be reflecting tighter monetary conditions. He/she also underlined three additional elements to consider in this monetary policy decision. First, that monetary policy operates with a lag and some of the transmission channels, such as the exchange rate and inflation expectations, act at a greater speed. He/she added that, since last September, the ex-ante real interest rate has been above the upper limit of the neutral range, and therefore the impact of monetary tightening will be more noticeable over the next quarters. Second, he/she noted that the ex-ante real interest rate will continue increasing insofar as inflation expectations decrease. Third, he/she pointed that, in addition to the reference rate, communication also acts as a policy tool and it can continue strengthening the actions that have already been implemented. He/she concluded that the proposed policy stance will have the necessary strength for inflation to continue converging to the target. He/she indicated that monetary policy actions should prevent this convergence from being compromised and should foster an orderly adjustment of the economy and financial markets, in accordance with the constitutional mandate. He/she stated that the proposed adjustment would consolidate the monetary policy stance and provide room to evaluate the effects of the significant reference rate increase, so that, in the absence of new shocks, looking ahead it would be convenient to maintain the monetary policy stance that would be attained in this decision.

3. MONETARY POLICY DECISION

The Governing Board evaluated the magnitude and diversity of the inflationary shocks and its determinants, along with the evolution of medium- and long-term inflation expectations and the price formation process. It considered the challenges stemming from the ongoing tightening of global financial conditions, the environment of uncertainty, the persistence of accumulated inflationary pressures and the possibility of greater effects on inflation, as well as the monetary policy stance already attained in this hiking cycle. Based on the above, and with the presence of all its members, the Board decided unanimously to raise the target for the overnight interbank interest rate by 25 basis points to 11.25%. With this action, it slows the pace of interest rate increases and the monetary policy stance adjusts to the trajectory required for inflation to converge to its 3% target within the forecast horizon.

The Board will thoroughly monitor inflationary pressures as well as all factors that have an incidence on the foreseen path for inflation and its expectations. The latter, in order to set a policy rate that is consistent at all times with both the orderly and sustained convergence of headline inflation to the 3% target within the time frame in which monetary policy operates as well as with an adequate adjustment of the economy and financial markets. For its upcoming decision, the Board will take into account the inflation outlook, considering the monetary policy stance already attained.

4. VOTING

Victoria Rodríguez, Galia Borja, Irene Espinosa, Jonathan Heath, and Omar Mejía voted in favor of increasing the target for the overnight interbank interest rate by 25 basis points to 11.25%.

5. DISSENTING OPINIONS / VOTES

Dissenting opinion on the monetary policy statement. Irene Espinosa.

Communication is a fundamental pillar of monetary policy. In recent years, our central bank has introduced changes and made significant progress in this field. Nevertheless, these have been mainly implemented on a case-by-case basis, according to circumstances, and, on occasions, without previously discussed guidelines. Such is the case of forward guidance. Its purpose is to aid in the formation of expectations aligned to the long-term view of monetary policy, which is conditional on available information, to enable an orderly adjustment of financial markets. However, the forward guidance proposed in this policy statement is limited only to the upcoming decision and omits communicating that we anticipate that the monetary policy stance must remain restrictive for 2 years in order to achieve convergence to the 3% exact target. This reinforces a very short-term view, inevitably partial and incomplete, that does not fulfill the purpose of contributing to the formation of expectations for the horizon in which monetary policy operates. For this reason, I reiterate the urgent need to evaluate our communication policy.

ANNEX

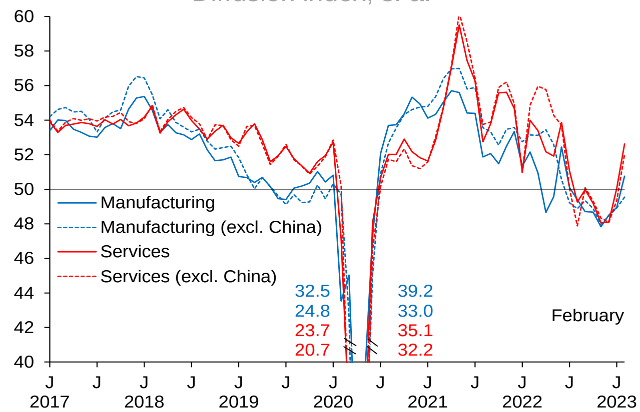
The information in this Annex was prepared for this meeting by the staff of Banco de México's Directorate General of Economic Research and Directorate General of Central Bank Operations. It does not necessarily reflect the considerations of the members of the Governing Board as to the monetary policy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

A.1. External conditions

A.1.1. World economic activity

Available information suggests that world economic activity recovered during the first quarter of 2023 relative to the fourth quarter of 2022. This would be driven by higher growth in some major economies, the continuing strength of their labor markets, an improvement in business and consumer confidence, lower pressures on energy prices, and the lifting of mobility restrictions in China. Purchasing Managers' Indices suggest a short-term improvement in both services and manufacturing (Chart 1). Global growth forecasts, however, continue suggesting a deceleration of world economic activity in 2023, compared to 2022, and a recovery in 2024. Between February and March, analysts' global growth forecasts for 2023 were revised slightly upwards and remained unchanged for 2024. Among the risks to the world economy the following stand out: persistent inflationary pressures, the worsening geopolitical tensions, tighter financial and monetary conditions, and challenges to financial stability. The latter challenges have been caused by turbulence in international financial markets over the last weeks in light of the events in the US and European banking systems, although financial authorities have implemented measures such as increasing deposit insurance and liquidity provision to maintain confidence in the financial system.

Chart 1
Global: Purchasing Managers' Index: Production Component
Diffusion index, s. a.1/



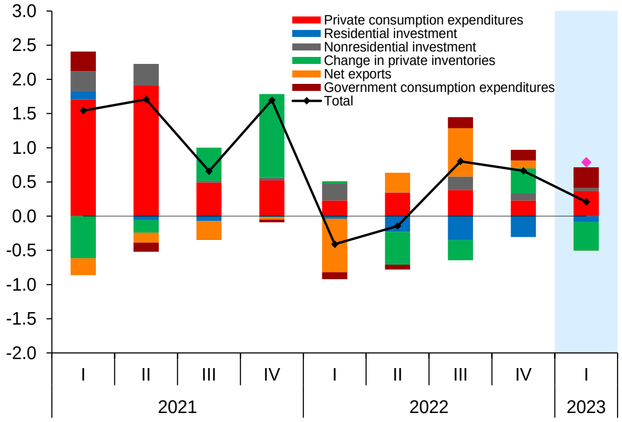
s.a./ Seasonally adjusted figures.
1/ The index varies between 0 and 100 points. A reading above 50 points is considered an overall increase compared to the previous month and below 50 points an overall decrease.
Note: The figures in the chart correspond to the minimum level of the indicator.
Source: IHS Markit.

In the United States, available indicators suggest that Gross Domestic Product (GDP) would have grown in the first quarter of 2023 at a slower pace than at the seasonally adjusted quarterly rate of 0.7% registered during the fourth quarter of 2022 (Chart 2).[1] During the first quarter of 2023, economic activity would have been sustained mainly by private consumption, which has shown strength due to the soundness of its labor market and the savings accumulated during the pandemic. Government spending and, to a lesser extent, nonresidential investment, would also contribute to GDP growth. The positive contribution of the aforementioned factors is expected to be partially offset by the evolution of the change in inventories and residential investment.

After expanding by 0.3% in January, US industrial production stagnated in February. This reflected a fall in mining, which was offset by a recovery in electricity and gas generation and a moderate growth in the manufacturing sector. Within the latter, the growth in the subsector of computers and electronic products stood out. In contrast, production of vehicles and auto parts fell. Purchasing Managers' Indices suggest that the manufacturing sector will continue showing weakness, in response to a sluggish domestic and external demand.

[1] Expressed as a seasonally adjusted annualized quarterly rate, the change in US GDP was 2.7% in the fourth quarter of 2022.

Chart 2
US Real GDP and Components
Quarterly percentage rate and contribution in percentage points, s. a.



s.a./ Seasonally adjusted figures.
Note: Components in the shaded area show the March Blue Chip forecasts, while the pink diamond shows the GDPNow forecast.
Source: BEA, The Federal Reserve Bank of Atlanta and Blue Chip.

The US labor market continued showing signs of tightness. The non-farm payroll registered a higher-than-anticipated creation of 311,000 new jobs in February 2023. The main increases were in services related to leisure and accommodation, commerce, government and health care. The unemployment rate remains low, despite having risen from 3.4% in January to 3.6% in February. This has occurred in a context in which the labor participation rate has been gradually increasing. Initial claims for unemployment insurance stood at 191,000 in the week ending March 18. Some wage indicators continued growing at a high rate.

In the euro area, available indicators suggest that economic activity exhibited a lack of dynamism during the first quarter of 2023, after GDP registered zero growth during the fourth quarter of 2022.[2] Economic activity would continue to be affected by the high uncertainty surrounding the military conflict in Ukraine, the weakening of external demand, and tightening financial conditions. However, other factors are expected to stimulate the economy, including a further improvement in supply conditions and the recovery in consumer and business confidence, as well as a strong labor market, and easing pressures on energy prices. Unemployment remained unchanged at 6.7% in January. Purchasing Managers' Indices suggest a stabilization of manufacturing activity and a recovery in services.

Economic activity in a large number of major emerging economies is expected to have recovered during the first quarter of 2023, although with some heterogeneity. In Emerging Asia, most economies are expected to have registered a recovery. In the particular case of China, economic activity is expected to have grown moderately during the first quarter in light of the lifting of mobility restrictions in that country, after being stagnant during the fourth quarter of 2022. In Emerging Europe, most economies would be registering a recovery during the first quarter. In Latin America, economic activity is expected to have deteriorated in some cases and in others to have registered moderate growth.

International commodity prices overall trended downwards since Mexico's previous monetary policy decision. During the second half of February, oil prices declined due to persistent concerns about lower world growth. This trend was partially reversed by the third week of February in a context of supply constraints, due to lower Russian oil exports and the agreement of the Organization of the Petroleum Exporting Countries and allied countries (OPEC+) to maintain the production cuts of two million barrels agreed last year. Starting on the second week of March, prices fell again due to expectations of further interest rate increases by the major central banks, led by the strength of certain economic indicators and concerns about the adverse effects these increases could have on demand, to which risks associated with the banking sector in the United States and Europe were added. However, in recent days this decline appears to have somewhat reversed as the aforementioned concerns have moderated. Meanwhile, natural gas reference prices in Europe trended downwards in response to relatively high inventory levels and forecasts of warmer temperatures. In the United States, natural gas prices declined during most of February due to a larger inventory accumulation. These prices subsequently increased due to higher exports of natural gas and lower temperature forecasts. Grain prices, in general, decreased in light of historically high production levels in countries such as Brazil. The renewal of the Black Sea security corridor agreement also contributed to such decrease. Finally, most industrial metal prices declined at the beginning of the period due to risks of a global recession and a lower outlook for Chinese demand,

[2] Expressed as a seasonally adjusted annualized quarterly rate, the change in euro area GDP was -0.1% in the fourth quarter of 2022.

although such decline partially reversed during the second half of March.

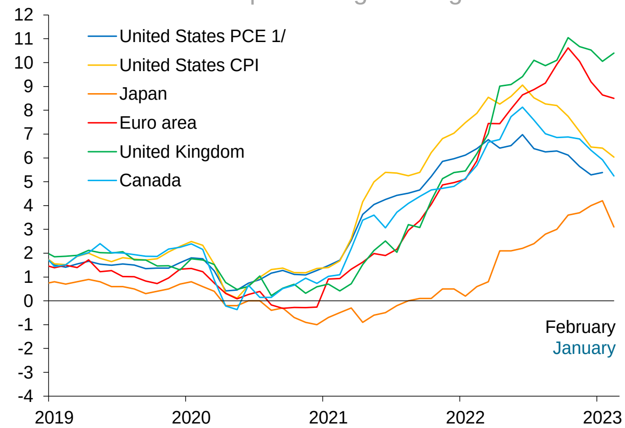
A.1.2. Monetary policy and international financial markets

Global inflation remains at high levels, although headline inflation continued decreasing in a large number of economies. The core component showed persistence. The decline in headline inflation in several major advanced economies (Chart 3) was mainly associated with a moderation in energy inflation. However, in some cases, the decline in inflation was smaller than anticipated, while in others it increased in recent readings. The core component increased in several of these economies, among them the euro area, Japan, and the United Kingdom.

In the United States, annual headline inflation as measured by the consumer price index declined from 6.4% in January to 6.0% in February. This reflected a fall in energy, food and, to a lesser extent, in core inflation. The annual variation of the latter went from 5.6 to 5.5% during the same period, mainly as a result of a lower inflation in merchandise prices, which was partially offset by an increase in services prices. Annual headline inflation of the personal consumption expenditures index decreased from 5.3 to 5.0% from January to February.

Analysts' short-term inflation forecasts for most of the main advanced economies remained at high levels, although they foresee a decline in 2023 from the levels registered in 2022. Longer-term inflation expectations drawn from financial instruments remained relatively stable for these economies.

Chart 3
Selected Advanced Economies: Headline Inflation
Annual percentage change



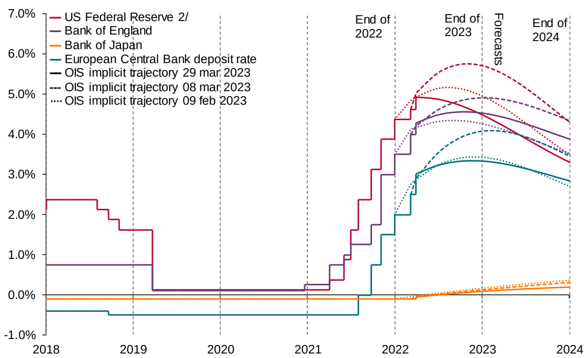
1/ The personal consumption expenditure deflator is used.
Source: Bureau of Economic Analysis, Bureau of Labor Statistics, Eurostat, Bank of Japan, The UK Office for National Statistics and Statistics Canada.

According to most recent readings, in a large number of major emerging economies headline inflation declined or stabilized as a reflection of the lower prices of food and energy and, in some cases, of the decline in core inflation.

Due to strong labor markets and inflation's persistence at high levels, during most of the reporting period, monetary policy expectations drawn from financial instruments anticipated further interest rate increases and that said rates would remain high for a longer period in most of the major advanced economies. However, recent banking sector problems in some advanced economies and concerns associated with financial stability moderated expectations of reference rate increases drawn from financial instruments and even already anticipate cuts in some economies towards the end of the year (Chart 4).

In this environment, since Mexico's previous monetary policy decision, the central banks of most of the main advanced economies continued tightening their monetary policy stances. The US Federal Reserve, the European Central Bank, the Reserve Bank of Australia and the Swiss National Bank maintained the pace of interest rate increases, while the central banks of Sweden, New Zealand and the United Kingdom reduced it in their latest decision. Some central banks, such as those of South Korea and Canada, paused their hiking cycles, although they are expected to maintain their interest rates at high levels for some time. Meanwhile, the Bank of Japan left its short and long-term interest rates unchanged, as well as its guidance on yield curve control. Regarding their asset purchase programs, most central banks in this group of economies continued to gradually reduce their securities' holdings. The central banks of countries that have faced problems in the banking sector have taken different measures such as increasing deposit insurance and liquidity provision to maintain confidence in the financial system.

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



1/ OIS: Fixed floating interest rate swap where the fixed interest rate is associated with the effective overnight reference rate.
2/ For the observed reference rate of the US, the average interest rate of the target range of the federal funds rate (4.75% - 5.00%) is used.
Source: Banco de México with data from Bloomberg.

Among the recent monetary policy decisions of major advanced economies, the following stand out:

i) The US Federal Reserve maintained its pace of reference rate increases in 25 basis points (bps) at its March meeting. It set the target range for the federal funds rate between 4.75 and 5.00%. The Federal Open Market Committee (FOMC) also pointed out that additional policy tightening may be appropriate in order to achieve a monetary policy stance that is sufficiently restrictive to bring inflation down to its 2% target. Regarding the financial environment, the Committee noted that the US banking system is sound and resilient. It added that recent developments are likely to lead to tighter credit conditions for households and firms, affecting economic activity and inflation, although the extent of these effects is uncertain. It reiterated that, in determining the future increases in the target range, it will take into account the cumulative tightening of monetary policy, the lags with which monetary policy affects economic activity and inflation, as well as the economic and financial developments. During a press conference, the chairman of that institution highlighted that the US Federal Reserve, in collaboration with the Treasury Department and the Federal Deposit Insurance Corporation (FDIC), took decisive measures to protect the US economy and strengthen public confidence in the banking system and that, with the support of the Treasury, the Bank Term Funding Program was created, which, together with the discount window, is effectively meeting the unusual funding needs that some banks have faced, making it clear that there is sufficient liquidity available in the system. He added that they are prepared to use all their tools as needed. He also stated that prior to the recent financial events, it appeared that the Committee would need to increase the federal funds rate more than previously expected in the December projections. However, he added that the tightening of credit conditions that is likely to result from the recent events would work in the same direction as an interest rate increase, although it is not yet possible to anticipate its magnitude. He noted that it is too early to determine the extent of the effects of such tightening, and therefore too early to state how monetary policy should respond. He pointed out that the possibility of making a pause in its hiking cycle was considered. He added that they do not consider to use different tools to conduct monetary policy, underlining that the reference rate works and that banks have been able to manage the interest rate increases. Regarding its balance sheet, the Federal Reserve reiterated that it will continue to reduce its securities holdings according to its previously announced plans. At the press conference, when questioned about the recent expansion of the balance sheet by increasing the use of some facilities, the US Federal Reserve chairman assured that this expansion will be temporary and is intended to provide liquidity to the banking system and not to change the monetary policy stance. The expected path for the federal funds rate implied by financial instruments was revised upwards for most of the reporting period in light of persistently high inflation and a strong labor market. However, given the uncertainty associated with the failure of certain banks in the United States around the second week of March, the reference rate trajectory drawn from financial instruments was revised significantly downwards. Based on the latest available information, the highest level of the interest rate during 2023 is expected to be 4.9%, before declining to 4.5% for the end of 2023 and to 3.3% for the end of 2024. This contrasts with the FOMC March forecasts, which left its expectation for the federal funds rate by the end of 2023 unchanged at 5.1% and revised upwards its expectation for the end of 2024 from 4.1 to 4.3%. At the press conference, the chairman of the US Federal Reserve ruled out several times the possibility of cuts in the reference rate this year. In this context, the median of the FOMC growth forecasts was revised from 0.5 to 0.4% for the end of 2023, from 1.6 to 1.2% for 2024 and from 1.8 to 1.9% for 2025. The median of unemployment projections was revised downwards for the end of 2023 and upwards for 2025. Meanwhile, headline inflation projections were revised from 3.1 to 3.3% for the end of 2023, while those for 2024 and 2025 remained unchanged at 2.5 and 2.1%, respectively. Regarding core inflation, the median projection was 3.6% for the end of 2023, 2.6% for 2024, and 2.1% for 2025. The chairman of that institution stated that a significant number of board members anticipated that there would be some tightening in credit conditions, and that this would have the same effects as their policy, and that they were therefore incorporating this into their forecasts.

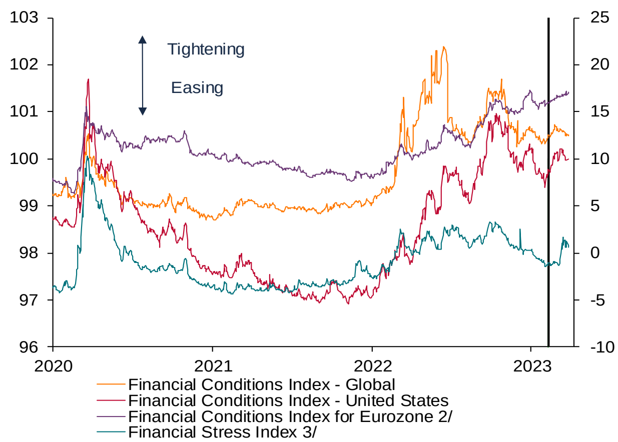
ii) The European Central Bank (ECB) raised its reference rate by 50 bps at its March meeting. Thus, it set its refinancing, key lending and key deposit rates at 3.50, 3.75 and 3.00%, respectively. In contrast to its previous decisions, the Governing Council did not provide specific guidance on the path of its interest rates. On the contrary, it indicated that the high level of uncertainty reinforces the importance of an approach dependent on incoming data for policy rate decisions, which will be determined by the assessment of the inflation outlook in light of new economic and financial data, the dynamics of core inflation, and the strength of monetary policy transmission. It added that the Council closely monitors tensions in financial markets and stands ready to respond as necessary to preserve price and financial stability. It pointed out that the banking sector in the euro area is resilient, with strong liquidity and capital positions, and that the ECB's policy toolkit is fully equipped to provide liquidity to the financial system if required and to preserve the smooth transmission of monetary policy. The president of said institution said that there is no opportunity cost between price stability and financial stability and that they will address each with their respective policy tool. The institution's vice president added that the increase in interest rates is positive in terms of European banks' margins and that, in terms of profitability, this improvement more than offsets potential losses in fixed income portfolios. Regarding the normalization of its securities' holdings, as previously announced, in March it began reducing its Asset Purchase Program (APP) securities portfolio at a measured and predictable pace, as not all principal payments on maturing securities are being reinvested. He reiterated that the reduction will be of 15 billion euros per month, on average, until the end of June 2023, and that the subsequent pace will be determined over time.

Since Mexico's previous monetary policy decision, some central banks of the main emerging economies continued raising their reference rates. Others, including those of Russia, Hungary, Poland, the Czech Republic, Ukraine, Indonesia, Malaysia, Brazil and Peru, left their rates unchanged. Some central banks suggested that keeping their interest rates at current levels for some time would ensure that inflation would decline in a sustainable manner and that future adjustments would depend on evolving conditions.

In the context described above, since Mexico's previous monetary policy decision, international financial markets became more risk-averse and financial conditions tightened (Chart 5). Volatility increased significantly, due to high uncertainty associated with the failure and financial problems of some financial institutions in advanced economies such as the United States and Switzerland. However, these trends have partially reversed in recent days. In this context, the stock markets of most major advanced and emerging economies registered losses. In foreign exchange markets, although the US dollar strengthened during most of the period, it reversed this trend recently. Emerging market currencies depreciated in general for most of the period, although some of them have gained strength recently. Interest rates on short- and long-term government bonds in most of the main advanced economies were highly volatile, after increasing significantly at the beginning of the period and declining considerably following the financial events described above. In several cases, interest rates are below the level observed at the time of Mexico's previous monetary policy decision (Chart 6). In emerging economies, long-term interest rates rose in several cases, although with volatility during the period (Chart 7). Further periods of volatility and risk aversion cannot be ruled out.

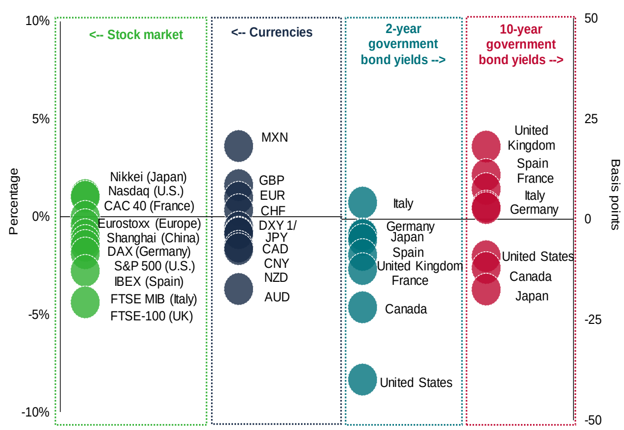
In this context, since Mexico's previous monetary policy decision, cumulative net inflows to emerging economies were registered, although outflows were observed since the second week of March. For most of the period, flows behaved differently across asset classes, with cumulative net inflows to equity assets and outflows from fixed-income assets.

Chart 5
Financial Conditions Indices[1/]
Units



1/ The financial conditions index is constructed considering the effect of five variables on economic activity: the reference interest rate, the 10-year government bond, the spread of investment-grade bonds over the government debt bond with equivalent maturity, the ratio of a stock index with 10-year average earnings per share, and the trade-weighted exchange rate.
2/ In the case of the euro area, the spread between the sovereign bonds of France, Italy, Spain, the Netherlands, Belgium, Austria, Portugal and Finland over the German 10-year bond is also considered.
3/ Data from the Office of Financial Research, constructed with 33 financial variables from five categories: credit, equity valuation, financing, safe haven assets, and volatility. The vertical black line indicates the last calendarized monetary policy meeting of Banco de México.
Source: Prepared by Banco de México with data from Bloomberg and Goldman Sachs.

Chart 6
Change in Selected Financial Indicators from February 9, 2023 to March 29, 2023
Percent; basis points



1/ DXY: a weighted average estimated by the Intercontinental Exchange (ICE) of the nominal exchange rate of the main six currencies operated globally with the following weights: EUR 57.6%, JPY: 13.6%, GBP: 11.9%, CAD: 9.1%, SEK: 4.2%, and CHF: 3.6%
Source: Bloomberg and ICE.

Chart 7
Selected Emerging Economies: Financial Assets Performance as of February 2, 2023
Percent, basis points

Region	Country	Currencies	Equity markets	2-year interest rates	10-year interest rates	CDS
Latin America	Mexico	1.60%	-2.05%	48	40	27
	Brazil	-3.60%	-10.27%	-129	-4	27
	Chile	-3.71%	-0.63%	-42	-43	21
	Colombia	-2.26%	-12.21%	-110	32	71
	Peru	1.52%	-4.46%	-33	-17	12
Emerging Europe	Russia	-8.60%	8.51%	-30	-5	N.A.
	Poland	-1.23%	-7.84%	21	36	10
	Turkey	-1.53%	6.27%	416	171	24
	Czech Rep.	-1.33%	-3.91%	-51	18	1
	Hungary	-1.24%	-7.48%	43	50	9
Asia	China	-2.31%	-1.04%	-1	-4	37
	Malaysia	-4.06%	-6.26%	0	11	23
	India	-0.23%	-3.80%	25	0	17
	Philippines	-0.80%	-5.60%	40	13	29
	Thailand	-5.06%	-5.30%	-5	-20	8
	Indonesia	-1.88%	-2.64%	16	18	33
Africa	South Africa	-7.28%	-5.72%	36	109	61

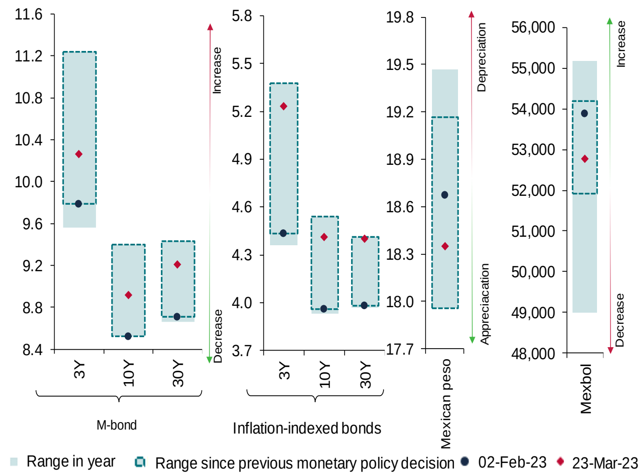
Note: An upward adjustment indicates currency appreciation. Interest rates correspond to swap rates at the specified terms, except for Hungary, where government securities with 3-year maturities were used as a reference. For the Philippines, a 2-year swap rate was used, and for Russia, 2-year and 3-year swap rates were used. The latest CDS data for Russia is as of June 1, 2022.
Source: Bloomberg.

A.2. Current situation of the Mexican economy

A.2.1. Mexican markets

In the international context described above, the Mexican peso appreciated slightly against the US dollar in domestic financial markets since Mexico's previous monetary policy decision, while interest rates for both short- and long-term maturities increased (Chart 8). The environment surrounding domestic financial markets was affected by risk aversion and episodes of volatility, including those resulting from the publication of several Mexican and US economic indicators, Banco de México's reference rate adjustments, the US Federal Reserve announcement of a more restrictive monetary policy stance, and the risks to financial stability associated with the US and European banking systems.

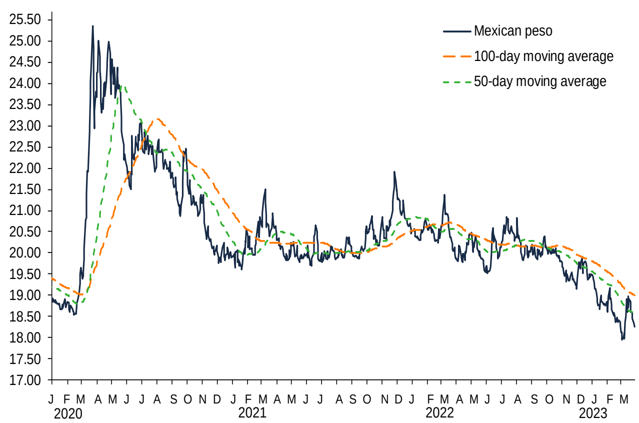
Chart 8
Mexican Markets' Performance
Percent, MXN/USD and index



Source: Prepared by Banco de México.

Since Mexico's previous monetary policy decision, the Mexican currency traded in a range of 1.40 pesos, between 17.89 and 19.29 pesos per US dollar, appreciating 1.60% and reaching its lowest level since September 2017 (Chart 9). The above occurred in a context in which trading conditions, both realized and prospective, deteriorated.

Chart 9
Mexican Peso Exchange Rate including Moving Averages
MXN/USD

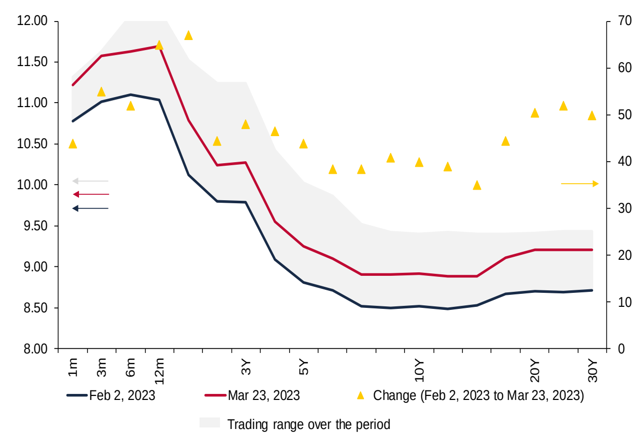


Source: Prepared by Banco de México.

Interest rates on government securities increased up to 67 bps in the short-term nodes, and 52 bps for longer-term nodes (Chart 10). The yield curve of real interest rate instruments exhibited increases that averaged 55 bps. In this context, breakeven inflation implicit in spreads between nominal and real interest rates of market instruments increased by up to 8 bps (Chart 11). These movements took place in an environment in which trading conditions continued deteriorating and failed to reach the levels observed prior to the onset of the pandemic.

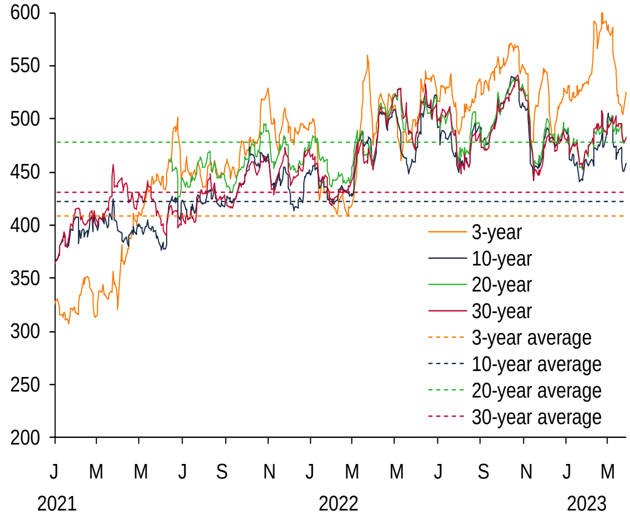
Regarding expectations for the path of the monetary policy reference rate, information implicit in the interest rate swaps curve incorporates an increase of 23 bps for the March decision (Chart 12). Most analysts surveyed by Citibanamex anticipate that the reference rate will be raised by 25 bps in the March decision, up to a level of 11.25%, while for the end of 2023 they anticipate a rate of 11.50%.

Chart 10
Nominal Yield Curve of Government Securities
Percent, basis points



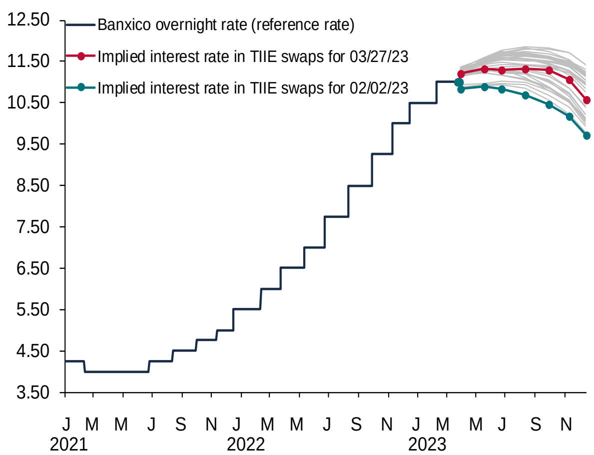
Source: PIP.

Chart 11
Breakeven Inflation and Inflation Risk Implied in Government Securities' Yields
Basis points



Source: PIP.

Chart 12
Interbank Funding Rate Implied in TIIE Swaps
Percent

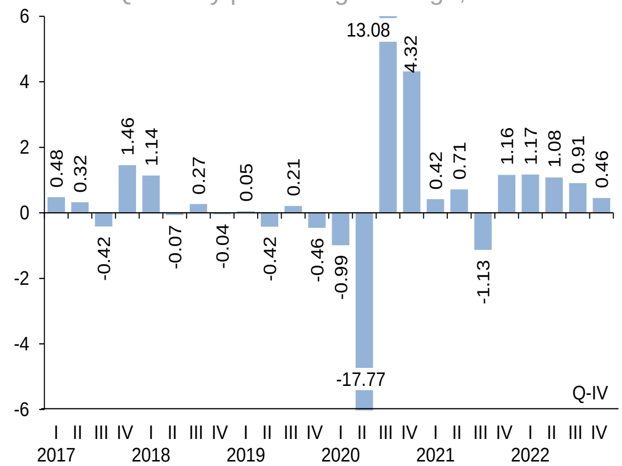


Source: Prepared by Banco de México with Bloomberg data.

A.2.2. Economic activity in Mexico

At the end of 2022, Mexico's GDP continued increasing, although at a slower pace compared to the first three quarters of 2022 (Chart 13). At the beginning of 2023, domestic economic activity continued growing and remained resilient in the face of a complex external environment.

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

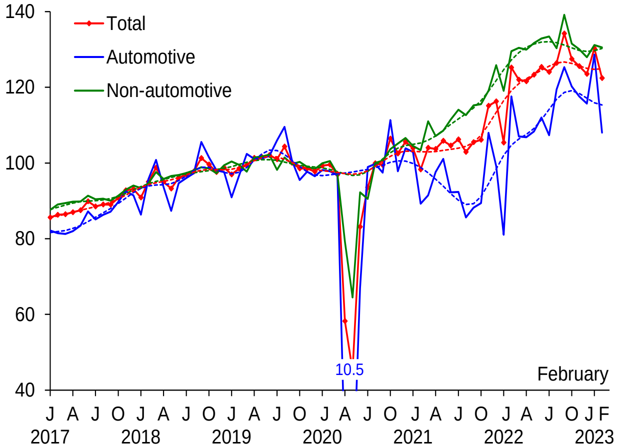


s. a. / Seasonally adjusted figures. The chart's range was adjusted to facilitate its reading.
Source: Mexico's System on National Accounts (SCNM, for its Spanish acronym), INEGI.

Regarding external demand, the value of manufacturing exports decelerated during the January- February 2023 period, mainly due to the behavior of automotive exports (Chart 14). As for domestic demand, in December 2022, private consumption continued growing at a moderate pace, driven by the recovery in the consumption of services. Gross fixed investment performed better, mainly due to the reactivation of construction.

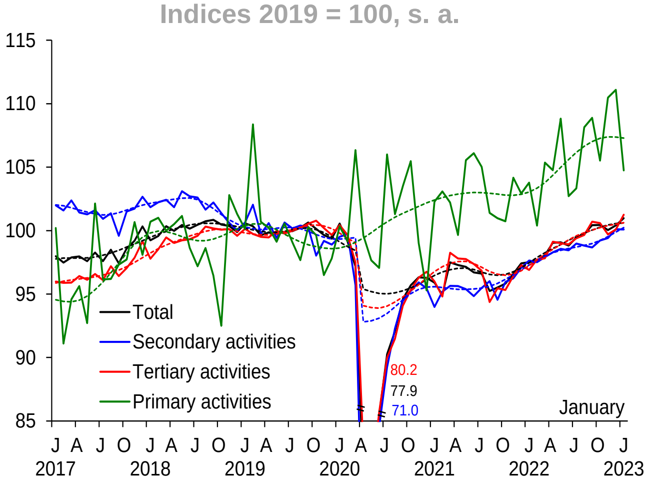
On the production side, in January 2023, the tertiary sectors increased (Chart 15), reflecting the good performance across most of its components. Industrial activity stagnated, due to a contraction in construction and in manufacturing of transportation equipment (Chart 16). In contrast, the rest of the secondary sectors expanded, with growth of manufacturing excluding transportation equipment standing out.

Chart 14
Total Manufacturing Exports
Indices 2019 = 100, s. a.



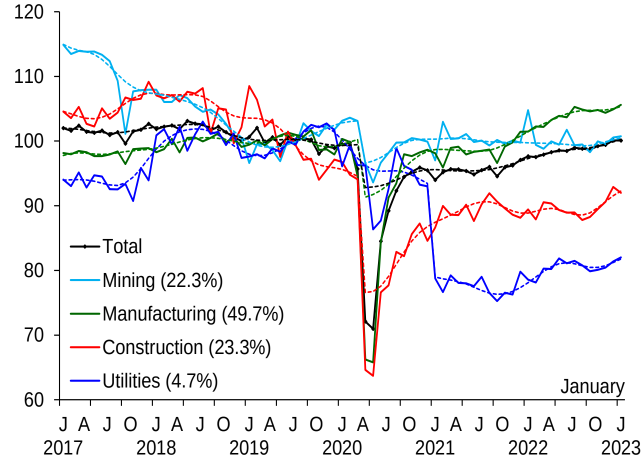
s. a. / Seasonally adjusted series and trend series based on data in nominal US dollars. The former is represented by a solid line and the latter by a dotted line. The chart's range was adjusted to facilitate its reading.
Source: Prepared by Banco de México with data from the Tax Administration Service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

Chart 15
Global Indicator of Economic Activity
Indices 2019 = 100, s. a.



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

Chart 16
Industrial Activity [1/]
Indices 2019 = 100, s. a.

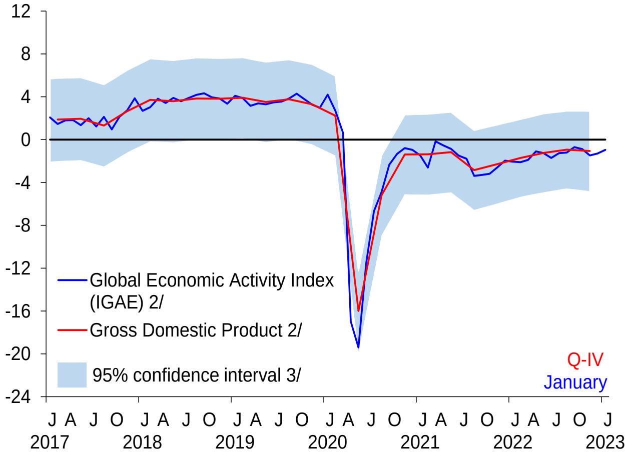


s. a. / Seasonally adjusted and trend series. The former is represented by a solid line and the latter by a dotted line.
1/ Figures in parenthesis correspond to their share in the total in 2013.
Source: Mexico's System of National Accounts (SCNM, for its Spanish acronym), INEGI.

Regarding the cyclical position of the economy, in the first months of 2023, the point estimate for the negative output gap is expected to have remained at a level similar to that observed at the end of 2022 (Chart 17). The labor market remains strong. At the beginning of 2023, both national and urban unemployment rates decreased (Chart 18). Based on seasonally adjusted figures, IMSS-insured jobs continued trending upwards in February. Finally, in January 2022, unit labor costs in the manufacturing sector declined, after having increased for two consecutive months, reaching a level similar to that observed throughout 2022 on average (Chart 19).

Chart 17
Output Gap Estimates [1/]

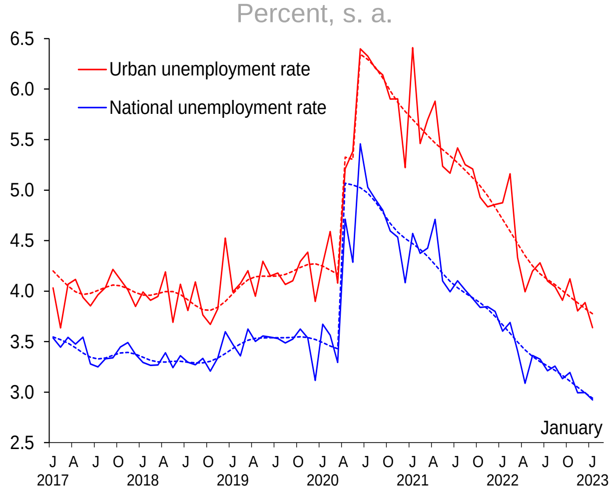
Potential output percentages, s. a.



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 4-2022 and IGAE implicit up to December 2022, consistent with said timely figure.
3/ Output gap confidence interval calculated with a method of unobserved components.
Source: Prepared by Banco de México with INEGI data.

Chart 18
National and Urban Unemployment Rates

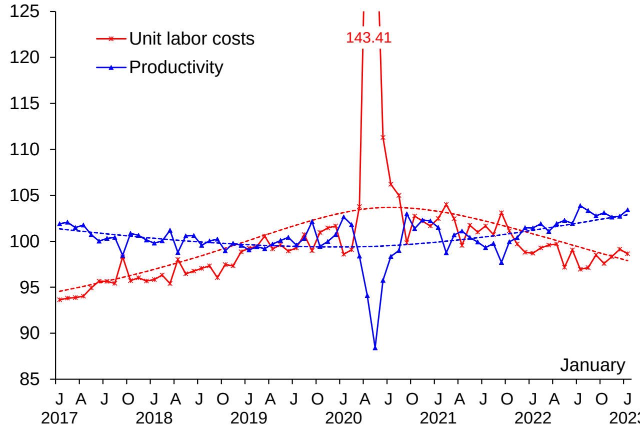
Percent, s. a.



s. a. / Seasonally adjusted and trend series. The former is represented by a solid line and the latter by a dotted line.
Source: Prepared by Banco de México with data from ENOE, ETOE (from April to June 2020), and ENOE new edition (ENOE[N]) from July to date.

Chart 19
Productivity and Unit Labor Costs in the Manufacturing Sector [1/]

Indices 2019 = 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 of the Monthly Manufacturing Industry Survey and industrial activity indicators of Mexico's System of National Accounts (*Sistema de Cuentas Nacionales de México, SCNM*), INEGI.

In January 2023, domestic financing to firms registered a positive real annual variation for the seventh consecutive month. Bank credit to firms continued recovering gradually, showing a positive real annual variation for the ninth consecutive month. This occurred in a context in which demand for corporate credit continued recovering and lending conditions remained tight compared to those prevailing at the onset of the pandemic. However, these conditions have tended to ease for smaller firms since the second half of 2021. Net medium- and long-term corporate debt issuance in the domestic market decreased slightly in the first two months of the year, after having increased significantly in the fourth quarter of 2022.

As for credit to households, commercial bank housing portfolio continued growing at the same pace during the fourth quarter of 2022. Banking consumer credit continued expanding in real terms as a result of the dynamism of payroll credit and credit cards loans. This has taken place in a context in which household demand for credit overall has continued to increase. Mortgage lending and consumer credit conditions remained relatively stable.

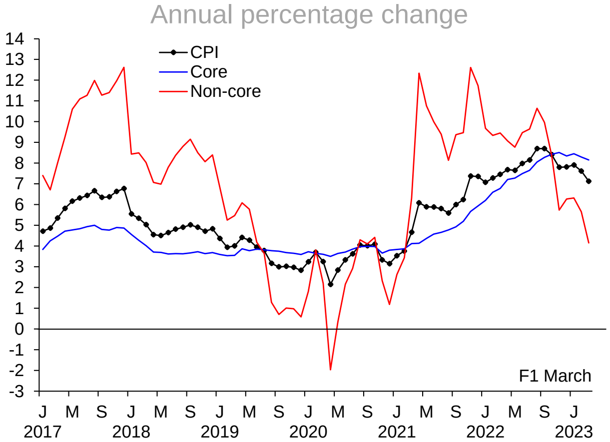
In January 2023, interest rates on bank credit to firms increased, consistent with the behavior of the reference rate, reaching levels above those observed at the end of 2019. Corporate credit intermediation margins remained at levels below those of February 2020, although they increased for the second consecutive month for smaller firms in January 2023. Interest rates on mortgages have increased since July 2022, after having remained at levels around their historical lows since August 2020. In December 2022, credit card interest rates increased with respect to the level observed in the third quarter, while those for payroll loans registered similar levels.

As for portfolio quality, in January 2023, corporate and housing loan delinquency rates remained stable with respect to those observed in the previous month and continued at low levels. Finally, consumer portfolio delinquency rates increased for the second consecutive month, although they remained at levels lower than those registered prior to the onset of the pandemic.

A.2.3. Development of inflation and inflation outlook

Between January and the first fortnight of March 2023, annual headline inflation decreased from 7.91 to 7.12% (Chart 20 and Table 1). This result was mainly due to the reduction in non-core inflation. Although core inflation also declined, it remains at high levels.

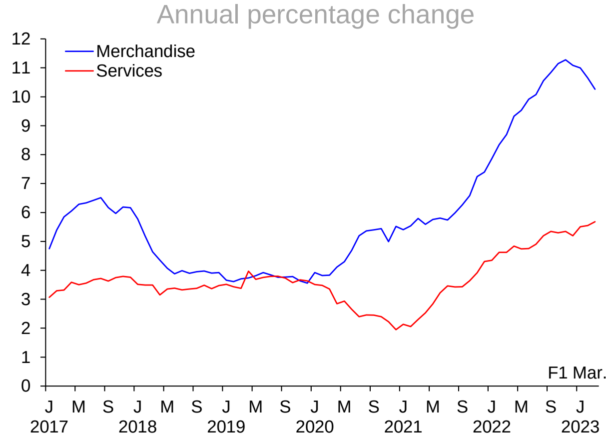
Chart 20
Consumer Price Index
Annual percentage change



Source: Banco de México and INEGI.

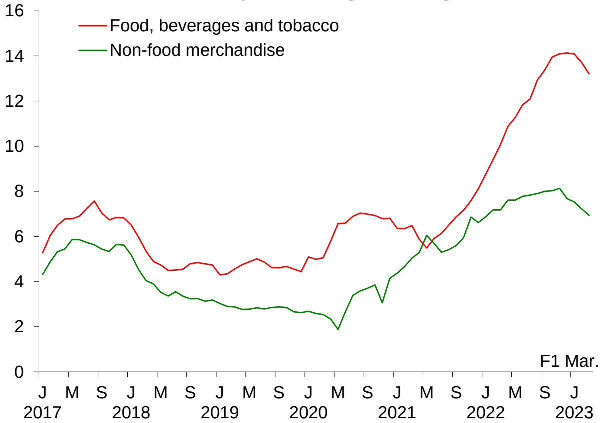
Annual core inflation declined from 8.45 to 8.15% between January and the first fortnight of March 2023. This was due to a decline from 11.00 to 10.26% in annual merchandise inflation (Chart 21), which continued to reflect the improvement in the operation of production and supply chains, as well as the stabilization and certain reduction in the prices of several production inputs. In this regard, although it still remains at high levels, annual inflation of food merchandise continued decreasing from 14.08 to 13.20% during the same period, while that of non-food merchandise fell from 7.53 to 6.94% (Chart 22). In contrast, annual services inflation, which rose significantly in January, continued trending upwards, increasing from 5.51% in that month to 5.68% in the first fortnight of March 2023. The prices of this component have continued to face significant pressures associated with higher input prices deriving from previous price increases and rising labor costs. It is also likely that after the lockdown and given the higher demand, there could be a greater cost pass-through effect compared to what had been observed in earlier stages of the pandemic. In the same months, annual inflation of services other than education and housing increased from 7.53 to 7.70%, while that of education rose from 4.48 to 4.88%. Annual housing inflation, which rose significantly in January, continued increasing from 3.38% in that month to 3.50% in its latest readings.

Chart 21
Merchandise and Services Core Price Sub-index
Annual percentage change



Source: Banco de México and INEGI.

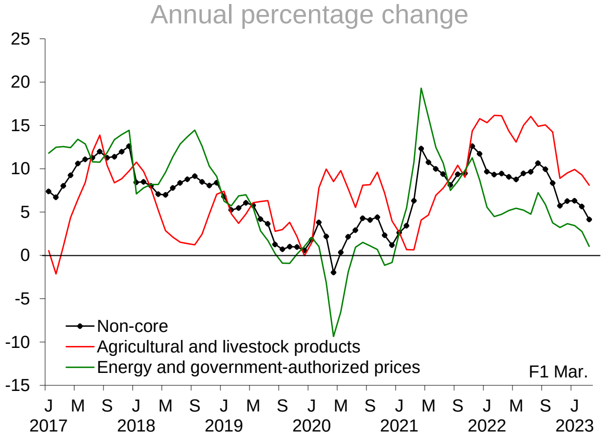
Chart 22
Merchandise Core Price Sub-index
Annual percentage change



Source: Banco de México and INEGI.

Between January and the first fortnight of March 2023, annual non-core inflation decreased from 6.32 to 4.15% (Chart 23 and Table 1). As for its components, the annual inflation of both agricultural and livestock products and energy goods continued to decline. The annual inflation of agricultural and livestock products decreased from 9.93 to 8.11% during the reference period, mainly due to a reduction from 10.17 to 6.97% in the annual variation of fruit and vegetable prices. The annual inflation of energy products decreased from 2.52 to -1.03%, with the reduction from -10.38 to -17.69% in the annual variation of L.P. gas prices standing out.

Chart 23
Non-core Price Sub-index
Annual percentage change



Source: Banco de México and INEGI.

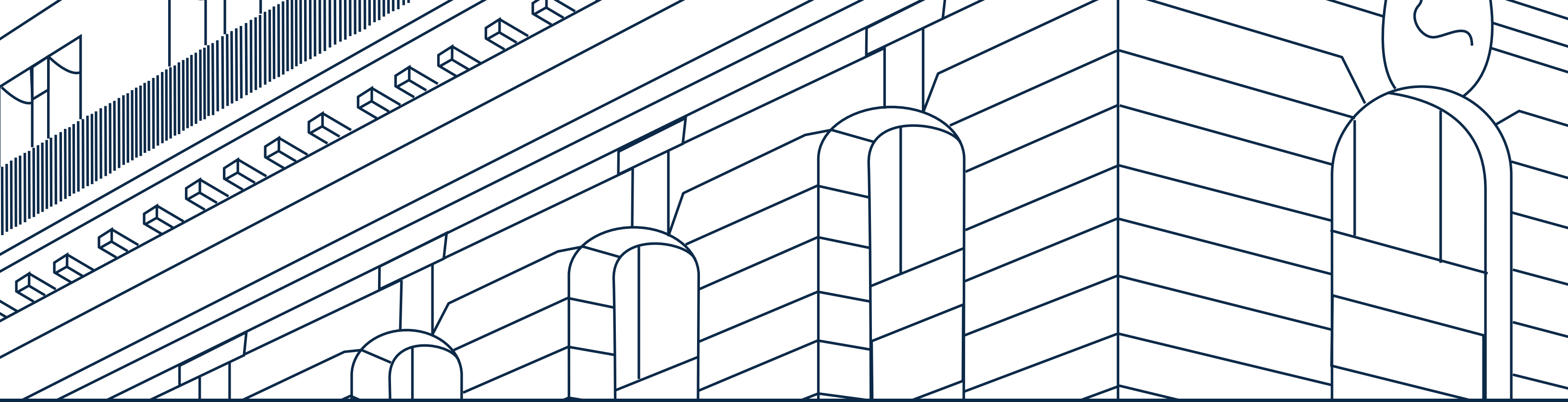
Regarding inflation expectations drawn from the survey conducted by Banco de México among private sector specialists, between January and February 2023, the medians for headline and core inflation for the end of 2023 increased from 5.18 to 5.28% and from 5.20 to 5.40%, respectively. The medians for headline and core inflation expectations for the end of 2024 increased slightly from 4.00 to 4.07% and from 4.00 to 4.04%, respectively. The median of headline inflation expectations for the next four years (medium term) remained at 3.80%, while that for core inflation went from 3.83 to 3.85%. The median of headline inflation expectations for the long term (5 to 8 years) increased slightly from 3.58 to 3.60%, while that for core inflation remained at 3.50%. Finally, compensation for inflation and inflationary risk rose during most of the reported period and remains at high levels. Within it, expectations implied by market instruments remained stable, while the inflation risk premium increased. Both remain at high levels.

Headline inflation is still projected to converge to the 3% target in the fourth quarter of 2024. These projections are subject to risks. On the upside: i) persistence of core inflation at high levels; ii) foreign exchange depreciation due to volatility in international financial markets; iii) greater cost-related pressures, and iv) pressures on energy prices or on agricultural or livestock product prices. On the downside: i) a greater-than-anticipated slowdown of the world economy; ii) a lower pass-through from some cost-related pressures; iii) a decline in the intensity of the geopolitical conflict or a better functioning of supply chains; and iv) a larger-than-anticipated effect from the Federal Government’s measures to fight elevated prices. The balance of risks for the trajectory of inflation within the forecast horizon remains biased to the upside.

Table 1
Consumer Price Index and Components
Annual percentage change

Item	January 2023	February 2023	1st fortnight March 2023
CPI	**7.91**	**7.62**	**7.12**
Core	**8.45**	**8.29**	**8.15**
Merchandise	**11.00**	**10.65**	**10.26**
Food, beverages and tobacco	14.08	13.70	13.20
Non-food merchandise	7.53	7.22	6.94
Services	**5.51**	**5.55**	**5.68**
Housing	3.38	3.43	3.50
Education (tuitions)	4.48	4.83	4.88
Other services	7.53	7.51	7.70
Non-core	**6.32**	**5.65**	**4.15**
Agricultural and livestock products	**9.93**	**9.29**	**8.11**
Fruits and vegetables	10.17	8.12	6.97
Livestock products	9.73	10.22	9.02
Energy and government-authorized prices	**3.44**	**2.77**	**1.05**
Energy products	2.52	1.50	-1.03
Government-authorized prices	5.70	5.93	6.31

Source: INEGI.



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