BANCO DE MÉXICO®

Minutes number 70

Meeting of Banco de México's Governing Board on the occasion of the monetary policy decision announced on September 26, 2019

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FOREWARNING
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1. PLACE, DATE, AND PARTICIPANTS

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

1.2. Date of Governing Board meeting: September 25, 2019.

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

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

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

Most members of the Governing Board noted that available information suggests that the moderation of world economic growth continued during the third quarter of the year. In particular, they stressed that global manufacturing production has continued to weaken. Some members mentioned that the risk of the weakness in the goods sector being passed on to the service sector cannot be ruled out. One member mentioned that trade tensions have been accumulating throughout the year, with periods of higher tariff threats and considerable impacts on the involved economies and on those more open to trade, which has contributed to the slowdown of world trade and manufacturing production. He/she noted that this environment of uncertainty has hindered investment and business confidence.

Most members indicated that during the recent weeks there has been more willingness of China and the U.S. to come to an agreement, while the risk of a no-deal exit of the United Kingdom from the European Union seems to have diminished. One member pointed out that the above helped to improve the business climate. With respect to the growth outlook, most members pointed out that for 2019 and 2020 it has been revised to the downside once again, highlighting the risks to the global economy. Such members emphasized among these risks those associated to the following factors: i) a possible intensification of trade tensions; ii) a marked deceleration of the Chinese economy; iii) a disorderly exit of the United Kingdom from the European Union; and, iv) the escalation of political and geopolitical tensions in the Middle East. In addition, one member mentioned that the risk of surprises or unwanted effects of monetary policy actions in advanced economies cannot be ruled out. In this context, most members pointed out that the balance of risks for world economic activity remains biased to the downside.

Regarding advanced economies, one member indicated that the service sector is still expanding, and that the gap between the Purchasing Managers' Index of the service sector and that of the manufacturing sector has reached high levels as compared to those of recent years. Another member pointed out that in the euro area, business confidence indicators and purchasing managers' indices continued to decline. With regard to the US economy, some members highlighted the moderation of its growth rate and the weakening of investment. One member added that exports have also had a negative performance and that manufacturing production remains stagnant. Another member noted that, by showing signs of a slight deceleration, such economy has started to show the effects of the trade tensions, albeit to a lower degree than other economies, given that it is less dependent on external demand. He/she mentioned that the inversion of the yield curve in some short-term segments points to a deceleration of the US economy, while another one considered that the probability of a recession in that country is still high.

Most members highlighted the lower inflation pressures worldwide. In the case of the main advanced economies, they pointed out that both headline and core inflation are below their respective central bank targets, underlining that there are no considerable wage pressures, even in a context of tight labor market conditions. One member specified that the abovementioned, along with the outlook for lackluster economic activity, contributes to the prevalence of inflation expectations at contained levels. Another member specified that muted

inflation pressures are observed despite the recent wage increases and added that in the major advanced economies services' inflation is close to 3%, while goods' inflation is negative. Some members agreed that the lower inflation pressures in advanced and emerging economies have been due to transitory factors, such as the lower energy and food product prices. One of them highlighted that, despite the above, it should be stressed that in advanced economies core inflation is at low levels and in emerging economies it displays a sustained downward trend. Another member mentioned that although commodity prices have declined, the recent attacks in Saudi Arabia have affected energy prices, although another member pointed out that such effects have been contained.

From a longer-term perspective, another member considered that technological change and the incorporation of countries with an abundant labor force into globalization have contributed to muted inflationary pressures, given that they have increased productivity and generated more competitive markets, with a lower possibility of passing cost pressures onto prices. In this context, he/she expressed that advanced economies face important challenges regarding monetary policy conduction. On the one hand, he/she stated that it would be advisable to take preventive measures to close the inflation gaps and to avoid inflation expectations from consolidating at levels below their targets. On the other hand, he/she mentioned that more vigorous actions would be required in order for inflation to converge to its target, which would imply using a large part of monetary policy's reduced room of maneuver or the use of unconventional monetary policies in a sustained manner, thus reducing the margin to face adverse scenarios in the future. He/she considered that these challenges are greater in the present environment of economic slowdown, and, mainly, in the current conditions registered in the euro area and Japan, which: i) largely depend on external demand and have thus been affected by the slowdown of world trade; ii) their aggregate demand remains fragile; and, iii) their medium- and long-term inflation expectations have consolidated below the inflation target. He/she pointed out that the monetary policy response of these economies' central banks has focused on generating great levels of inflation, a goal that has not been achieved, thus perpetuating exceptional monetary conditions. Another member delved into the criticism of the extent and effectiveness of the unconventional measures. He/she mentioned that monetary variables have a limited impact on the magnitude and evolution of real variables and therefore the results cannot be sustained in the medium and long term. He/she added that interest rate levels, which have been even negative in some economies, represent a risk for financial system stability. Finally, he/she indicated that such measures fail to address the structural barriers that limit growth, such as competitiveness, innovation, legal certainty, and property rights.

All members noted that, given the environment of global economic slowdown and low inflation pressures, several central banks have eased their monetary policy stances. They noted that, in the case of the US Federal Reserve, in its September meeting, it cut the target range of the federal funds rate by 25 basis points. One member pointed out that the statement of such decision was perceived by markets to have a less accommodative tone than was expected. Some members noted that the median of the forecast range of the Federal Open Market Committee does not point to additional adjustments for 2019 and 2020, although one member expressed that market expectations continue incorporating additional reductions during that period. Most members mentioned that the European Central Bank adopted diverse measures of monetary policy easing by reducing its key deposit facility rate by 10 basis points and by announcing the implementation of a new asset purchase program for an indefinite period. One member considered that differences still prevail among the members of the monetary policy committees of the Federal Reserve and the European Central Bank as to how to address the current juncture. In addition, another member underlined that the monetary authorities of Japan and England announced their willingness to adjust their monetary policy as circumstances warrant. As to emerging economies' monetary policy stances, most members mentioned that they have continued trending towards a greater easing, especially in the cases of Brazil, Chile, Peru, Colombia and Russia. Regarding the monetary policy outlook, some members pointed out that in the future more accommodative monetary policy stances are foreseen worldwide. One of them stated that, in addition to monetary policy easing, the governments of some economies, particularly in Asia, have also applied greater fiscal stimuli.

Most members noted that episodes of volatility were registered in international financial markets, mainly associated with trade tensions, although, as mentioned above, these have diminished in recent weeks. One member pointed out that, during times of higher trade tensions, episodes of search for safe haven assets have been observed, which has affected emerging economies' markets. Most members highlighted that, in a context of accommodative monetary policies, global financial conditions have eased. Some members indicated

that interest rates have decreased throughout the yield curve in both advanced and emerging economies. One of them added that recently stock markets in most countries posted gains and that emerging economies' currencies appreciated against the US dollar. Another member noted that the capital outflows from emerging economies which had been observed seem to have stopped, although there is still a possibility of a new reversal of such flows if risks materialize, which would have implications for asset prices and the financial systems of these economies. He/she added that the easing of global financial conditions has been of smaller magnitude than in previous episodes, as a result of the environment of caution and risk aversion prevailing in international financial markets. Most members mentioned that these markets could be affected by the prevailing risks for the global economy and considered that emerging economies could be especially affected by a decline in risk appetite. Nevertheless, one member pointed out that the impact that the materialization of such risks could have on financial markets should be evaluated, given that the central banks of the major economies would seek to improve the global financial conditions via more accommodative monetary policy stances. Therefore, he/she considered that the balance of risks to global financial markets remains stable.

All members noted that available information suggests that economic activity in Mexico in the previous quarters and in July remained stagnant. One member specified that economic activity has grown, on average, only 0.02% in the last five quarters, and another one mentioned that it has decelerated at a higher-than-expected rate. Most members highlighted that a slight improvement in economic activity is anticipated for the July–September period, although one member considered that currently there is scant information available to assess the evolution of the economy during this period.

In regards to aggregate demand components, all members pointed out that exports maintain their dynamism, highlighting the positive performance of manufacturing exports. One member mentioned that the increase in automotive exports contributed to the above. As for domestic demand, most members noted the slowdown of consumption, although they specified that it shows signs of recovery at the margin. In this respect, some members underlined the evolution of some of its determinants, such as the increase in remittances and the growth of the wage bill. One member specified that consumption of durable goods has registered negative annual rates for three consecutive quarters.

Regarding investment, most members highlighted the downward trajectory of both private and public sector investment. One member indicated that public investment has contracted for several years and that it has been the public spending item which has borne the brunt of the adjustment in public finances. Another member indicated that investment and its components exhibit a negative trend since mid-2018. Most members emphasized the lack of dynamism of construction as well as the decline in imported machinery and equipment. One member detailed that, similar to public spending, private investment has declined for five consecutive quarters. He/she mentioned that the lack of investment is one of the most worrisome issues, to such an extent that adverse effects begin to be perceived in the balance of payments. Some members associated the lack of dynamism of investment with the surplus in the current account during the second quarter of the year. One of them emphasized that such surplus is visibly higher than others that have been observed previously, even during economic crises. He/she underlined that gross fixed investment is so low that external savings are not necessary to finance it. Another member specified that the above should not come as a surprise in a context of tight macroeconomic policies. He/she indicated that a restrictive monetary policy encourages private savings and discourages investment, while a tight fiscal policy generates higher public savings, and that, therefore, both policies lead to a higher current account balance. He/she mentioned that such surplus could also be reflecting a change in the structure of aggregate spending, where wage increases, higher remittances and the new social programs could be contributing to a higher consumption of domestically-produced goods and to a reduction in the growth of consumption of imported products.

From a medium-term perspective, one member mentioned his/her concern over the secular slowdown in the growth rate of private consumption that has been observed since 2016, as well as over the stagnation of private investment during the same period. The same member pointed out that the interest rate and the cost of financing for households and firms have grown steadily since then and that the growth rate of credit by commercial banks has decreased. He/she considered that the latter brings to the fore that risks associated to maintaining a high interest rate for a long period should not be minimized. Another member indicated that it is fundamental to keep in mind the factors that have contributed to the weakness of investment. In this regard, he/she specified that data from surveys conducted among analysts and business contacts indicates that such factors are mainly associated

with problems of uncertainty and governance, rather than with monetary policy, to which they assign little importance. In this sense, one member stated that since late 2016 private investment has been affected by the uncertainty over the foreign trade environment and, recently, by factors of domestic uncertainty.

On the supply side, most members mentioned the weakness shown by industrial production, while one member pointed out that its contraction has been accompanied by an upward trend of manufacturing production and evidence suggesting a moderate growth of the service sector. Some members highlighted the weakness of construction and mining, and one of them specified that the slowdown of mining was due to lower oil production. Another member considered that the economic weakness is evident even in the service sector.

Most members noted that growth expectations for 2019 and 2020 remain consistent with the range foreseen in the Quarterly Report April – June 2019 and indicated that such expectations consider a slight recovery for the rest of the year. One member pointed out that analysts' expectations for GDP growth in 2019 continued to decline in August. Regarding the factors that would support the economic recovery over the next months, one member highlighted the following: i) that the wage bill and the growth of remittances should continue supporting private consumption; ii) the sectoral composition of the evolution of US manufacturing production, combined with export opportunities for Mexican products as a result of the trade conflict between the U.S. and China; and, iii) the anticipated recovery of public expenditure given the underspending observed during the first half of the year. He/she added that, despite the expected improvement in the rate of economic growth during the second half of 2019 and in 2020, the economy would remain in a situation of weakness. He/she underlined that this would be accompanied by a lack of dynamism in investment, given that this indicator is not anticipated to reverse its contraction of recent months.

All members highlighted that, in an environment of marked uncertainty, the balance of risks for growth remains biased to the downside. Thus, most members argued that growth is subject to both external and domestic risks. Among external risks, in addition to the already described global risks, one member mentioned the possible delays in the ratification of the USMCA, together with new threats of US tariffs imposed on Mexico, although the latter has subsided recently. Regarding domestic risks, such member emphasized the possibility of additional reductions in public revenue and domestic factors affecting the confidence and the outlook for the Mexican economy. He/she added that in Mexico, as in other emerging economies, idiosyncratic risk factors have reinforced the impact of the global trend of lower growth and uncertainty that have hindered investment. Another member specified that the risk that economic activity remains stagnant or that it deteriorates even further persists, pushing the economy towards a recession. He/she added that coincident indicators generated by INEGI to establish the trajectory of the economic cycle indicate the need to remain watchful of a possible recession.

Most members agreed that slack conditions have widened, although at the beginning of the third quarter they remained at levels similar to those of the previous quarter, with a persistent negative output gap. One member noted that, if the slight recovery foreseen for the third quarter of the year is confirmed, it could moderate the widening of slack conditions observed during the second quarter of the year. In this regard, some members specified that negative output gaps are expected within the forecast horizon, although one of them mentioned that slack conditions could loosen less than anticipated.

With respect to the labor market, most members noted that it has continued to weaken and some members highlighted that the unemployment rate has increased. However, one member emphasized that it is still below the Non-Accelerating Inflation Rate of Unemployment (NAIRU), and that, for this reason, its increase does not imply the presence of slack. Another member mentioned that the weakness of the labor market has been particularly reflected in the behavior of formal employment, and specified that in August 2019 the number of jobs enrolled at IMSS increased by 343,000 in annual terms, while in the same month of the previous year, the increase was 750,000 in annual terms. He/she added that increases have simultaneously been observed not only in the unemployment rate, but in informal sector employment and in underemployment. Some members considered that the weakness of the labor market is partly associated with the economic slowdown. One of them added, as a factor explaining such weakness, the increase in the growth rate of unit labor costs, resulting mainly from the simultaneous effect of the contractions in labor productivity and the increases in mean real earnings.

All members mentioned that between July and the first fortnight of September headline inflation declined from 3.78% to 2.99% and noted that such

reduction was mainly due to the non-core component. Most members indicated that headline inflation is in line with the 3% target and some members pointed out that it has decreased faster than anticipated. One of them pointed out the continuation of the downward trend that inflation has shown since mid-2018.

All members highlighted that non-core inflation has decreased significantly due to the lower increases of energy and agricultural and livestock product prices. Most members pointed out that this component lies at historically low levels. Nevertheless, they warned that it is subject to high volatility. In this context, one member argued that the analysis of inflationary pressures should not rely exclusively on the evolution of the headline price index since, currently, due to the high volatility of the non-core component, it may provide only a partial and even erroneous view of the trend of inflation.

The majority of members pointed out that core inflation has remained persistent around 3.8%. Some members noted that the abovementioned is in part due to the evolution of food merchandise and services prices. One member underlined that core inflation has remained at levels above 3% for over seventeen months, higher than the path foreseen by Banco de México. He/she also mentioned that the trimmed mean of core inflation indicates that pressures are not concentrated only on a few products. Another member stated that the persistence of this component reflects, among other factors, the indirect effects of the increases in energy product prices in the second half of 2018 as well as those related to the minimum wage increases since the beginning of 2019, which have a lagged impact. He/she also highlighted that at the margin there were greater pressures on services than on merchandises. One member emphasized the core inflation has been decreasing since April and that inflation of both food merchandise and food services prices are trending downwards, after having reached maximum levels some months ago. He/she pointed out that the six-month moving average of the monthly annualized rates of change of core inflation continues trending downwards, reaching 3.33% in August. He/she mentioned that, if this behavior continues, its annual rates of change will eventually reflect similar levels. Another member considered that it is too early to conclude that core inflation has resumed a downward trend. He/she emphasized that inflation of food services, transportation, and recreation prices is at high levels and around 4.5%.

Some members noted that short-term inflation expectations drawn from surveys have followed the latest data, while longer term ones have remained relatively stable, although at levels above 3%. One member explained that, during April and May, analysts increased their inflation expectations to 3.75% for 2019 due to a calendar effect. Nevertheless, in August, they lowered them to only 3.36%. He/she added that expectations are below what was anticipated in previous Quarterly Reports. For his part, another member pointed out that breakeven inflation and inflationary risk premium implied in fixed income instruments have been decreasing.

Most members mentioned that the baseline scenario for headline inflation is near the path published in the last Quarterly Report. In this regard, another member considered that, given the slack indicators, the widening of the negative output gap, and the dynamics of agricultural and livestock product prices, there is an increased probability that headline inflation converges to the target not only earlier than expected, but that at the end of the year it lies below the forecasts of the latest Quarterly Report. One member explained that in the Quarterly Report published in May the forecast for headline inflation for the end of 2019 had increased to 3.7%, but in the latest Report published in August it had decreased to only 3.2%. Nevertheless, another member noted that the convergence of inflation to the target in 2020 could be delayed.

Regarding core inflation expectations, most members pointed out that it is anticipated to start decreasing as the indirect effects of the shocks on energy product prices fade. One member added the fading of the shocks on food prices, while another emphasized the effects related to exchange rate adjustments. The majority highlighted that the downward trend of core inflation would be influenced by the amount of slack in the economy. One member added that this subindex will also be influenced by the effects of wages, which have a lagged impact. In this context, some members mentioned that core inflation is still expected to converge to the 3% target within the forecast horizon.

As for upside inflation risks, most members mentioned the possibility that core inflation continues to show persistence. Some members added that this may occur despite the greater amount of slack in the economy. One member considered that the persistence of this component would contribute to the increase of its medium-term expectations and of headline inflation expectations remaining above the 3% target, thus hindering the convergence to the target in the foreseen time frame. The majority of members mentioned the risk that the exchange rate comes under pressure stemming from external or domestic factors. One

member stated that, considering the uncertainty that the economy is facing, this is the most important risk. In this regard, he/she pointed out that, although the pass-through of exchange rate fluctuations on prices is low, it is not zero. Another member noted that there is the possibility that the exchange rate depreciates further than expected and puts pressure on prices through a greater pass-through than the observed so far. Another member warned that, despite evidence that the pass-through effect of the exchange rate is limited, short-term inflation and its expectations are significantly sensitive to sharp exchange rate fluctuations. Most members mentioned that another upside risk to inflation is the threat by the United States to impose tariffs on Mexican imports and the adoption of compensatory measures, although this risk has diminished. They added the risk that energy or agricultural and livestock product prices increase. One member noted the possibility that non-core inflation reverts to its historic values. In this regard, another member added that, given the high volatility of these products, this risk persists even considering the current administration's gasoline price policy. Another member mentioned that, insofar as energy price inflation remains low due to the new pricing policy of the federal government, a perception of low and stable inflation will be generated, which is certain to have a favorable impact on the price formation process. The majority of members mentioned as risks an environment of weak public finances and that given the magnitude of various wage revisions, cost-related pressures arise, insofar as such revisions exceed productivity gains. In this regard, one member highlighted that the outlook for wage adjustments for the next year is still uncertain. Another member considered that, in his/her opinion, the available evidence points to a limited impact of minimum wage increases on inflation, considering that headline inflation is below 3% and that in the border area it is below the national average. He/she added that inflation of services other than housing and education, which, in principle, could be affected by the wage increases, is not too far from its historic average after excluding the atypical deflationary behavior of the telecommunications sector during 2014-2016. Most members added the risk that global protectionist measures worldwide escalate. Finally, one member also mentioned the potential impact of the increase to the tax on flavored drinks and on cigarettes projected on the 2020 budget.

Regarding downside risks, most members mentioned the possibility that the peso exchange rate appreciates, which could be associated with a context of more accommodative monetary policy stances and lower interest rates worldwide, or in case that greater certainty arises regarding the trade relation with the United States. The majority added as a downside risk that the prices of certain goods included in the non-core subindex register lower rates of change. In this regard, one member explained that energy product prices are following a downward trend associated with the global economic slowdown. All members mentioned the possibility that slack conditions widen more than anticipated, which would impact the behavior of core inflation. Nevertheless, one member pointed out that it remains to be seen to what extent the sluggish performance of economic activity contains the pressures on prices.

In this context, the majority of members agreed that high uncertainty regarding the risks that might affect inflation continues to persist. One member estimated that, given the inflation forecasts and the atypical behavior of the non-core component, it is difficult to gauge the balance of risks. Another member considered that, although it is difficult to assess a balance of risks in such an uncertain environment, in his/her opinion, it remains biased to the upside. For their part, some members mentioned that risks have decreased substantially as compared to those of previous months. One member pointed out that such behavior is associated with the significant downside inflation risks described above and with the balance of risks for growth being sharply biased to the downside. Another member noted that, although domestic and external risks persist, they are not necessarily at levels above those observed in past episodes. He/she added that the continuous widening of the output gap, along with a favorable dynamics of agricultural and livestock product prices, suggests a balance of risks for inflation biased to the downside.

Most members pointed out that domestic financial markets have reflected the effects of lower interest rates for all terms in the main advanced economies, as well as episodes of volatility with exchange rate adjustments, although these have diminished over the last weeks. One member considered that domestic factors, such as the agreement of the federal government with the firms operating gas pipelines, Pemex's bond repurchase and refinancing, and the presentation of the 2020 Economic Package, contributed to the favorable performance displayed by domestic financial markets in September. The majority of members stated that yields on government securities for all terms have continued to decrease. One member pointed out that mixed trajectories were observed for different terms, with sharper falls in those of up to five years. Another member explained that yields are at their lowest levels of the year. Another member mentioned that nominal and real yield curves are

inverted vis-à-vis the target for the overnight interbank funding rate. He/she explained that, when decomposing long-term yields, both expectations for short-term interest rates and term premia are found to have fallen in the last months. He/she added that real interest rates on Udibonos have also decreased. He/she argued that maintaining prudent macroeconomic stances has been fundamental for the orderly and downward adjustment of nominal and real yield curves, given the combination of looser global financial conditions and the presence of significant idiosyncratic risks. Some members noted that the peso exchange rate appreciated since the monetary policy decision of August, although another member highlighted that the peso exchange rate has been subject to depreciation episodes associated with uncertainty factors in international financial markets, to idiosyncratic factors, and to contagion from other emerging economies. Some members mentioned that the stock market registered a significant recovery and one member emphasized that this favorable performance stands out among emerging economies. As to risk premia, some members pointed out that these have decreased significantly since the last monetary policy decision. One member explained that such reduction was similar to that observed in other emerging economies, which suggests that it is fundamentally determined by external factors. He/she emphasized that Credit Default Swaps (CDS) premia for Mexico's sovereign debt remain above those of other emerging economies with a lower credit rating. He/she argued that, among the main fifteen emerging economies, only Mexico, along with Turkey and Brazil, have registered a downgrading of their sovereign credit rating in the last year. Finally, another member stated that capital inflows from foreign investors have been negative with regard to those channeled to fixed income instruments, although their holdings maintain a balance similar to that observed in previous years, while inflows destined to equity instruments were positive.

As to the risks that may affect the performance of financial assets in Mexico, most members mentioned that uncertainty persists with respect to the bilateral relationship between Mexico and the United States and to the credit rating outlook both for Pemex's debt and for Mexico's sovereign debt. One member highlighted the possibility of a deterioration of public finances. In addition, another member considered that although several uncertainty factors persist in the external environment, the measures adopted by the central banks of the main economies have contributed to mitigate such risks. He/she also considered that most domestic risks associated with public policies such as those related with public finances and Pemex, have been fading throughout the year. He/she added that, in his/her opinion, the most important financial risks for domestic financial markets are low growth and maintaining an overly restrictive monetary policy.

The majority of members highlighted that the current environment continues to pose significant risks that could affect the country's macroeconomic conditions, its ability to grow, and the economy's price formation process. In this regard, they pointed out that it is particularly important that, in addition to a prudent and firm monetary policy, measures to foster an environment of confidence and certainty for investment and higher productivity are adopted, and that public finances are consolidated in a sustainable way. In this context, they noted that it is necessary to address the deterioration of both the sovereign's and Pemex's credit ratings as well as achieving both the fiscal targets for 2019 and the goals set in the 2020 Economic Package. They also stated that strengthening the rule of law, tackling corruption, and fighting insecurity are equally imperative. One member underlined the need to increase productivity through the adoption of new technologies and the strengthening of human capital. Regarding the 2020 Economic Package, most members agreed that the primary surplus targets are appropriate and that, in general, it was well received by economic agents, although one member added that the new budget implies a trajectory for both the public debt and the public sector's borrowing requirements as a percentage of GDP slightly above those announced originally. Some members warned that several analysts have expressed that certain assumptions in the budget, particularly regarding crude oil production and income, are optimistic and, therefore, risk factors for fiscal policy persist.

The majority of members noted that the fiscal support package for Pemex and the recently announced financial measures to strengthen the state-owned company's financial profile are efforts in the right direction, which have led to a recovery in the value of Pemex's debt instruments and to a decrease of its CDS premia. Nevertheless, some members mentioned that most analysts agree that such measures represent a short-term relief since they do not solve the company's structural problems. One member highlighted that another problem that Pemex faces is the possibility of observing a lower oil platform than expected due to both the low levels of investment and the cancellation of private participation in new developments that may allow an increase of crude oil production. Some members warned that the risk of a downgrading of Pemex's credit rating persists and that this would imply the

loss of its investment grade. Although one member acknowledged that expectations of additional actions by rating agencies have been delayed temporarily, another member argued that one rating agency has stated that significant increases of Pemex's net debt, an operational performance below forecasts, and a decline of crude oil reserves or of their expected duration, may lead to a downgrading of Pemex's rating, which would bring about the loss of its investment grade. He/she also pointed out that such agency considers that Pemex's capital expenditure for 2019 and 2020 is far below the required to replace reserves in these years. Thus, in his/her opinion, the risk of such event taking place is high.

In this context, one member noted that Pemex remains the main domestic risk factor given its dependence on the federal government's financial support. He/she mentioned that, although financial instruments continue to discount the downgrading of Pemex's credit rating, it cannot be ruled out that its materialization would trigger forced sales that may generate disorderly adjustments in financial markets. He/she added that the cessation of bidding rounds or the revision of contracts granted to the private sector for the supply of natural gas, have generated uncertainty and affected the confidence of economic agents. He/she warned about several sources of uncertainty for public finances, such as the pressures associated with the growing pensions and the financial support to Pemex. He/she also pointed out that revenues may be lower than expected, due to lower economic growth. He/she noted that the abovementioned represents a challenge, given that the resource gap would need to be offset with greater public spending cuts, a higher tax-collection capacity and, probably, with the use of more resources from the Oil Revenues Stabilization Fund (FEIP, for its acronym in Spanish) which may lead to future pressures on public finances, given that part of the reserves to face future shocks would be depleted.

As for the monetary policy decision, considering the reduction of headline inflation, the width of slack conditions in the economy, and the recent behavior of external and domestic yield curves, most members considered that lowering the target for the overnight interbank interest rate by 25 basis points to 7.75% is consistent with the convergence of inflation to the central bank's target within the time frame in which monetary policy operates. The majority of members highlighted that maintaining a prudent monetary policy is necessary given the uncertain scenario that inflation faces. In this regard, one member argued that the monetary policy stance should be adjusted gradually, carefully assessing the incoming information to better identify the conditions in the economy, the process of inflation reduction, and the balance of risks for both. He/she underlined that, although in the baseline scenario inflation converges to its target within the time frame in which monetary policy operates, risks that may affect this forecast and delay the consolidation of lower inflation persist.

He/she pointed out that such has been the case in the last two years with the presence of factors that have affected the domestic economy, the price formation process, and which have led to a greater resistance of core inflation to decline. In addition, such member mentioned that, although short-term interest rate spreads remain high, the peso exchange rate has been subject to pressures and depreciation episodes. Another member explained that the new level of the policy rate allows for reducing the level of monetary restriction to facilitate the efficient convergence of inflation to its target and maintain the relative monetary policy stance in order to avoid an unnecessarily widening of the spread between short-term instruments denominated in Mexican pesos and in US dollars. Another member noted that, given the environment described above, monetary policy in Mexico continues to face an uncertain and contrasting outlook. On the one hand, he/she stated that the additional cut of the US federal funds rate opens up space for monetary policy implementation in Mexico. He/she added the weakness of the economy, which should be reflected in the evolution of prices, and the importance for the central bank to ensure an orderly adjustment of inflation to the target. On the other hand, he/she noted the need to take into consideration core inflation's continuing persistence; that inflation expectations for 2020 and longer terms are above the target; that the sovereign risk increased in the last months; and, that a situation of marked uncertainty may imply a significant shock for the economy in a not-too-distant horizon. In this context, he/she emphasized that, in his/her opinion, it is not possible to determine a cycle for monetary policy. He/she added that monetary policy must prioritize prudence and effectively respond to the needs that arise according to incoming data and the circumstances at each point in time. He/she pointed out that an important part of the environment of concern that the economy is facing stems from domestic factors that limit the scope of action for monetary policy. He/she stated that the implementation of decisive measures to solve such challenges would allow not only for a more balanced economic policy approach, but also to mitigate the situation of uncertainty, the central problem behind the complex performance of the economy.

Some members considered that a 50 basis point adjustment to the target rate was appropriate. One member argued that taking into consideration the latest reduction in the federal funds rate, a 25 basis point reduction to the policy rate in Mexico would leave the monetary policy stance relative to that of the United States at historically high levels, despite the fact that inflation is at 3%, that the economy is in a slump with a persistent negative output gap which is widening, and that global risks have declined. He/she added that with a 50 basis point reduction to the policy rate in Mexico, the interest rate spread between Mexico and the United States would still be very much above the spreads of all emerging economies within the same group of assets. The current spread between the target level for the monetary policy rate and observed inflation in Mexico is not only the widest among comparable emerging economies, but also turns out to be practically twice Russia's, which has the second highest rate in this group of economies and which has reduced rates by 75 basis points so far this year. Even with a 50 basis point reduction, in relative terms we would have a spread with the United States of 550 basis points, and that such spread would still be very much above practically all relevant emerging economies for our class of assets. The only country that would be above Mexico would be Turkey, a country which faces an inflation rate of 15%. For the same reason, the carry-trade that many believe must be maintained given the risks faced by the Mexican economy, would continue to be the highest among this group of countries.

The same member added that a level of 7.5% is still a rate above the ceiling of the risk-adjusted neutral range. He/she added that considering that the Mexican economy is still far from potential, the policy rate in real terms that is consistent with the current juncture would be below natural rate estimates, which is the real rate consistent with GDP at its potential level and with inflation at its target. In this regard, he/she concluded that, considering the economy's cyclical position, the current monetary policy stance is even more restrictive.

In this context, the same member pointed out that although in the current conditions the monetary policy stance must remain restrictive, there is wide room for maneuver and a window of opportunity to lower the monetary policy rate and still maintain its restrictive character, but less so than currently, considering that the present monetary policy stance is the most restrictive in the last ten years in absolute and relative terms, even above that observed in periods in which inflation was higher and there was significant uncertainty and greater risks.

Nevertheless, he/she acknowledged that currently there are numerous risks and that looking ahead, the Bank must act cautiously and according to incoming information. He/she pointed out that the highly restrictive monetary policy stance must be adjusted to a less restrictive one, although the pace of such an adjustment will have to weigh the risks to core inflation.

The same member pointed out that it is essential to maintain a prudent policy stance until the Bank clearly fulfils its mandate in a more solid manner given that in order to ensure that headline inflation remains around 3%, it is necessary for core inflation to converge to that same level, albeit currently it is not very far from 3%.

Another member mentioned that, given the latest reduction in the federal funds rate, a 25 basis point reduction to the reference rate in Mexico would make the monetary policy stance relative to that of the United States remain unchanged, which could give the impression that Banco de México is following mechanically the US Federal Reserve. He/she was of the opinion that it would be advisable to send the signal that the Bank is acting independently and is responding mainly to an improvement of domestic conditions. He/she also added that so far this year, other central banks in Latin America have loosened their monetary policy stances to a greater extent than Banco de México and that currently their policy rates are lower. He/she argued that the latter illustrates that Mexico's monetary policy stance is very restrictive, especially taking into account that inflation is near its target. He/she added that the current conditions allow for a greater monetary policy easing in the Mexican economy than in other advanced or emerging economies, given that in some of these, the margin of maneuver is limited because interest rates are already at low levels. The same member emphasized that domestic conditions in Mexico have changed significantly over the last year. Such member pointed out that in September 2018, headline inflation was 5.02%, which implies that in a year inflation decreased slightly more than 200 basis points. In addition to the improvement in the country's economic outlook, he/she mentioned the sharp economic deceleration in the last year, the radical adjustment in the monetary policy outlook of advanced economies, and the satisfactory outcome of certain uncertainties that had been present, especially regarding the fiscal situation that would prevail under a new administration in Mexico. Such member mentioned that if the policy rate were to be reduced only by 25 basis points, it would only allow a return to the rate that was in effect in September 2018 (7.75%), which would imply that Mexico's

monetary policy stance would have just remained constant despite the fact that the present domestic and international conditions are completely different from those at that time.

Lastly, the same member pointed out that the tone of the monetary policy statement should highlight the significant decline of both inflation and its risks during the year, and also the fact that inflation has been below both market expectations and the central bank's forecasts. Such member argued that this would send a message of certainty and confidence, confirming that the central bank has inflation under control and that it can loosen its monetary policy stance, seeking to keep inflation at its target with the least possible costs for the Mexican economy.

The majority of members considered that the central bank message must communicate clearly that the future of monetary policy depends mainly on the evolution of inflation and on how inflation deviates from its expected trajectory, in an environment characterized by high risks and high levels of uncertainty. Such members highlighted that the monetary policy statement must reflect that the Governing Board considers that the present decision is prudent and consistent with the 3% inflation target and that the current situation, characterized simultaneously by economic weakness and persistently high core inflation in an environment of uncertainty, requires following up closely the incoming information. One member mentioned that such follow up would allow to update the balance of risks and inflation forecasts in a timely manner, in order to be able to act appropriately, fulfil the price stability mandate effectively, and preserve the confidence gained over twenty five years of central bank independence.

3. MONETARY POLICY DECISION

To guide its monetary policy actions, Banco de México's Governing Board follows closely the development of inflation vis-à-vis its forecasted trajectory, taking into account the monetary policy stance and the time frame in which monetary policy operates. In this process, it uses available information on all inflation determinants as well as on medium- and long-term inflation expectations, including the balance of risks for such factors. Monetary policy must also act prudently if for any reason the uncertainty faced by the economy increases significantly. In this context, considering the reduction of headline inflation, the ample slack in the economy, and the recent behavior of external and domestic yield curves, Banco de México's Governing Board decided by majority to lower the target for the overnight interbank interest rate to 7.75%, taking into account that under the current environment such level is consistent with the convergence of headline inflation to the central bank's target within the time frame in which monetary policy operates. Two members voted for lowering said target to 7.50%. In order to consolidate a low and stable inflation, in an environment in which price formation and slack conditions in the economy are subject to risks, the Governing Board will continue to follow closely all factors and elements of uncertainty that have an impact on inflation and its outlook, and will take the required actions based on incoming information so that the policy rate is consistent with the orderly and sustained convergence of headline inflation to Banco de México's target within the time frame in which monetary policy operates.

Banco de México's Governing Board will maintain a prudent monetary policy stance and, under the current environment of uncertainty, will follow closely the potential pass-through of exchange rate fluctuations to prices, Mexico's monetary policy stance relative to that of the U.S.-in an external environment that it is still subject to risks- and the behavior of slack conditions and cost-related pressures in the economy. In the presence and possible persistence of factors that, by their nature, involve risks to both inflation and its expectations, monetary policy will be adjusted in a timely and firm manner to achieve the convergence of inflation to its 3% target and to strengthen the anchoring of medium- and long-term inflation expectations so that they attain such target.

4. VOTING

Alejandro Díaz de León-Carrillo, Irene Espinosa-Cantellano and Javier Eduardo Guzmán-Calafell voted in favor of lowering the target for the overnight interbank rate by 25 basis points to 7.75%.

Gerardo Esquivel-Hernández and Jonathan Ernest Heath-Constable voted in favor of lowering the target for the overnight interbank rate by 50 basis points to 7.50%.

5. DISSENTING OPINIONS / VOTES

Vote. Gerardo Esquivel-Hernández

Headline inflation has behaved better than expected and is already at levels close to Banco de México's target. Inflation accumulated in the first three quarters of the year will be below 1%, thus allowing to foresee that inflation will end the year close to or even below 3%. Although core inflation is still at

relatively high levels, it is possible to anticipate that it will diminish over the next months as a result of the fading impact that the increase in energy prices at the end of 2018 had on food prices. Looking ahead, both headline and core inflation are expected to converge to the target. In addition, both the widespread reduction of interest rates worldwide and the country's significant economic deceleration open up some room to lower the policy rate in Mexico far more than the reduction observed in the United States. For this reason, I consider that on this occasion it is possible and desirable to lower the overnight interbank interest rate by 50 basis points without jeopardizing or compromising Banco de México's primary mandate.

Vote. Jonathan Ernest Heath-Constable

Although headline inflation is at the 3.0% point target, such target was not attained by a reduction of the core component, making it necessary to maintain a restrictive monetary policy stance. The question is if a rate as high as the current one is justified, to the extent that in absolute and relative terms it represents the most restrictive policy stance maintained over the last ten years, even above the observed during periods in which we faced higher inflation levels, with high uncertainty and greater risks. Under the current conditions, there is room to lower the monetary policy rate and still keep its restrictive character given: that the negative output gap is still widening; a smaller deviation of inflation from its target; global risk aversion has diminished and accommodative monetary policies continue to prevail in most economies. In other words, we must maintain our monetary policy restrictive for as long as necessary, but not as restrictive as the current one. The present conditions provide a window of opportunity to make this adjustment and for this reason I am in favor of lowering our target rate by 50 basis points.

ANNEX

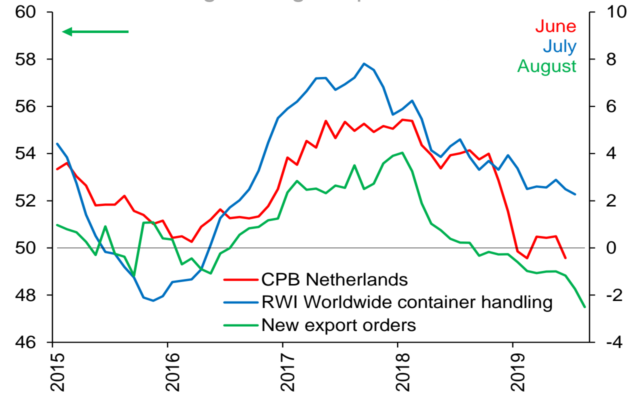
The information in this Annex was prepared for this meeting by the staff of Banco de México's General Directorate of Economic Research and General Directorate of Central Bank Operations. It does not necessarily reflect the considerations of the members of the Governing Board as to the monetary policy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

A.1. External conditions

A.1.1. World economic activity

Available indicators suggest that the moderation of world economic growth continued during the third quarter of the year. Several risk factors have continued to negatively affect business confidence, capital expenditure, manufacturing activity and global trade (
Chart 1). Outstanding risk factors include the greater uncertainty stemming from escalating trade tensions worldwide; evidence pointing to a further weakening of some major economies; the possibility of a no-deal exit of the United Kingdom from the European Union; the worsening of the political situation in the Middle East; and, other geopolitical risks. Likewise, during this period episodes of volatility in financial markets have also taken place, mainly associated with trade tensions between the United States and China, although they have recently diminished. In addition, the outlook for global growth has continued to be revised downwards and other political and geopolitical risks to the world economy persist. Thus, the balance of risks for world economic activity remains biased to the downside. In this environment of economic weakness, in which headline and core inflation in the main advanced economies are below their central banks' targets, several central banks have implemented more accommodative monetary policy stances and some economies, particularly in Asia, have announced the adoption of greater fiscal stimuli.

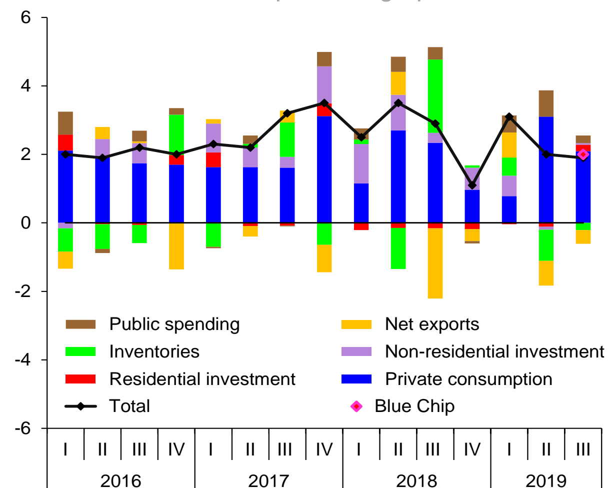
Chart 1
World Trade Volume and Leading Indicators
Diffusion index and annual change of 3-month moving average in percent, s. a.



s. a. / Seasonally adjusted figures.
Source: CPB Netherlands, Markit and RWI Leibniz Institute for Economic Research.

In the United States, available indicators point to certain moderation in the growth rate of GDP during the third quarter due mainly to a lower dynamism of private consumption vis-à-vis the previous quarter (Chart 2). Non-residential investment and net exports have remained weak, while inventories are expected to continue having a negative contribution to growth.

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



s. a. / Seasonally adjusted figures.
Note: The third quarter refers to GDPNow estimates of the Federal Reserve Bank of Atlanta and to Blue Chip Survey of September 2019.
Source: Bureau of Economic Analysis (BEA), Blue Chip and Federal Reserve Bank of Atlanta.

In August, US industrial production picked up, growing at a monthly rate of 0.6%, after having contracted 0.1% in July. Such improvement was largely due to the recovery of mining, after having been affected by hurricane Barry in July, and to a moderate recovery of manufacturing, despite the fall in car production. Thus, during July and August, manufacturing production increased at an annualized rate of 1.2% when compared with the second quarter, after having contracted for two consecutive quarters. Looking ahead, the manufacturing sector Purchasing Managers' Index (PMI) suggests a certain stabilization of that sector in September, although at low levels.

Some of the main US labor market indicators remain strong. In particular, the growth of the non-farm payroll remained solid, given that the 130,000 new jobs created in August are above the level necessary to absorb the growth of the labor force. In addition, the labor force participation rate has been increasing, particularly in the 25-54 year age group. The unemployment rate remained at 3.7%, near its lowest level in the last five decades. In this context, the growth rate of wages has increased.

In the euro area, information drawn from indicators and business surveys continues to suggest a moderate growth of economic activity during the third quarter of the year, driven by private consumption and residential investment, items which have continued to exhibit a relative strength stemming from the adequate performance of the labor market. Nevertheless, both external demand and the manufacturing sector remain weak, reflecting the contraction of Germany's industrial activity, due, in turn, to the lower global demand for automobiles and machinery. The services and manufacturing sector Purchasing Managers' Index (PMI) resumed its downward trend, which suggests that the weakness of that economy may persist.

In Japan, available indicators for the third quarter suggest that Japanese economic activity may grow at a more moderate rate largely because of a weakening of consumption and fixed business investment. In addition, indicators on business confidence continued to deteriorate, particularly those associated with the manufacturing sector, which indicates that the weakness of this economy may intensify further.

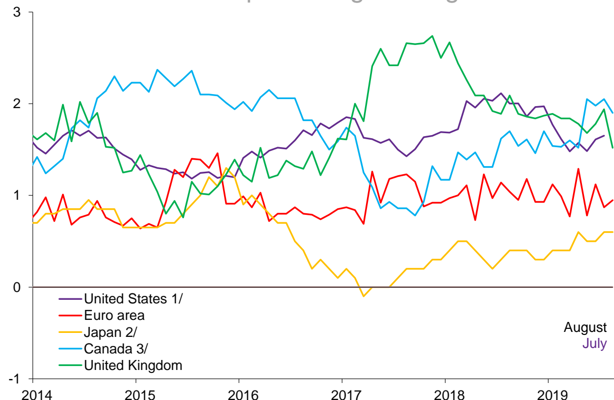
In emerging economies, available information indicates that their growth rate will remain weak during the third quarter. In the case of China, economic activity indicators continued to point to a gradual deceleration, given that retail sales, industrial activity and fixed investment grew at a more moderate rate, despite the upturn of infrastructure spending.

International commodity prices in general followed an upward trend in the last weeks. In particular, after having shown an erratic behavior in August, oil prices recovered moderately at the beginning of September driven by the greater expectations that the agreement to cut oil production quotas among members of the Organization of Petroleum Exporting Countries (OPEC) and other producing countries would be extended for a longer period, as well as to a reduction in US commercial crude oil inventories. Later, oil prices registered a sharp increase after the attacks on Saudi Arabia's oil facilities, although they have partially decreased due to lower uncertainty as to the time it will take this country to fully reestablish its oil production. Grain prices recovered in the last weeks due to greater Chinese demand and less favorable sowing conditions in the United States. Finally, at the beginning of September, industrial metal prices recovered due to the perception of more favorable conditions for trade negotiations between the United States and China. Nevertheless, by mid-September, these prices decreased once more after indicators confirming the weakness of Chinese industrial production were published.

A.1.2. Monetary policy and international financial markets

Headline and core inflations in most advanced and emerging economies are below their central banks' targets. Headline inflation has decreased in some of these economies over the last months partly because of lower energy product prices. In turn, core inflation has registered a moderate recovery in some of the main advanced economies, driven partly by the fading of some transitory factors (Chart 3). In the United States, core inflation as measured by the personal consumption spending deflator remained stable at a 1.6% annual rate in July. In the euro area and Japan, core inflation has remained at low levels, despite the low unemployment rates. In most emerging economies, headline and core inflation have remained low and, in some cases, even below their respective central banks' targets.

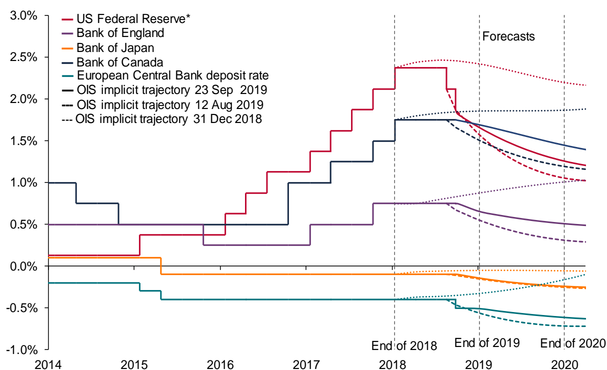
Chart 3
Selected Advanced Economies: Core Inflation
Annual percentage change



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

In this context, the central banks of a large number of economies have continued to adopt more accommodative monetary policy stances, given the lower inflation levels, lower growth expectations, and the greater risks to world economic activity. In addition, expectations that several central banks will continue cutting their reference rates prevail (Chart 4).

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



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

In its September meeting, as anticipated, the US Federal Reserve cut the target range for the federal funds rate by 25 basis points (bps) to 1.75-2%. It is worth noting that, although the majority of members voted for cutting the federal funds rate, two members voted in favor of leaving the rate unchanged and another voted for cutting it by 50 basis points. In its policy statement, this central bank mentioned that, in light of the implications of global events for the economic outlook, as well as muted inflation pressures, it decided to lower the target range for the federal funds rate. The Fed highlighted that such action supports its baseline scenario of a sustained economic activity and inflation near its symmetric 2% target, although it mentioned that uncertainty about this scenario prevails. It reaffirmed that, in determining the path to be followed by monetary policy, it will continue monitoring available information and will take the appropriate measures to keep a sustained economic expansion, a strong labor market, and inflation levels around its target. In his press conference, the Federal Reserve Chairman also highlighted that the reduction in the federal funds rate aims at maintaining the strength of economic activity and providing insurance against certain latent risks. It is worth noting that no significant changes to the assessment of the economy were made and that modifications to the Fed's economic projections were marginal. It is worth highlighting that the median value of the Fed's projections for the federal funds rate does not anticipate additional cuts in 2019 and 2020, although seven of the Fed's seventeen members are still expecting an additional 25 basis points cut before the end of the year. The implied path in federal funds futures reflects an additional cut in 2019 and another in 2020.

In its September meeting, the European Central Bank (ECB) left its benchmark rate and key marginal lending facility rate unchanged, at 0% and 0.25%, respectively. Nevertheless, it announced several measures to ease its monetary policy stance in order to achieve its inflation target. Among them are the reduction of its key deposit facility rate from -0.4 to -0.5%; adjustments to the quarterly targeted longer-term refinancing operations (TLTRO III); the implementation of a tiered interest rate system for bank's reserve requirements; and, the implementation of a new €20 billion per month asset purchase program (APP) starting November 1 that will run for as long as necessary and end shortly before the ECB starts raising its key policy interest rates. This central bank also confirmed its plans to continue reinvesting the principal payments from maturing securities purchased under the APP for an extended period of time past the date when it starts raising its policy interest rates. As to its forward guidance, the ECB stated that key policy interest rates will remain at or even below the current levels

at least until inflation clearly converges to a level close but below 2%. In addition, it emphasized the need for a high level of monetary stimulus and stated that it is willing to adjust all its monetary policy tools as required.

In its September meeting, the Bank of Japan left its policy interest rates unchanged, reaffirming that it will keep them at extremely low levels until at least the spring of 2020. This central bank emphasized that downward risks to economic activity have increased. In this environment, the Bank of Japan highlighted the need to analyze more closely the possibility that the achievement of its price stability target is jeopardized and, as a result, it will assess once again developments in both economic activity and prices in its October meeting when its growth and inflation outlook is revised.

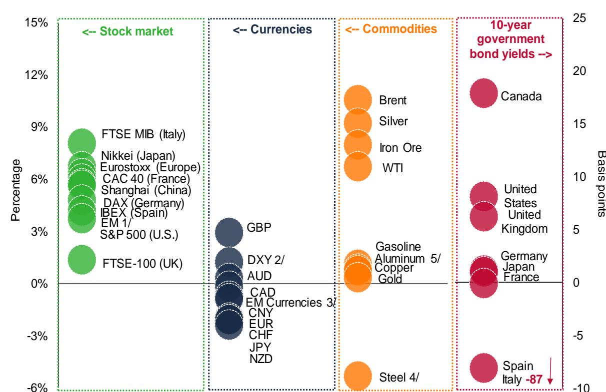
In its September meeting, the Bank of England left its policy rate at 0.75% and did not modify its stock of government bond purchases. This central bank pointed out that recent political events may lead to a sustained period of uncertainty as to the future relationship between the United Kingdom and the European Union. In this regard, it highlighted that the longer this period is extended, the greater the possibility that the growth of demand remains below potential. Although the Bank of England pointed out that the aforementioned would be reflected in lower pressures on prices, it did not set out a position as to its policy interest rates, stressing that its monetary policy decision would not be automatic and would be taken in whichever direction is necessary.

The Bank of Canada left its policy interest rate unchanged at 1.75% in its September meeting. This central bank mentioned that the growth rate of economic activity during the second quarter was higher than anticipated. Nevertheless, it highlighted that the effects of escalating trade and geopolitical tensions on both trade and investment have been greater than anticipated and that the economy is expected to grow at a more moderate rate during the second half of the year. In this environment, the Bank of Canada pointed out that the economy is operating near its potential and inflation is at its target. Considering the above, this central bank argued that its accommodative monetary policy stance remains appropriate and underlined that it will follow closely the development of the global economy and its impact on the Canadian economy.

In emerging economies, several central banks continued to cut their policy rates, such as those of Chile, Indonesia, Paraguay, Russia, and Turkey. The People's Bank of China loosened the reserve requirement ratio (RRR) of all banks to the lowest level observed since 2007, seeking to inject liquidity into the economy and counteracting the domestic deceleration and the negative effects of the trade tensions with the United States. Looking forward, additional monetary stimulus measures are expected to be adopted by this group of economies.

In the last weeks of August, international financial markets continued registering episodes of volatility driven by the ups and downs in the trade negotiations between the United States and China and the presence of other geopolitical events. Nevertheless, in September, financial markets exhibited certain stability as some risks had diminished and given the more accommodative monetary policy stances adopted by most central banks of advanced economies. In this context, a slight upward adjustment was observed in the financial asset prices that had registered significant falls since the second quarter of the year. Thus, in advanced economies, the main stock exchange markets posted gains, interest rates increased, and safe-haven currencies, such as the yen and the Swiss franc, depreciated (Chart 5).

Chart 5
Change in Selected Financial Indicators from August 12 to September 23, 2019
Percent, basis points



1/ MSCI Emerging Markets Index (includes 24 countries).
2/ DXY: Weighted average of the nominal exchange rate of the six main world-traded currencies (calculated by Intercontinental Exchange, ICE) with the following weights: EUR (57.6%), JPY (13.6%), GBP (11.9%), CAD (9.1%), SEK (4.2%), and CHF (3.6%).
3/ J.P. Morgan Index constructed from a weighted average of the nominal exchange rate of emerging economies' currencies with the following weights: TRY (8.3%), RUB (8.3%), HUF (8.3%), ZAR (8.3%), BRL (11.1%), MXN (11.1%), CLP (11.1%), CNH (11.1%), INR (11.1%), and SGD (11.1%).
4/ The steel index corresponds to the active contract traded in the New York Mercantile Exchange.
5/ The aluminum index corresponds to the active contract traded in the London Metal Exchange.
Source: Bloomberg and ICE.

In contrast, in an environment of low liquidity, capital outflows were registered in emerging economies. While outflows were moderate in debt markets, in stock markets they took place during practically all the period. The deterioration of financial markets in Argentina stood out (Chart 6).

Chart 6
Emerging Economies: Financial Assets Performance from August 12 to September 23, 2019
Percent, basis points

Region	Country	Currencies	Equity markets	Interest rates 2Y	Interest rates 10Y	CDS
Latin America	Mexico	0.58%	8.98%	-53	-27	-13
	Brazil	-4.75%	2.61%	-26	-8	-3
	Chile	-1.15%	4.42%	-15	-7	-6
	Colombia	-0.31%	4.02%	0	-7	-9
	Argentina	-7.41%	4.37%	2,327	609	1,737
Emerging Europe	Russia	2.39%	3.55%	-50	-48	-31
	Poland	-3.48%	1.71%	5	-1	5
	Turkey	-2.86%	0.62%	-49	-12	-20
	Czech Republic	-2.22%	1.39%	30	16	2
	Hungary	-5.48%	-0.22%	-2	-6	3
Asia	South Korea	1.81%	7.69%	10	6	-3
	Malaysia	0.11%	-1.37%	-3	0	-11
	India	-0.20%	4.01%	17	4	-2
	Philippines	-0.57%	0.17%	8	-15	-8
	Thailand	0.76%	-1.69%	6	3	-4
	Indonesia	1.14%	-0.71%	-18	-16	-18
Africa	South Africa	2.67%	0.45%	-14	-18	-12

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

Looking ahead, market participants will remain attentive to the evolution of several risk factors that may lead to higher volatility and to a deterioration of international financial market conditions. Outstanding risk factors include concerns regarding trade tensions between the United States and its main trade partners and their potential negative impact on global economic growth. In addition, the risks related to Brexit as well as other political and geopolitical events persist, particularly the greater instability in the Middle East.

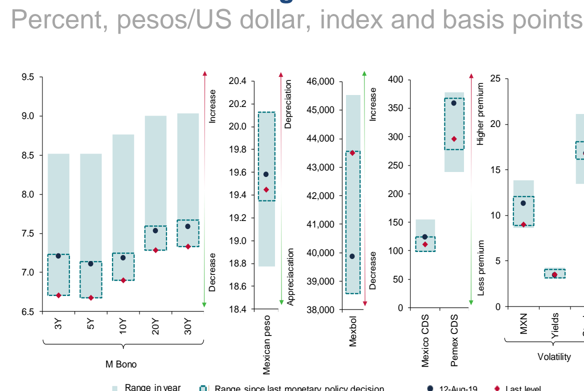
A.2. Current situation of the Mexican economy

A.2.1. Mexican markets

Since Banco de Mexico's previous monetary policy decision to date, domestic financial markets have reflected the effects of lower interest rates for all terms in the main advanced economies as well as episodes of volatility with exchange rate adjustments, although these have diminished over the last weeks.

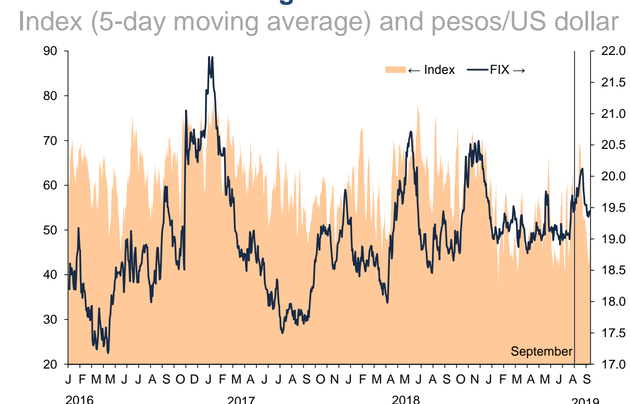
Thus, the peso/dollar exchange rate reached a maximum level of 20.25 pesos per US dollar during the period. The abovementioned took place in a context of low liquidity due to seasonal effects. However, in the last weeks the peso recovered by 0.63%, registering 19.49 pesos per US dollar at the end of the period (Chart 7). Forward outright trading conditions for the peso implied in FX spot options remained stable (Chart 8).

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



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

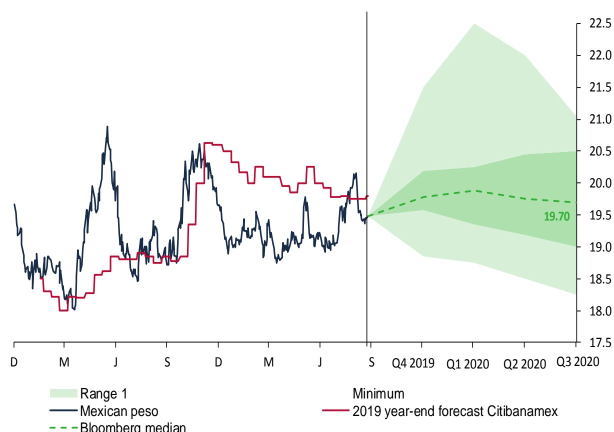
Chart 8
Mexican Foreign Exchange Market Trading Conditions
Index (5-day moving average) and pesos/US dollar



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

Since the last monetary policy decision, peso exchange rate expectations by forecasters from several financial institutions for the end of 2019 remained at 19.80 pesos per US dollar, while those for the end of 2020 were adjusted upwards, from 20.00 to 20.23 pesos per US dollar (Chart 9).

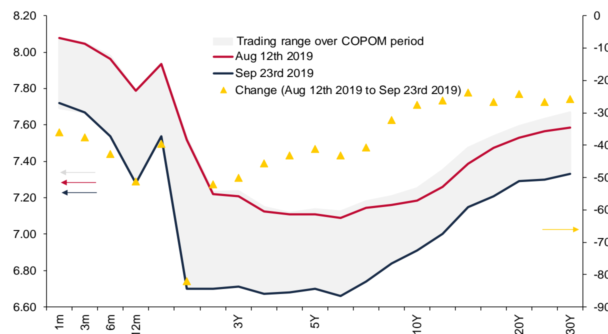
Chart 9
Analysts' Mexican Peso Exchange Rate Expectations for Each End of Quarter
Pesos per US dollar



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

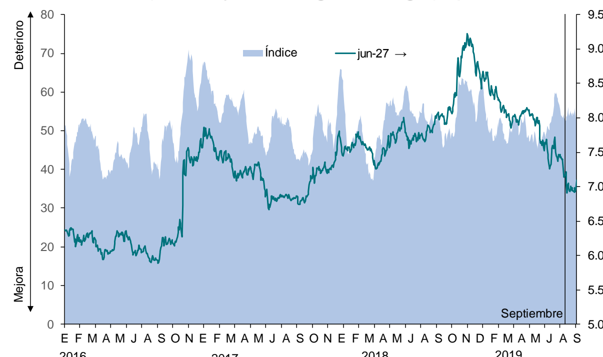
Interest rates of government securities have continued to decrease for all terms. In particular, interest rates with terms above one year exhibited reductions of up to 52 bps (Chart 10). These reductions were associated with the adjustments observed in most debt markets worldwide driven by expectations that the central banks of the main advanced economies will adopt even more accommodative monetary policy stances and that a more benign environment for inflation will prevail. The preceding occurred in a context of low trading volume and in which trading conditions deteriorated during certain days of the period (Chart 11).

Chart 10
Nominal Yield on Government Securities
Percent, basis points



Source: PIP.

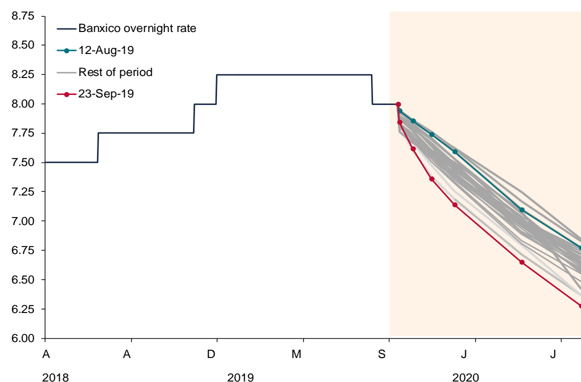
Chart 11
Mexican Government Debt Market Trading Conditions and Jun-27 Bond Rate
Index (10-day moving average), percent



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

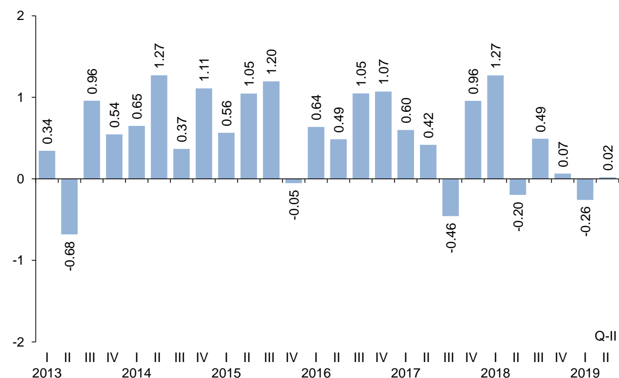
As to expectations regarding the path of the monetary policy target rate implied in the yield curve structure, these were adjusted downwards vis-à-vis the levels observed in the previous period, although an adjustment to the target rate for the September monetary policy decision has not been completely discounted (Chart 12). This contrasts with the expectations of private sector analysts surveyed by Citibanamex, who are anticipating a 25 bps cut to the target rate for that decision. For the end of 2019, both expectations implied in market rates as well as the median of the latest survey among forecasters anticipate a 50 bps cut in the policy rate, down to 7.50%.

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



Source: Banco de México with Bloomberg data.

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



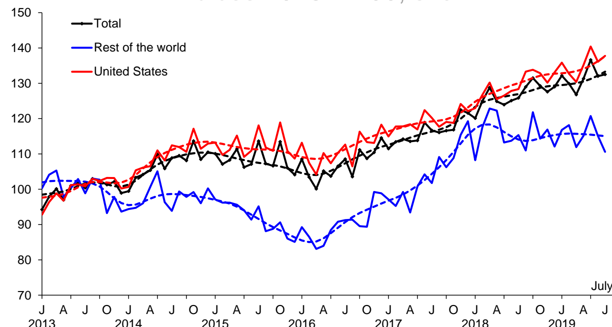
s. a. Seasonally adjusted figures.
Source: Mexico's National Accounts System (SCNM, for its acronym in Spanish), INEGI.

A.2.2. Economic activity in Mexico

During the second quarter and beginning of the third quarter of 2019, Mexico's economic activity remained stagnant (Chart 13). This behavior mainly reflects the unfavorable performance that investment continues to exhibit, the moderate recovery of private consumption, and the rebound of exports.

Delving further into the evolution of external demand, at the beginning of the third quarter, manufacturing exports continued to recover despite the weakening of world trade and the escalation of trade tensions worldwide. Such recovery stemmed from the dynamism of automotive exports, given the lackluster performance of the rest of the manufacturing exports. By destination, exports to the United States continued trending upwards, while those to the rest of the world continued to exhibit the same weakness that has been observed since mid-2018 (Chart 14).

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



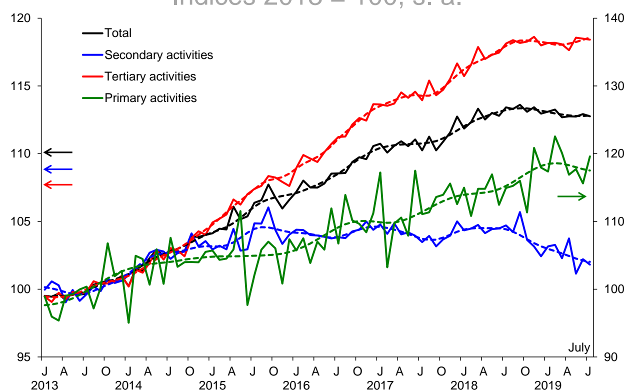
s. a. / Seasonally adjusted series and trend series based on data in nominal USD. The former is represented by a solid line and the latter by a dotted line.
Source: Prepared by Banco de México with data from the Tax Administration Service (SAT, for its acronym in Spanish), the Ministry of the Economy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

As for domestic demand, according to its monthly indicator, private consumption registered a moderate recovery in June 2019, due mainly to the improvements in domestic goods and services. In addition, at the beginning of the third quarter, more timely indicators of consumption, albeit of less coverage, such as retailer's earnings and sales of manufacturing industries that are more correlated with domestic consumption, continued trending upwards. In contrast, sales of light vehicles continued registering an unfavorable performance. For its part, during the second quarter of 2019 the negative trend followed by gross fixed investment since early 2018 became more evident. Indicators related with investment, such as construction activity and capital

imports, suggest that such weakness could persist during the early part of the third quarter.

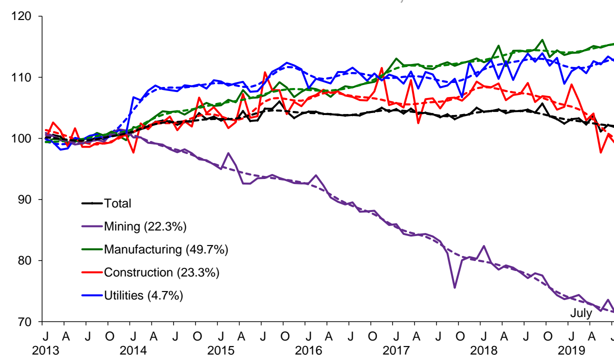
As for production, the stagnation of economic activity in the second quarter and in July 2019 was due to the negative performance of secondary activities and the weakness that tertiary activities have been showing (Chart 15). Indeed, at the end of the second quarter and the beginning of the third quarter of 2019, industrial activity continued on a downward trajectory, associated with the negative trends that both mining and construction have continued to display. In contrast, manufacturing production continued trending upwards, vis-à-vis the slowdown observed during the second half of 2018 and the early part of 2019 (Chart 16). For its part, the weakness of services in July 2019 is mainly explained by the decline observed in wholesale and retail trade; in arts, recreation and entertainment and other services (except public administration); and, in accommodation and food services.

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



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

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

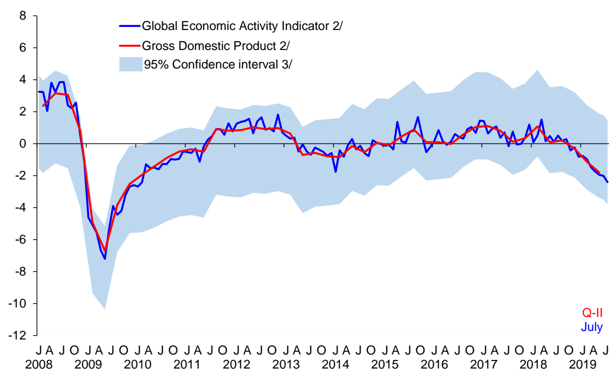


s. a. / Seasonally adjusted and trend series. The former is represented by a solid line and the latter by a dotted line.
1/ Figures in parentheses correspond to its share in the total in 2013.
Source: Mexico's National Accounts System (SCNM, for its acronym in Spanish), INEGI.

As to the economy's cyclical position, at the beginning of the third quarter of 2019 slack conditions continued at levels similar to those of the previous one, with a persistent negative output gap (Chart 17). As to labor market conditions, both national and urban unemployment rates remained at levels above those reported during most of 2018 (Chart 18), while the sharp deceleration in the growth rate of the number of jobs enrolled at IMSS persisted. With information available for the second quarter of 2019, given the behavior of productivity and real average earnings, unit labor costs in the overall economy followed an upward trend, while at the beginning of the third quarter of 2019 manufacturing unit labor costs remained at relatively high levels (Chart 19).

Chart 17
Output Gap Estimates [1/]
Excluding Oil Industry [4/]

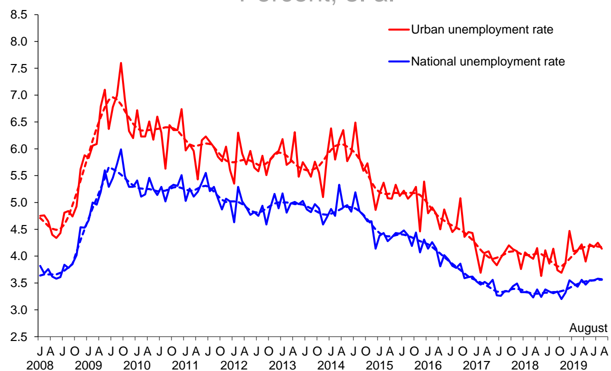
Potential output percentages, s. a.



s. a. / Calculations based on seasonally adjusted figures.
1/ Output gap estimated with a tail-corrected Hodrick-Prescott filter; see Banco de México (2009), "Inflation Report (April-June 2009)", p.74.
2/ GDP figures up to the second quarter of 2019 and of IGAE up to July 2019.
3/ Output gap confidence interval calculated with a method of unobserved components.
4/ Excludes both oil and gas extraction, support activities for mining, and petroleum and coal products' manufacturing.
Source: Prepared by Banco de México with INEGI data.

Chart 18
National Unemployment Rate and Urban Unemployment Rate

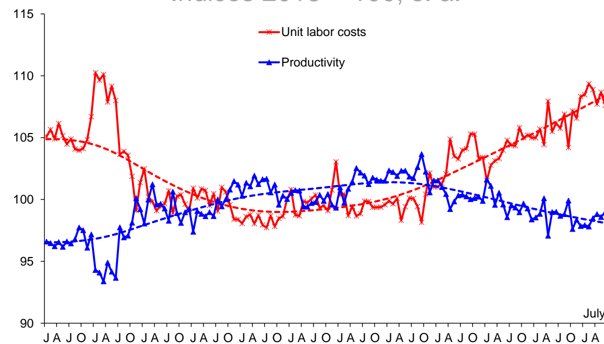
Percent, s. a.



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

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

Indices 2013 = 100, s. a.



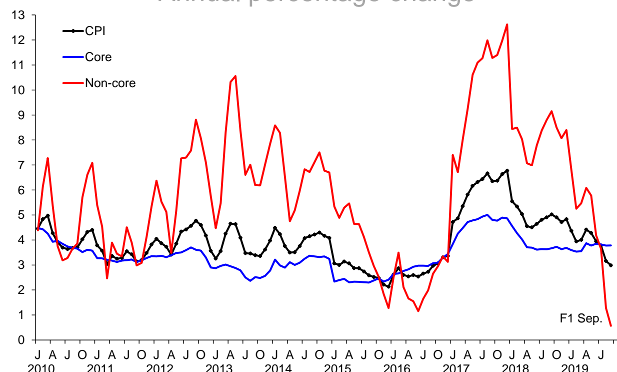
s. a. / Seasonally adjusted and trend series. The former is represented by a solid line and the latter by a dotted line.
1/ Productivity based on hours worked.
Source: IGPLE published by INEGI. Unit labor costs prepared by Banco de México with INEGI data.

In July 2019, the growth rate of domestic financing to the private non-fiancial sector continued to slow down. As for its components, financing to private non-financial firms continued to decelarate, due mainly to the lower growth of both bank credit and debt issuance. As for the household segment, mortgages continued registering a high dynamism, while consumer credit kept growing at a low rate. As for interest rates, those related to firm financing did not change significantly at the margin, although they remain at high levels. Meanwhile, interest rates of mortgages have remained stable since the second quarter of 2017, whereas in the segment of consumer credit those of credit cards continue trending upwards. With regards to portfolio quality, firms and mortgage delinquency rates remained at low levels, while those related to consumption did not register significant changes, although they are still at high levels.

A.2.3. Development of inflation and inflation outlook

Between July and the first fortnight of September 2019, annual headline inflation fell from 3.78 to 2.99% (Chart 20 and Table 1). Such reduction reflected a decline of 4 bps in the incidence of core inflation and of 75 bps in that of non-core inflation.

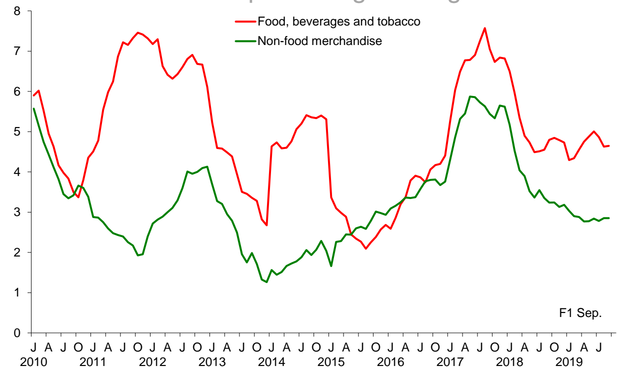
Chart 20
Consumer Price Index
Annual percentage change



Source: Banco de México e INEGI.

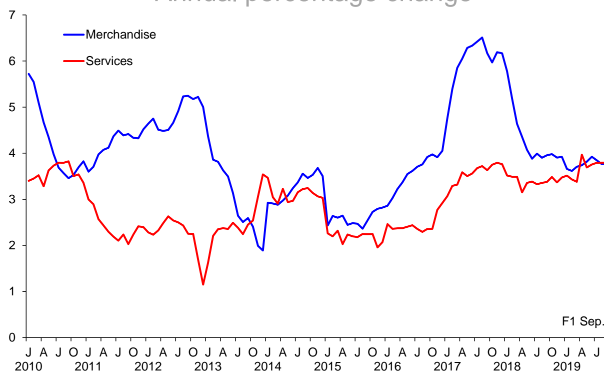
Between July and the first fortnight of September 2019, annual core inflation decreased from 3.82 to 3.78%, thus continuing to show persistence. Within this component, the annual rate of change of food merchandise prices remains at high levels, although it has decreased in the last months, while that of non-food merchandise prices is at relatively stable levels below 3% (Chart 21). As to the annual rate of change of services prices, it remained at levels around 3.8% (Chart 22). Nevertheless, the annual rates of change of several food, transportation and recreation prices persisted at levels above 5%.

Chart 21
Merchandise Core Price Subindex
Annual percentage change



Source: Banco de México e INEGI.

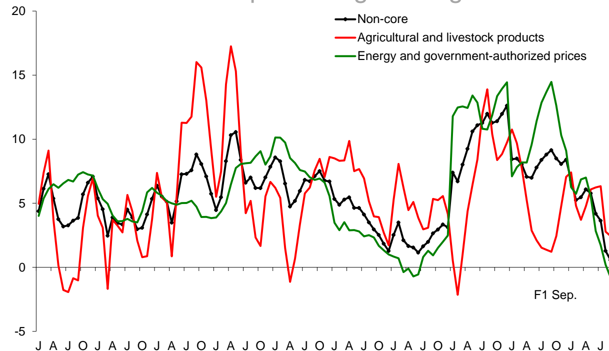
Chart 22
Merchandise and Services Core Price Subindex
Annual percentage change



Source: Banco de México e INEGI.

Annual non-core inflation has followed a noticeable downward trend, decreasing from 3.64 to 0.57% between July and the first fortnight of September 2019 (Chart 23 and Table 1). This result is due to the decline in the annual rates of change of energy and agricultural and livestock product prices.

Chart 23
Non-core Price Subindex
Annual percentage change



Source: Banco de México e INEGI.

The medians for short-term inflation expectations drawn from Banco de México's Survey of Private Sector Forecasters exhibited mixed adjustments. Indeed, between July and August, the medians for headline inflation expectations for the end of 2019 and 2020 were adjusted downwards from 3.66 to 3.36% and from 3.60 to 3.56%, respectively. Such adjustments are explained by the reduction in implied non-core inflation expectations, which decreased from 3.76 to 2.46% for the end of 2019 and from 4.34 to 4.10% for the end of 2020. The medians for core-inflation expectations for the end of 2019 and 2020 remained practically unchanged at levels around 3.67 and 3.40%, respectively. The medians for headline inflation expectations for the medium term (next four years) also remained unchanged at 3.50%,

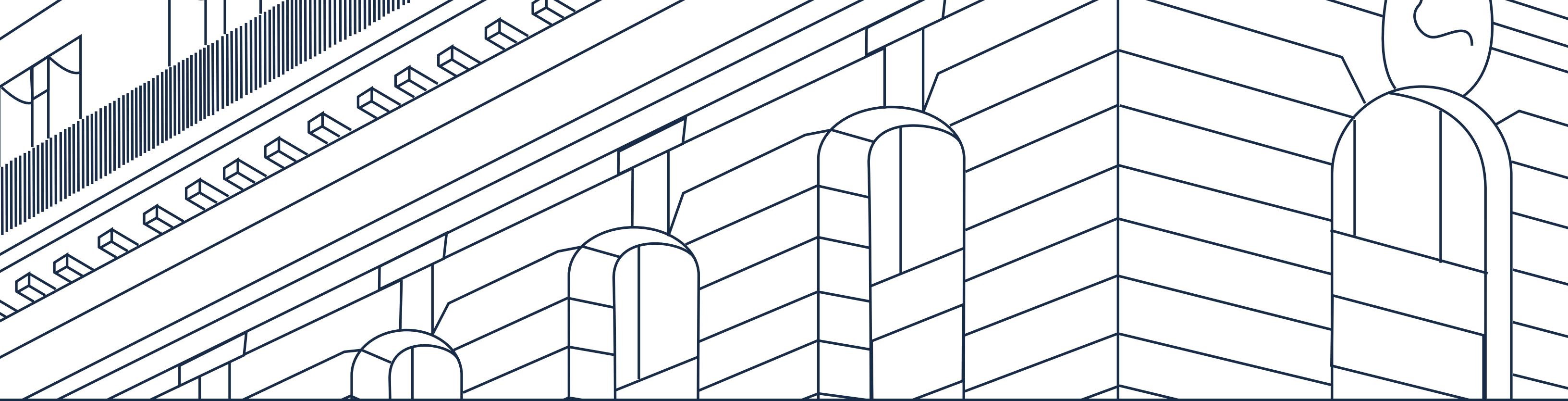
while that for core inflation increased from 3.41 to 3.49%. As to the medians for headline and core inflation expectations for the longer term (five to eight years), these remained at 3.50 and 3.40%, respectively. Thus, expectations for both headline and core inflation remain above the 3% headline inflation target. Finally, inflation expectations implicit in long-term market instruments (drawn from 10-year government bonds) decreased slightly between July and August, although they remained at levels close to 3.50%, while the inflation risk premium also decreased marginally.

Among inflation risks, the following stand out. To the upside, core inflation may continue to show persistence and there is the possibility that the peso exchange rate comes under pressure stemming from external or domestic factors. Additional risks are the threat by the United States to impose tariffs on Mexican imports and the adoption of compensatory measures, although these have dissipated somewhat; that energy and agricultural and livestock product prices increase; weak public finances; and, that global protectionist measures escalate. In addition, given the magnitude of several wage revisions, that cost-related pressures arise, insofar as such revisions exceed productivity gains. Regarding downside risks, the peso exchange rate may appreciate, possibly associated with a context of more accommodative monetary policy stances and lower interest rates worldwide or in case greater certainty arises regarding the trade relation with the United States. Another downside risk is that the prices of certain goods included in the non-core subindex register lower rates of change. In addition, that slack conditions widen more than anticipated, which would impact the behavior of core inflation. Given the aforementioned, high uncertainty still persists regarding the risks that might affect inflation.

Table 1
Consumer Price Index and Components
Annual percentage change

Item	July 2019	August 2019	1st fortnight Sep. 2019
CPI	**3.78**	**3.16**	**2.99**
Core	**3.82**	**3.78**	**3.78**
Merchandise	**3.85**	**3.76**	**3.77**
Food, beverages and tobacco	4.87	4.63	4.65
Non-food merchandise	2.78	2.85	2.85
Services	**3.79**	**3.79**	**3.79**
Housing	2.86	2.92	2.89
Education (tuitions)	4.91	4.66	4.73
Other services	4.40	4.40	4.41
Non-core	**3.64**	**1.28**	**0.57**
Agricultural and livestock products	**6.33**	**2.78**	**2.45**
Fruits and vegetables	5.61	-0.75	-0.21
Livestock products	7.06	5.77	4.67
Energy and government-authorized prices	**1.73**	**0.20**	**-0.78**
Energy products	0.76	-1.53	-2.89
Government-authorized prices	4.04	4.30	4.30

Source: INEGI.



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