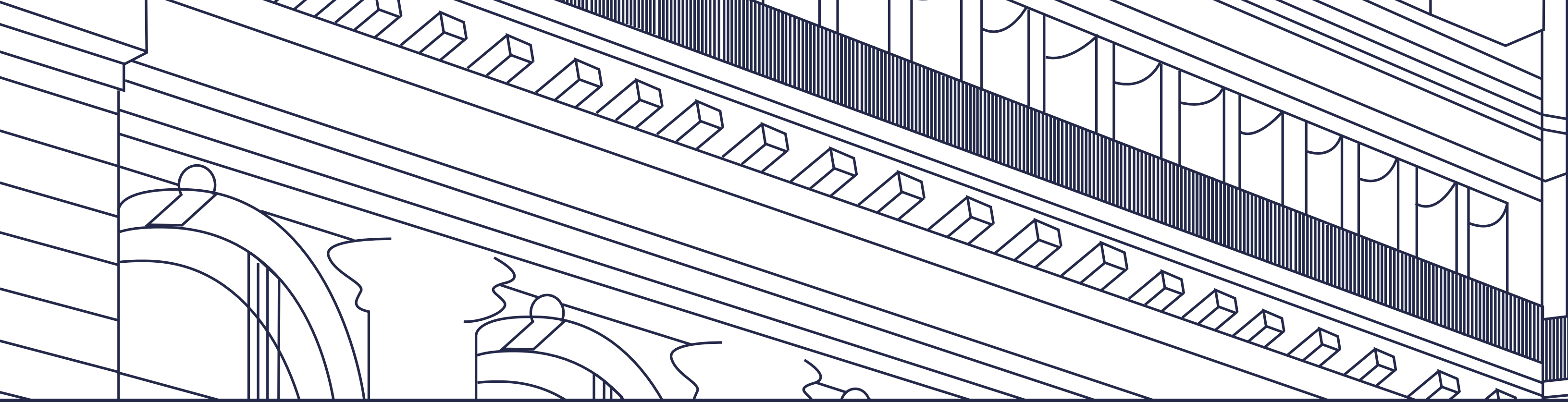
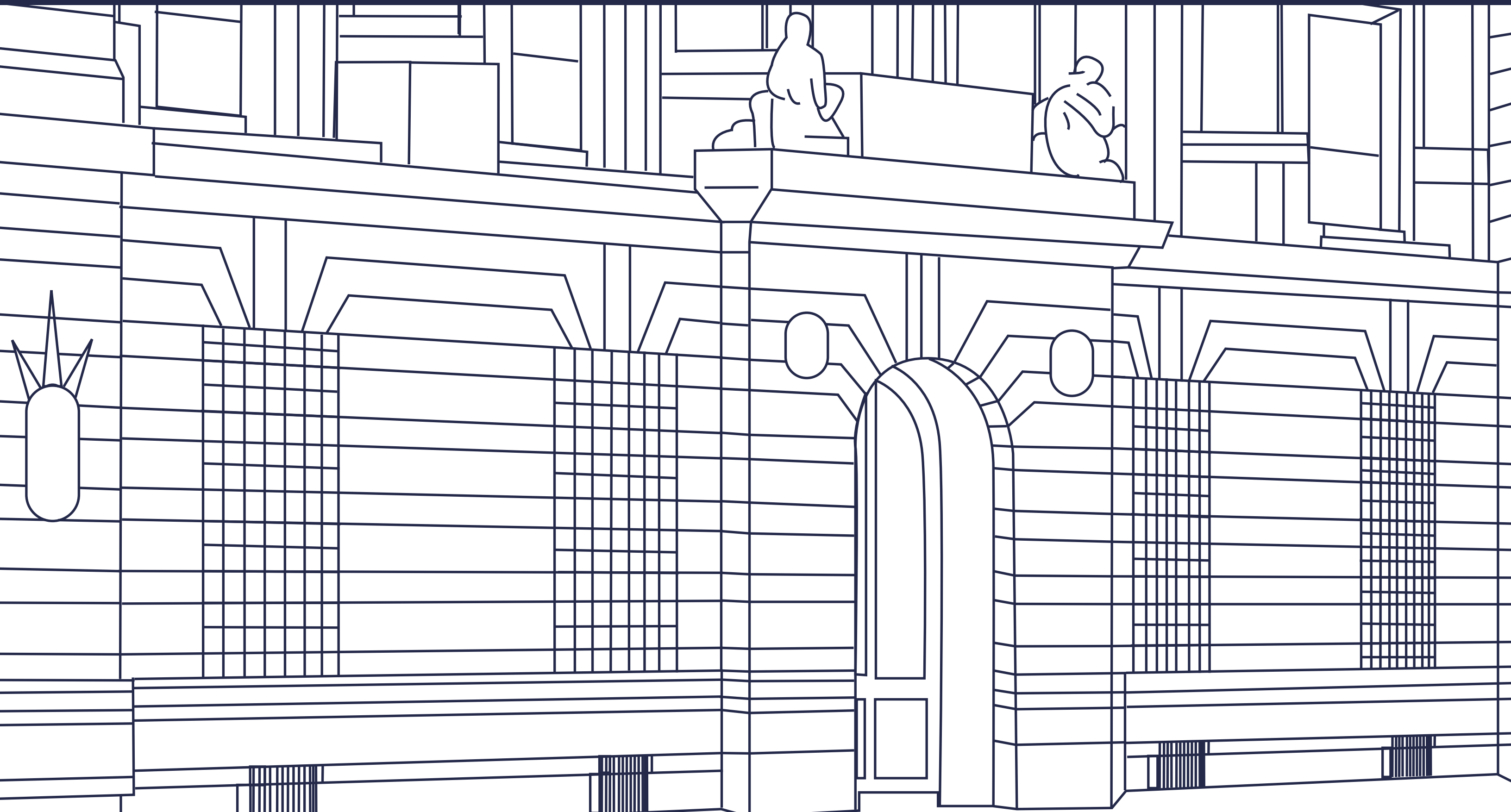


BANCO DE MÉXICO

Minutes number 59

Meeting of Banco de México's Governing Board on the occasion of the monetary policy decision announced on May 17, 2018



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1. PLACE, DATE, AND PARTICIPANTS

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

1.2. Date of Governing Board meeting: May 17, 2018

1.3. Participants:

Alejandro Díaz de León-Carrillo, Governor

Roberto Del Cueto-Legaspi, Deputy Governor

Irene Espinosa-Cantellano, Deputy Governor

Javier Eduardo Guzmán-Calafell, Deputy Governor

Manuel Ramos-Francia, Deputy Governor

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

Miguel Messmacher-Linartas, Undersecretary of Finance and Public Credit

Fernando Luis Corvera-Caraza, Secretary of the Governing Board

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

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

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

All members highlighted that the world economy continued to expand in a generalized manner during the first quarter of 2018. One member pointed out the increasing international trade and the recovery in investment as the main foundations of world growth. Most members noted that, at the margin, a slowdown was also observed, and that this is mainly explained by the lower growth of developed economies due to certain temporary factors and to adverse weather conditions. One member considered that this lower dynamism is also associated with the fact that a significant part of developed and emerging economies is currently undergoing a late stage of their business cycles. The majority of members mentioned that forecasts for world economic growth for 2018 and 2019 have remained unchanged in relation to the projections published at the beginning of 2018. One member stated that, despite the increased volatility in financial markets and the concerns about the trade policies that could be adopted, the outlook for world economic recovery rests upon an improvement in labor markets, a higher confidence of economic agents, and the effects of greater fiscal incentives in some developed economies. Another member mentioned that the expected strengthening of the world economy during the April-June quarter supports the forecast of higher economic growth worldwide in 2018, vis-a-vis 2017. One member stated that short-term risks to the world economy, that is, for 2018 and 2019, appear to be balanced. Nevertheless, most members agreed that there are several downward risks, particularly in the medium and long terms, such as the escalation of protectionist trade measures, increased volatility in international financial markets, the tightening of global financial conditions resulting from a faster-than-expected U.S. monetary policy normalization, and/or the materialization of some geopolitical risks.

In relation to the possible adoption of protectionist measures, most members pointed out that these could have significant effects on international trade and investment. Particularly, one member noted that, although the fears associated with a U.S.-China trade conflict have tempered in recent weeks, the risk of trade-related tensions between these two countries persists. This member added that the imposition of restrictions on trade and investment flows would have implications not only for the conflicting parties, but also for the global economy as a whole. The same member stated that both the allocation of resources and the dynamism of economic activity would be affected at both the regional and global level. Also, this member argued that major disruptions in global value chains might arise that, by affecting investor confidence, could contribute to increased volatility in international financial markets. In this context, the same member pointed out that despite the efforts to reduce geopolitical tensions in some regions of the world, these have not faded and have even worsened in some regions, such as the Middle East. Another member added that, if the current conditions of rapidly ageing population and low productivity growth in some countries persist, the average potential growth of the world economy could fall to levels of between 2.3% and 2.5% in annual terms in the next decade.

In relation to world inflation, some members stated that, during the first quarter of 2018, there were gradual increases in inflation in certain economies, derived partly from the increasing prices of commodities and a significant reduction of slack in labor markets. One member pointed out that these price increases have been fueled by the outlook for continued global economic growth and, in the case of energy goods, that oil prices have also been affected by some supply-related factors. Another member emphasized that the re-imposition of sanctions on Iran recently announced by the United States, has contributed to the spike in international oil prices to levels unseen since the end of 2014, and that this could have relevant implications for economic activity and inflation in several developed and emerging economies. In this regard, another member pointed out that the outlook for world inflation is that it will continue on an upward trend, albeit increasing at a more moderate pace, and that the prices of assets currently incorporate this prevision. Another member added that, although the balance of short-term risks to world inflation remains stable, latent upward risk factors persist for the months ahead.

Most members emphasized that economic activity in the U.S. grew at a more moderate pace during the first quarter of 2018. Some members pointed out that this was mainly due to the lower expansion of private consumption. One member added that this slowdown was partially offset by higher levels of investment. The same member mentioned that this lower growth took place in an environment where economic agents' confidence is at historically high levels. One member noted that the U.S. economy has undergone an atypical cycle of extended and gradual recovery. In this regard, some members emphasized that data indicate a continued strengthening of the labor market, while the unemployment rate is at its lowest levels of the last decades. Thus, most members pointed out that there has been a sustained reduction in the degree of slack in the U.S. economy. As for forecasts for U.S. economic activity, most members underlined that it is expected to grow at a solid pace in the coming quarters. They also mentioned that timely indicators of private demand suggest an uptick in growth during the second quarter and a greater dynamism for the remainder of 2018 and in 2019. One member added that the significant tax cuts approved at the end of last year and the expected increase in the government's budget will have the most significant effects on growth precisely in these two years. Another member added that growth forecasts for these years already incorporate the effects of the tax reform and that they remain stable at 2.8% and 2.6%, respectively. As for the risks to U.S. growth, some members mentioned the possibility of the effects of the tax incentives gradually fading in the following years. One member stated that the higher interest rates along the yield curve could also have a negative impact on growth. Another member mentioned that another risk to economic activity is the possibility of a further deterioration in U.S. public finances, as well as the materialization of scenarios associated with both tariff-related issues with China and geopolitical conflicts.

Regarding U.S. inflation, one member stated that there appears to be a consensus that the Phillips curve has flattened sharply in the last years, which could explain why the tightening in U.S. labor market conditions has not led to stronger pressures on wages and inflation. Also, this member added that two important factors to explain this situation would be the increased automation of various manufacturing processes and the effect of globalization. Another member pointed out that the U.S. Federal Reserve acknowledged in its last monetary policy statement that both headline and core inflation have come closer to their 2% target. Furthermore, most members emphasized that the Fed stated that it expects inflation to be around its 2% symmetrical target. One member added that such emphasis on symmetry could be interpreted as a certain tolerance to inflation figures above the target. Some members suggested that inflation could be subject to upward pressures in an environment where the labor market is near full employment and facing the possibility of the U.S. economy operating above potential in the coming years. One member pointed out that the above has led to an upward revision in inflation expectations, as well as an increase in inflationary uncertainty and a possible upward bias in inflation. Another member indicated that, notwithstanding the above, financial markets do not appear to assign a high likelihood to the possibility of adverse inflationary shock in the U.S.

Most members highlighted that in its FOMC meeting of May, the U.S. Federal Reserve kept unchanged the target range for the federal funds rate at a level of 1.5% to 1.75%, as was expected. They pointed out that the Fed also reiterated its expectation of gradual increases in its target range. They also noted that, given the degree of slack in the U.S. economy, and in an environment of fiscal stimulus measures, the materialization of a scenario of a faster monetary policy adjustment is increasingly probable for both markets and analysts, which have changed their projections from to 3 to 4 policy adjustments in 2018. In this regard, one member said that expectations that U.S. inflation will converge to its target sooner than other advanced economies, has resulted in expectations of U.S. interest rates increasing at a higher and faster rate than in other advanced economies.

In relation to the rest of the developed economies, one member stated that during the first quarter of 2018, Eurozone GDP grew at a moderate rate of 0.4% and of 1.7% in seasonally adjusted annual terms, due to a reduction in the dynamism of demand, after the strong recovery observed in 2017. Another member pointed out that, in addition to other factors, the above could have been reflected in the recent weakness of their currencies against the US dollar. Some members emphasized that growth expectations for the Eurozone economies continue to indicate a greater dynamism in 2018 and 2019. In this regard, one member added that the Eurozone is expected to grow 2.3% in 2018 and 2.0% in 2019. Another member stated that although growth estimates at the beginning of 2018 for Japan and the Eurozone for 2018 and 2019 were revised upwards, the latest information is not clear as to how strong their economic expansion will be. Some members underlined that labor markets in developed economies show tight cyclical conditions. One member added that there has been a moderate increase in wages, inflation, and inflation expectations. Another member stated that slack conditions in the Eurozone have not been exhausted, in contrast with those of the U.S. economy. The same member pointed out that in the rest of the advanced economies, inflation is still below their central banks' targets and, as a result, these countries have maintained an accommodative monetary policy stance, which is likely to continue at least for the rest of 2018. The same member also emphasized that up to March 2018, inflation in the Eurozone had not yet attained its target level, while the unemployment rate continued falling. Also, that member argued that this was the reason why, in its last monetary policy decision of April, the European Central Bank (ECB) left its reference rate unchanged and indicated that it will end its asset purchase program in September 2018 and will begin the gradual normalization of the reference rate until the second half of 2019. The same member mentioned that the Bank of England kept its reference rate at 0.5%, despite the fact that inflation fell to 2.5% in March, its lowest level in one year. This member also stated that Brexit negotiations pose an additional challenge for the U.K. Monetary Policy Committee to enable a faster monetary policy normalization process in 2018. This member also added that the Bank of Japan will continue with its accommodative monetary policy stance in the coming months and has changed the period of time to attain its 2% inflation target for fiscal year 2019.

Some members agreed that emerging economies grew at a high rate during the first quarter of 2018. One member pointed out that China grew at an annual rate of 6.8%, fueled mainly by consumption. Another member indicated that labor markets in several emerging economies also show tight cyclical conditions. One member added that in these economies inflation remains close, or even below, their central banks' targets, except for Turkey and Argentina. The same member highlighted the case of Colombia, where the central bank continues its monetary easing cycle, as reflected by the recent cut of 25 basis points in its reference rate. The same member underlined that, despite the good performance of emerging economies, risks persist, particularly for China, due to its deleveraging process and to growing trade tensions with the US.

All members pointed out that there has been an increase in interest rates in the U.S., particularly for shorter terms, while the US dollar has strengthened in a generalized manner. One member mentioned that these results are due to the relatively better performance of the U.S. economy, vis-a-vis other advanced economies, as well as to the convergence of inflation to the Federal Reserve's target and to expectations that the Fed will continue its monetary policy normalization process in the short term. Another member added the upward revision in inflation expectations, the greater inflationary uncertainty, and even a possible upward bias in inflation as other factors leading to increases in U.S. interest rates. The same member explained that, since the beginning of September 2017 to date, 2-year bond interest rates have increased by more than 120 basis points, while 10-year bond interest rates did so by more than 100 basis points and exceeded 3.0%. One member pointed out that these rates reached their highest levels since 2008 in 2-year maturities and since 2014 in longer maturities. The majority of members agreed that the increase in U.S. government securities' interest rates has generated episodes of volatility in international financial markets, lower risk appetite, and capital outflows from emerging economies. One member expressed that this market adjustment occurred in a relatively orderly manner, but another noted that capital outflows from emerging economies could intensify in the months and years ahead. Some members noted that gains in asset price valuations have reverted. Particularly, one of the members mentioned that the search for yield in higher-risk instruments has also reverted due to adjustments in both the inflation outlook and interest rates. The same member pointed out that such reversal took place in an environment where, throughout 2017 and early 2018, stock markets had grown significantly and the search for yield prevailed in response to the expected tax cuts and to the prevision that interest rates would increase at a sufficiently gradual pace. Some members noted that, in an environment of a lesser search for yield, the idiosyncratic factors of the different emerging economies could become more relevant to determine their market prices.

Particularly, one of the members mentioned that the tightening of financial conditions that is likely to ensue in the years ahead would affect mostly those economies that still have weak fundamentals, such as high levels of indebtedness, especially when denominated in foreign currency. One member highlighted that, in the absence of historical precedents, a faster-than-expected increase in the level of U.S. wages, inflation and reference interest rates, could result in strong financial stress worldwide due to the re-composition of foreign investors' portfolios in unforeseen magnitudes. The same member emphasized that this would affect capital flows to emerging economies like Mexico.

Most members pointed out that the available information suggests that Mexico's economic activity continued to rebound in the first quarter of 2018, attaining an even higher growth rate than in the previous quarter. One member stated that this compares favorably with the slowdown of the first three quarters of 2017, while another noted that this was the highest quarterly GDP growth rate figure since July-September 2016. Most members added that exports continued to follow a positive trajectory, while private consumption continued to expand, albeit at a slower pace, and that investment recovered. Most members pointed out that the recovery in investment was driven by the reconstruction efforts after the earthquakes of September 2017 and by certain public infrastructure projects, some of them adding that the recent recovery of spending in domestic and imported machinery and equipment have also contributed to the upswing in investment. Most members noted that, as to productive activity, economic growth in the first quarter of 2018 reflected both the dynamism of services and the recovery of industrial activity, which is explained mainly by the abovementioned upturn in construction and manufacturing. In terms of a lower frequency view, some members pointed out that, in the last years, the country's economy has been subject to marked uncertainty and decreased availability of external resources, which has led to a sharp depreciation of the real exchange rate. Some members expressed their views that aggregate demand has been adjusting to the changing relative prices and to an environment of higher real interest rates in the U.S. One of the members added that, in general terms, this has resulted in a greater dynamism of exports, a certain moderation in consumption, and in weak investment, although the latest information shows that it has slightly recovered.

Some members mentioned that the forecasts for growth in Mexico for 2018 and 2019 remain stable. Some members noted that the higher growth rates observed during the first quarter of 2018 are not expected to continue in the following months. In this regard, one of them considered that the latter is because the uptick in certain GDP components is apparently a response to temporary factors, and to the fact that both investment and industrial production figures partly reflect the effect of the reconstruction efforts to address the impact of the earthquakes that hit the country in September 2017. This member noted that what has been observed frequently in previous election processes, is stronger economic activity in the first half of the year, which reverts, at least partially, in the second half. Thus, this member held, that although, in principle, the higher-than-expected growth of GDP during January-March would imply an upward revision of 2018 growth expectations, it remains to be seen to what extent the trajectory of economic activity in the months ahead is affected by the aforementioned factors.

Most members pointed out that, although the latest economic activity figures indicate a greater dynamism, given the prevailing conditions of economic uncertainty the balance of risks to growth continues to be downward-biased. One member noted that several risk factors, external and domestic, influence the above. Most members mentioned that downward risks include the uncertainty related to the renegotiation of the North America Free Trade Agreement (NAFTA) and the volatility associated with the electoral process, one of them adding the risk of post-electoral volatility. As for the first risk, one member noted the possible negative impact of uncertainty on aggregate demand. Another member pointed out that reaching an agreement in NAFTA renegotiations in the next days or before the country's elections, as had been announced, seems very unlikely, and therefore the renegotiation rounds could be postponed until next year, which could imply cautious decisions related to spending and/or that investment projects will be postponed further. As for the second risk, the same member highlighted that it is difficult to anticipate the magnitude and duration of these volatility episodes, but that a strongly influential factor could be a small percentage difference between the election's winner and the runner-up. Some members mentioned other additional risks to growth, such as the tightening of international monetary and financial conditions, a faster-than-expected normalization of U.S. monetary policy, and/or unexpected changes in the aforementioned normalization process. Some members noted that, in light of this risk, volatility in international financial markets could increase, affecting economic activity growth and capital flows to emerging economies, including Mexico. One member also mentioned the risk implicit in the tax reform approval by U.S. Congress last December, explaining that it could affect private sector investment decisions, which in turn would impact Mexico's tax base and economic activity. Some members also mentioned the adoption of protectionist trade policies as a risk, while one member also included the potential impact of the materialization of geopolitical risks. One member pointed out the need for Banco de México to refine its analysis of the balance of risks to inflation and growth, mentioning that the probability of several of these risks taking place changes significantly over time, a fact that has never been mentioned before, and that the nature of risks in terms of how they affect growth and inflation in the short, medium and long terms should be distinguished. This member considered that the risks to growth in the short term have diminished considerably, while those for the medium and long terms have not.

As for the economy's cyclical position, most members emphasized that conditions remained tight, particularly in the labor market. In this regard, one member noted that statistical estimates suggest that the unemployment rate is significantly below its long-term level. Nevertheless, this member argued that there is the possibility that the latter does not reflect accurately labor market conditions, particularly because wages are not showing an excessive increase and the demand-side pressures that would be expected under those circumstances are not observed. The same member mentioned that the labor market situation is more compatible with the close-to-zero output gap estimates and that the recent trajectory of three of the four indicators used by Banco de México to estimate monthly slack indices, also point to that conclusion. Another member stated that indicators of the cyclical position of the economy show, at the margin, that tightness has been decreasing at a moderate pace. The same member noted that indicators of labor market slack should be interpreted cautiously because, in general terms, they react to the cyclical conditions with a lag. That member mentioned also that loose cyclical conditions had not been observed since some months ago and that in the past Banco de México's communications regarding this matter had not been very clear and opportune. This member also considered that it would be consistent to observe pressures on nominal wages generated by the economy's cyclical conditions, simultaneously with a fall in real wages, given the depreciation of the real exchange rate, which would result in a slower adjustment of inflation to its target, if monetary policy were not operating effectively. This member pointed out that, if the cyclical conditions had been less tight, inflation would have fallen very rapidly under the monetary policy stance adopted by the central bank. Likewise, that a broad range of labor market indicators suggest that there is no slack in this market. For this member, the economy's tighter cyclical conditions over the last years have been a determining factor in the adjustments to the monetary policy target rate. The same member emphasized that Banco de México recently acted in a timely manner when it published its new indicators to better understand the economic cycle, emphasizing the need to take full advantage of the publication of these indicators to improve the central bank's communication on economic slack matters, as has been done. In this regard, another member noted that it is necessary to evaluate accurately the market conditions in order to fully identify their role in the price formation process.

All members pointed out that during the first four months of 2018, annual headline inflation continued to decrease. Most members stated that the fall in observed inflation is consistent with the forecasts published by Banco de México in its October-December 2017 Quarterly Report. Some members considered that this indicator has fallen more sharply than expected, from 6.77% in December to 4.55% in April. One mentioned that, although the behavior of headline inflation has been the result of temporary reductions in the prices of some products, the percentage of items in the CPI basket with annualized monthly increases below or equal to 3% has continued to increase and in April accounted for 50% of the total. Another member stated that it is still too early to be confident that the process of inflation reduction in 2018 has been consolidated. As for core inflation, some members pointed out that from December to April it decreased from 4.87% to 3.71%, respectively. The majority of members agreed that this reduction has been the result of the monetary policy actions adopted and of the fading out of the shocks that affected it last year. One member stated that core inflation has reached levels below the upper bound of the variability interval around the central bank's inflation target, adding that the fundamental core inflation indicator, a variable that reflects more adequately changes in the economic cycle, has continued to fall, registering figures below those of core inflation. As for non-core inflation, some members mentioned that from December to April, it decreased from 12.62% to 7.07%, respectively. Most of them pointed out that this result is mainly due to reductions in the prices of certain fruits and vegetables and of LP gas. Finally, in this respect, one member said that this component remains at high levels and that it has been under certain additional pressures, especially related to gasoline prices.

All members agreed that headline inflation expectations for the end of 2018 were revised slightly downwards, while those for the medium and long terms remained stable. Some stated that inflation expectations for the end of 2018 were revised downwards from 4.09% in March to 3.98% in April. One member mentioned that the anchoring of medium and long run inflation expectations makes it clear that Banco de México's monetary policy actions have prevented the emergence of second-round effects from the different shocks that have affected prices. Nevertheless, this member also pointed out that inflation expectations for all terms are above the central bank's projections. In this regard, most members said that long-term inflation expectations remain above the target, around 3.5%. One member mentioned that long-term inflation expectations in recent years have fluctuated no more than 20 basis points around 3.5%, even when inflation figures were below the target –like in 2015- or above the target -like in 2017. This member stated that this outcome could respond to various motives, and that Banco de México has tried to strengthen its commitment to attain the inflation target by adopting measures to increase the central bank's transparency and accountability. As for inflation expectations derived from market instruments, one member mentioned that these have remained unchanged for three consecutive months, while another stated that the differentials between nominal and real yields continue suggesting upward risks for inflation in the long run.

Most members agreed that looking forward, and in view of the current monetary policy stance, inflation will continue to be in line with the forecasts published in Banco de México's October-December 2017 Quarterly Report. One member stated that forecasts for the end of 2018 for both headline and core inflation were adjusted slightly to the downside, while those for non-core inflation rose because the outlook for prices of energy goods was adjusted. Another member mentioned that the forecasts for terms over one year continue in line with the convergence of inflation to its target. Most members acknowledged that the base scenario assumes an orderly behavior of the exchange rate, the absence of labor market pressures, and non-core inflation continuing to decline at the expected rate for the remainder of 2018. One member mentioned that there are risk factors that might affect inflation and delay the forecasted disinflationary trajectory, and the convergence of inflation to its target. Another member considered such convergence will occur in the first half of 2019.

Most members coincided that the balance of risks to inflation in relation to its expected path is still biased upwards, in an environment characterized by a high degree of uncertainty. Some members pointed out that such bias responds to the possibility that the assumptions incorporated in the aforementioned inflation forecasts are affected by several factors. One member mentioned that this balance has not deteriorated in relation to that mentioned in the previous monetary policy statement, while another member said that there are still risks and uncertainty in the short term, which appear to have increased, in relation to the scenario foreseen in the last monetary policy decision meeting. Among the main upward risks, most members agreed that the peso exchange rate could continue to be under pressure due to both an environment of higher external interest rates and the strengthening of the US dollar, and uncertainty associated with NAFTA negotiations and Mexico's 2018 electoral process. One of them also included the uncertainty related to the post-election period. As for NAFTA renegotiations, some members stated that there is the risk of negotiations extending for a long period, while one added that there is an additional risk of these renegotiations having a negative outcome. This member also included other risks, such as the geopolitical ones, albeit specifying that markets do not perceive them to have a high probability of materializing, despite their media coverage. In addition, this member mentioned the risk of having an adverse inflationary shock in the U.S. and the significant risk the U.S. tax reform could pose on investment and public finances in Mexico. The same member also pointed out the structural weakness of Mexican public finances as an additional risk to inflation and that total factor productivity in Mexico has remained stagnant for many years. This member highlighted that, if this latter development continues, or if productivity even falls, adverse shocks –both external and domestic- could have greater effects on the price level and, therefore, on inflation, and at a faster pace. This member added that this is a risk in the short and medium terms that could last very long if the different factors that affect productivity are not addressed. Moreover, he argued that the apparent weak association between aggregate economic activity and employment in Mexico is a clear reflection of the abovementioned problem. The same member stated that, indeed, in the last years, employment has grown at rates above productive activity, thus suggesting that the jobs that are currently being created show, on average, low productivity levels. On another front, he also added the presence of another risk generated by the fact that inflation expectations are currently anchored at 3.5%, above Banco de México's target, and that the continuous presence of different risks and the fact that they could occur simultaneously, could considerably affect the rate of price growth. This member argued that the balance of risks described above includes only those high-frequency risks related to the business cycle, albeit noting that there are also others of low frequency and structural nature. To conclude, this member noted that it is important: i) to specify which risks are temporary and which could possibly lead to permanent shocks; ii) to identify their nominal or real nature, and if they are domestic or external, and iii) to identify how these shocks have evolved. One member stated that sudden increases in non-core inflation cannot be ruled out, given the volatility exhibited by most of its components. Another member mentioned, among these risks, the possibility of shocks to the prices of agricultural products and upward pressure on the prices of some energy-related goods. This member also added that there could be a risk in 2019 –generated by the new administration- of possible changes in the policy for government-authorized prices. Most members specified that given the economy's cyclical conditions, unit labor costs could put a pressure on inflation. In this regard, one member added the possibility of demand-side pressures. As for downward risks, some members pointed out a possible appreciation of the Mexican peso if NAFTA negotiations have a favorable outcome.

As for Mexican financial markets, most members pointed out that since the last monetary policy decision, the peso depreciated significantly and became increasingly volatile, in line with the exchange rates of most emerging economies. They ascertained that the evolution of the peso was due to the generalized strengthening of the US dollar as well as to domestic factors, such as the uncertainty about the NAFTA renegotiation and the country's elections. One member noted that these two factors caused the Mexican peso to be among emerging economies' most depreciated currencies in the period, and explained that, of these two factors, the outcome of the NAFTA renegotiations was the one that had the most adverse impact on the peso's exchange rate. Another member underlined that the increase in implied volatility in exchange rate options has been particularly noticeable for those maturing after the elections; and that this behavior is related to both the diminished expectations of reaching a favorable agreement within the NAFTA rounds in the next weeks and the uncertainty associated with the country's elections, which gains relevance as the day of the election approaches. Some members pointed out that, under this environment, foreign exchange market conditions slightly deteriorated; of these members, one specified that higher bid/ask spreads and a decreased market depth was observed. Another member stated that the market has operated under orderly conditions. As for interest rates in Mexico, one member mentioned that these posted increases throughout the yield curve, affected by the same factors that had an impact on the peso exchange rate. This member noted that such increases were of higher magnitude than in the U.S. Another member noted that a restructuring in foreign investors' government securities portfolio has been observed, towards more medium- and long-term positions, while opting for less positions in options with maturities under three years. As for the development of domestic financial markets in the near future, one member pointed out that such markets and the peso's exchange rate could be affected by the aforementioned risks. In view of these conditions, another member mentioned that foreign exchange rate expectations, drawn from Banco de México's Survey of Private Sector Forecasters, remain relatively unchanged since the last monetary policy decision, posting, on average, 18.60 and 18.28 pesos per dollar, for the end of 2018 and 2019, respectively. This member also mentioned that this could suggest that, although the market recognizes some degree of volatility surrounding the country's elections, it assumes that in the medium-and long terms the peso's foreign exchange will return to the levels observed at the beginning of 2018, thus implying that the prevailing macroeconomic conditions are expected to continue. One member gave insight as to the external and domestic risks that financial markets face. Regarding external risks, this member mentioned that markets do not seem to consider that there is a high probability of an adverse inflationary shock in the U.S. or that the abovementioned geopolitical risks will materialize. As for domestic risks, markets are incorporating a high probability of NAFTA renegotiations extending or having an adverse outcome, while they do not seem to fully incorporate the risk of a higher volatility associated with the election process. This member pointed out that although government economic authorities pursue different objectives than financial market participants and that, therefore, they evaluate both risks and their implications differently, for the monetary authority's decision making it is important to analyze how the markets are assessing the different types of risk and how that assessment is being reflected in the behavior of asset prices.

Some members pointed out that it is worth highlighting that the Mexican economy has been subject to marked levels of uncertainty and a lower availability of external resources, which have led to a significant depreciation of the real exchange rate and to an increase in real interest rates. One of the members added that in response to the financing shock that affected the economy in recent years, the monetary policy response adopted by the central bank contributed to a major correction aimed at reducing the current account deficit. Another member stated that the monetary policy stance adopted to keep medium- and long-term inflation expectations anchored, together with the attainment of the fiscal objectives and the financial system's resilience, have contributed to place the Mexican economy in a better position to face possible adverse scenarios. One of the members noted that, looking ahead, the economy is expected to continue undergoing a complex environment, both in the external and domestic fronts. This member added that, for this reason, it is important that, in addition to following a prudent and robust monetary policy, authorities adopt measures to foster a greater productivity and achieve a sustainable consolidation of public finances. The same member also underlined the importance of consolidating the economy's resilience and furthering the progress of the Mexican financial system, emphasizing that it is an essential ingredient, in order to reduce the probability of possible abrupt restructurings of investment portfolios and even of capital outflows. Another member highlighted that it is essential to consider the possibility of transiting through a period of high uncertainty for a long time, and that even in a scenario in which some of the current challenges could fade, others will probably persist for a prolonged period, such as the tightening of external financial conditions. The same member underlined that, in this environment, the required scope of action encompasses other areas beside monetary policy, and that the magnitude of the challenges that the country is facing brings to the fore the need for timely and adequate economic policy responses, in order to strengthen the economy's fundamentals. The same member mentioned that, although some sources of uncertainty are beyond the control of the authorities, there are others that are not and, for this reason, once the election process concludes, it will be important to know as soon as possible the detailed economic policy actions that the incoming administration has the intention of implementing, particularly regarding the management of public finances. One of the members stated that regardless of who the winner of the election is, the perception that public finances and the fiscal stance may suffer, in general terms, a deterioration, has started to gain relevance, given that the winner of the elections will have to fulfill several of the actions and public policies promised during the campaign. The same member added that, as is well known, the Public Sector Borrowing Requirements' Historical Balance exhibited, in gross terms, a sizable increase through the last years, except for 2017, reaching levels above 50% of GDP. The same member considered that this is a very important risk given the structural weakness of public finances, and that the adverse effects would be greater if Mexico's sovereign risk ratings deteriorate in case of this eventuality. The same member added that this could also be considered as a short- medium- and long-term risk. Some members mentioned as an additional risk for Mexican public finances, the effects that the US tax reform approved last year might have. Among the elements of uncertainty that the Mexican economy will continue to face, one of the members underlined the adverse sociopolitical environment that prevails in the country. The same member mentioned that the election process that will take place in July, besides generating extreme polarization, poses an unprecedented institutional challenge for the electoral and jurisdictional authorities that will have to judge the elections, given the number and complexity of the aspects it involves. This member also mentioned that this situation, already complex *per se*, occurs in an environment of institutional weakness where the State itself is vulnerable to various crime groups, particularly in certain regions of the country. This member cited as examples of this situation the growing number of cargo trains that are attacked every day, the increasing clandestine fuel supply lines, as well as the figures published by the National Electoral Institute (Instituto Nacional Electoral, INE) regarding the resignation of candidates running for election office to safeguard their lives and, in more dramatic although less frequent cases, the homicides of candidates during the electoral campaign. Also, that same member stated that in addition to the temporary uncertainty that is always associated with all election processes, which in itself involves an unfavorable environment for economic activity, there is another type of uncertainty that is not related to the election's results, but that runs deeper, is not limited in time, and that bears relation with the minimum regulatory effectiveness that is essential for economic and any other kind of development. The same member added that it is precisely this very effectiveness that is directly undermined by corruption, since the goal of the latter is to make regulation ineffective. In this context, another member highlighted that a determining factor of the lack of growth in the country's total factor productivity is the absence of the rule of law. The same member underlined that, to improve this situation, corruption and impunity should be fought since, in many cases, they represent the greatest threat in making property rights sustain a dynamic investment process. For this reason, this member emphasized that, although there are several channels that should be addressed to increase the level of investment and productivity in the economy, it is essential to respect and have a clear understanding of property rights.

All members of the Governing Board agreed that the downward trajectory followed by inflation can be, to a large extent, attributed to the monetary policy actions adopted by Banco de México. One member pointed out that these actions have allowed the economy to avoid second-round effects, originated by the shocks on certain prices, from taking place. Another member emphasized that, in Mexico, adopting a tighter and robust monetary policy has contributed to an orderly adjustment in the yield curve, the foreign exchange market and the other financial markets in Mexico. All members pointed out that the current monetary policy stance is consistent with annual headline inflation following a downward trend to its target. All members also mentioned that monetary policy has been implemented under an adverse and uncertain environment, and that several domestic and external factors still persist. For this reason, all members agreed that it is necessary to continue implementing a prudent monetary policy. All members also indicated that the Mexican economy could be affected by some shocks that could generate additional inflationary pressures in the following months. These shocks, all members pointed out, must be assessed and monitored. One member pointed out that the effects these shocks might have on the expected disinflation trajectory, within the horizon in which monetary policy operates, need to be considered. Some members mentioned the possibility of these shocks materializing simultaneously, and one of these members emphasizing that the covariance among different shocks could be possibly positive. One member noted that since some months ago, monetary policy has been implemented under conditions of higher-than-normal uncertainty, and that the latter has not faded as the key dates for certain risk factors have come nearer. The same member pointed out that some risks have even started to materialize. This member also pointed out that the events of recent weeks are an example of some of the challenges monetary policy could face in the following months. The same member also stated that some risks may worsen as other key dates approach, and that the implications for monetary policy under such a complex environment are clear: monetary policy must focus on attaining the convergence of inflation to its target, facing decisively any shock that might arise, and preserving the central bank's credibility through an approach emphasizing prudence, without disregarding its implications for economic activity. The same member stated that this could imply new upward adjustments to the reference interest rate, even in the near future. One member pointed out that given the highly uncertain environment, it is important that the monetary policy stance continues to contribute to an orderly adjustment of the Mexican financial markets, including the foreign exchange market. The same member pointed out that in the case the Mexican economy should face and adverse scenario that would require the real exchange rate to be adjusted, measures would need to be taken to prevent medium- and long-term inflation expectations from being affected and second-round effects on the price formation process from taking place. Finally, all members emphasized that it is important that monetary policy continues to contribute to the convergence of inflation to its target and to strengthen the anchoring of inflation expectations.

3. MONETARY POLICY DECISION

To guide its monetary policy actions, Banco de México's Governing Board closely follows the development of inflation vis-a-vis its anticipated trajectory, taking into account the monetary policy stance adopted and the horizon in which monetary policy operates, as well as available information on all inflation determinants and on medium- and long-term inflation expectations, including the balance of risks to such factors. Considering the latest information on these elements and that the current monetary policy stance is consistent with annual headline inflation following a downward trend to its target, Banco de México's Governing Board voted unanimously to keep the target for the overnight interbank interest rate unchanged at 7.50%.

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

4. VOTING

Members voting in favor of this decision: Alejandro Díaz de León-Carrillo, Roberto Del Cueto-Legaspi, Irene Espinosa-Cantellano, Javier Eduardo Guzmán-Calafell, and Manuel Ramos-Francia voted unanimously to keep the target rate unchanged at 7.50%.

ANNEX

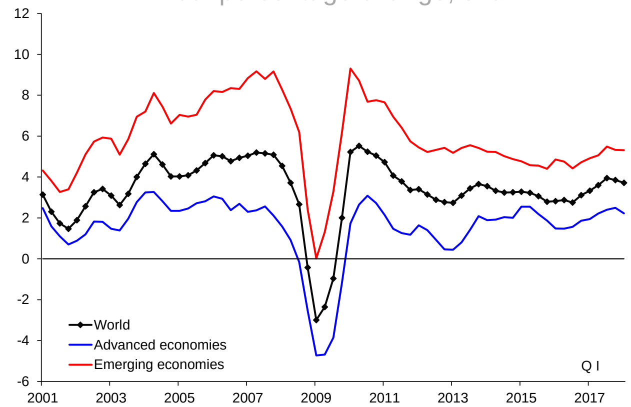
The information in this section was prepared for this meeting by the staff of Banco de México's General Directorate of Economic Research and General Directorate of Central Bank Operations. It does not necessarily reflect the considerations of the members of the Governing Board as to the monetary policy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

A.1. External conditions

A.1.1. World economic activity

During the first quarter of 2018, the world economy kept growing in a generalized manner, although at a more moderate pace, as compared to the last quarter of 2017 (Chart 1). The scenario for 2018 and 2019 continues suggesting a recovery of world economic activity, driven by an improvement in labor markets, a higher confidence by economic agents, and the effects of greater fiscal stimulus implemented in some of the major advanced economies. Nevertheless, in the medium and long terms, uncertainty and risks to global growth and financial stability have increased. These include the possibility of a sudden tightening in global financial conditions if monetary policy normalization in advanced economies occurs at a faster-than-expected pace, the adoption of protectionist actions on trade and investment, and that certain geopolitical events materialize. In the last weeks, the perception of greater risks has been reflected in increased international financial market volatility, affecting particularly those emerging market economies with greater macroeconomic imbalances.

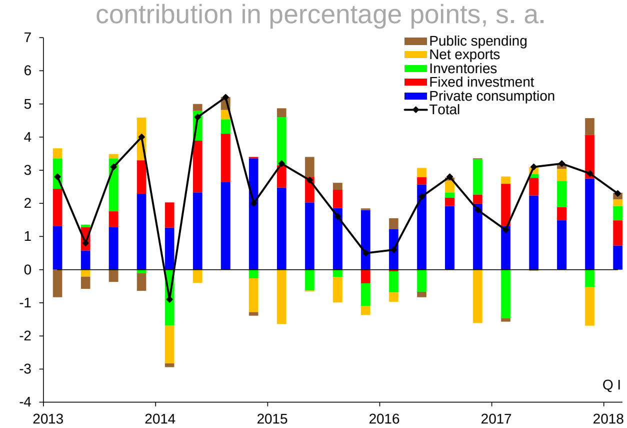
Chart 1
World GDP Growth
Annual percentage change, s. a.



s. a. / Seasonally adjusted data.
Calculations of Q1 2018 GDP are based on estimates of certain countries. The sample of countries used in the calculations accounts for 84.6% of world GDP measured by purchasing power parity.
Source: Prepared by Banco de México with information from Haver Analytics, J. P. Morgan, and International Monetary Fund.

U.S. economic activity expanded at an annualized rate of 2.3% in the first quarter of 2018, after having grown 2.9% in the previous quarter. The lower growth rate is mostly attributed to the slowdown in private consumption spending, which partly reflects the delay in tax reimbursements associated with the tax reform. Non-residential fixed investment grew at a solid rate, driven by a rebound in infrastructure investment, offsetting the downturn in equipment investment (Chart 2). It is worth mentioning that consumer and business confidence remain high and solid growth in economic activity is expected in the following quarters.

Chart 2
U.S.: Real GDP and Components
Annualized quarterly percentage change and contribution in percentage points, s. a.



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

U.S. industrial production grew at a monthly rate of 0.7% in April. This expansion was the result of the continuing recovery of electricity and gas supply, after weather conditions normalized following atypical warmer temperatures at the beginning of the year -which reduced the demand for heating- as well as the continuing strength in mining activities related to crude oil and gas extraction. Additionally, manufacturing expanded significantly in that month, mainly due to the strong growth in equipment production, which suggests that the slowdown of investment in this item during the first quarter of the year might have been transitory.

Most U.S. labor market indicators suggest that slack conditions have decreased significantly. The non-farm payroll increased by 200,000 jobs per month on average during the first four months of the year, as compared to the 177,000 jobs created per month on average during the same period of 2017. The unemployment rate dropped to 3.9% (its lowest level since April 2000), while other indicators, such as the difficulty to fill job vacancies, recruitment, and quit rates, remained at pre-crisis levels. In this context, wages grew at a faster rate.

In the Eurozone, GDP growth slowed considerably, from an annualized 2.7% rate in the fourth quarter of 2017 to 1.7% in the first quarter of 2018. This decrease was due to temporary factors, such as adverse weather conditions and labor strikes and, possibly, to a moderation in demand. In this environment, the unemployment rate remained at 8.5% in March, its lowest level since January 2009, while wages grew at a faster rate. Economic activity is expected to recover during the second quarter, driven by a higher household and business confidence, as well as by still accommodative lending conditions.

During the first quarter of 2018, U.K. economic activity grew at a slower rate than in the fourth quarter of 2017. This was partly due to the winter storms, which led to modest growth in manufacturing activities and to the contraction in construction. The latter offset the good performance of the mining industry, as well as of energy generation and distribution. The Purchasing Manager's Indices suggest that this economic weakness could continue in the second quarter of 2018.

Available indicators from Japan suggest that economic activity weakened during the first quarter of 2018, due to temporary climate-related factors and to the seasonal effects of the Lunar New Year. Particularly, these indicators point to a lower dynamism of consumption and residential investment. Nevertheless, the Purchasing Manager's Indices suggest that Japan's economy may recover in the second quarter.

Emerging economies continued to recover during the first quarter of 2018. Leading indicators suggest that this upward trend will continue for the remainder of the year. Nevertheless, while commodity-exporting economies could continue benefiting from the higher commodity prices, increased volatility in international financial markets could have an impact on countries with higher levels of indebtedness and significant external borrowing requirements. Additionally, the Asian region is expected to grow at a moderate rate, as a result of China's policy initiatives to ensure sustainable growth. Nevertheless, domestic and external demand indicators in that country point to a greater dynamism of the Chinese economy than was anticipated at the beginning of 2018. However, the escalation of economic tensions with the U.S. and its high level of indebtedness could limit its growth prospects for the next years.

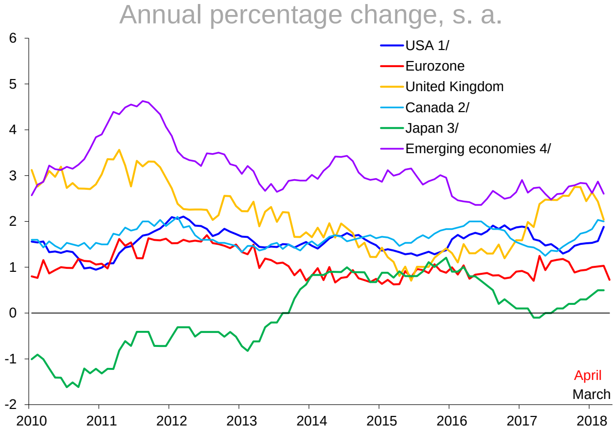
International commodity prices rose in the last weeks, driven by both the stronger demand for these goods and different supply factors. Crude oil prices continued to climb, in view of the reduction of Venezuela's oil production, the risk of restrictions being imposed on crude oil exports from Iran, and greater risks of an armed conflict in the region after the recent announcement of the U.S. withdrawal from the Iran nuclear deal. On another front, grain prices rebounded, in response to the adverse weather conditions prevailing in the U.S. Finally, the prices of industrial metals exhibited some volatility as a result of the changes in import tariffs imposed by the U.S. on aluminum and steel producers.

A.1.2. Monetary policy and international financial markets

The expansion of economic activity in advanced economies has started to be reflected in several of them in tighter labor markets and in a gradual increase in wages and inflation (Chart 3). In March, the U.S. personal consumption expenditure deflator attained the Federal Reserve's annual target of 2%. As for Japan and the Eurozone, inflation remained below their central banks' targets, although it is expected to gradually move closer to them.

Inflationary pressures recently eased in emerging economies. Inflation thus remains close to the central banks' targets in most countries, except for Argentina, the Philippines, Turkey, and Ukraine, where it remained above the target due to idiosyncratic factors.

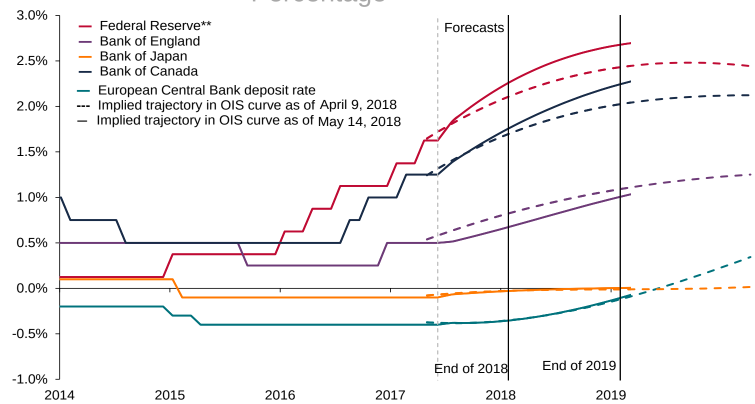
Chart 3
Core Inflation
Annual percentage change, s. a.



s. a. / Seasonally adjusted data.
1/ Corresponds to the personal consumption expenditure deflator.
2/ Average of the Bank of Canada's three most preferred core inflation indicators.
3/ Core inflation indicator preferred by the Bank of Japan. Excludes the effect of Japan's consumption tax.
4/ Average of 18 emerging economies, weighted by their share in the global economy and adjusted by purchasing power parity.
Source: Haver Analytics, BEA, Eurostat, and Statistics Bureau.

In this environment, the central banks of the major advanced economies are expected to continue shifting gradually towards a more neutral monetary policy stance, although the pace at which these institutions could adjust their monetary policies is expected to show a greater divergence (Chart 4). In contrast, conditions have been more heterogeneous in emerging economies. While many economies have continued to follow an accommodative policy stance (as reflected in their latest monetary policy statements), others like Turkey and Argentina raised their reference interest rates to cope with the greater financial instability.

Chart 4
Target rates and implied trajectory in OIS curves *
Percentage



*OIS: Fixed floating interest rate swap where the fixed interest rate is the effective overnight reference rate.
** The average interest rate of the federal funds target range was used to calculate the U.S. observed target rate (1.50%-1.75%).
Source: Bloomberg.

As expected, in its FOMC meeting of May, the Federal Reserve maintained the federal funds target range at between 1.5 and 1.75 percentage points. In its last monetary policy statement it pointed out that economic activity continued to grow at a moderate rate, the labor market strengthened, and that both headline and core inflation came close to the symmetric 2% target, while medium-term headline inflation is expected to remain at about 2%. In this regard, inflation expectations drawn from the federal funds rate futures imply an increase in the target rate of 25 basis points by June and of an additional 25 basis points by the end of the year. In contrast, private sector analysts consider a more rapid process of monetary policy normalization, forecasting three additional increases of 25 basis points before the end of 2018.

In its April meeting, the Bank of Canada left its policy interest rate unchanged at 1.25%, pointing out that, in its forecast horizon, the economy is expected to run above potential and inflation to be around its 2% target, despite the uncertainty that prevails over the trade policies of its main trading partners. The Bank of Canada is hence expected to tighten monetary conditions so that its target for the overnight rate reaches 1.75% at the end of the year.

In its April meeting, the European Central Bank (ECB) kept its monetary policy stance unchanged. The ECB also emphasized that reference rates will remain unchanged even after its asset purchase program has been completed in September. At this meeting, the ECB pointed out that the moderate rate of growth of economic activity during the first quarter of the year could have been influenced by temporary factors. Also, that although risks appear to be balanced, external ones have increased, particularly those related to the implementation of protectionist trade policies. Under this environment, the expectations for monetary policy remained practically unchanged. The ECB is thus expected to end its asset purchase program at the end of 2018 and begin its process of gradually normalizing its reference rate by mid-2019.

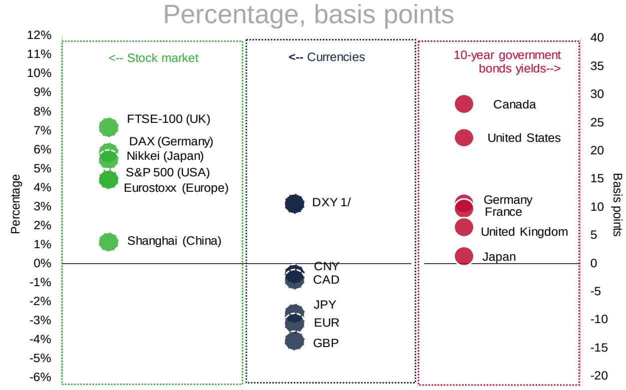
In its May meeting, the Bank of England kept its reference interest rate unchanged. This decision was not unanimous, since two members of the Monetary Policy Committee considered that a 25 basis point increase was needed to attain the inflation target. Nevertheless, this central bank considers that the inflation target will be reached sooner than expected, as a result of the faster-than-expected fading out of the pass-through effects of the weakening pound sterling on prices. In this regard, most Committee members considered that the risks of waiting in order to gather more information to evaluate whether the recent softening of economic activity is only temporary before making any decision to raise their reference interest rates are low. In this regard, market instruments incorporate only a 25 basis point increase in the reference rate for the second half of 2018.

In its April meeting, the Bank of Japan kept its short-term deposit rate, the long-term government bonds target rate, and the volume of its asset purchase program unchanged. In its quarterly Outlook Report, the Bank marginally raised its forecasts to growth and inflation, and eliminated the phrase stating that inflation was to reach its target in 2019.

The relative improvement in the U.S. economy and the consequent divergence between expectations on the pace of normalization of the Federal Reserve's monetary policy as compared to other central banks, contributed to both the strengthening of the US dollar vis-à-vis other currencies and to an increase in US Treasury bills interest rates, which reached their highest levels since 2008 for the 2-year rate, and their highest level since 2014 for the long term rates. The stock markets of most advanced economies partly reverted the losses incurred at the beginning of the year, supported by corporate reports that reflected higher yields than those expected by analysts (Chart 5).

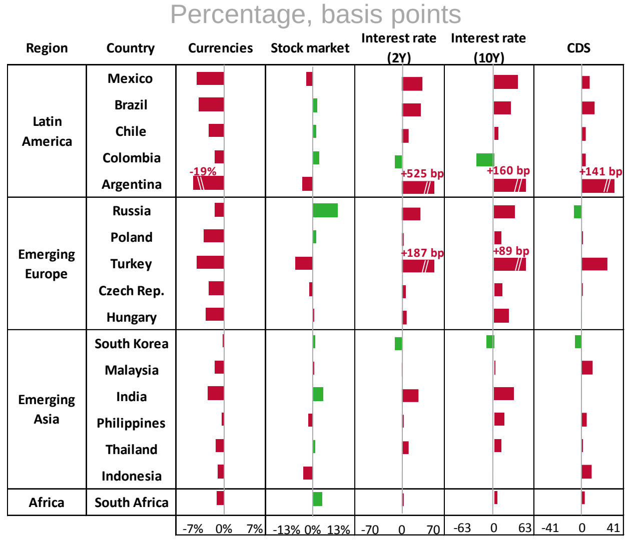
As for emerging economies' financial markets, capital flows to these economies moderated, while their currencies depreciated significantly. As a result, the central banks of Argentina, Brazil, Hungary, Indonesia, and Turkey intervened in their respective financial markets (Chart 6).

Chart 5
Change in selected financial indicators
(April 9 - May 14, 2018)
Percentage, basis points



1/ DXY: weighted average of the nominal exchange rates of the six main worldwide-traded currencies and their share: EUR: 57.6%, JPY: 13.6%, GBP: 11.9%, CAD: 9.1%, SEK: 4.2%, and CHF: 3.6%, calculated by Intercontinental Exchange (ICE).
Source: Bloomberg.

Chart 6
Performance of selected emerging market assets
(April 9, 2018 - May 14, 2018)
Percentage, basis points



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

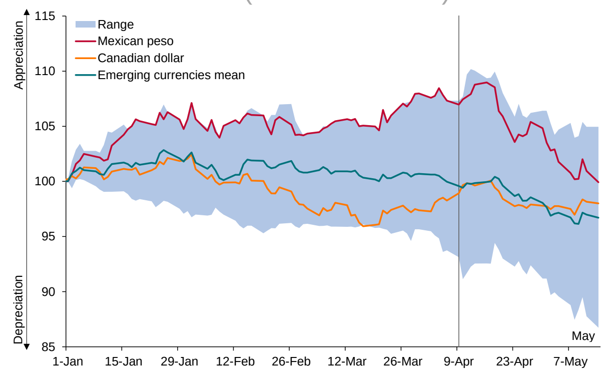
Looking ahead, given the escalation of a series of risk factors, a scenario of greater volatility in international financial markets cannot be ruled out. The first of these risks is that financial markets perceive monetary policy normalization in advanced economies taking place at a faster pace than expected, and thus generate sharp corrections in financial asset prices and limit emerging economies' financing sources. Second, the escalation of protectionist trade policies around the world could pose a risk for the expansionary trend of the current economic cycle. Third, the election processes that will take place in some emerging economies could be reflected in higher volatility in financial markets. Finally, the risks posed by geopolitical instability, the high level of indebtedness of private non-financial sectors in certain regions, and the high financial asset valuations continue to prevail.

A.2. Current situation of the Mexican economy

A.2.1. Mexican markets

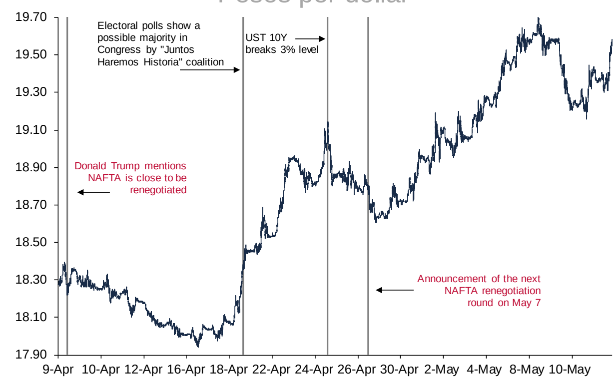
In the weeks after Banco de México's last monetary policy statement, the Mexican peso depreciated against the US dollar by around 6.5%, practically reverting all the appreciation exhibited throughout the year (Chart 7). This depreciation was due mainly to the generalized strength of the dollar against most developed and emerging market currencies. The peso also responded negatively to the uncertainty related to the North American Free Trade Agreement (NAFTA) renegotiations and, to a lower extent, to the political uncertainty that is traditionally generated by Mexican presidential elections (Chart 8). Under this scenario, Mexican foreign exchange operating conditions deteriorated moderately (Chart 9). It is worth mentioning that the implied volatility and skewness of Mexican peso/dollar options with 2-month or longer tenors remain at high levels, relative to the levels observed in other comparable currencies (Chart 10).

Chart 7
Accumulated index of selected emerging currencies and Mexican peso in 2018
Index (Dec 2017 = 100)



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

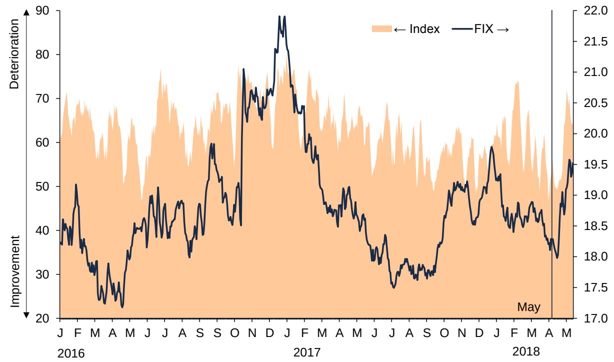
Chart 8
Mexican peso exchange rate
Pesos per dollar



Note: The period considered is from Banco de México's last monetary policy decision to date.
Source: Bloomberg.

Chart 9
Mexican foreign exchange market operating conditions index and peso-dollar exchange rate

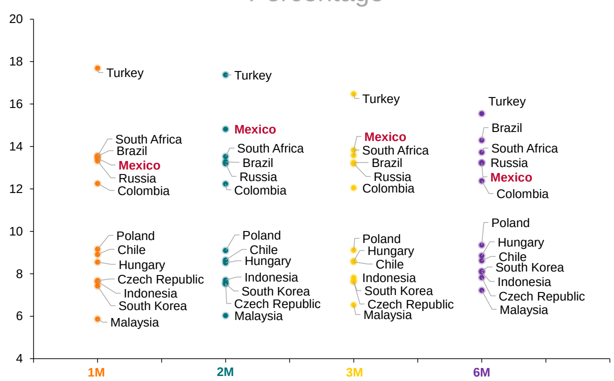
Index, pesos per dollar



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

Chart 10
Latest level of implied volatility in selected emerging currencies-USD options (different maturities)

Percentage



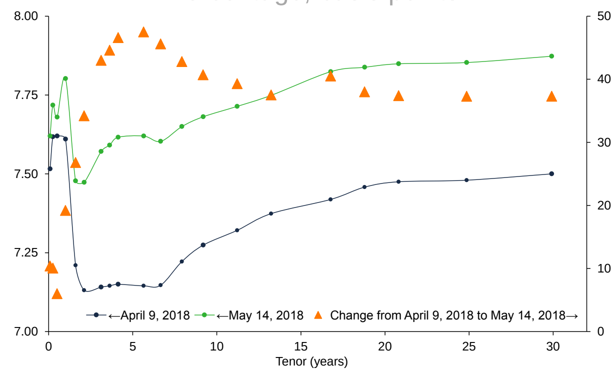
Source: Bloomberg.

Since the previous monetary policy statement, the yield curve of government securities showed a negative performance that resulted in generalized increases of up to 47 basis points (bps) (Chart 11), in an environment where Mexican fixed-income market-operating conditions also deteriorated moderately (Chart 12). Notwithstanding the above, there was an increase in non-resident investors' government bonds positions. Particularly, inflows were observed in practically all maturities over 3 years.

Finally, monetary policy target rate expectations implied in the interest rate swap yield curve anticipate a 25 bps increase in the reference rate during the second half of the year (Chart 13).

Chart 11
Government bond yield curve

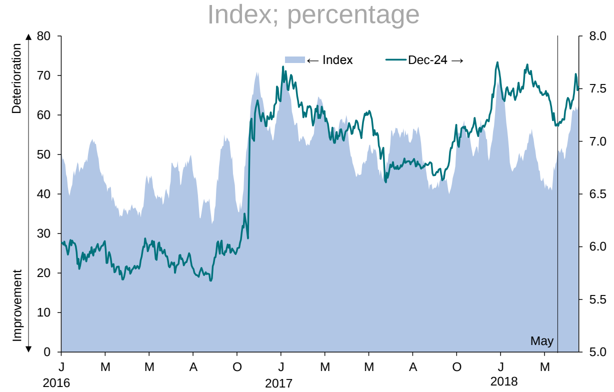
Percentage, basis points



Source: PIP.

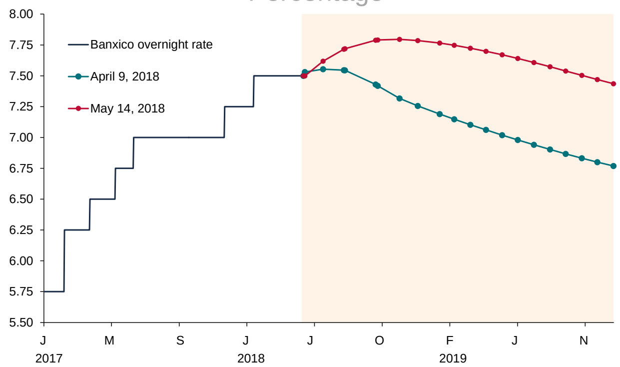
Chart 12
Mexican fixed-income market operating conditions index and interest rate of nominal bond maturing December 2024

Index; percentage



Note: Index calculated using the changes in intraday trading bond interest rates, trade volatility, bid-ask spread, average of differences between quotes, and the client and regular traded volume. With this data, the percentiles are then calculated since 2012, and the percentile daily average is used for each day. The black vertical line indicates Banco de Mexico's last monetary policy decision.
Source: Banco de México with data from Bloomberg, PIP, and brokerage firms.

Chart 13
Banxico overnight interest rate implied in 28-day TIIE IRS curve
Percentage

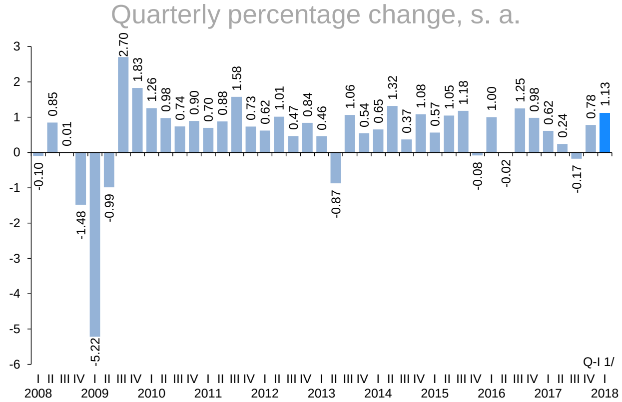


Source: Banco de México with PIP data.

A.2.2. Economic activity and determinants of inflation

According to INEGI's flash GDP estimate, economic activity continued to recover during the first quarter of 2018 (even growing at a higher rate than in the previous quarter), in contrast with the slowdown exhibited during the first three quarters of 2017 (Chart 14). Particularly, exports continued to show significant dynamism and private consumption expanded further, while investment displayed an uptick in growth between December 2017 and February 2018.

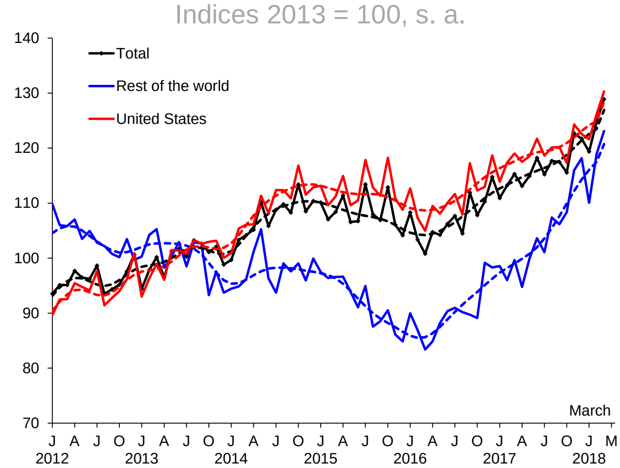
Chart 14
Gross Domestic Product
Quarterly percentage change, s. a.



s. a. / Seasonally adjusted figures.
1/ The figure corresponding to the first quarter of 2018 refers to the flash estimate of quarterly GDP released by INEGI.
Source: Mexico's National Accounts System (SCNM, for its acronym in Spanish), INEGI.

Manufacturing exports to the U.S. and to other countries continued to exhibit significant dynamism during the first quarter of 2018, consistent with world economic growth (Chart 15). These developments were reflected in both automobile and non-automobile exports. As for domestic demand, according to its monthly indicator, private consumption continued to expand during the first two months of 2018, albeit at a slower pace than in previous quarters. Latest timely indicators, although of less coverage, show heterogeneous outcomes. While revenues of retail stores exhibited an incipient recovery as compared to observed figures in most of 2017, the weakness of sales of light vehicles persisted. Moreover, from December 2017 to February 2018, investment recovered as compared to the stagnation it had been registering since the end of 2015. This recovery was mostly driven by the rebound in construction, mainly associated with the reconstruction efforts after the earthquakes in September and with some public infrastructure projects, as well as by the recent recovery of business spending on machinery and equipment.

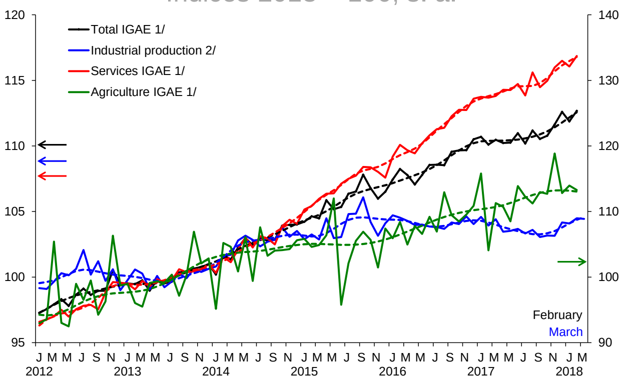
Chart 15
Total manufacturing exports
Indices 2013 = 100, s. a.



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

During the first quarter of 2018, on the production side, the expansion of economic activity reflected the dynamism of tertiary activities and the recovery of industrial activity vis-à-vis the negative trend it had exhibited during most of 2017 (Chart 16). Indeed, the upward trend in services continued at the beginning of 2018. Finance and insurance; real estate, rental and leasing; professional, scientific, and technical services; management of companies and enterprises; public administration; and, retail trade were the items that majorly contributed to this positive performance. As for industrial activity, the significant recovery of construction and the incipient rebound of manufacturing are noteworthy, as compared to the weak figures exhibited during most of 2017 (Chart 17). In contrast, mining continued on a negative trend, remaining at significantly low levels.

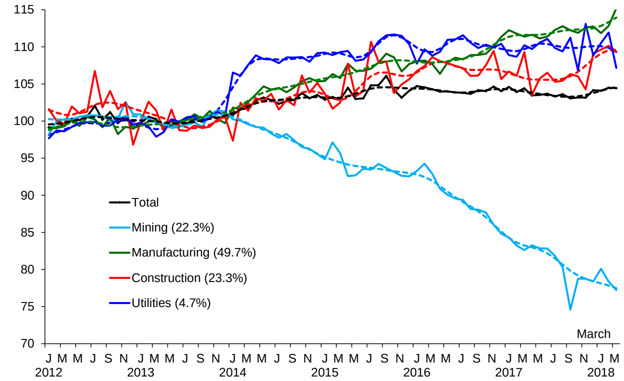
Chart 16
Economic Activity Indices
Indices 2013 = 100, s. a.



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

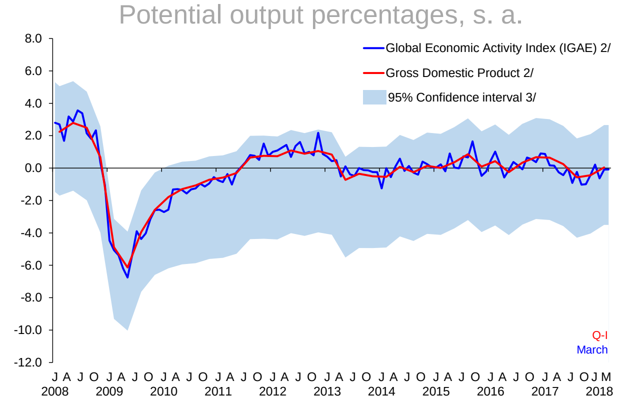
As to the cyclical position of the economy, i.e., the slack conditions and their role in the price formation process, several indicators, such as output gap estimates (excluding the oil sector), suggest that slack conditions at the beginning of 2018 remained tight. In particular, labor market conditions remained tight during the first quarter of 2018. National and urban unemployment rates remained at historically lows since the National Survey on Occupation and Employment (ENOE, for its acronym in Spanish) first started collecting data in 2005 (Chart 19). The number of IMSS-insured jobs continued on an upward trajectory. Nevertheless, according to available information up to the fourth quarter of 2017, developments in productivity and real average earnings caused overall labor costs to decrease further in real terms (Chart 20).

Chart 17
Industrial Activity
Indices 2013 = 100, s. a.



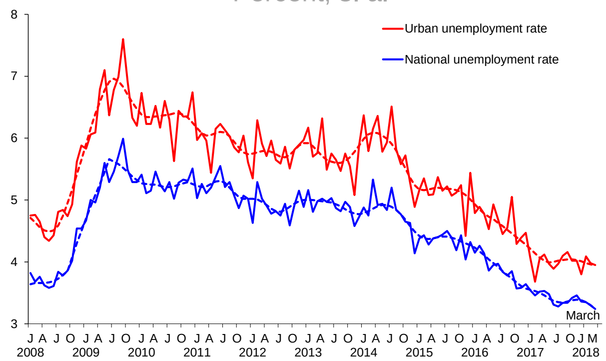
s.a./ Seasonally adjusted series and trend series. The former is represented by a solid line and the latter by a dotted line.
Source: Mexico's National Accounts System (SCNM, for its acronym in Spanish), INEGI.

Chart 18
Output Gap Estimates [1/]
Excluding Oil Industry [4/]
Potential output percentages, s. a.



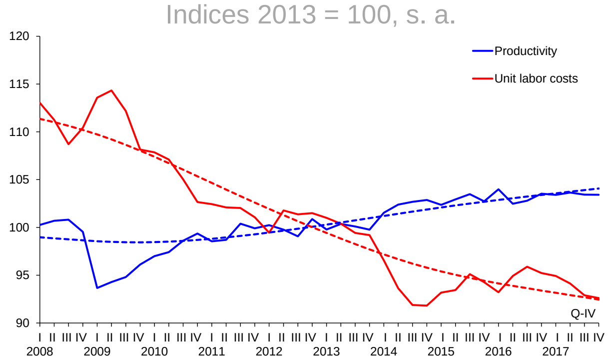
s. a. / Seasonally-adjusted figures.
1/ Output gap estimated with a tail-corrected Hodrick-Prescott filter; see Banco de México (2009), "Inflation Report (April-June 2009)", p.74.
2/ First quarter of 2018 GDP figures refer to INEGI's GDP flash estimate; IGAE implied figures for March 2018 are consistent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

Chart 19
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 20
Global Index of Labor Productivity (IGPLE, for its acronym in Spanish) and Unit Labor Costs[1/]
Indices 2013 = 100, s. a.



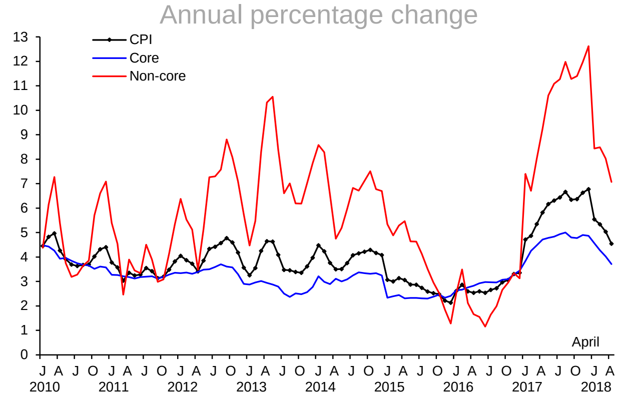
s. a. / Seasonally-adjusted and trend series. The former is represented by a solid line and the latter by a dotted line. Trend series estimated by Banco de México.
1/ Productivity based on hours worked.
Source: IGPLE published by INEGI. Unit labor costs prepared by Banco de México with figures from INEGI.

The real annual growth rate of domestic financing to the private non-financial sector picked up during the first quarter of 2018, as compared to the previous one. This outcome is mostly attributed to the dynamism of financing to large companies, since lending to small and medium companies (known in Mexico as PyMES, for their acronym in Spanish) continued to expand at a moderate pace. Household credit kept growing at low rates, although above those registered at the end of 2017. These developments took place in an environment where interest rates remained at levels higher than those observed on average in 2017, but without significant changes as compared to the fourth quarter of 2017. In general terms, delinquency rates remained at low and stable levels, except those related to consumer lending portfolio, which remained relatively high, although showing incipient signs of not deteriorating any further. Evidence therefore suggests that lending markets are not facing demand-related pressures.

A.2.3. Developments in inflation and inflation outlook

Annual headline inflation continued decreasing, from 5.04% in March 2018 to 4.55% in April, as a result of lower annual price variations in both its core and non-core components (Chart 21 and Table 1).

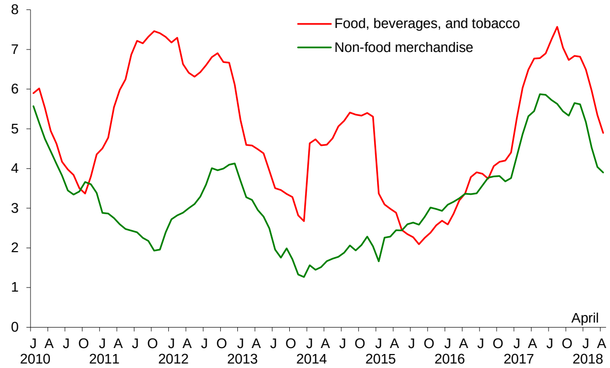
Chart 21
Consumer Price Index
Annual percentage change



Source: Banco de México and INEGI.

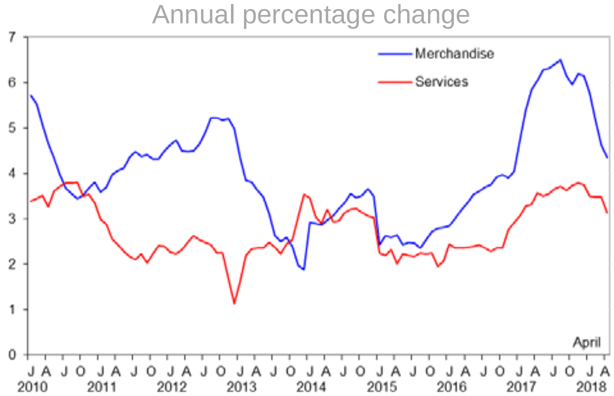
Specifically, annual core inflation dropped from 4.02% to 3.71% between March and April 2018. This outcome is explained by the monetary policy actions implemented by Banco de México, as well as the fading of the shocks that affected this indicator last year. The prices of food and non-food items continued to exhibit lower variation rates mainly due to the fluctuation of the exchange rate in previous months (Chart 22). As for the services price subindex, it has also been declining at an annual rate (Chart 23 and Table 1). The above is partly explained by the temporary price reductions in tourism services, as well as the lower increases in the prices of certain food-related services, as compared to 2017.

Chart 22
Merchandise Core Price Subindex
Annual percentage change



Source: Banco de México and INEGI.

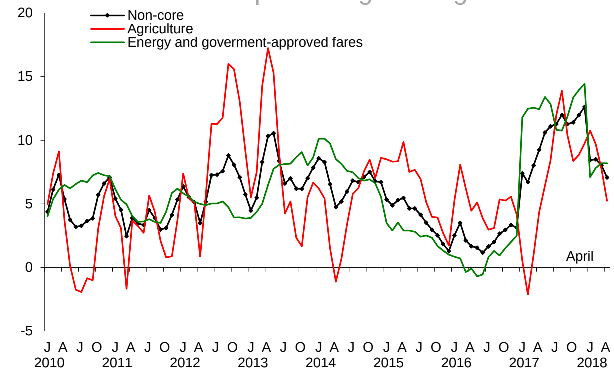
Chart 23
Merchandise and Services Core Price Subindex
Annual percentage change



Source: Banco de México and INEGI.

Annual non-core inflation registered 8.03% in March 2018 and then decreased to 7.07% in April. This result is mostly explained by the reduction in the prices of fruits and vegetables and LP gas, which were partially offset by increases in gasoline prices (Chart 24 and Table 1).

Chart 24
Non-core Price Subindex
Annual percentage change



Source: Banco de México and INEGI.

The medians for short-term inflation expectations from Banco de México's Survey of Private Sector Forecasters were adjusted downwards between March and April, in line with the recent inflation figures, which came in lower than was expected by analysts. Medians for headline inflation expectations for the end of 2018 and 2019, decreased from 4.09% to 3.98% and from 3.60% to 3.58% in the March and April surveys, respectively. In contrast, expectations for the following 12 months from these surveys, both relative to the month in which data is collected and to the subsequent month, were adjusted upwards, from 3.85% to 4.01% and from 3.89% to 3.98%, respectively. Furthermore, the medians for short- and long-term inflation expectations remained stable at around 3.5%. As for inflation expectations implied by the quoted market prices of long-term money market instruments (drawn from 10-year government bonds), they continued to remain at levels close to 3.5% in this period, while inflation risk premia decreased by around 10 basis points in the same period.

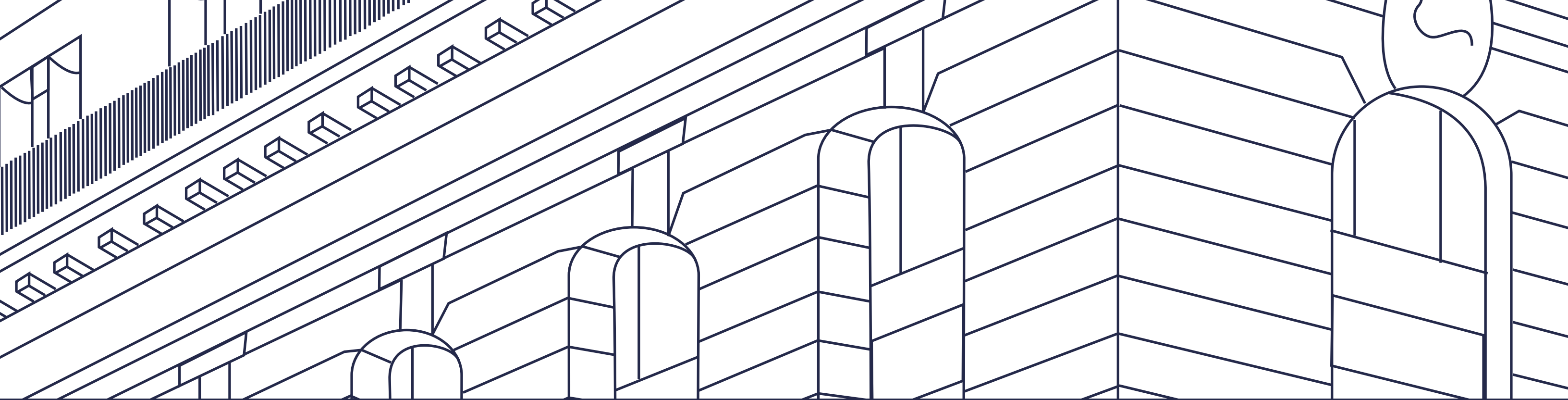
The decline in inflation in the first four months of 2018 is consistent with the forecasts presented by Banco de México in its October – December 2017 Quarterly Report. According to latest available information, and considering the current monetary policy stance and the horizon in which monetary policy operates, looking forward, inflation is expected to be in line with these forecasts. Such forecasts consider an orderly behavior of the exchange rate, an absence of labor market pressures, and non-core inflation continuing to decrease as expected for the remainder of 2018.

The abovementioned scenario is subject to risks and to a high level of uncertainty. The most important upward risks are that the peso exchange rate continues to be under pressure due to an environment of higher external interest rates and US dollar strength, and uncertainty associated with both the NAFTA renegotiation and Mexico's elections. The risk of additional shocks in agricultural product prices and upward pressures in the prices of certain energy goods prevails. Taking into account the cyclical conditions of the economy, the adjustment in unit labor costs could also have an upward impact on inflation. As for downward risks, there is the possibility of a potential peso appreciation as a result of a favorable outcome in the renegotiation of NAFTA. Considering the aforementioned, the balance of risks to inflation in relation to its expected path remains biased upwards, under conditions of significant uncertainty.

Table 1
Consumer Price Index and Components
Annual percentage change

Item	December 2017	February 2018	March 2018	April 2018
CPI	**6.77**	**5.34**	**5.04**	**4.55**
Core	**4.87**	**4.27**	**4.02**	**3.71**
Merchandise	**6.17**	**5.18**	**4.64**	**4.35**
Food, beverages, and tobacco	6.82	5.97	5.35	4.90
Non-food merchandise	5.62	4.53	4.04	3.90
Services	**3.76**	**3.49**	**3.49**	**3.15**
Housing	2.65	2.55	2.54	2.56
Education (tuitions)	4.74	4.83	4.84	4.84
Other services	4.63	4.06	4.07	3.24
Non-core	**12.62**	**8.49**	**8.03**	**7.07**
Agriculture	**9.75**	**9.69**	**7.74**	**5.24**
Fruits and vegetables	18.60	15.50	8.82	4.07
Meats, poultry, fish, and eggs	4.50	6.49	7.12	5.94
Energy and government-authorized prices	**14.44**	**7.81**	**8.19**	**8.18**
Energy goods	17.69	8.16	8.85	9.12
Government-authorized prices	8.36	7.08	6.85	6.36

Source: INEGI.



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