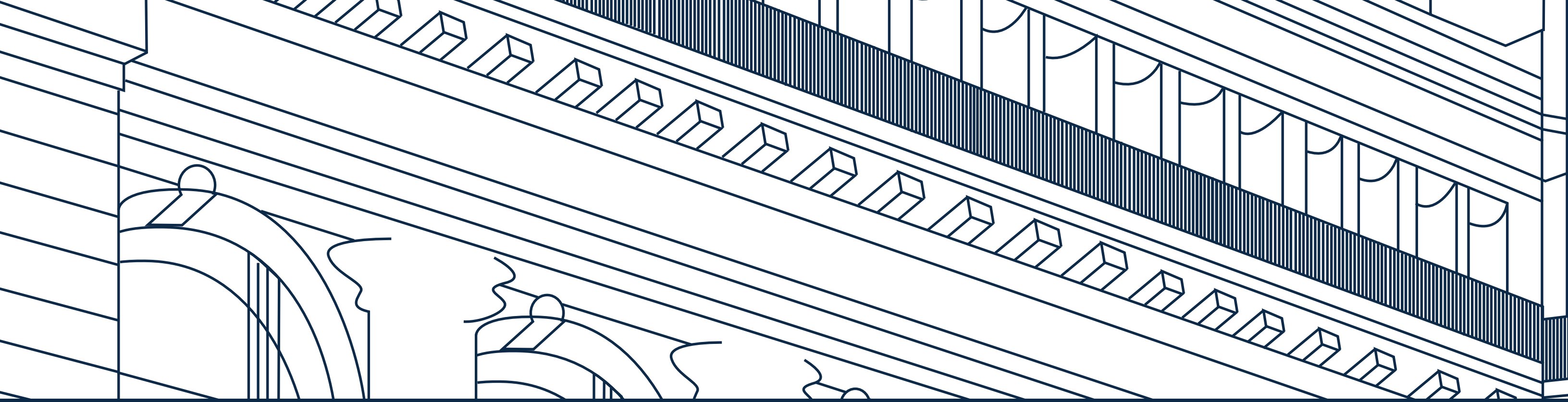

BANCO DE MÉXICO®

Minutes number 103

Meeting of Banco de México's Governing Board on the occasion of the monetary policy decision announced on September 28, 2023

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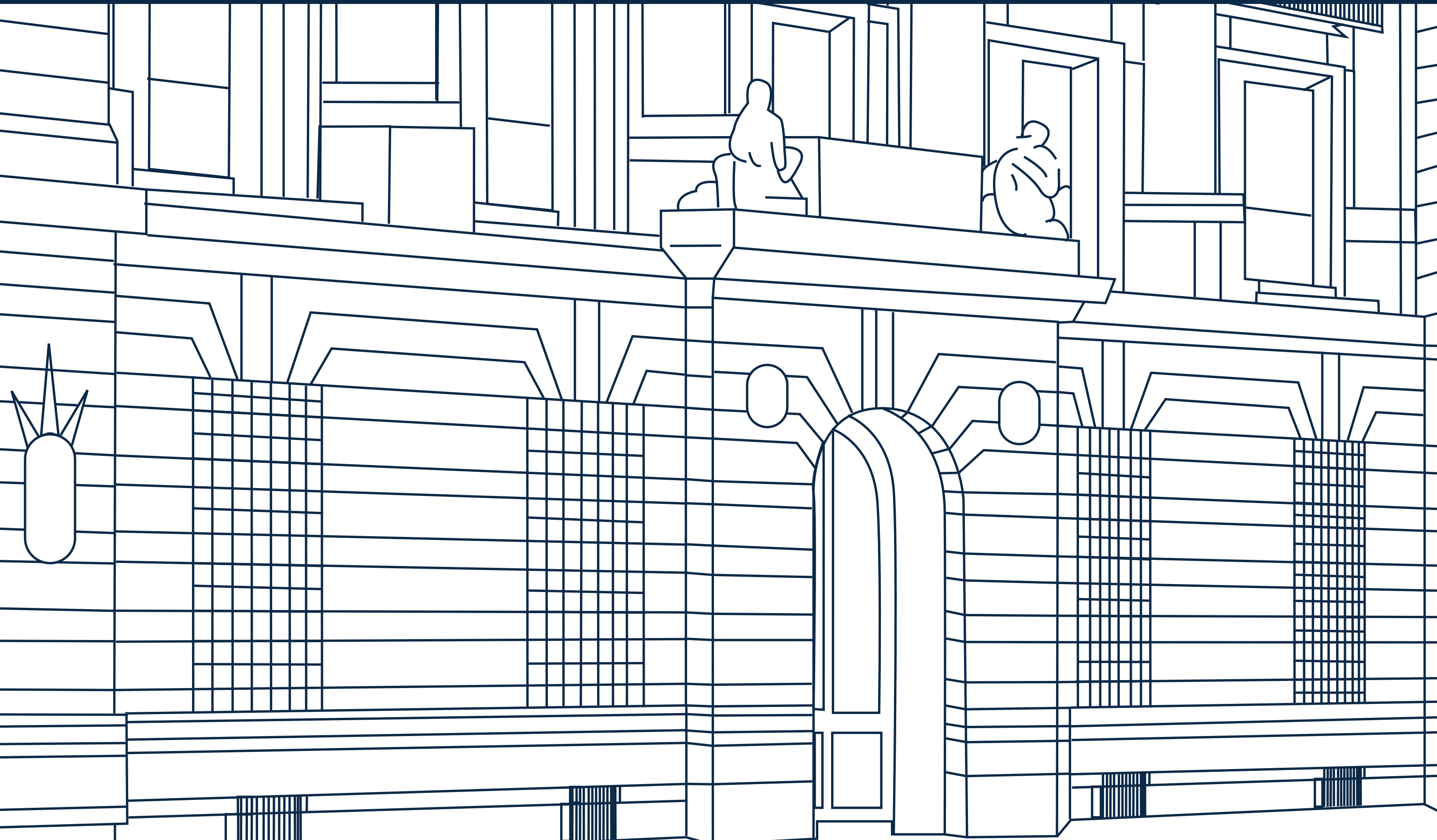

FOREWARNING
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1. PLACE, DATE AND PARTICIPANTS

1.1. Place: Meeting held by virtual means.

1.2. Date of Governing Board meeting: September 27, 2023.

1.3. Participants:

- Victoria Rodríguez, Governor.
- Galia Borja, Deputy Governor.
- Irene Espinosa, Deputy Governor.
- Jonathan Heath, Deputy Governor.
- Omar Mejía, Deputy Governor.
- Rogelio Eduardo Ramírez, Secretary of Finance and Public Credit.
- Eduardo Magallón, Alternate Secretary of the Governing Board.

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

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

International environment

Most members indicated that, so far in 2023, global economic activity has registered a higher-than-expected dynamism. However, they noted that economic growth has been heterogeneous across regions. In this regard, they contrasted the resilience of the US economy with the weakening of the euro area and Chinese economies. One member added that some emerging economies have slowed down. He/she mentioned that economic growth in several economies has not been reflected in a greater volume of international trade, due to the increase in trade restrictions in recent years. He/she considered that this could imply a shift in the sources of growth, given that domestic and regional determinants are gaining relevance.

Some members indicated that prospects for world growth imply a higher rate of expansion for 2023 as compared to previous forecasts. Nevertheless, **one** member recalled that a slowdown with respect to the previous year is still expected. **Another** member noted that leading indicators continue pointing towards weakness in manufacturing and, recently, to a deceleration in the services sector. He/she added that a moderation in the growth rate is also anticipated for 2024. In the case of the United States, **one** member pointed out that growth forecasts have been revised upwards considerably. **Some** members highlighted that the probability of a recession in the United States as estimated by analysts has diminished. However, **one** member warned that strikes in the automotive sector could deteriorate the sector's output and affect supply chains negatively. **In the case of China, most members pointed out that growth forecasts have been revised downwards. Some** members forewarned about the fragility of the real estate sector in that country. **One** member added that the deterioration of China's economic outlook has negatively affected the projections for other emerging economies with which it has strong trade links. Meanwhile, **another** member indicated that growth expectations for the euro area also decreased. **One** member mentioned that the balance of risks for global economic activity remains biased to the downside as a result of factors such as a greater-than-expected weakness of the Chinese economy and the effects of restrictive monetary policies.

Regarding labor markets, **some** members highlighted that these remain tight in several countries. However, **one** member noted that recent data point to a possible easing in some economies. **Another** member stated that there are mixed signals in the case of the United States. In this regard, **one** member mentioned that different indicators in that country point to a better supply-demand balance. He/she stated that, since the decline in the number of vacancies has not been accompanied by higher unemployment levels, it suggests that it is possible to maintain certain economic dynamism, consistent with a soft-landing scenario. He/she added that nominal wage growth has trended downwards in the United States, in contrast with the upward trend still observed in the euro area and in the United Kingdom. **Another** member considered that wage negotiations have intensified in some strategic industries, such as the automotive industry in the United States.

Most members highlighted that headline inflation continued decreasing in most economies, although it remains at high levels. Some members indicated that it continues being above the central banks' targets in a large number of economies. **Most members underlined that in some cases headline inflation has slightly rebounded. Some** members attributed the above to the increase in oil prices. Nevertheless, **some** members noted that the international prices of a number of commodities have decreased. **With regard to core inflation, most members stated that it continues showing resistance to decline. One** member emphasized that it remains high. **Some** members pointed out that, regarding its components, services' prices are still subject to significant pressures. **One** member considered that the slow decline of the core component generates uncertainty as to inflation's pace of convergence to the central banks' targets. **Another** member stated that, despite the signals indicating that monetary policy effects have been passed on to the labor market and the economy, the US Federal Reserve and the Bank of England currently foresee headline inflation converging to their targets towards the beginning of 2026 and 2025, respectively.

Among the risks to world inflation, most members mentioned the possibility of a surge in international commodity prices. One member highlighted that the global inflationary outlook has become more challenging, given that the risks for inflation's convergence to the targets have increased significantly. He/she stated that the above derives from higher global economic growth expected for 2023, tight labor markets, a greater persistence of core inflation, and the reversion of non-core inflation, which had been at historically low levels. **Another** member underlined that the international experience proves that the disinflationary process could be non-linear, given the challenges prevailing in the inflationary outlook.

Most members highlighted that, currently, central banks' actions are heterogeneous across economies. One member added that such heterogeneity has intensified given the differentiated evolution across economies. **Another** member stated that, insofar as inflation has declined, central banks' actions have tended to be more cautious, taking into consideration in each case the restriction already achieved, the monetary policy lags, as well as the specific conditions of each economy. **The majority pointed out that most central banks of advanced economies left their reference rates unchanged.** However, **one** member stated that some of them, such as the European Central Bank and the Central Bank of Norway, raised their reference rates. **Most members considered that the monetary authorities in advanced economies appear to be near the end of their hiking cycles. They highlighted that said institutions have strengthened the message that reference rates will remain high for an extended period. Some** members added that decreases are no longer anticipated to take place before the first quarter of 2024. **One** member mentioned that additional increases cannot be ruled out for the remainder of 2023. With regard to emerging economies, he/she specified that several central banks opted to keep their reference rates unchanged. However, **some** members pointed out that in certain cases they reduced their reference rate in view of concerns over the deceleration of economic activity. **One** member noted the reference rate cuts in Brazil, Chile and Peru.

All members mentioned that, in its September policy meeting, the US Federal Reserve left the target range for the federal funds rate unchanged. One member added that the chairman of that institution explained that subsequent actions will remain dependent on incoming data and that a further upward adjustment during the rest of 2023 cannot be ruled out. Likewise, **another** member noted that, based on the median projection for the federal funds rate of the members of the Federal Open Market Committee (FOMC), an additional increase in said rate is anticipated for the rest of the year. **One** member emphasized that expectations drawn from market instruments also imply that an additional increase at the end of the year is possible. **Most members highlighted that the median of FOMC projections for the end of 2024 and 2025 increased by 50 basis points with respect to the projections made in the June meeting. They underlined that the above reinforces the message that reference rates will remain at high levels for an extended period. One** member mentioned that, even prior to the Federal Reserve's latest monetary policy decision, both analysts and markets had already been revising upwards their expectations for the federal funds rate for 2024, given the economy's resilience and that inflation is still high in the United States.

In this context, most members stated that international financial markets registered volatility, that sovereign interest rates, mostly long-term ones, increased, and that the US dollar registered a generalized appreciation. Some members underlined that financial markets have shown high sensitivity to the release of economic figures. **One** member pointed out that this has occurred in response to data reinforcing the expectation of monetary policy rates remaining high for an extended period. **Another** member underlined that financial markets in emerging economies registered negative dynamics in terms of interest rates, exchange rates, and stock market indices. He/she mentioned that inflows to equity assets are still being observed in these markets, along with outflows from fixed-income assets.

Economic activity in Mexico

The majority noted that following the update of the base year of Mexico's System of National Accounts, the recovery of the economy after the initial shock of the pandemic has been more dynamic than previously estimated. They added that available information suggests the Mexican economy kept expanding during the third quarter of 2023. In this regard, **some** members considered that the Mexican economy continues showing resilience. **One** member pointed out that, with the expansion in the third quarter of 2023, the Mexican economy would have grown for eight consecutive quarters. Despite the above, **another** member stated that during the third quarter of the year, economic activity would have expanded at a slower pace than during the first half of 2023. **One** member considered that the Mexican economy is expected to continue showing resilience in the complex international environment and that risks remain balanced. He/she specified that, on the one hand, a greater nearshoring towards Mexico could provide a larger-than-expected boost to the Mexican economy. On the other hand, he/she stated that a significant slowdown in the US economy cannot be ruled out.

All members noted that consumption remained dynamic. One member pointed out that it is at historic highs**. Most members emphasized the high growth in services consumption.** Specifically, **one** member argued that this is largely explained by the normalization of households' spending patterns. However, **another** member noted that it shows some deceleration. **Most members also underlined the significant growth in the consumption of imported goods. One** member mentioned that it has been spurred by the exchange rate appreciation. However, he/she added that consumption of domestic goods is also expanding. With regard to the determinants of consumption, **some** members highlighted that consumer confidence remains at high levels. **One** member stated that the above, along with the wage bill and remittances, will sustain the dynamism of consumption for several months. Nevertheless, **another** member considered that, based on leading indicators, consumption growth is expected to moderate somewhat towards the second half of the year.

All members underlined that investment growth has received a strong impulse from spending on machinery and equipment as well as from non-residential construction. One member added that the latter has benefited from the nearshoring phenomenon. Regarding external demand, **some** members noted that automotive exports have trended upwards during the year. **One** member mentioned that this has offset the decline in the non-oil non-automotive balance and has allowed a reduction of the trade deficit with respect to 2022.

On the production side, considering information as of the second quarter and the beginning of the third one of 2023, most members underlined the heterogeneity in the components of industrial production and of services. One member mentioned that, based on timely indicators, over the last months, secondary and tertiary activities continued registering positive annual variations, although they showed some moderation. **The majority highlighted that industrial production continued expanding in July. They specified that it has been largely supported by civil engineering construction projects associated with the public sector infrastructure projects. Some** members underlined the sluggishness in manufacturing other than transport equipment. **One** member pointed out that such weakness would be in line with that observed in US manufacturing. **Some** members highlighted that transport equipment has offset the performance of the rest of the manufacturing sector. As for services, they noted that, from a medium-term perspective, this sector has shown dynamism after the economy's reopening process, while **one** member mentioned that growth in some of its segments has moderated.

Some members indicated that the output gap is in positive territory. **One** member added that, considering the new data for Mexico's national accounts, which reflects a faster recovery, and the greater boost to economic activity that is expected for 2024, the point estimate for the output gap has become slightly positive in the forecast horizon. Nevertheless, he/she stated that it is still not expected to be statistically different from zero.

All members pointed out that the labor market continues showing strength. Most members highlighted that the unemployment rate remained at historically low levels. One member underlined that the unemployment gap has become more negative since almost a year ago. **Some** members mentioned that an estimate of the non-occupied population who is available for employment has decreased significantly. **One** member pointed out that this has been particularly noticeable in the case of women. **Another** member added that this indicator is also at historically low levels. **Most members highlighted the behavior of the labor force participation rate. One** member pointed out that, based on July data, said rate has continued increasing. **Another** member asserted that it is at relatively high levels. **One** member noted that both labor participation and the underemployment rate are close to their historic averages. **Some** members underlined the dynamism of employment. **One** member emphasized that the creation of formal employment remains above its historic mean, although it appears to be decelerating. **Another** member mentioned that the labor informality rate remains high.

Most members stated that annual wage growth remains high. Some members highlighted that wages of IMSS-insured workers continue registering double-digit annual variations. However, **some** members mentioned that some measures of wage indicators have been slightly lower at the margin. **One** member considered that this deceleration could indicate a moderation in the strength of the labor market. Meanwhile, **another** member argued that wage revisions appear to maintain an inertia that is unlikely to decelerate rapidly, especially if the minimum wage is raised significantly. He/she warned that this issue is worsened by the increasingly noticeable shortages in both skilled and unskilled labor.

Inflation in Mexico

Most members mentioned that, since the last monetary policy decision, headline inflation continued decreasing and registered 4.44% in the first fortnight of September. One member stated that this is the lowest level since February 2021. **Another** member noted that, considering the latest readings, headline inflation has decreased by 426 basis points since its highest level registered in August 2022. **Some** members indicated that progress in the disinflation process has been reflected in a number of metrics. **One** member highlighted the following: i) a reduction in the share of CPI items with annualized monthly rates higher than 10%, which shifted from figures above 40% in 2022 down to 11.3% in the latest readings; ii) the frequency of price revisions, which, after having been at levels above their historical average in 2022, have been more in line with these averages in 2023; and iii) a significant fall in seasonally adjusted and annualized monthly price changes. Despite the important progress in the disinflationary process, **some** members forewarned that headline inflation is still at high levels.

Most members acknowledged that the non-core component has contributed the most to the decline in headline inflation. In this regard, **one** member emphasized that it has been good fortune, because the prices of this component do not respond to the monetary policy actions, and that it is highly likely that an upward trend of these prices will be observed. He/she added that, for that reason, it will be necessary to pay greater attention to the dynamics of the core component. **In that sense, most members pointed out that the downward incidence of the core component on headline inflation has increased in recent months. One** member mentioned that, at the margin, the fall in headline inflation is explained by the reduction in its core component, given that non-core inflation started to increase. **Another** member pointed out that the rates of reduction are heterogeneous among the various components of inflation.

Regarding core inflation, most members stated that, after the latest monetary policy meeting, it continued decreasing and registered 5.78% in the first fortnight of September. Some members highlighted that, considering the latest readings, this component has decreased by 273 basis points since it reached its highest level of 8.51% in November 2022. They noted that such decline shows the progress in the disinflation process. **One** member underlined that the percentage of the CPI items in the core consumption basket with annualized monthly rates above 10% has decreased significantly with respect to the figures registered in 2022. He/she added that the seasonally adjusted and annualized monthly rate of this component has decreased after having averaged 8.35% in 2022, so that it averaged 4.48% in the last three months.

Despite its decrease, most members emphasized that core inflation still remains at high levels. In addition, they highlighted that it shows persistence. In this regard, **one** member underlined that the seasonally adjusted and annualized monthly inflation has not managed to remain consistently below the upper limit of the variability interval and appears to begin reversing the downward trend it had been showing during this year. **Some** members argued that internal factors, such as the dynamism of domestic demand, have contributed to the persistence of core inflation. **One** member mentioned that the strength of the labor market has also contributed to said persistence.

Most members pointed out that merchandise inflation has decreased more significantly than services inflation. One member stated that it has recently declined from 7.82% in July 2023 to 6.35% in the first fortnight of September. **Another** member underlined that seasonally adjusted and annualized monthly changes of merchandise prices have decreased considerably in recent months. He/she added that the share of CPI items within the merchandise basket registering variations below or equal to 3% shifted from 18% at the beginning of the year to 40% in the latest figures. Regarding the components of merchandise inflation, **some** members stated that, in its latest readings, the annual variation of food merchandise prices decreased to 7.73%, while that of non-food merchandise prices declined to 4.74%. **Some** members argued that the easing of the shocks resulting from the pandemic and the geopolitical conflict in Ukraine, such as the normalization of supply chains and the fall in the international references of some commodities, has contributed to the decline in merchandise inflation. **One** member added that the exchange rate appreciation has contributed to the above process, as it has eased pressures on imported goods' prices, including intermediate and final goods. He/she stated that services inflation has also declined, but at a more gradual pace. He/she pointed out that it has recently decreased, from 5.24% in July to 5.08% in the first fortnight of September. Another member characterized this reduction as barely noticeable. **Some** members mentioned that the recent readings in services have turned out above projections.

Most members agreed that the gradual reduction in core inflation mainly reflects the persistent behavior of services inflation. They argued that the pass-through of higher costs stemming from the pandemic and the military conflict in Ukraine to services prices has been slow and characterized by lags. They explained that this has been due to the fact that the demand for services has been recovering gradually, after having contracted significantly at the beginning of the pandemic in the face of weak economic activity, the lockdown, and the change in households' consumption patterns. Some members stated that price increases in food and energy products, among others, have exerted pressure on services' operating costs. **One** member added that these costs also increased due to the implementation of sanitary measures, the adoption of technology to facilitate remote work, and the increase in real estate rental prices, among other factors. **Some** members noted that, contrary to this described behavior of services, in the case of merchandise, the cost pass-through was faster given the higher demand registered since the beginning of the pandemic. **Most members considered that the recovery in the demand for services is allowing a greater pass-through of accumulated costs, which would explain the persistence exhibited by this component. One** member stated that the dynamism of both the economy and the labor market is also contributing to the gradual decline in services inflation. However, he/she mentioned that, in his/her opinion, the resilience of economic activity explains the slow rate of decrease of this component, although not necessarily its high levels. He/she highlighted that this distinction is relevant for the conduction of monetary policy. Regarding the change in household consumption patterns, he/she pointed out that, according to the National Survey of Household Income and Expenditure (ENIGH, for its acronym in Spanish), the fraction of spending allocated to leisure and education decreased significantly between 2018 and 2020, and that by 2022 it had not yet fully recovered, and thus a normalization of these patters has probably still been observed during 2023. He/she acknowledged that there could be permanent changes in consumption patterns that are still difficult to identify. As a reflection of these factors, **some** members highlighted the case of educational services, whose biweekly inflation in the first half of September was the highest for an equivalent fortnight since 2008.

Most members noted that non-core inflation remained at particularly low levels, registering 0.48% during the first fortnight of September. However, **they pointed out that it rebounded slightly as compared to previous readings. One** member mentioned that this was due to increases in the annual variations of fruit and vegetable prices, as well as energy prices, particularly LP gas. He/she stated that these increases are largely attributed to the base effects that had already been anticipated.

Most members noted that longer-term inflation expectations remained relatively stable at levels above target. One member pointed out that they remain above their historical average. He/she added that, at the margin, inflation expectations for the end of 2023 slightly increased, while those for the end of 2024 slightly decreased. **Another** member underlined that, although the medians of expectations for all different horizons registered limited adjustments, improvements continued to be observed in the distribution of short-term expectations, as the share of analysts expecting a lower inflation increased. Regarding expectations drawn from market instruments, **one** member indicated that, since the last monetary policy decision, breakeven inflation increased. He/she added that this could imply higher inflation expectations for the short term, as well as a higher inflation risk premium.

Most members pointed out that forecasts for headline and core inflation have been revised upwards reflecting a more gradual decline than previously foreseen. All members mentioned that inflation is now projected to converge to the target in the second quarter of 2025. Most members highlighted that the adjustment in forecasts is primarily due to the expectation of a greater persistence in the services component, due to the accumulation of costs that have not yet been fully passed on to consumer prices. Some members noted that the forecasts consider a more resilient economic activity. **One** member added that pressures on core inflation are accompanied by the effects of higher economic growth, and an expansionary fiscal framework for 2024 not foreseen in previous projections.

All members considered that the inflationary outlook is still complex. One member stated that it cannot be ruled out that the effects of the shocks may dissipate more slowly than expected and that some inflation components may show fluctuations that interrupt or delay their downward trajectory. **All members agreed that the balance of risks for the foreseen trajectory of inflation within the forecast horizon remains biased to the upside. Some** members mentioned that, in their opinion, said balance has deteriorated since the last monetary policy decision. **One** member argued that, considering the new forecasted trajectory, the balance of risks for inflation has not deteriorated.

Among upside risks to inflation, all members highlighted the persistence of the core component at high levels. One member stated that the decline in this component could moderate once the base effects dissipate. He/she added that services prices could continue to be subject to pressures from cumulative costs. He/she noted that the favorable downward effects associated with the behavior of merchandise prices could be wearing off. **Some** members highlighted the risk of exchange rate depreciations in light of international financial volatility events. **One** member pointed out that periods of more severe exchange rate volatility than those observed recently cannot be ruled out, with greater and more lasting effects on the exchange rate, which could particularly affect merchandise prices. **Another** member argued that not only external factors but also internal ones could exert pressure on the Mexican peso. **Some** members stated that the expansion of the fiscal deficit for 2024 could represent additional inflationary pressures. **One** member highlighted some challenges ahead for public finances associated with: i) the fiscal adjustment required to achieve consolidation in 2025; ii) the rigidity of the expenditure structure; iii) the expectation of lower world growth in 2025; and iv) the reduction of fiscal space to increase spending on infrastructure. He/she argued that the latter is key to increase potential growth and take advantage of the nearshoring process. In addition, he/she stated that Pemex's situation is a cause of concern for the sustainability of public finances due to its dependence on federal resources.

Some members added as an upside risk to inflation the possibility of greater cost-related pressures. They considered that those from the labor market could be aggravated by the wage policy. **One** member pointed out that insecurity could also affect indirectly firms' operating costs. **Some** members noted the risk that the economy's resilience leads to a more gradual reduction in inflation than expected. In this regard, **one** member mentioned the increasing domestic demand pressures. **Another** member cautioned about higher global economic growth being an external factor that could also affect inflation dynamics in Mexico. **Some** members forewarned about the risk of pressures on energy or agricultural and livestock product prices due to geopolitical or climate-related events. **One** member highlighted the possibility of the increase in non-core inflation leading it to converge to levels similar to its historical values. He/she added that given the prevailing risks, medium and long-term inflation expectations could rebound. **Another** member stated that there is the risk of inflation stagnating above the variability range in 2024, given the increasing domestic pressures.

Macrofinancial environment

Regarding financing in the economy, **one** member noted that total financing maintained a moderate pace of growth. **Some** members pointed out that domestic financing also continued growing. **One** member stated that foreign financing decreased. **Most members mentioned that credit from commercial banks continued expanding. In particular, they highlighted the increase in credit**

to firms. Some members noted the increase in consumer credit. **Some** members stated that the dynamism of credit reflects the labor market's strength. **One** member mentioned that delinquency rates are at low and stable levels, although a marginal increase has been observed recently in credit card and payroll loans.

Most members stated that, since the last meeting, the Mexican peso traded in a wide range, exhibited volatility, and depreciated somewhat. They highlighted that this behavior was mainly due to global factors, in particular, to the expectation of a greater monetary tightening by the main central banks of advanced economies, such as the Federal Reserve. In this regard, **one** member noted that the volatility and depreciation of the Mexican peso were mainly associated with the generalized appreciation of the US dollar. **Most members pointed out that trading conditions in the foreign exchange market remained orderly.**

Some members asserted that, despite the depreciation, the Mexican peso remained stronger than during the first months of the year. **Some** members highlighted that the Mexican peso has shown resilience, due to the solid macroeconomic fundamentals and the monetary policy actions. **As for the behavior of the exchange rate, most members mentioned the announcement of the Foreign Exchange Commission regarding the reduction in the foreign exchange hedging program. They stated that, although the currency depreciated and registered volatility after the announcement, the reaction was brief. One** member added that analysts and traders reacted favorably to this announcement.

Most members noted that interest rates on government securities, mainly medium and long-term ones, increased, in line with the higher interest rates observed worldwide. One member highlighted that liquidity conditions in this market have not yet reached pre-pandemic levels. **Another** member pointed out that sovereign risk premia continued fluctuating within a narrow range, with recent increases mainly related to global factors. **One** member noted that the stock market performed negatively, mainly due to the communications sector. **Another** member noted that both markets as well as analysts are assigning a greater probability to the possibility that there are no changes to the reference rate until the beginning of 2024, and that likewise, expectations for interest rate cuts throughout the horizon have moderated.

Monetary policy

The Governing Board evaluated the magnitude and diversity of the inflationary shocks and their determinants, along with the evolution of medium- and long-term inflation expectations and the price formation process. It considered that, although progress in the disinflation process has been made, the outlook is still very complex. Based on the above, and taking into account the monetary policy stance already attained and the persistence of the shocks that the Mexican economy is facing, with the presence of all its members, the Board decided unanimously to maintain the target for the overnight interbank interest rate at 11.25%. With this decision, the monetary policy stance remains in the trajectory required for inflation to converge to its 3% target within the forecast horizon.

The Board will thoroughly monitor inflationary pressures as well as all factors that have an incidence on the foreseen path for inflation and its expectations. It estimates that the inflationary outlook will be complicated and uncertain throughout the entire forecast horizon, with upward risks. Thus, in order to achieve an orderly and sustained convergence of headline inflation to the 3% target, it considers that it will be necessary to maintain the reference rate at its current level for an extended period. The central bank reaffirms its commitment with its primary mandate and the need to continue its efforts to consolidate an environment of low and stable inflation.

One member argued that the monetary policy actions implemented, together with the dissipation of shocks, allowed the disinflation process to begin and advance in recent months. This occurred after the multiple deep and generalized shocks the world has undergone. He/she stated that monetary policy is operating through all its transmission channels. He/she underlined the role of the expectations and exchange rate channels. He/she pointed out that longer-term inflation expectations have remained stable and the Mexican peso has shown resilience, which has contributed to ease pressures on prices. He/she warned that, although inflation is decreasing, it is doing it from high levels and in an environment in which upward risks prevail. He/she mentioned that under these conditions, a prudent conduction of monetary policy has implied taking time to allow the achieved monetary stance to continue operating and evaluating the development of the inflationary outlook. He/she pointed out that under this cautious approach it is essential to analyze the information that is accumulating on the dynamics of shocks and their effects. He/she added that this is required to avoid reference rate cuts that are premature or implemented faster than necessary and, consequently, that could jeopardize the downward trajectory of inflation. Taking into account the above, he/she considered that the reference rate should remain at its current level for an extended period. He/she reflected on the fact that, although inflation figures are below the highest levels observed in the past year, they are still above the central bank's permanent target. He/she highlighted that this illustrates both the progress that has been made in disinflation, as well as the tasks that still need to be addressed. He/she stated that in subsequent meetings the Governing Board will remain attentive, as it has been doing, to the evolution of macroeconomic conditions, considering that the road ahead is still lengthy and is not exempt from risks. He/she noted that the more gradual decline in inflation that is now foreseen could imply that, looking ahead, the reference rate may need to be lowered more gradually, once the disinflationary process allows for such decreases. Finally, he/she reiterated that the priority when conducting monetary policy must continue to be lowering inflation and consolidating an environment of price stability in Mexico, in line with the central bank's mandate and for the benefit of the Mexican population.

Another member considered that the outlook for inflation has become more complex for the conduct of monetary policy, because of both a more adverse external environment and idiosyncratic factors. In this context, he/she expressed that it is essential to maintain the level of monetary restriction attained as long as more information and analyses are available to evaluate the need to implement additional adjustments in the monetary policy stance. He/she stated that the factors supporting the upward revision in inflation forecasts should be explained, and that the balance of risks for inflation has deteriorated in an environment of high uncertainty. He/she added that in view of the more complex outlook, forward guidance should highlight that a restrictive stance will be maintained for a more extended period than the previously foreseen. He/she reiterated that it is convenient to maintain the monetary stance in restrictive territory during the entire forecast horizon. He/she expressed that the fiscal package could generate pressures on aggregate demand. He/she added that if the fiscal consolidation process contemplated for 2025 is not achieved, given the challenges that this implies, the consequences for inflationary dynamics could be even greater for that year. He/she mentioned that in a scenario of greater pressures, it will be necessary to maintain the level of monetary restriction for an even longer period than that foreseen in the previous meeting and, going forward, expanding this policy stance could be required, either actively or passively. He/she added that the best course of action should be evaluated in case inflationary pressures materialize, with the aim to preserve price and financial stability.

One member stated that the current restrictive stance should be maintained for an extended period in order to ensure the convergence of inflation to its target, which is now foreseen for the second quarter of 2025. He/she highlighted that the disinflationary process faces domestic pressures from a tightening labor market and the dynamism of aggregate demand, in addition to the still uncertain effects of fiscal expansion. He/she emphasized that the lack of synchronization between the expansionary fiscal policy and a restrictive monetary policy, implies it is necessary to pay attention to: i) the possibility of offsetting the likely effects of this stimulus on aggregate demand; and ii) the possibility that the fiscal stance lasts longer than anticipated, if the fiscal balance reduction projected for 2025 is not of the expected magnitude. He/she considered that the materialization of these risks could require monetary restriction for a longer period. He/she added that the monetary cycle should continue focusing on domestic pressures, primarily on the core component, and remain unaffected by changes in the monetary policy stances of other countries. He/she pointed out that in order to address the risks to inflation and allow the restrictive stance to take full effect, its passive management must continue. He/she considered that, since the last reference rate increase, the decline in 12-month inflation expectations caused the real ex-ante rate to increase by almost 70 basis points. He/she pointed out that this passive management should continue until: i) core inflation improves beyond the marginal adjustments it has registered; ii) expectations of headline and core inflation for 2024 consolidate within the variability interval; and iii) the risk of economic overheating is mitigated. He/she considered that forward guidance should highlight that a restrictive stance will be maintained for an extended period. He/she indicated that the period in which the nominal interest rate remains fixed should last at least for the rest of the year, with the possibility of extending beyond the first quarter of 2024 if necessary. He/she expressed that the monetary policy statement should maintain the categorization of such period as "extended" and even "not yet defined", in order to contribute to the expectation that it is still not possible to accurately forecast the date of the beginning of reference rate cuts. He/she added that it should also be communicated that the period to reach a neutral stance is still beyond the forecast horizon. He/she concluded by stating that the increasing domestic risks call for strictly adhering to the primary mandate and, therefore, to a much more restrictive tone in communication.

Another member stated that the disinflationary process is still complex. He/she noted that various metrics point to a favorable downward trajectory for inflation, while different measures of inflation expectations continue improving. However, he/she mentioned that inflation's behavior over the forecast horizon still faces significant challenges. He/she pointed out that the forecasts had been adjusted upwards for six quarters, and convergence had been postponed for two. He/she mentioned that such revisions were attributable mainly to a worsening of the expected determinants of inflation, for which there are various sources of uncertainty that maintain the balance of risks biased to the upside. He/she highlighted that the dynamism of economic activity implies challenges for the monetary policy transmission mechanisms, given a highly dynamic labor market supporting the growth of credit and consumption, in addition to the normalization of expenditure patterns which has fostered a new adjustment of relative prices between merchandise and services, starting at high levels. Likewise, he/she pointed out that services prices are showing a larger pass-through of accumulated cost-related shocks, due to the greater demand they face, and that in those sectors in which costs have already decreased, market structures have facilitated the continuation of price increases. For this reason, he/she considered that, given the current environment of high uncertainty, the monetary policy stance should remain restrictive for an extended period in order to continue fostering conditions for inflation to return to its target. He/she pointed out that the real ex-ante short-term interest rate has continued to increase, that the real ex-post rate of new credit to firms could reach historically high levels, and that the real exchange rate continues working in favor of lower inflation. He/she considered that monetary conditions are at a sufficiently restrictive level, but that they require time to be adequately transmitted to the economy. He/she mentioned that while last year's environment of uncertainty required a risk management approach and forceful decision making, the current uncertainty is more associated with the speed at which inflation will converge to its target. He/she indicated that the monetary policy approach should remain prudent, cautious and gradual. He/she added that communication should highlight the need for certainty on the observed and expected determinants of inflation, in order to consolidate a trajectory for inflation towards its target, and comply with the central bank's constitutional mandate.

One member argued that, despite the advances in the disinflationary process, convergence has become slower and the main challenge continues to be the persistence of core inflation, especially that of services. In this regard, he/she highlighted that, given the weakness of demand that they faced, the pass-through of the increase in costs to services prices has been lower than for merchandise. Thus, some items of the services sector continue recovering from the effects of the changes in the consumption patterns, on top of which the dynamism of the labor market has also contributed to its persistence. Likewise, he/she emphasized the relevance of having communicated a prolonged pause and of continuing to be cautious with the stance that has been achieved, given the prevalence of the challenges in the inflationary front. In this regard, he/she highlighted that, on the one hand, the real ex-ante short-term interest rate is close to 350 basis points above the upper limit of the neutral range and, since September 2022, it has been in restrictive territory. He/she added that communication has been an important complementary tool that, without being too explicit, has allowed to convey the Governing Board's view of the inflation outlook to the markets. He/she pointed out that, under these two axes, the monetary policy stance is expected to continue operating through its different channels. He/she stated that monetary restriction has favored a recomposition in the holding of assets towards those of longer terms. He/she added that the Mexican peso has appreciated around 24% in real terms since the beginning of the hiking cycle. He/she pointed out that, although the nominal reference rate has remained unchanged since last May, there have been no reductions in long-term interest rates or an easing of financial conditions. He/she considered that this indicates that communication has contributed to avoid a premature easing of monetary conditions. He/she expressed that all of the above has helped inflation expectations to remain anchored and the adverse effects on their distribution to show improvements. Thus, in this period of pause, the real ex-ante interest rate has increased, and this passive tightening also allows to handle the various risks that prevail. He/she considered that, given the risks to inflation, it is pertinent to reaffirm that the reference rate will remain at its current level for an extended period. He/she stated that, in this way, the monetary policy stance will continue contributing to the disinflationary process consistent with the primary mandate of price stability.

3. MONETARY POLICY DECISION

The Governing Board evaluated the magnitude and diversity of the inflationary shocks and their determinants, along with the evolution of medium- and long-term inflation expectations and the price formation process. It considered that, although progress in the disinflation process has been made, the outlook is still very complex. Based on the above, and taking into account the monetary policy stance already attained and the persistence of the shocks that the Mexican economy is facing, with the presence of all its members, the Board decided unanimously to maintain the target for the overnight interbank interest rate at 11.25%. With this decision, the monetary policy stance remains in the trajectory required for inflation to converge to its 3% target within the forecast horizon.

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The Board will thoroughly monitor inflationary pressures as well as all factors that have an incidence on the foreseen path for inflation and its expectations. It estimates that the inflationary outlook will be complicated and uncertain throughout the entire forecast horizon, with upward risks. Thus, in order to achieve an orderly and sustained convergence of headline inflation to the 3% target, it considers that it will be necessary to maintain the reference rate at its current level for an extended period. The central bank reaffirms its commitment with its primary mandate and the need to continue its efforts to consolidate an environment of low and stable inflation.

4. VOTING

Victoria Rodríguez, Galia Borja, Irene Espinosa, Jonathan Heath, and Omar Mejía voted in favor of maintaining the target for the overnight interbank interest rate at 11.25%

ANNEX

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

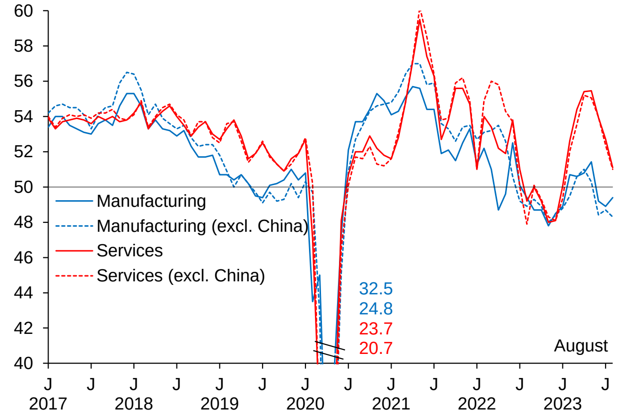
A.1. External conditions

A.1.1. World economic activity

Available indicators suggest that during the third quarter of 2023 global economic activity would have expanded at a slightly faster pace than in the previous quarter and above the rate anticipated at the beginning of this quarter. However, the different economies are expected to perform heterogeneously. Growth prospects for the United States have been revised upwards for the third quarter, while those for China have been revised downwards. Purchasing Managers' Indices point to a slowdown in services, mainly in advanced economies, and to a weakness in global manufacturing activity during the third quarter (Chart 1). Among global risks, the following stand out: persistence of inflationary pressures, intensification of geopolitical tensions, tighter financial conditions, and to a lesser extent, challenges to financial stability.

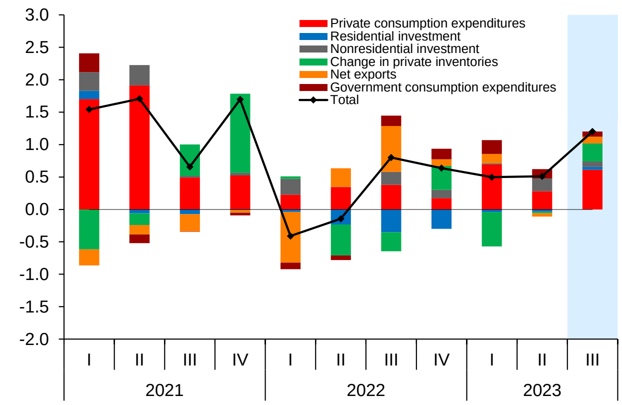
In the United States, Gross Domestic Product (GDP) is expected to have expanded during the third quarter, at a faster pace than the 0.5% seasonally adjusted quarterly rate registered during the second quarter.[1] Available indicators suggest that growth in the third quarter would have been mainly driven by private consumption, residential and non-residential investment, net exports, and inventory accumulation (Chart 2).

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



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

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



s. a./ Seasonally adjusted figures.
Note: The shaded area refers to the Atlanta Fed's GDPNow forecasts as of September 27.
Source: BEA and Federal Reserve Bank of Atlanta.

[1] Expressed as a seasonally adjusted annualized quarterly rate, the change in US GDP was 2.1% in the second quarter of 2023.

US industrial production expanded at a seasonally adjusted monthly rate of 0.4% in August, after having increased by 0.7% in July. The increase in August reflected progress in all of its components, with the 1.4% growth in mining production standing out. Manufacturing activity increased 0.1% as a result of growth in non-durable and durable goods. Purchasing Managers' Indices suggest that activity in the services sector slowed down and that manufacturing production remained somewhat sluggish.

The US labor market has remained tight, although some indicators have shown signs of moderation. The non-farm payroll continued expanding, albeit at a more moderate pace, from 201 thousand new jobs on average per month during the second quarter to 172 thousand new jobs on average per month in July and August. In recent months, new job creation figures have been subject to statistical revisions after their first release that have consistently modified the data to the downside. The vacancy rate remained at high levels, albeit with marginal declines in recent months. Initial claims for unemployment insurance remained at low levels. The unemployment rate rose from 3.5% in July to 3.8% in August.

In the euro area, economic activity is expected to have remained weak during the third quarter of 2023, after having grown at a seasonally adjusted quarterly rate of 0.1% in each of the previous two quarters.[2] The sluggish performance expected for the third quarter would be associated with a lower external demand, tighter domestic financial conditions, and lower residential and business investment. The services sector, which had been showing resilience, has lost dynamism. In July, the unemployment rate remained at the previous month's level of 6.4%.

Economic activity in major emerging economies is expected to have expanded during the third quarter of 2023. However, there are differences in the pace of quarterly growth between countries. In Europe and Emerging Asia, some countries are expected to be more dynamic, while others are expected to decelerate. In the case of China, although higher growth is expected during the third quarter compared to the previous one, this expectation has been revised downwards. In Latin America, economic activity is expected to have continued growing in most countries, except for Argentina and Brazil, which are foreseen to have contracted and stagnated, respectively.

International commodity prices registered a mixed behavior since Mexico's previous monetary policy decision. Crude oil reference prices continued trending upwards during most of the period. This was largely due to the extension of voluntary production cuts in Saudi Arabia and Russia until the end of the year and the fall in inventories in the United States. At the end of September, crude oil prices reached their highest levels so far in 2023. Meanwhile, natural gas reference prices in Europe exhibited high variability due to the risk of lower imports from Australia as a result of strikes by the oil industry workers in that country, as well as possible warmer temperatures for the end of the year. In the United States, natural gas reference prices decreased due to the expectation of lower demand for the upcoming winter. Grain prices fell overall due to an increase in wheat supply from Russia and prospects for higher corn production in the United States. Finally, industrial metals exhibited a mixed behavior, registering price increases between the end of August and the beginning of September. This was due to prospects of an expansion of the construction sector in emerging economies. Afterwards, prices fell in response to reports about the Chinese economy's weakness.

A.1.2. Monetary policy and international financial markets

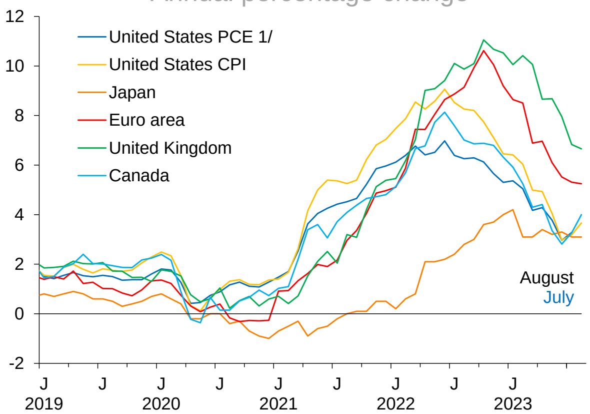
Headline inflation continued decreasing in most economies, although it remains at elevated levels. In most cases it continues being above the respective central banks' targets. Core inflation continues showing a resistance to decline.

In some advanced economies headline inflation rebounded slightly in its most recent reading (Chart 3). This was associated, in several cases, with greater pressures on energy prices. In turn, in most advanced economies, core inflation declined in its latest reading. Nevertheless, it has decreased at a slower pace than headline inflation. The gradual decline in core inflation has been partly associated with pressures on services prices. In the United States, annual headline inflation, measured by the consumer price index, increased from 3.2% in July to 3.7% in August, and still remains above the 2% inflation target. This result reflected a lower annual

[2] Expressed as a seasonally adjusted annualized quarterly rate, the change in euro area GDP was 0.5% in the second quarter and 0.3% in the first quarter of 2023.

deflation in energy prices that was partially offset by a decline in both food inflation and core inflation. The annual variation of core inflation went from 4.7 to 4.3% during the same period, as a result of a decline in the inflation of goods and, to a lesser extent, of services. US headline inflation measured by the personal consumption expenditures price index increased in annual terms from 3.0% in June to 3.3% in July. Annual core inflation went from 4.1 to 4.2% during the same period.

Chart 3
Selected Advanced Economies: Headline Inflation
Annual percentage change



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

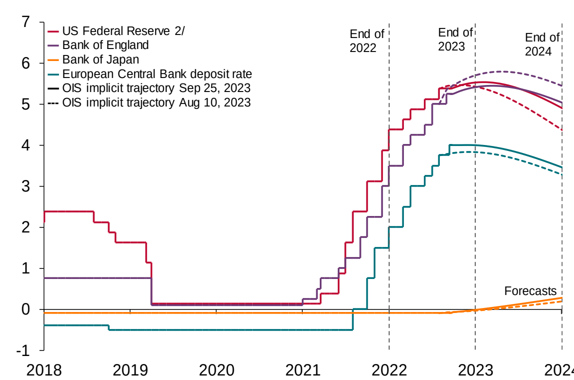
Analysts' short-term inflation forecasts for most major advanced economies remained relatively stable. Although these forecasts continued anticipating a moderation of headline inflation in 2023 from its levels in 2022, it would continue being above their central banks' targets. Longer-term inflation expectations for these economies derived from financial instruments showed relative stability with respect to the levels registered at the beginning of August.

In a large number of emerging economies, annual headline inflation decreased. However, in some of these economies, particularly in the Asian region, inflation rebounded in its latest reading. In most of them, inflation remains above their respective central banks' targets. In other cases, such as Brazil, South Africa, Thailand, Indonesia and China, annual headline inflation was within the central banks' variability interval or even below its point target. In the particular case of China, annual headline inflation remained at levels close to 0%. In most of the major emerging economies, core inflation gradually decreased.

In this environment, since Mexico's previous monetary policy decision, the central banks of the main advanced and emerging economies have made heterogeneous adjustments to their monetary policy reference rates, depending on the evolution of inflation and other economic indicators, which, in turn, have exhibited differences across countries. Regarding future adjustments, several central banks highlighted that these will depend on the evolution of relevant data and on the inflationary outlook.

Most central banks in the major advanced economies left their reference rates unchanged during the period since Banco de México's last decision. Moreover, several central banks expect them to remain at high levels for an extended period. In some cases, the decision to keep interest rates unchanged was announced after a series of consecutive hikes. As for their asset purchase programs, most central banks in this group of economies continued to gradually reduce their securities' holdings. Regarding expectations on the monetary policy rate, based on the latest available information for most of the major advanced economies, interest rates implicit in interest rate swap curves (OIS) are expected to remain at high levels for the rest of 2023 and during 2024. Expectations for the reference rate for the end of 2024 were revised slightly upwards, especially for the United States (Chart 4).

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



1/ OIS: Fixed floating interest rate swap where the fixed interest rate is associated with the effective overnight reference rate.
2/ For the observed reference rate of the US, the average interest rate of the target range of the federal funds rate (5.00%- 5.25%) is used.
Source: Banco de México with data from Bloomberg.

Regarding recent monetary policy decisions in the United States and the euro area, the following stand out:

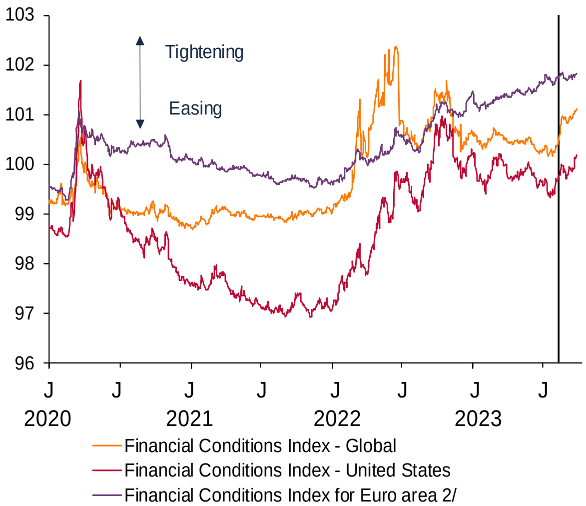
i) The US Federal Reserve left the target range for the federal funds rate unchanged at its September meeting, after raising it by 25 basis points (bps) in July. The target range thus remained between 5.25 and 5.50%. The Fed also continued to reduce the size of its balance sheet. It reiterated that it will continue evaluating incoming information and that, in order to determine the degree of additional tightening that might be appropriate, it will take into account the cumulative tightening of monetary policy, the lags with which it affects economic activity and inflation, as well as economic and financial developments. The chairman of that institution stated that he considers the current monetary policy stance to be restrictive and that it exerts downward pressure on economic activity, employment, and inflation. He also added that the economy is facing adverse effects from the tightening of credit conditions for households and businesses. He noted that, given the previous tightening, they would proceed with caution. He also stated that the Federal Reserve is prepared to raise rates further if appropriate and that it intends to keep monetary policy at a restrictive level until there is confidence that inflation is declining in a sustained manner towards its target. Regarding adjustments to the Federal Open Market Committee (FOMC) forecasts, between June and September the median of the annual growth rate was revised upwards from 1.0 to 2.1% for the fourth quarter of 2023 and from 1.1 to 1.5% for the fourth quarter of 2024, while remaining unchanged at 1.8% for the same period of 2025. Headline inflation forecasts increased from 3.2 to 3.3% for the end of 2023, remained at 2.5% for the end of 2024, and were adjusted from 2.1 to 2.2% for the end of 2025. As for core inflation, the median was modified downwards from 3.9 to 3.7% for the end of 2023, left unchanged at 2.6% for the end of 2024, and increased from 2.2 to 2.3% for the same period of 2025. The Committee did not change its expectation of 5.6% for the federal funds rate for the end of 2023. However, the expected level of the federal funds rate for the end of 2024 increased from 4.6 to 5.1%, and for the end of 2025, from 3.4 to 3.9%. This is relatively consistent with expectations drawn from financial instruments. Based on the latest available information, these anticipate that the reference rate will be raised up to around 5.6% during the first quarter of 2024, and then decrease to levels close to 5.0% by the end of that same year.

ii) The European Central Bank (ECB) maintained the pace of its reference rate hikes by announcing an increase of 25 bps in September. Its refinancing, key lending and key deposit rates thus stood at 4.50, 4.75 and 4.00%, respectively. In this regard, its Governing Council considers that interest rates have reached levels that, if maintained for a sufficiently long period, will contribute substantially to the timely return of inflation to its target. It also reiterated that its future decisions will ensure that the ECB's monetary policy rates are set at sufficiently restrictive levels for as long as necessary. It again stated that it will continue using a data-dependent approach to determine the appropriate level and duration of monetary tightening. The president of that institution indicated that she cannot affirm that interest rates are currently at peak.

Since Mexico's last monetary policy decision, in the main emerging economies, most central banks left their interest rates unchanged. However, considering the specific economic circumstances in these countries, some of them announced cuts, such as the central banks of Brazil, Chile, Peru, Poland, and China. The latter kept its interest rates unchanged in its most recent decision and subsequently reduced its reserve requirements to provide more liquidity to the economy. Meanwhile, the central banks of Russia, Thailand and Turkey continued raising their interest rates.

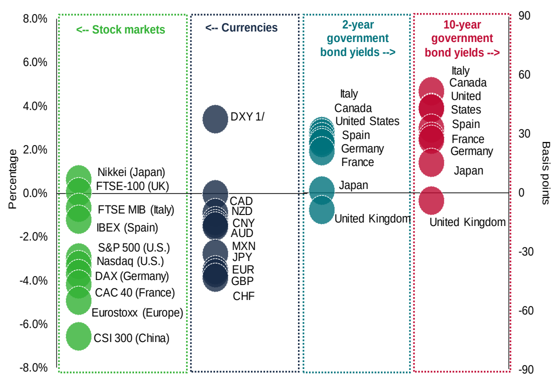
In this environment, international financial markets registered some increase in volatility and a tightening of financial conditions in August (Chart 5). This behavior was in response to concerns about the fiscal position in the United States and the expectation of a tighter monetary stance for a longer period, among other factors. Thus, sovereign debt interest rates rose globally, especially longer-term ones (Chart 6 and Chart 7). Stock markets in both advanced and emerging economies showed, in general, some losses. In the foreign exchange markets, the US dollar registered a generalized appreciation in the period being reported. Since Mexico's last monetary policy decision, the currencies of most of the major emerging economies depreciated against the US dollar. Cumulative net capital inflows to emerging economies were observed during the period. However, these flows exhibited a differentiated behavior among asset classes, with cumulative net inflows to equity assets and outflows from fixed-income assets.

Chart 5
Financial Conditions Indices[1/]
Units



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

Chart 6
Change in Selected Financial Indicators from August 10 to September 25, 2023
Percent; basis points



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

Chart 7
Selected Emerging Economies: Financial Assets Performance as of August 4, 2023
Percent, basis points

Region	Country	Currencies	Equity markets	Interest rates 2Y	Interest rates 10Y	CDS
Latin America	Mexico	-1.40%	-4.29%	83	77	17
	Brazil	-1.64%	-2.93%	20	64	9
	Chile	-5.58%	-7.41%	56	50	5
	Colombia	1.53%	-6.81%	53	99	18
	Peru	-1.68%	-4.29%	-4	11	8
Emerging Europe	Russia	-0.59%	-1.91%	478	380	N.D.
	Poland	-7.48%	-7.76%	-35	26	3
	Turkey	-0.90%	11.16%	878	516	-12
	Czech Rep.	-4.24%	-1.65%	23	51	0
	Hungary	-3.97%	2.12%	-110	-51	0
Asia	China	-1.92%	-5.25%	18	4	25
	Malaysia	-2.91%	-0.12%	4	10	6
	India	-0.37%	0.46%	9	-4	-9
	Philippines	-1.84%	-4.31%	-12	-1	12
	Thailand	-3.87%	-1.51%	29	52	6
	Indonesia	-1.52%	2.12%	23	42	12
Africa	South Africa	-1.63%	-4.63%	26	64	25

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

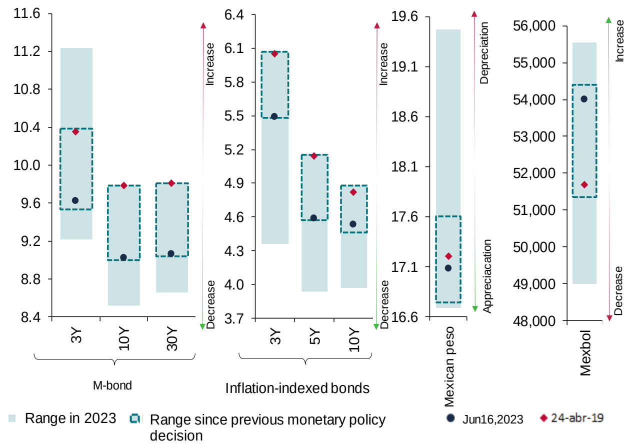
A.2. Current situation of the Mexican economy

A.2.1. Mexican markets

In the international context described above, since Mexico's last monetary policy decision, the Mexican peso has registered volatility and depreciated slightly against the US dollar. Interest rates on government securities, mainly those of medium and long terms, increased (Chart 8).

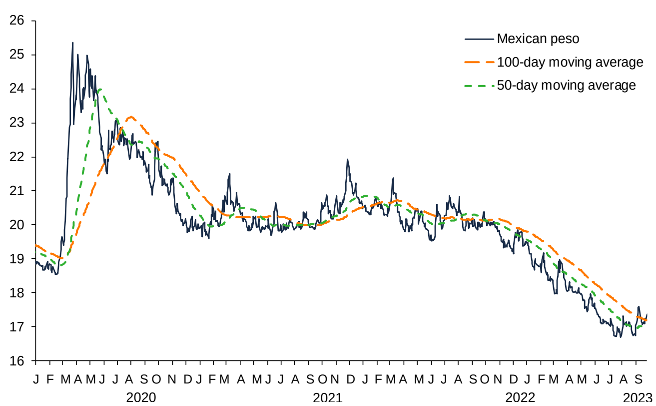
In greater detail, the Mexican peso traded in a range of 1 peso and 2 cents, between 16.69 and 17.71 pesos per US dollar since the last monetary policy decision. During the period, it depreciated by 1.40% (Chart 9), in a context in which trading conditions were stable for most of the period.

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



Source: Prepared by Banco de México.

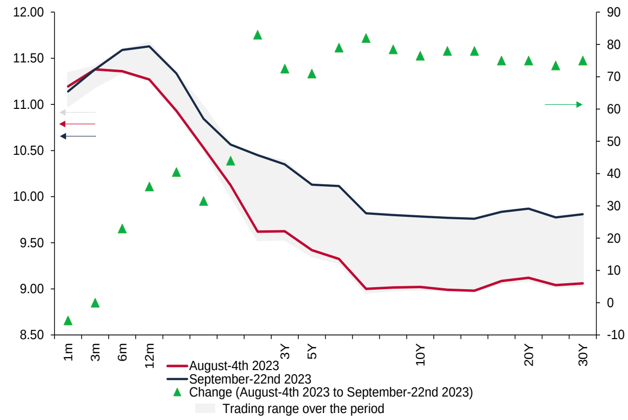
Chart 9
Mexican Peso Exchange Rate
MXN/USD



Source: Prepared by Banco de México.

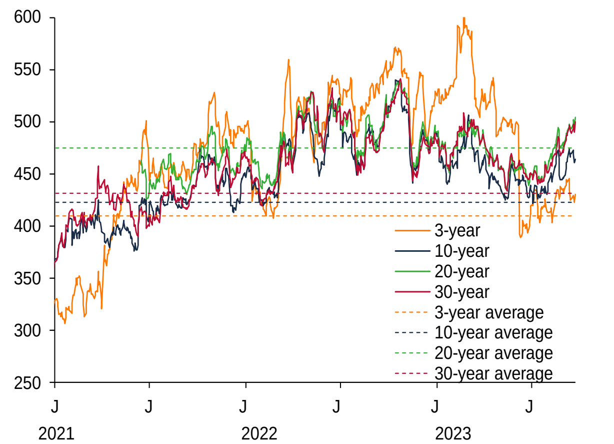
Interest rates on government securities registered negative dynamics, with increases of between 70 and 83 bps in the medium and long-term nodes, while increases of up to 30 bps in short term ones (Chart 10). The yield curve of real rate instruments exhibited generalized increases of up to 67 bps. In this context, breakeven inflation implicit in spreads between nominal and real rates of market instruments registered increases in all terms (Chart 11). These movements occurred in an environment in which trading conditions slightly deteriorated.

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



Source: PIP.

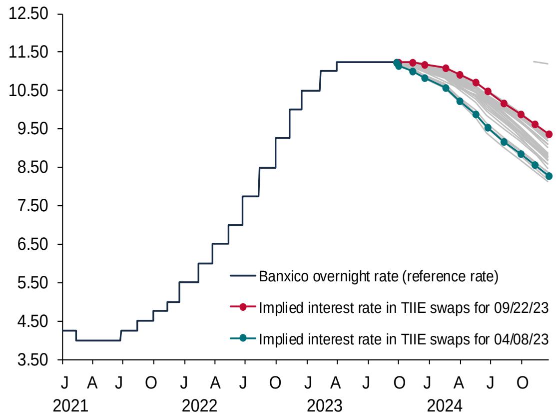
Chart 11
Breakeven Inflation and Inflation Risk Implied in Government Securities' Yields
Basis points



Fuente: PIP.

Regarding expectations for the path of the monetary policy reference rate, information implicit in the interest rate swap curve does not incorporate any adjustment for the September decision and includes a first cut of 25 bps between February and March 2024 (Chart 12). Most analysts surveyed by Citibanamex anticipate that the interest rate will remain unchanged in the September decision and then continue at the same level for the rest of 2023.

Chart 12
Interbank Funding Rate Implied in TIIE Swaps
Percent



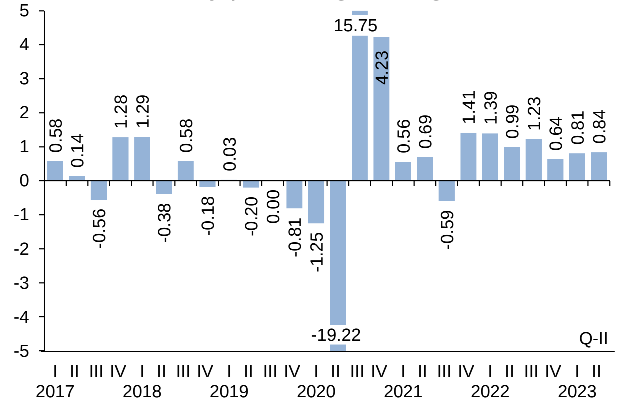
Note: Shaded areas represent the range since the last monetary policy decision.
Source: Prepared by Banco de México with Bloomberg data.

A.2.2. Economic activity in Mexico

During the second quarter, economic activity in Mexico continued showing resilience, growing at a similar pace to that of the previous quarter (Chart 13). Although available information for the third quarter is limited, productive activity is expected to have continued expanding during said quarter.

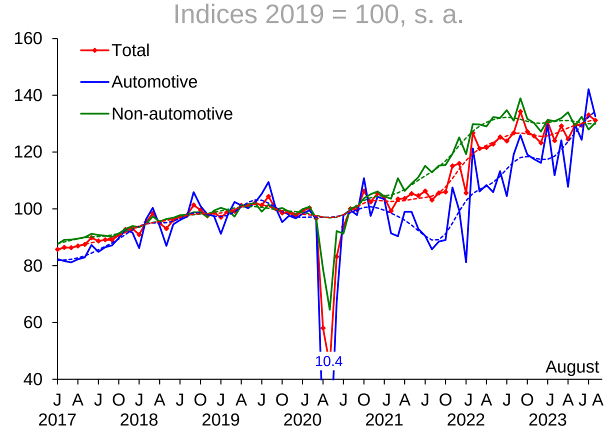
Regarding the evolution of domestic demand, at the end of the second quarter, private consumption continued trending upwards due to the dynamism of consumption of imported goods and the continued growth in the consumption of services. Gross fixed investment increased significantly as a result of considerable improvements in spending on imported machinery and equipment and, to a larger extent, in non-residential construction. As for external demand, in the period of July-August, the value of manufacturing exports grew as a result of a rebound in automotive exports (Chart 14).

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



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

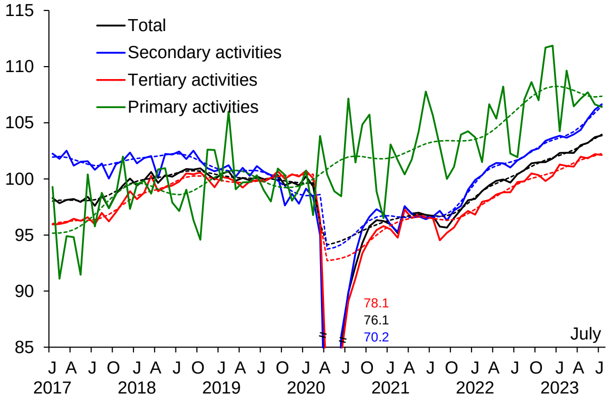
Chart 14
Manufacturing Exports
Indices 2019 = 100, s. a.



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

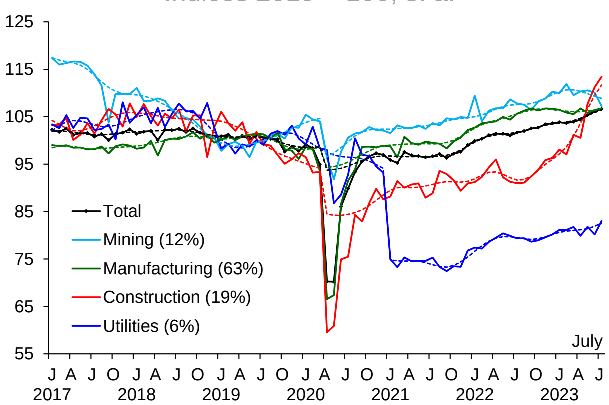
On the production side, economic activity remained resilient at the beginning of the third quarter (Chart 15). Particularly, industrial activity grew mainly as a result of the favorable evolution of construction (Chart 16). Transportation equipment manufacturing increased, although the aggregate for the rest of manufacturing continued showing weakness. Services decreased slightly at the margin, although they remained at elevated levels.

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



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

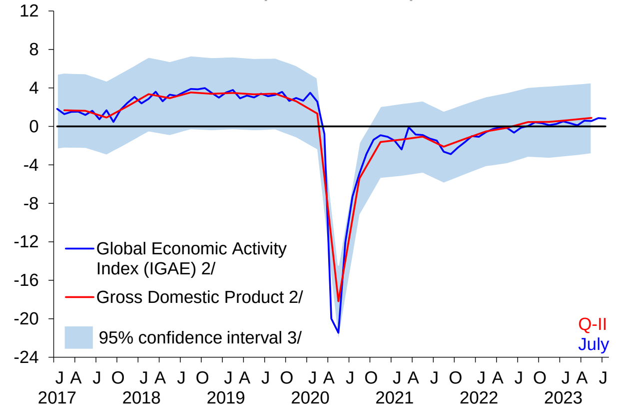
Chart 16
Industrial Activity 1/
Indices 2019 = 100, s. a.



s. a. / Seasonally adjusted and trend series. The former is represented by a solid line and the latter by a dotted line.
1/ Figures in parenthesis correspond to their share in the total in 2018.
Source: Mexico's System of National Accounts (SCNM, for its Spanish acronym), INEGI.

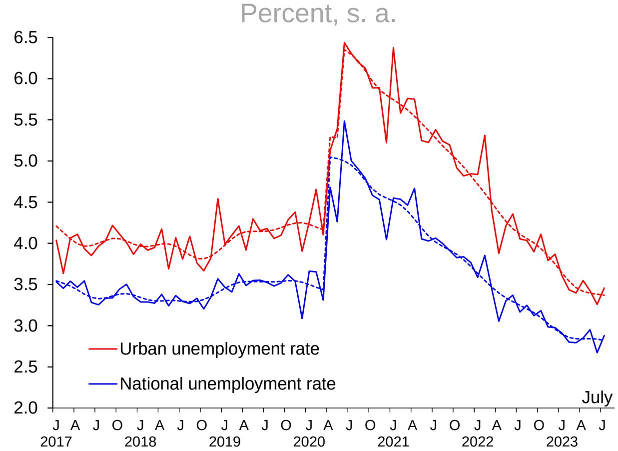
Regarding the cyclical position of the economy, the point estimate of the output gap during the second quarter of 2023 was close to zero (Chart 17). The labor market continued exhibiting strength. In July, both national and urban unemployment rates remained at low levels (Chart 18). With seasonally adjusted figures, in August, the creation of IMSS-insured jobs continued trending upwards. Finally, in July, unit labor costs in the manufacturing sector decreased for two consecutive months, although they remained at relatively high levels (Chart 19).

Chart 17
Output Gap Estimates 1/
Percent of potential output, 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 Q2-2023 and IGAE up to July 2023
3/ Output gap confidence interval calculated with a method of unobserved components.
Source: Prepared by Banco de México with INEGI data.

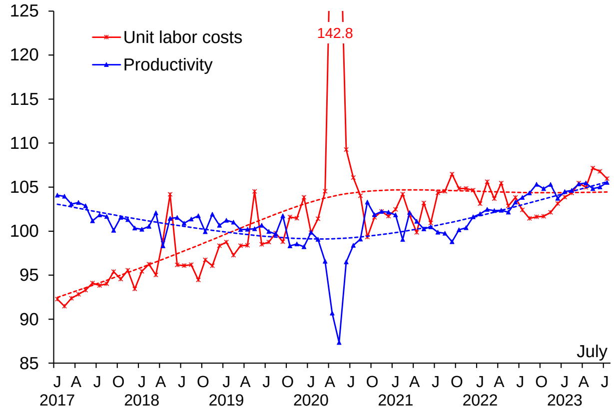
Chart 18
National and Urban Unemployment Rates
Percent, s. a.



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

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

Indices 2019 = 100, s. a.

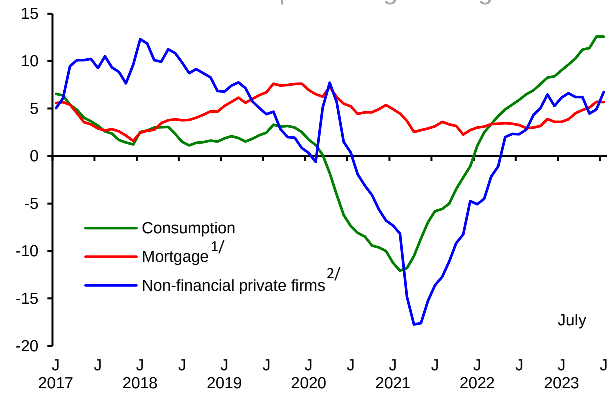


s. a. / Seasonally adjusted and trend series. The former is represented by a solid line and the latter by a dotted line. The range of the chart was narrowed to make it easier to read.
1/ Productivity based on hours worked.
Source: Prepared by Banco de México with seasonally adjusted data of the Monthly Manufacturing Industry Survey and industrial activity indicators of Mexico's System of National Accounts (Sistema de Cuentas Nacionales de México, SCNM), INEGI.

In July 2023, domestic financing to the private sector continued to expand. Within it, bank lending to firms rebounded, bringing its annual growth rate back to a level similar to that observed at the beginning of the year (Chart 20). As for lending to households, the bank housing portfolio continued registering an expansion, which has accelerated in recent months. Likewise, bank consumer credit continued growing at high rates, in line with the resilience of economic activity and the strength of the labor market.

Chart 20
Performing Credit from Commercial Banks to the Non-financial Private Sector

Real annual percentage change



1/ Adjusted to account for the withdrawal from and the incorporation of non-bank financial intermediaries to the credit statistics.
2/ Adjusted for valuation effects due to movements in the exchange rate.
Source: Banco de México.

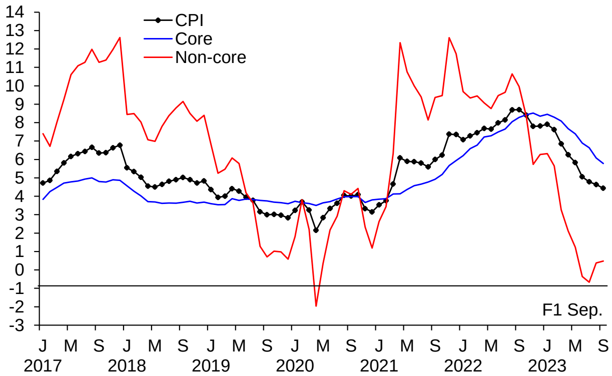
As for the cost of financing, interest rates on bank lending to firms remained stable in July 2023. Corporate credit intermediation margins continued to be generally lower than those observed prior to the pandemic. Interest rates on mortgages did not register significant changes with respect to June, and continued being at levels similar to pre-pandemic ones. Within consumer credit, credit card interest rates have been adjusting to changes in the reference rate, to a greater extent than what was observed until June 2022. Lastly, interest rates on payroll loans have remained relatively stable since August 2021.

As for portfolio quality, corporate and mortgage delinquency rates remained stable in July 2023 with respect to those observed in June, and thus continued at low levels. Finally, consumer portfolio delinquency rates increased for the third consecutive month, although they remain below pre-pandemic levels.

A.2.3. Development of inflation and inflation outlook

Between July and the first half of September 2023, annual headline inflation decreased from 4.79 to 4.44%. This result reflected the reduction in core inflation, which more than offset the increase in non-core inflation (Chart 21 and Table 1).

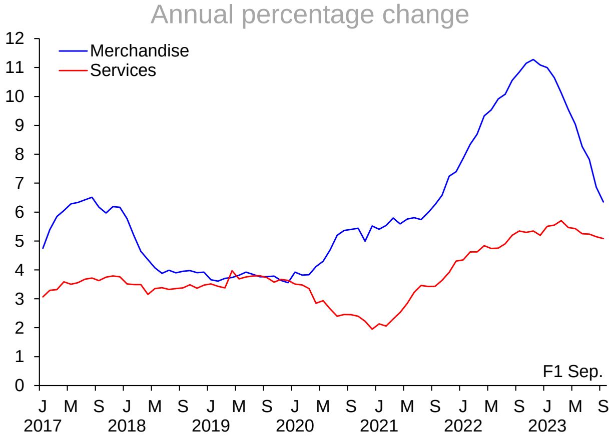
Chart 21
Consumer Price Index
Annual percentage change



Source: INEGI.

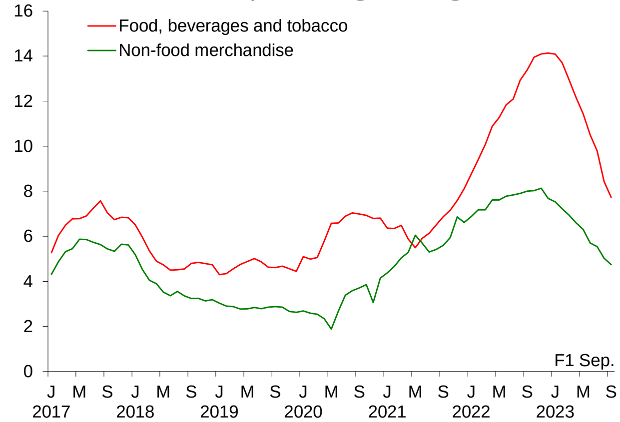
Annual core inflation decreased from 6.64 to 5.78% between July and the first fortnight of September 2023. Within it, both merchandise and services inflation decreased (Chart 22). In the former case, it went from 7.82 to 6.35%, due to a decrease from 9.79 to 7.73% in the annual inflation of food merchandises and from 5.54 to 4.74% in that of non-food merchandises (Chart 23). As for services, their annual inflation decreased from 5.24 to 5.08% during the same period, influenced by the lower annual inflation of services other than education, which went from 5.27 to 4.92%. In contrast, annual inflation of education services rose from 4.92 to 6.58%.

Chart 22
Merchandise and Services Core Price Subindex
Annual percentage change



Source: INEGI.

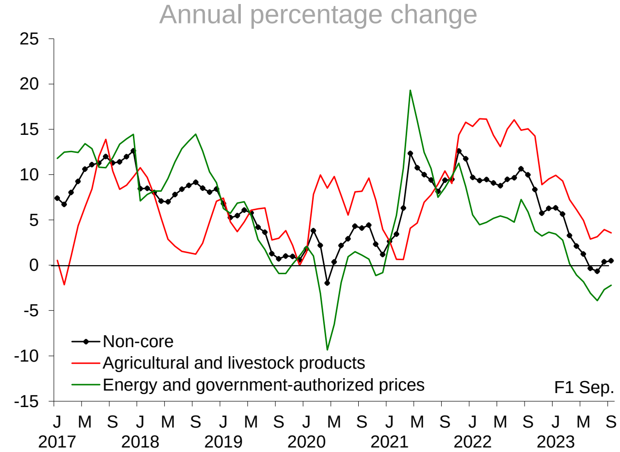
Chart 23
Merchandise Core Price Subindex
Annual percentage change



Source: INEGI.

After registering -0.67% in July 2023, annual non-core inflation increased in the first fortnight of September 2023, although it remained at atypically low levels, laying at 0.48% in said fortnight (Chart 24 and Table 1). This performance was mainly associated with an increase from -7.82 to -5.30% in the annual inflation of energy, as a result of the higher annual variation of L.P. gas prices, which, although remaining negative, rose from -34.87 to -28.18%. The increase in annual non-core inflation during the referred period was also influenced by an increase from 3.16 to 3.57% in the annual inflation of livestock and agricultural products, which was driven by the higher annual variations in the prices of fruits and vegetables and of livestock products.

Chart 24
Non-core Price Sub-index
Annual percentage change



Source: INEGI.

Regarding inflation expectations drawn from the survey conducted by Banco de México among private sector specialists, between July and August

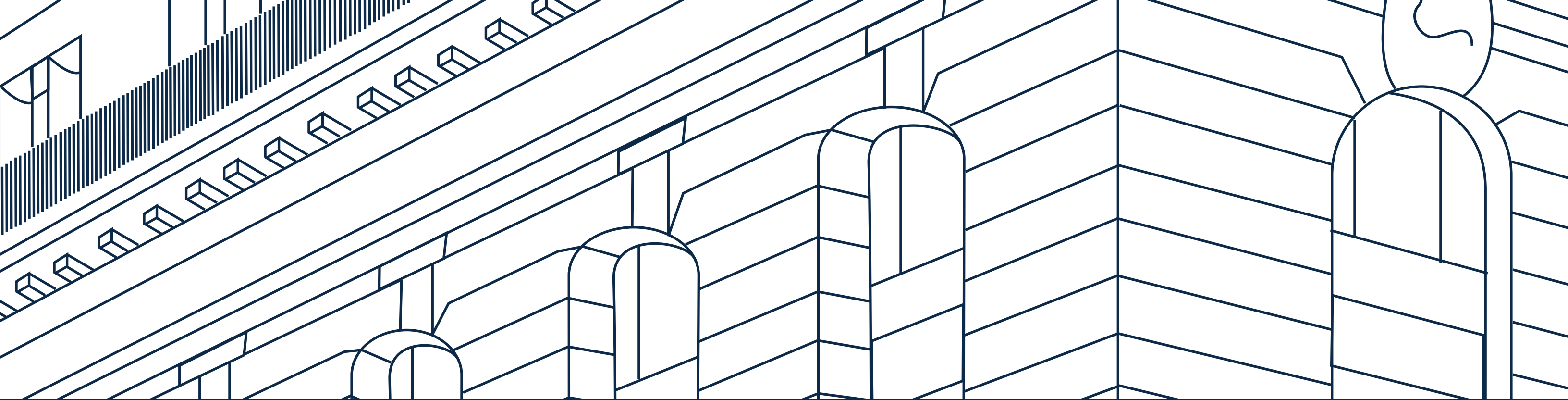
2023 the median for headline inflation at the end of 2023 increased from 4.60 to 4.66%, while that for the core component laid at 5.21% after registering 5.20% in July. The median for headline inflation expectations for the end of 2024 changed from 4.03 to 4.00%, while that for the core component went from 4.13 to 4.12%. The median of headline inflation expectations for the next four years remained at 3.80%, while that for the core component adjusted from 3.80 to 3.79%. The median of headline inflation expectations for the long term (5 to 8 years) decreased from 3.60 to 3.53%, while that for the core component remained unchanged at 3.60%. Finally, compensation for inflation and inflationary risk increased since the previous monetary policy decision. Regarding its components, the inflation risk premium was adjusted upwards and expectations implied by market instruments rose slightly.

Inflation is projected to converge to the 3% target in the second quarter of 2025. This projection is subject to risks. On the upside: i) persistence of core inflation at high levels given the magnitude, extent, and duration of the shocks that have been experienced and have pushed it to high levels; ii) foreign exchange depreciation due to volatility in international financial markets; iii) greater cost-related pressures that could be passed onto consumer prices; iv) that the economy's resilience contributes to a more gradual decline in inflation than foreseen, and v) pressures on energy prices or on agricultural and livestock product prices. On the downside: i) a greater-than-anticipated slowdown of the world economy; ii) a lower pass-through effect from some cost-related pressures, and iii) that the exchange rate appreciation contributes more than anticipated to mitigate some pressures on inflation. The balance of risks for the trajectory of inflation within the forecast horizon remains biased to the upside.

Table 1
Consumer Price Index and Components
Annual percentage change

Item	July 2023	August 2023	1st fortnight Sep. 2023
CPI	**4.79**	**4.64**	**4.44**
Core	**6.64**	**6.08**	**5.78**
Merchandise	**7.82**	**6.86**	**6.35**
Food, beverages and tobacco	9.79	8.44	7.73
Non-food merchandise	5.54	5.03	4.74
Services	**5.24**	**5.15**	**5.08**
Housing	3.66	3.59	3.58
Education (tuitions)	4.92	5.49	6.58
Other services	6.61	6.38	6.03
Non-core	**-0.67**	**0.37**	**0.48**
Agricultural and livestock products	**3.16**	**3.94**	**3.57**
Fruits and vegetables	7.14	8.15	6.98
Livestock products	0.00	0.47	0.70
Energy and government-authorized prices	**-3.90**	**-2.68**	**-2.20**
Energy products	-7.82	-5.99	-5.30
Government-authorized prices	5.51	5.24	5.13

Source:INEGI.



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