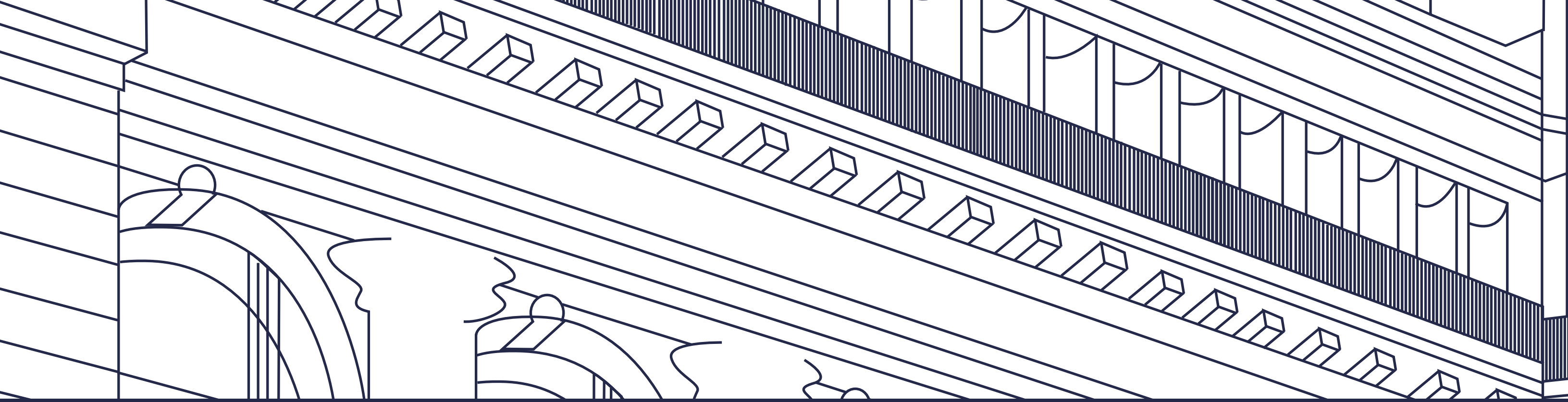

BANCO DE MÉXICO®

Minutes number 62

Meeting of Banco de México's Governing Board on the occasion of the monetary policy decision announced on October 4, 2018

FOREWARNING
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1. PLACE, DATE, AND PARTICIPANTS

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

1.2. Date of Governing Board meeting: October 3, 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

Miguel Messmacher-Linartas, Undersecretary of Finance and Public Credit

Eduardo Magallón-Murguía, Deputy Secretary of the Governing Board

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

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

All members agreed that during the second quarter of 2018, the world economy continued to grow at a moderate pace, and that the divergence among the main advanced economies' performance increased. In this context, some members mentioned that the outlook for world economic activity has deteriorated due partly to the materialization of some risks, such as the intensification of trade disputes. Some members agreed that the balance of risks to the world economy continues biased to the downside. All members agreed that the world economy is subject to a high degree of uncertainty and that the following are major risks: I) a further escalation of international trade disputes; ii) a further tightening of financial conditions; and, iii) political and geopolitical factors.

As for the risks of greater protectionist measures, some members pointed out that the number and intensity of these actions has been increasing significantly. They also stated that evidence shows that such measures are already affecting world trade volume and capital expenditure, as well as indicators of production, business confidence and household confidence. One member mentioned that available indicators suggest that the effect of these measures has started to be evidenced in economies and regions other than those directly involved in such disputes. Most members noted that the intensity of the trade disputes has differed across countries. In some cases, such intensity seems to have eased, as in the case of the trade negotiations between Mexico, the U.S. and Canada; whereas in other cases, like the trade dispute between China and the U.S., it has worsened. One member highlighted the relevance of the Chinese-U.S. case for the world economy, given the size of both economies and their high share in global value chains.

As for the second risk to the global economy, most members mentioned the possibility of the U.S. economy facing higher-than-expected inflationary pressures, while one member stated that this situation could lead to significant increases in the yield curve. As for the risk related to political and geopolitical factors, some members stated that in the Eurozone some vulnerabilities associated with domestic turmoil and political differences have increased, stating as an example those related to the approval of the budgetary process in Italy, the Brexit, the U.S. midterm elections in November, and Brazil's presidential elections.

In addition to the aforementioned risks, some members included the possibility of international prices of crude oil and other energy goods continuing on an upward trend, which could affect economic activity and inflation worldwide. In this regard, one member emphasized that the increase in oil prices responds to several factors, such as a greater demand in the United States, the inelastic supply by OPEC countries, and the effects of the U.S. trade sanctions imposed to Iran.

Most members stated that the divergence among the main advanced economies' performance has increased. They also mentioned that, in contrast with the Eurozone, Japan and the U.K., which have grown below expectations, economic activity in the U.S. exhibited higher growth, partly in response to the fiscal stimulus implemented. Most members warned that, under conditions of reduced slack in the economy, the greater dynamism of the U.S. economy could exert greater pressure on inflation. As for the prospects for growth for the U.S. economy, such members expressed that they expect it to continue growing at a high rate in the next semesters. Some members highlighted that the latter is due to the strength of consumption and investment in that country, associated with the high levels of household and business confidence indicators, and with the low levels of unemployment. However, another member pointed out that, in the medium run, the cyclical position of the U.S. economy could start being a factor that could hinder its dynamism. As to other advanced economies, one member mentioned that weak economic activity in the Eurozone, Japan and the United Kingdom this year was a factor that contributed to revise downward the forecasts for growth for these countries, to rates below potential. Some members mentioned that, in most advanced economies, labor markets have tightened further and their unemployment rates are below their natural levels. One member added that, up to this point, wages do not seem to be subject to pressures.

As for emerging economies, one member mentioned that these exhibited slower dynamism than the observed in previous quarters and have also faced tighter financial conditions, in a scenario where advanced economies are foreseen to raise their interest rates. In the case of the Chinese economy, some members indicated that it has been struck by the effects of the intensifying trade disputes with the U.S. and the environment of uncertainty that this situation generates. In this regard, these members pointed out that the outlook for manufacturing activity, capital expenditure and business confidence has been particularly affected. Most members added that indicators for other emerging economies, such as Argentina and Turkey, have deteriorated. In this context, one member underlined that although problems differ among economies, there are two common factors: an inadequate macroeconomic –particularly fiscal- management, and an institutional weakness related, principally, to central bank independence. As for expectations for growth for emerging economies, one member stated that they have been revised downwards and that greater differences have been observed among countries. The same member mentioned that in Latin America, expectations for growth have been revised downwards due to the slowdown of global trade growth and to various idiosyncratic factors, whereas another member added that growth expectations for most crude oil exporting countries have improved significantly.

Some members stated that in the main advanced economies, headline inflation continues converging to their central banks' targets, albeit one of them added that core inflation has remained below such targets. Some members pointed out that in the United States, inflation has fluctuated around the Federal Reserve's target, while in the Eurozone and Japan it has remained below their central banks' targets. In this context, some members indicated that given the tightening labor markets in these economies, in the future wages are expected to have greater effects on prices. As for emerging economies, some members mentioned that inflation has trended upward gradually. One member noted that in these economies, the outlook for inflation is heterogeneous and that the risks of higher inflation have escalated in several of them. In this regard, one member added that pressures related to the exchange rates' depreciation could deteriorate even further the outlook for inflation in emerging economies. In light of the above, most members mentioned that world inflation has increased, and that the higher prices of energy have contributed to such results. Some emphasized that the central banks of both advanced and emerging economies have stressed the possibility of inflationary pressures arising in the short term due to the escalation of trade protectionist measures. One member warned that, in the short term, the balance of risks for world inflation is biased to the upside, although with some differences across countries.

All members mentioned that differences in the rate of monetary policy normalization are expected among the main advanced economies. Some members pointed out that such divergence is a reflection of the different stages of the business cycle each of these economies is currently undergoing. In the case of the United States, most members highlighted that, as anticipated, in September the Federal Reserve increased the target for the federal funds rate and reiterated its prevision of increasing it gradually, causing a rise in interest rates in all terms. One member added that the latter was mainly observed in short-term interest rates and, hence, the yield curve remained relatively flat. The same member mentioned that, in particular, the 5-year interest rate was already at levels above 3%, while those of 30 years are already above 3.3%. Such member expressed that these figures show that term premia are still at low levels. Most members highlighted that, in the event of inflationary surprises in the U.S., there is a risk of a faster-than-expected process of monetary policy normalization in that country. One member mentioned that such inflationary surprises could be due to demand-related pressures, given the reduced slack in the U.S. economy, or to the pass-through of import tariffs imposed by the U.S. onto final prices in that country. In this regard, another member made reference to the discussion about the process of price formation in that country, and the flattening of the Phillips curve, which suggests that inflation's response to the slack conditions in the U.S. has been small. The same member added that several explanations have been proposed to describe this phenomenon, such as: globalization's disciplinary effect on prices and wages, productivity gains related to automation, large businesses' monopsonic position in labor markets, and the effects through time of the presence of large e-commerce retailers on the economy's price formation process. Such member pointed out that despite such explanations, a high degree of uncertainty persists as to the price formation process in the United States, which increases the probability of inflationary surprises. Such member highlighted that the risk is not so much that inflation increases in an environment where monetary policy normalization is done gradually and with transparency, but rather that inflationary surprises emerge. Some members added that, in contrast with expectations for the United States, those for Japan and the Eurozone point to a barely moderate monetary policy adjustment over a longer period. One of them mentioned that, in England, the central bank has maintained the projected pace of normalization, despite the inflationary pressures it faces. Finally, the same member pointed out that, among emerging economies, tighter monetary policy stances are also anticipated. In particular, this member stressed the case of Argentina, whose central bank adopted recently a monetary policy framework based on a target for the monetary base.

All members pointed out that international financial markets have undergone episodes of volatility and considered that the prices of emerging economies' assets have performed negatively in recent weeks. Some members mentioned that this has occurred in an environment of U.S. dollar strength and interest rate increases. Most members stated that the lower risk appetite observed in the last months has already caused both an adjustment of investment portfolios and capital outflows from some emerging economies. In this regard, most members added that differences among these economies were observed depending on macroeconomic fundamentals and idiosyncratic factors inherent to each of these countries. These members highlighted that, in the foreseeable future, an environment of higher external interest rates and U.S. dollar appreciation is expected, which would lead to a greater tightening of financial conditions that will particularly affect emerging economies. As for the risks to international financial markets, most members emphasized those previously described about world economic growth, as well as those associated with sharp adjustments in these markets, which would have a considerable effect on financial asset prices.

Most members mentioned that the latest information suggests that, at the beginning of the third quarter of 2018, economic activity in Mexico expanded, after having contracted during the second quarter. One member noted that this contraction was preceded by two quarters of growth recovery. As for aggregate demand, most members highlighted the higher dynamism of exports. As for consumption, some members pointed out that timely indicators suggest a moderate recovery after the stagnation observed during the previous quarter. Some members coincided that investment has remained weak. As for production, most members argued that its performance is explained by the growth of services and the slight recovery of industrial activity. One member mentioned the favorable change in the trend of construction, while some members noted the recovery of manufacturing and the continuing deterioration of mining. In this regard, one member noted that this deterioration has been observed mainly in crude oil extraction.

One member pointed out that, after the fluctuations observed in previous months resulting mainly from the natural disasters at the end of 2017, the trajectory of economic activity is expected to normalize throughout the second half of the year. In line with the above, another member noted that, after the growth forecasts of Banco de México's latest Quarterly Report were revised downwards, the baseline scenario for growth for both 2018 and 2019 remains unchanged. Another member added that expectations for growth slightly below potential during both this year and 2019 prevail. Most members argued that GDP growth for 2018 and 2019 is expected to be between 2.0 and 2.6% and 1.8 and 2.8%, respectively, as published in Banco de México's latest Quarterly Report. Some members mentioned that the forecast for 2019 is subject to a high degree of uncertainty and consider several challenges, such as the incoming administration's implementation of public policy, a slight weakness in the aggregate demand components, and the low levels of crude oil production.

Most members stated that, given the complex environment the economy is currently facing, the balance of risks to growth remains biased to the downside, although such bias has decreased at the margin as a result of the trade agreement recently reached with the U.S. and Canada. One member stated that the announcement of the new agreement is, undoubtedly, positive news that may contribute to strengthen confidence in Mexico. One member explained that, although the ratification process will be lengthy, which could give rise to uncertainty, this should decrease significantly as compared to that observed prior to the announcement, and therefore help to boost domestic demand and, particularly, private investment. Most members stated that there is a risk of uncertainty as to the length of the ratification process, that Congress does not ratify it or that challenges arise in the implementation of some chapters of the agreement. On top of the aforementioned global risks, some members mentioned as an additional risk to growth, the deceleration of public expenditure that is generally observed at the beginning of a new administration. In this same regard, most members pointed out that relevant details of the economic agenda of the incoming administration remain to be explained. Some members mentioned that another risk is for crude oil production to remain significantly below the expected levels. Among the risks to medium- and long-term growth, some members included the possible loss of efficiency and productivity of the Mexican economy, as well as the possible impact to competitiveness caused by domestic factors, such as the deterioration of public security. One member added other factors such as corruption, impunity, and the absence of the rule of law, which affect investment prospects. Another member also included the risk of deviating from the ongoing fiscal consolidation process and public policies that would affect potential growth, as well as an eventual slowdown of the U.S. economy.

Most members considered that the slack conditions in the economy are estimated to have remained similar to those observed during the second quarter, pointing out that the economy's cyclical conditions continued to loosen vis-à-vis the levels observed at the beginning of 2018. One of the members emphasized that this is evident in practically all the different slack indicators monitored by Banco de México, except those related with the labor market. However, another member mentioned that several indicators currently suggest an output gap close to zero. As to the labor market, some members stated that its conditions remain tight. In this regard, one of the members pointed out that the unemployment rate is still at low levels and that although it has not undergone additional decreases, it has remained around its current level for a relatively long period. The same member added that unit labor costs for the overall economy have increased recently, though starting from low levels and, in general terms, no excessive wage pressures have been observed. Another member argued that wages have increased somewhat and that, for this reason, wage revisions should be assessed fully to identify their effects on the price formation process. In this regard, the same member stated that it is important that the different alternatives for wage revisions are associated with productivity gains and do not generate overall cost pressures on the economy. Another one stated that, in that member's opinion, demand-related pressures stemming from such increases are a factor of greater concern. Finally, as to the forecasts for economic activity, some members pointed out that, if growth expectations for the rest of 2018 and for 2019 materialize, less tight cyclical conditions would be expected in the following quarters. Nevertheless, one of the members noted that these conditions would be consistent with an output gap not far from zero.

Most members mentioned that headline inflation has been affected by the significant increases of its non-core component, emphasizing that, since June, higher-than-expected rises in energy prices have been observed, mainly those of gasoline and L.P. gas. Such members noted that these price increases stem from higher international references, stating that the gradual adjustments of domestic gasoline prices has made such increases more persistent. Some members pointed out that the contribution of energy prices to the increase in headline inflation was significant during the first half of September and larger than that exhibited in January 2017. One member specified that in such two-week period, gasoline prices registered an annual rate of change of above 21%, whereas L.P. gas prices of above 26%. In this context, some members mentioned that annual headline inflation increased from 4.85% to 4.88% between the first half of July and the first half of September, while non-core inflation did so from 8.52% to 8.90% during the same period. As to the evolution of core inflation, most members highlighted that it has behaved according to expectations. The same members mentioned that the core component decreased from 3.64% to 3.56% between the first half of July and the first half of September. Nevertheless, most members noted that the rate at which core inflation has been declining has been contained by the indirect effects of non-core inflation on production costs. One member added that core inflation has shown a high degree of persistence, despite the deceleration of productive activity and the relatively more favorable behavior of the exchange rate. The same member added that fundamental core inflation figures, drawn from price index data, constructed with those items that are more sensitive to the business cycle, has fluctuated between 3.4% and 3.45% in the last five months.

Most members mentioned that expectations for headline inflation for the end of 2018 were revised upwards from 4.25 to 4.50% from July to September, while those for the end of 2019 increased from 3.60 to 3.70% for the same period. One member highlighted that such expectations are reflecting the aforementioned shocks. Most members emphasized that medium- and long-term expectations remained around 3.50%. Some members observed that, although expectations have remained stable, they are still above the target. Most members also pointed out that expectations for core inflation for the end of 2018 decreased from 3.60 to 3.53%, while those for the end of 2019 remained practically unchanged. Finally, one member underlined that the yield spread between nominal and real government bonds remains high, which suggests that markets are perceiving upside risks for headline inflation in the medium- and long-terms.

All members agreed that, although the shocks that affected inflation in Mexico are of transitory nature, they have delayed the convergence of headline inflation to its target. One member added that non-core inflation is expected to remain high during the next months and will continue to be affected by pressures from energy prices, which will in turn affect the trajectory of headline inflation. Another member considered that the forecasts for inflation for the next months remain complex. Most members also stated that core inflation remains in line with forecasts and is expected to continue its downward trend towards 3%. Some members pointed out that core inflation is anticipated to decrease, but at a slower rate.

All members considered that the balance of risks to the forecasted trajectory of inflation remains biased upwards, in an environment of uncertainty where external and domestic risks persist. One member mentioned that, although some risks to inflation have decreased as a result of the recently approved trade agreement with the United States and Canada, other risks have intensified. Another member added that this balance deteriorated since the last monetary policy decision, mainly due to the rise in energy prices and expectations that they will continue to increase. One member argued that some of these risks are cyclical in nature, while others are of a more structural nature. The same member emphasized that both types of risks are operating in the same direction and reinforcing each other. Among the main risks to the upside, most members highlighted the possibility of pressures on the peso exchange rate due to external or domestic factors; a possible escalation of protectionist measures worldwide, which could affect inflation; additional upward pressures on energy prices, as indicated by the futures prices of some of these products; a possible reversion in the favorable behavior of agricultural products' prices; and, the risk that wage negotiations are not consistent with productivity gains. In this regard, one member stated that wage pressures could appear as a result of the tight labor market conditions or the expected adjustment to minimum wages. Some members also noted the risk of higher-than-expected levels of public expenditure. One of the members emphasized that this could reduce the rate at which core inflation has been decreasing. Another member added the risk that the inertial trend of a greater participation of current expenditure in total government expenditure continues. Some members stated that, if supply shocks, such as those of energy prices, persist for a significant period, the probability of second-round effects in the price formation process could increase significantly. One of the members pointed out that the persistence of these shocks could also intensify the negative consequences that protectionist measures could have on inflation. Finally, another member considered that, on balance, the aforementioned factors jeopardize the convergence of inflation to the 3% target, within the time frame specified in Banco de México's latest Quarterly Report.

One member elaborated on the risks of a more structural nature, stressing that the persistence of inflation is currently high and that this may be due to various factors. The same member indicated that, in general terms, persistence is introduced into the inflationary process through formal and informal mechanisms that seek to protect economic agents from inflationary and/or exchange rate risk, and that these mechanisms are used in contracts or in other forms of determining transactions in the economy, in a context in which price formation does not seem to be consistent with the 3% target. Such member emphasized that there may be various reasons for this, but that long-term inflation expectations have remained at levels of around 3.5% for several years, and that this fact implies that economic agents assign a low probability to the event of attaining the 3% target. In this context, the same member mentioned the structural vulnerability of public finances as well as the uncertainty about the management of fiscal policy by the incoming administration. Such member also considered that the most relevant risk is the lack of total factor productivity growth in Mexico over the last two decades, stressing that under such conditions it is difficult to believe that the economy is in a good situation to efficiently absorb -that is, with a low inflationary impact- adverse shocks, such as those to the real exchange rate, the terms of trade, and to the prices of energy and other commodities. The same member argued that a necessary condition for an economy to keep inflation low in a continuous and sustained manner is through constant gains in productivity. As for the downside risks, some members highlighted that the ratification of the trade agreement with the United States and Canada could have favorable consequences on both markets and exchange rate.

The majority of the members noted that since the last monetary policy decision, the Mexican peso has exhibited more resilience than the currencies of other emerging economies, attributing this situation to both the progress in the trade negotiations with the United States and Canada, and the country's prudent macroeconomic management, highlighting the monetary policy stance adopted by Banco de México. In this sense, one member emphasized that the monetary policy stance that has been implemented has allowed interest rate differentials between Mexico and the United States to remain high, a fact that is one of the main reasons that explain the relatively good performance of the prices of Mexican assets. Another added to the above factors the end of the electoral process in Mexico. As for interest rates, one member indicated that short-term rates registered slight changes, while increases in medium- and long-term rates were observed. Another member commented that, in general, the country's yield curve has remained relatively flat, making it clear that monetary policy has been effective in containing inflation expectations and the term premia. One member pointed out that, although there were outflows by foreign investors of fixed income instruments, mainly medium and long term, sovereign risk indicators did not show significant adjustments and that they remain at levels consistent with the country's risk profile. The majority of the members agreed that domestic financial markets and Mexico's exchange rate, in particular, could be affected by the aforementioned external and domestic risks.

In this context, the majority of the members highlighted the importance of having solid macroeconomic fundamentals, which have allowed the economy to adjust in an orderly manner to a particularly complex environment. One member argued that maintaining solid macroeconomic fundamentals is necessary to preserve favorable conditions for economic activity and to avoid vulnerabilities, which, in the event of risk materialization, could lead to a rebalancing of asset portfolios and to capital outflows. Another member stated that prudent monetary policy actions are essential to reach and maintain macroeconomic stability. The same member stated that, nevertheless, in the absence of an adequate support from fiscal policy, these actions would have higher costs for the economy and they might even be insufficient. For this reason, the member emphasized the importance, beyond a solid fiscal position in 2019, of paying timely attention to the challenges that the country's public finances face in the medium and long runs. Such member stated that, in that member's opinion, the most relevant matter for the monetary and fiscal authorities at this stage is to evaluate how to safeguard what has already been achieved and how to address the pending issues in a timely manner. In this sense, one of the members warned that public finances display a high level of vulnerability, pointing out that in the years previous to 2017 public indebtedness had increased considerably. In particular, this member mentioned that, from 2007 to 2016, the Historical Balance of Public Sector's Financial Requirements (SHRFSP, for its acronym in Spanish) went from 28.8 to 48.7% of GDP, and from 2013 to 2016, from 37.2 to 48.7% of GDP. That member added that, despite the reduction of the SHRFSP in 2017, it is difficult for this decline to be sustainable, since it was based, to a large extent, on cutbacks in public investment, which is currently at very low levels. The same member warned that, given the country's fiscal situation, and taking into account the expected future increases in international interest rates, the conditions of access to financing can turn less favorable. Furthermore, such member argued that, in addition to the structural vulnerability of public finances, there is also uncertainty about the fiscal management of the incoming administration. Another member added that the president elect and his transition team have stated their commitment to preserve the health of public finances. However, the same member highlighted that it is necessary to know in detail the public policies of the new administration and their potential effects on productivity and on the country's competitiveness. One member stated that financial markets discount that a solid fiscal position will be continued.

Elaborating on the structural challenges that the economy faces, one member highlighted the lack of total factor productivity (TFP) growth over the past two decades and the weakness of investment. The same member pointed out that according to INEGI figures the last spike in the TFP was observed in 1998, and that from that year to 2016 it fell by 10%. Such member noted that from 2007 to 2012, this indicator decreased 0.8% each year, whereas from 2013 to 2016 it did so by 0.2% each year. The same member attributed the above to various factors: a) a regulation and, more generally, rules of economic interaction, that allow excessive market power in some sectors – including several strategic ones— and the few incentives for innovation, research and development; b) a fiscal and social security system that generates large distortions in the labor market, spurring informality; and, c) the prevalence of corruption and insecurity which, together with the aforementioned factors, threatens the rule of law and, particularly property rights. The same member considered that given such factors, the slower dynamism of investment over several years should not be surprising. Such member expressed concerns about some of the public policy proposals that have been discussed recently, and about their possible effect over the economy's development in the long run. First, such member reflected upon different commentator's opinions regarding the objectives that a central bank ought to have. Such member emphasized that monetary policy cannot influence the potential growth of an economy, and that, at best, it can only affect the cyclical component of aggregate demand in order to guide inflation towards a particular target. In this sense, such member stated that assuming there is a trade-off between growth and inflation which can be harnessed systematically by a central bank, in the short and long run, implies returning to past discussions and debates that have been solved in both academic and practical terms. Such member noted that this argument is based on fifty years of economic analysis, at an international level, as well as on the historical experience of Mexico and many other countries in the last decades. Second, such member indicated that the proposals about using the international reserves to finance public spending, for example in investment or any other type of expenditure, do not take into account the fact that international reserves are not a source of net wealth, since these have to be financed with the issuance of liabilities by the central bank. The same member emphasized that the implementation of such proposals would directly jeopardize the central bank's independence and its main statutory mandate, leading to a situation of fiscal dominance over monetary policy. The same member argued that, in the best case, implementing some of these measures would generate a greater inflationary bias, besides the one the Mexican economy already has, and, in the worst case, it would be a return to policies that have already been tried and have failed, and that would imply returning to times of recurring financial and balance of payments crises.

Regarding the factors to be taken into consideration for the monetary policy decision, the majority of the members highlighted that core inflation –the component that responds more clearly to the monetary policy stance– has evolved, in general, as anticipated, and is expected to continue to decrease, although some of them pointed out that at a lower rate and subject to greater risks. In this regard, one member emphasized that such component has exhibited a significant degree of persistence. In this context, the majority acknowledged that monetary policy faces challenges and that it must avoid that the supply shocks that have affected non-core inflation contaminate the economy's price formation process. One member mentioned that the latter is important since these shocks can continue for a considerable period, significantly increasing the risk of second-round effects. The same member added that the latter risk is high in an environment where long term inflation expectations have persistently remained above the target, arguing that, in this context, the central bank's credibility could be affected, which would imply high costs for the Institution and the economy. Another member said that the current conditions make the monetary policy decision complex since, as mentioned before, inflation is still high and its speed of convergence has decreased, while its core component remains on a downward trend and domestic conditions have improved.

The majority of the members reiterated that the lower uncertainty after the trade agreement reached in North America has contributed to the Mexican peso's resilience. One member argued that the latter opens up some room for maneuver for monetary policy in Mexico in the face of the increases expected for the federal funds rate in the United States. Another member noted that while such trade agreement reduces an important source of uncertainty, it is unlikely to have enough impact on the exchange rate as to significantly increase the likelihood of inflation converging to its target during the forecast horizon. The same member specified that the current monetary policy stance, prudent and defensive –both domestic and relative to the United States– has contributed to the recent favorable evolution of the Mexican financial markets. The same member argued that the latter has taken place in an environment in which monetary policy's risk-taking channel is operating intensively and, therefore, capital flows are very sensitive to rate differentials. In this regard, the same member stated that both the inflation differential between the two countries which is anticipated in the short term, and the reduction in the interest rate differential that markets expect, are factors of concern because of the deterioration that such differentials would entail for Mexico's domestic and relative monetary policy stance.

Some members pointed out that, in the current circumstances, the likelihood of additional adjustments in the monetary policy stance in the short term has increased. One of them warned that either if the persistence shown by core inflation continues, or if some of the anticipated risks materialize or if other risks arise, Banco de México would need to act in a decisive and forceful manner. Another member pointed out that, in the event of an adverse scenario in which the real exchange rate would need to adjust, it is important to prevent medium and long-term inflation expectations from being affected, and to avoid possible second-round effects on the economy's price formation process. Elaborating on Mexico's monetary policy, one member detailed that given the shocks that have affected inflation since 2017, the monetary policy stance has been adjusted in order to ensure that inflation converges to its target in a time frame consistent with the full operation of the monetary policy transmission mechanism. Some members stressed that Banco de México has been communicating about several changes in such horizon, currently deferring inflation's convergence to the second quarter of 2020. One member expressed that such forecast is subject to a high degree of uncertainty. The same member considered that the language of the monetary policy statement should convey clearly such possibility and also that the outlook for inflation is complicated. Likewise, the same member expressed disagreement with the forecasts made by analysts and market participants, which suggest that Banco de México is about to conclude its restrictive cycle and that it is likely to start a loosening cycle in 2019. Finally, the majority of the members agreed that, given a complex environment in which external and domestic risks persist, the Governing Board should remain attentive to the evolution of the factors that could entail additional pressures on inflation and delay its convergence to the goal, in order to be able to react in a timely manner.

3. MONETARY POLICY DECISION

To guide its monetary policy actions, Banco de México's Governing Board follows closely the development of inflation vis-à-vis its anticipated trajectory, taking into account the monetary policy stance adopted and the time frame 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 for such factors. Given the Mexican economy's recent developments, that the shocks that have affected inflation recently are of a transitory nature, and that the expected trend for core inflation remains downward, Banco de México's Governing Board has voted by majority to maintain the target for the overnight interbank interest rate unchanged at 7.75%. One member voted for increasing the rate by 25 basis points. The Governing Board will monitor the potential pass-through of the shocks that have affected non-core inflation as well as other factors that could affect the evolution of core inflation, which is particularly relevant in the present scenario, since this indicator is still above 3%. The central bank will take the necessary actions, specifically, maintaining or possibly strengthening the current monetary policy stance so that headline inflation converges to Banco de México's target within monetary policy's period of influence.

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

4. VOTING

Alejandro Díaz de León-Carrillo, Roberto Del Cueto-Legaspi, Irene Espinosa-Cantellano and Javier Eduardo Guzmán-Calafell voted in favor of leaving the target rate unchanged at 7.75%.

Manuel Ramos-Francia voted in favor of raising the target rate by 25 basis points to 8.00%.

5. DISSENTING VOTE

For some time, inflation has been subject to a complex environment characterized by both cyclical and structural factors. This situation is evident as shown by long-term inflation expectations, which have remained around 3.5 percent for several years, regardless of the stage of the business cycle the

Mexican economy is undergoing. Although there are several reasons for this, all of them are potentially reflected in the lack of growth of total factor productivity over the last two decades. This condition makes it more difficult for the Mexican economy to absorb supply- or demand-related shocks with low inflation. Due to the aforementioned, core inflation currently shows a high degree of persistence. Such persistence, together with perspectives for non-core inflation, makes it unlikely for the current forecast for headline inflation to be attained. Recently, Banco de México has already adjusted on several occasions its estimates for the time frame in which headline inflation is expected to converge to its target. Considering the current inflation forecast targeting framework for monetary policy, as well as the factors that are affecting core inflation, in my opinion, not responding as a consequence of this environment could be very costly for the central bank's credibility.

ANNEX

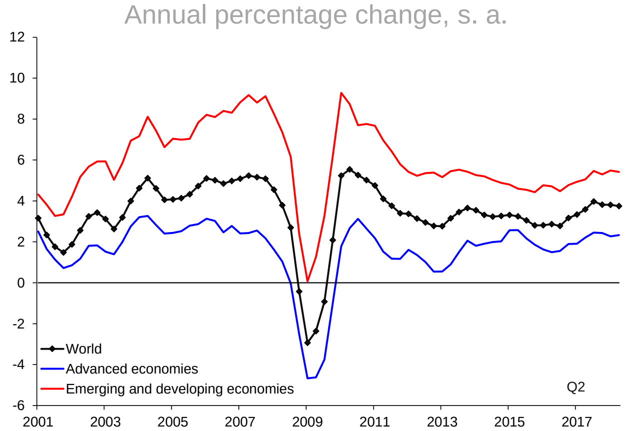
The information in this section was prepared for this meeting by the staff of Banco de México's General Directorate of Economic Research and General Directorate of Central Bank Operations and Payment Systems. It does not necessarily reflect the considerations of the members of the Governing Board as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

A.1. External conditions

A.1.1. World economic activity

During the second quarter of 2018, the world economy continued to grow at a moderate pace, although the divergence among the main advanced economies' performance increased (Chart 1). Indeed, while several advanced economies have grown below expectations and emerging economies exhibited a lower dynamism, economic activity in the U.S. registered higher growth. Under conditions of reduced slack in the economy, this could exert greater pressure on inflation.

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



s. a. / Seasonally adjusted data.
Note: 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 and International Monetary Fund.

The outlook for the world economy is subject to a high degree of uncertainty due to the risks associated to a further intensification of international trade disputes, a greater tightening of financial conditions, and geopolitical factors. Uncertainty regarding escalating trade disputes has been reflected in a deterioration of indicators of business activity and production, business confidence, and capital expenditure.

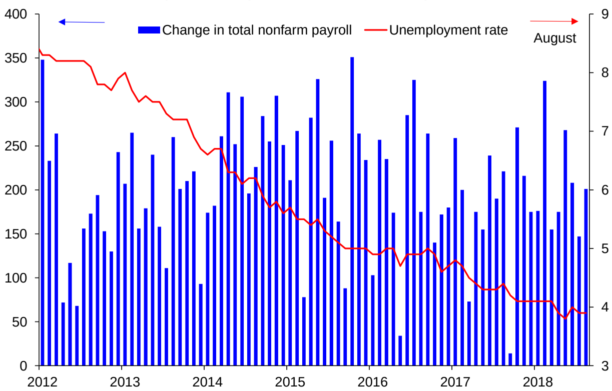
In an environment where advanced economies are expected to raise their reference interest rates at different paces, an additional tightening of global financial conditions could also be observed. There are other risks to world economic growth, including higher crude oil prices and various geopolitical factors. In this context, the forecasts for world economic growth for 2018 and 2019 have moderated, reflecting the expectation of weaker conditions in some of the main advanced economies, including the Eurozone and the United Kingdom, as well as in some emerging economies, like Argentina and Turkey.

In the U.S., economic activity grew at an annualized quarterly rate of 4.2% (seasonally adjusted figures) during the second quarter of 2018, after having grown 2.2% during the first quarter of the year. Available data suggests that private consumption and investment continued to grow at a high rate during the third quarter of 2018, fueled by the high levels of consumer and business confidence. Inventory figures reveal that these might have also contributed positively to growth, after the strong rundown of inventories exhibited during the second quarter of 2018. For the following quarters, economic activity is expected to continue growing at a high pace, driven partly by the fiscal stimulus. However, in the medium run, a deceleration is anticipated as this stimulus gradually fades out and financial conditions become less accommodative.

U.S. industrial production continued to grow during July and August, due to the favorable performance of its three main components. Gas and electricity generation, in particular, grew at a high rate, while mining production maintained the positive trend it has exhibited since the end of 2016. In turn, manufacturing production continued to expand moderately, mainly due to the rebound in vehicle and auto parts production. Leading indicators suggest that manufacturing will continue to observe a dynamism similar to that of previous months.

U.S. labor market conditions continued to strengthen. The non-farm payroll increased by 185,000 jobs on average during June and August, above the rate needed to keep pace with the growing labor force (Chart 2). Since April, the unemployment rate has stabilized at around 3.9%, below the natural unemployment rate estimated by the U.S. Congressional Budget Office (CBO). The tightening of the labor market was also reflected in the difficulty to fill vacancies, while vacancy and quit rates remained at pre-crisis levels. In this context, wage growth continued to pick up.

Chart 2
USA: Non-farm Payroll
Monthly change and 3-month moving average of the monthly change in thousand jobs, s. a.



s. a. / Seasonally-adjusted figures.
Source: BLS.

In the Eurozone, available data suggests that economic activity continued to grow at a moderate rate during the third quarter of 2018, after having contracted during the first half of the year due to a negative contribution of net exports. Private consumption and investment have been driven by the higher income of households, higher business profits, and the higher levels of installed capacity. In this environment of moderate growth, the region's unemployment rate remained at 8.1% in August, below the estimated long-term level, while wages started to grow at a faster rate. Nevertheless, a greater divergence in regional economic growth has been observed between economies like France and Germany, and others like Italy. Looking ahead, the weakening of consumer and business confidence indexes is one of the main risks to the Eurozone's dynamism. If such weakening continues, it may affect adversely the levels of investment and consumption.

In Japan, available indicators point to a weaker growth of economic activity during the third quarter of 2018, after the 3% (seasonally adjusted annualized quarterly rate) rebound observed during the second quarter due to the higher levels of fixed investment. Net exports weakened, while private consumption has been affected by several natural disasters that struck in July and September. In this environment, Japan's unemployment rate registered 2.4% in August (close to its lowest level in the last two decades), while wages rebounded.

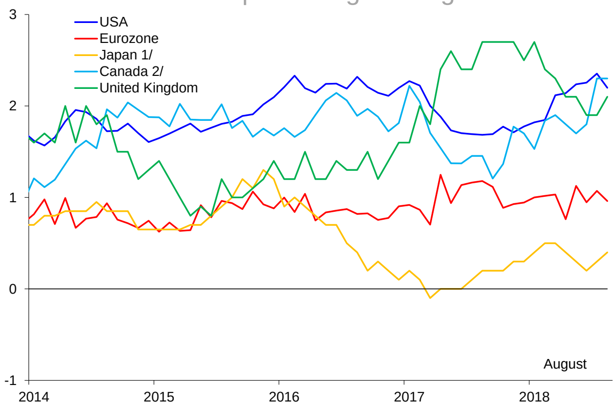
In most emerging economies, economic activity has weakened due to the growing international trade tensions, the tighter financial conditions, and several idiosyncratic factors. Economic growth slowed significantly in several countries, such as Turkey, Argentina, Brazil, India, and South Africa. A further escalation of trade tensions between the U.S. and China may also have an adverse effect on both economic activity and inflation in China and other emerging economies, mainly Asian.

During recent weeks, the international prices of commodities posted heterogeneous results. In a context of increasing uncertainty about the effects of U.S. trade sanctions to Iran's oil exports, at the end of August oil prices rose under expectations that the Organization of Petroleum Exporting Countries (OPEC) and other oil producers would decide to leave their production levels unchanged, as was confirmed by their decision taken on the meeting of September 23. In contrast, the prices of industrial metals remained at low levels due to the forecasts of a weaker global manufacturing expansion and a possible escalation of trade disputes between the U.S. and China. Finally, the prices of grains fell after the U.S. Department of Agriculture revised upwards its forecast for world wheat production.

A.1.2. Monetary policy and international financial markets

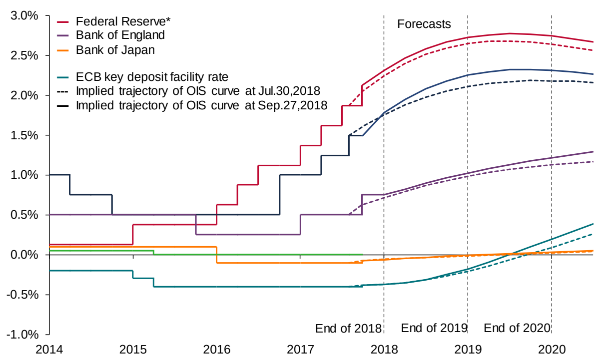
In a context of tighter labor market conditions in the main advanced economies, higher crude oil prices, and greater macroeconomic imbalances in several emerging economies, inflation remained on an upward trend, although there is still a persisting divergence among countries (Chart 3). In recent months, inflation in the U.S. rose and remains currently around its target, while in the Eurozone and Japan, it has remained below their central banks' targets. In this context, the central banks of advanced economies are expected to continue a gradual process towards a more neutral monetary policy stance, albeit with differences in terms of the speed at which they adjust their policies (Chart 4). Both the U.S. Federal Reserve and the Bank of Canada are anticipated to continue raising their reference rates before the end of 2018, while the Bank of England and the European Central Bank (ECB) are expected to do so by the second half of 2019. The Bank of Japan is expected to adopt a more cautious policy stance as to raising its reference rate.

Chart 3
Selected Advanced Economies: Core Inflation
Annual percentage change



1/ Excludes fresh foods, energy, and the direct effect of the consumption tax increase.
2/ Excludes food, energy, and the effect of adjustments on indirect taxes (CPI-XFET).
Source: Haver Analytics, BEA, Eurostat, and Statistics Bureau.

Chart 4
Target Rates and Implied Trajectory of OIS Curves[1/]
Percent



1/ OIS: Fixed floating interest rate swap where the fixed interest rate is the effective overnight reference rate.
* In the case of the U.S. observed reference rate, the average interest rate of the federal funds target range is used (2.00% - 2.25%).
Source: Bloomberg.

As was expected, in its September meeting, the Federal Reserve raised the target range for the federal funds rate to between 2 and 2.25%, and reiterated its forecast of increasing it gradually, causing an increase in interest rates in all terms. In its previous monetary policy statement, the Fed omitted the phrase describing monetary conditions as accommodative. The Fed's Chairman clarified that change did not imply a shift in its monetary policy stance. As to its forecasts for economic and financial variables, the slightly upward revisions in economic growth estimates for 2018 and 2019; the marginal adjustments to the projections of unemployment --which is expected to remain below the long-term rate throughout the forecast period--, and a few changes in the forecasts for inflation --which is estimated to remain around its target in the medium term-- stand out. The FOMC's forecasts for the federal funds rates suggest an additional increase of 25 basis points (bps) in December, in line with the expectations of analysts and those implied by financial market variables. The Fed estimates point to three additional increases of 25 basis points to the target rate during 2019 and another one of 25 bps in 2020, in order to attain a range of between 3.25 and 3.50%, placing the target rate above 3%, which corresponds to the Fed's forecast for the long-term rate.

In its September meeting, the ECB left its forward guidance and key deposit facility rate unchanged, reiterating that the latter will remain at that level at least until the summer of 2019. The ECB also confirmed that in October it will reduce its asset purchase program from 30,000 to 15,000 million euros, stating that, though depending on incoming data, it anticipates concluding this program in December. The ECB revised slightly downwards its growth forecasts for 2018 and 2019 in light of expectations of a lower contribution of foreign trade, while keeping its inflation forecast for the next two years unchanged at 1.7%. The European Central Bank Governor described the risks to economic growth as balanced and pointed out that uncertainty regarding inflation expectations has decreased and that inflation is expected to increase gradually in the medium term, driven by an accommodative monetary policy, the economic upturn, and wage increases. Nevertheless, he also mentioned that monetary stimulus is still essential to get inflation near its target. Monetary policy expectations implied by market instruments continue to anticipate that the first raise to the key interest rate will take place until the third quarter of 2019.

In its September meeting, the Bank of England left its reference rate unchanged at 0.75%, after raising it by 25 basis points in August. The Monetary Policy Committee pointed out that, if the economy performs as expected, it would be appropriate to continue tightening its monetary policy stance gradually and to a limited extent. Although the Bank of England highlighted that wages and consumption have grown above expectations, it pointed out that uncertainty regarding the Brexit has increased. In this context, market variables suggest that the next reference rate increase will take place during the third quarter of 2019.

In its September meeting, the Bank of Canada left its reference rate unchanged at 1.5% and pointed out that the latest economic data suggests that a raise in the reference rate will be needed to achieve the inflation target in the medium term. Nevertheless, it reiterated that it will continue tightening its monetary policy stance gradually, following closely the economy's response to higher interest rates, and monitoring the trade negotiations with Mexico and the U.S. and their impact on inflation expectations. Both professional forecasters and market indicators therefore anticipate that the Bank of Canada will raise its target rate by 25 basis points in its October meeting.

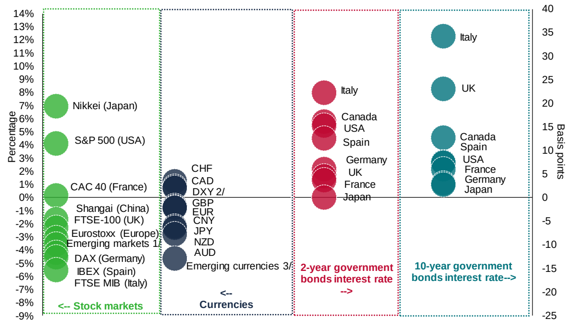
Finally, in its September meeting, the Bank of Japan left unchanged its short-term reference rate at 0.1% and its reference rate indexed to its 10-year bond at 0%. In its monetary policy minutes, this central bank pointed out that domestic demand is expected to continue to grow. Nevertheless, it is monitoring the impact of U.S. protectionist trade policies and their possible effect on the Japanese economy, in particular, on the global value chains. The Bank of Japan also reiterated that it will continue with a highly accommodative monetary policy for as long as needed to reach its price stability target.

In most emerging economies, although headline inflation has remained below the targets of their respective central banks, it has increased further due to factors such as the recent depreciation of their currencies, the rise in energy prices, and, in some cases, the lower slack in their economies. The central banks of Argentina, the Philippines, Indonesia, the Czech Republic, Russia, and Turkey raised their monetary policy target rates, while other central banks are anticipated to adopt a more restrictive monetary policy stance in the following months given the deteriorated balance of risks to inflation.

In this environment, in recent weeks international financial markets underwent episodes of volatility and the prices of emerging economies' assets performed negatively. As mentioned above, the strength of the world economy continues to be subject to a high degree of uncertainty due to risks associated mainly with a further intensification of international trade disputes, a further tightening of financial conditions, and with geopolitical factors. Since Banco de México's last monetary policy meeting, most currencies have depreciated against the US dollar, while the indexes of advanced economies fell in the last month, except for those of Japan and the U.S., which benefited from the positive dynamism of the U.S. economy. Fixed income markets registered interest rate increases, in a context where the main central banks are expected to continue the normalization process of their respective monetary policies (Chart 5). The instability of some emerging economies also led to a cautious attitude by investors. The outflow of foreign investment continued in emerging economies, while the prices of both fixed and variable income financial assets remained on a downward trajectory, influenced by the possible impact of U.S. protectionist trade policies and various idiosyncratic factors. Nevertheless, differences among these economies were observed depending on their macroeconomic fundamentals and factors inherent to each country. Countries with the largest macroeconomic imbalances, like Argentina, Turkey, South Africa, and Brazil, have undergone the sharpest exchange-rate depreciations (Chart 6).

Looking ahead, risk factors to both international financial markets and world economic activity persist. The possible consequences of an increased loss of confidence among households, businesses, and investors due to the protectionist trade measures already implemented and their possible intensification stand out. Another persisting risk is that the main advanced economies adjust their respective monetary policies more rapidly than expected if an unexpected pick-up in inflation takes place. In this regard, the financial risks stemming from the high valuations of some financial assets and the uncertainty associated with certain geopolitical events, the rising oil prices, and the deteriorated macroeconomic imbalances of some emerging economies also deserve mention.

Chart 5
Change in Selected Financial Indicators (July 30 – September 28, 2018)
Percent, basis points



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

Chart 6
Performance of Emerging Market Assets since July 30, 2018
Percent, basis points

Region	Country	Currencies	Equity markets	Interest rates 2Y	Interest rates 10Y	CDS
Latin America	Mexico	-0.80%	0.17%	-22	9	-2
	Brazil	-6.98%	-2.11%	48	80	54
	Chile	-2.78%	-1.61%	27	3	-4
	Colombia	-4.26%	2.11%	18	13	6
	Argentina	-31.11%	13.47%	76	123	179
Emerging Europe	Russia	-4.42%	7.69%	130	43	8
	Poland	-1.39%	-2.28%	2	2	2
	Turkey	-17.89%	2.47%	556	-38	63
	Czech Republic	-2.02%	0.30%	33	27	-4
	Hungary	-1.50%	2.65%	23	36	-3
Asia	South Korea	0.78%	1.98%	2	-7	-7
	Malaysia	-1.90%	1.25%	2	-1	11
	India	-5.80%	-2.58%	8	1	11
	Philippines	-1.64%	-7.09%	56	50	5
	Thailand	3.28%	3.44%	7	6	-7
	Indonesia	-3.35%	-1.38%	15	-35	20
Africa	South Africa	-7.42%	-2.66%	26	45	22

Note: Interest rates correspond to interest rate swaps for 2-year and 10-year maturities. In the case of Indonesia, rates with 1-year and 5-year maturities are used because there are no quotes for 2-year and 10-year maturities. For Argentina, rates in US dollars are used as they are the most liquid ones and those that best reflect the performance of that country's fixed-income market.
Source: Bloomberg.

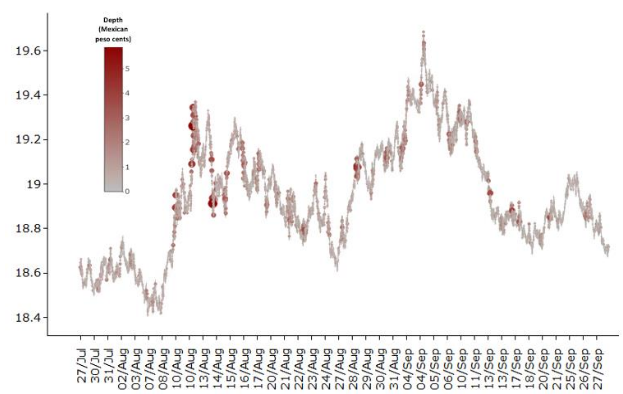
A.2. Current situation of the Mexican economy

A.2.1. Mexican markets

In the weeks after Banco de México's latest monetary policy decision, the Mexican peso depreciated 0.9% against the US dollar, in an environment where most emerging market currencies have undergone greater exchange rate depreciations (Chart 7). The resilience of Mexico's foreign exchange market can be associated with the country's prudent macroeconomic management and with the favorable developments related to the trade agreement reached with the U.S. and Canada. The Mexican peso remains the emerging currency with the best performance so far this year, appreciating by 5% (Chart 8).

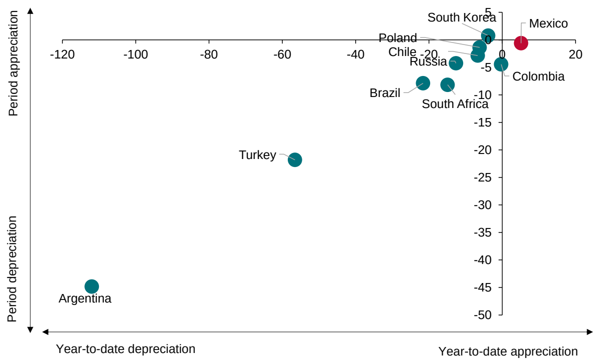
In this context, foreign-exchange market operation conditions remained stable during practically the entire period (Chart 9). Particularly, in relation to the implied exchange-market conditions measured through the implied volatility on foreign currency options, the peso stood out among all emerging market currencies due to its stability (Chart 10). A moderate reduction in derivatives positions in favor of the Mexican peso was also observed, mainly among foreign investors with short-term investment horizons.

Chart 7
Mexican Peso and Intraday Depth
Pesos per US dollar



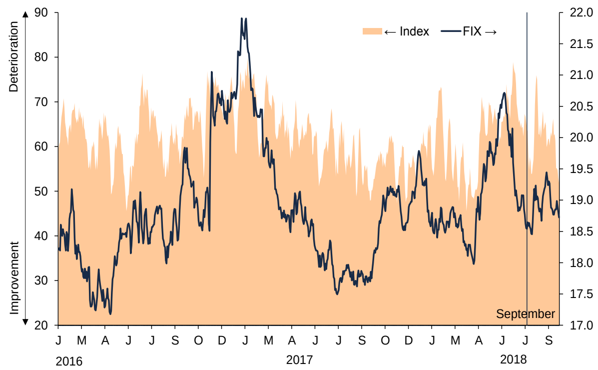
Source: Calculated by Banco de México with "tick by tick" data from Reuters Matching platform.

Chart 8
Percentage Change of Selected Currencies vs. US dollar during the Period
Percent



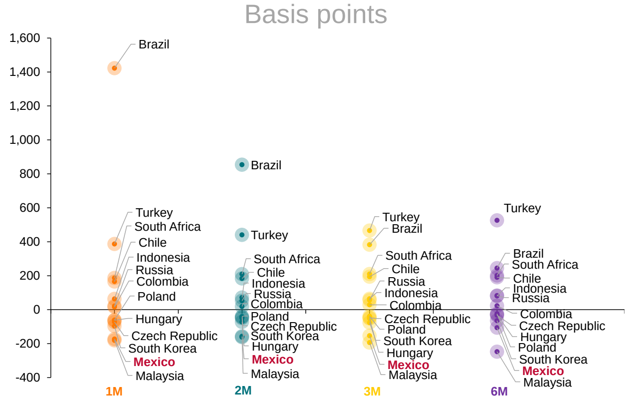
Source: Banco de México with Bloomberg data.

Chart 9
Mexican Foreign Exchange Market Operating Conditions and Peso-dollar Exchange Rate
Index (5-day moving average), pesos per US dollar



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

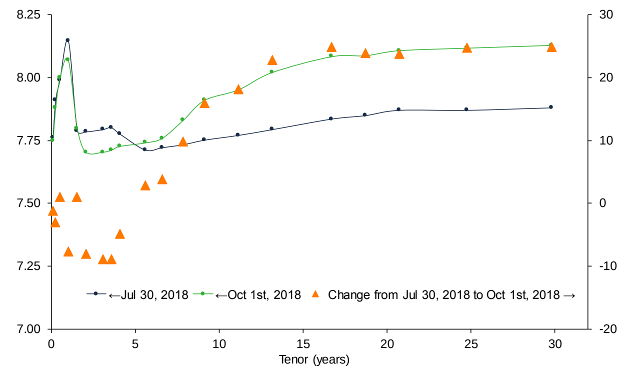
Chart 10
Changes during the Period in Volatility Implied in US Dollar Options at Different Tenors
Basis points



Source: Bloomberg.

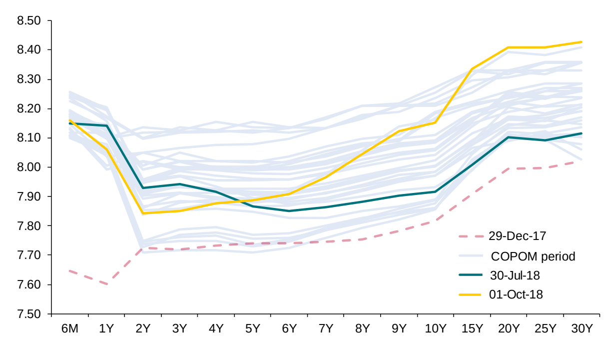
Since Banco de México's previous monetary policy statement to date, the yield curve of government securities' interest rates increased by up to 25 basis points (bps), reaching their highest levels since 2011 (Chart 11). The slope of the yield curve, measured through the spread between 30- and 3-year bonds, steepened by around 34 bps to levels of 42 bps (Chart 12). The aforementioned took place in a context where the operating conditions of this market also remained stable.

Chart 11
Government Bond Yield Curve
Percent, basis points



Source: PIP.

Chart 12
Zero-coupon Curve of Government Securities Interest Rates
Percent

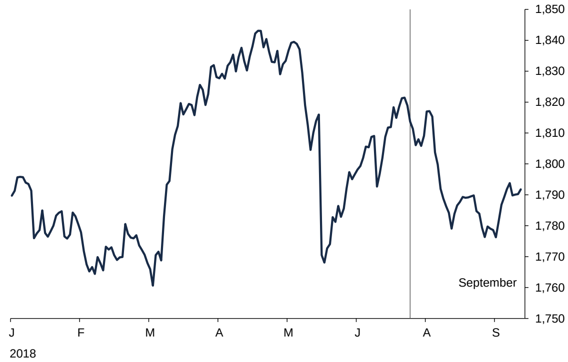


Source: Banco de México with PIP data.

During recent weeks, some capital outflows by foreign investors were registered, reducing their exposure to long-term instruments denominated in Mexican pesos (Chart 13).

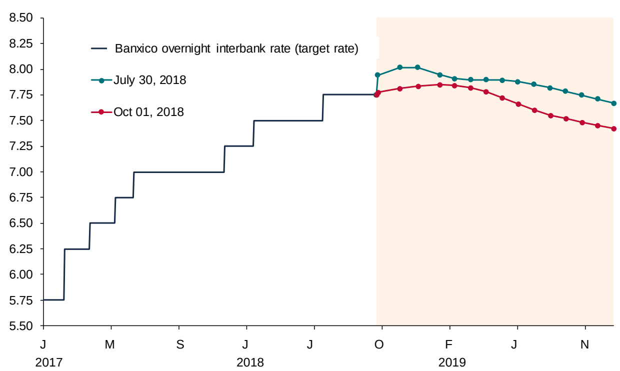
Finally, expectations regarding the level of the monetary policy target rate implied by the yield curve did not change significantly relative to the previous period's levels. Markets foresee that the target rate will reach 7.77% in the central bank's monetary policy decision of October and 7.84% by the end of the year (Chart 14). The consensus among professional forecasters is that no changes in the target rate are expected in the October monetary policy decision and that it will remain at 7.75% until the end of the year.

Chart 13
Non-resident Investors' Risk Position on *Bonos M*
Thousand million Mexican pesos (nominal value)



Note: The vertical black line represents Banco de México's last monetary policy decision.
Source: Banco de México.

Chart 14
Banxico Overnight Interbank Rate Implied in 28-day TIIE IRS Curve
Percent

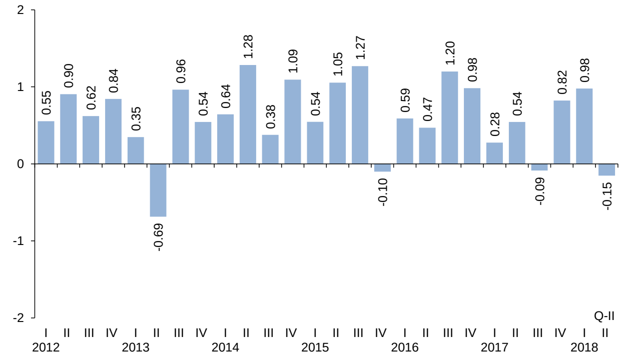


Source: Banco de México with PIP data.

A.2.2. Economic activity and determinants of inflation

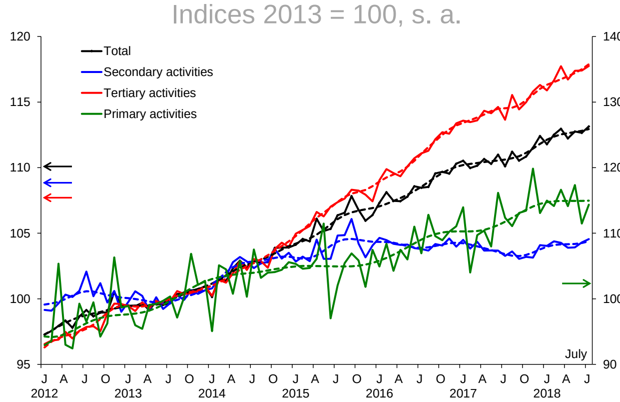
During the second quarter of 2018, economic activity in Mexico contracted relative to the first quarter (Chart 15). This result was due to both the reversion in the dynamism exhibited by investment at the beginning of the year, and a weakening of both consumption and exports. Nevertheless, at the beginning of the third quarter, Mexico's economic activity expanded. The IGAE July figures showed an improvement in its three main economic activity groups relative to their performance in the second quarter of 2018 (Chart 16).

Chart 15
Gross Domestic Product
Quarterly percentage change, s. a.



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

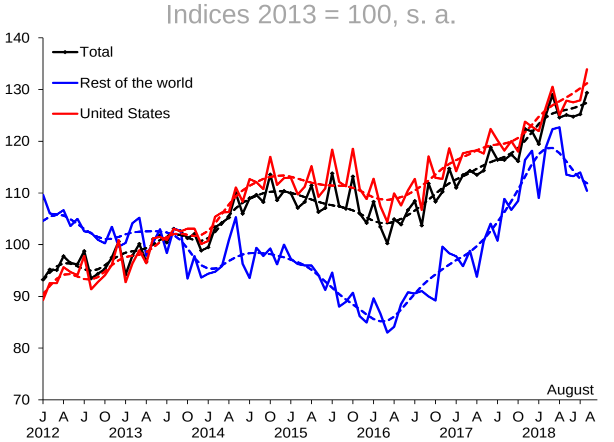
Chart 16
Global Index of Economic Activity
Indices 2013 = 100, s. a.



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

As for external demand, manufacturing exports grew at a higher rate during July and August 2018, vis-à-vis the weakness exhibited during the second quarter of this year. By destination, exports to the U.S. continued to grow, while those to the rest of the world continued to exhibit the same negative trend that has persisted since the beginning of 2018 (Chart 17). According to Mexico's National Accounts System, during the second quarter of 2018, private consumption remained at a level similar to that of the previous quarter. With information up to July, revenues of retail stores continued to exhibit positive results, while, during July and August 2018, sales of light vehicles continued weakening, in contrast with the significant growth they registered between 2014 and 2016. During the second quarter of 2018, both private and public investment slowed down, which led to a partial reversion of the rebound that overall investment had exhibited during the first quarter of this year.

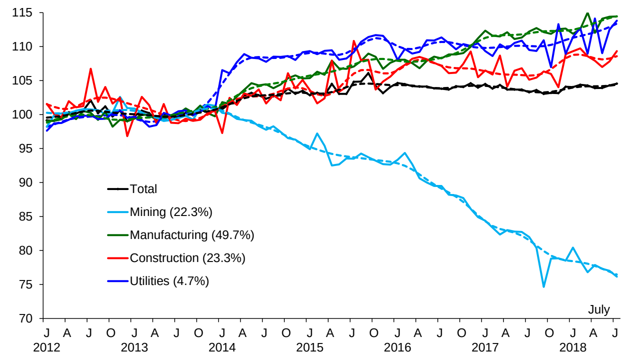
Chart 17
Total Manufacturing Exports
Indices 2013 = 100, s. a.



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

As for production, at the beginning of the third quarter of 2018, services continued on an upward trend and secondary activities continued showing an incipient recovery, while primary activities decelerated slightly (Chart 16). The rebound of tertiary activities was driven mainly by the contribution of the components of finance and insurance; real estate and rental and leasing; transportation and warehousing; information and cultural industries; wholesale trade; accommodation and food services; and, educational services and health care and social assistance. Regarding industrial activity, construction recovered slightly, while manufacturing continued exhibiting some improvement vis-à-vis the weak results observed during most of 2017. In contrast, mining continued on a negative trend (Chart 18).

Chart 18
Industrial Activity
Indices 2013 = 100, s. a.

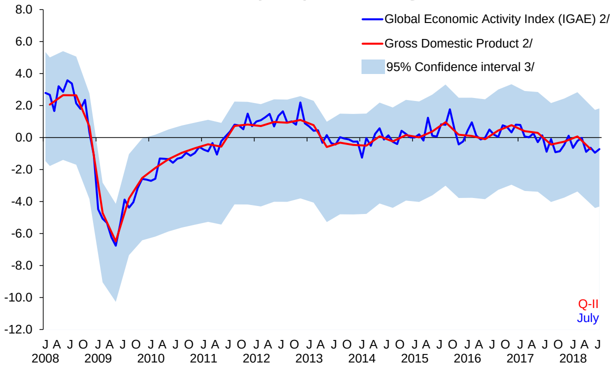


s. a. / Seasonally adjusted series and trend series. The former is represented by a solid line and the latter by a dotted line.
Source: PEMEX and Mexico's National Accounts System (SCNM, for its acronym in Spanish), INEGI.

As for the economy's cyclical position, at the beginning of the third quarter of 2018, slack conditions are estimated to have remained at levels similar to those observed during the second quarter (Chart 19). Regarding labor market conditions, both the urban and national unemployment rates remained at low levels (Chart 20), while the number of IMSS-insured jobs continued exhibiting positive results, albeit with a certain lesser dynamism. According to available information from the second quarter of 2018, as a result of the growth of real average earnings, unit labor costs in real terms for the overall economy increased, reaching levels above their long-term trend (Chart 21). At the beginning of the third quarter of 2018, manufacturing unit labor costs also followed an upward trend.

Chart 19
Output Gap Estimates [1/]
Excluding Oil Industry [4/]

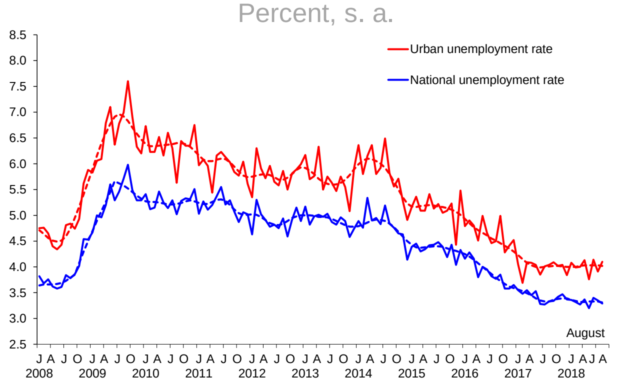
Potential output percentages, s. a.



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/ Second quarter of 2018 GDP figures; IGAE figures up to July 2018 consistent with GDP figures.
3/ Output gap confidence interval calculated with a method of unobserved components.
4/ Excludes both oil and gas extraction, support activities for mining, and petroleum and coal products' manufacturing.
Source: Prepared by Banco de México with INEGI data.

Chart 20
National Unemployment Rate and Urban Unemployment Rate

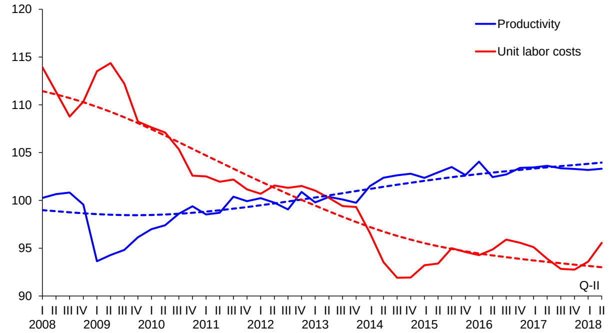
Percent, s. a.



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 21
Global Index of Mexican Labor Productivity (IGPLE, for its acronym in Spanish) and of Unit Labor Costs[1/]

Indices 2013 = 100, s. a.



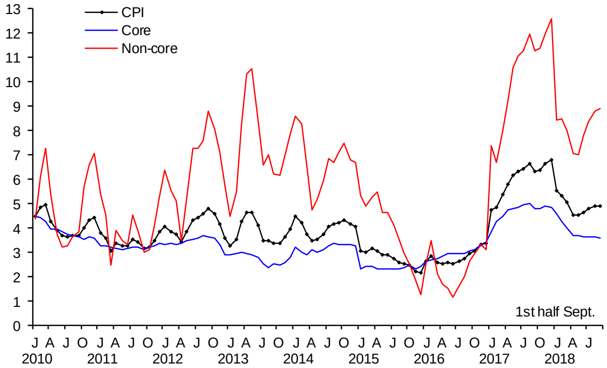
s. e. / Seasonally-adjusted and trend series. The former is represented by a solid line and the latter by a dotted line. Trend series estimated by Banco de México.
1/ Productivity based on hours worked.
Source: IGPLE published by INEGI. Unit labor costs prepared by Banco de México with INEGI data.

In July and August of 2018, financing to the private non-financial sector grew at a more moderate rate as compared with the first half of the year. This was due to the smaller growth of domestic financing to companies, as well as to the continued slowdown of consumer lending. The aforementioned took place in a context where financing costs reached levels above those observed on average during 2017 and, in general, showed slight increases vis-à-vis the first quarter of 2018. Business and housing delinquency rates remained at low and stable levels, while those related to consumer lending apparently stopped worsening, as they had been doing since the end of 2016, although they still remain at relatively high levels. Evidence therefore suggests an absence of demand pressures in the loanable funds market.

A.2.3. Developments in inflation and inflation outlook

Between July and the first half of September, annual headline inflation rose from 4.81 to 4.88%. This increase is explained by a higher price inflation in the non-core component, mainly attributed to increases in energy prices. In contrast, core inflation continued falling. Nevertheless, core inflation's rate of decline has been affected by the indirect effects of energy price increases on the production costs of some items of this sub-index (Chart 22 and Table 1).

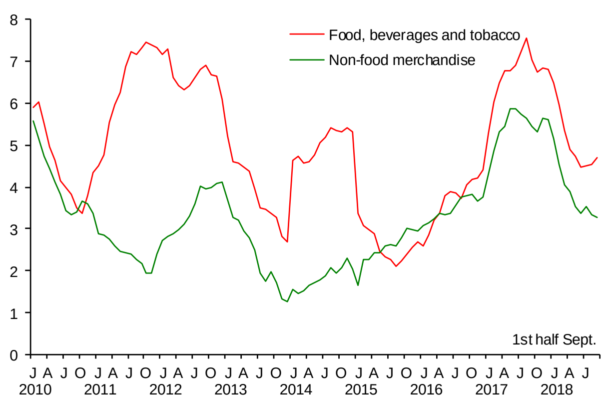
Chart 22
Consumer Price Index
Annual percentage change



Source: Banco de México and INEGI.

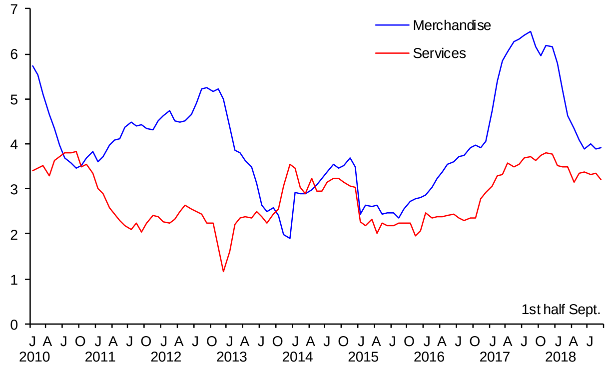
Despite the aforementioned indirect effects, annual core inflation fell from 3.63% in July to 3.56% during the first half of September. Noteworthy was the reduction in the annual rate of change of merchandise prices, driven by the lower increases in the prices of non-food items, which were partially offset by the higher prices of food items (Chart 23 and Chart 24). Service prices also grew at a lower annual rate, due partly to a reduction in the price increases of educational services vis-à-vis the previous year (Chart 25 and Table 1).

Chart 23
Merchandise Core Price Subindex
Annual percentage change



Source: Banco de México and INEGI.

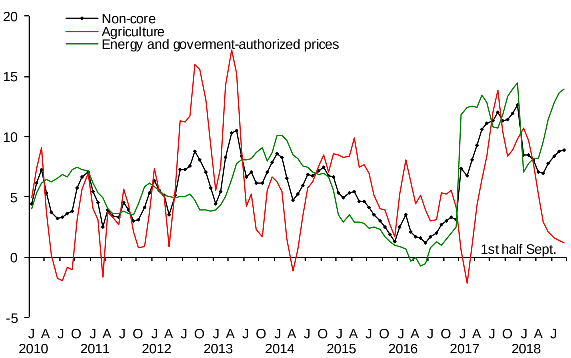
Chart 24
Merchandise and Services Core Price Subindex
Annual percentage change



Source: Banco de México and INEGI.

Annual non-core inflation remains high and continues to increase. Between July and the first half of September, this component jumped from 8.38 to 8.90%, due to the increases in energy prices, mainly those of gasolines and L.P. gas. It is worth noting that, although these price increases stem from higher international references, the gradual adjustment in domestic gasoline prices has made them more persistent. In contrast, the annual rate of change of agricultural prices remained at low levels (Chart 25 and Table 1).

Chart 25
Non-core Price Subindex
Annual percentage change



Source: Banco de México e INEGI.

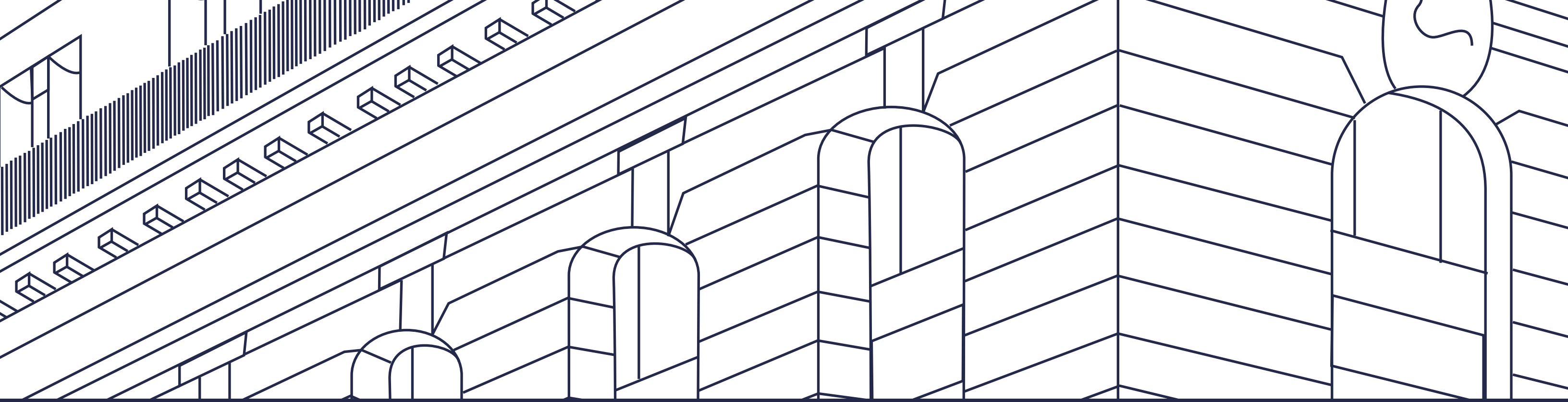
The medians for short-term inflation expectations drawn from Banco de México's Survey of Private Sector Forecasters increased between July and September. The rise in the median for headline inflation expectations for the end of 2018 stands out, as it was adjusted upwards from 4.25 to 4.50% during the same months, after the inflation data observed in June, July and August –particularly, those pertaining to the non-core component– were above forecasters' figures. The median for headline inflation expectations for the end of 2019 was also adjusted from 3.60 to 3.70%, as revealed by the surveys of the same months. In contrast, the median for core inflation for the end of 2018 fell from 3.60 to 3.53%, while that for the end of 2019 remained practically unchanged at 3.43%. The medians for 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 downwards, from 3.85 to 3.76% and from 3.80 to 3.70%, respectively. Finally, the medians for medium- and long-term inflation expectations remained stable at around 3.5%. As for inflation expectations implied in quoted market prices of long-term money market instruments (drawn from 10-year government bonds), they remained near 3.5% during the same period. Inflation risk premia increased during the same period.

Annual headline inflation is expected to continue moving towards the 3% target during the rest of 2018 and in 2019, being close to it during the first half of 2020. Annual core inflation is also foreseen to continue decreasing during the time frame in which monetary policy operates. Inflation faces several risks. To the upside: a) pressures on the peso exchange rate due to an environment of higher external interest rates and to other persisting external and domestic factors; b) additional pressures on energy prices (as revealed by the futures quotes of some of these products); c) a further escalation of protectionist and compensatory measures worldwide that could affect negatively the evolution of inflation; and, d) greater-than-anticipated levels of public expenditure. Moreover, if wage negotiations are not consistent with productivity gains, inflationary pressures on the economy could also appear. To the downside: a) the ratification of the new trade agreement with the U.S. and Canada could have a favorable impact on markets and on the Mexican peso exchange rate.

Table 1
Consumer Price Index and Components
Annual percentage change

	December 2017	June 2018	July 2018	1st half Sept. 2018
CPI	**6.77**	**4.85**	**4.85**	**4.88**
Core	**4.87**	**3.64**	**3.64**	**3.56**
Merchandise	**6.17**	**4.02**	**4.02**	**3.91**
Food, beverages and tobacco	6.82	4.55	4.55	4.69
Non-food merchandise	5.62	3.57	3.57	3.27
Services	**3.76**	**3.31**	**3.31**	**3.20**
Housing	2.65	2.61	2.61	2.61
Education (tuitions)	4.74	4.81	4.81	4.68
Other services	4.63	3.58	3.58	3.70
Non-core	**12.62**	**8.52**	**8.52**	**8.90**
Agriculture	**9.75**	**2.23**	**2.23**	**1.22**
Fruits and vegetables	18.60	0.67	0.67	-1.03
Meats, poultry, fish and eggs	4.50	3.21	3.21	2.40
Energy and government-authorized prices	**14.44**	**12.59**	**12.59**	**14.01**
Energy products	17.69	17.16	17.16	19.32
Government-authorized prices	**8.36**	**4.39**	**4.39**	**4.07**

Source: INEGI.



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