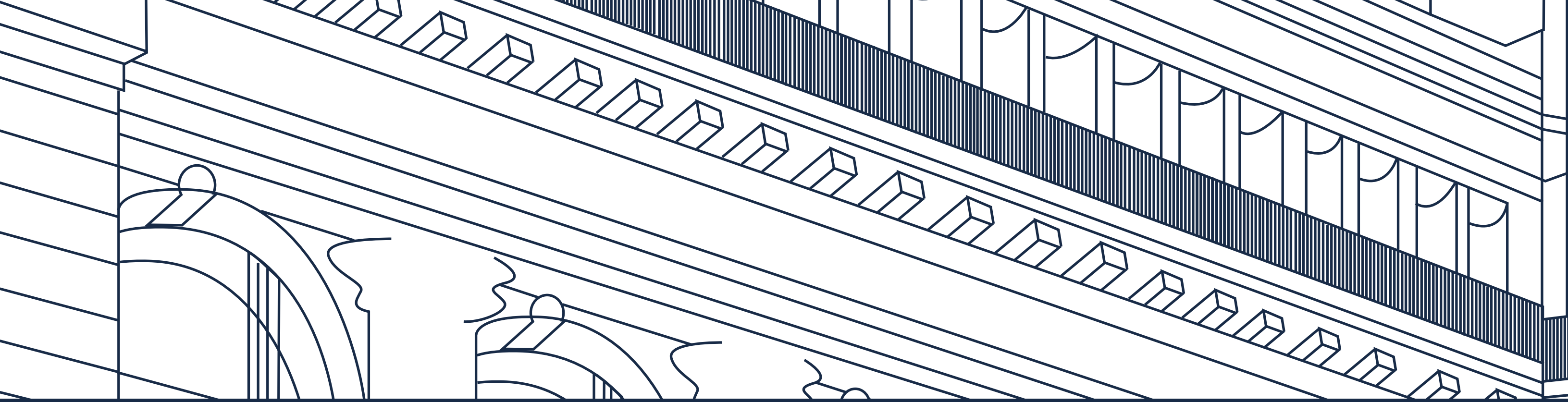

BANCO DE MÉXICO®

Minutes number 68

Meeting of Banco de México's Governing Board on the occasion of the monetary policy decision announced on June 27, 2019

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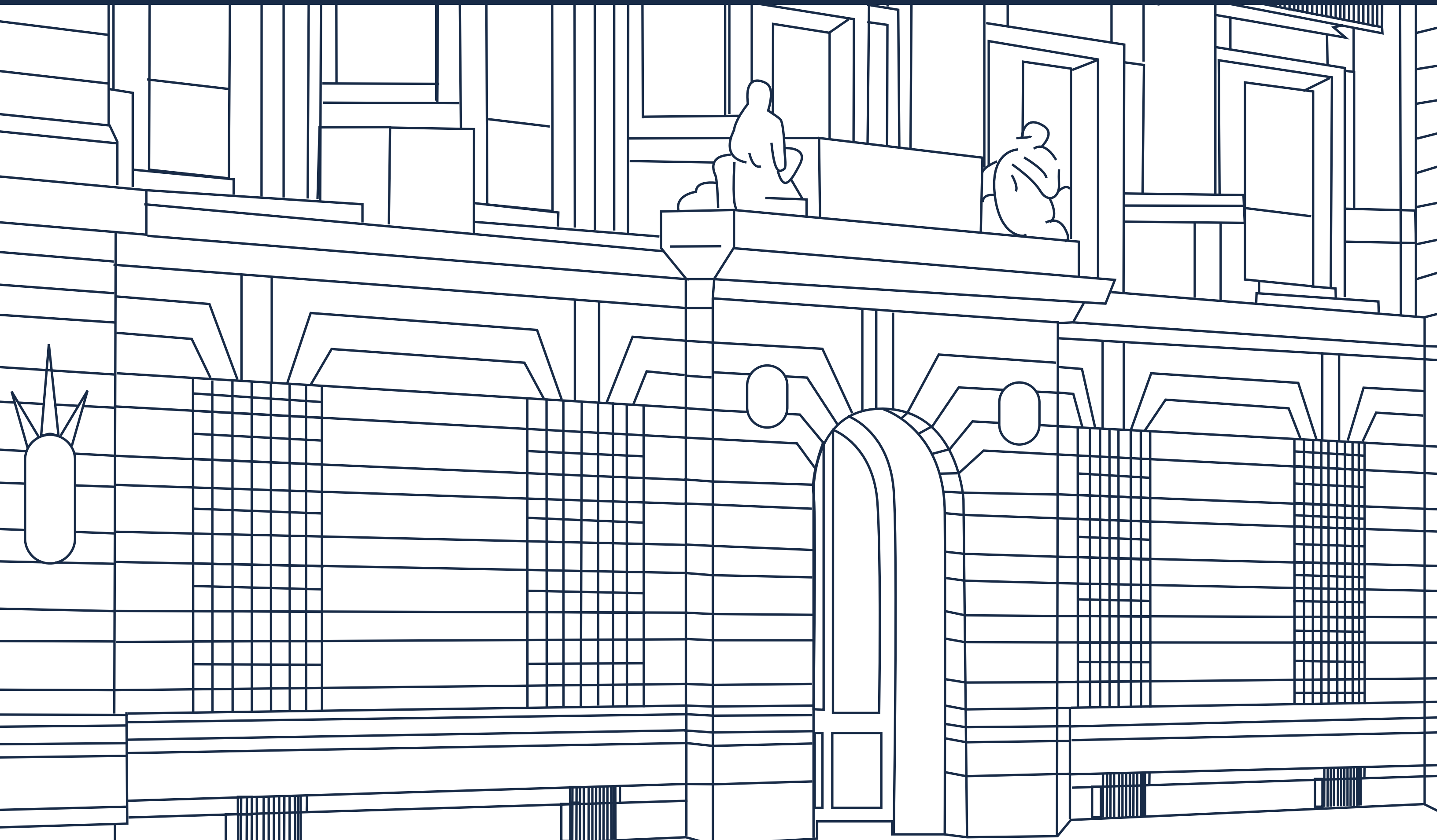

FOREWARNING
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1. PLACE, DATE, AND PARTICIPANTS

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

1.2. Date of Governing Board meeting: June 26, 2019.

1.3. Participants:
Alejandro Díaz de León-Carrillo, Governor
Irene Espinosa-Cantellano, Deputy Governor
Gerardo Esquivel-Hernández, Deputy Governor
Javier Eduardo Guzmán-Calafell, Deputy Governor
Jonathan Ernest Heath-Constable, Deputy Governor
Elías Villanueva-Ochoa, Secretary of the Governing Board

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

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

All members highlighted that available information suggests that during the second quarter of 2019 the world economy decelerated as a reflection of moderation of growth in some of the main advanced and emerging economies. Most members stated that this performance was caused by a more adverse environment for world trade, with periods of significant tension and tariff threats. Some members stressed that indicators related to international trade and the manufacturing sector point to such weakness. Some members noted that business confidence and investment have been affected by this environment to a larger degree. With respect to growth expectations, most noted that these have declined again for 2019 and 2020. One member added that projections corresponding to international trade point to the lowest dynamism of cross-border flows of goods and services since the global financial crisis.

Most members indicated that the balance of risks for global growth remains biased to the downside. They stated that among the major risks those that stand out are: i) a further escalation of trade tensions between the U.S. and its main trade partners; ii) that the weakness of some of the main economies lasts longer than anticipated; iii) that new episodes of international financial volatility occur; and, iv) that some political and geopolitical risks intensify. Regarding the latter, one member stated that such risks could affect the market for energy goods and global financial stability. He/she added that an additional risk factor is the historically high level of corporate and public sector leverage in many countries, which, he/she considered leaves little room for maneuver for fiscal policy to serve as a buffer in the event of a greater deceleration or a recession. Finally, he/she underlined that all of the above could bring about systemic financial vulnerabilities.

As for economic activity in advanced economies, most members argued that growth during the second quarter of the year suggests a new deceleration. One member stressed the case of the euro area, which displays clear signs of weakness both in business confidence indicators and in those associated with manufacturing activity. In the case of the U.S., he/she pointed out that both residential and non-residential investment show an incipient weakness, while exports have started to slow down. In this context, another member mentioned that, although the yield curve of Treasury bonds has inverted in certain tranches, the lower risk premium suggests that such performance points more to a deceleration than to a recession, although all members pointed out that the US economy is expected to undergo a gradual deceleration while most of them indicated that the risk of US recession has increased. Most members stated that although job creation has slightly decreased in advanced economies, unemployment rates remain at low levels and wages continue recovering gradually. One member mentioned that unemployment gaps have remained at historic lows. In this respect, he/she stated that services, which are more labor intensive and less associated with trade activity, have continued to exhibit a better performance, supporting consumption and employment.

Most members mentioned that latest information suggests a deceleration in different emerging economies. One member argued that in the current environment, emerging economies that are more open to world trade face significant challenges to boost investment. He/she explained that idiosyncratic risk factors have increased uncertainty regarding these economies' growth outlook and that in some of them, such as Mexico's, they have hindered investment. Another member warned that the materialization of events of variable but high likelihood, such as the referred global risks, would have severe repercussions for emerging economies, beyond the financial volatility that would be generated. He/she added that regarding economic activity, recent World Bank estimates show that a simultaneous one percentage point deceleration in the growth of the U.S., the euro area and China would generate a negative impact of 1.4 percentage points on growth of emerging economies in the first year alone, followed by a further fall of approximately one percentage point during the second year. Another member delved into downward risks to emerging economies' growth, highlighting the possibility of a greater deceleration of the Chinese economy and of a recomposition of world trade. In this regard, he/she argued that lower bilateral deficits of the major economies could reduce trade opportunities of other economies and break the links of global value chains.

All members stressed that global inflationary pressures are biased to the downside. Some of them agreed that lower commodity prices, especially those of energy products, have contributed to the above. One member claimed that, despite the risk of additional increases in oil prices as a result of geopolitical tensions and/or agreements regarding supply among the main producing countries, downward pressures on inflation could intensify over the next months, which is a cause of concern for some of the main advanced economies. Delving into the case of such economies, most members emphasized that headline and core inflation are below their central bank's targets, and that this has taken place despite the solid performance of their labor markets and the increase, albeit contained, of wages. Some added that the economic weakness is expected to contribute to maintain inflation at low levels. One of them elaborated on the different factors that have kept inflation structurally low in advanced economies. In this regard, he/she highlighted technological change and the integration of regions with abundant labor force into globalization, which have allowed for the fragmentation of productive processes according to comparative advantages and to the cost structure of different countries and regions. He/she stressed that this has led to productivity gains and more competitive markets, which has made it more difficult for companies to raise their prices. In this context, he/she stated that marked differences have been observed between the inflation of goods and that of services. He/she pointed out that the future behavior of inflation in these economies will largely depend on the permanence or the weakening of such factors. Finally, he/she mentioned that expectations of inflation remaining at low levels and without considerable pressures in these economies prevail, although this scenario is subject to risks.

All members pointed out that, given the lesser inflationary pressures and the deceleration of the global economy, expectations that the central banks of the main economies will maintain more accommodative monetary policies have strengthened. In this regard, one member highlighted that in several countries like Australia, Chile, India and Russia, policy rates have already been cut, given the improved outlook in the balance of risks for inflation, in what appears to be the beginning of a new cycle of rate cuts at the global level. Most members mentioned that the recent communications of the European Central Bank point to a greater monetary policy easing. Some members pointed out that it has shown willingness to use all its available tools to support economic activity and to ensure that inflation converges to its target. In addition to the above, one of them stressed that both the Bank of Japan and the Bank of England reaffirmed their commitment to take the necessary actions to reach their targets. As for the US Federal Reserve, most members stated that in its June meeting the target range for the federal funds rate was left unchanged. They stressed the change in the tone of the monetary policy statement towards greater easing, as well as the commitment to adopt the appropriate measures to sustain the economic expansion in view of the increased uncertainty faced by the US economy. They added that the projections for the federal funds rate of the Federal Open Market Committee (FOMC) declined for the end of this year and the following. Most members agreed that the future trajectory of the federal funds rate implied by financial instruments shows a decrease of over 100 basis points accumulated for the end of 2020, and some of them specified that a reduction of at least 25 basis points is anticipated for July's meeting.

Some members stressed that the more adverse environment for world trade which has prevailed since the beginning of May, had a negative effect on international financial markets, in particular, on riskier assets. However, most members argued that, recently, expectations of a more accommodative monetary policy stance by the central banks of major advanced economies has contributed to a decline in interest rates throughout the entire yield curve, both in advanced and emerging economies, as well as to an increase in risk appetite. In this respect, some members mentioned the increase in stock market indices, mainly in advanced economies, as well as the strengthening of emerging economies' currencies. In this context, they emphasized that global financial conditions have eased. One of them specified that portfolio flows to emerging economies have resumed and that sovereign borrowing costs in these economies have declined. Nevertheless, some members noted that, given the idiosyncratic deterioration in some emerging economies and the lower commodity prices, it is possible that capital flows to such economies will not be of the same magnitude as observed in other episodes of increasing risk appetite. One member mentioned that some segments of these markets continue registering outflows and therefore similar patterns of behavior for longer periods or more generalized, cannot be ruled out. Among the risk factors for international financial markets, some members highlighted those previously mentioned with regard to the global economy. One member added the possibility of an intensification of tensions related to investment and technological development as well as a greater slowdown of the Chinese economy. Another member considered that risks to international financial markets have decreased.

All members underlined that available information suggests that economic activity in Mexico exhibits a greater-than-anticipated deceleration, with a contraction in the first quarter of 2019 and signs of weakness in the second quarter. One member added that there is no evidence of a rebound in economic activity, as was anticipated after it was affected by transitory factors in early 2019. Some members specified that an environment of weakness persists in most components of aggregate demand, mainly domestic demand. One of them added that all components exhibited negative variations during the last quarter of 2018, and that similar dynamics are observed for the first quarter of 2019. Delving into domestic demand, most members highlighted the slowdown of consumption and the lack of vigor of investment. One member stated that households' consumption exhibits signs of weakness after having contributed strongly to growth during previous periods, while public spending exhibits negative growth rates. He/she specified that although in the first quarter of 2019 gross fixed investment registered a positive growth rate, this was due to an unusual increase in January, a trend that did not continue during the subsequent months. In this respect, some members added that timely information points to a continuing negative trend in investment, mainly associated to the uncertainty derived from domestic and external factors. As for external demand, some members mentioned that, despite the deceleration of global trade, manufacturing exports have strengthened throughout 2019.

From a longer-term perspective, one member highlighted the secular slowdown in private consumption that has been observed since 2016 as well as the stagnation of private investment during the same period. He/she indicated that nowadays investment is even lower than that registered during 2015. He/she considered that the cost of financing for households and firms has increased constantly since 2016, and that the growth rate of commercial banks' credit has declined since then. In his/her opinion, the transmission mechanism of the tight monetary policy is operating through channels that affect real variables.

On the supply side, most members pointed out that available information suggests that economic activity registered a marginal monthly increase in April in seasonally adjusted terms, below market expectations. Some members highlighted that the Global Economic Activity Indicator (IGAE, for its acronym in Spanish) shows signs of weakness in all of its components. Most members emphasized the slowdown of the services sector, and some members highlighted that a significant unfavorable change in the trend of this sector can already be observed, after having peaked at the end of last year. One of them stated that the latter is worrisome, not only due to the importance of this sector in GDP, but also because for a long time services seemed to have been isolated from the fluctuations in the rest of the economy and were an important growth driver.

Most members pointed out that, given the recent evolution of economic activity in Mexico, the growth outlook has continued to deteriorate. One member specified that downward adjustments have been due to a weaker international environment as well as to domestic factors. He/she added that the economy's weakness is expected to persist, that investment is estimated to continue showing lack of vigor, and that consumption is anticipated to continue loosing dynamism. Another member added that growth expectations among business analysts surveyed by Banco de México have declined and reached 1.35% in May and noted that these figures did not include IGAE's latest data yet and, therefore, they can be expected to continue adjusting to the downside. He/she also mentioned that some private analysts are already forecasting a growth rate as low as 0.5%. In this context, most members noted that during 2019 growth could be lower than expected. One member pointed out that, in his/her opinion, growth could lay around the lower bound of the range estimated in the latest Quarterly Report, and then exhibit some improvement in 2020, although he/she emphasized that this outlook should be considered with caution, due to the limited information published so far. Another member stated that the growth rates of the last two quarters and the results of the Coincident and Leading Composite Indicators System (SICCA, for its acronym in Spanish) already suggest the possibility of a mild recession. In this sense, the same member noted that for 2019 Mexico is expected to grow at a rate lower than that observed during the last ten years and below that forecasted for most emerging economies. One member considered that the economic outlook for 2019 continues to include high uncertainty due to both domestic and external factors.

Most members pointed out that the balance of risks to growth had expanded its downward bias as a result of both external and domestic factors, and some members mentioned that the balance of risks has become more uncertain. Among external factors, in addition to the already described global risks, they added: i) the possibility that there are difficulties in the ratification of the United States-Mexico-Canada Agreement (USMCA) by the legislative bodies of the U.S. and Canada; and, ii) that there are new threats of tariffs on Mexican imports by the U.S. In this regard, one member underlined that, although the negotiations between the governments of these two countries led to the indefinite suspension of tariffs, such agreement is a temporary solution and will be revised in mid-July, and the way in which the results of Mexico's commitments will be measured is not clear. He/she stressed that the mere perception of the U.S. authorities that Mexico is not fulfilling its commitments, as well as the electoral cycle in the U.S., could prolong the threat of the imposition of tariffs. He/she emphasized that the ratification of the USMCA in the U.S. and Canada could become more complex, and that, even if the agreement is ratified by the congresses of the three countries, the continuous threat of tariffs by the U.S. towards Mexico could hinder the implementation of the new trade agreement.

Among domestic risks, some members mentioned the possibility of additional reductions to the sovereign credit rating and to that of Pemex's. One member pointed out that a similar situation could occur with the Federal Electricity Commission (CFE, for its acronym in Spanish), whose credit rating and outlook were also revised downwards by an agency, although its debt continues maintaining investment grade. Another member mentioned the risk of a greater decrease in public revenues. Finally, one member pointed out the direction taken by public policies in different areas. These elements are addressed in detail further in this document.

Most members mentioned that slack conditions in the economy have loosened even more than expected. In this regard, some noted that the risk of economic slack widening in the next quarters persists. One member mentioned that, despite the economic weakening, different indicators point to relatively high wage pressures. He/she added that the combination of weak economic activity and wage pressures has affected the evolution of employment. He/she noted that a broad range of labor market indicators, such as the unemployment rate, the share of employed population that became unemployed, or the withdrawals from individual AFORE accounts due to unemployment, show the greater lassitude exhibited by this market. Some members mentioned that the labor market shows a lower rate of job creation. One member pointed out that informal sector employment has increased and formal employment has contracted. He/she specified that across different regions of Mexico, the weakening of employment is more evident in the Northern border free zone, where the larger wage adjustments have been observed, and that the lessons derived from this experience should be taken into consideration.

Most members mentioned that between April and the first fortnight of June 2019, headline inflation decreased from 4.41 to 4.00%. One member highlighted that this indicator lay at the upper limit of the variability interval around the target. All members indicated that the decline of headline inflation was due to a significant decrease of the non-core component. In turn, most members pointed out that core inflation remains at high levels. One member pointed out that headline inflation has shown a clear downward trend since September, when it was at 5.02%, although it rebounded temporarily in March and in April due to calendar factors. He/she stressed that the recent evolution of inflation has been better than anticipated, and that the figure of the first fortnight of June turned out to be far below the forecast in the Quarterly Report published in May. He/she added that observed inflation has been considerably below the expectations at the end of 2018, when analysts expected cumulative inflation up to May 2019 to be 0.68%, while it was only 0.21%. In this context, another member stated that cumulative headline inflation for the first five months of 2019 was the third lowest for a similar period since Banco de México adopted the current inflation-targeting regime, and that with June's figure, which again surprised on the downside, the cumulative rate of the first half of the year points to be the second lowest after the historically low figure registered in 2015. He/she emphasized that this responds to the fact that cumulative non-core inflation of the last five months is the lowest for this statistic since the measurements of core and non-core inflation have been on record, and that the random and volatile nature of non-core inflation should be stressed, given that cumulative core inflation during the same period was 1.60%, the fourth highest in the last 20 years. One member pointed out that although the decline in headline inflation has been fundamentally due to non-core inflation developments, it is possible to anticipate that over the next months core inflation will also begin to decrease.

As to the performance of the non-core and core components, all members highlighted that the former has been following a downward trend and the majority indicated that it decreased from 6.08 to 4.34% between April and June 2019. The majority also highlighted that such reduction was mainly the result of the lower increases in energy products, which were partly due to the fall in their international references. Some members also added the lower increases observed in the prices of fruits and vegetables. As for core inflation, most members pointed out that it was 3.87% both in April and June 2019. One member noted that it surprised again to the upside in June. Most members mentioned that core inflation has been affected by the indirect effects of pressures on energy prices and that, within it, the higher rates of change of food merchandise and services prices are noteworthy. Some members stated that core inflation's resistance to decline is worrisome, since a greater economic slack should lead to lower pressures on this component. One member argued that core inflation's persistence may be partly due to the fact that both the labor gap and wage pressures have offset the effects that a negative output gap and slack conditions may have otherwise had. Another member underlined that this subindex, in addition to remaining at high levels, has registered new increases in recent months. Such member noted that this performance is not explained by the behavior of some of the items within it but rather by widespread pressures on core inflation, as shown by trimmed mean indicators, the median of the rates of change, and the re-weighted estimates which smooth the influence of extreme variations. He/she pointed out that, in the case of services, significant increases in education and figures close to 6% in services other than housing and education, excluding tourist and telecommunication services, as well as an upward trend in the prices of housing-related services, although still below 3%, are observed. He/she added that, due to their nature, the factors that explain these trends probably stem from the shocks on food merchandise and energy prices as well as the wage adjustments that took place in previous months. Another member stated that, to understand the latest inflation dynamics, it is useful to consider an indicator such as the six-month moving average of the seasonally adjusted annualized monthly rate of change, as it does not carry forward the performance of inflation from relatively distant periods and is not affected by problems related to the base of comparison. The same member noted that, according to such indicator, core inflation displays a clear downward trend, laying at around 3.5%, while headline inflation is close to 3.1%.

Most members mentioned that, between early May and mid-June, short-, medium- and long-term headline inflation expectations did not register significant adjustments. Some members pointed out that, in the same period, core inflation expectations for 2019 and 2020 increased slightly. The majority highlighted that, for all terms, expectations remained above the 3% target. One member emphasized that they are also above Banco de México's forecasts. Another member emphasized that although observed inflation from December to May has been significantly below inflation expectations registered at the end of 2018, headline and core inflation expectations for the end of 2019 have been adjusting upwards. The same member added that these upward adjustments are surprising given that between December and May, observed inflation was below expectations and several inflation risk factors for inflation have mitigated in relation to their levels of December of last year. As to information drawn from market instruments, most members mentioned that medium- and long-term breakeven inflation expectations remain at high levels. In this regard, one member warned that the latter suggests the perception of high risks for inflation in the long run. Nevertheless, another member pointed out that such premium decreased slightly at the margin.

The majority of members pointed out that both headline and core inflation are expected to follow a downward trend in the following months. Some members stated that headline inflation may improve slightly, mainly due to lower pressures on non-core inflation. Another member noted that average annual headline inflation figures for the second quarter of 2019 may be below the forecasts in the two Quarterly Reports published this year. He/she mentioned that if the monthly rates continue exhibiting a relatively favorable performance, the annual rates of change of headline inflation and core inflation may eventually converge to lower levels, once the effects related to the base of comparison fade. Delving into the outlook for core inflation, some members noted that it should begin to decline, partly due to the lower indirect effects of energy prices, as well as to the weakness of the economy. In this context, they pointed out that headline inflation is still expected to attain the target towards mid-2020. One member considered that it is feasible to attain the 3% target in the first half of 2020 and a figure below 3.5% towards the end of 2019. Another member pointed out that core inflation should begin to decrease once the temporary indirect effects on food prices that resulted from increases in energy products during the second half of 2018 begin to dissipate. These effects were due to the confluence of supply shocks in energy and food products, which will eventually end up fading.

As for inflation risks, most members pointed out that some have diminished and others have gained relevance. Among risks to the upside for headline inflation, most members highlighted the possibility that the peso exchange rate comes under pressure stemming from external or domestic factors. In this regard, one member considered that it is unclear how relevant the risk of a greater exchange rate depreciation passing through on prices is, since the pass-through coefficient is either extremely low or very close to zero. He/she stated that the pass-through is practically insignificant for economies with inflation targeting regimes, central bank independence from the fiscal authority, and with flexible exchange rates. Nevertheless, he/she acknowledged that this risk cannot be entirely ruled out since the pass-through is not static and may have an unexpected non-linear behavior. In this regard, another member highlighted the risk of exchange rate pressures due to Pemex's loss of investment grade by a second rating agency and that such risk has increased due to the lack of a credible business plan for Pemex. The majority stated as an additional upward risk the threat of the United States imposing tariffs on Mexican imports and the adoption of compensatory measures, although this risk has decreased as a result of the recent agreement. One member also included the risk associated to the USMCA ratification. Some members mentioned the possibility of protectionist measures escalating worldwide and that core inflation's persistence leading to a greater resistance to decline of medium- and long-term inflation expectations. Most members also underlined the risk that public finances deteriorate.

The majority of members highlighted the risk that, given the magnitude of several wage revisions, cost-related pressures arise, insofar as such revisions exceed productivity gains. One member highlighted that the above may affect formal employment and put pressure, particularly on core inflation. Another member noted his/her concern that such cost pressures are being observed in the overall economy and, especially, in the manufacturing sector. He/she added that such pressures may intensify at the beginning of 2020 if minimum wages are adjusted above productivity gains. One member underlined that a lower-than-expected capacity of the economy to absorb labor cost increases, may put pressure on the most labor-intensive sectors, as is the case of several of the service sectors. He/she mentioned as additional risks that the indirect effects of energy prices and of the IMSS-insured workers' wage materialize into higher pressures on housing prices and those of other services, as well as the possibility of greater increases in food merchandise prices due to increases in international prices. Another member added that, despite the greater economic slack, core inflation's resistance to decline may continue, just as has been the case in the last quarters, in which despite economic activity having weakened more than expected, core inflation has continued to show resistance to decline and has even increased at the margin. As to the risks to the upside that may affect the non-core component directly, most members mentioned the possibility that energy prices revert their trend or that agricultural and livestock product prices increase. One member stated that, in an environment of geopolitical tensions, the international price of crude oil may differ from its forecast. He/she warned that a higher crude oil price affects gasoline prices, limiting the scope of action of the federal government to stabilize them through adjustments to the special excise tax on production and services (IEPS, for its acronym in Spanish).

As for risks to the downside for headline inflation, the majority of members highlighted that the peso exchange rate appreciates, which may possibly be associated with a context of more accommodative monetary policy stances and lower interest rates worldwide, or in case greater certainty regarding the trade relation with the United States is achieved. They also pointed out the possibility that slack conditions widen more than anticipated, as suggested by the latest information on economic activity, which might influence the behavior of core inflation. One member added the possibility that public finances improve. Regarding the risks to the downside that affect non-core inflation directly, most members mentioned that there may be lower rates of change in the prices of some of the goods included in this subindex, as has been the case with energy prices. One member pointed out that the price of gasoline may decrease if there is a fall in crude oil prices, given the greater weakness of the world economy.

Most members agreed that significant uncertainty persists regarding the risks that might affect inflation. They considered that the net impact of inflation risks is uncertain since opposite effects are taking place. One member argued that, in his/her opinion, inflation risks have decreased significantly vis-à-vis those observed in December 2018, adding that this is due to several factors, such as the improvement in global financial conditions, which lessens the pressure on the peso exchange rate and, eventually, on inflation. The same member added that energy prices are expected to remain stable, in line with the federal government's price fixing policy. He/she highlighted that the impact of the minimum wage on inflation has been only slightly significant, that slack conditions in the economy have been increasing, and that the balance of risks for growth remains clearly biased to the downside. Another member expressed that the balance of risks remains tilted to the upside, despite expectations of a greater economic slack and the recent monetary policy statements by the US Federal Reserve, as it remains to be seen if specific actions by this central bank materialize and in that case what their impact on inflation would be. The same member highlighted that as evidenced by the recent experience with the trade tensions with the U.S., and the changes in the credit rating or in the credit outlook of sovereign debt and of Pemex's debt, the exchange rate might suddenly adjust due to domestic and external events. Such member added the risks of wage pressures being above productivity gains and of the behavior of non-core inflation. He/she noted that in his/her opinion, the convergence of inflation to the target in 2020 implies figures for that item of around 3%, when it is the case that its long-term average has been above such figure. One member argued that, as to the balance of risks for inflation, it is important to analyze the risks to non-core inflation on one side, and those to core inflation on the other, since the factors determining each component are different. He/she stated that, on the one hand, risks to non-core inflation are more symmetrical; that is, their occurrence may either favor or harm their dynamics, and they are also not affected by monetary policy; on the other hand, risks to core inflation are more asymmetrical and, in principle, susceptible to monetary policy actions. He/she considered that the balance of risks for core inflation seems to be biased to the upside, while that for non-core inflation is slightly biased to the downside.

All members highlighted that, since the last monetary policy decision, domestic financial markets displayed episodes of volatility due to the threat of tariffs on US imports of Mexican products. The majority pointed out that the revisions to the outlook or the credit rating of the sovereign debt and that of Pemex by some rating agencies also contributed to the greater volatility. Nevertheless, they underlined that, in recent weeks, long- and medium-term nominal and real interest rates of government securities decreased significantly and that the peso exchange rate reverted the depreciation that was previously observed. Most members considered that this improvement was driven by the agreement reached between the governments of Mexico and the United States, the increase in risk appetite among investors given the outlook for more accommodative monetary policy stances in advanced economies, and the interest-rate spreads between Mexico and other economies. In this regard, one member mentioned that such spreads have mitigated capital outflows, mainly in public and private fixed income, although, given the prevailing uncertainty, there has been a rebalancing of government bond holdings towards long-term instruments, which partly explains the yield curve's inversion. One member mentioned that long-term nominal and real interest rates provide useful information regarding the risk premia in the economy. He/she added that both yield curves are inverted, which may provide insights for the assessment of both the economy and the monetary policy stance. One of them pointed out that, in line with the significant improvement in global financial conditions since June, long-term interest rates on government securities are at their lowest levels of the year and have decreased in more than 100 basis points, the sovereign risk premium has slightly decreased and the Mexican Stock Exchange resumed an upward trend, after having fallen in May. The same member also highlighted that the peso has appreciated with respect to the levels observed at the end of 2018 and noted that the level of the exchange rate is sustained by interest rate spreads, by the trade agreement with the U.S. and Canada (USMCA) and its recent ratification by the Mexican Senate, by investors' consent to the New Mexico City International Airport bond buyback offer, by the fight against fuel theft, and by the new administration's commitment to fiscal discipline. In this regard, another member added that although long-term interest rates decreased in Mexico, they did so to a lesser extent than in other emerging economies. He/she pointed out that although Mexico's favorable interest rate spread with respect to that observed in other emerging economies, has mitigated the adjustment of the exchange rate in the presence of shocks, the peso exchange rate against the US dollar has accumulated an appreciation similar to that observed in other Latin American currencies in 2019, which evidences the risk perception about the Mexican economy.

Most members warned that there are factors that may deteriorate the performance of financial assets in Mexico, such as the risks regarding the credit outlook of the sovereign debt and that of Pemex, as well as the uncertainty regarding the US-Mexico bilateral relationship. One member noted that, given the aforementioned risks, domestic assets are being traded at a discount vis-à-vis other similar emerging economies' assets. Another member considered that the risks for domestic financial markets have been decreasing, although he/she acknowledged that those related to global and domestic economic weakness, as well as with Pemex's situation, remain latent.

Some members stated that the credit rating of both sovereign debt and Pemex's debt were downgraded by one rating agency and that their credit outlook was revised from stable to negative by another one. One member pointed out that it is worth recalling that, although several Mexican financial assets and their derivatives —such as the credit default swaps— had already discounted the adjustment from BBB+ to BBB since several months ago, there is still concern regarding additional adjustments due to possible vulnerabilities coming from public finances. Another member noted that the rating agencies highlighted the following aspects to justify their decisions on their sovereign credit rating: i) the uncertainty regarding the implementation of public policies and their impact on investor's confidence; ii) the changes and lack of clarity as to the energy policy; iii) the risks regarding Pemex's financial situation and the uncertainty about its business plan; and, iv) the implications of the above described factors on public finances and on economic growth.

Most members considered that addressing the deterioration of both the sovereign credit rating and that of Pemex is necessary. With regards to this company, one member highlighted that the rating agency that recently downgraded its credit rating mentioned that such adjustment reflected: i) the downgrading of the sovereign credit rating; ii) the continuing deterioration of Pemex's financial profile; and, iii) the lack of investment to revert the decline in its production capacity. Another member stated that the fact that the decision to revise downwards the credit rating or outlook of Pemex's debt was taken before the company announced its business plan is noteworthy. The majority emphasized that Pemex's risk premium has deteriorated significantly. One member attributed such deterioration to the rating agencies' actions, pointing out that, although the increase of Pemex's debt risk premium has affected its financial cost, the impact on the financial cost of the sovereign debt has been limited, given that the sovereign debt risk premium decreased even while that of Pemex's was increasing. Some members noted that markets are discounting the loss of Pemex's investment grade by a second credit rating agency. They stated that the confirmation of this event might lead to forced sales of the company's debt by investors, a process that may already be underway. One member mentioned that this would complicate even further not only the company's financing capacity but of the overall economy, it could affect volatility in financial markets and compromise the consolidation of public finances. He/she noted that the price of Pemex's external debt has deteriorated in the secondary market, which may imply a lower availability of resources in the future. Another member argued that Pemex's loss of investment grade would not necessarily lead to episodes of financial volatility since such risk has already been discounted and the adjustments in investors' portfolios may take place gradually.

In this context, most members noted the importance of preventing an additional deterioration in the credit rating of Pemex's debt. They noted that to improve the situation of the company, a clear and credible business plan is necessary, together with a medium- and long-term strategy focused on value generation and that improves the company's access to financial markets. Nevertheless, one member warned that a solution for the company's problems has not been offered yet. He/she noted that only isolated measures that affect the development of the energy sector have been announced, such as the cancellation of the last bidding rounds; the construction of the oil refinery in Dos Bocas; and the international arbitration process started by CFE against the builders of the Texas-Tuxpan sea-bed pipeline. Some members mentioned that in case the actions taken to reactivate oil production and restore the health of Pemex's finances are insufficient, this would have important implications for public finances and in general for the economy. One member deemed it increasingly urgent to implement measures that address the challenges faced by this company. Some members warned that CFE's financial situation also contributes to increase the vulnerability of public finances in Mexico.

Most members highlighted that the current environment continues to pose significant medium- and long-term risks that could affect the country's macroeconomic conditions, its capacity to grow, and the economy's price formation process. One member noted that in light of a highly complex external situation and insufficient actions domestically to offset such complexity, the impact on investment and on potential growth might be significant, in an environment in which the latter seems to already be decreasing. In this regard, such member highlighted that private sector analysts' expectations for Mexico's economic growth rate over the next ten years lay only slightly above 2%. In this context, the majority pointed out that, in addition to a prudent and firm monetary policy, public finances must be consolidated in a sustainable way. One member argued that such consolidation is of paramount importance given that monetary policy's room for maneuver increases in an environment of robust public finances. The majority added that measures to foster an environment of confidence and certainty for investment and higher productivity should be adopted, with one member pointing out the adoption of new technologies and the strengthening of human capital. Most members also mentioned that strengthening the rule of law, tackling corruption, and fighting insecurity are equally imperative. In this context, one member underlined the need to avoid the combination of an economic deceleration along with actions that could affect price formation, and pressure inflation above its target.

As to public finances, most members warned that, in an environment of lower revenues, fiscal policy has little room for maneuver. In particular, one member pointed out that public sector's total budgetary revenues, including Pemex, CFE, and other government agencies under direct budgetary control, were below the expected in the program. He/she noted that such reduction was due to the contraction of the oil production platform and to transitory decreases in VAT tax collection. He/she also stated that this situation may worsen if there is a greater-than-expected economic deceleration. In addition, he/she emphasized that there is an under-spending of programmable budgetary resources in various items and that projections suggest that public sector revenues and spending will end the year with negative deviations vis-à-vis the levels programmed for 2019. Under such scenario, he/she noted that the public sector has limited room for maneuver to offset the revenue shortfalls. He/she emphasized that this may lead to a policy of raising the IEPS for fuels and/or to withdrawals from the Budget Revenue Stabilization Fund (*Fondo de Estabilización de los Ingresos Presupuestales*, FEIP). Nevertheless, another member added that, given its explicit commitment to fiscal consolidation, the federal government would not have margin to finance the deficit with debt nor have room for adjusting spending, which has already been reallocated to social programs that are difficult to cut down. In this regard, he/she highlighted that the lack of clarity and predictability regarding the direction of several public policies in strategic sectors, and an expenditure policy that has favored the redistribution of resources towards social transfers in detriment of public investment, are factors that continue undermining investors' confidence and putting pressure on the dynamics of the economy and of public finances.

Finally, one member highlighted that domestic banks have a robust capitalization level and a high liquidity level. He/she mentioned that these indicators reflect that banks are capable of responding to unexpected losses or stress situations that may arise in the short run. He/she concluded that the stress tests published in the last Financial Stability Report confirm the resilience of the Mexican banking system.

The majority considered that the current monetary policy stance is consistent with the convergence of inflation to the target. However, they expressed their concern about the resistance to decline displayed by core inflation. One member stressed that such persistence has occurred despite the tight monetary policy stance and has been an obstacle to headline inflation's convergence to the target. Another member argued that the core component is the one that more adequately reflects inflationary pressures in the economy and that it has remained at high levels despite the slowdown of economic activity. The majority mentioned that it is essential to monitor closely the evolution of core inflation and that it resumes its downward trend. One member added that core inflation's persistence, coupled with the volatility of non-core inflation and a balance of risks for inflation that, in his/her opinion, is biased to the upside, could lead to a persistence of long-term headline inflation expectations above the target or to a de-anchoring of such expectations. Another member expressed his/her concern about the level of short-, medium- and long-term inflation expectations reflecting a lack of credibility in the central bank's actions.

The majority pointed out that expectations of a more accommodative monetary policy stance by the US

Federal Reserve provides Banco de México greater room for maneuver. One member pointed out that monetary policy in Mexico is one of the most restrictive among emerging economies, adding that since May 2017, the policy rate in Mexico has been adjusted in a synchronized manner with that of the Fed, in such a way that the yield spread between Mexico and US interest rates has remained at around 575 basis points. He/she considered that given the latest developments observed in the path of inflation, economic growth and financial stability risks, a widening yield spread cannot be justified, so that in the event of a monetary policy easing in the United States, Banco de México should act accordingly, so that the current spread is maintained. Another member added that if a cut in the Fed's target range for the federal funds rate were to take place, it would represent a challenge for monetary policy conduction in Mexico, since a widening in the yield spread between both countries could generate and additional tightening in monetary conditions in Mexico, although he/she stressed that this has not yet materialized.

Some members mentioned that given the complex environment faced by inflation, it would not be convenient to ease the monetary policy stance if inflation does not show a clear trend towards the 3% target. One of them added that the possibility of weak economic growth coupled with persistent inflationary pressures in which the convergence of inflation to its target is delayed cannot be ruled out, and that if such a scenario materializes, monetary policy decision-making would become more complex. Another member argued that a downward adjustment of 25 basis points to the policy rate is necessary, given inflation's favorable evolution, unfavorable expectations regarding economic growth and the outlook of a monetary policy easing in the United States. He/she added that, in his/her view, this adjustment in Mexico's monetary policy stance would be consistent with the convergence of inflation to its target within the time frame in which monetary policy operates. He/she argued that the monetary policy statement should highlight that risks for inflation have decreased since December of last year, that inflation has behaved as expected by the central bank, and that it is foreseen to attain the inflation target in the near future. He/she mentioned that this would send a message of certainty and confidence to markets that inflation is under control and on the path towards the target. In this regard, he/she stated that the information provided by the central bank to economic agents serves to shape their own beliefs regarding the state of the economy, and therefore the tone of the central bank's communications can become a mechanism for coordinating or confirming private agents' beliefs. He/she stressed that the pessimistic tone of the recent monetary policy statements cannot be ruled out as being one of the reasons behind the recent increase in inflation expectations. Another member pointed out that if the behavior of inflation continues to be aligned with the convergence to its target, it will be necessary to begin a cycle of monetary policy easing in a relatively short horizon. He/she pointed out that there is the risk of maintaining a tight monetary policy for a prolonged period, to the detriment of economic growth, public finances and financial costs. However, he/she added that given the inflation risks, the decision to begin a cycle of policy rate cuts must be taken very prudently and cautiously. He/she pointed out that a premature easing of monetary policy could generate volatility in domestic financial markets and affect key variables for financial stability. In light of the aforementioned, he/she considered that, although the policy rate should not be adjusted on this occasion, the monetary policy statement should have a less restrictive tone.

Most members agreed that monetary policy faces a complex juncture in which a high degree of uncertainty prevails and in which certain factors are putting downward pressure on inflation, while others are pushing it upwards. One member highlighted that it is to be expected that over the next months, the path of inflation will be very much influenced by the combined impact of the deceleration of economic activity, supply shocks from several sources, and the persistence of a situation of high uncertainty with potential effects on the exchange rate. He/she mentioned that the incidence in opposite directions on inflation of the above mentioned factors requires monetary policy to be managed with extreme caution. Such member underlined that there is still no evidence of a decline in core inflation and that although some inflation risks have slightly decreased, others such as those stemming from the trade relationship with the U.S. and with the sovereign and Pemex's credit rating persists or have even intensified. He/she pointed out that under such circumstances, there is the risk that the path of the exchange rate exhibits fluctuations that are incompatible with the attainment of the inflation target in 2020. Such member concluded that the monetary policy adjustment must be based on convincing evidence of a sustained decrease of inflation towards the target, and that in an environment of increased economic slack and such high levels of uncertainty, Banco de México's Governing Board must be prepared to respond in case of surprising events. Another member stated that although greater economic slack, together with an external environment of prevailing lower interest rates and a certain lack of vigor in the outlook for growth, point to an environment of lower inflationary pressures within the time frame in which monetary policy operates, there are other elements that are also influencing the domestic economy and price formation, especially when headline and core inflation are at levels above 3%, and have shown a resistance to decline, and several risks are still present. The majority agreed that under such challenges the central bank must maintain a prudent and cautious policy stance and monitor closely all determinants of inflation, its outlook, its balance of risks and the possible materialization of certain risks, in order to guarantee the convergence of inflation to its target. Finally, they stated that the central bank's communication should reflect that it will be attentive to taking the required monetary policy actions based on incoming information, and will act in a timely manner to guarantee the orderly convergence of inflation to its goal.

3. MONETARY POLICY DECISION

To guide its monetary policy actions, Banco de México's Governing Board follows closely the development of inflation vis-à-vis its forecasted trajectory, taking into account the monetary policy stance and the time frame in which monetary policy operates. In this process, it uses available information on all inflation determinants as well as on medium- and long-term inflation expectations, including the balance of risks for such factors. Monetary policy must also respond prudently if for any reason the uncertainty faced by the economy increases considerably. In this context, considering that the current monetary policy is consistent with the convergence of inflation to its target within the time frame in which monetary policy operates, Banco de México's Governing Board decided by majority to maintain the target for the overnight interbank interest rate at 8.25%. One member voted to reduce the target by 25 basis points. Considering the challenges to consolidate a low and stable inflation as well as those the economy's price formation is subject to and the amount of slack in the economy, the Governing Board will continue to follow closely all factors and elements of uncertainty that have an impact on inflation and its outlook and will take the required actions based on incoming information so that the policy rate is consistent with the orderly convergence of headline inflation to Banco de México's target within the time frame in which monetary policy operates. Banco de México's Governing Board will maintain a prudent monetary policy stance and, under the current environment of uncertainty, will follow closely the potential pass-through of exchange rate fluctuations to prices, Mexico's monetary policy stance relative to that of the U.S. —in an external environment that it is still subject to risks— and the behavior of slack conditions and cost-related pressures in the economy. In the presence and possible persistence of factors that, by their nature, involve risks to both inflation and its expectations, monetary policy will be adjusted in a timely and firm manner to achieve the convergence of inflation to its 3% target and to strengthen the anchoring of medium- and long-term inflation expectations so that they attain such target.

4. VOTING

Alejandro Díaz de León-Carrillo, Irene Espinosa-Cantellano, Javier Eduardo Guzmán-Calafell and Jonathan Ernest Heath-Constable voted in favor of maintaining the target for the overnight interbank rate at 8.25%.

Gerardo Esquivel-Hernández voted in favor of reducing the target for the overnight interbank rate by 25 basis points to set it at a level of 8.00%.

5. DISSENTING VOTES

Vote. Gerardo Esquivel-Hernández

Inflation has exhibited a better performance than the one forecasted in previous Quarterly Reports and is on a convergent path to Banco de México's target. Cumulative inflation for the first semester of the year will fluctuate around 0.30% and will be the second lowest figure so far this century. Annual figures for both headline as well as core inflation have been influenced (either directly or indirectly) by the increase in energy prices during the second semester of 2018. These effects, however, must fade in the second half of the year. Thus, I estimate that by December 2019, inflation will be very close to or even below 3.4%, that is, in line with the forecasts of last year's Quarterly Reports. In addition to the above, there are other elements that must be considered in the determination of the target interest rate: the announced loosening of the monetary policy of advanced economies and the noticeable economic deceleration in the country. These factors open a space to be able to cut the interest rate in 25 basis points without putting at risk nor compromising the fundamental mandate of Banco de México.

ANNEX

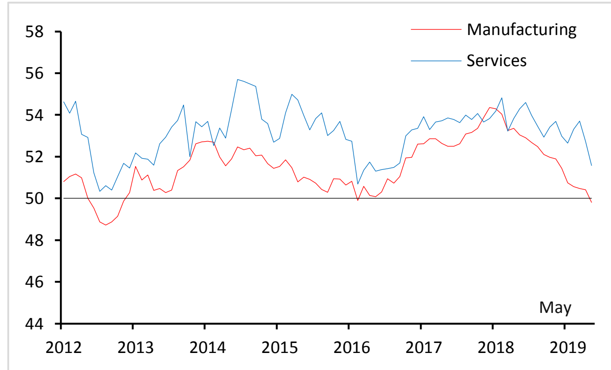
The information in this Annex was prepared for this meeting by the staff of Banco de México's General Directorate of Economic Research and General Directorate of Central Bank Operations. It does not necessarily reflect the considerations of the members of the Governing Board as to the monetary policy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

A.1. External conditions

A.1.1. World economic activity

Available information suggests that the world economy decelerated during the second quarter of the year, due to moderation of growth in some of the main advanced and emerging economies. Similarly, indicators on world trade, business confidence, and investment have also weakened further over the last months, partly due to the environment of greater uncertainty regarding the trade relations between the United States and some of its main trade partners. Additionally, forward-looking indicators, such as the manufacturing and services Purchasing Managers' Index (PMI), suggest a further weakening of the global economy during the following months (Chart 1). The scenario described above has led to new downward adjustments in the global growth outlook by several international organizations. Headline and core inflation in the main advanced economies have remained at low levels and their expectations have decreased. The aforementioned environment has strengthened expectations that central banks of the major economies will adopt more accommodative monetary policy stances. Notwithstanding all of the above, the balance of risks for the global economy remains biased to the downside. In particular, there is a possibility of further escalations of trade tensions between the United States and its main trade partners, that the weakness of some of the major economies extends for longer than previously foreseen, that new episodes of volatility arise in international financial markets, and that certain political and geopolitical risks intensify, including the possibility of a disorderly exit of the United Kingdom from the European Union (Brexit) and the escalation of tensions between the United States and Iran.

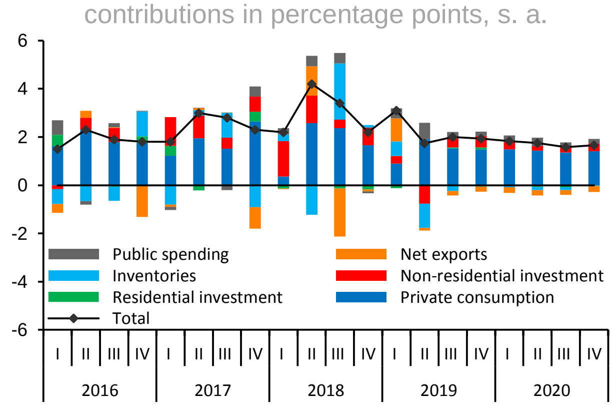
Chart 1
Global Purchasing Managers' Index
Diffusion indices, s. a.



s. a. / Seasonally adjusted figures.
Source: IHS Markit.

In the United States, available indicators suggest that GDP will grow at a seasonally adjusted annualized quarterly rate below the 3.1% registered during the first quarter (Chart 2). These expectations can be associated with the greater weakness exhibited by both residential and non-residential investment and, as expected, with a sharp deacumulation of inventories and a lower growth of net exports. In contrast, private consumption and public spending are expected to rebound, thus mitigating the weak performance of the aforementioned indicators.

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



s. a. / Seasonally adjusted figures.
Source: Bureau of Economic Analysis (BEA) and Blue Chip.

U.S Industrial production grew at a monthly rate of 0.4% in May, after having contracted 0.4% in April. The improvement in May was mainly associated with the strong recovery of 2.1% in electricity and gas production, given that the mining and manufacturing sectors grew at more moderate rates of 0.1 and 0.2%, respectively. The lack of vigor of manufacturing continued to reflect the impact of trade tensions and the weakness of world growth. In addition, forward-looking indicators, such as the component of new orders of the Purchasing Managers Index (PMI), continue to suggest that the weakness of manufacturing production may persist in the short run.

The US labor market exhibited signs of lower strength. In particular, the non-farm payroll increased by only 75,000 jobs in May, while employment figures for March and April were revised downwards; thus, the three-month moving average decreased from 238,000 jobs in January 2019 to 151,000 in May. Nevertheless, the US unemployment rate remained at 3.6% in May, while other indicators such as job openings and initial unemployment insurance claims continued to reflect tight labor market conditions. In this context, both nominal and real wages continued to grow.

In the euro area, although private consumption remained strong, driven by the increase in employment and wages, as well as by the high levels of consumer confidence, available figures point to a lower GDP growth during the second quarter. Such weakness is related to a further deterioration of international trade stemming, in turn, from lower world growth. In this regard, forward-looking indicators, such as the Manufacturing PMI and business confidence, suggest that this sector's lassitude may persist in the following months. Nevertheless, the labor market continued to strengthen, as it displayed a decline in the unemployment rate from 7.7 in March to 7.6% in April.

In Japan, available indicators for the second quarter of 2019 show a moderation of economic activity, after having increased at a seasonally adjusted annualized quarterly rate of 2.2% in the first quarter of this year. The weakening of economic activity in this country seems to be related to the continuous deterioration of net exports, while consumption and public investment appear to be contributing positively to growth. The negative trend of the Manufacturing Purchasing Managers' Index intensified, increasing the possibility of a contraction in that sector during the second quarter. In this context, the strengthening of Japan's labor market moderated its pace, although it remained tight. Indeed, the unemployment rate in April remained at 2.4%, in line with the average of the past year, although wage growth decreased.

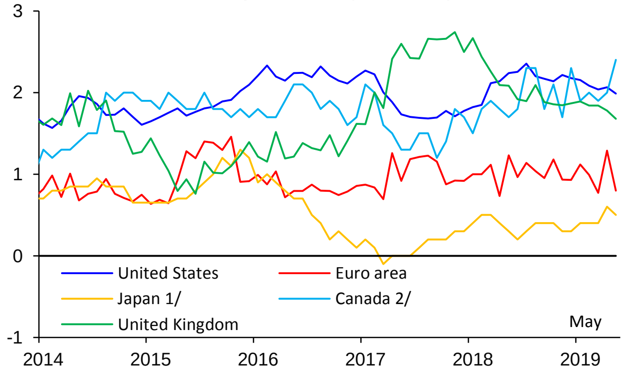
In emerging economies, forward-looking indicators suggest a moderation of economic activity during the second quarter. In China, economic activity indicators reflect a slight weakening during the second quarter, after the stabilization of the rate of GDP growth observed during the first quarter. The main European emerging economies, notably Turkey, Hungary, and Poland, are also expected to weaken. In turn, timely indicators suggest an upturn of economic activity in countries such as India, Korea, the Philippines, and some of the main Latin American economies.

As for international commodity prices, these have, for the most part, followed a downward trend. Particularly, crude oil prices decreased until mid-June as a result of several factors that affected the global demand for crude oil, such as the escalation of trade tensions between the United States and its main trade partners; the unexpected surge in US crude oil and fuel inventories; and, the slowdown of global economic activity. Nevertheless, in recent weeks, the intensification of geopolitical tensions between the United States and Iran contributed to a partial recovery of such prices. Industrial metal prices continued to fall, given the lower dynamism in industrial activity worldwide and the U.S.-China trade standoff. In contrast, grain prices, particularly wheat and maize, rose sharply due to the unfavorable climate conditions for crop sowing observed recently in the United States.

A.1.2. Monetary policy and international financial markets

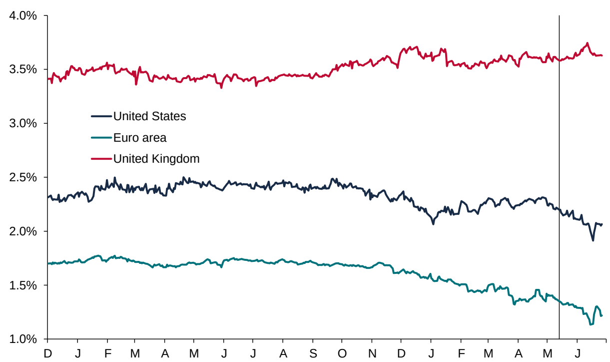
In most advanced economies, core inflation has remained relatively stable and at low levels (Chart 3). The possibility that economic activity continues to weaken and that inflation expectations decline further may increase the risks of persistently low inflation rates. In the United States, the annual rate of change of the personal consumption expenditure deflator (PCE) remained below the Federal Reserve's target, while core inflation, as measured by the Consumer Price Index (CPI), continued to decrease in May, going from 2.1 to 2%. In the euro area, core inflation has remained at low levels, in part due to the apparent decision by firms to reduce their profit margins rather than to raise consumer prices in the face of gradual increases in their labor costs. In recent weeks, inflation expectations implicit in market instruments for advanced economies have decreased, among which those for the euro area that are at historically low levels, stand out (Chart 4).

Chart 3
Selected Advanced Economies: Core Inflation
Annual percentage change



1/ Excludes fresh food, 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, Statistical Office of the European Union (Eurostat), and Statistics Bureau (Japan).

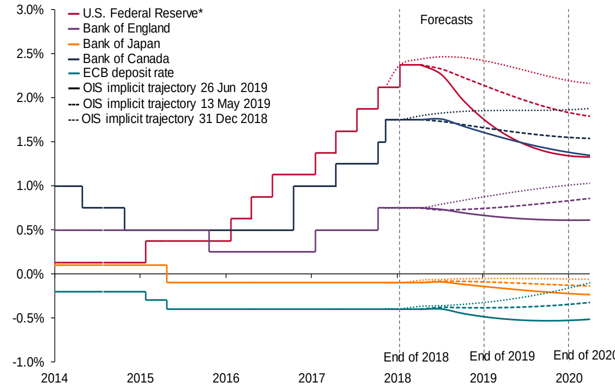
Chart 4
Selected Advanced Economies: Inflation Implied in 5-year Inflation Swaps in Five Years
Percent



Note: An inflation swap is a contract in which one of the parties is bound to pay the expected inflation rate (fixed rate) and receive the realized inflation rate during the period (variable rate).The vertical line represents the day of the latest monetary policy decision.
Source: Bloomberg.

The aforementioned environment has strengthened the expectation that the central banks of the major economies will adopt more accommodative monetary policy stances, especially if risks to economic growth in their countries intensify (Chart 5).

Chart 5
Reference Rates and Implied Trajectories in OIS Curves[1/]
Percent



1/ OIS: Fixed floating interest rate swap where the fixed interest rate is the effective overnight reference rate.
* In the case of the US observed reference rate, the average interest rate of the federal funds target range is used (2.25% - 2.50%).
Source: Bloomberg.

In its June meeting, the US Federal Reserve left the target range for the federal funds rate unchanged at 2.25-2.5% as expected, although one member voted for reducing it by 25 basis points. In its policy statement, the Federal Open Market Committee (FOMC) expressed that, although growth of household spending appears to have picked up, business investment has remained weak, while inflation remains below its 2% target. The FOMC mentioned that the uncertainty faced by the US economy has increased, in a context in which there is an absence of inflationary pressures and, hence, its members will follow closely the economic developments. The FOMC added that its members would take the appropriate measures to sustain the economic expansion with a strong labor market and inflation at levels close to its 2% symmetric objective. The median of the FOMC's economic projections reflected the expectation of lower growth for 2020 and a decline in headline and core inflation for 2019 and 2020. In this context, the median of its projections on the policy rate suggest that it may remain at its current level during 2019, although eight out of seventeen members are anticipating a lower target rate before the year ends. The median of the policy rate for 2020 was also revised downwards from 2.625 to 2.125%, while that for 2021, from 2.625 to 2.375%. Market instruments are anticipating between two and three 25 basis points decreases for this year and an additional one for 2020.

In its June meeting, the European Central Bank (ECB) left its benchmark rate unchanged at 0%, its key deposit facility rate at -0.4% and its key marginal lending facility rate at 0.25%. Regarding its forward guidance, the ECB stated that key interest rates will remain at the current levels at least until the first half of 2020, instead of until the end of 2019, as expressed in its last policy statements. Later, as part of his speech at the ECB Forum in Sintra, ECB President Mario Draghi highlighted that, in the absence of improvement in economic activity, such that the convergence of inflation to the ECB target is threatened, an additional monetary stimulus would be required. In this regard, he pointed out that, if necessary, the ECB has tools to ease its monetary policy, stating that, in its last meeting, some measures were discussed, such as the possibility of adjusting the bias and conditionality of its forward guidance, cutting its key interest rates, and extending its targeted longer-term refinancing operations (TLTRO).

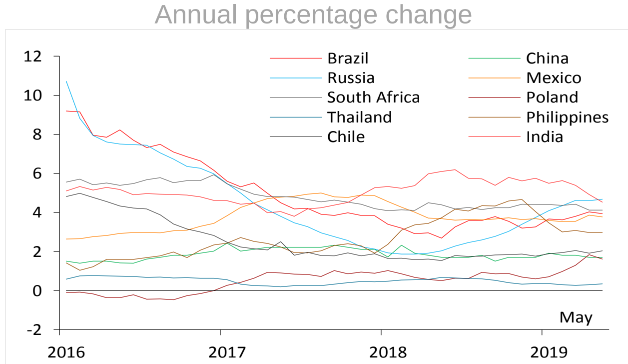
In its June meeting, the Bank of Japan left its short-term policy interest rate unchanged at -0.1% and its long-term interest rate (indexed to its 10-year bond) at 0%. Although this central bank stated that the economy is expected to continue growing at a moderate pace, it highlighted that external risks will continue to be significant. As to its forward guidance, the Bank of Japan reaffirmed that it will keep short- and long-term interest rates at extremely low levels until at least the spring of 2020, although it underscored that it will assess the risks to its conduction of monetary policy and make the appropriate adjustments, taking into account the developments regarding economic activity, prices, and financial conditions. Nevertheless, in a press conference, Governor Kuroda mentioned that the Bank of Japan will ease its monetary policy stance if the upward trend of inflation weakens.

In its May meeting, the Bank of Canada left its policy interest rate unchanged at 1.75%, as expected. In its communication, this central bank declared that the Canadian economy has behaved in accordance with its estimates and that available figures suggest a rebound of economic activity during the second quarter of 2019, after the weakening of economic activity observed in the last part of 2018 and early 2019. However, it argued that, in an environment of escalating trade risks, an accommodative monetary policy stance remains appropriate. The Bank of Canada also highlighted that it will closely follow the development of household spending, oil markets, and trade policies worldwide. In this environment, market variables incorporate a cut in its policy interest rate in the next twelve months.

In its June meeting, the Bank of England left its base rate (Bank rate) unchanged at 0.75%. This central bank emphasized that the latest figures on economic activity are consistent with its May projections, although it acknowledged that downward risks have intensified, particularly the higher possibility of a no-deal exit of the United Kingdom from the European Union and the growing uncertainty regarding the outlook for the global economy. With regard to its monetary policy, the Bank of England reaffirmed that although the most appropriate stance continues to be that of a gradual and limited increase of the policy rate, such rate will be adjusted in whatever direction is necessary. In particular, it stated that this adjustment will depend on the conditions under which the United Kingdom exits from the European Union and its consequent impact on aggregate supply and demand and on the pound sterling exchange rate.

In most emerging economies, inflation increased driven by the rise in energy prices in the first months of 2019, and recently, in food prices. Nevertheless, core inflation has remained low, and only with certain exceptions, without significant changes (Chart 6). In this context, some central banks started or continued easing their monetary policy stances. In particular, the Central Bank of India cut its policy interest rate in a context in which the negative output gap has widened and inflation is below target; the Central Bank of Chile cut its monetary policy rate, highlighting that economic growth during the first quarter was below forecast; and the Central Bank of the Russian Federation lowered its key rates, emphasizing that it may further reduce the rate once or twice in the remainder of 2019. The People’s Bank of China adopted additional measures to increase the liquidity ratio of small-sized banks.

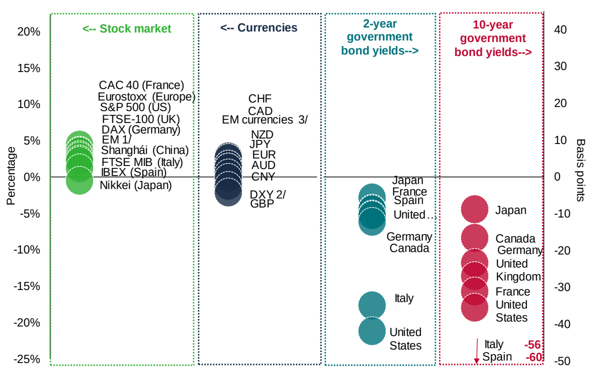
Chart 6
Emerging Economies: Core Inflation
Annual percentage change



Source: Haver Analytics.

Expectations of the event that a more accommodative monetary policy stance will be adopted by the central banks of some of the major advanced economies, led to a decline in interest rates throughout the entire yield curve and to an increase in risk appetite in international financial markets (Chart 7). In advanced economies, stock market indices registered moderate gains in anticipation of the possibility of lower financing costs in the near future, while the US dollar depreciated slightly against most currencies, given expectations that the Federal Reserve will reduce its target rate in the coming months. In this context, the prices of financial assets of emerging economies overall registered a positive performance, with a slight appreciation of their currencies, a decrease in interest rates of government securities, and a certain recovery of most stock market indices (Chart 8). As to capital flows to these economies, they exhibited mixed results, with inflows to debt markets and outflows from stock markets.

Chart 7
Change in Selected Financial Indicators (May 13, 2019 – June 26, 2019)
Percent, basis points



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

Chart 8
Emerging Economies: Financial Assets Performance (May 13, 2019 – June 24, 2019)
Percent, basis points

Region	Country	Currencies	Equity markets	Interest rates 2Y	Interest rates 10Y	CDS
Latin America	Mexico	0.17%	1.30%	-32	-50	-11
	Brazil	4.07%	10.89%	-116	-121	-26
	Chile	1.83%	2.14%	-83	-61	-8
	Colombia	3.05%	2.68%	-57	-66	-17
	Argentina	5.99%	23.57%	-237	-117	-197
Emerging Europe	Russia	4.20%	10.12%	-65	-47	-18
	Poland	2.71%	6.41%	-7	-26	-1
	Turkey	4.02%	10.31%	-424	-407	-64
	Czech Republic	2.29%	1.18%	-25	-29	0
	Hungary	1.57%	-0.15%	-19	-47	-7
Asia	South Korea	2.62%	2.28%	-33	-26	-2
	Malaysia	0.58%	4.69%	-13	-16	-7
	India	1.68%	5.48%	-39	-62	3
	Philippines	1.39%	4.11%	-73	-65	-6
	Thailand	2.89%	4.63%	-20	-28	-1
	Indonesia	1.95%	2.49%	-26	-59	-1
Africa	South Africa	-0.29%	4.23%	-40	-23	-19

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

Going forward, market participants will remain attentive to the evolution of several risk factors that may lead to higher volatility and to a deterioration of financial market conditions. Among those that stand out are an unfavorable outcome of trade negotiations between the U.S. and its main trade partners; the risk of a sharper deceleration of economic activity in a context in which the scope of action of central banks is limited; and, an escalation of geopolitical tensions worldwide.

A.2. Current situation of the Mexican economy

A.2.1. Mexican markets

Since Banco de Mexico's latest monetary policy decision to date, the prices of financial assets in Mexico underwent episodes of volatility associated with different events that took place in the country. Among those that stand out are:

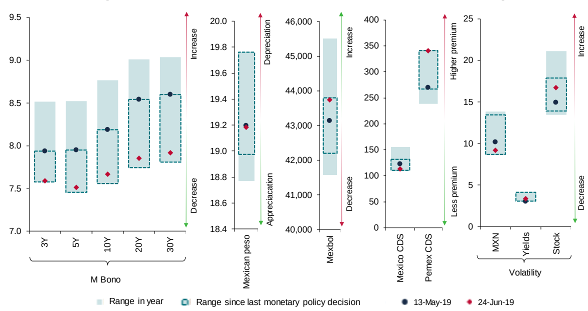
- The announcement by the US government of the potential imposition of tariffs on all Mexican imports, which was averted given the temporary agreement reached between both governments on matters of migration.

- The downgrading of the long-term sovereign credit rating by Fitch Ratings from BBB+ to BBB and the later adjustment of Petróleos Mexicanos' (Pemex) credit rating from BBB- to BB+. With this adjustment, Pemex's debt lost its investment grade in this credit rating agency's scale.

- Although Moody's rating agency confirmed its A3 long-term foreign-currency debt rating for Mexico, it reviewed the country's outlook from stable to negative for both the sovereign and Pemex's credit ratings.

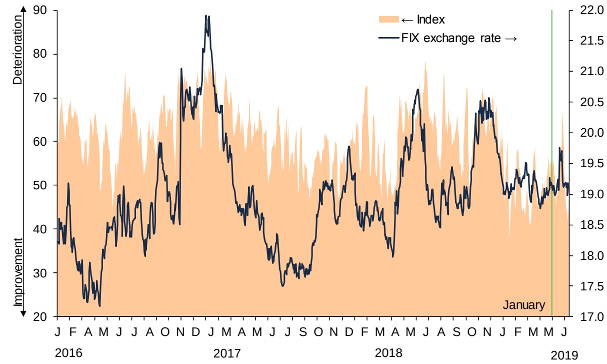
Thus, the peso exchange rate fluctuated widely against the US dollar, reaching a maximum level of 19.80 pesos per US dollar. Nevertheless, in recent weeks, given the agreement reached with the United States, which averted the previously announced tariffs, and the greater risk appetite among investors in view of the outlook for more accommodative monetary policies in advanced economies, the peso exchange rate appreciated by 0.10%, ending the period at 19.18 pesos per US dollar (Chart 9). Similarly, both FX spot and forward outright trading conditions deteriorated after the announcement of the possible trade tariffs on Mexican products, and stabilized after the migration agreement was reached (Chart 10).

Chart 9
Mexican Markets' Performance and Trading Conditions
Percent, pesos/US dollar, index and basis points



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

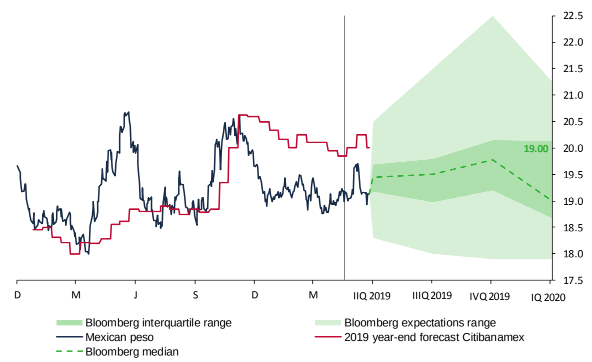
Chart 10
Mexican Foreign Exchange Market Trading Conditions
Index (5-day moving average) and pesos/US dollar



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

As for the peso exchange rate, expectations by several financial institutions' forecasters were adjusted upwards. For the end of 2019 such expectations were revised from 19.85 to 19.90 pesos and from 20.00 to 20.23 pesos per US dollar for the end of 2020 (Chart 11).

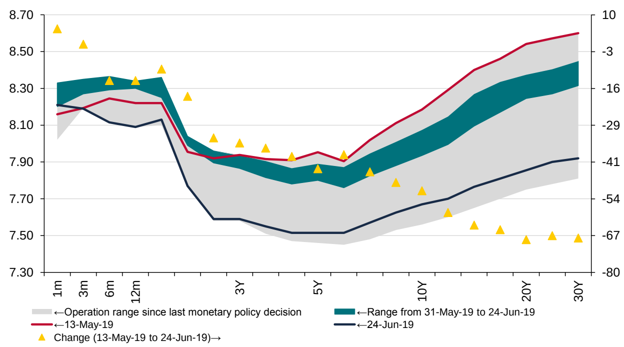
Chart 11
Analysts' Mexican Peso Exchange Rate Expectations for Each End of Quarter
Pesos/US dollar



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

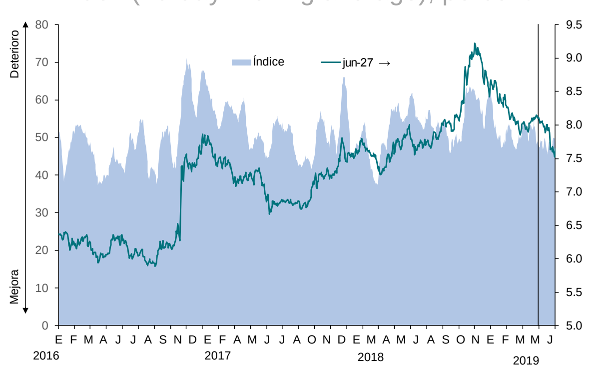
Interest rates on government securities decreased by up to 69 basis points, primarily for medium and long term instruments (Chart 12). This movement was associated on the one hand to the adjustments observed in most debt markets worldwide, which were due to expectations that central banks of the main advanced economies will adopt a more accommodative monetary policy and, on the other hand, to the monetary policy stance adopted by Banco de México given the environment of inflationary risks that prevails in Mexico. The above described occurred in a context in which trading conditions deteriorated some days during the period (Chart 13).

Chart 12
Nominal Yield on Government Securities
Percent, basis points



Source: PIP.

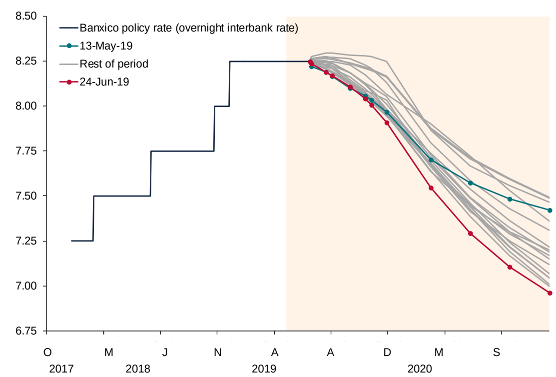
Chart 13
Mexican Government Debt Market Trading Conditions and Jun-27 Bond Rate
Index (10-day moving average), percent



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

As to expectations regarding the path of the monetary policy reference rate implied in the yield curve, these remained unchanged vis-à-vis the levels observed in the previous period (Chart 14). In this regard, both expectations of the consensus of private sector analysts surveyed by Citibanamex and those implied by market instruments do not anticipate changes to the target rate for the monetary policy decision of June. For the end of 2019, both expectations implied by market rates and the median of the last survey among economists foresee a reduction of 25 basis points in the policy rate.

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



Source: Banco de México with Bloomberg data.

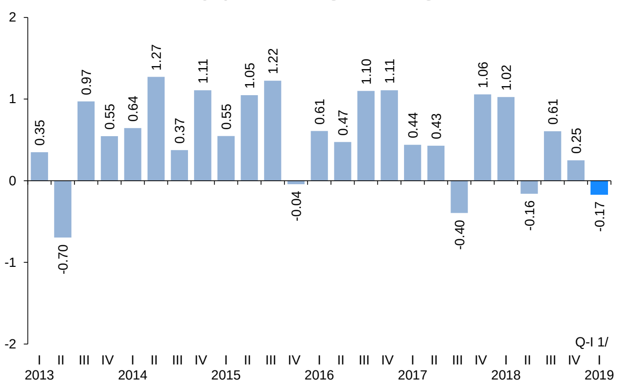
A.2.2. Economic activity in Mexico

During the first quarter of 2019, Mexico's GDP contracted as compared to the previous period (Chart 15). Available information suggests that in April 2019 economic activity increased marginally on a month-to-month basis vis-à-vis the previous month, in an environment where most components of aggregate demand remain weak, especially those related to domestic demand.

Regarding the performance of external demand, notwithstanding the weakening of world trade and the escalation of trade tensions, at the beginning of the second quarter of 2019 manufacturing exports recovered slightly, as compared to the deceleration observed in the two previous quarters (Chart 16). Particularly, automotive exports remained on a positive trajectory, while the rest of manufactures rebounded, after the decreases registered in previous months. By destination of exports, there was an improvement in both those destined for the United States and those for the rest of the world.

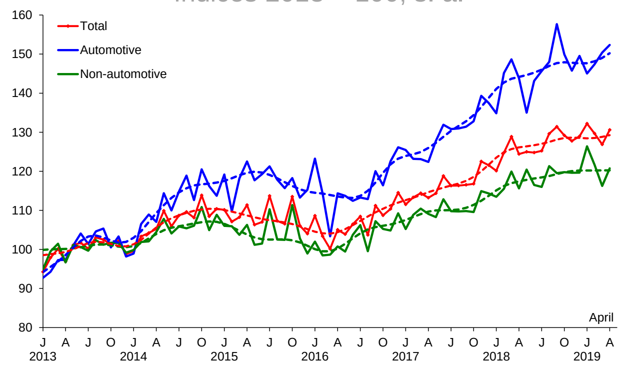
In relation to the evolution of domestic demand, according to its monthly indicator, during the first quarter of 2019 private consumption decelerated relative to the dynamism observed during most of 2018. In particular, services consumption grew at a lower rate, in contrast with the dynamism it had been displaying since the end of 2017, while the consumption of goods continued to show a lack of vigor. Timely indicators of consumption, albeit of less coverage, such as earnings of retailers, imports of consumer goods, and manufacturing sales in the domestic market –which are highly correlated with the consumption of nationally produced goods– exhibited certain recovery in April 2019, as compared to the lackluster performance observed in previous months. In contrast, sales of light vehicles continued on a negative trend. During the first quarter of 2019, the negative trend that gross fixed investment had been exhibiting since the beginning of 2018 became more pronounced, despite the upturn registered in both machinery and equipment spending and construction investment in January, as this responded to transitory factors. Indeed, investment in machinery and equipment continued to exhibit weakness, while that in construction trended downwards.

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.

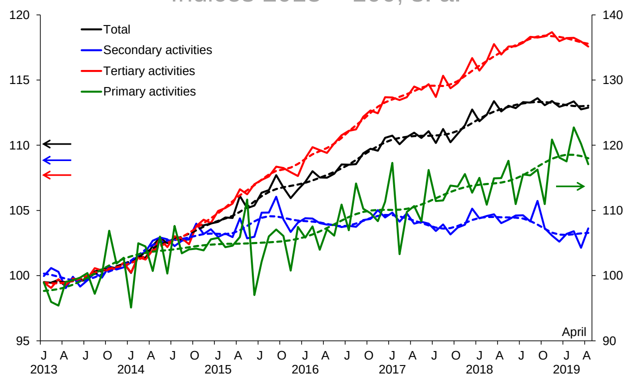
Chart 16
Total Manufacturing Exports
Indices 2013 = 100, s. a.



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

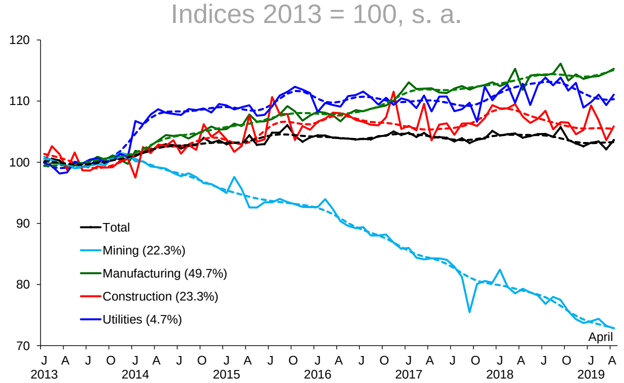
On the production side, at the beginning of the second quarter of 2019 economic activity continued to show a lack of vigor, reflecting the lackluster performance of services and primary activities (Chart 17). In particular, the unfavorable behavior of tertiary activities in April is explained by the decline in trade; professional, administrative and support services; and accommodation and food services. Despite the growth registered by industrial activity in April 2019, it remains at levels similar to those observed at the beginning of the year. Within industrial production, both mining and construction continued trending downwards (Chart 18). In contrast, manufacturing exhibited certain recovery with respect to the weakness it had been displaying since the end of 2018.

Chart 17
Global Indicator of Economic Activity
Indices 2013 = 100, s. a.



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

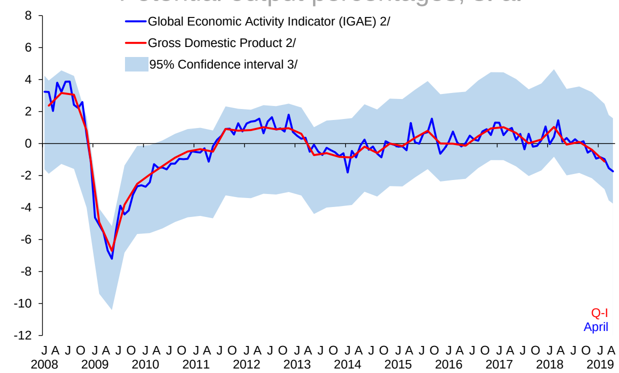
Chart 18
Industrial Activity [1/]
Indices 2013 = 100, s. a.



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

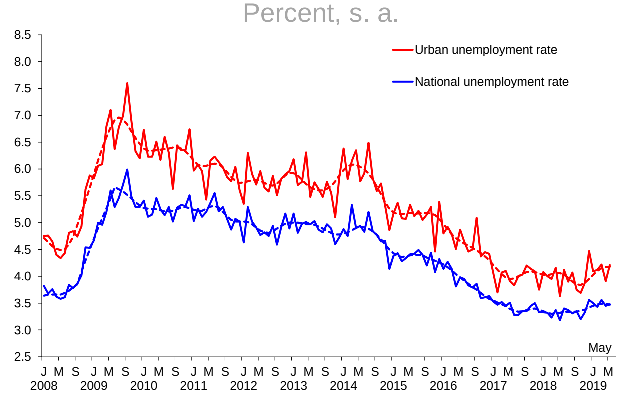
As to the economy's cyclical position, slack conditions in the economy have loosened even further than expected (Chart 19). Regarding labor market conditions, both the national and urban employment rates have been at levels above those reported during most of 2018 (Chart 20). Likewise, the growth rate of the number of IMSS-insured jobs has continued to slow down markedly. With information to the first quarter of 2019, as a result of the behavior of productivity and real average earnings, unit labor costs in the economy as a whole have increased relative to the previous quarter. For the manufacturing sector, despite the fall in unit labor costs at the beginning of the second quarter of 2019, these remain at high levels (Chart 21).

Chart 19
Output Gap Estimates [1/]
Excluding Oil Industry [4/]
Potential output percentages, s. a.



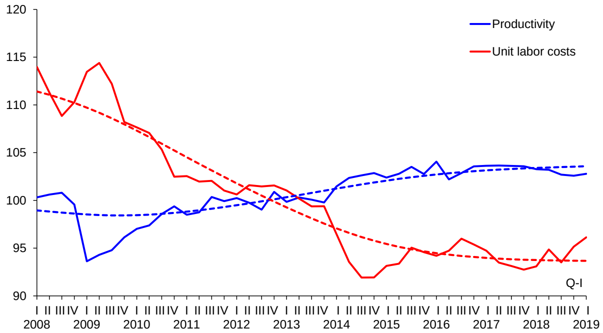
s. a. / Seasonally adjusted figures.
1/ Output gap estimated with a tail-corrected Hodrick-Prescott filter; see Banco de México (2009), "Inflation Report (April-June 2009)", p.74.
2/ GDP flash figures up to the first quarter of 2019; IGAE figures up to April 2019, consistent with timely figures.
3/ Output 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 Indicator of Labor Productivity (IGPLE, for its acronym in Spanish) and Unit Labor Costs [1/]
Indices 2013 = 100, s. a.



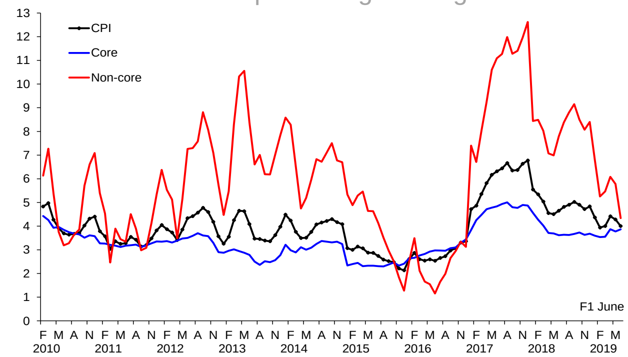
s. a. / Seasonally adjusted and trend series. The former is represented by a solid line and the latter by a dotted line. Trend series estimated by Banco de México.
1/ Productivity based on hours worked.
Source: IGPLE published by INEGI. Unit labor costs prepared by Banco de México with INEGI data.

In April 2019, domestic financing to the private non-financial sector displayed an annual real growth rate similar to that observed in the first months of this year. The same behavior was observed in the annual growth rate of financing to non-financial firms and lending to households, particularly in housing credit. Meanwhile, the rate of expansion of consumer credit continued to slow down. Regarding interest rates, those related to firm financing did not change significantly at the margin, although they remain at high levels. In turn, interest rates of housing credit have remained stable since the second quarter of 2017, whereas those of consumer credit have remained practically unchanged during the same period, with the exception of those of credit cards, which have increased. With regards to portfolio quality, firms and mortgage delinquency rates remained at low levels, while those related to consumption have followed a downward trend since August 2018, although they remain at high levels.

A.2.3. Developments in inflation and inflation outlook

Between April and the first fortnight of June 2019, headline inflation fell from 4.41 to 4.00% (Chart 22 and Table 1). This result is explained by the significant decline of non-core inflation, given that core inflation remained at the same level.

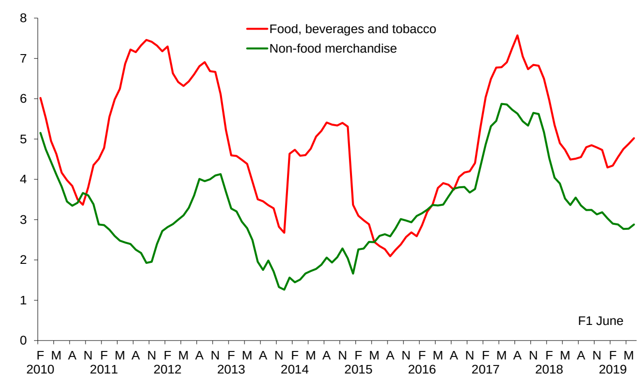
Chart 22
Consumer Price Index
Annual percentage change



Source: Banco de México and INEGI.

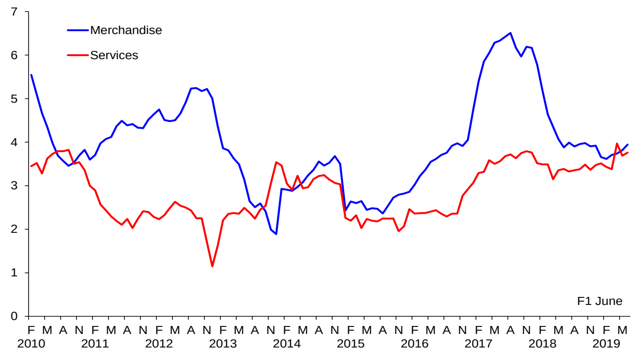
In fact, core inflation was 3.87% both in April and in the first fortnight of June 2019. Within this component, the annual rates of change of food merchandise prices continued trending upwards and displaying high levels, while those of non-food merchandise prices remained below 3% (Chart 23). On the other hand, the annual rate of change of services prices decreased -influenced by the fading of an upward calendar effect, given that Easter this year took place in April- although it still remains at high levels (Chart 24), while the prices of several food, transportation, and entertainment services continue exhibiting annual rates of change of above 5% and, in some cases, increasingly higher. Additionally, the annual growth rate of the housing prices subindex continued trending upwards, albeit it remains below 3%.

Chart 23
Merchandise Core Price Subindex
Annual percentage change



Source: Banco de México and INEGI.

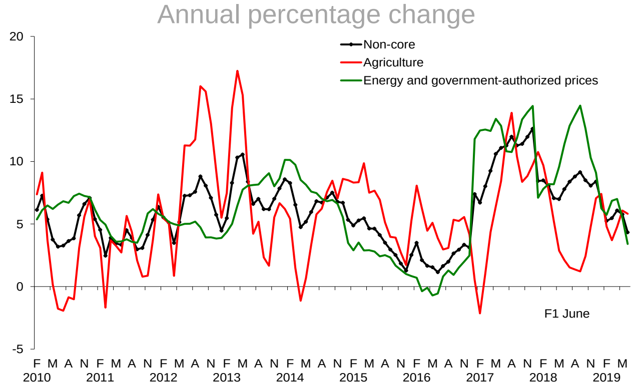
Chart 24
Merchandise and Services Core Price Subindex
Annual percentage change



Source: Banco de México and INEGI.

Regarding annual non-core inflation, it went from 6.08 to 4.34% between April and the first fortnight of June, reflecting the lower increases observed in the prices of fruits and vegetables as well as in energy products, the latter partly due to the fall in their international references. The lower increases in both of these components more than offset the increases registered in livestock product prices (Chart 25 and Table 1).

Chart 25
Non-core Price Subindex
Annual percentage change



Source: Banco de México and INEGI.

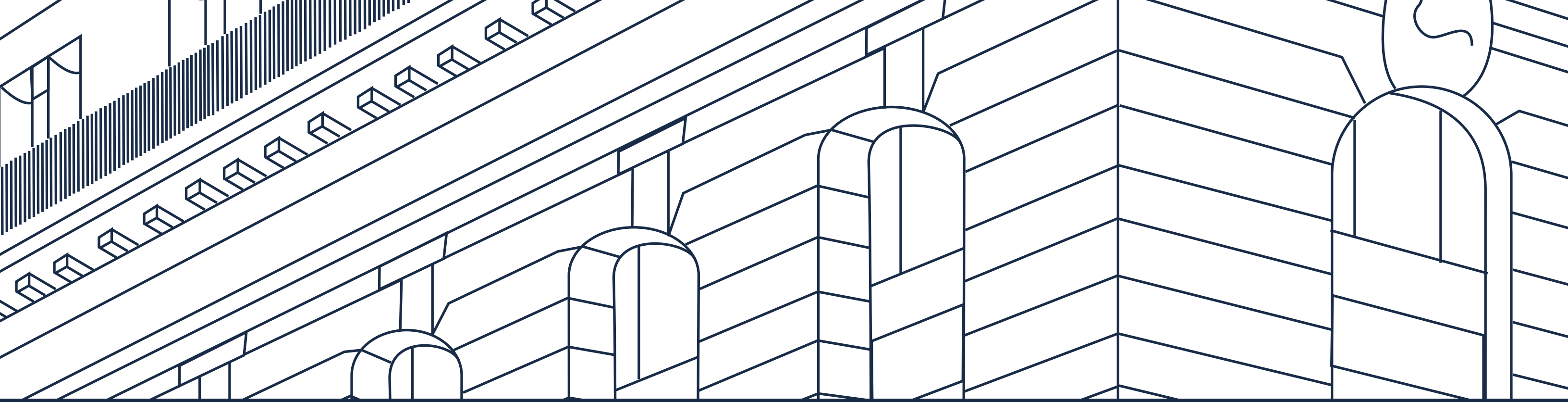
Between April and May, the medians for short-term inflation expectations drawn from Banco de México's Survey of Private Sector Forecasters exhibited mixed adjustments. In particular, it stands out that, the median of expectations for headline inflation for the end of 2019 was adjusted upwards from 3.70 to 3.75%, while that for the end of 2020 remained at 3.60%. At the same time, the medians for core inflation for the end of 2019 and for 2020 went from 3.56 to 3.60% and from 3.50 to 3.40%, respectively. Thus, implied non-core inflation expectations for the end of 2019 and 2020 were adjusted from 4.13 to 4.21% and from 3.91 to 4.22%, respectively. The median of headline inflation expectations for the medium term (next four years) remained at around 3.55%, while that for the longer terms (next five to eight years) remained stable at 3.50%. It should be noted that the median of medium-term core inflation expectations remained close to 3.50%, while that for the longer term remained at 3.40%, after being at 3.30% during most of 2018. Thus, between early May and mid-June, short-, medium- and long-term expectations for headline and core inflation did not register significant adjustments, albeit in all cases they remained above the 3% target. As for information drawn from market instruments, medium- and long-term breakeven inflation remains at high levels.

As for inflation risks, some have diminished and others have gained relevance. To the upside, the possibility that the peso exchange rate comes under pressure stemming from external or domestic factors stands out. Should the economy require adjustments either to the real exchange rate or to medium- and long-term interest rates, Banco de México will contribute to orderly adjustments, in an effort to prevent second-round effects on the economy's price formation process. Additional upward risks are the threat by the United States to impose tariffs on Mexican imports and the adoption of compensatory measures, although this risk has decreased due to the recent agreement; that energy prices revert their downward trend or that agricultural and livestock product prices exhibit increases; that public finances deteriorate; that core inflation's persistence generates greater resistance for medium- and long-term inflation expectations to decline; and, that global protectionist measures escalate. Also, given the magnitude of several wage revisions, that cost-related pressures arise, insofar as such revisions exceed productivity gains. As for risks to the downside, it stands out that the peso exchange rate appreciates, possibly associated with a context of more accommodative monetary policy stances and lower interest rates worldwide, or in case greater certainty regarding the trade relation with the United States is achieved. Another downside risk is that the prices of certain goods included in the non-core subindex register lower rates of change, as observed in the case of energy goods, due to the greater weakness exhibited by the world economy. In addition, that slack conditions widen more than anticipated, as suggested by the latest information on economic activity, which might influence the behavior of core inflation. Given the aforementioned, high uncertainty persists regarding the risks that might affect inflation.

Table 1
Consumer Price Index and Components
Annual percentage change

Item	April 2019	May 2019	1st fortnight June 2019
CPI	**4.41**	**4.28**	**4.00**
Core	**3.87**	**3.77**	**3.87**
Merchandise	**3.74**	**3.82**	**3.94**
Food, beverages and tobacco	4.75	4.88	5.02
Non-food merchandise	2.77	2.78	2.88
Services	**3.97**	**3.69**	**3.76**
Housing	2.78	2.83	2.86
Education (tuitions)	4.84	4.86	4.85
Other services	4.98	4.30	4.40
Non-core	**6.08**	**5.78**	**4.34**
Agriculture	**4.77**	**6.08**	**5.82**
Fruits and vegetables	10.19	11.26	9.45
Meats, poultry, fish and eggs	1.38	3.29	4.26
Energy and government-authorized prices	**7.01**	**5.50**	**3.41**
Energy products	8.58	6.51	3.34
Government-authorized prices	3.52	3.64	3.74

Source: INEGI.



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