BANCO DE MÉXICO®

Minutes number 94

Meeting of Banco de México's Governing Board on the occasion of the monetary policy decision announced on August 11, 2022

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FOREWARNING
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1. PLACE, DATE AND PARTICIPANTS

1.1. Place: Meeting held by virtual means.

1.2. Date of Governing Board meeting: August 10, 2022.

1.3. Participants:

Victoria Rodríguez, Governor.
Galia Borja, Deputy Governor.
Irene Espinosa, Deputy Governor.
Gerardo Esquivel, Deputy Governor.
Jonathan Heath, Deputy Governor.
Rogelio Eduardo Ramírez, Secretary of Finance and Public Credit.
Gabriel Yorio, Undersecretary of Finance and Public Credit.
Elías Villanueva, Secretary of the Governing Board.

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

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

International Environment

Most members stated that global economic activity weakened during the second quarter. They pointed out that, timely indicators suggest said weakness would persist during the third quarter. They mentioned that economic activity was mainly affected by the slowdown in China, in view of mobility restrictions, the adverse effects of the military conflict, and the tightening of global financial and monetary conditions. They highlighted specifically, that in the United States GDP fell for the second consecutive quarter. One member stated that this was associated with a decrease in inventories, and, to a lesser extent, with a decline in investment. He/she added that certain indicators associated with the real estate sector of that country registered a considerable moderation. **Nevertheless, most members highlighted that job creation in the United States accelerated at the beginning of the third quarter. One** member mentioned that this is considered to be incompatible with a recession scenario. **Another** member pointed out that an incipient change of trend is starting to be observed in certain indicators, such as vacancies and initial unemployment insurance claims.

Most members underlined that global economic growth forecasts have been revised downwards. They added that fears of recession in the near future have escalated. Among the risks to the global economy they highlighted those associated with the pandemic, greater adjustments to monetary and financial conditions, and the intensification of geopolitical tensions. Some members indicated that these factors have resulted in an environment of uncertainty and risk aversion. **One** member considered that the balance of risks to global economic activity remains biased to the downside.

Most members pointed out that world inflation continued increasing, in some cases once again reaching levels unseen in decades. This occurred in an environment where imbalances between demand and supply in diverse markets and high levels of food and energy prices persist. However, they highlighted that different commodity prices have stabilized recently and have even decreased. Some members added that disruptions in supply chains have decreased at the margin. **One** member underlined that the expected trajectories for inflation in the short-term in the main advanced economies were revised upwards, albeit maintaining the convergence to their respective central banks' targets towards the end of 2023 and the beginning of 2024. **Another** member mentioned that the increase in input and final goods' prices reported in purchasing managers' surveys has moderated, that inflation expectations implicit in market instruments have decreased, and that global aggregate spending has moderated. He/she argued that the above-mentioned facts allow to foresee that the downward adjustment in world inflation has already begun. He/she pointed out that said progress is reflected in the latest figure for US inflation. **Most members pointed out that, although headline inflation in the United States decreased between June and July, it still remains high. One** member considered that there are signs indicating that it has reached a peak. **Another** member underlined that core inflation remained high, reflecting labor market pressures. **Some** members indicated that the personal consumption expenditure deflator increased between May and June. **One** member pointed out that around 70% of the components of this inflation indicator registered annual variations above 4%. **Another** member stated that in the euro area annual headline inflation continued increasing between June and July. **Some** members noted that inflation also continued increasing in emerging economies. **One** member pointed out its persistence in Latin America, where the declines in commodity prices have not been reflected in lower levels of inflation, which could imply the presence of second-round effects.

All members stated that a large number of central banks continued raising their reference rates. Most members noted that, in some cases, they did it in a greater magnitude than previously expected. Regarding the Federal Reserve, they stated that in its latest monetary policy decision it raised the target range for the federal funds rate by 75 basis points for a second consecutive time and anticipated future increases. Some members indicated that the European Central Bank raised its reference rate by 50 basis points. **One** member added that said institution announced its strategy to prevent the fragmentation of European sovereign debt markets, to reestablish orderly trading conditions, and to limit the risks for monetary policy implementation. As to emerging economies, he/she pointed out that their central banks also continued raising their reference rates. **Another** member mentioned the presence of certain heterogeneity in monetary tightening in these economies, which depends on whether there are demand pressures or not, and on the observed levels of inflation. He/she indicated that, in most of them, real interest rates remain at low or even negative levels. He/she added that Mexico continues to be one of the economies with the highest real interest rate worldwide.

Most members stated that uncertainty prevails regarding the future trajectory of monetary policy worldwide. They underlined that several central banks have adopted a forward guidance that conditions reference rate adjustments to the evolution of data. Some members agreed that the slowdown of global economic activity has moderated expectations of a faster reduction of the monetary stimulus. **Some** members added that, in certain economies, interest rates are expected to decrease starting in the second quarter of 2023. **One** member pointed out that financial markets anticipate the Federal Reserve's rate to be above 3.5% by the end of 2022. **Another** member highlighted that, according to the Federal Reserve, the magnitude of the subsequent rate increases is yet to be discussed. **One** member mentioned that according to such institution, although the interest rate already lies at a neutral level, the need for the rate to attain to a more restrictive level is foreseen, which generated uncertainty about the terminal value for the Federal Reserve's rate in the current cycle. **Another** member stated that a certain unwarranted optimism with respect to US monetary policy prevails, regarding expectations of quickly achieving a "soft landing". He/she emphasized that a historic analysis of US disinflationary periods suggests that the current monetary policy is behind the curve and that a greater than expected monetary effort is required to bring inflation back to its target. He/she added that, over the last decades, the Federal Reserve has not managed to reduce inflation rates that were higher than 3% without causing a significant deterioration in economic activity and employment. For this reason, he/she considered it surprising that the Federal Reserve's projections anticipate a reduction of inflation in a short period of time, with a low reference rate, and without affecting employment.

All members stated that international financial markets registered volatility, in an environment in which financial conditions remained tight and economic activity weakened. Some members noted a reduction in risk appetite. **One** member pointed out that the new geopolitical tensions between the US and China add to the uncertainty resulting from the Russian-Ukrainian military conflict. **Another** member added that volatility implicit in foreign exchange options signals a greater level of uncertainty. **Most members mentioned that the US dollar registered a generalized appreciation. They pointed out a decrease in government bond yields, especially long-term ones. One** member added that certain forward-looking indicators of interest rates have trended downwards. **Another** member mentioned that corporate bond spreads exhibited a mixed behavior. **Most members pointed out that stock markets registered gains. One** member indicated that this behavior was supported by the lower costs of financing and, more recently, by the favorable inflation figures in the United States. **Another** member pointed out that, in emerging economies, yield curves registered a mixed behavior, while the foreign exchange market had a negative performance and the stock market, a positive one. He/she underlined that outflows from the equity market were observed for the first time, while the fixed-income market maintains a negative balance. **One** member stated that, for most of these economies, risk premia had a somewhat positive behavior during the period.

Economic Activity in Mexico

Most members pointed out that economic activity continued recovering and that timely information indicates that in the second quarter of 2022 it grew at a rate similar to that of the previous quarter. Some members underlined that the economic recovery continued, despite the complex environment and the rebound in the number of infections. However, **some** members noted that the recovery is still incomplete. **One** member highlighted that monthly Global Economic Activity Indicator (IGAE, for its acronym in Spanish) figures indicate that during the period of May-June the recovery rate moderated slightly. He/she added that some high-frequency indicators suggest that said moderation might have continued at the beginning of the third quarter.

On the supply side, most members stated that industrial production continued recovering, supported by progress in the manufacturing sector. Some members added that a slight recovery in the construction sector also contributed. **One** member pointed out that mining and construction have remained flat since the first months of 2021. **Most members indicated that the services sector kept expanding**, although **some** members highlighted that said recovery has been heterogeneous. **One** member noted that both industrial activity and services moderated during the May-June period.

On the demand side, most members mentioned that consumption continued recovering. Some members noted that the recovery has been observed, to a larger extent, in the consumption of imported goods. **One** member pointed out that their consumption is around 30% above its pre-pandemic level, while the demand for national goods has barely reached such level. **Most members stated that different indicators, such as consumer confidence, retail sales and real average income, among others, suggest that private consumption has started to decelerate.** Nonetheless, **some** members mentioned that certain determinants of consumption, such as remittances and the wage bill in real terms, remain at high levels. **Most members highlighted that investment has slightly improved**, while **some** members pointed out that it slowed down in May. **Some** members noted that investment has been driven by spending on machinery and equipment, while spending on construction remains sluggish. **Regarding the external sector, most members highlighted the expansion in manufacturing exports, both automotive and non-automotive. One** member underlined that the increase in manufacturing exports has derived from increases in both their volume and prices. However, **some** members noted a moderation in their growth rate.

Most members stated that different labor market indicators have continued to improve. Nonetheless, they pointed out that the recovery remains incomplete. One member pointed out that the improvement in employment has included most economic sectors. **Another** member noted that the labor participation rate and the employment rate among the working age population continued approaching their pre-pandemic levels, while the national and urban unemployment rates remained low. **One** member pointed out that annual nominal wage revisions of IMSS-insured workers registered record increases of 11.5% in July, while those of the private sector fluctuated between 7 and 9% throughout the year. He/she warned that said increases may be indicating a certain contamination towards wages due to the high levels of inflation. He/she considered that these increases contrast with the 3.5% average adjustment observed in the public sector. However, **some** members highlighted that certain labor market indicators show weakness, such as the extended unemployment rate, which includes the unemployed, the underemployed, and individuals who are not economically active but willing to work, which still remains above its pre-pandemic levels.

Most members pointed out that slack conditions in the economy have decreased. However, **one** member mentioned that slack in economic activity and in the labor market remains ample. **Another** member pointed out that, if professional and business support services are excluded, the gap appears to have closed. However, he/she warned that said estimates should be taken with caution, given that their measurements exhibit a wide range of variability, depending on the methodology used.

Most members agreed that an uncertain environment for the economic recovery prevails. One member pointed out that the economy is expected to continue recovering, albeit at a lower rate than in the first semester. **Some** members indicated the presence of risks associated with a lower external demand from the United States and with strong inflationary pressures. **One** member stated that a survey to businesses identified both the observed and expected behavior of inflation as the main obstacles to sales and investment, due to its harmful effects on consumers' purchasing power and to the difficulty in making plans for the future. **Some**

members mentioned drought conditions in Mexico as an additional risk. **One** member pointed out that this could affect primary sector activities and the manufacturing industry in the affected regions. **Some** members agreed that the balance of risks for economic activity is biased to the downside.

Inflation in Mexico

All members emphasized the high inflation levels. Most members stated that in July headline and core inflation registered annual rates of 8.15 and 7.65%, respectively. One member pointed out that the accumulation of unexpected, subsequent, broad-spectrum, deep and persistent inflationary shocks has been reflected in the significant price increases registered by most CPI items. **Another** member stated that, on several occasions since the beginning of 2021, headline inflation has been higher than expected. **One** member underlined that in July the annualized monthly rate of headline inflation was significantly higher than its pre-pandemic average, which implies that pressures have continued at the margin, albeit having declined slightly in relation to the previous four months. **Most members indicated that inflation in Mexico is partly attributed to a global phenomenon. Some** members pointed out that this is directly due to the imported content in goods or, indirectly, due to the incidence of international references on local prices. **One** member highlighted that the above poses a significant challenge for price formation. Nevertheless, **another** member pointed out that certain products' prices have also been subject to domestic pressures related to insecurity in the country. **One** member mentioned that headline inflation has been mainly affected by a greater incidence of the core component. **Another** member underlined the sharp upward trend followed by the inflation of processed and unprocessed foods, whose incidence accounts for over half of the level of headline inflation in July, a contribution that is greater than the nearly one-third that was observed, on average, between 2017 and 2019.

Most members mentioned that core inflation remained at high levels. Some members pointed out that this component continues on a concerning upward trajectory. **One** member added that it continues showing significant persistence. **Another** member highlighted that it has increased for twenty consecutive months. He/she noted that all of its components, except for telecommunication services, register seasonally adjusted monthly variations that are above the average of the last ten years. **One** member pointed out that core inflation remains subject to pressures related to increases in production costs, increases of different input prices, and to disruptions in production and distribution chains. He/she added that these factors have hindered the adjustment of supply to the high levels of demand worldwide. **Some** members underlined that merchandise inflation reached double digits. **One** member mentioned that its components have faced continuous shocks for three years. **Most members pointed out that food merchandise inflation registered the greatest increase, reaching 12.09% in July. One** member highlighted that this component has increased by double digits for five months and that the outlook is complex, even if food merchandise prices are excluded from the core inflation estimation, as is the case in the United States. He/she pointed out that inflation of non-food merchandise and of services have settled above 4%. **Another** member expressed his/her concern about services inflation, which better reflects domestic pressures, maintaining an upward trend for over a year and reaching levels close to 5%. **One** member mentioned that said inflation increased as a result of the higher adjustments in tourism and food services' prices. He/she highlighted that services inflation is the highest on record since 2009 and that of services other than housing and education registered its highest variation in the last 20 years. **Another** member noted that, at the margin, pressures on merchandise prices remained similar to those observed in recent months, while those on services prices decreased slightly.

All members noted that non-core inflation remains at high levels, affected mainly by the prices of agricultural and livestock products. Some members highlighted that these goods registered double-digit inflation levels. **One** member added that said inflation has been subject to pressures due to an increase in input prices, such as those of fertilizers and grains. **Most members mentioned that energy inflation has remained at relatively low levels. Some** members pointed out that variations in this component have been contained by Federal Government policies. **One** member highlighted that the dynamics of the energy price subindex were influenced by the lower variations in L.P. gas prices.

All members mentioned that expectations for headline and core inflation for 2022 rose again. Most members pointed out that those for 2023 and for the medium-term increased to a lesser extent. One member indicated that expectations for the next 12 months have remained stable for five consecutive months, although above the 3% target. **Another** member noted that even though the deterioration of medium-term expectations has eased at the margin, these are still affected. **Some** members noted that long-term expectations for headline inflation remained stable, although at levels above target. **Some** members highlighted that those for long-term core inflation increased at the margin. **One** member pointed out that between May and July, those corresponding to the next four years went from 3.70 to 3.83%, while those for the next 5 to 8 years were adjusted from 3.50 to 3.57%. **Some** members considered the gradual deterioration of long-term expectations a cause for concern. **One** member mentioned that this could signal the beginning of a process of unanchoring of inflation expectations. **Another** member indicated that this could suggest negative effects on the price formation process. Regarding expectations drawn from market instruments, **some** members pointed out that these have continued to deteriorate. However, **some** members noted that breakeven inflation decreased for all maturities. **One** member underlined that longer-term expectations drawn from market instruments remained at levels close to the 3% target, although with slight increases at the margin.

Most members indicated that in view of greater-than-anticipated inflationary pressures, the forecasts for headline and core inflation were revised upwards for the period up to the third quarter of 2023. They pointed out that convergence to the 3% target is still projected to be attained in the first quarter of 2024. Some members underlined that inflation is still expected to reach its highest level in the third quarter of 2022. **One** member pointed out that observed and expected inflation continue to be at levels incompatible with the 3% target, in a context of high uncertainty. **Another** member highlighted that although it is possible that inflation reaches a peak during the third quarter, it will almost certainly be above 8% by the end of the year. He/she pointed out that, given the persistence of inflation, doubts have increased as to whether the inflection point in its trend is near. He/she stated that it is highly probable that the inflationary peak will be reached later than expected. He/she said that each revision to the inflation forecast incorporates the assumption that inflation will reach a higher level at a later-than-anticipated date, and thus it is not possible to assure that the peak of the inflationary cycle has been reached.

Among upward risks to inflation, **some** members mentioned cost-related pressures. **One** member highlighted labor-related costs. He/she noted that minimum wage increases above 20% could be observed in 2022 and 2023. He/she mentioned that these would materialize just at the time when inflation is expected to begin converging to its target. **Some** members noted that droughts in several areas of the country could exert further pressure on the prices of agricultural and livestock products. **One** member highlighted as additional upward risks: i) the persistence of core inflation at high levels; ii) the external inflationary pressures associated with the pandemic; iii) the continued pressures on agricultural and livestock product prices and on energy prices due to the ongoing geopolitical conflict; and iv) an exchange rate depreciation. Among downward risks, **one** member pointed out: i) a greater-than-anticipated slowdown in global economic activity; ii) a decline in the intensity of the geopolitical conflict; iii) better functioning of supply chains; iv) a greater-than-expected effect from the negative output gap; and v) a larger-than-anticipated contribution from the Policy Program to Fight Inflation and High Prices (PACIC, for its acronym in Spanish). He/she stated that in both Mexico and the rest of the world, inflation would eventually perform favorably insofar as the Federal Reserve's actions contribute to bring down inflation levels in the United States. **Another** member indicated that, although world and US inflation might have reached a peak, this will not necessarily translate into an immediate reduction of inflation in Mexico, given the lag between world and domestic inflation cycles. **Most members stated that the balance of risks for the trajectory of inflation within the forecast horizon remains biased significantly to the upside.**

Macrofinancial environment

Regarding domestic financial markets, most members highlighted the resilience of the exchange rate, although it exhibited episodes of volatility. They highlighted that the resilience of the Mexican peso in relation to other currencies was partly due to the wide volatility-adjusted interest rate spread relative to the United States. They also highlighted Mexico's solid macroeconomic fundamentals. One member noted that the Mexican peso stood out as the second-best performing currency during the period, only slightly behind the Brazilian real.

Most members pointed out that short-term interest rates increased and longer-term ones decreased. One member mentioned that the flattening of yield curves was supported by inflows into *Udibonos* and marginally into *M-Bonos*. He/she added that the interest-rate spread between *M-Bonos* and US Treasuries also adjusted downwards. **Most members noted that the stock market remained stable. One** member mentioned that this market was recently favored by a greater appetite for risk. **Another** member added that the premia reflected by credit default swaps at different maturities shifted downwards. **Some** members highlighted that tighter monetary conditions and the increase in geopolitical tensions are a source of uncertainty and volatility for domestic financial markets and have generated an environment of risk aversion.

Some members pointed out that the rounds of dispute settlement consultations with the United States and Canada regarding Mexico's energy policies within the framework of the USMCA could have significant repercussions for the Mexican economy. **One** member warned that they could result in compensatory tariffs that would translate into pressures on the country's balance of payments. **Another** member noted that one rating agency ratified the country's sovereign rating while changing the outlook from negative to stable, while another one downgraded both the sovereign and Pemex's ratings. In this regard, **one** member pointed out that there are factors of domestic pressure that could increase the idiosyncratic risk premium.

Some members noted that financing conditions for the private sector have improved at the margin. They highlighted that during the second quarter of 2022, domestic financing to firms continued moderating its rate of contraction in annual terms. They pointed out that commercial bank credit to firms continued recovering. They indicated that this occurred in a context of increased demand from firms and in spite of the tighter monetary conditions. **One** member noted that lending conditions for smaller firms have become less restrictive since the second half of 2021. He/she added that interest rates on credit to firms were at levels similar to those observed prior to the pandemic and that delinquency rates continued to decrease. In contrast, he/she warned about the 13.6% contraction in the amount of development banks' financing to firms, as compared to an expansion of 2.1% by commercial banks. Regarding household financing, **another** member mentioned that mortgage lending continued growing moderately at a real annual rate. He/she added that consumer credit continued increasing in real annual terms, mainly as a result of the sustained dynamism of payroll credit and the credit-card portfolio, as well as the recent recovery in the personal-loan portfolio.

Monetary policy

The Governing Board evaluated the magnitude and diversity of the shocks that have affected inflation and its determinants, along with the evolution of medium- and long-term inflation expectations and the price formation process. It considered the increasing challenges for monetary policy stemming from the ongoing tightening of global financial conditions, the environment of significant uncertainty, and inflationary pressures accumulated as a result of the pandemic and the geopolitical conflict, as well as the possibility of greater effects on inflation. Based on these considerations, all members voted to raise the target for the overnight interbank interest rate by 75 basis points to 8.50%. They highlighted that, with this action, the monetary policy stance adjusts to the trajectory required for inflation to converge to its 3% target within the forecast horizon.

The Governing Board will thoroughly monitor inflationary pressures as well as all factors that have an incidence on the foreseen path for inflation and its expectations. This, in order to set a policy rate that is consistent at all times, with both the orderly and sustained convergence of headline inflation within the time frame in which monetary policy operates as well as with an adequate adjustment of the economy and financial markets. The Board added that it will assess the magnitude of the upward adjustments in the reference rate for its next policy decisions based on the prevailing conditions.

One member stated that, like most economies, Mexico has faced a highly complex and uncertain environment due to the concurrence of shocks that have caused widespread and large-scale inflationary pressures. In this context, it has been imperative to focus on establishing a monetary policy stance conducive to an adequate adjustment of relative prices and domestic financial markets. He/she pointed out that Banco de México has acted timely and decisively considering: i) the negative impact that a prolonged period of inflation well above the target could have on longer-term inflation expectations; ii) the high social and economic costs derived from inflation; and iii) the risk of a disorderly behavior in financial markets, including the foreign exchange market. He/she recalled that, although from June 2021 to June 2022 the reference rate has been raised by 375 basis points, until early 2022, the impact on the ex-ante real interest rate had been partially offset by the increase in inflation expectations due to the additional and unexpected shocks that were observed. However, he/she estimated that, given the 75 basis points increase of the previous decision, an additional 75 basis points increase in the current decision would allow the ex-ante real interest rate to be in restrictive territory. He/she considered that a smaller increase would be insufficient for the real interest rate to exceed the estimated range for the neutral interest rate. He/she highlighted that it is essential for Banco de México to act decisively in order to avoid a deterioration in the price formation process. He/she added that, given the complexity of the environment, characterized by tighter global financial conditions and high uncertainty, it is the central bank's responsibility to take the necessary measures to comply with its constitutional mandate, which increases the importance of decisively raising the reference rate in the present decision. He/she warned that in order to guarantee the convergence of inflation to its target, additional upward adjustments in the reference rate will be required, the magnitude of which must be assessed according to the available information.

Another member stated that the inflationary landscape confirms that a process of unanchoring of inflation expectations is beginning to take place. He/she underlined that, in his/her opinion, it is evident that the adjustments implemented in the monetary policy stance have been insufficient to counteract the deterioration in the price formation process and the increase in inflation expectations, and therefore he/she considered it absolutely necessary to bring the real interest rate to restrictive territory. He/she pointed out that only through firm and decisive actions it will be possible to rebuild the confidence in the central bank's commitment to the convergence of inflation to the target within the forecast horizon. He/she added that the deterioration in the global economic environment, geopolitical conflicts, uncertainty about the reestablishment of supply chains, and the future path of world inflation, result in an even greater challenge for the conduction of monetary policy, and that the start of a period of elevated interest rates and economic weakness may be witnessed. He/she highlighted that in addition to figuring out the adequate pace of adjustment, the duration of the restrictive stance must also be defined. He/she considered that, currently, the main risk is the possibility of unforeseen changes in monetary policy in the United States. He/she argued that given the complex outlook, it is crucial to maintain a risk management approach, maintain the pace of monetary tightening, eliminate inflationary inertia, strengthen confidence and anchor inflation expectations at around 3%, as well as to promote an orderly adjustment of markets in light of tighter financial conditions. He/she added that the monetary policy statement should allow to anticipate more restrictive monetary conditions in the future. He/she pointed out that given the high uncertainty prevailing in the economic environment, such forward guidance should guarantee flexibility and reiterate that Banco de México will act decisively when required. He/she mentioned that the number of shocks the economy has faced, as well as their intensity and duration, have persistently accelerated inflationary dynamics. He/she warned that, in accordance with the central bank's constitutional mandate, it is the Governing Board's duty to implement an active monetary policy that curbs the aforementioned inflationary dynamics and seeks the stability of prices and of inflation expectations around the target, thus strengthening monetary policy's main transmission channels.

One member stated that the proposed adjustment of the reference rate is appropriate for reasons of financial stability and to avoid second-round effects on the price formation process. He/she indicated that these effects occur in view of high and persistent inflation and consist of prices increasing simply because they rose yesterday and are expected to do so tomorrow. To avoid this, and considering the nature of the shocks, it is necessary to transit to a moderately restrictive monetary policy stance. However, he/she warned that an excessive tightening could imply a high cost in terms of employment, purchasing power, and economic activity, and even be counterproductive for macroeconomic and financial stability. He/she considered that since the consequences of the pandemic and the intensification of geopolitical conflicts are still being experienced, there is high uncertainty about the effect of the monetary adjustments on inflation and economic activity, however, there are signs that an unnecessarily high level of monetary tightening is soon to be reached. He/she mentioned that the variables most sensitive to the monetary policy stance, such as investment, construction, consumer durables sales and business credit, have remained weak since before the pandemic, and that further tightening could affect their performance even more. He/she added that the incipient deceleration of production in various sectors, of private consumption and of investment suggests that the monetary policy stance might have already started to have an impact on these variables. He/she stated that inflationary pressures stem mainly from external factors, and thus a moderation in domestic spending would not necessarily translate in an improvement in the country's price formation process. He/she argued that, in the current environment, the use of monetary policy could be relatively inefficient. He/she mentioned that there are signs that global pressures have started to ease, and therefore inflation in Mexico might decline regardless of the monetary policy stance. He/she indicated that avoiding an excessively restrictive monetary policy would imply the possibility of decoupling from the pace of the Federal Reserve's interest rate hikes relatively soon. He/she expressed that this is feasible since: i) the volatility-adjusted interest rate spread relative to the United States is one of the highest among emerging economies; ii) the Mexican peso stands out for its good performance and low volatility; iii) the Federal Reserve's policy stance is an important factor to consider, but Mexico's monetary policy stance should rely more on the evolution of domestic variables and on the absolute policy stance; iv) Mexico started the hiking cycle earlier, and with a 75-basis point increase the policy stance would be situated in restrictive territory; v) unlike the United States, Mexico does not seem to face inflationary pressures from demand or the labor market; and vi) inflation in Mexico is closer to its target than the United States and other countries. For said reasons, he/she stated that there is room for a less restrictive monetary policy than in other emerging countries.

Another member considered that, given the inflationary outlook, the hiking cycle must continue and a restrictive policy stance must be consolidated to contain inflation in the short-term and have a policy stance consistent with a downward path of inflation, even if this occurs in the medium term. He/she added that adjustments in the policy rate will not eliminate global pressures, but will help to avoid second-round effects. He/she pointed out that there are also domestic pressures. He/she indicated that there are no clear signs of deceleration, and that a lower slack allows for a more restrictive monetary policy stance. He/she stated that in view of the continuous deterioration of observed inflation and its expectations, during this hiking cycle it has been necessary to increase the pace of tightening two times. Even so, the ex-ante real interest rate remained in expansionary territory for almost a year, and after the last decision it finally reached a neutral stance. He/she estimated that an increase of 75 basis points would allow to barely reach a restrictive level, so there should be no concern that the real interest rate is too high or harmful for economic activity. He/she highlighted that cyclical conditions become less important, until inflation is under control. He/she stated that an interest rate increase lower than that of the Federal Reserve is not feasible because: i) the interest rate spread of 600 basis points relative to the United States has been sufficient to enable a good performance of the Mexican peso under episodes of volatility and a generalized appreciation of the dollar, and maintaining a relative policy stance would contribute to avoid episodes of exchange rate volatility; ii) there is still a sentiment of global risk aversion; and iii) there are idiosyncratic factors that could increase the risk premium. He/she pointed out that a change of direction in the monetary cycle remains distant since: i) there is no guarantee that the inflationary cycle has reached a peak; ii) even if it is reached, the reference rate cannot be lowered too early without being sure that inflation is clearly trending downwards; and iii) the deterioration of inflation expectations, especially long-term ones, might suggest the presence of negative effects on the price formation process. He/she stated that it is crucial to provide guidance on the path of the policy rate, to communicate explicitly that the hiking cycle is not over yet, to emphasize that the central bank will act decisively as needed, and that the Governing Board will monitor the evolution of the inflationary outlook and the external monetary conditions to determine whether the pace of increases in the reference rate will be maintained or if there is a space that can be used to ameliorate this pace. He/she stated that the central bank's reaction function must be communicated with a clear and explicit forward guidance. For this purpose, the qualitative references about the future actions that have been made in previous communications must be complemented. He/she mentioned that the favorable reception of these changes by the public suggests that communication with forward guidance in which the path of the reference rate consistent with the inflation forecast is published should be analyzed. With such an addition, there would be greater certainty about the outlook for the current hiking cycle in order to counterbalance the uncertainty in the inflationary scenario. He/she indicated that this exercise of transparency and accountability would reinforce the credibility on the central bank's commitment to its mandate.

One member highlighted that the international monetary conditions showed greater tightness and that geopolitical tensions increased and are an important source of uncertainty and volatility. He/she added that inflation continued increasing and that its expectations are still affected. He/she argued that an increase of 75 basis points in this decision would strengthen the absolute monetary policy stance in two dimensions: i) the ex-ante real interest rate would exceed the upper threshold of the estimated range for the neutral rate, which, in his/her opinion, is a key element for the monetary policy stance to be effective and decisively support the process of inflation convergence to its target. He/she also added that it would allow to send a clear signal so that inflation expectations remain anchored and return to their previous levels; and ii) the nominal interest rate would reach the level of headline inflation and exceed that of core inflation, a circumstance that has been observed in other monetary cycles before achieving inflation convergence. He/she added that, at the global level, during the current monetary cycle, this situation has been observed in very few economies. He/she mentioned that, as for the relative monetary policy stance, the interest rate spread relative to the United States is above both its historical average and the average observed during previous hiking cycles. He/she argued that there are two elements that indicate that the current relative monetary policy stance is competitive: i) when the interest rate spread relative to the United States is measured through ex-ante real interest rates, a much more solid policy stance in terms of level, speed and celerity can be noted, highlighting that said soundness has even been transmitted along the yield curve, where medium and long-term interest rate spreads are at high levels; and ii) since Mexico is an economy that complements its sources of financing with foreign savings, it is important to note that the interest rate spread has been complemented by favorable expectations on the performance of the Mexican peso with respect to other emerging economies' currencies, even when such indicators are adjusted for volatility. He/she argued that the current environment of high uncertainty worldwide, with domestic inflation at high levels, and with the policy stance that would be achieved with the proposed increase, would require, in the future, to carefully assess the available space so that the next decisions are consistent with the convergence of inflation to the target as well as with an orderly adjustment of the economy and financial markets, prioritizing the safeguarding of the central bank's credibility.

3. MONETARY POLICY DECISION

The Governing Board evaluated the magnitude and diversity of the shocks that have affected inflation and its determinants, along with the evolution of medium- and long-term inflation expectations and the price formation process. It also considered the increasing challenges for monetary policy stemming from the ongoing tightening of global financial conditions, the environment of significant uncertainty, and inflationary pressures accumulated as a result of the pandemic and the geopolitical conflict, as well as the possibility of greater effects on inflation. Based on these considerations, and with the presence of all its members, the Board decided unanimously to raise the target for the overnight interbank interest rate by 75 basis points to 8.50%. With this action, the monetary policy stance adjusts to the trajectory required for inflation to converge to its 3% target within the forecast horizon.

The Board will thoroughly monitor inflationary pressures as well as all factors that have an incidence on the foreseen path for inflation and its expectations. This, in order to set a policy rate that is consistent at all times, with both the orderly and sustained convergence of headline inflation to the 3% target within the time frame in which monetary policy operates as well as with an adequate adjustment of the economy and financial markets. The Board will assess the magnitude of the upward adjustments in the reference rate for its next policy decisions based on the prevailing conditions.

4. VOTING

Victoria Rodríguez, Galia Borja, Irene Espinosa, Gerardo Esquivel, and Jonathan Heath voted in favor of increasing the target for the overnight interbank interest rate by 75 basis points to 8.50%.

ANNEX

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

A.1. External conditions

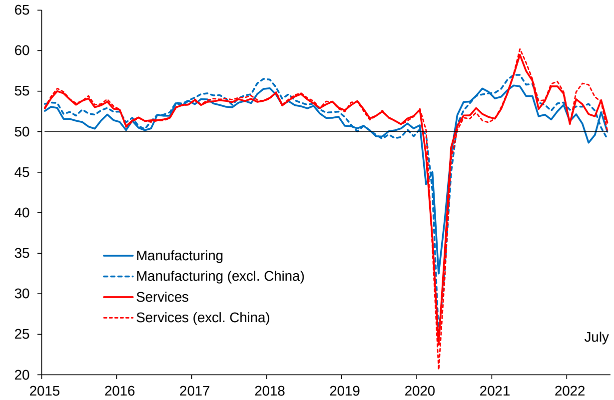
A.1.1. World economic activity

World economic activity weakened during the second quarter of the year. This has mainly been the result of the negative economic effects of the military conflict between Russia and Ukraine, the slowdown of the Chinese economy as a result of the implementation of temporary closures to contain COVID-19 infections in some regions and the weakening of its real estate sector, and a tightening of global financial conditions due to a more accelerated withdrawal of monetary stimulus in response to the high inflation levels. Timely indicators suggest that this weakening could persist in the third quarter, although with significant heterogeneity across countries (Chart 1).

World inflation continued increasing, once again reaching its highest levels in decades in some of the main economies. Inflationary pressures have spread to a larger number of items, in addition to the elevated prices of energy and food, in an environment in which imbalances between demand and supply persist in various markets. In this context, a large number of central banks continued raising their reference rates, some of them in a greater magnitude than anticipated, while expectations of an accelerated reduction of monetary stimulus worldwide persist. Financial conditions therefore remained tight. Nevertheless, given the risks of a sudden slowdown in economic activity, expectations regarding monetary policy rates in the main advanced economies, particularly those for 2023, lay at levels below those foreseen in previous months.

Among the most important global risks to growth are those associated with the COVID-19 pandemic, inflationary pressures, the escalation of geopolitical tensions, the risk of greater adjustments to economic, monetary and financial conditions, and the intensification of health emergencies due to other diseases.

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



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

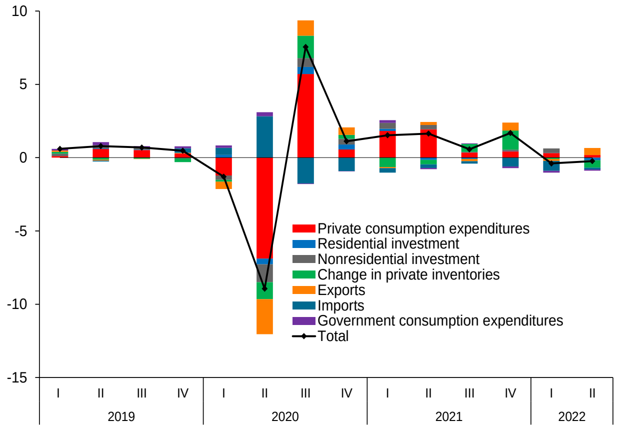
In the United States, Gross Domestic Product (GDP) contracted during the second quarter of 2022 at a seasonally adjusted quarterly rate of 0.2%, after having decreased 0.4% during the previous quarter (Chart 2).[1] The contraction in economic activity mainly reflected the negative contributions from changes in inventories and, to a lesser extent, from residential investment and investment in structures and equipment, as well as government spending. Meanwhile, net exports and personal consumption, particularly in services, contributed positively to growth during the quarter, although the lower purchasing power of households and the expectation of a faster monetary tightening have reduced the dynamism of private consumption. It is worth mentioning that, in August, the US Senate approved the Inflation Reduction Act, which aims to reduce the costs faced by US families and reduce the fiscal deficit through measures in the areas of health, clean energy, and taxes.

US industrial production contracted 0.2% at a seasonally adjusted monthly rate in June, after remaining unchanged in May. This weakening reflected a contraction in gas and electricity-generation activities as well as in manufacturing activity, after the latter contracted for the second consecutive month, largely as a result of the fall in

[1] Expressed as a seasonally adjusted quarterly annualized rate, US GDP grew at a rate of -1.6% during the first quarter of 2022 and -0.9% in the second quarter.

machinery, metal products and vehicles. In contrast, mining grew at a faster pace, supported by oil and gas production. The manufacturing Purchasing Managers' Index (PMI) suggests that the sector will continue to be affected by the slowdown in global demand, high production costs, the deterioration of expectations, and the persistence of disruptions in supply chains, although these have recently diminished.

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



s. a. / Seasonally adjusted figures.
Source: BEA.

The US labor market continued to show improvement during June and July. Job creation accelerated, with non-farm payrolls increasing by 463 thousand new jobs on a monthly average during June and July, after growing by 386 thousand jobs in May. With this, the non-farm payroll recovered its pre-pandemic level. The most notable increases were in professional and business services, leisure and hospitality, and health care. The unemployment rate registered 3.5% in July, after having been at 3.6% for four consecutive months. Meanwhile, despite declining in recent readings, vacancy rates the growth of wages remain high, giving signs of a tight labor market.

In the euro area, economic activity expanded at a faster-than-expected pace during the second quarter, increasing at a seasonally adjusted quarterly rate of 0.7%, after registering growth of 0.5% in the previous quarter.[2] The normalization of activities following the decline in COVID-19 cases and higher household spending driven by the strength of the labor market contributed to these results. However, more recent data began to reflect the adverse effects of the military conflict between Russia and Ukraine, such as disruptions in supply chains, mainly for natural gas, and higher production costs. In June, the unemployment rate remained at 6.6% for the third consecutive month. Purchasing managers' indices point to a weakening of manufacturing production and a moderation of services in view of the effects associated with the military conflict between Russia and Ukraine, and the high levels of inflation.

In Japan, available information suggests a rebound in economic activity during the second quarter of 2022, after having contracted 0.1% at a seasonally adjusted quarterly rate in the first one.[3] This was due to the recovery of private consumption, particularly in services, following the lifting of mobility restrictions due to COVID-19. Regarding the external sector, net exports are expected to contribute negatively to the quarter's growth due to the unfavorable external conditions registered at the beginning of the quarter, especially after the lockdown measures in China. In this environment, the unemployment rate remained unchanged at 2.6% in June. Purchasing managers' indices suggest a moderation in both manufacturing and services activity.

In the main emerging economies, available indicators suggest a weakening of growth during the second quarter of 2022, although with marked heterogeneity across countries and regions. In Emerging Asia, a slower pace of growth is expected in most of the region, where the 2.6% contraction of economic activity at a seasonally adjusted quarterly rate in China stands out, following the imposition of restrictions in various cities and provinces of the country to contain contagions, and in light of the continued weakening of its real estate sector.[4] In Emerging Europe, available indicators point to a weakening of economic activity in most of the economies in the region, and to a sharp contraction in Russia and Ukraine. In Latin America, a gradual recovery is expected in most economies.

In general, international commodity prices have trended downwards since the last monetary policy

[2] Expressed as a seasonally adjusted annualized quarterly rate, the change in euro area GDP was 2.0% during the first quarter of 2022 and 2.8% in the second quarter.
[3] In annualized terms, Japan's GDP registered a quarter-on-quarter seasonally adjusted variation of -0.5 during the first quarter of 2022.
[4] Expressed as a seasonally adjusted quarterly rate, China's GDP growth went from 1.4% during the first quarter of 2022 to a contraction of 2.6% in the second quarter, while at an annual rate, it moderated from 4.8% during the first quarter of 2022 to 0.4% in the second quarter.

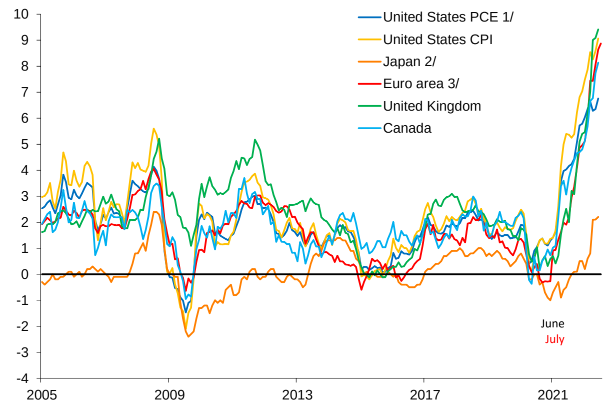
decision in Mexico. Oil prices declined due to concerns about a possible slowdown in world economic growth and its implications for energy demand. Meanwhile, natural gas reference prices in the United States increased due to strong demand for air conditioning as a result of unusually high temperatures, which, together with high exports to Europe, has prevented the adequate replenishment of inventories. In the European market, natural gas prices rose sharply as a result of disruptions to the flow from Russia and the risk of such disruptions intensifying. The price quotations of most industrial metals trended markedly downwards at the beginning of the period, primarily due to lower demand as a result of intermittent production shutdowns in China and concerns regarding slower growth in world economic activity. However, at the end of July and beginning of August, prices partially reversed this trend in view of the prospects of lower production and the risk that some industrial metal producers in Europe could be affected in the event of an energy crisis. Meanwhile, grain prices have decreased since the last monetary policy decision in Mexico due to concerns of a lower demand for grains in response to a slowdown in world economic activity, coupled with increased global supplies following a better-than-expected harvest in the northern hemisphere and the gradual reopening of some grain export channels from Ukraine. However, these prices remain at relatively high levels due to the uncertainty generated by the military conflict between Ukraine and Russia.

A.1.2. Monetary policy and international financial markets

World inflation continued to rise, once again reaching maximum levels in decades in some of the world's major economies. Inflationary pressures have spread to a greater number of items. This, in an environment in which imbalances continue to exist between the recovery of demand and supply in various markets, and where energy and food prices are still high. Although disruptions in global supply chains and pressures on commodity prices stemming from the military conflict between Russia and Ukraine have moderated recently, they remain at high levels and uncertainty persists about their future evolution and their effect on global inflation.

In most major advanced economies, headline and core inflation continued to rise, with headline inflation in most cases remaining significantly above their central banks' targets for a prolonged period (Chart 3). In particular, in the United States, the Consumer Price Index increased from an annual rate of 8.6% in May to 9.1% in June, its highest level since 1981. Although it declined to 8.5% in July, mainly reflecting a fall in energy prices, it remains at high levels. Meanwhile, annual core inflation, after having reached 6.0% in May, stood at 5.9% in June and July. In this context, although in general short-term inflation expectations derived from surveys for the main advanced economies continued to increase, longer-term inflation expectations derived from financial instruments for most of these economies moderated slightly, after having risen during March and April in some cases.

Chart 3
Selected Advanced Economies: Headline Inflation
Annual percentage change



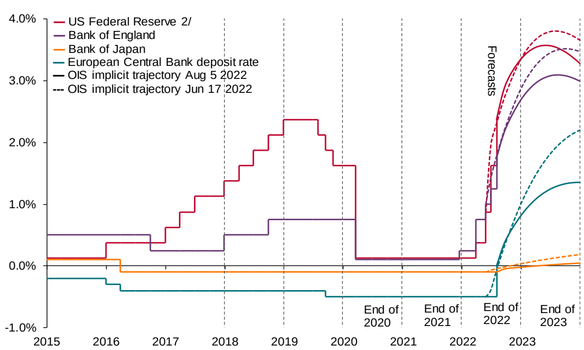
1/ The personal consumption expenditure deflator is used.
2/ Excludes fresh food. This series does not exclude the effect of the increase in the consumption tax in May 2014 and October 2019 nor the effect of the free daycare and preschool program in October 2019.
3/ Preliminary figures for July.
Source: Bureau of Economic Analysis, Bureau of Labor Statistics, Eurostat, Bank of Japan, Statistics Canada, Office of National Statistics.

In most of the main emerging economies, headline inflation also continued to rise, remaining significantly above their central banks' target. The rise in inflation in this group of economies has continued to be driven, in general, by increases in energy and food prices, as well as by core inflation in light of pressures on the prices of other goods and services.

In this context of high inflation and tightening labor markets in some of the major advanced economies, the central banks of most of these economies have continued with the reduction of their monetary stimulus, in some cases accelerating the pace of interest rate hikes and/or announcing larger than anticipated increases. The European Central Bank announced the first increase in its interest rates since

2011. The Bank of England implemented its largest increase in 27 years by raising its reference rate by 50 basis points up to 1.75%, while the Committee stated that monetary policy does not follow a preset path and will act forcefully if necessary. It also noted that it is tentatively prepared to begin asset sales shortly after its September meeting, depending if the economic and market conditions are appropriate. Regarding their asset purchase programs, most of these economies continued with the gradual reduction of their securities holdings, mainly through the suspension of maturity rollovers. Looking ahead, expectations from financial instruments for most of the major advanced economies foresee a lower than previously anticipated level of interest rates at the end of 2022, suggesting, in some cases, such as the United States, Canada and, to a lesser extent, the United Kingdom, that these rates would begin to decline during the second half of 2023 (Chart 4). The latter, in light of expectations of a slowdown of economic activity and its potential effects on inflation. It is worth noting that, given the highly uncertain environment, some of the central banks have chosen to limit their forward guidance measures regarding their next reference rate movements.

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



1/ OIS: Fixed floating interest rate swap where the fixed interest rate is associated to the effective overnight reference rate.
2/ For the observed reference rate of the US, the average interest rate of the target range of the federal funds rate (2.25% - 2.50%) is used.
Source: Banco de México with data from Bloomberg,

Among the recent monetary policy decisions of the main advanced economies' central banks, the following stand out:

i) At its July meeting, the Federal Reserve raised the target range for the federal funds rate by 75 basis points for the second consecutive meeting, to between 2.25 and 2.50%. The FED reiterated that it anticipates that successive increases in the target range will be appropriate and that the Committee is strongly committed to returning inflation to its 2% target. The chairman stated that while another unusually large increase may be appropriate at their next meeting, the pace of interest rate hikes will continue to depend on the data and the evolution of the outlook for the economy and that they will make decisions on a meeting-by-meeting basis without providing specific guidance. He added that the target range for the rate is at an interval they consider neutral and that, as the monetary policy stance tightens further, it will likely be appropriate to reduce the pace of increases. Regarding the Federal Reserve's balance sheet, the Federal Open Market Committee (FOMC) ratified that it will continue to reduce its holdings of Treasury securities, agency debt, and mortgage-backed securities as outlined in the Plans to Reduce the Size of the Federal Reserve's Balance Sheet published in May. Following the July decision, statements by some of the Federal Reserve's regional branch presidents and better-than-expected July employment data helped to offset the declines in the market-implied reference rate that had been registered at the beginning of the period due to concerns about a possible economic recession. Thus, the expected interest rate levels at the end of 2022 were similar to those observed in the previous period, while those associated with 2023 showed some reduction.

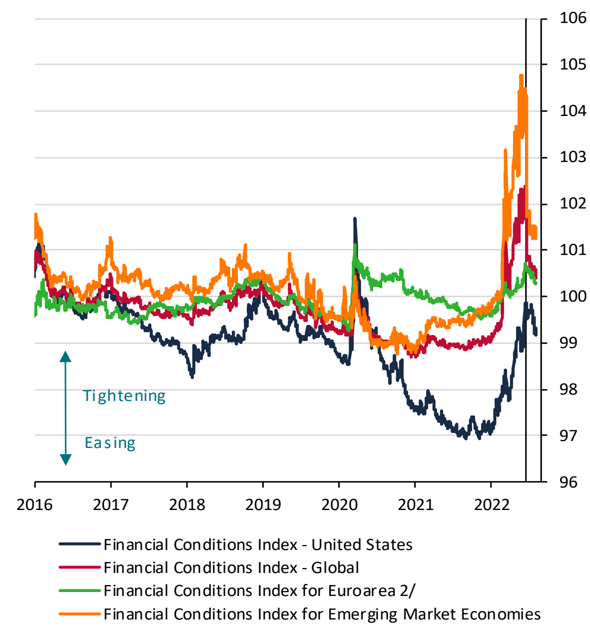
ii) At its July meeting, the European Central Bank raised its refinancing, key lending and key deposit rates for the first time since 2011 by 50 basis points, setting them at 0.5, 0.75 and 0.0%, respectively. The magnitude of the hike was larger than the Bank itself had anticipated at its June meeting, when it indicated that it intended to raise these rates by 25 basis points at its July meeting. It also reiterated that further normalization of interest rates would be appropriate at its next meetings. Regarding the Asset Purchase Program (APP), it concluded its purchases as of July 1 of this year, in line with its previous expectation, although it reiterated the Governing Council's plans of reinvesting the principal payments on securities reaching maturity. In the case of its Pandemic Emergency Purchase Program (PEPP), it also reiterated its plans to reinvest principal payments on maturing securities, although it added that flexibility in said reinvestments remains the first line of defense to counter pandemic-related monetary policy transmission mechanism risks. The Council approved the Transmission Protection Instrument (TPI), which seeks to ensure that the monetary policy stance is transmitted in a uniform manner to all euro area countries as it continues its normalization process. It added that, subject to the fulfillment of established criteria, the Eurosystem may make secondary market purchases of securities issued in jurisdictions experiencing a deterioration in financing conditions that is not justified by the specific fundamentals of the country. It pointed out that purchases are not restricted in advance and that the scale of these purchases will depend on the severity of the risks faced by the transmission of monetary policy.

iii) In its July meeting, the Bank of Japan left the benchmark rate unchanged at -0.1% and the 10-year interest rate target around zero and restated that it expects interest rates to remain at their current levels or even lower. Said central bank reiterated the guidelines for its yield curve control strategy, as well as for the purchase of assets other than government bonds.

In the main emerging economies, during the analyzed period, most central banks raised their reference interest rates, with significant increases equal to or greater than 100 basis points registered in cases such as Hungary and Colombia, among others. Meanwhile, Indonesia, Turkey, China, Ukraine and Czech Republic kept their interest rates unchanged, while Russia's central bank cut its reference rate by an additional 150 basis points in July, bringing it down to 8.0%.

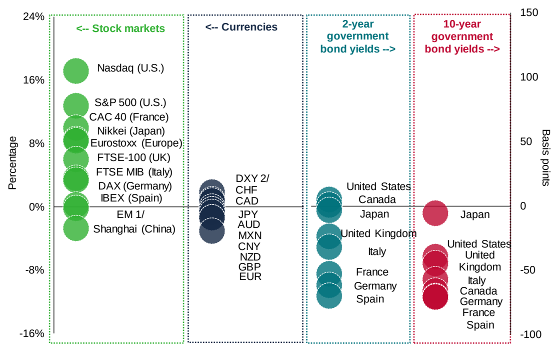
International financial markets reflected an environment of high uncertainty and concern associated with the high levels of world inflation, the evolution of geopolitical tensions and of the pandemic, as well as with a moderation in global economic activity. Increased concerns about the economic slowdown in some of the main economies thus resulted in a slight improvement of financial conditions, although they continue to reflect a high level of tightening (Chart 5). Equity markets in most of the major advanced economies showed some recovery, while emerging economies registered a mixed performance with a positive bias. In foreign exchange markets, the dollar continued exhibiting strength against most advanced economies' currencies, reaching its highest level in more than 20 years during the period. Most emerging market currencies depreciated against the dollar (Chart 6), although such trend reverted partially in recent weeks. Government bond interest rates in most major advanced economies declined, mainly for longer maturities, in a context of concerns regarding the slowdown in economic activity. In the United States, the slope of the yield curve, measured by the spread between 10-year and 2-year bond interest rates, recently moved into negative territory, which in the past has been associated with periods of recession. In emerging economies, interest rates exhibited a heterogeneous behavior, differentiated by region (Chart 7). In this context, since the last monetary policy decision in Mexico, capital outflows from emerging economies, both from fixed income and equity markets, were generally registered, although capital inflows to equity markets were registered in China during the period.

Chart 5
Financial Conditions Index[1/]
Units



1/ The financial conditions index is constructed considering the effect of five variables on economic activity: the reference interest rate, the 10-year government bond, the spread of investment-grade bonds over the government debt bond with equivalent maturity, the ratio of a stock index with 10-year average earnings per share and the trade-weighted exchange rate. Emerging economies include Brazil, Chile, China, Czech Republic, Hungary, India, Indonesia, Israel, Malaysia, Mexico, Philippines, Poland, Romania, South Korea, South Africa, Thailand, and Turkey. The global sample includes G10 countries and emerging economies.
2/ In the case of emerging economies, the financial conditions index considers the CDS as the credit spread component and includes the debt-weighted exchange rate. The vertical black line indicates the last scheduled meeting of Banco de México's Monetary Policy Committee.
Source: Prepared by Banco de México with Bloomberg and Goldman Sachs data.

Chart 6
Change in Selected Financial Indicators from June 17, 2022 to August 5, 2022
Percent; basis points



1/ The MSCI Emerging Markets Index includes 24 countries.
2/ DXY: a weighted average estimated by the Intercontinental Exchange (ICE) of the nominal exchange rate of the main six currencies operated globally with the following weights: EUR 57.6%, JPY: 13.6%, GBP: 11.9%, CAD: 9.1%, SEK: 4.2%, and CHF: 3.6%.
Source: Bloomberg and ICE.

Chart 7
Selected Emerging Economies: Financial Assets Performance since June 20, 2022
Percent, basis points

Region	Country	Currencies	Equity markets	2-year interest rates	2-year interest rates	CDS
Latin America	Mexico	-0.09%	-2.21%	-49	-75	-13
	Brazil	0.52%	6.63%	-24	-35	-11
	Chile	-3.91%	2.52%	167	6	25
	Colombia	-11.43%	-10.59%	45	61	5
	Peru	-4.93%	-0.15%	50	28	5
Emerging Europe	Russia	-8.96%	-12.96%	-15	-105	N.D.
	Poland	-4.35%	2.75%	-184	-256	24
	Turkey	-3.64%	9.76%	-392	-239	-98
	Czech Republic	-2.40%	-5.72%	-71	-181	12
	Hungary	-2.28%	10.89%	152	-61	38
Asia	China	-1.01%	-2.37%	-15	-8	-4
	Malaysia	-1.33%	3.80%	-8	-37	-15
	India	-2.14%	14.06%	-15	-8	8
	Philippines	-2.72%	1.58%	-5	-35	-14
	Thailand	-1.34%	3.18%	-18	-50	10
	Indonesia	-0.30%	1.58%	-2	-36	8

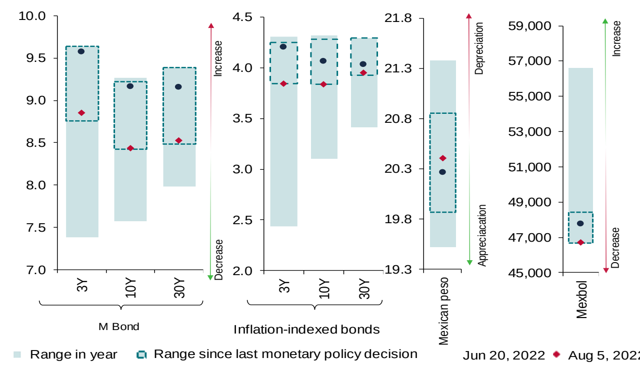
Note: An upward adjustment indicates currency appreciation. Interest rates correspond to swap rates at th3 specified terms, except for Hungary, where government securities with 3-year maturities were used as a reference. For the Philippines, a 2-year swap rate was used, and for Russia, a 2-year and 3-year swap rate was used.
Source: Bloomberg.

A.2. Current situation of the Mexican economy

A.2.1. Mexican markets

In the international context described above, in the domestic financial markets, the Mexican peso remained stable against the dollar, while longer-term interest rates showed downward movements, in line with the movements observed in global yield curves (Chart 8), in response to a less aggressive adjustment in the Federal Reserve's expected path for monetary policy.

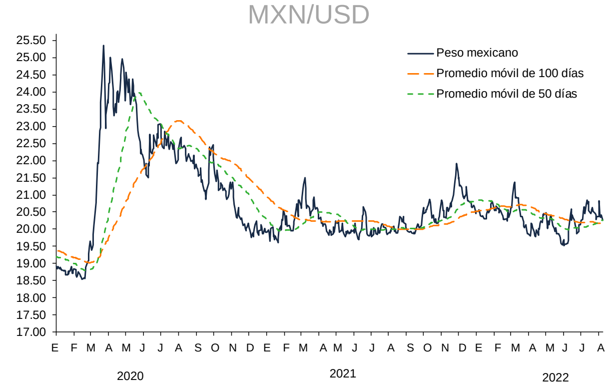
Chart 8
Mexican Markets' Performance
Percent, MXN/USD and index



Source: Prepared by Banco de México.

The Mexican peso fluctuated in a range of 99 cents, between 19.87 and 20.86 pesos per dollar, ending the period with a marginal depreciation of 0.09%. (Chart 9). This occurred in a context in which both spot and future trading conditions slightly deteriorated.

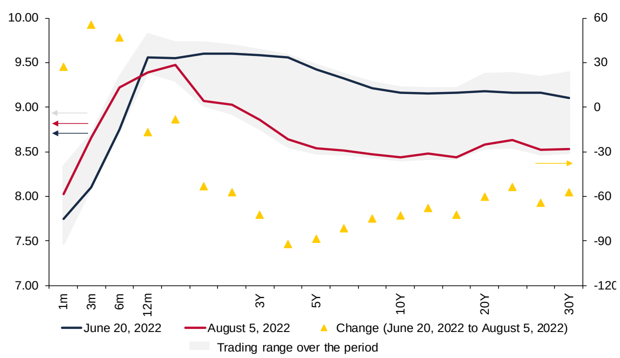
Chart 9
Mexican Peso Exchange Rate with Moving Averages
MXN/USD



Source: Prepared by Banco de México.

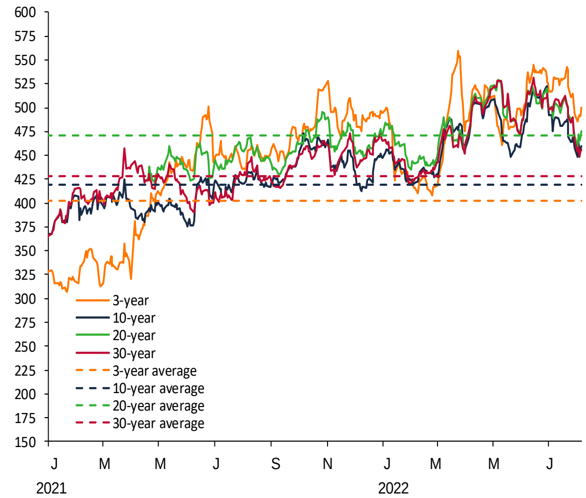
Interest rates on government securities moved mainly downward (Chart 10), with movements of between -72 and +30 basis points in the short-term segment, and decreases of up to 92 basis points and 64 basis points in the medium- and long-term nodes, respectively. Likewise, the yield curve for real-rate instruments registered a steepening, with decreases of between 16 and 34 basis points in the short and medium term and decreases of up to 11 basis points in longer-duration instruments. In this context, breakeven inflation registered generalized decreases of between 30 and 51 basis points in all maturities (Chart 11). These movements took place in an environment in which trading conditions remained relatively unchanged in relation to the previous period.

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



Source: PIP.

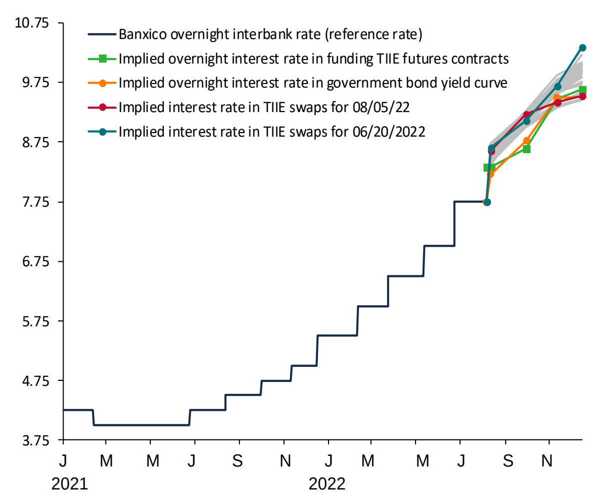
Chart 11
Breakeven Inflation and Inflation Risk Implied in Government Securities' Yields
Basis points



Source: PIP.

Regarding expectations for the monetary policy reference rate, the information implicit in the interest rate swap curve incorporates an increase of 86 basis points for the August decision, while for the end of 2022 it points to a rate of 9.51% (Chart 12). The majority of the analysts surveyed by Citibanamex anticipate that the reference rate will be raised 75 basis points up to a level of 8.50% in the August decision, while for the end of 2022 they anticipate a rate of 9.50%.

Chart 12
Interbank Funding Rate Implied in TIIE Swaps
Percent



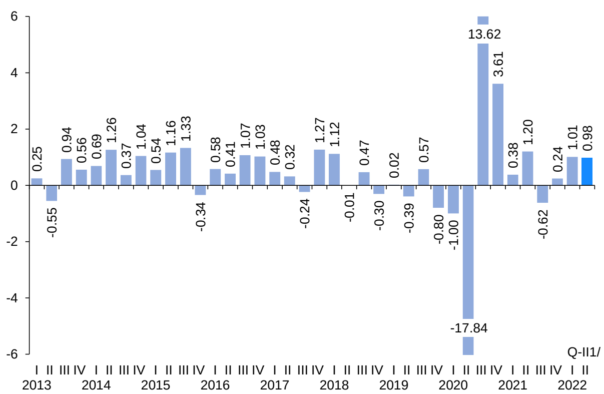
Source: Prepared by Banco de México with Bloomberg data.

A.2.2. Economic activity in Mexico

According to the GDP flash estimate for Mexico, during the second quarter economic activity maintained a similar pace of recovery to that of the previous quarter (Chart 13). This, despite the fact that during said period uncertainty persisted regarding the evolution of the pandemic due to the increase in the number of COVID-19 infections, disruptions in global supply chains, and, in general, a complex global economic environment.

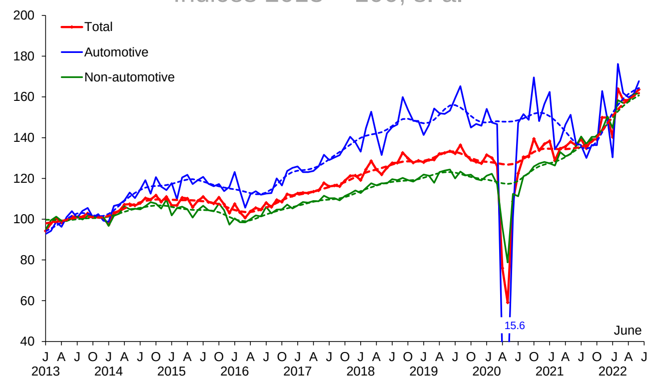
Regarding external demand, during the second quarter, the value of manufacturing exports, both automotive and non-automotive, continued increasing (Chart 14).[5] By destination, manufacturing exports to the United States continued to grow, while shipments to the rest of the world contracted marginally.

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



s. a. / Seasonally adjusted figures.
1/ The Q2-2022 figure corresponds to GDP's quarterly flash estimate by INEGI.
Source: Mexico's System on National Accounts (SCNM, for its Spanish acronym), INEGI.

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



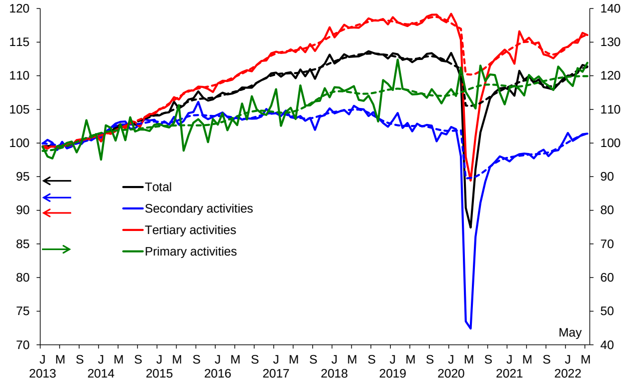
s. a. / Seasonally adjusted series and trend series based on data in nominal US dollars. The former is represented by a solid line and the latter by a dotted line
Source: Prepared by Banco de México with data from the Tax Administration Service (SAT, for its Spanish acronym), the Ministry of the Economy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

On the domestic demand side, based on its monthly indicator, private consumption halted its growth in May, after having increased at the margin for ten consecutive months. Within it, consumption of domestic goods showed an incipient downward trend, while consumption of imported goods and services moderated its rate of expansion. In May, gross fixed investment reversed part of the rebound observed in the previous two months. Machinery and equipment interrupted the growth observed in the previous seven months, while construction investment spending continued showing weakness.

On the production side, industrial activity continued growing during the April-May period (Chart 15), mainly due to an increase in manufacturing and a moderate reactivation of construction (Chart 16). Services continued to expand, although with some differences in the levels of reactivation by sector. The services that contributed the most to growth during the April-May period were transportation and mass media information services, commerce, financial and real estate services, leisure and other services.

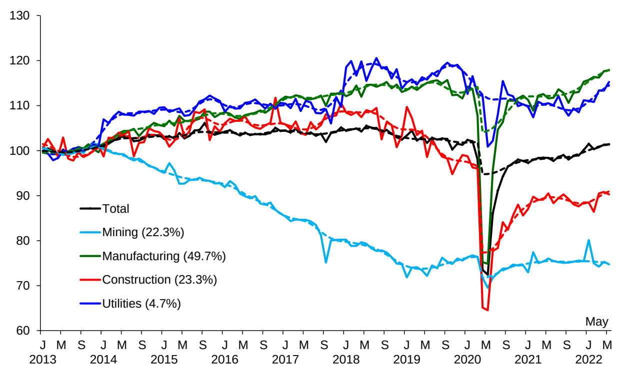
[5] Refers to the value of merchandise exports in current dollars. This value differs from that reported for goods' exports in Mexico's System of National Accounts, since the latter represents value added, measured in constant pesos.

Chart 15
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 System of National Accounts (SCNM, for its Spanish acronym), INEGI

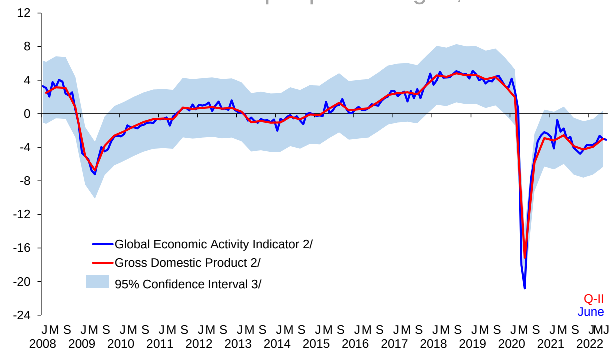
Chart 16
Industrial Activity 1/
Indices 2013 = 100, s. a.



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

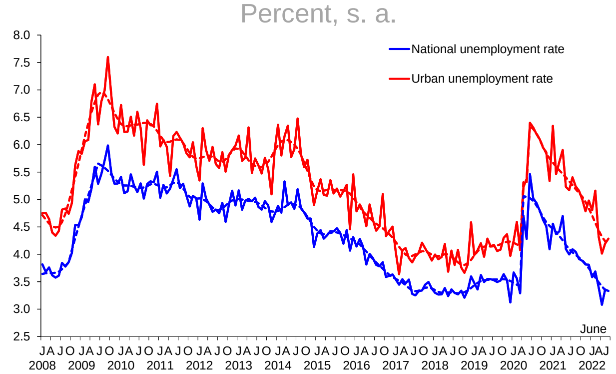
Regarding the cyclical position of the economy, slack conditions decreased during the second quarter (Chart 17). In particular, the estimated negative output gap declined in relation to the previous quarter, in line with the behavior of economic activity during the period. In June, the national unemployment rate exhibited a level similar to that of the previous month, while the urban unemployment rate increased marginally (Chart 18). This took place in a context in which both the labor participation rate and the employment rate among the working age population grew slightly in relation to May. Based on seasonally adjusted figures, the net creation of IMSS-insured jobs continued trending upwards between May and July. Unit labor costs in the manufacturing sector contracted in May, after having increased for three consecutive months (Chart 19).

Chart 17
Output Gap Estimates 1/
Excluding Oil Industry 4/
Potential output percentages, s. a.



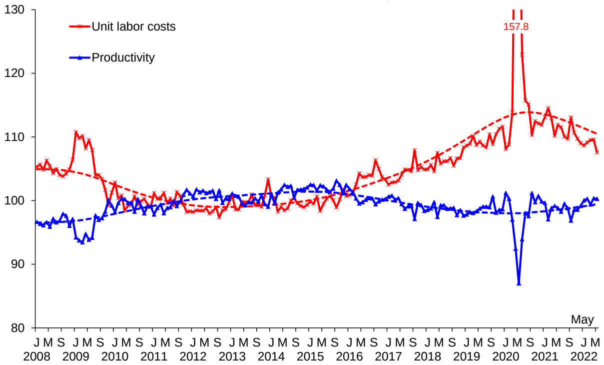
s. a. / Calculations based on seasonally adjusted figures.
1/ Output gap estimated with a tail-corrected Hodrick-Prescott filter; see Banco de México (2009), "Inflation Report, April-June 2009", p.74.
2/ GDP figures up to the first quarter of 2022 and IGAE up to June 2022.
3/ Output gap confidence interval calculated with a method of unobserved components.
4/ Excludes both oil and gas extraction, support services for mining, and petroleum and coal products' manufacturing.
Source: Prepared by Banco de México with INEGI data.

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



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

Chart 19
Productivity and Unit Labor Costs in the Manufacturing Sector [1/]
Indices 2013 = 100, s. a.



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

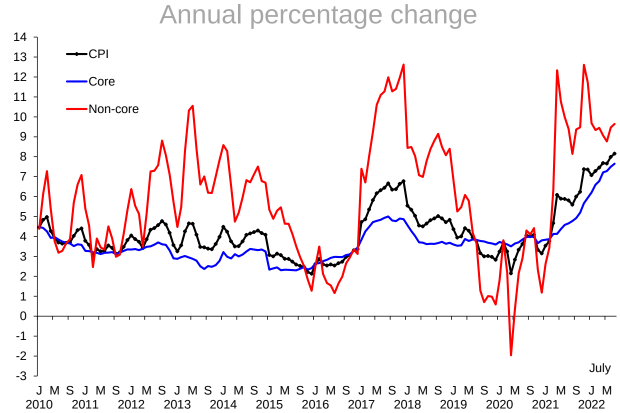
In June 2022, domestic financing to firms continued moderating its annual rate of contraction in real terms. Within it, bank credit to firms continued recovering gradually, exhibiting a positive real annual variation for the second consecutive month, thus accumulating three quarters of increases in its balance. This, in a context in which corporate credit demand continued recovering, while lending conditions remained tight compared to those that prevailed at the beginning of the pandemic, although these have been easing for smaller firms since the second half of 2021. Net corporate debt issuance in the domestic market was negative during the first half of this year. As for credit to households, commercial bank housing portfolios expanded at a pace similar to that of the first quarter of the year. In turn, outstanding bank consumer credit registered an increase in its pace of growth with respect to the previous quarter, mainly as a result of the sustained dynamism of payroll credit and credit card portfolios, as well as the recent recovery of the personal credit portfolio. This has taken place in a context in which household demand for credit has continued to increase. Mortgage lending conditions remained stable, while consumer credit conditions eased during the second quarter of the year.

Interest rates on bank credit to firms are at levels similar to those observed prior to the pandemic. Between January and June 2022, corporate credit intermediation margins narrowed, and therefore are generally at levels below those observed prior to the pandemic. At the same time, mortgage loan interest rates remained at levels around their historic lows, although they slightly increased. In February 2022, credit card interest rates were at levels similar to those observed during the fourth quarter of 2021. Regarding portfolio quality, in June 2022, corporate and housing loan delinquency rates declined, thus remaining at low levels. Lastly, consumer portfolio delinquency rates also declined, remaining at levels lower than those registered prior to the onset of the pandemic, although they continue to be high.

A.2.3. Development of inflation and inflation outlook

Between June and July 2022, annual headline inflation increased from 7.99 to 8.15% (Chart 20 and Table 1), thus continuing to reflect the pressures from the COVID-19 pandemic and the military conflict between Russia and Ukraine.

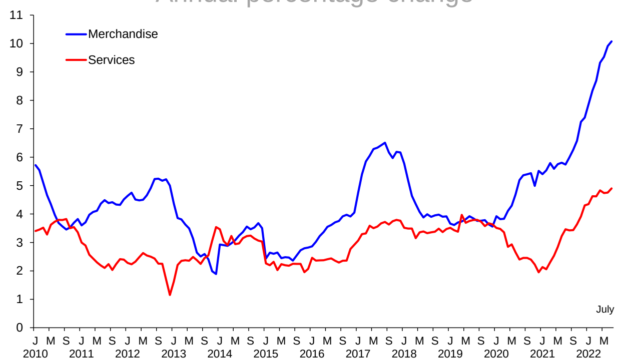
Chart 20
Consumer Price Index
Annual percentage change



Source: Banco de México and INEGI.

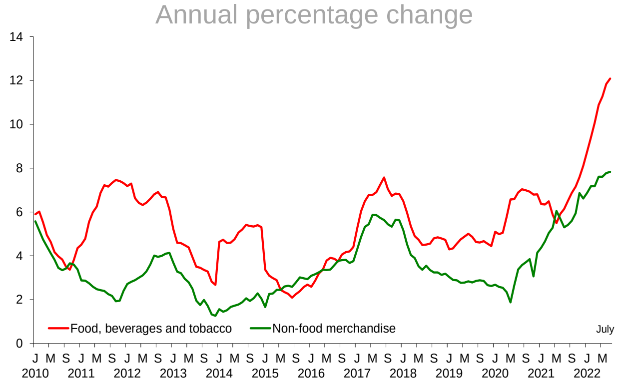
Annual core inflation increased from 7.49 to 7.65% between June and July 2022, thus remaining on the same upward trend followed since December 2020 (Chart 21). Within it, in said months annual merchandise inflation was 9.91 and 10.07%, respectively, pressured by the persistent disruptions in production and distribution chains, as well as by the price increases of several inputs at the international level, where foods stand out. This has been particularly noticeable in food merchandise inflation, which was already at high levels and increased from 11.84 to 12.09%. Annual non-food merchandise inflation remained relatively stable at 7.78 and 7.83% in the aforementioned months (Chart 22). Annual services inflation increased from 4.76 to 4.90% in the same period, driven by the reopening of activities and the greater operating costs that had to be faced to avoid infections as well as those related to the increasing prices of services' inputs. In particular, annual inflation of services other than education and housing increased from 6.61 to 6.87% in the same dates, being food and transportation the items with the highest annual price variations.

Chart 21
Merchandise and Services Core Price Sub-index
Annual percentage change



Source: Banco de México and INEGI.

Chart 22
Merchandise Core Price Sub-index
Annual percentage change

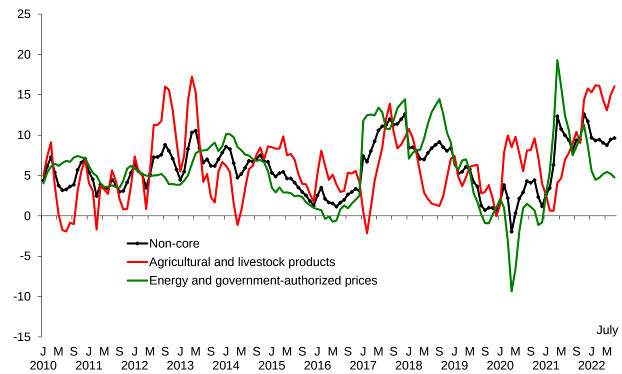


Source: Banco de México and INEGI.

Between June and July 2022, annual non-core inflation shifted from 9.47 to 9.65% (Chart 23 and Table 1). This reflected the high levels of annual inflation of agricultural and livestock products, which increased from 15.02 to 16.05% in the aforementioned dates, affected by the price increases of production inputs, such as fertilizers and grains. Meanwhile, annual energy inflation decreased from 5.68 to 4.68% during the same period.

Regarding inflation expectations from the survey conducted by Banco de México among private sector specialists, between May and July the median for headline inflation for the end of 2022 increased from 6.81 to 7.80%, while that for the core component rose from 6.38 to 7.08%. The median of headline inflation expectations at the end of 2023 was revised from 4.34 to 4.50%, while that for core inflation increased from 4.14 to 4.31%.

Chart 23
Non-core Price Sub-index
Annual percentage change



Source: Banco de México and INEGI.

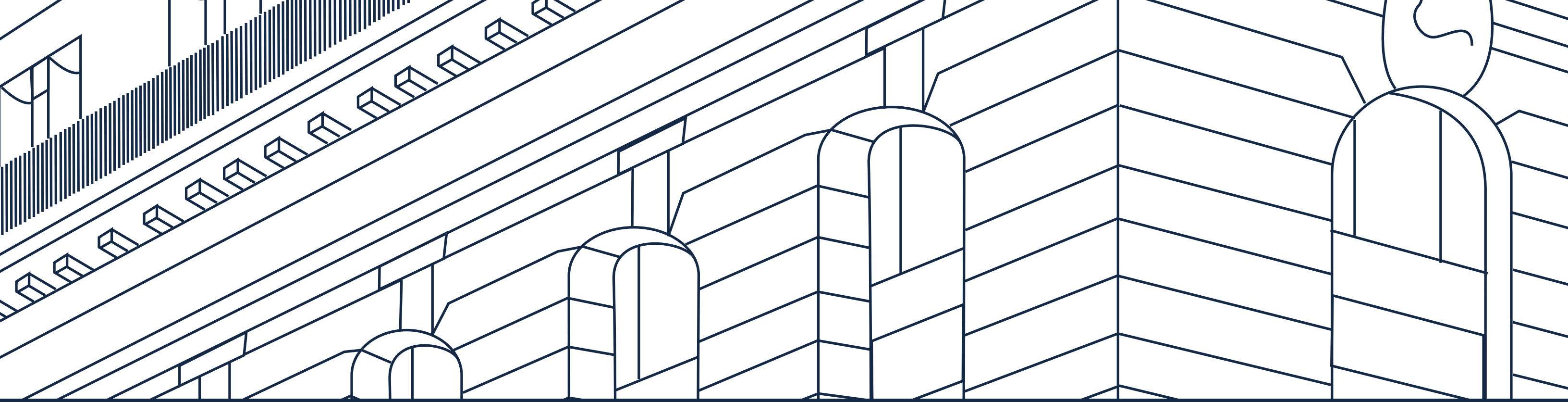
The median of headline inflation expectations for the medium term was adjusted slightly from 3.80 a 3.82%, while that for core inflation was adjusted from 3.70 to 3.83%. The median of headline inflation expectations for the long term (5 to 8 years) remained at 3.60% and for core inflation increased from 3.50 to 3.57%. Finally, compensation for inflation and inflationary risk decreased. Within it, expectations implied by market instruments continued increasing, while the inflation risk premium remains at elevated levels.

Convergence to the 3% target is still projected to be attained in the first quarter of 2024. These projections are subject to risks. On the upside: i) persistence of core inflation at high levels; ii) external inflationary pressures associated with the pandemic; iii) continued pressures on agricultural and livestock product prices and on energy prices due to the ongoing geopolitical conflict; iv) exchange rate depreciation; and v) cost-related pressures. On the downside: i) a greater-than-anticipated slowdown in world economic activity; ii) a decline in the intensity of the geopolitical conflict; iii) a better functioning of supply chains; iv) a greater-than-expected effect from the negative output gap; and v) a larger-than-anticipated effect from the Policy Program to Fight Inflation and High Prices (PACIC, for its acronym in Spanish). The balance of risks for the trajectory of inflation within the forecast horizon remains significantly biased to the upside.

Table 1
Consumer Price Index and Components
Annual percentage change

Item	May 2022	June 2022	July 2022
CPI	**7.65**	**7.99**	**8.15**
Core	**7.28**	**7.49**	**7.65**
Merchandise	**9.53**	**9.91**	**10.07**
Food, beverages and tobacco	11.27	11.84	12.09
Non-food merchandise	7.61	7.78	7.83
Services	**4.74**	**4.76**	**4.90**
Housing	2.84	2.97	3.02
Education (tuitions)	3.24	3.30	3.27
Other services	6.71	6.61	6.87
Non-core	**8.77**	**9.47**	**9.65**
Agricultural and livestock products	**13.08**	**15.02**	**16.05**
Fruits and vegetables	12.88	14.39	16.16
Livestock products	13.24	15.51	15.96
Energy and government-authorized prices	**5.44**	**5.22**	**4.76**
Energy products	6.30	5.68	4.68
Government-authorized prices	3.41	4.12	4.95

Source: INEGI.



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