BANCO DE MÉXICO®

Minutes number 65

Meeting of Banco de México's Governing Board on the occasion of the monetary policy decision announced on February 7, 2019

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ERRATUM
In this version of the Minutes there is a sentence that has been corrected relative to the Minutes published originally. The previous version stated in the first paragraph of section 3, page 10:

"the Governing Board will take the necessary actions, *in whatever direction is required*, so that the reference rate is kept at a level consistent with the convergence of headline inflation to Banco de México's target within the time frame in which monetary policy operates."

while the correct phrase is:

"the Governing Board will take the necessary actions so that the reference rate is kept at a level consistent with the convergence of headline inflation to Banco de México's target within the time frame in which monetary policy operates."

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: February 6, 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

Carlos Manuel Urzúa-Macías, Secretary of Finance and Public Credit.

Arturo Herrera-Gutiérrez, Undersecretary of Finance and Public Credit.

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 agreed that towards the end of 2018 the world economy decelerated, with most advanced and some emerging economies showing less dynamism. One member mentioned that, although the weakening of the global economy has been persistent, it has occurred at a moderate rate. Some members argued that such deceleration was sharper than expected, due partly to the escalation of trade disputes and to idiosyncratic and geopolitical factors. Some members noted the negative performance that coincident and leading indicators are recently showing. One member pointed out the negative evolution of industrial production, investment spending, and global trade flows for advanced and, more recently, for emerging economies. As for the outlook for global economic activity, all members stated that growth expectations for this year have been revised downwards on an ongoing basis, while some added that forecasts for 2020 have also been reduced. One member noted that trade tensions, mainly those between the U.S. and China, have contributed to the downward revision of growth expectations.

As for the balance of risks to global growth, most members stated that it is significantly biased to the downside and one pointed out that it has deteriorated. Most members agreed that, among the main risks, the following stand out: i) an escalation of trade disputes; ii) a lower-than-expected economic growth of the Chinese economy; and, iii) political, geopolitical, and idiosyncratic factors. In relation to the first of these risks, most members highlighted the uncertainty surrounding the trade disputes between the U.S. and China. In this regard, one member warned that, although the negotiations within the ninety-day-period agreed to in December appear to be progressing satisfactorily, it is not possible to rule out a scenario of greater trade barriers between both economies starting in March, which would have effects on the world economy. As for the second risk, another member argued that the Chinese economy registered its lowest growth rate since the beginning of the 1990s and that a significant decline in China-U.S. trade can already be observed. The same member added that this lower dynamism would lead to a deceleration of global demand for basic commodities, with a negative effect on global trade. In regards to the third risk, some members mentioned that international financial markets may react abruptly to developments of either economic, political or geopolitical nature, with spillover effects on the real economy. One member pointed out that vulnerable emerging economies would be

particularly affected. Among these events, most members noted the possibility of a Brexit process without mutually convenient agreements between the U.K. and the European Union, as well as prospects of a resumption of the U.S. government shutdown. Some members stated that the uncertainty stemming from such factors has translated into a warning of a further decline in economic activity. One member noted that business confidence has been affected by both the impact of the aforementioned developments on the real economy and the uncertainty and volatility that they have generated in markets.

Most members highlighted the lower dynamism of economic activity and continued divergence among the main advanced economies. In this regard, some members pointed out that the U.S. has decelerated less than other advanced economies. One member attributed this difference, among other factors, to the transitory effects of the procyclical fiscal stance adopted by this country during the mature phase of its business cycle. Another member mentioned that the economic contraction of the Eurozone has become more visible due to the deceleration of external demand and the presence of transitory factors that have affected industrial production in certain economies, in addition to business confidence remaining in negative terrain. Regarding growth expectations of advanced economies, most members agreed that those for 2019 and 2020 have been revised downwards on an ongoing basis. The majority highlighted that in the particular case of the U.S., the uncertainty about the outlook for its growth persists and the probability of a recession over the next 12 months has even increased. In this regard, some members noted that some financial variables suggest the possibility of a recession. Nevertheless, one member acknowledged that the change in the Federal Reserve's message regarding future adjustments to the target range for the federal funds rate and the possible moderation of the balance sheet reduction process could mitigate or postpone the possibility of such recession. Other members stated that the outlook for deceleration in the U.S. is associated with the fading fiscal incentives, a progressively less expansionary monetary policy stance, the economic costs of the partial government shutdown, and the decline in investment.

Regarding emerging economies, most members mentioned that their economic growth has weakened and that forecasts about their growth rate have been revised downwards. One member pointed out that the deceleration of China is a risk factor for other emerging economies, both directly through a reduction in trade, and indirectly through lower commodity prices. Most members highlighted that the Chinese economy has decelerated more than the other emerging economies and that the risk of a lower-than-expected dynamism prevails. One member noted that economic growth estimates for China have been declining steadily and in a sustained manner. In this regard, some members underlined the willingness of the Chinese authorities to seek an orderly adjustment in the transition to a more moderate and balanced growth by considering the adoption of fiscal, monetary and regulatory easing measures. One member stated that, to reverse the negative impact of the trade dispute with the U.S., the People's Bank of China relaxed its reserve requirements, pointing out that it will grant improved financing conditions to small and medium enterprises.

Most members noted that due to the lower economic dynamism and the fall in energy prices, inflationary pressures have moderated worldwide. As for such pressures in advanced economies, most members mentioned that these have decreased, while some of them added that pressures have decreased in both headline and core inflation. Some members emphasized that this has occurred notwithstanding the tightening of their labor markets and faster wage growth. As for the U.S., some members pointed out that headline inflation is near the Fed's 2% target, while in the Eurozone and Japan inflation is still below the targets of their central banks. Continuing with the U.S., one member stated that there are no signs of possible inflationary pressures in the foreseeable future, except for a possible impact stemming from wage pressures on its labor market. One member added that the behavior of the prices of food and of some industrial metals, as well as the favorable performance of core inflation in some emerging economies, have also contributed to diminish inflationary pressures worldwide. As for inflation in emerging economies, another member underlined that it decreased due to the fall in crude oil and food prices, the fading effect of the depreciation of their currencies on prices, and lower global dynamism.

All Governing Board members highlighted that the lower dynamism of global economic activity has been reflected in expectations of a slower monetary policy normalization by the major central banks, and in lower short- and long-term interest rates in the United States. Most members added that, as expected, in January, the U.S. Federal Reserve left the target range for the federal funds rate unchanged. Such members mentioned that this central bank stated that it will be patient in making future adjustments to the target range for the federal funds rate. Some members indicated that the Fed sent clear signals that the upward trend of interest

rates will stop at least for some time, eliminating from its statement all references to additional rises. In this regard, one member highlighted the change in the Federal Reserve's policy stance. Another member noted that, in this environment, market variables no longer incorporate the possibility of an additional increase in the reference rate during this year and are even starting to discount a decrease in interest rates in 2020. Additionally, most members pointed out that the Fed stated that it could adjust its balance sheet normalization program if necessary, one member adding that the balance sheet normalization program could end sooner and at a higher level than expected. Nevertheless, another member warned that, in a context of an economic downturn but with forecasts for GDP growth above potential for this year, there are greater challenges in terms of the assessment of the economy's cyclical position as well as in terms of communication. Therefore, the same member estimated that surprises in the monetary normalization process cannot be ruled out.

From a longer-term perspective, another member argued that, since the years after the 2008 crisis, the Federal Reserve has used forward guidance to exert a greater influence on expectations for short-term interest rates along the entire yield curve and strengthen its effects on aggregate demand. The same member considered that this policy was useful for the cyclical recovery of the U.S. economy, but that it has faced significant challenges in the current phase of the cycle. In this regard, he/she highlighted that, albeit having announced several years ago that the withdrawal of monetary stimulus was to be gradual and preannounced, this type of guidance and commitment faces significant challenges when the monetary policy stance is close to a possible inflection point or when it faces an environment of high uncertainty. He/she pointed out that this has occurred in recent months, when the cyclical path of the U.S. economy has become more uncertain. He/she mentioned that this situation led to a considerable adjustment in the Fed's message, which in September appeared to be operating under a prescheduled strategy, while by the end of December and in January, it announced that its actions would be determined on the basis of incoming information. Another member underlined that, on the one hand, the central banks of the Eurozone and Japan left their reference rates unchanged, stating that the Bank of Japan pointed out that it will continue with a highly accommodative monetary policy for a prolonged period. The same member mentioned that, on the other hand, the central banks of most emerging economies left their monetary policy stances unchanged and several of them have stated that they will remain vigilant to developments and incoming data that may jeopardize the convergence of inflation to their targets.

Most members mentioned that, recently, financial markets in both advanced and emerging economies have exhibited a more favorable performance associated, to a large extent, with the greater caution with which the central banks of advanced economies, particularly the U.S. Federal Reserve, have stated they will proceed henceforth. Some members agreed that interest rates in these economies decreased and one member noted that this decrease was more significant in the U.S. Some members highlighted that the yield curve in that country flattened considerably. Most members stated that this has been reflected in an appreciation of most emerging economies currencies against the U.S. dollar. One member emphasized that the best performing currencies were those exhibiting greater interest rates spreads vis-à-vis advanced economies. Some members underlined that as a result of this environment, emerging economies have registered significant capital inflows.

Nevertheless, most members warned about the persistence of certain risks, whose materialization may affect financial markets significantly. Some members pointed out that the global economic deceleration might sharpen and lead to greater financial volatility, reversing the apparent increase in risk appetite. One member added that tight financial conditions may become even tighter than they already are. In this regard, some members warned that financial markets were already affected in 2018, precisely by a deterioration of growth forecasts due to the materialization of some risks to the global economy. One member recalled that the abovementioned led to a lower risk appetite. The same member pointed out that the initial adjustment in financial markets to an environment of increasing interest rates implied a downward adjustment in stock markets and high credit risk spreads, thus tightening financial conditions. He/she stated that, towards the end of 2018, markets recovered as expectations of lower interest rates consolidated gradually. Finally, he/she underlined that now that lower pressures from external markets are expected, the performance of emerging economies will be determined, to a larger extent, by idiosyncratic risk factors and by the soundness of their macroeconomic fundamentals.

As for economic activity in Mexico, most members highlighted that during the fourth quarter of 2018, it decelerated significantly as compared to the previous quarter. One member mentioned that this deceleration is due to transitory factors as well as others of a more persistent nature and that, thus, the

rate of economic growth continued on a downward trend which has been observed since 2016. Some members stated that the evolution of the labor market also suggests a weakening of economic activity during such period. One member noted that latest figures for the fourth quarter of 2018 imply that growth for the entire year was 2% and indicate the effects of some factors that have affected growth negatively. On the demand side, most members agreed that consumption showed signs of deceleration during the fourth quarter of 2018. Nevertheless, one member pointed out that, overall, consumption continued on a positive trend supported by the recovery of the total wage bill and the dynamism of revenues from remittances, which, during 2018, reached historical highs of above 33 billion USD. Most members mentioned that private investment continued following a downward trend and one member stated that this is due to the lower spending in both construction and machinery and equipment. The majority of members noted that in the last quarter of 2018 manufacturing exports maintained a level similar to that of the third quarter. One member mentioned that in December imports fell drastically vis-à-vis the previous month. Another member pointed out that the public sector is anticipated to have continued being a drag on aggregate demand at the end of 2018.

One member noted that recent indicators suggest that the weakening of economic activity during the fourth quarter of 2018 may extend to the beginning of 2019. As an example, the same member highlighted that consumption started showing signs of deceleration for the first time. Another member stated that it remains to be known if the economic slowdown is transitory, resulting from the adjustment that usually occurs at the beginning of a new administration, or if it is a phenomenon associated with a new phase of the economy's business cycle. The same member argued that maybe the most evident sign of this latter phenomenon is what is reflected in the trend of all the components of the Coincident Indicator of INEGI's Cyclical Indicators System, which have contributed negatively to this indicator for at least four consecutive months, and stated that some of these components have been contributing negatively to such indicator for at least nine consecutive months. He/she stated that the last time that such indicator reached a level as low as that of November 2018 with a negative trend was between November and December 2008, right at the beginning of Mexico's last recession.

One member mentioned that there is not enough statistical information available to make an accurate assessment of economic activity for the beginning of 2019. Nevertheless, the same member added that the economy may weaken further during the first quarter of 2019, given that no changes have been observed in the fundamental determinants that have recently been affecting the economy, highlighting the complex international environment and the global slowdown, and a domestic environment of persisting uncertainty. Such member added that in addition to the aforementioned, the impact of the transitory shocks should also be considered, especially the shortage of fuel in several regions of the country, the blockage of railroads in Michoacán, the labor conflicts in Tamaulipas, and the U.S. government shutdown. In this context, the same member pointed out that growth forecasts for the next two years have deteriorated, and that it is foreseen for 2019 that the economy will expand less than what was observed in 2018 and then strengthen slightly in 2020. In this regard, some members warned that such forecasts are subject to a higher degree of uncertainty. One member added that a negative growth rate for the first quarter of 2019 would not be surprising. Another member considered that the environment for growth for 2019 will depend on the public policies to be implemented. Most members highlighted that private sector specialists have revised downwards their growth forecasts for 2019. Another member delved into the dispersion of such forecasts, which increased between December 2018 and January 2019, reflecting higher uncertainty. Such member pointed out that the range for such forecasts decreased during the same period. Another member mentioned that the most worrying concern is the deteriorating prospects for growth, as gross fixed investment has remained stalled for three consecutive years and consumption and exports have not exhibited sufficient dynamism to foster higher growth. The same member added that the start of every six-year administration is always complicated and is now accompanied by additional transitory challenges, such as those associated with fuel distribution, the blocking of transportation routes, and the labor conflicts in the state of Tamaulipas. Such member expressed his/her view that starting out with a persistent environment of caution for investment in addition to the direct and indirect effects originated by the aforementioned developments, a stronger emotional constraint must also be considered.

All members said that the balance of risks to growth is biased to the downside: one member added that the downward bias is present in both short- and medium-term horizons and some members noted that the balance of risks has deteriorated. One of them argued that there are external and domestic factors that have substantially increased the uncertainty about the country's economic performance. The majority warned that in the

beginning of 2019 transitory factors that could affect the growth rate during the first quarter of this year have been observed. One stressed that it is estimated that the shortage of fuel in some states will have a negative effect on GDP growth in the first quarter of 2019, which will depend on its intensity and duration.

In addition to the global risks described above, the majority mentioned other downside risks for growth, such as: i) obstacles in the ratification of the trade agreements reached between Mexico, the United States and Canada; ii) factors leading to greater domestic uncertainty and less confidence in the outlook for the Mexican economy; and, iii) certain delays in the execution of public expenditure related to the beginning of a new administration. In this regard, one member added that, given the lower global dynamism, the country will face a certain deceleration in foreign trade, which has been one of Mexico's main growth drivers in recent years. Another member warned that the substantial reallocation of public expenditure can translate into greater delays and inefficiencies in resource allocation and weaken economic activity to a larger extent than normally observed at the beginning of a new administration. One added the uncertainty about public policies in the next years, which according to such member is hindering the recovery of business confidence from its very low levels. In addition, some warned that a lower-than-expected growth would reduce tax collection, and would make it difficult to execute public expenditure in the second half of this year.

As upside risks for growth, some members pointed out the important increase in consumer confidence. One member added that there could be a positive effect from new social programs, which could boost the domestic market given their focus on segments of the population, such as seniors and young people, which have a high propensity to consume. Another member added as a risk the possibility that economic policy and public expenditure begin making a positive contribution to economic growth, which could surprise to the upside towards the second half of the year or towards 2020. In addition, such member mentioned that, given the deterioration in growth expectations, the unusual increase in consumer confidence is striking, which was especially motivated by the perception of the country's future economic situation, currently at historical highs. The same member noted that there is an exceptional contrast with business confidence, which has not really changed in the past months. However, such member specified that the latter indicator has improved in the past couple of years and that it maintains a path which is slightly above the 50-point threshold. The same member noted that consumer perception about the country's future economic situation is better than that of business owners, while that of the future situation of households is practically aligned with the future perception of businesses. In this regard, such member pointed out that despite the events of recent months and the deterioration in growth projections, firms maintain positive expectations, while consumers have more confidence in government actions. The same member concluded that it is possible that these confidence levels favor consumption and an eventual recovery in private investment, which could translate into a better economic performance during the second half of the year or by 2020.

Most members considered that slack conditions in the economy relaxed towards the end of 2018 and the beginning of this year, and one member highlighted that these slack indicators have remained at less tight levels than those registered at the beginning of 2018. In this regard, another member pointed out that with indicators which exclude oil production these conditions remained neutral. As to the labor market, some noted the rise in the unemployment rate at the end of 2018, and one noted the deceleration in the creation of IMSS-insured jobs during the last quarter of 2018. This last member indicated that labor market figures might have been affected by factors related to the present juncture, such as the cancelation of the New Mexico City International Airport's construction, which would also have been reflected in economic activity in general. Some members mentioned that, notwithstanding the latter, the labor market remains tight. Some pointed out that slack conditions in the economy are expected to widen in the coming quarters and indicated that it is very likely that during the period of influence of monetary policy the output gap with and without oil production begins to lie in the negative region. One of them noted that it is relevant to consider that the economy is currently in a situation with an output gap that is not very different from zero.

The majority pointed out that from November to January, headline inflation decreased, some members specifying that it went from 4.72% to 4.37% during such period. Most members mentioned that this decrease was mainly due to the reduction of non-core inflation. One of them indicated that headline inflation continued with the downward trend shown since September. Another member warned that although this reading points in the right direction, it is early to conclude that inflation has returned to a clear downward path. He/she added that coincident and prospective indicators

associated with prices suggest that despite the marginal improvement, the inflationary process continues to show a strong resistance to decline. Likewise, one member remarked that the decrease in January was due to one-time adjustments, such as the reduction of the VAT in the border region. Another expressed that headline inflation has been affected by the significant adjustments in the real exchange rate. However, one member stated that the latest inflation figures are in line with their anticipated path of gradual convergence to the target in the horizon in which monetary policy operates.

As for the components of headline inflation, all members highlighted that core inflation continues to show a resistance to decline and some of them pointed out that it went from 3.63% in November to 3.60% in January. Most members stated that core inflation has remained around 3.6% in the last 10 months. One member emphasized that it shows a high persistence which for several months has prevented it from decreasing at the desired speed. Some members indicated that, given that core inflation is a more appropriate indicator of fundamental pressures on prices and it is the component that should respond more to monetary policy actions, its persistence is a matter of concern. Nevertheless, another member stated that despite its rigidity, core inflation seems to have started a downward trend. With regards to the factors that explain core inflation's behavior, some members mentioned the increase in prices of services other than housing and education, as well as the indirect effects of increases in energy prices. One member added to the above the indirect effects of recent increases in the prices of some fruits and vegetables. Another member mentioned also the impact of the exchange rate, the tight economic conditions observed until recently, and the real wage increases during 2018. Regarding non-core inflation, some members stated that it fell from 8.07% to 6.81% between November and January. Some mentioned that this reflects lower increases in energy prices and livestock products, although such effect was partially offset by greater increases in the prices of some fruits and vegetables. One member indicated that the recent trends of core and non-core inflation seem to be associated with the credibility of Banco de México's monetary policy decisions and to the operation of monetary policy's real transmission channels.

The majority mentioned that headline inflation expectations for 2019 and 2020 showed a clear deterioration in December and some improvement in January. They highlighted that those corresponding to the end of 2019 went from 3.71% in October to 3.89% in December, and then decreased to 3.80% in January. Some noted that those corresponding to the end of 2020 were adjusted upwards from 3.5% to 3.79% and then downwards to 3.71% in the same comparison periods. Regarding core inflation expectations for the end of 2019, the majority emphasized that they went from 3.45% in October to 3.50% in December and January. Most members rated the behavior of inflation expectations drawn from surveys as mixed, since those of headline inflation improved from December to January, while those of core inflation did not. One member stated that both headline inflation and core inflation expectations had a shift in trend, since between May and December 2018 both had been increasing steadily and significantly. Some members stressed that core inflation's persistence has even contaminated inflation expectations, one member adding that, in particular, it has had an influence on medium-term expectations.
The majority indicated that headline inflation expectations for the medium and long terms still stand above the permanent target of 3%, at levels of around 3.50%. One member pointed out that a convergence of long-term core inflation expectations to the levels of headline inflation can be observed. As for information derived from market-based instruments, some stressed that medium- and long-term inflation risk premium showed a deterioration by the end of 2018 and subsequently decreased, although it continues at high levels. One highlighted that these levels continue to suggest significant upward risks for inflation in the medium and long terms.

Some members noted that inflation forecasts suggest that inflation is following a downward trajectory in line with Banco de México's last Quarterly Report. One member highlighted that it is estimated that forecasts for the next 12 months will have mixed revisions. As for the outlook for headline inflation, a member mentioned that it has been affected significantly by non-core inflation, which has also put pressure on core inflation, albeit its effects have slightly decreased. Some members highlighted an upward revision of core inflation during the first semester of the year because of its resistance to decline. One member emphasized that this can affect the convergence of headline inflation to its target. Another member cautioned that the risk of inflationary pressures that are not consistent with the attainment of the target within the expected timeframe persists, and that a larger number of favorable observations is necessary to confirm that risks of possible second round-round effects have started to dissipate. Nevertheless, one member indicated that the latest figures suggest that the paths of headline, core and non-core inflation could

be converging even faster than as indicated in the last Quarterly Report.

Most members considered that the balance of risks with regards to the expected path of inflation continues to be biased to the upside, in an environment of marked uncertainty. One of them indicated that the upward bias is slight and another one that inflation faces a more benign scenario than at the time of the previous monetary policy statement. As for the main risks to the upside for inflation, the majority highlighted the possibility that the peso exchange rate continues to be pressured by external and domestic factors, one of them adding that in his/her opinion this is one of the main risks for inflation in the near future. The majority mentioned that inflation could also be affected in case that new pressures on the prices of energy or agricultural products are observed, or if there is an escalation of protectionist and compensatory measures worldwide, or in case public finances deteriorate. One of them pointed out that this last risk has intensified. Some members indicated that a further continuation of the problems in fuel distribution as well as the blocking of railways and labor conflicts, are also risks for inflation. Additionally, the majority agreed that, given the magnitude of the recent increases in the minimum wage, beyond their possible direct impact, there is the risk that these lead to wage revisions that exceed productivity gains and thus generate cost pressures, affecting formal employment and prices. One member expressed that the above would imply a higher resistance or even additional pressures on core inflation.

One of them alerted to the possibility of second-round effects in the price formation process. Most members warned about core inflation's persistence, which could lead to a higher resistance to decline for long-term inflation expectations. One of them highlighted that it is particularly worrisome that core inflation is expected to remain in coming months above the level that was forecast only recently. Additionally, some members insisted that inflation expectations implied by financial market instruments continue signaling upward risks to inflation. One of them pointed out that the above can be observed for the medium and long terms, and another one argued that expectations drawn from surveys also signal the same risk. One of them added that inflation expectations drawn from surveys show a contrasting behavior, with those for 2019 and 2020 linked to headline inflation beginning to decline, while those focused on core inflation registering a slight upward trend. He/she pointed out that in the case of long-term inflation expectations, although those corresponding to headline inflation have remained stable at around 3.5%, there is a convergence of those corresponding to core inflation towards the levels of those of headline inflation. He/she argued that, if it continues, this trend would represent a deterioration of long-term inflation expectations, since it would imply a stronger anchoring of such expectations at levels above the target. Another one argued that such upward trend as well as the decreased dispersion among forecast answers in the survey, at levels above the target in the last few months, suggest a risk of contagion of long-term inflation expectations. Regarding downside risks, some members mentioned the possibility of smaller variations in the prices of certain goods included in the non-core index, or that slack conditions widen more than expected.

All members highlighted that since the last monetary policy decision, financial asset prices in Mexico exhibited a more favorable performance. Most of them agreed that this was a reflection of more favorable external conditions and of domestic factors such as the approval of the economic package for 2019 presented by the Ministry of Finance, which included fiscal targets that were in line with market expectations; investors' consent to the New Mexico City International Airport bond buyback offer; and, the implementation of a prudent monetary policy with interest rate spreads above those of other economies. All members pointed out that the peso exchange rate appreciated and reduced its volatility while one member added that the foreign exchange market's operating conditions had improved and that analysts' exchange rate expectations had been revised downwards. The majority pointed out that risk premia and long- and medium-term interest rates decreased, and some of them mentioned that operating conditions in government securities markets also improved. One member mentioned that foreign investment inflows have been observed, in particular, to government securities. Regarding the stock market, most mentioned that in line with the appreciation of the peso and the decline in interest rates, it registered gains during the same period, and some of them indicated that it has reversed the losses observed in the last quarter of 2018. Most members emphasized that, recently, domestic financial markets resented Fitch's revision of Pemex's credit rating from BBB+ to BBB- with a negative outlook, albeit one member pointing out that such revision had already been anticipated by markets. One member stressed that, despite the latter, sovereign risk premia have not been affected, although an impact on them cannot be ruled out if this situation deteriorates. The majority of members mentioned that although financial asset prices in the country have exhibited positive results, the peso-US dollar exchange rate, medium- and long-term interest rates, and risk premia are at levels higher

than those registered at the beginning of October, before domestic uncertainty escalated as a result of factors such as the announcement of the cancellation of the New Mexico City International Airport, the presentation of some legislative projects and raising concerns about the business model of Pemex. In this regard, one member mentioned that an environment of high uncertainty prevails in domestic financial markets, especially related with domestic factors. Another member mentioned that the balance of macro-financial risks has deteriorated due to the increasing uncertainty about the country's economic and financial environment. The same member added that this could mean lower inflows of foreign investment (direct and portfolio) to the country, with its subsequent impact on the exchange rate. Another member pointed out that future episodes of volatility in domestic financial assets in response to external and/or domestic factors cannot be ruled out.
From a longer-term perspective, one member stated that in recent years the economy has faced two major shocks: i) a lower availability of external resources; and ii) a significant deterioration in the oil trade balance. The combination of both shocks has led to a major adjustment of the non-oil trade balance. Such member acknowledged that the economy has also been affected by uncertainty about the trade relationship with North America, the process of monetary policy normalization in the United States and other idiosyncratic factors. The same member argued that this has required a significant depreciation of the real exchange rate and that for such an adjustment to take place in an orderly way and without affecting domestic output, the nominal exchange rate must be flexible, and inflation must remain contained and close to its target. Such member added that this process requires the combination of a sound fiscal policy and a responsible monetary policy stance to prevent the contagion of inflation expectations and the deterioration of the price formation process. Also, that the economy still faces a significant tightening of external financing which is imperative to reverse. In this regard, another member highlighted that the greatest risk of not mitigating the country's economic and financial uncertainty is the possibility of having lower inflows of foreign investment (direct and portfolio), with the subsequent increases in risk premia that would make credit more expensive, thus hampering the country's economic recovery.

Most members considered that the current environment continues facing medium- and long-term risks that might affect the country's macroeconomic conditions. Among such risks, the majority of the members mentioned: Pemex's financial fragility and outlook, and, in particular, an additional downgrade to its credit rating as it could have an impact on the federal government's financial cost and, in general, on the country's conditions for accessing external financing. One member pointed out that the business strategy to be adopted by Pemex will play a key role in determining the short- and medium-term outlook for the Mexican economy. The same member added the latter is due not only to the size of the oil company and its connection with many other corporations and domestic financial institutions, but also to its relevant role in domestic and international financial markets, stressing the importance of Pemex's debt in the portfolio of different asset management institutions specialized in emerging markets. Another member pointed out that the recently announced actions to improve the financial situation of Pemex represent a positive element, but that additional efforts to strengthen the oil company's production capacity and its financial outlook and, therefore, credibility on the fiscal targets for the short and long terms are required. The same member stated that the intention of the authorities to announce shortly a set of measures to face these challenges is highly relevant, given that greater hardships faced by Pemex would significantly affect public finances and, in general, the overall economy. Most members mentioned that a potential financial support to Pemex by the federal government or a reduction in its fiscal burden addressing its structural problems could mitigate the aforementioned risks, as long as these measures are consistent with the fiscal targets set by the government.

Most members pointed out that in order to foster higher growth it is key to consolidate a solid macroeconomic framework as well as measures that contribute to raise productivity levels. In this regard, some stated that it is relevant to ensure an environment of confidence and certainty for investment and that public finances are consolidated sustainably. As a risk for the latter, some members highlighted, besides the already mentioned financial fragility of Pemex, the possibility of a lower-than-expected GDP growth, which might affect tax collection and put at risk the attainment of the fiscal targets. One member added that it is important that the primary surplus target of 1% for 2019 is achieved. Finally, some members pointed out that the macroeconomic framework that accompanied the fiscal package for 2019 presented last December contributed to increase investors' confidence and generated a positive response from markets.

As to measures to boost productivity, some members considered that public policies must foster an efficient allocation of resources in the economy. In this regard, one member emphasized that the policies affecting price formation, as well as the

higher minimum wages and the guaranteed prices are a cause for concern. Some members pointed out the need to ensure the Rule of law and tackle the challenges of public insecurity, corruption and impunity. In addition to these measures, another member considered the need for adopting public policies that support the strengthening of human capital, the adoption of new technologies, the narrowing of opportunity gaps, and the generation of adequate incentives for growth and development. Another member highlighted the need to carefully assess the implications of the current strategy for long-term growth and to introduce corrective measures when needed, particularly because of the economy's low potential growth and the risks to the economy stemming from the continuous contraction in investment ratios. Most members acknowledged that the weakness of investment is a factor that may affect the country's productivity and future growth. One member added that it is desirable that the new public investment is channeled to projects of proven economic and social returns.

All members agreed that Mexico's economic activity decelerated and that its balance of risks continues to be biased to the downside. One member considered that, in principle, the country's economic deceleration should favor a faster process of inflation reduction. Nevertheless, the same member noted that, under the current juncture, inflationary risks stemming from Mexico's complex economic and financial environment persist. Another member stated that the current environment features dilemmas and risk in the short- medium- and long-terms, adding that it is clear that the challenges to the economy and to inflation are not only of a cyclical nature. In this regard, he/she underlined that it is important to avoid a situation with a period of weak economic growth and where also other factors that affect the price formation process keep inflation under pressure and above its target.

Most members agreed that the evolution of headline inflation has remained in line with the forecast published at the end of November in Banco de México's past Quarterly Report and that core inflation continues to exhibit a resistance to decline. One member mentioned that this is a cause for concern since such component should be responding more clearly to the monetary policy actions. Another member highlighted that although core inflation has shown resistance to decline, it is starting to follow a downward trend.

Most members pointed out that Banco de México should maintain a prudent approach and signal clearly its commitment with its price stability mandate. In this regard, most members considered that the current monetary policy stance is consistent with the convergence of headline inflation to the target within the time frame in which monetary policy operates. One member added that the outlook that inflation is facing, in addition to the persistent risk of a de-anchoring of inflation expectations, suggest that the monetary policy tightening implemented should be kept in place for a lengthy period. Another member argued that the central bank should remain vigilant to the conditions prevailing in Mexico's economy so that a very restrictive monetary policy stance is not in place for too long, in case the economy's slack conditions continue to widen significantly. One member underlined that the combination of a weakening economic activity, on the one hand, and persistent inflationary pressures with a balance of risks to the upside and short-term and long-term inflation expectations above Banco de México's projections, on the other, intensifies the challenges for monetary policy. The same member argued that monetary policy must focus on attaining the inflation target, but considering the high uncertainty prevailing as well as the effects of the evolution of economic activity on prices and the need of an orderly and efficient convergence of inflation to the target. He/she pointed out that the latter requires a prudent approach in which monetary policy decisions will depend fundamentally on additional information on inflation, its determinants and outlook, and which must be aimed at strengthening the central bank's credibility. Such member indicated that given the aforementioned, additional adjustments to the monetary policy rate cannot be discarded. One member emphasized that the central bank message should not reflect an easing of monetary policy stance given the weakening of economic activity, but rather convey the persistence of risks to inflation, thus strengthening monetary policy's credibility. The same member added that the central bank's communication should reflect the concern for core inflation's resistance to decline in spite of the clearly restrictive monetary policy stance so far adopted. Some members mentioned that the rises in the reference rate have increased interest rate spreads vis-à-vis other countries, thereby helping to mitigate the volatility that financial markets have exhibited due to external and domestic factors. One of the members stated that, given the expectations of more gradual and smaller increases in interest rates in advanced economies, Banco de México would have a slightly wider margin as to its monetary policy decisions. Most members highlighted the importance of pointing out that Banco de México's Governing Board will remain vigilant to the evolution of inflation, its determinants and expectations and, that if necessary, it will take the actions required to attain the inflation target.

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 forecast trajectory, taking into account the monetary policy stance adopted and the time frame in which monetary policy operates, as well as available information on all inflation determinants and on medium- and long-term inflation expectations, including the balance of risks for such factors. In this context, considering that the recent developments in inflation and its main determinants have not changed significantly with respect to their foreseen trajectories, that the cyclical position of the economy has loosened somewhat, and that the current monetary policy stance is consistent with the convergence of inflation to its target, Banco de México's Governing Board has decided unanimously to leave the target for the overnight interbank interest rate unchanged at 8.25%. Considering the risks inflation is subject to, the Governing Board will take the necessary actions so that the reference rate is kept at a level consistent with the 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, the monetary policy stance relative to that of the U.S., under an external environment that it is still subject to risks, and to the behavior of the conditions of slack in the Mexican economy. In the presence and possible persistence of factors that, by their nature, involve risks to both inflation and inflation expectations, monetary policy will be adjusted in a timely and robust manner to achieve the convergence of inflation to its 3% target and to strengthen the anchoring of medium- and long-term inflation expectations so that they attain such target.

4. VOTING

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

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 and Payment Systems. It does not necessarily reflect the considerations of the members of the Governing Board as to the monetary policy decision.

A.1. External conditions

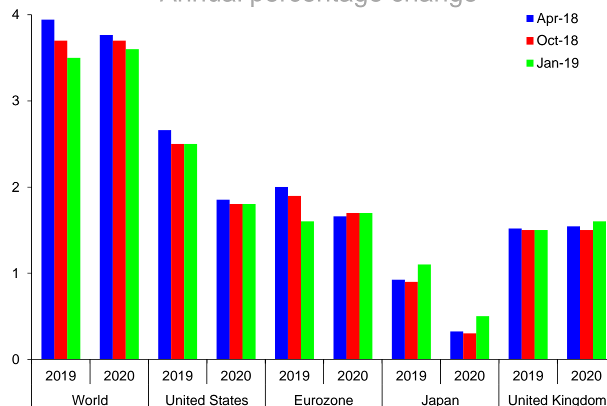
A.1.1. World economic activity

During the fourth quarter of 2018, the world economy decelerated, as evidenced by a lower dynamism in the main advanced and emerging economies, particularly the Eurozone, China, and, to a lesser extent, the United States. This reflects, among other factors, the effects of trade disputes, declining business confidence, and transitory shocks. This environment of lower dynamism of economic activity led to downward revisions in the outlook for world growth for 2019 and 2020. Available indicators on business confidence, manufacturing activity and international trade support the outlook of lower global economic growth. This, together with the previous fall in crude oil prices and in other commodities, contributed to a moderation of inflationary pressures in the main economies (Chart 1).

High risks to economic growth persist, such as those related to the uncertainty associated to the trade disputes between the U.S. and China, and to the possibility of a further tightening of international financial conditions due to a greater risk aversion. Among the possible triggering factors for further pessimism among investors are a lower-than-expected growth of the Chinese economy and a disorderly Brexit process. Additional factors are political and geopolitical risks and the possibility of a further deterioration of growth in emerging countries, due to both a lower global demand and idiosyncratic factors.

In this environment of slowing world economy, falling stock markets during a large part of the fourth quarter of 2018, and lower inflationary pressures, the main central banks, particularly the U.S. Federal Reserve, were more cautious as to their monetary policy normalization processes vis-à-vis their previous statements. In this context, in recent weeks, financial markets in both advanced and emerging economies exhibited a more favorable performance.

Chart 1
GDP Growth Forecasts for 2019 and 2020
Annual percentage change

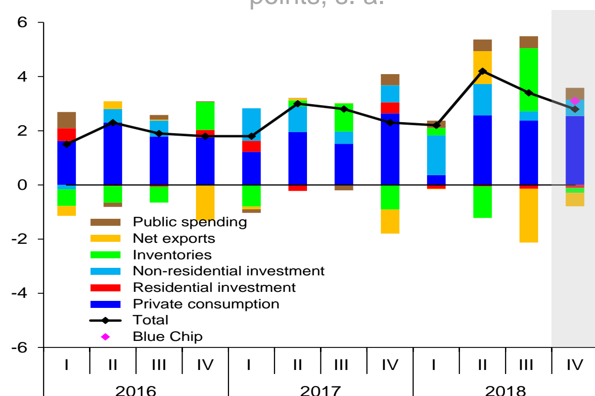


Source: IMF, *World Economic Outlook*, October 2018 and January 2019.

In the U.S., the main components of aggregate demand continued signaling a moderation of economic activity during the fourth quarter of 2018 (Chart 2). In particular, housing investment further weakened, due mostly to higher mortgage interest rates, while investment in equipment kept a decelerating trend. In contrast, private consumption continued showing dynamism, supported by a strong labor market, the fiscal stimuli, the still high household confidence, and lower fuel prices. Uncertainty about the outlook for the U.S. economy persists due to the fading fiscal incentives, the lower growth of the world economy, and the latent risk of escalating trade tensions with China.

According to the U.S. Congressional Budget Office (CBO), the recent partial government shutdown between December 22, 2018 and January 25, 2019, could reduce annualized GDP growth of the fourth quarter of 2018 and the first quarter of 2019 by around 0.2 and 0.4 percentage points, respectively. Since the agreement to reopen the government guarantees sufficient funds only for three weeks, the risk of another shutdown prevails, which could raise the total cost on economic activity, especially in a context where the deadline for renewing the U.S. debt ceiling is also approaching.

Chart 2
USA: Real GDP and its Components
Annualized and seasonally adjusted quarterly percentage change and contribution in percentage points, s. a.



s. a. / Seasonally adjusted figures.
Source: BEA and Blue Chip January 2019, and Federal Reserve Bank of Atlanta.

U.S. industrial production grew at a monthly rate of 0.3% in December, a still-high pace, albeit below the 0.4% rate observed in November. The decrease is explained by the 6.3% contraction in the supply of electricity and gas in response to the lower demand for heating that resulted from warmer-than-usual temperatures in several regions of the U.S. This contraction was partially offset by the expansion of mining and manufacturing. In particular, manufacturing registered its highest growth since February 2018, growing at a monthly rate of 1.1%. Although forward-looking indicators, such as the Purchasing Managers' Index (PMI), continued to exhibit a relative strength at the beginning of the year, the strengthening of the U.S. dollar during 2018 and the greater trade barriers point to a slight weakening of manufacturing in the next months.

Finally, the U.S. labor market continued strengthening. In particular, 304,000 new jobs were created in January, figure above the one required to meet the growth of the labor force. The sharp increase in labor participation rates in the U.S., despite negative demographic factors and, to a lesser extent, the effects of the government shutdown, led to an increase in the unemployment rate, from 3.7% in September to 4.0% in January. Nevertheless, the latter figure is still considerably below its estimated long-term level. In this context, a greater increase in wages was observed.

In the Eurozone, economic activity grew at seasonally adjusted annualized rate (SAAR) of 0.9% during the fourth quarter of 2018, after having expanded by only 0.6% during the third quarter. This weakness was associated with the slowdown of external demand and the continued presence of temporary factors, such as tighter regulations on air pollutant emissions that kept on affecting automobile production in Germany, and the fall in chemical industry production due to the low navigation levels of the Rhine. The Italian economy weakened further due to deteriorating financial conditions and higher political risks. Additionally, the downward trend followed by the Purchasing Managers' Indices for the manufacturing sector and by business confidence in the Eurozone intensified in January. Nevertheless, the unemployment rate of December remained at 7.9%, its lowest level since October 2008, while salaries grew at a faster rate.

In Japan, available information for the fourth quarter of 2018 suggest a rebound of economic activity, after having contracted 2.5% (SAAR) during the third quarter due to the effects of certain natural disasters. In this context, the labor market continued tightening and the unemployment rate remained near its lowest level in the last 25 years. Nevertheless, forward-looking indicators such as the Purchasing Managers' Indices of the manufacturing sector suggest a slight deterioration of both external and domestic demand during the first quarter of 2019.

In emerging economies, growth continued to moderate during the fourth quarter of 2018, although a large heterogeneity prevails across these countries. In the case of China, GDP growth decelerated further from 6.5% in the third quarter of 2018 to 6.4% in the fourth. As for other countries, although the financial situation of Turkey and Argentina improved during the last quarter of 2018 after these countries implemented respective stabilizing measures, their growth rates were affected by the tighter monetary and fiscal policies and the lower availability of external financing.

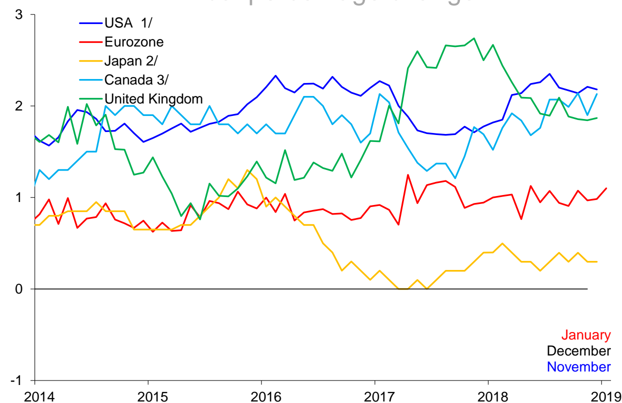
International commodity prices recovered slightly in the last weeks. In particular, at the end of December the strong fall in oil prices observed since October came to a halt after OPEC members and other oil producers agreed on oil production cuts. The prices of industrial metals rose due to the expectations generated by the U.S. and Chinese governments' efforts to solve their trade disputes. Finally, grain prices followed an erratic trend due to abrupt climate changes in key cultivation areas in Brazil and Argentina.

A.1.2. Monetary policy and international financial markets

In a context of lesser economic dynamism and falling oil prices, the further tightening of labor markets in advanced economies has not been accompanied with higher inflationary pressures (Chart 3). In the U.S., CPI inflation fell from 2.2% in November to 1.9% in December, due mainly to the lower energy prices, while its core component remained at 2.2%. In the Eurozone and Japan, core inflation remained at low levels and below their central banks' targets. In most emerging economies, inflation decreased due to the fall in oil and food prices, the lower dynamism of global demand and, in certain cases, the fading effect on prices of the previous depreciation of their currencies.

Similarly, market-implied inflation expectations have been adjusted downwards in most advanced economies, suggesting a lower probability that inflation will consistently exceed the targets of the main central banks in the short term.

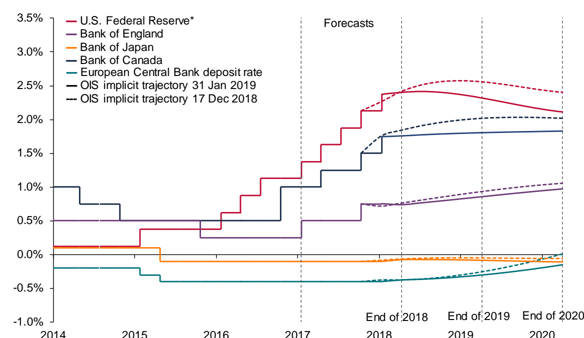
Chart 3
Selected Advanced Economies: Core Inflation
Annual percentage change



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

In this environment of a deteriorating outlook for global growth and of low inflation, the central banks of the major advanced economies, particularly the U.S. Federal Reserve, have been more cautious, which may lead reference rates to reach lower levels than those expected some months ago (Chart 4).

Chart 4
Reference Rates and Implied Trajectories in OIS Curves1/
Percent



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

Indeed, in recent weeks, the U.S. Federal Reserve communication strategy was adjusted significantly to reflect a more cautious tone. In its January meeting, this central bank left the target range for the federal funds target rate unchanged (2.25% - 2.5%). In its monetary policy statement, the Fed stated that U.S. growth remained strong, that the labor market continued to strengthen, and that inflation remained close to its target. Nevertheless, it eliminated the statement referring to additional gradual increases of its reference rate as being consistent with sustained economic growth, a strong labor market, and an inflation rate near its 2% symmetric target. It also reiterated that, in light of the limited inflationary pressures and the recent developments in the global economy and in international financial markets, it will be patient in making future adjustments to the target range for the federal funds rate. It also stated that it could adjust the composition and size of its balance sheet if necessary. Similarly, Jerome Powell, the Fed's Chairman, mentioned that information drawn from surveys and market instruments suggests that balance sheet normalization could end sooner and at a higher level than what was expected some months ago. In this environment, market variables have completely ruled out the possibility of additional increases in the reference rate during this year and are even starting to include a cut in the reference rate in 2020.

In its January 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%, reiterating that these rates will remain at those levels until the summer of 2019, and, in any case, until necessary to ensure that inflation converges close to 2% in the medium term. It also confirmed its plans to re-invest the maturing bonds of its balance sheet for an extended period of time, even after having started its process for raising its reference rates. The ECB also modified its balance of risks for growth to the downside from balanced. Such adjustment responded to the persistent uncertainty regarding geopolitical factors, the protectionist policies of several countries, the vulnerabilities of emerging economies, and the volatility in financial markets. The recent statements from ECB members have been more cautious, even suggesting the possibility of not raising the benchmark rate throughout 2019, as was expected some months ago.

In its January meeting, the Bank of Japan left its short-term reference rate unchanged at -0.1% and its long-term reference rate associated to its 10-year bond at 0%, reiterating that it will continue with a highly accommodative monetary policy, keeping interest rates at low levels for as long as needed to reach its price stability target. The Bank of Japan's decision takes into consideration the uncertainty about economic growth and inflation, including the effects of the increase in that country´s consumption tax scheduled for the end of 2019. In addition, this central bank revised downwards its inflation expectations for 2019 and 2020 due mainly to the fall in oil prices.

In its February meeting, the Bank of England left its reference rate unchanged at 0.75%. In its statement, the Monetary Policy Committee pointed out that economic activity has been decelerating since the end of 2018, due to the deterioration of the world economy and the increasing uncertainty on Brexit. Thus, this central bank revised downwards its growth and inflation projections for 2019 and 2020. It also emphasized that it could adjust its monetary policy as required depending on the effects of the Brexit process on demand and supply and on the pound sterling exchange rate. Although the Bank of England reiterated that it foresees a gradual and limited adjustment of interest rates, the path for the reference rate implied in market-based instruments suggests a slower process than anticipated in November.

As expected, the Bank of Canada left its reference rate unchanged at 1.75% in its January meeting, while adjusting downwards its growth forecast for 2019 and estimating that inflation will remain below the target during most of this year. This central bank reiterated that the trade disputes between the U.S. and China have had a significant impact on global demand, highlighting that consumer spending and household investment rates have performed weaker than expected. The Bank of Canada also mentioned that the continuing weakness is expected to prevail given the lower growth of oil producing regions. Finally, it pointed out that, although interest rates should continue increasing towards their neutral level to attain the inflation target, future raises will depend on incoming data and other factors, such as the evolution of the crude oil market, the real estate sector, and global trade policies.

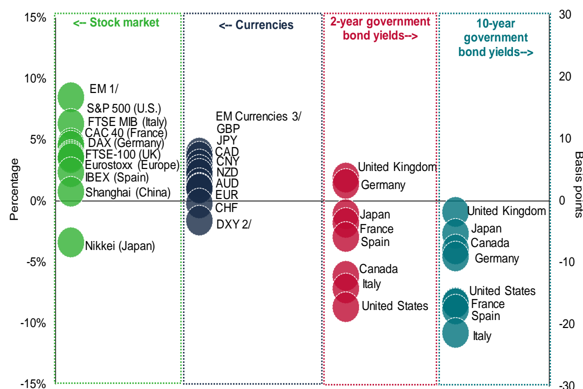
In this environment of lower inflationary risks, most central banks of emerging economies left their monetary policy rates unchanged. Several of these countries have emphasized in their statements that they will remain vigilant to developments and incoming data that may jeopardize the convergence of inflation to their targets. In China, its central bank adopted measures to ease financial conditions by reducing the reserve requirements of banks and providing liquidity through open market operations.

Expectations that the central banks of the major advanced economies will be more cautious and patient and that this would lead to lower interest rates than expected some months ago had a favorable impact on financial markets since the beginning of 2019, as reflected by the favorable performance of riskier assets. Stock market indices in advanced economies partly reversed the losses registered at the end of 2018. In this regard, U.S. stock markets have advanced around 9% so far this year. Similarly, the yield spreads between corporate and government bonds were adjusted downwards, while most currencies appreciated against the U.S. dollar. Finally, interest rates of government bonds of the major advanced economies decreased moderately along the yield curve, in line with the central banks' messages of greater caution (Chart 5).

As for emerging economies, the relative easing of international financial conditions vis-à-vis those observed in mid-December 2018, was beneficial for most of their assets, as reflected in the appreciation of their currencies against the U.S. dollar and in the recovery of their stock markets (Chart 6). Additionally, risk premia decreased slightly vis-à-vis the levels observed in mid-December 2018, although

they still remain high due to the risks that these economies are facing.

Chart 5
Change in Selected Financial Indicators
(December 17, 2018 – February 1, 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 ICE.

Chart 6
Emerging Economies: Financial Assets Performance
(December 17, 2018 - February 1, 2019)
Percent, basis points

Region	Country	Currencies	Equity markets	Interest rates 2Y	Interest rates 10Y	CDS
Latin America	Mexico	4.79%	9.27%	-43	-50	-5
	Brazil	6.19%	12.72%	-40	-96	-33
	Chile	5.01%	6.57%	-7	-11	-9
	Colombia	2.80%	4.21%	-4	-16	-8
	Argentina	2.82%	23.07%	-78	-160	-147
Emerging Europe	Russia	1.97%	6.89%	-43	-20	-10
	Poland	0.75%	4.25%	-8	-23	-3
	Turkey	3.02%	14.42%	-255	-306	-71
	Czech Republic	1.18%	1.99%	-25	-49	-1
	Hungary	2.75%	3.27%	-19	-53	-2
Asia	South Korea	1.10%	6.39%	9	3	-8
	Malaysia	2.01%	2.55%	-6	-12	-23
	India	0.42%	0.55%	5	-3	-8
	Philippines	1.42%	8.29%	-19	-35	-12
	Thailand	4.56%	3.12%	-1	-10	-2
	Indonesia	4.36%	7.38%	-22	-14	-22
Africa	South Africa	7.41%	4.60%	-36	-48	-47

Note: Interest rates correspond to interest rate swaps for 2-year/10-year maturities. In the case of Argentina, considering low liquidity and in order to reflect the performance of the fixed income market adequately, rates in US dollars are used.
Source: Bloomberg.

Despite the good performance of markets in the last month, risk factors persist that could lead to greater volatility in financial markets. These risks include: a slower growth of the world economy; the possibility of a further deterioration of household and business confidence stemming from uncertainty regarding trade negotiations between the U.S. and China; the approaching deadline for the Brexit and the possibility of it being a disorderly process; the high corporate leverage in some advanced countries; other political and geopolitical risks; and, the possibility of a sharper-than-expected deceleration of the Chinese economy.

A.2. Current situation of the Mexican economy

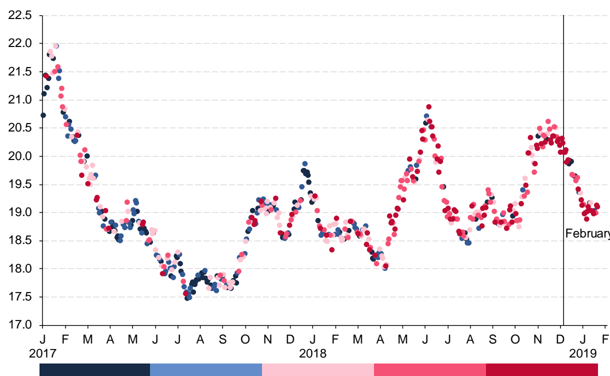
A.2.1. Mexican markets

Since the last monetary policy decision, the prices of financial assets in Mexico have exhibited a more favorable performance, in line with the trend observed for the financial assets of other emerging economies. Several factors contributed to such results. First, the expectation that the Federal Reserve will continue its monetary policy normalization at a more gradual pace than previously anticipated led to an environment of greater search for yield and, therefore, to a positive performance of emerging markets overall. In addition, the approval of the 2019 Economic Package and the New Mexico City International Airport (NAICM, for its acronym in Spanish) bond buy-back contributed favorably to compress the risk and uncertainty premia that had gone up after the announcement of the cancellation of the NAICM. Nevertheless, toward the end of the period Fitch Ratings' downgrade of Pemex's investment grade from BBB+ to BBB- with a negative outlook increased the volatility of Mexican financial assets.

As for domestic currency developments, the Mexican peso appreciated 4.79%, thus being one of the currencies that appreciated the most during the period. Operating conditions in the foreign exchange market (FX market) remained robust, with trade volumes, bid/ask spreads and depth levels not seen since September 2018 (Chart 7 and Chart 8). Similarly, forward-looking conditions implied by exchange rate options, measured through volatility and depreciation bias in the short term, improved, reflecting the lower risk premia. Finally, forecasters from several financial institutions adjusted their exchange rate expectations downwards, from 20.63 to 20.33 pesos per U.S. dollar for the close of 2019, and to 20.00 pesos per U.S. dollar for the close of 2020 (Chart 9).

Chart 7
Mexican Peso Exchange Rate and Trading Volume

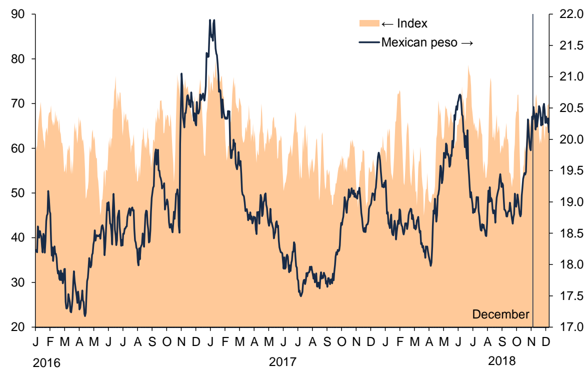
Pesos per US dollar; million USD



Note: Volume exchanged in the spot market classified in percentiles according to historical series from January 2017 to date (0-20%, 21%- 40%, 41%-60%, 61%- 80% and 81%-100%). The black vertical line represents Banco de México's latest monetary policy decision.
Source: Prepared by Banco de México with data from Bloomberg/Banco de México.

Chart 8
Mexican Foreign Exchange Market Operating Conditions and Peso-dollar Exchange Rate

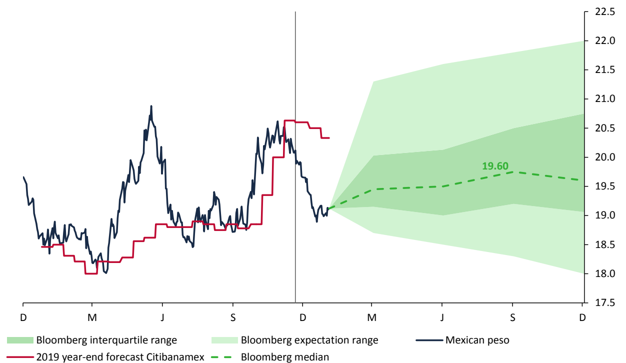
Index (5-day moving average), pesos per US dollar



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

Chart 9
Analysts' Mexican Peso Exchange Rate Expectations for Each End of Quarter

Pesos per US dollar

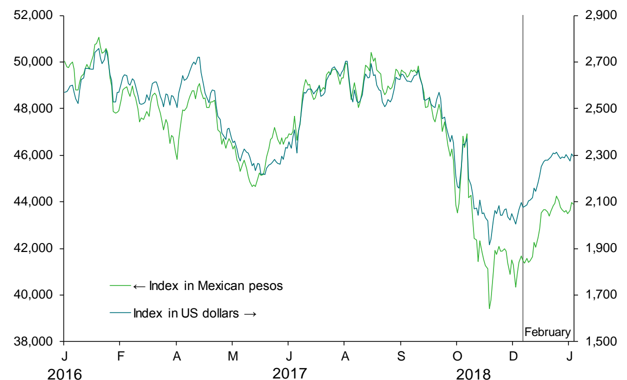


Note: The black vertical line represents Banco de México's latest monetary policy decision.
Source: Bloomberg and Citibanamex survey.

Mexico's stock exchange recovered by 9.0% in the last weeks, completely reversing the losses observed in November 2018 (Chart 10).

Chart 10
BMV Mexican Stock Exchange Index

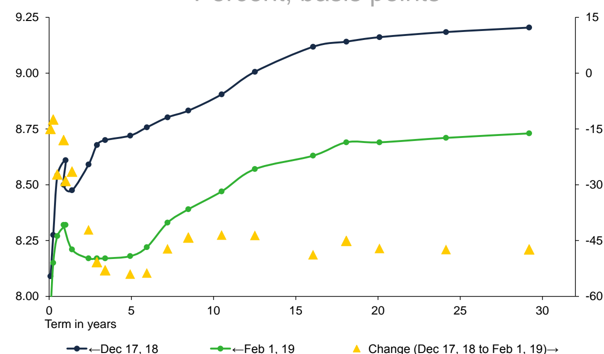
Percent



Source: Banco de México with Bloomberg data. The black vertical line represents Banco de México's latest monetary policy decision.

Interest rates on government securities exhibited generalized reductions of between 20 and up to 53 basis points along the entire yield curve (Chart 11). Such reductions took place in a context where operating conditions improved vis-à-vis those observed in November and during the first half of December of 2018 (Chart 12).

Chart 11
Nominal Yield on Government Securities
Percent, basis points



Source: PIP.

Chart 12
Index of Mexican Government Debt Market Operating Conditions and June 2027 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 is calculated. The vertical line represents the date of Banco de México's latest monetary policy decision.
Source: Calculated by Banco de México with data from Bloomberg, PIP and brokerage firms.

Similarly, the spreads between the yield of Mexican debt denominated in foreign currency and U.S. Treasury bonds decreased marginally (Chart 13), while the spreads between Pemex bonds and federal government bonds in US dollars widened, due to the credit rating downgrade of Mexico's state-owned oil company (Chart 14).

Chart 13
Spread between Nominal Interest Rates in Mexico and the United States in Foreign Currency
Basis points

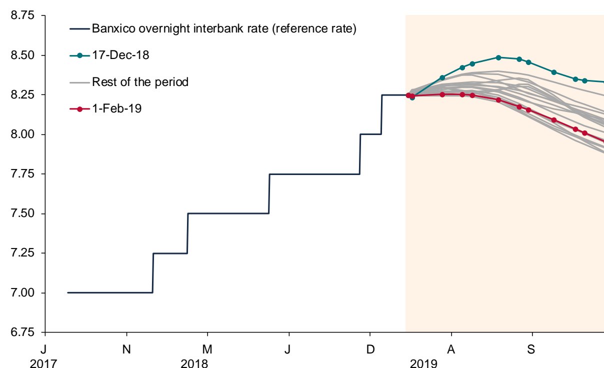
Source: Banco de México with Bloomberg data.

Chart 14
Spread between Pemex and UMS Bonds in US dollars (Different Terms)
Basis points

Note: The black vertical line represents Banco de México's latest monetary policy decision.
Source: Banco de México with Bloomberg data.

Finally, expectations regarding the level of the monetary policy target rate implied in the yield curve structure remained stable vis-à-vis the levels of the previous period (Chart 15). Thus, markets are not anticipating adjustments to the monetary policy target rate in the monetary policy decision of February, in line with the forecasters surveyed by Citibanamex. As for expectations for the monetary policy target rate for the end of 2019, markets anticipate that it will end the year at 8.00%, while the median forecast by analysts is that it will end at 8.25%.

Chart 15
Banxico Overnight Interbank Rate Implied in 28-day TIIE IRS Curve
Percent

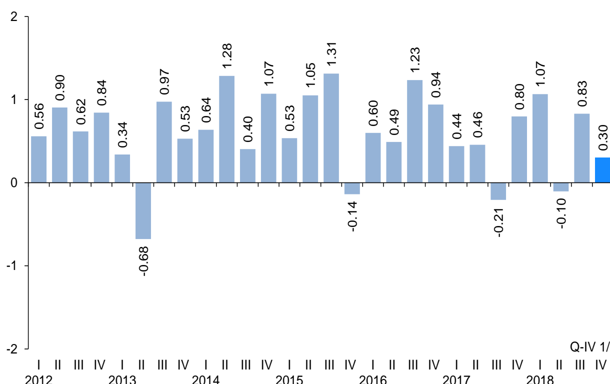


Source: Calculated by Banco de México with PIP data.

A.2.2. Economic activity in Mexico

According to INEGI's GDP flash estimate, economic activity decelerated significantly during the fourth quarter of 2018, as compared to the previous quarter (Chart 16). In particular, manufacturing exports slightly stagnated, private consumption exhibited some deceleration, and investment remained on a negative path. This loss of dynamism could continue in the first months of 2019 as a result of the slowdown of the world economy, some weakness in domestic demand, and other transitory factors, such as those associated with fuel distribution and the blocking of transportation routes.

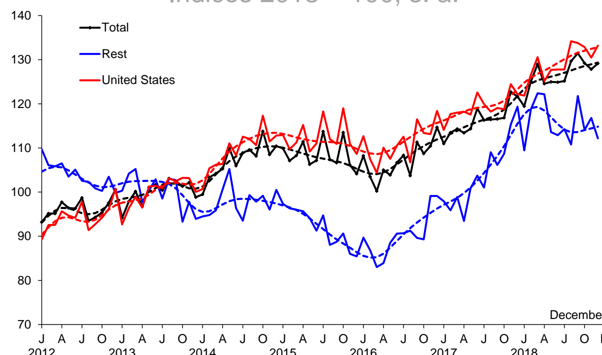
Chart 16
Gross Domestic Product
Quarterly percentage change, s. a.



1/ Figures for the fourth quarter of 2018 correspond to INEGI's GDP quarterly flash estimate.
Source: Mexico's National Accounts System (SCNM, for its acronym in Spanish), INEGI.

As for external demand, during the last quarter of 2018 manufacturing exports remained at a level similar to that of the previous quarter, in a context where global trade has slowed. By destination, exports to the U.S. grew at a lower rate than in the previous quarters, while those to the rest of the world contracted again (Chart 17). Similarly, automotive exports decreased and non-automotive exports decelerated.

Chart 17
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: Prepared by Banco de México with data from the Tax Administration Service (SAT, for its acronym in Spanish), the Ministry of the Economy (SE, for its acronym in Spanish), Banco de México, the National Institute of Statistics and Geography (INEGI, for its acronym in Spanish), Mexico's Merchandise Trade Balance, and National System of Statistical and Geographical Information (SNIEG, for its acronym in Spanish).

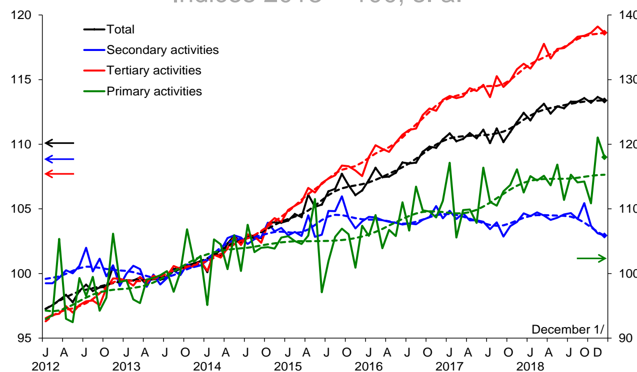
As for domestic demand, according to its monthly indicator, private consumption exhibited a large contraction in October 2018. Although this indicator is expected to recover in November, a slight loss of dynamism is observed in private consumption, relative to previous months. This lower dynamism reflects the weakness in the consumption of overall goods, given that the consumption of services has continued on a positive trend. Latest indicators of consumption, although of less coverage continued posting weak results. In particular, retail stores revenues decelerated vis-à-vis the growth observed in the first half of 2018, while sales of light vehicles contracted significantly at the end of the year.

The negative trend followed by gross fixed investment continued, due partly to weak construction spending, which can be associated, to some extent, to the slowing down and suspension of most NAICM construction works and, to a lesser extent, to the completion of some public infrastructure works. In addition, the negative trend followed by investment in machinery and equipment continued.

As for production, the downturn in economic activity during the fourth quarter of 2018 reflected the weakness of secondary activities, given that tertiary

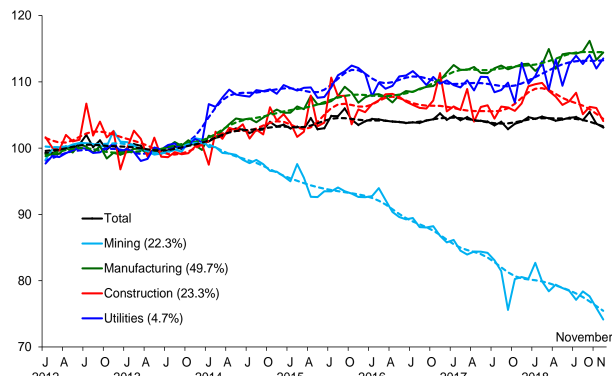
activities kept exhibiting dynamism and primary activities exhibited an even better performance than in the previous quarter (Chart 18). As for industrial production, both construction and mining, activities followed a downward trend, while manufacturing continued to show lack of vigor, after an incipient recovery observed in the first half of 2018 (Chart 19). As for services, the subsectors of finance and insurance; real estate and rental and leasing; transportation and warehousing, information; educational services; and health care and social assistance contributed to a large degree to the dynamism exhibited by this sector.

Chart 18
Global Index of Economic Activity
Indices 2013 = 100, s. a.



s. a. / Seasonally adjusted and trend series. The former is represented by a solid line and the latter by a dotted line.
1/ Figures up to December 2018 correspond to the implicit estimate based on INEGI's GDP flash estimate for the fourth quarter of 2018.
Source: Mexico's National Accounts System (SCNM, for its acronym in Spanish), INEGI.

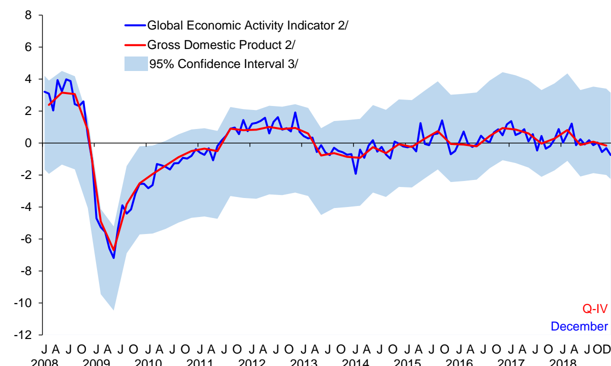
Chart 19
Industrial Activity
Indices 2013 = 100, s. a.



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

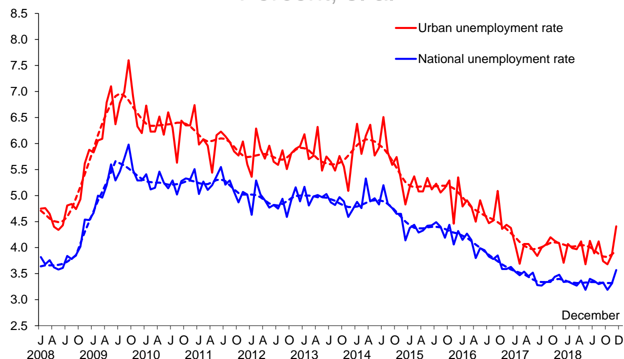
As for the economy's cyclical position, slack conditions are deemed to have eased in the fourth quarter of 2018, relative to the third quarter (Chart 20). Regarding the labor market, both national and urban unemployment rates increased significantly in December 2018, reaching their highest levels since the end of 2016 (Chart 21). Similarly, by the end of 2018, IMSS-insured jobs exhibited a significant reduction in its growth rate, mostly associated with the negative performance of certain sectors, such as construction and some services. Despite the decrease observed in November 2018, unit labor costs in the manufacturing industry maintained an upward trend.

Chart 20
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 fourth quarter of 2018; IGAE figures up to December 2018, consistent with INEGI's flash estimate.
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 21
National Unemployment Rate and Urban Unemployment Rate
Percent, s. a.



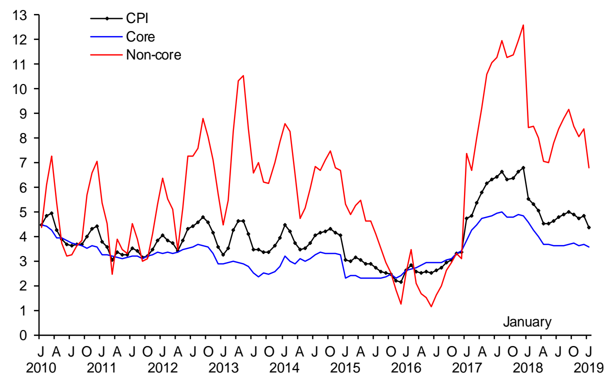
s. a. / Seasonally adjusted and trend series. The former is represented by a solid line and the latter by a dotted line.
Source: National Survey of Occupations and Employment (ENOE, for its acronym in Spanish), INEGI.

In December 2018, domestic financing to the private sector continued following the decelerating trend that began to be observed at the start of the third quarter of that year. The aforementioned reflected the reduction in the growth rate of financing to companies that has been observed since the second half of 2018, while lending to households continued growing at low rates. The latter occurred in a context where the cost of financing to companies remained on an upward trend and where interest rates of credit to households did not change significantly, except for those associated with credit cards. Business and mortgage delinquency rates remained at low levels, while those related to consumption credit have followed a downward trend since August 2018, although they still remain at high levels. In addition to the decline in financing to the non-financial private sector, there was a contraction of available external resources, while the lack of vigor of domestic sources of financing observed since October 2018 increased further.

A.2.3. Developments in inflation and outlook for inflation

Annual headline inflation fell from 4.72% in November 2018 to 4.37% in January 2019, mainly due to a reduction in non-core inflation, as core inflation continued to exhibit resistance to decline (Chart 22 and Table 1).

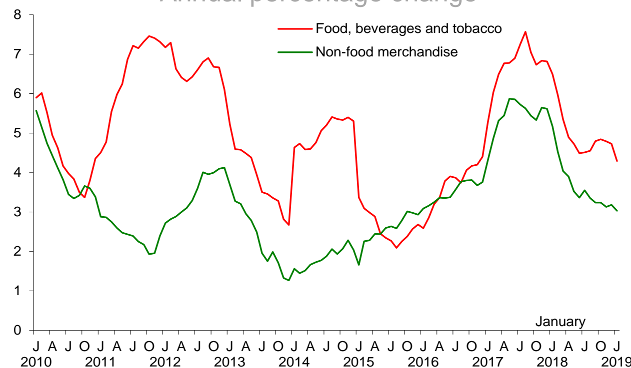
Chart 22
Consumer Price Index
Annual percentage change



Source: Banco de México and INEGI.

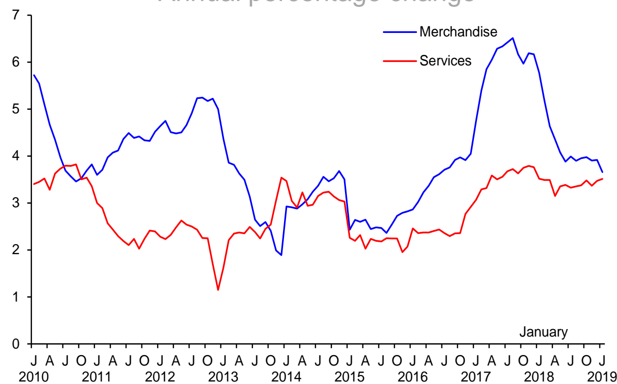
Indeed, annual core inflation remained at similar levels from November 2018 to January 2019, registering rates of 3.63% and 3.60%, respectively. The annual rates of change of both food and non-food merchandise goods prices decreased (Chart 23). Nevertheless, the annual rate of change of services prices increased (Chart 24) due to the higher price increases of services other than housing and education, especially those observed in the prices of tourist services.

Chart 23
Merchandise Core Price Subindex
Annual percentage change



Source: Banco de México and INEGI.

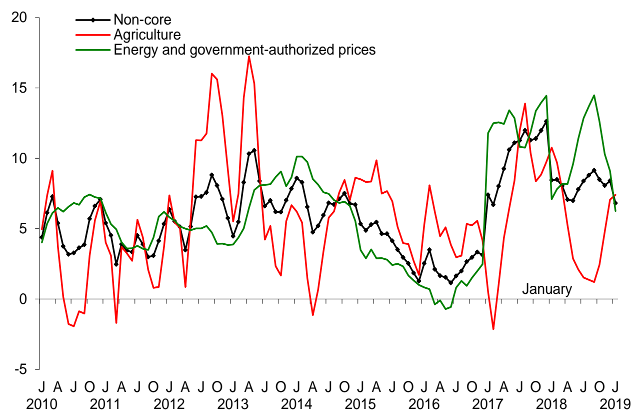
Chart 24
Merchandise and Services Core Price Subindex
Annual percentage change



Source: Banco de México and INEGI.

Annual non-core inflation fell from 8.07 to 6.81% between November 2018 and January 2019. The reduction is associated with the lower increases in energy and in meats, poultry, fish and eggs prices. These results were partially offset by increases in fruit and vegetable prices (Chart 25 and Table 1)

Chart 25
Non-core Price Subindex
Annual percentage change



Source: Banco de México and INEGI.

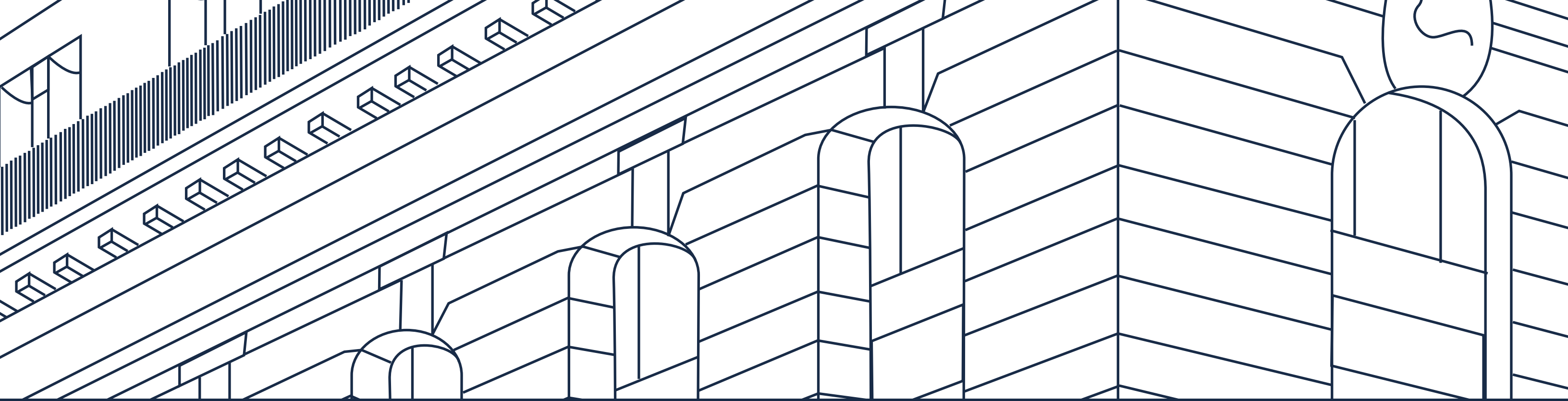
The medians for short-term inflation expectations drawn from surveys decreased. In particular, the medians for headline inflation expectations from Banco de México's Survey of Private Sector Forecasters for the end of 2019 and 2020 were adjusted downwards, from 3.89 to 3.80% and from 3.79 to 3.71%, respectively. This decrease is explained by the reduction in implied non-core inflation expectations (from 5.10 to 4.73% and from 5.09 to 4.51%, respectively), given that the median for the core component for 2019 remained unchanged at 3.50% and that for 2020 was adjusted upwards from 3.37 to 3.45%. The medians for headline inflation expectations for the following 12 months, relative to the month in which data is collected and to the subsequent month, were adjusted from 3.89 to 3.98% and from 3.87 to 3.98%, respectively. The median for headline inflation expectations for the medium term (next four years) fell by 2 basis points to 3.53% in January's survey. In contrast, the median for longer terms (next 5 to 8 years) remained stable at around 3.50%. In recent surveys, the medians for core inflation increased to levels near 3.4%, above the 3% headline inflation target. Finally, although inflation expectations implied in quoted market prices of long-term money market instruments (drawn from 10-year government bonds) increased gradually and remained at levels close to 3.5% during the reported period, the inflation risk premium decreased. Nevertheless, the latter remains at relatively high levels not seen since March 2017.

The forecasts for annual headline inflation continue to anticipate that it will reach a level around Banco de México's inflation target during the first half of 2020. Annual core inflation is expected to be near 3% from year-end 2019. The abovementioned forecasts are subject to risks. Among upward risks are: that the peso exchange rate comes under pressure stemming from external and domestic factors; that new pressures on energy prices or on agricultural product prices arise; that an escalation of protectionist and compensatory measures worldwide materializes; that public finances deteriorate; and, considering the magnitude of the recent minimum wage increases, besides their possible direct impact, that these bring about wage revisions that exceed productivity gains and give rise to cost pressures, thus affecting formal employment and prices. In order to raise the purchasing power of wages sustainably, the role of other public policies must be considered, in particular, fostering competition in those sectors of goods and services with a high share in the consumption basket of the segments of the low income population. An additional upward risk is that the persistence shown by core inflation could also give rise to a greater resistance of long-term inflation expectations to decline. Among downside risks, those that stand out are possible lower price variations in some of the goods included in the non-core subindex or greater-than-foreseen slack conditions. Considering all of the above, the balance of risks for the forecast path of inflation remains biased to the upside, in an environment of high uncertainty.

Table 1
Consumer Price Index and Components
Annual percentage change

	November 2018	December 2018	January 2019
CPI	**4.72**	**4.83**	**4.37**
Core	**3.63**	**3.68**	**3.60**
Merchandise	**3.90**	**3.92**	**3.66**
Food, beverages and tobacco	4.79	4.73	4.30
Non-food merchandise	3.13	3.18	3.03
Services	**3.37**	**3.47**	**3.51**
Housing	2.60	2.62	2.59
Education (tuitions)	4.69	4.69	4.68
Other services	3.98	4.09	4.28
Non-core	**8.07**	**8.40**	**6.81**
Agriculture	**4.78**	**7.06**	**7.41**
Fruits and vegetables	6.02	10.20	13.23
Meats, poultry, fish and eggs	3.15	3.35	1.95
Energy and government-authorized prices	**10.30**	**9.10**	**6.26**
Energy products	13.26	11.62	7.36
Government-authorized prices	**3.39**	**3.15**	3.45

Source: INEGI.



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