BANCO DE MÉXICO®

Executive Summary

Quarterly Report January - March 2022

Summary

The environment of high inflation worldwide, generated by the effects of the COVID-19 pandemic, deteriorated further as a result of the geopolitical conflict in Ukraine, which has led to increases in energy and food prices and to new disruptions in supply chains. This conflict has also contributed to a decline in global growth expectations and to greater risk aversion. The increasing number of COVID-19 infections in China and the measures taken to control it could imply further disruptions to supply chains. Under such scenario, most central banks have continued withdrawing the monetary stimulus given the persistently high levels of inflation, and, in some cases, they have even accelerated such process. In particular, the Federal Reserve is expected to keep the rate of withdrawal of the monetary stimulus. In Mexico, economic activity showed a moderate reactivation, although ample slack conditions prevail in the economy, while the environment of uncertainty has generated some episodes of volatility in domestic financial markets.

In this context, annual headline inflation remained significantly above the 3% target, while core inflation continued increasing, such that both have reached levels unseen in two decades. Given the risk of contamination to the price formation process and medium- and long-term expectations, Banco de México has pursued a timely implementation of monetary policy, seeking an orderly adjustment in relative prices and in financial markets. Given the outlook of higher inflationary pressures associated with the pandemic and the geopolitical conflict, and of tighter global monetary and financial conditions, Banco de México will continue focusing on seeking an orderly and sustained convergence of inflation toward its target within the time frame in which monetary policy operates, being ready to take more forceful measures, if conditions so require.

During the first quarter of 2022, global economic activity grew less than expected, among other factors, due to the rapid spread of the Omicron variant of the SARS-CoV-2 virus, the persistence of bottlenecks in supply chains, and the economic effects of the military conflict between Ukraine and Russia, as well as the economic sanctions imposed on the latter country. While a number of forward-looking indicators showed some recovery for certain economies in the middle of the reported quarter due to the lifting of mobility restrictions in most countries, other indicators have started to reflect the impact of the military conflict on the global economy and the effects of the resurgence of COVID-19 cases in China.

As a result of the shocks related to the pandemic and the military conflict that are affecting global economic activity, as well as the more accelerated reduction of monetary stimulus in systemically important economies, the 2022 outlook for world's growth was revised downwards. Nevertheless, the impact of these shocks is expected to be heterogeneous across countries. These forecasts are subject to a particularly high degree of uncertainty given the difficulty of anticipating how the aforementioned factors will evolve.

World inflation continued increasing, reaching its highest levels in four decades in some countries, due to the persistent imbalance between supply and demand, as well as pressures on food and energy prices. As a result, inflation in most advanced and emerging economies remained above their respective central banks' targets.

The purpose of the box *Determinants of US inflation* is to evaluate the contribution of different components of inflation in that country, specifically, the effect that the fiscal stimulus programs may be exerting on inflation. After modifying traditional labor market indicators to reflect the additional disposable income generated by the fiscal stimulus, the results suggest that during 2021 these programs were an important determinant of inflation in the United States. To a lesser extent, tight labor market conditions and external sector factors have also contributed to the higher levels of inflation, reflecting the effects of the pandemic and geopolitical tensions.

In this context, most central banks in main advanced economies have continued to normalize their monetary-policy stances and, in some cases, have even accelerated said process. In emerging economies, a large number of central banks have continued raising their reference rates, except for some relevant cases, like China. The fact that world inflation has continued increasing has generated expectations that the pace of the withdrawal of the monetary stimulus at the global level will continue. In this environment, international financial markets registered episodes of greater volatility and risk aversion, as well as an increase in interest rates and a strengthening of the US dollar.

In Mexico, economic activity grew in the first quarter of 2022, after having declined in the third quarter of 2021 and having been weak in the fourth quarter. This was observed despite the rebound in COVID-19 infections at the beginning of the year, the persistence of disruptions in global supply chains, and the uncertainty generated by the military conflict in Eastern Europe. This recovery mainly reflected the dynamism of manufacturing and a moderate improvement in services.

The box *Mexico's Trade Exposure in light of the Military Conflict in Eastern Europe* shows that Mexico maintains limited trade relations with both Ukraine and Russia, except for a few products. As a result of the weak trade links, it is estimated that, based on the analysis of counterfactual scenarios within a model for global trade, sanctions on Russia would have limited effects on domestic economic activity, while the impact on prices could be considerable.

During the period covered by this Report, domestic financial markets overall performed favorably, albeit with some episodes of volatility. The exchange rate depreciated between late February and early March 2022. However, thereafter, the peso displayed a better performance. Interest rates increased along the entire yield curve, particularly in shorter terms. Adjustments at the short-term end were mainly due to increases in the reference rate by Banco de México, while adjustments at the long-term end responded to interest rate increases in the United States, given expectations of a more accelerated withdrawal of monetary stimulus in that country.

During the first quarter of 2022, the inflation environment in Mexico, already complex indeed, became even more complicated, since to the effects of the shocks related to the COVID-19 pandemic, which have not been resolved yet, more pressures were added to the prices of food and non-food commodities, due to the military conflict, which, moreover, has generated greater economic uncertainty and increased the upward risks for inflation. These shocks have had cross-cutting effects with a widespread impact on the goods and services that belong to the Mexico's Consumer Price Index (INPC, for its acronym in Spanish) basket. Under this environment, annual headline inflation in Mexico has increased to levels unseen in two decades and between the fourth quarter of 2021 and the first of 2022 it rose from 6.99 to 7.27%, reaching 7.58% in the first fortnight of May. On the other hand, annual core inflation, which has trended upwards for more than a year, increased from 5.60 to 6.53%, and then further to 7.24% on the aforementioned dates. Furthermore, non-core annual inflation remains at high levels, although it fell from 11.28% in the fourth quarter of 2021 to 9.49% in the first quarter of 2022, reaching 8.60% in the first fortnight of May.

The Box *Inflationary Pressures in the Concurrence of the Pandemic and the War between Russia and Ukraine* illustrates that the geopolitical conflict has suddenly intensified the already significant inflationary pressures generated by the pandemic and faced by the world economy, and by the Mexican economy in particular, further deteriorating the inflation outlook.

Regarding monetary policy decisions, Banco de México's Governing Board decided to increase the target for the overnight interbank interest rate by 50 basis points in each of its meetings in February, March and May 2022, to a level of 7.00%. At its meetings, it revised the expected trajectories for headline and core inflation upwards, mainly for the short term. It considered the magnitude and diversity of the shocks that have affected inflation and its determinants, the risk of medium- and long-term expectations and price formation becoming contaminated, as well as the challenges in the face of the larger adjustments in global monetary and financial conditions. In its latest decision, the Board highlighted that, on top of the inflationary shocks stemming from the health emergency, there are also pressures associated with the geopolitical conflict and the strict lockdown measures recently imposed by China. Along with said actions, it pointed out that the monetary policy stance is in line with the path required for inflation to converge to its 3% target within the forecast horizon. In this way, the Governing Board reaffirms its commitment to Banco de México's constitutional mandate of ensuring the stability of the peso's purchasing power.

For the next monetary policy decisions, the Board will monitor thoroughly inflationary pressures as well as all factors that have an incidence on the foreseen path for inflation and its expectations. The latter, in order to set a policy rate that is consistent at all times with the trajectory needed to facilitate the orderly and sustained convergence of headline inflation to the 3% target within the time frame in which monetary policy operates, as well as an adequate adjustment of the economy and financial markets. Given the growing complexity in the environment for inflation and its expectations, taking more forceful measures to attain the inflation target may be considered.

As for Banco de México’s macroeconomic outlook:

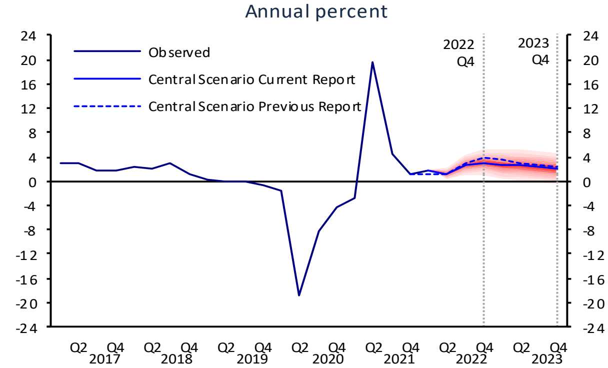
Growth of the national economy: For 2022, GDP growth is expected to be between 1.6 and 2.8%, with a central estimate of 2.2%. For 2023, GDP growth is expected to be between 1.4 and 3.4%, with a central estimate of 2.4% (Chart 1). The point estimates compare with those of 2.4 and 2.9% for each year of the previous Report.[1]

Revised figures for both years reflect both external and domestic factors. Indeed, a complex and challenging environment prevails for the world economy as a result of the continued effects of the global pandemic, to which the impact of the conflict in Eastern Europe were added. Thus, disruptions in global supply chains and strong inflationary pressures persist, which have led to more restrictive monetary policy stances, both worldwide and in Mexico, and to a deterioration in the outlook for growth for the world economy. In addition, while the domestic economy faces a more favorable evolution of the pandemic in the country, which is expected to support the performance of domestic demand, factors such as the country's expected oil production platform have been revised downward.

Should growth in 2022 materialize close to the upper bound of the indicated range, economic activity would recover in the fourth quarter of the current year to the level observed at the end of 2019. With growth close to the point estimate for 2022, such recovery would take place around the first quarter of 2023. With growth close to the lower bound of the ranges described above, the level observed at the end of 2019 would be reached in the fourth quarter of 2023.

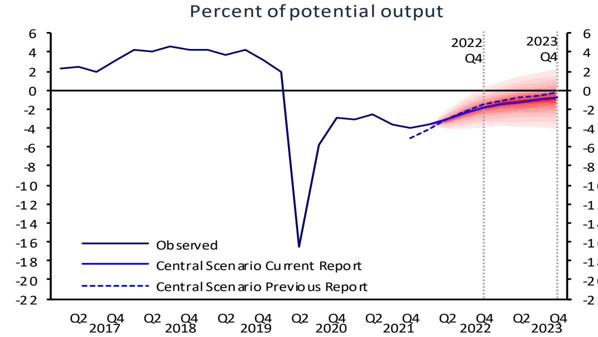
As for the cyclical position of the economy, slack conditions are expected to continue diminishing over the forecast horizon, albeit at a more gradual pace than that expected in the previous Report (Chart 2).

Chart 1
Fan Chart: GDP Growth, s.a.
Annual percent



s.a./ Seasonally adjusted figures.
Source: INEGI and Banco de México.

Chart 2
Fan Chart: Output Gap Estimate, s.a.
Percent of potential output



s.a./ Seasonally adjusted figures.
Source: Banco de México.

[1] Intervals are compared to those reported in the previous Report of 1.6-3.2% for 2022 and 1.9-3.9% for 2023.

Employment: Based on the outlook for economic activity and on the most recent information regarding the number of IMSS-insured jobs, the expected growth of between 560 and 760 thousand jobs for 2022 is maintained. For 2023, a variation of between 490 and 690 thousand jobs is expected, which compares with the expectation of between 510 and 710 thousand jobs published in the previous Report.

Current account: For 2022, the trade balance is expected to be between -16.6 and -10.6 billion dollars (-1.2 and -0.7% of GDP), and the current account balance is expected to be between -6.7 and 3.3 billion dollars (-0.5 and 0.2% of GDP). For 2023, a trade balance of between -17.2 and -9.2 billion dollars (-1.1 and -0.6% of GDP) and a current account balance of between -7.9 and 4.1 billion dollars (-0.5 and 0.3% of GDP) are projected.[2]

Risks to growth: It is considered that the highly uncertain global environment has reinforced the negative bias in the balance of risks for growth in the country. In this context, an escalation of the geopolitical conflicts could accentuate said bias even further. Among the risks to the downside in the forecast horizon, the following stand out:

i. A lower external demand, particularly from the United States, to the detriment of economic activity in Mexico.

ii. That, as a result of the continued effects of the worldwide pandemic or geopolitical conflicts, the impact on trade and bottleneck problems in global supply chains that have led to shortages of inputs in some economic sectors in Mexico persist or intensify. Similarly, that the aforementioned leads to higher input and production costs in various sectors of the economy.

iii. Tighter-than-expected financial conditions and episodes of volatility in international financial markets that could affect financing flows to emerging economies.

iv. A lower-than-expected or insufficient recovery of investment spending to support the reactivation process and long-term growth of the economy.

v. The emergence of new waves of contagion, possibly associated with new variants of COVID-19, adversely affecting economic recovery.

Among the risks to the upside in the forecast horizon, the following stand out:

i. That a lower number of reported infections leads to a more vigorous recovery of the economy, particularly in those sectors that have lagged the most because of the pandemic.

ii. That, within the framework of the USMCA, Mexico becomes an attractive destination for investment in view of a global reconfiguration of production processes, benefitting its economic activity and productivity.

iii. That global financial conditions conducive to a faster economic recovery are maintained.

Inflation: At the time of publication of the previous Quarterly Report, the geopolitical conflict was a very recent event and there was considerable uncertainty about the magnitude of its effects and its duration. Thus, although the upward risks to inflation were emphasized, the inflation forecasts did not include possible pressures derived from said conflict, pending further information on how it would evolve. Despite the current prevailing uncertainty regarding its consequences, since the publication of the previous Report, the significant implications it has had on world inflation have been evident, mainly due to its effects on the reference prices of various commodities, especially food and energy.

[2] Figures for 2022 compare with the previous Report's figures of a trade balance of between -15.0 and -9.0 billion dollars (-1.1 and -0.6% of GDP) and a current account balance of between -8.2 and 1.8 billion dollars (-0.6 and 0.1% of GDP). Figures for 2023 compare with the previous Report's forecast of a trade balance of between -17.8 and -9.8 billion dollars (-1.2 and -0.6% of GDP) and a current account balance of between -10.1 and 1.9 billion dollars (-0.7 and 0.1% of GDP).

Also, as highlighted throughout the Report, the shocks derived from the military conflict are taking place in an already difficult environment for inflation due to the effects of shocks associated with the COVID-19 pandemic, which remain unresolved. Indeed, disruptions in production and supply chains have continued, probably intensified by the military conflict and by restrictions on mobility in some Chinese cities to reduce COVID-19 infections. Thus, high demand is maintained against a supply that continues facing increases in input costs and shows little flexibility to adjust in the short term, extending the imbalance between supply and demand that has been driving inflation upwards globally and in Mexico.

In this context, and, considering that the magnitude and duration of the shocks on inflation have been greater than expected, Banco de México revised upwards its inflation forecasts in the Monetary Policy Statements of March 24 and of May 12, 2022. In this Report, the inflation trajectory presented in the most recent Monetary Policy Statement remains valid.

Thus, the upward revision in headline inflation between this Quarterly Report and the previous one includes pressures on both core and non-core inflation. Regarding the core component, the revision responds to a greater extent to the expected trajectory for merchandise, although that corresponding to services has also been adjusted upwards. The forecast includes greater-than-anticipated pressures, which could be associated with higher input prices because, compared to the previous report, the futures of international references for food and non-food commodities have been revised upwards, which is expected to generate pressures on core inflation looking ahead. This takes place in a context of disruptions in production and distribution chains, a still high global demand, and a reopening of the economy at the local level. In addition, wage revisions have been increasing and therefore it is anticipated that they could have a greater impact on inflation. Regarding the non-core component, inflation of agricultural and livestock products has remained at high levels, in addition to the fact that shocks associated with the conflict, such as higher prices of fertilizers or grains used as inputs, which were already at high levels due to the effects of the pandemic, are expected to lead to greater pressures than those previously estimated. Greater pressures on energy inflation are also anticipated, although shocks to international energy references would only partially pass through to consumer prices, given the energy-related government policies. Finally, the revision of the forecast considers the effects of the Policy Program to Fight Inflation and High Prices (PACIC, for its acronym in Spanish).

The largest adjustments to the headline inflation forecast are for the short term, over the next four quarters. In particular, annual headline inflation is expected to continue increasing in the second quarter of 2022. However, it will subsequently decline in the remainder of 2022 and throughout 2023, reaching levels close to Banco de México's 3% inflation target in the first quarter of 2024 (Table 1 and Chart 3a). At the same time, annual core inflation is also expected to maintain an upward trajectory in the second quarter of 2022, and then decline in 2022 and 2023, reaching 3% in the first quarter of 2024 (Table 1 and Chart 3b).

Table 1 and Chart 4 show the annual and annualized seasonally adjusted quarterly rates of change for the forecast horizon. After the second quarter of 2022, it is observed that the seasonally adjusted and annualized quarterly rates of the Consumer Price Index decline faster than the annual changes, also settling at lower levels than those observed in 2021 and in the first two quarters of 2022. Likewise, the core price index’s annualized seasonally adjusted quarterly rates would be around 3% since the first quarter of 2023. Since annual rates are influenced for 12 months by short-term shocks that affected inflation, their reduction is slower than those seasonally adjusted. Therefore, annual changes are above those seasonally adjusted during the stage where shocks to inflation are being assimilated, for most of the forecast horizon, for both headline and core inflation.

The expected trajectories for headline and core inflation, in addition to Banco de México's monetary policy actions, reflect the prevision that the effects of the shocks of the pandemic and the military conflict subside. In this regard, the pandemic control process is expected to continue to allow a normalization of production and distribution conditions, as well as greater mobility of the population, which will provide greater flexibility to supply. This, combined with the reduction of monetary and fiscal stimuli in advanced countries, will reduce the imbalance between supply and demand observed in several markets around the world, allowing for a gradual stabilization of input prices and, therefore, of production costs. However, it cannot be ruled out that the effects of the shocks on inflation may last longer, that they may worsen or that new shocks may occur that would exert upward pressures on it, which could also mean an even more complicated environment for inflation. Moreover, there exists the possibility of non-linearities in the effects of the different variables on inflation given its high levels in Mexico and other economies, in a context of marked uncertainty. Thus, the balance of risks with respect to the expected trajectory of inflation over the forecast horizon remains biased to the upside and has continued deteriorating.

Among the main risks to inflation, the following stand out:

On the upside:

i. Persistence of core inflation at high levels.

ii. External inflationary pressures associated with the evolution of the pandemic.

iii. Greater price-related pressures derived from the geopolitical conflict, particularly on food and energy products.

iv. Episodes of exchange rate depreciation, possibly as a result of volatility in international financial markets.

v. Cost-related pressures associated with hiring conditions or wages, which could be passed on to consumer prices.

On the downside:

i. That a reduction in the intensity of the military conflict between Russia and Ukraine implies lower pressures on inflation.

ii. That control of the pandemic results in production and distribution chains resuming an efficient functioning that allows for a release of pressures on prices.

iii. That, given the slack conditions in the economy, cost-related pressures and labor hiring conditions do not exert pressure on prices.

iv. That the measures implemented by PACIC have a greater-than-anticipated effect.

Table 1
Forecasts for Headline and Core Inflation
Annual percentage change of quarterly average indices

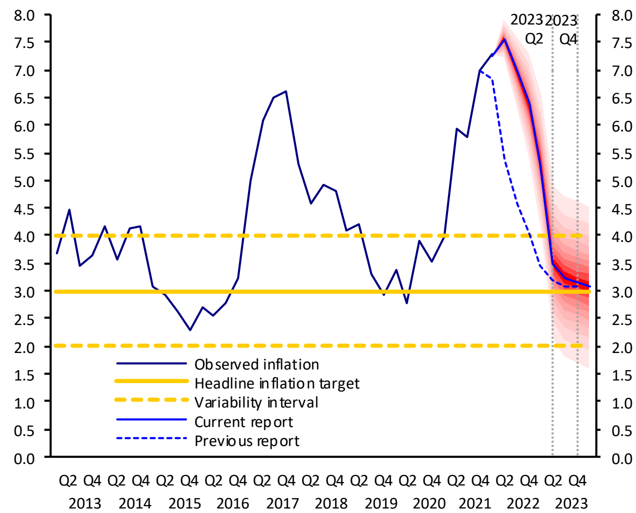
	2021	2022				2023				2024
	IV	I	II	III	IV	I	II	III	IV	I
CPI										
Current Report = Monetary Policy Statement of May 2022 1/	7.0	7.3	7.6	7.0	6.4	5.3	3.5	3.2	3.2	3.1
Previous Report = Monetary Policy Statement of February 2022 2	7.0	6.9	5.4	4.6	4.0	3.4	3.2	3.1	3.1	
Core										
Current Report = Monetary Policy Statement of May 2022 1/	5.6	6.5	7.2	6.6	5.9	4.8	3.6	3.3	3.1	3.0
Previous Report = Monetary Policy Statement of February 2022 2	5.6	6.4	6.1	5.1	4.3	3.3	2.9	2.7	2.7	
Memo										
Annualized seasonally adjusted quarterly variation in percent 3/										
Current Report = Monetary Policy Statement of May 2022 1/										
CPI	7.1	7.3	9.3	4.4	4.5	3.2	1.9	3.5	4.0	2.9
Core	6.7	7.8	7.6	4.2	4.2	3.2	2.7	3.2	3.4	2.7

1/ Forecast starting May 2022. It corresponds to the forecast published in the Monetary Policy Statement of May 12th 2022.
2/ Forecast starting February 2022. It corresponds to the forecast published in the Monetary Policy Statement of February 10th 2022.
3/ See methodological note on seasonal adjustment process.
Source: INEGI for observed annual variation figures and Banco de México for seasonally adjusted figures and forecasts.

Chart 3

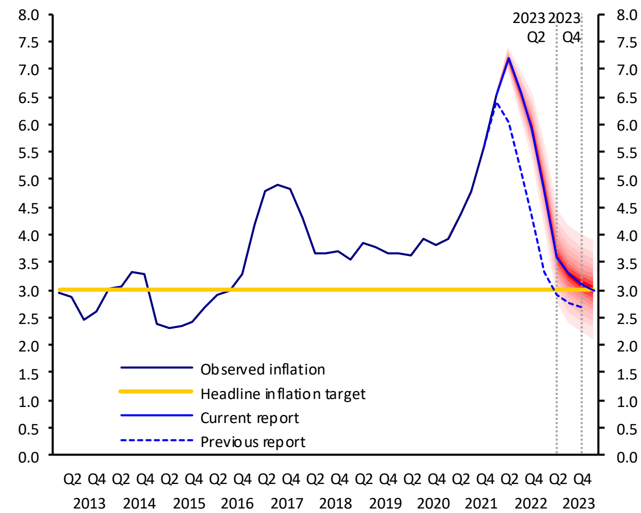
a) Fan Chart: Annual Headline Inflation 1/

Percent



b) Fan Chart: Annual Core Inflation 1/

Percent



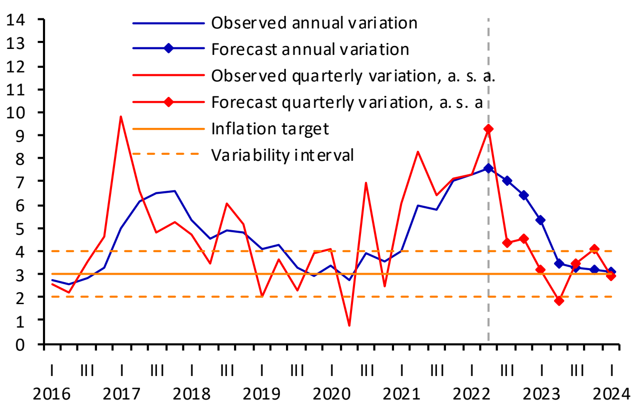
1/ Quarterly average of annual inflation. The next four and six quarters are indicated with vertical lines, using as a reference the second quarter of 2022, that is, the second quarter of 2023 and the fourth quarter of 2023, respectively, time frames in which the transmission channels of monetary policy fully operate.

Source: Banco de México and INEGI.

Chart 4

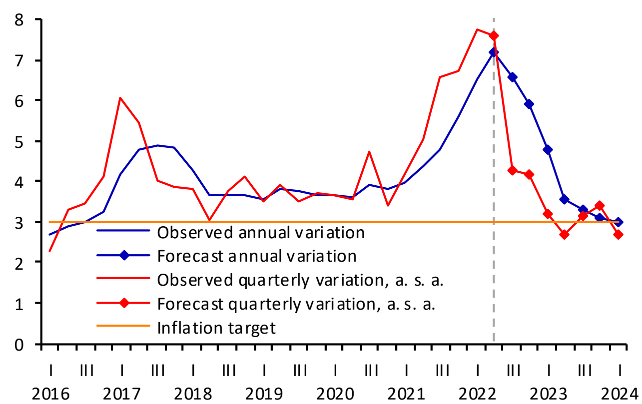
a) Headline Index

Quarterly variation, annualized and s.a., and annual variation in percent



b) Core Index

Quarterly variation, annualized and s.a., and annual variation in percent



s.a. seasonally adjusted figures.
a.s.a. annualized seasonally adjusted figures.
Vertical line corresponds to second quater of 2022.
Source: Banco de México and INEGI.

The relative resilience of Mexican economic activity to the rebound in COVID-19 cases earlier in the year proves the importance of vaccination, as well as the adaptation of producers and consumers to the conditions imposed by the pandemic. However, uncertainty persists regarding the global evolution of the health emergency, particularly in relation to the possible emergence of new variants and the need to apply additional booster doses. Likewise, the pandemic continues generating problems in global supply chains. In addition to this complex environment, there is also the military conflict in Eastern Europe, which, besides causing a humanitarian crisis in the region, has intensified many of the negative effects of the pandemic, especially the inflationary pressures associated with the behavior of commodities.

In this context, to support the reactivation of economic activity, Mexico's economic policy must continue to maintain sound macroeconomic fundamentals, including fiscal discipline, a sound and resilient financial system, as well as a monetary policy focused on achieving price stability. In this regard, Banco de México's Governing Board determines its monetary policy stance seeking to foster an orderly adjustment of relative prices, financial markets and the economy as a whole, leading to the convergence of inflation to the 3% target and preserving the anchoring of inflation expectations.

The reactivation of the economy must not only lead to achieve the levels of economic activity prior to the health emergency, but also seek to promote a more rapid and widespread growth that will enable even higher levels of growth. To this end, it is essential to adopt actions that generate an environment conducive to investment and productivity growth. This would also help to mitigate inflationary pressures in sectors with limited productive capacity. Likewise, as mentioned in previous Reports, the rule of law and the fight against insecurity must be strengthened, as this will lay the foundations for a greater and sustained long-term growth that will lead to the creation of more and better jobs for the benefit of the population.

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