BANCO DE MÉXICO®

Executive Summary

Quarterly Report July - September 2023

Summary*

In the period analyzed in this Report, Banco de México continued conducting monetary policy in a complex and uncertain environment. Externally, although global inflation continued decreasing, it remained at levels that are still high. In light of a greater-than-foreseen expansion of economic activity in systemically important economies, such as that of the United States (US), strong labor markets and pressures on energy prices, the challenge of inflation converging to its target became more complex in several economies. In this context, the perspective that the central banks of the major advanced economies will maintain reference rates at high levels for an extended period has consolidated. This contributed to a greater tightening of international monetary conditions. Additionally, the uncertainty over the global inflation outlook increased in light of the intensification of geopolitical tensions. Domestically, in view of Banco de México's monetary policy stance and progress in the dissipation of the effects of the shocks associated with the pandemic and the military conflict in Ukraine, the disinflationary process continued underway. However, annual headline inflation persisted above the central bank's target. Core inflation has decreased more gradually than headline inflation. Similarly, the balance of risks for the foreseen inflation trajectory remained biased to the upside. In this context, in the monetary policy decisions of the reported period, the Governing Board deemed it necessary to leave the reference rate unchanged at 11.25%.

During the third quarter of 2023, global economic activity is estimated to have grown at a higher rate than during the previous quarter and above what was expected at the beginning of the period. However, a marked heterogeneity was observed among countries. In particular, the US and Chinese economies exhibited greater dynamism compared to the second quarter. In contrast, economic activity in the euro area continued registering weakness during the quarter. For 2023 as a whole, forecasts of international organizations continue pointing to a lower growth rate of global economic activity as compared to the previous year. On the other hand, growth in 2024 is expected to be similar to that registered this year. In the case of the United States, the growth outlook was revised upwards for 2023 and 2024.

The box *Evolution of international fiscal and monetary policy stances in the context of the global economic recovery* shows that since the beginning of the COVID-19 pandemic, in a significant number of countries, fiscal and monetary policies have been generally coordinated, albeit with some desynchronization in some of them in the course of 2023. In this context, it highlights the importance of coordinating both policies to efficiently attain their goals.

In terms of global inflation, although headline inflation decreased in most of the major economies, it remained above the respective central banks' targets, and, in some cases, it even rebounded in recent readings. Additionally, while the core component continued decreasing during the quarter, it declined at a slower pace than headline inflation. In addition to the above, risks to the global disinflationary process persist. The latter is primarily due, in economies like that of the US, to the resilience of productive activities and the strength of the labor market, as well as to the possibility of new pressures from energy prices are observed.

The box *Labor market in the United States* analyzes certain features that this market has exhibited in the post-pandemic period. Even though the Federal Reserve has increased its reference rate significantly, the US labor market has remained strong. The rate of available job vacancies is at levels much higher than those observed prior the pandemic, while the

* *Note: In the electronic version of this document, the information that allows to generate all the charts and tables included in this report can be obtained by clicking on them, except for those that are not produced or prepared by Banco de México.*

unemployment rate has remained stable. The decline in average working hours observed in some sectors, along with adjustments in labor participation patterns, might be suggesting more structural changes. This implies that it will be necessary to monitor a wide range of indicators and differentiate among sectors of economic activity to gain a better understanding of the degree of tightening in the labor market.

During the reported period, most central banks of both advanced and emerging economies left their reference rates unchanged. Some authorities, however, continued tightening their monetary policy stances. Overall, most central banks underlined that future adjustments to policy rates will be data-dependent. However, the resilience of economic activity and the labor market, as well as the persistence of inflation at high levels in some countries have contributed to the expectation that these rates will remain at high levels for longer than previously anticipated, especially in the United States. This aims at maintaining a sufficiently restrictive policy stance so that inflation returns to its target level. The above, along with higher term premia following a greater uncertainty regarding the evolution of global activity and inflation, as well as concerns about the fiscal situation in the United States, including high levels of public debt, was reflected in significant increases in medium and long-run sovereign interest rates at a global level. Also, the outlook that interest rates will remain higher for a longer in the United States contributed to a generalized appreciation of the US dollar. However, part of these adjustments in the fixed-income and foreign exchange markets have recently reversed. In line with the volatility in global markets, in Mexico interest rates of government bonds also increased, and the Mexican peso, like the currencies of most economies, depreciated against the US dollar. Nevertheless, these adjustments also partially reversed.

The box *Relationship between long-term interest rates in Mexico and the United States* uses a Vector Autoregressive (VAR) model to show that the 10-year interest rate in Mexico tends to increase in response to shocks that raise the 10-year interest rate and inflation in the United States. Thus, the results indicate that increases in the 10-year interest rate in Mexico observed in July, August, and September 2023 responded largely to shocks to the 10-year interest rate in the United States and, to a lesser extent, to shocks to the monthly inflation in that country.

During the third quarter of 2023, the Mexican economy kept expanding and continued experiencing robust growth. This evolution during the quarter reflected the strong performance of tertiary activities, which grew at a faster rate than in the previous quarter, as well as the dynamism of the industrial sector, supported by vigorous growth in non-residential construction. Looking ahead, the Mexican economy is expected to continue showing resilience, driven by domestic spending and the fiscal stance currently foreseen, in the context of the fiscal balance approved for 2024. The cyclical position of the economy is expected to continue exhibiting tightness.

In the period analyzed in this Report, Mexico's disinflationary process continued underway. Between the second and the third quarters of 2023, annual headline inflation decreased from 5.71 to 4.63%, while in the first fortnight of November it reached 4.32%. The decline in headline inflation was due, to a greater extent, to the reduction in annual core inflation. However, the latter remained at high levels. Between the referred quarters, it decreased from 7.31 to 6.16%, and to 5.31% in the first fortnight of November. Its decline primarily reflected the downward trajectory of merchandise inflation. In contrast, annual services inflation still does not show a clear change in trend. In this regard, accumulated costs, combined with the recovery of demand after the lockdown, still continue to affect services prices. Meanwhile, annual non-core inflation declined from 1.00 to 0.10% between the second and the third quarters of 2023. This was the result of lower levels of inflation of agricultural, livestock and energy products. During the first fortnight of November, although non-core inflation increased, it remained at atypically low levels as it registered 1.41%.

The box *Estimation of production cost indices for goods and services in the core price index basket* approximates the pressures faced by firms due to changes in production costs. The estimations indicate that during the pandemic these increased significantly and at a faster rate than consumer prices. Moreover, in the case of services, the cumulative change in consumer prices from the beginning of the pandemic to date is still below that estimated for their costs. These observations could help to explain why services inflation has been more persistent than that of merchandises.

In the monetary policy meetings of the reported period, the Governing Board decided unanimously to keep the reference rate unchanged at 11.25%. It deemed that the above was necessary in light of the complex inflationary environment. In this regard, it pointed out that progress in the disinflationary process continued due to the monetary policy stance already attained and the mitigation of the effects of inflationary shocks. However, the Board considered that these shocks continued affecting inflation. As such, it underlined that inflation persisted at high levels, with a balance of risks biased to the upside for its projected trajectory. For the September meeting, both headline and core inflation continued decreasing. However, the Board estimated that, given the accumulated cost-related pressures, especially on the services component, and the previously described resilience of Mexican economic activity, looking ahead, the decline in inflation would be slower than previously anticipated. Subsequently, in the November meeting, the Board noted that the outlook continued posing challenges. The Board continue to highlight the high levels of inflation and the upward bias in the balance of risks. However, it considered that both headline and core inflation had continued decreasing, reaching levels clearly below the peaks attained in 2022. In addition, the central bank's inflation forecasts remained practically unchanged, pointing out to the projection that the disinflationary process will continue.

The Board will thoroughly monitor inflationary pressures as well as all factors that have an incidence on the foreseen path for inflation and its expectation. It considers that, in order to achieve an orderly and sustained convergence of headline inflation to the 3% target, the reference rate must be maintained at its current level for some time. The latter, taking into account that, although the outlook remains complicated, progress on disinflation has been made. The central bank reaffirms its commitment with its primary mandate and the need to continue its efforts to consolidate an environment of low and stable inflation.

As for Banco de México's macroeconomic outlook, the following stands out:

Growth of the national economy: For 2023, GDP growth is expected to be between 3.1 and 3.5%, with a central estimate of 3.3%, higher than the 3.0% of the previous Report (Chart 1a and Table 1). This adjustment is primarily due to the fact that in the third quarter Mexico's economic activity performed better than previously anticipated, as a result of the resilience of external demand and the dynamism of domestic spending. For 2024, GDP growth is expected to be between 2.3 and 3.7%, with a central estimate of 3.0%, higher than the 2.1% in the previous Report. The revision for that year is explained, to a greater extent, by the fiscal stance currently foreseen. It also responds, in part, to the updated outlook for growth in the United States, which now suggests a less pronounced deceleration of Mexico's external demand. The greater base for growth resulting from the higher levels of economic activity foreseen for the end of 2023 also contributes to the adjustment of the forecast for 2024. Finally, for 2025, growth is expected to be between 0.7 and 2.3%, with a central estimate of 1.5%.[1]

The box *Change of 2018 base year in the measurement of Mexico's National Accounts System shows* how the new information on Mexico's Gross Domestic Product (GDP) that was recently published reflects more clearly the resilience of economic activity in recent years as compared to what was appreciated using the previous base year. The box describes the revisions implemented following the update of the base year from 2013 to 2018 through a decomposition that distinguishes between changes explained by the differentiated performance among sectors and other revaluation changes resulting from modifications in relative prices determined by the new base year.

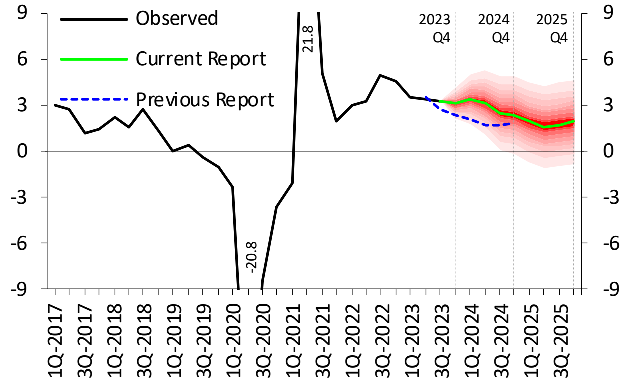
Delving into the expected behavior of the Mexican economy, given the resilience of productive activity, it is anticipated that the economy will continue showing a positive evolution in the fourth quarter of 2023. At the national level, the effects of Hurricane Otis, which made landfall at the end of October, are estimated to be limited, both on national growth and inflation, due to the relatively low participation of the affected area in aggregate indicators. However, the effects for Acapulco and its surrounding municipalities in the state of Guerrero will be profound.

For 2024, despite the forecast of a deceleration of external demand, robust growth is expected for the year as a whole, supported by domestic spending. In particular, the fiscal package for that year set a target of 5.4% of GDP for the public sector borrowing requirements, higher than the 3.2% anticipated in the 2024 Preliminary Budget Guidelines published last April. The dynamism of economic activity is expected to be biased towards the first half of 2024, in line with the pattern observed in previous election years.

Chart 1

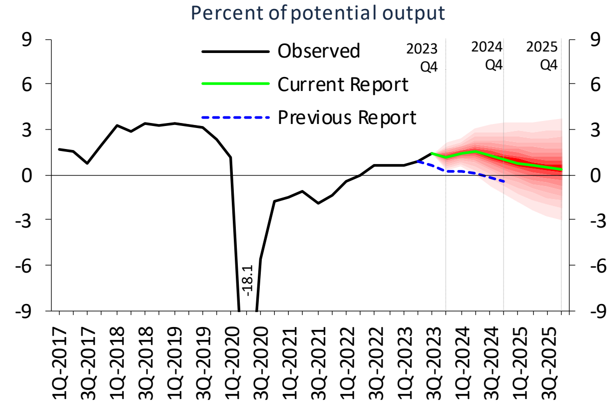
a) Fan chart: GDP growth, s.a.

Annual percent



b) Fan chart: output gap estimate, s.a.

Percent of potential output



s.a./ Seasonally adjusted figures.

Note: In the present Report the forecast begins in Q4 2023. In the previous Report, it started in Q3 2023.

Source: a) INEGI and Banco de México. b) Banco de México.

[1] In 2024, there will be one more day with respect to 2023, given that it will be a leap year. This will cause that the annual growth rate of GDP that is calculated without seasonal adjustment (currently estimated to be 3.0%) will be higher than the seasonally adjusted growth rate (currently estimated to be 2.8%). In 2025, there will be one day less than in 2024. This will cause that the annual growth rate of GDP that is calculated without seasonal adjustment (currently estimated to be 1.5%) will be lower than the seasonally adjusted growth rate (currently estimated to be 1.8%).

Table 1
Forecasts for GDP growth
Annual percent

Year	Central	Interval
2023	3.3	Between 3.1 and 3.5
2024	3.0	Between 2.3 and 3.7
2025	1.5	Between 0.7 and 2.3

Note: Not seasonally adjusted forecasts. The central estimates for 2023 and 2024 compare with the previous Report's forecasts of 3.0 and 2.1% for each year. Intervals compare to those published in the previous Report of 2.5 and 3.5% for 2023 and 1.3 and 2.9% for 2024. Mexico's GDP increased 3.9% in 2022 with figures that are not seasonally adjusted.
Source: Banco de México.

Growth is expected to be below its historical average for 2025, with some change in the composition of external and domestic demand. In particular, domestic spending would reflect the anticipated fiscal consolidation effort, while external demand would gain more relevance due to the better performance for the US economy anticipated for that year. The ongoing nearshoring of some firms to Mexico is expected to provide some momentum to economic activity over the forecast horizon, recognizing the high uncertainty as to its potential magnitude and effects.

Regarding the cyclical position of the economy, the estimate of the output gap is expected to show a tighter economy than that of the previous Report. This gap is expected to remain at levels similar to those of the third quarter of the year until the first half of 2024, and then narrow over the remaining forecast horizon (Chart 1b). The estimate of this non-observable indicator is subject to a high degree of uncertainty.

The box *Historical evolution of the sources and uses of financial resources and analysis of sectoral financing of depository institutions in Mexico* shows that, currently, the absorption of financial resources by the public and private sectors in Mexico is expanding at a high level compared to its recent history. Both sectors' financing needs are also expected to remain high next year. In this context, it is argued that, in order to meet these financial requirements, the sources of domestic resources will have to continue increasing at a historically high rate in 2024.

Given the complex and uncertain environment expected for global economic activity over the forecast horizon, it will be important for the domestic economy to maintain the sound macroeconomic fundamentals that have characterized it for years. The announcement of the approval of the new Flexible Credit Line with the IMF provides Mexico with an additional instrument to face possible adverse shocks. It is also a recognition of the soundness of the country's macroeconomic framework. Looking ahead, it will be important to continue strengthening said macroeconomic framework. Thus, continuing efforts to ensure price stability will be essential to create the conditions for a greater economic development.

Employment: Table 2 presents the forecasts for IMSS-insured jobs. Based on the most recent information on the evolution of formal employment and projections for economic activity, forecasts are adjusted for 2023 and 2024 compared to the previous Report, while the corresponding forecasts for 2025 are presented.

Table 2
Forecasts for the number of IMSS-insured jobs
Annual change in thousands of jobs

Year	Interval current report	Interval previous report
2023	Between 670 and 770	Between 670 and 830
2024	Between 610 and 810	Between 570 and 770
2025	Between 550 and 750	n.a.

n.a. Non available.
Source: Banco de México.

Current Account: Table 3 shows the forecasts for the trade balance and the current account based on the latest information.

Table 3
Forecasts for the trade balance and current account

Year	2023	2024	2025
Trade balance			
% of GDP	Between -0.9 and -0.6	Between -1.5 and -1.1	Between -1.5 and -1.0
Billions of dollars	Between -16.0 and -10.0	Between -27.8 and -19.6	Between -26.8 and -17.4
Current account			
% of GDP	Between -1.0 and -0.5	Between -1.3 and -0.6	Between -1.3 and -0.4
Billions of dollars	Between -18.6 and -8.6	Between -24.3 and -11.6	Between -23.4 and -7.4

Note: Figures for 2023 compare with those of the previous Report of a trade balance of between -30.6 and -24.1 billion dollars (-1.7 and -1.3% of GDP) and a current account balance of between -31.6 and -21.5 billion dollars (-1.8 and -1.2% of GDP). Figures for 2024 compare with the previous Report's figures of a trade balance of between -30.4 and -22.2 billion dollars (-1.7 and -1.2% of GDP) and a current account balance of between -28.6 and -15.6 billion dollars (-1.6 and -0.8% of GDP). In 2022, the trade balance was -26.9 billion dollars (-1.8% of GDP) and the current account balance was -18.0 billion dollars (-1.2% of GDP).
Source: Banco de México.

The box *Incidence of demand and supply factors on the price behavior of Mexico's non-oil merchandise exports and imports* presents estimations on the aforementioned incidence starting in the period of the pandemic. The results show that both types of shocks had a strong influence on price variations, both from exports and imports. Although the effects of these shocks have been easing, the results suggest that they have not yet faded completely.

Risks to growth: Although the outlook for domestic economic activity remains complex and uncertain, the Mexican economy has proven to be resilient and performed better than expected. Risks to growth of economic activity over the forecast horizon are considered to be balanced. Among the risks to the downside in the forecast horizon, the following stand out:

i. A lower external demand to the detriment of economic activity in Mexico, particularly in the event of a deep and lasting recession in the United States.
ii. Negative effects on international trade, given the context of several conflicts and geopolitical and commercial tensions in different regions of the world.
iii. Tighter-than-expected financial conditions and/or episodes of volatility in international financial markets that affect financial flows to emerging economies.
iv. Lower-than-expected or insufficient recovery of investment spending in Mexico to support the growth of the economy, particularly in the long term.
v. That public spending provides a lower-than-anticipated boost to economic activity.
vi. That severe weather phenomena, such as extreme temperatures or cyclones, adversely impact national economic activity.

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

i. That the slowdown in the US economy is lower than expected.
ii. That the Mexican economy shows greater resilience than expected.
iii. That, within the USMCA framework, Mexico becomes an attractive investment destination in light of a global reconfiguration of production processes, benefitting its economic activity and productivity.
iv. That public spending results in a higher-than-anticipated boost to economic activity.

Inflation: The forecasts for headline and core inflation published in the November 9, 2023 Monetary Policy Statement remain unchanged in this Quarterly Report. Compared to the previous Report, the current forecasts show more gradual downward trajectories for both indicators. This is due to an upward adjustment in headline inflation, reflecting higher levels of core inflation, as non-core inflation adjusted downwards. The revision of core inflation included the greater pressures that have affected services inflation. Now, services inflation is expected to decline more gradually than previously anticipated. This takes place in a context of recovering demand for services after the lockdown, in which businesses have been passing higher costs accumulated since the pandemic on to consumers with a lag. The adjustment to the forecast also considered the environment of resilient economic activity and the greater expected strength of the economy looking ahead, as described.

The box *Deviations of the relative prices of goods and services from their long-run equilibrium* illustrates that changes in the composition of household spending on goods and services and shocks to the real exchange rate have driven the relative price of goods (as compared to services) to deviate from their long-run relationship after the initial shock of the COVID-19 pandemic. The econometric model suggests that, looking ahead, in the absence of new shocks, the relative prices of goods (as compared to services) would be expected to decline to restore their long-term relationship.

The current projection presented in this Quarterly Report still anticipates headline and core inflation to continue declining over the forecast horizon (Chart 2). However, while the previous Report anticipated that both indicators would reach levels close to 3% in the fourth quarter of 2024, this is now expected to occur in the second quarter of 2025 (Table 4 and Chart 3). The expected downward trend in headline and core inflation trajectories considers the monetary policy actions implemented by Banco de México, as well as the expectation that various pressures on inflation will continue easing.

Table 4 and Chart 4 show the annual rate of change and the annualized seasonally adjusted quarterly rate of change of the headline and core indices. The seasonally adjusted annualized quarterly rates of headline and core indices are expected to decline in the following quarters, reaching levels of around 3% starting in the second quarter of 2024. Since annual rates are affected over twelve months by short-term shocks on inflation, their reduction is slower than that of seasonally adjusted ones. As a result, the annual variations of the headline and core indices are above the seasonally adjusted ones at the stage in which the shocks on inflation are assimilated.

The inflation environment remains complex and uncertain. The effects of shocks associated with the pandemic and the geopolitical conflict, together with a more resilient-than-expected economic activity, continue affecting inflation. In this scenario, the possibility of longer-lasting shocks on inflation or of new shocks that exert upward pressure on it cannot be ruled out. In this context, the balance of risks for the expected trajectory of inflation over the forecast horizon is considered to remain biased to the upside.

Among the main risks for the forecasted trajectory of inflation, the following stand out:

On the upside:

i. Persistence of core inflation, given the magnitude, scope and duration of the shocks that have been faced and that have raised it to high levels.
ii. Episodes of exchange rate depreciation, possibly as a result of volatility in international financial markets.
iii. Higher cost-related pressures that could be passed on to consumer prices.
iv. Greater-than-expected resilience in the economy, leading to a more gradual reduction in inflation than expected.
v. New upward pressures on non-core inflation due to the possibility of greater-than-anticipated variations in some food and energy prices due to changes in domestic or international supply and demand conditions, especially in view of geopolitical conflicts or adverse climate-related conditions.

On the downside:

i. That a greater-than-anticipated deceleration in world economic activity, mainly in the United States and Mexico, leads to lower pressures on Mexican inflation.
ii. A limited pass-through of cost-related pressures to prices.
iii. That the lowest exchange rate levels since the beginning of the year contribute more than anticipated to mitigate certain pressures on inflation.

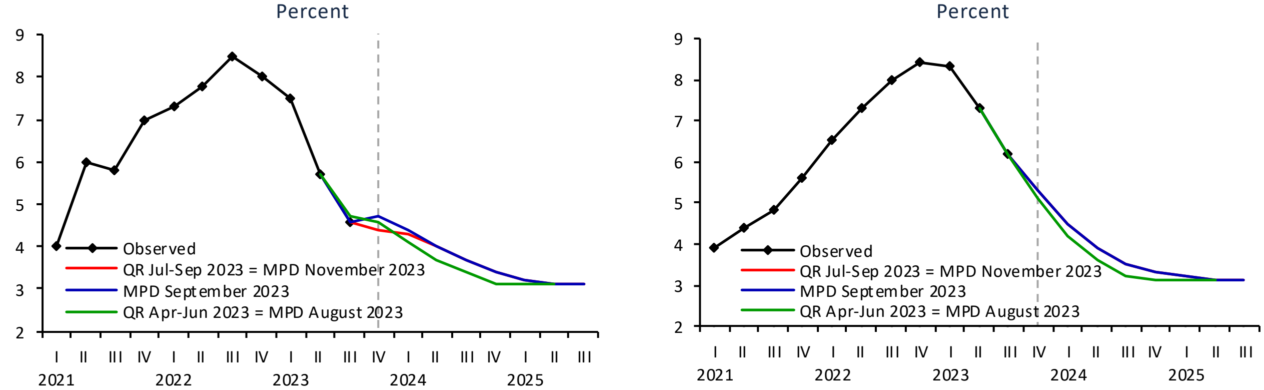
Table 4
Forecasts for headline and core inflation
Annual percentage change of quarterly average indices

	2023			2024				2025		
	II	III	IV	I	II	III	IV	I	II	III
CPI										
Current report = monetary policy statement of November 2023 1/	5.7	4.6	4.4	4.3	4.0	3.7	3.4	3.2	3.1	3.1
Previous report = monetary policy statement of August 2023 2/	5.7	4.7	4.6	4.1	3.7	3.4	3.1	3.1	3.1	
Core										
Current report = monetary policy statement of November 2023 1/	7.3	6.2	5.3	4.5	3.9	3.5	3.3	3.2	3.1	3.1
Previous report = monetary policy statement of August 2023 2/	7.3	6.2	5.1	4.2	3.6	3.2	3.1	3.1	3.1	
Memo										
Annualized seasonally adjusted quarterly variation in percent 3/										
Current report = monetary policy statement of November 2023 1/										
CPI	3.9	4.4	4.9	4.0	3.0	3.3	3.2	3.2	2.9	3.3
Core	5.3	4.6	4.4	3.5	3.0	3.2	3.4	3.0	2.7	3.3

1/ Forecast starting November 2023. It corresponds to the forecast published in the Monetary Policy Statement of November 9th 2023.
2/ Forecast starting August 2023. It corresponds to the forecast published in the Monetary Policy Statement of August 10th 2023.
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.

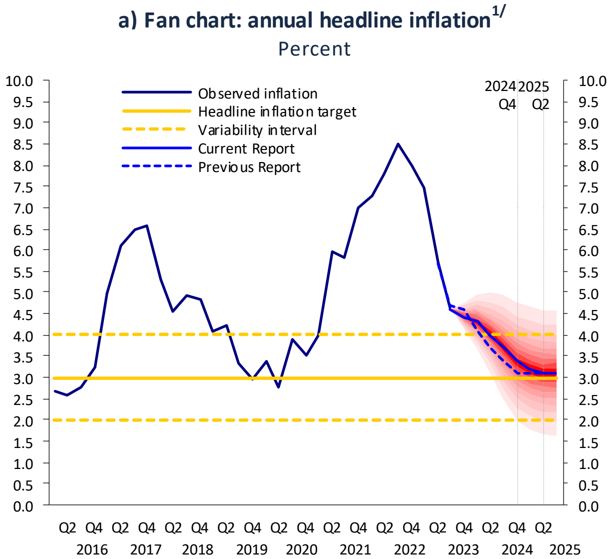
Chart 2

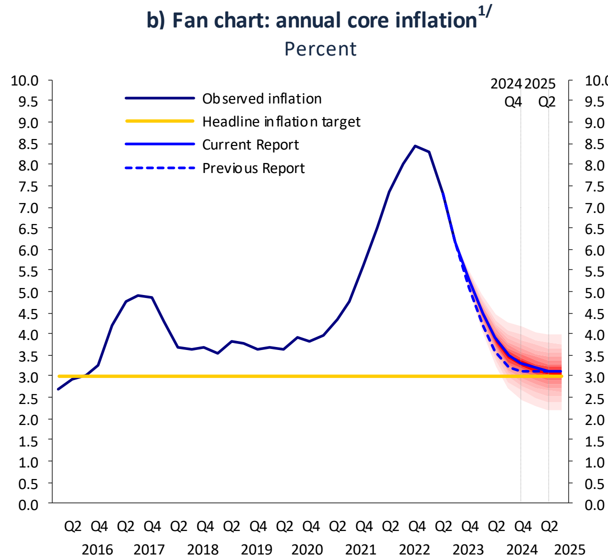
Annual headline inflation forecasts 1/ / **Annual core inflation forecasts 1/**
Percent



1/Annual percentage change of quarterly average indices. QR refers to Quarterly Report and MPD refers to Monetary Policy Decision. Vertical line corresponds to fourth quarter of 2023.
Source: Banco de México and INEGI.

Chart 3

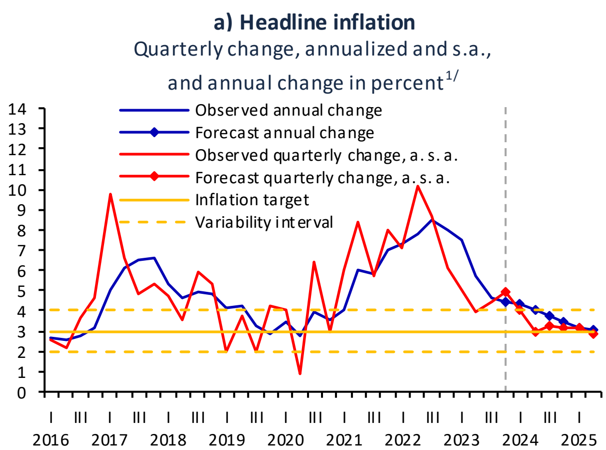


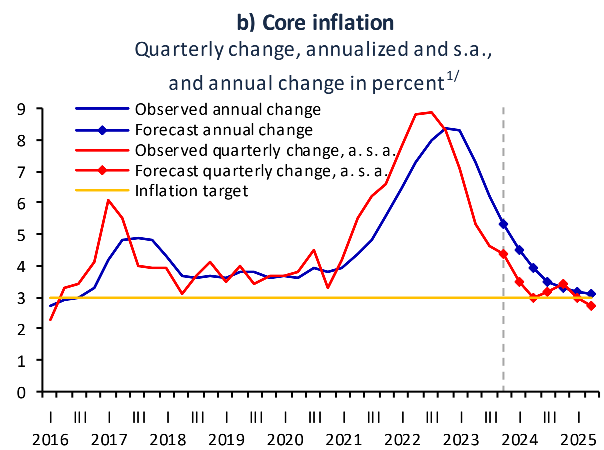


1/ Annual percentage change of quarterly average indices. The next four and six quarters are indicated with vertical lines, using as a reference the fourth quarter of 2023, that is, the fourth quarter of 2024 and the second quarter of 2025, respectively, to indicate the time frames in which the transmission channels of monetary policy fully operate.

Source: Banco de México and INEGI.

Chart 4





s.a./ Seasonally adjusted figures.

a.s.a./ Annualized seasonally adjusted figures.

1/ Calculated using the quarterly average indices.

Vertical line corresponds to fourth quarter of 2023.

Source: Banco de México and INEGI.

The aftermath of the pandemic and various geopolitical conflicts have led to a complex and uncertain international environment. Global inflation remains high and world economic activity faces significant challenges. In this context, after the initial negative effects of the pandemic, the Mexican economy has shown resilience and has grown continuously. This performance has been supported by the country's sound macroeconomic framework that has been built over many years, anchored on fiscal discipline and price stability, as well as a healthy financial system, a well-capitalized banking sector, sustainable external accounts, and a flexible exchange rate. Going forward, maintaining and strengthening all these pillars will enable the country to face the challenges ahead. In this regard, Banco de México's Governing Board will continue setting its monetary policy stance with the strong commitment to foster an orderly adjustment of relative prices, of financial markets and the economy as a whole, in order to lead inflation to its 3% target and ensure the anchoring of inflation expectations.

While it is expected that, despite adverse external conditions, the Mexican economy will continue expanding, given the resilience it has shown, the ongoing process of reconfiguring global value chains and the anticipated fiscal stance, Mexico must continue moving forward by taking actions that will allow it to achieve a sustainable long-term growth. As emphasized in previous Reports, in order to promote greater economic development, it is necessary to continue strengthening the rule of law and to continue fighting insecurity and corruption. In addition, an environment conducive to investment and productive activity must be fostered, as well as adopting measures to promote a better allocation of resources. In this way, Mexico will be able to lay the foundations to strengthen its domestic market and fully benefit from the opportunities associated with its trade openness. This will generate more and better jobs and will allow the country to have more resources to address the population's economic lags and needs to the benefit of all Mexicans' wellbeing.

November 29th, 2023

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