BANCO DE MÉXICO

Executive Summary

Quarterly Report October – December 2018

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Summary

Since the last part of 2014, the Mexican economy has faced a sequence of negative shocks, which have implied a tighter external financing constraint. Among these shocks, one that stands out is the fall in international oil prices since the second half of 2014, which, along with the significant contraction in the oil production platform, led to a shift in the oil trade balance from a surplus to a deficit in 2015. In addition, the Mexican economy started to be negatively affected by the uncertainty over the future of the trade relationship with the United States and Canada, as well as by the effects of the Federal Reserve's monetary policy normalization process on international financing conditions. The adjustment of the Mexican economy to this environment required a reduction in the current account deficit, in order for such deficit to be consistent with the lower availability of external financial resources. Such adjustment was complex because, in addition to the lower external resources, the required adjustment increased due to the significant deterioration of the oil trade balance. This called for a major adjustment in the non-oil trade balance. A considerable depreciation of the real exchange rate was necessary to accomplish the latter.

In this process, an orderly adjustment of the economy was necessary, facilitating a significant change in relative prices without generating second-round effects on the economy's price formation process. In other words, avoiding inflation expectations from being affected. In addition, measures had to be taken to offset the reduction in external financial resources with an increase in financing from domestic sources, and a reduction in the absorption of financial resources by the public sector. These measures were aimed at mitigating the effects of a lower availability of external financial resources on private sector financing. In this context, the macroeconomic policy response consisted of an improvement of public finances' stance and an adjustment of the monetary policy stance. The latter has sought to address inflationary pressures and the deterioration of the balance of risks to inflation under the described environment, contributing to the anchoring of medium- and long-term inflation expectations. Furthermore, it has also induced an intertemporal reallocation of economic agents' expenditure, encouraging savings, especially in long-term instruments. Thus, monetary policy has contributed to mitigate the effects of a greater constraint on external financing and to foster an orderly adjustment of the economy.

More recently, during 2018, an environment of high uncertainty associated with both global factors and others more directly related to the Mexican economy persisted and led to a further tightening of the external financing constraint. Among the external factors were trade tensions at a global level, the monetary policy normalization process in the United States, as well as several political and geopolitical risks. As for factors that have a more direct incidence on the Mexican economy, during the first half of 2018, the uncertainty associated with the electoral process stood out. Similarly, during such period the uncertainty about the future of Mexico's trade relationship with the United States and Canada persisted, but diminished during the fourth quarter of 2018 as a result of the announcement of a new trade agreement in North America. Nevertheless, in this last quarter, the uncertainty associated with some policies of the new administration was added to the persistence of the aforementioned global factors. In this context, during a large part of the fourth quarter, Mexican financial markets registered high volatility, an exchange rate depreciation, as well as an increase in long-term interest rates and in risk premiums in general. Two rating agencies even lowered their outlook on Mexico's sovereign debt from stable to negative. Nevertheless, towards the end of the year, the performance of domestic financial markets, including the foreign exchange market, improved. Among the factors contributing to the latter were external events such as the reduction of interest rates in the United States and the weakening of the US dollar, as well as domestic factors such as the 2019 Economic Package approved by Congress, which projects a primary surplus of 1% of GDP, and the investors' consent to the buyback offer of the New Mexico City International Airport's bonds. Thus, over the last weeks the prices of financial assets in Mexico exhibited a better performance. The Mexican peso appreciated and its volatility decreased, while sovereign risk premia and the medium- and long-term interest rates diminished, partly reverting the increases exhibited in the last months of 2018, although they still remain at relatively high levels.

However, the rating agency Fitch announced the downgrade of Pemex's credit rating, which will imply greater financing costs for this company going forward and warns about the challenges it faces, highlighting its importance for the country's economy and, particularly, for public finances. In this regard, it is worth noting that actions in support of Pemex's financial situation have been announced.

Delving deeper on the external environment, available indicators suggest that during the fourth quarter of 2018 the world economy showed a sharper deceleration than anticipated, with a lower dynamism exhibited by most of the major advanced economies and some emerging economies, standing out the cases of the Euro area, China, and, to a lesser extent, the United States. Indicators of manufacturing activity, international trade and business confidence confirm the outlook of a deeper-than-expected weakening of the world economy. Additionally, the outlook for world economic growth for 2019 and 2020 was revised downwards and significant risks persist, such as the uncertainty on the trade tensions between the United States and China, a disorderly Brexit process, a lower-than-expected growth of the Chinese economy, and an escalation of political and geopolitical tensions in different regions.

In this sense, the box *Escalation of Trade Tensions and its Potential Effects on the Global Economy* estimates the possible effects of the imposition of diverse tariff measures for different countries, considering the complex network of productive links among countries and sectors.

The effect of the tariff measures implemented so far on real income is estimated to be limited, although negative for all the countries studied. Nonetheless, an escalation of trade-restrictive measures, such as those being considered by some countries, raises the negative effects for the global economy significantly, in particular for the United States and China.

Although for Mexico the effect on both economic activity and on the general price level is estimated to be moderate, additional risks stemming from the intensification of trade conflicts persist, as gains in productivity that have been achieved through the country's integration to Global Value Chains may be affected.

Thus, in a context of lower economic dynamism and lower oil prices, inflationary pressures eased in most economies, leading to the expectation of a slower-than-anticipated normalization process of monetary policy of major central banks. In particular, the United States Federal Reserve modified its message significantly, stating that it will be patient in making future adjustments to the target rate. This contributed to the fact that, although during most of the period covered by the present Report financial markets operated in an environment of high risk aversion and volatility, financial markets in both advanced and emerging economies have shown a more favorable performance since the end of 2018, albeit still exhibiting low levels of risk appetite.

With regard to the latter, the box *The United States Federal Reserve Monetary Policy and Evolution of International Financial Markets* describes how, over the period, changes in the expected evolution of the Federal Reserve's monetary policy stance were reflected in international financial markets. Thus, the recent message of the Federal Reserve suggesting patience regarding future increases in its reference rate has been reflected so far in less tight global financial conditions. However, additional episodes of financial volatility caused by surprises in the evolution of the economy that lead to an adjustment in the Fed's monetary policy stance cannot be ruled out.

Regarding the domestic environment, in the last quarter of 2018 there was a significant deceleration of economic activity with respect to the previous quarter, which might extend to the early part of 2019. The latter in response to the slowdown of the world economy, as well as to some weakness in domestic demand and some factors of a transitory nature. In particular, during the period of this Report, exports and, to a lesser extent, consumption, displayed a lower dynamism, while investment's negative trend accentuated. In this context, slack conditions in the economy are estimated to have eased with respect to the previous quarter. In particular, output gap estimates exhibited lower levels than those of the previous quarter.

With regards to the most recent developments of annual headline inflation, this indicator decreased on average from 4.91 to 4.82% between the third and fourth quarters of 2018, and then fell to 3.89% in the

first two weeks of February 2019. This decline was mainly due to a reduction in annual non-core inflation, as core inflation continued to exhibit a resistance to decline. In particular, between the aforementioned quarters, annual non-core inflation decreased on average from 8.78 to 8.32%, reaching a level of 5.15% in the first two weeks of February, due in large part to the lower annual growth rate of energy prices. In contrast, annual average core inflation was 3.64 and 3.68%, respectively, in the above mentioned quarters, reaching 3.51% in the first two weeks of February. The behavior of annual core inflation results from the magnitude and simultaneous nature of the aforementioned shocks, from which those standing out are the indirect effect of the price increases that several energy products had shown, as well as the behavior during most of 2018 of the exchange rate and real wages and the relatively tight slack conditions in the economy. Core inflation has also been affected indirectly by price increases that since the fourth quarter of 2018 were registered in some agricultural products, although these shocks have tended to revert in early February. In this context, the type of shocks that have affected core inflation, together with the relatively high levels it still exhibits, might be contributing to the greater persistence and difficulty that this subindex has shown to converge to a 3% level.

The box *Analysis of Core Inflation Persistence* argues that annual core inflation has been subject to a great number of simultaneous shocks of considerable magnitude, both domestic and external, which took place in a context of relatively tight cyclical conditions of the economy, which caused it to increase significantly. According to the analysis, when this type of shocks leads to a higher level of annual core inflation, it also seems to generate a greater persistence, which in turn leads this index to exhibit greater resistance to decline, despite such shocks gradually fading away.

In early 2019, some states of Mexico registered fuel distribution problems, after the strategic closing of pipelines, as part of the government's efforts to fight fuel theft. The box *Effects of Fuel Distribution Problems on Inflation* estimates the direct effects of the increase in gasoline prices on inflation in the affected states, as well as the indirect effects on the prices of other goods and services caused by the shortage of gasoline. The evidence shows that the impact on headline inflation was limited, which is consistent with the opinions of business executives interviewed by Banco de México, although they noted that it did have a negative effect on economic activity in some entities of the Central and Northern regions of Mexico.

As for Banco de México's monetary policy decisions, in its October meeting the Governing Board decided to leave the target for the overnight interbank interest rate unchanged at 7.75%. Nevertheless, the Board expressed concerns about the risk that the shocks that had affected non-core inflation could affect the evolution of core inflation. Subsequently, in its November and December meetings, the Governing Board decided to raise the target for the overnight interbank interest rate by 25 basis points in each occasion, taking it to a level of 8.25%. Such decisions took into consideration that the balance of risks to inflation still showed an upward bias, which had deteriorated in both the short and medium terms. In this regard, the expected trajectory for headline and core inflation released by Banco de México at the end of November presented higher levels than previously estimated in both indicators for 2019 as a whole, as well as a delay in the convergence to the 3% target. Finally, in its February meeting, Banco de México's Governing Board decided to leave the target for the overnight interbank interest rate unchanged at 8.25%, taking into account that the recent developments in inflation and its main determinants have not changed significantly with respect to their expected trajectory at the end of November, 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 macroeconomic scenario forecast is as follows:

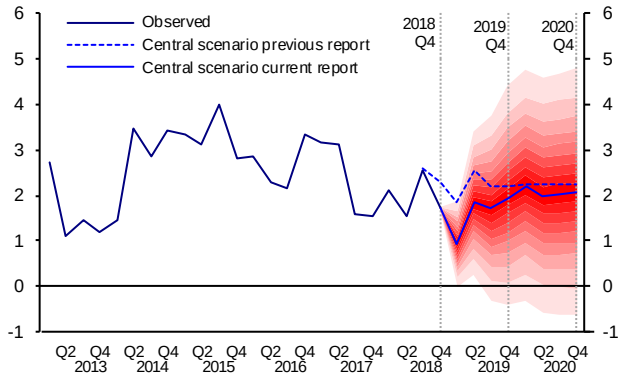
GDP growth: The economic activity outlook for 2019 in Mexico has been revised from an expected growth between 1.7 and 2.7% in the previous Report to an interval of 1.1 and 2.1% (Charts 1 and 2). For 2020, the interval has been adjusted from between 2.0 and 3.0%, to between 1.7 and 2.7%. These forecasts consider that a solid macroeconomic framework and

sustainable public finances will remain in place. The adjustment for 2019 reflects several considerations. Regarding the external environment, a greater-than-expected loss in the dynamism of international trade and global economic activity has been observed, which is expected to affect the behavior of Mexico's external demand.[1] Regarding the domestic environment, in the second half of 2018, and especially towards the end of the year, economic activity decelerated more markedly than was forecasted in the previous Report.[2] The latter led to a lower GDP level for the end of 2018, which implies a lower initial point for growth in 2019. The increased weakness of several indicators of internal demand towards the end of 2018 suggests that the deceleration could extend into the early part of 2019. In addition, there is the anticipation that productive activity at the beginning of the year might have been affected by temporary factors such as fuel shortages in certain regions of the country in January, the railway blocking in Michoacán, and the labor conflicts in Matamoros. Moreover, taking into account the negative trend that the oil production platform maintained towards the end of 2018 and early 2019, its expected trajectory for the forecast horizon has been revised downwards. Finally, the weakness in investment is still expected to persist, given that risk premiums remain at relatively high levels, although they have shown some reversion recently.

It is worth noting that at the beginning of a new administration there is usually a lag in public spending, which could affect economic growth. Additionally, there are different elements of public policy that have uncertain effects on the economy. This could contribute to a lower dynamism of economic activity in the early part of this year. Thus, significant uncertainty prevails regarding this outlook and it is deemed that the Mexican economy will continue facing a complex environment in which different external and domestic risk factors prevail in the forecast horizon.

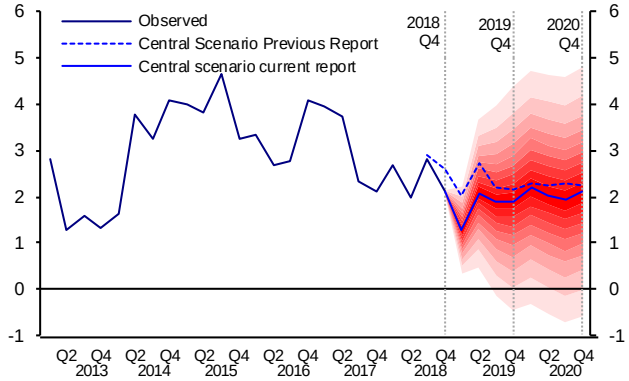
In regards to the economy's cyclical position, slack conditions are anticipated to show a higher degree of easing throughout the forecast horizon as compared what was expected in the previous Report (Charts 3, 4 and 5).

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: GDP Growth Excluding the Oil Sector, s. a.
Annual percent



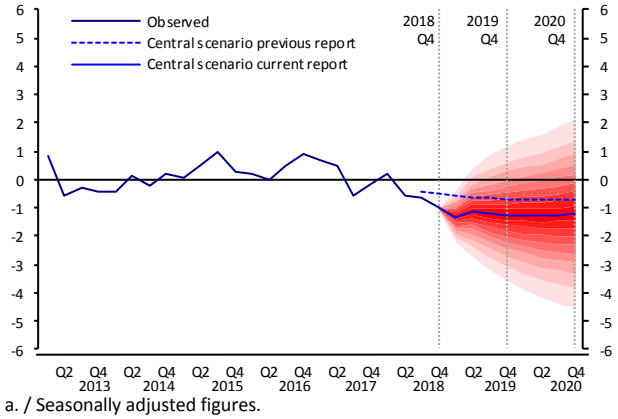
s. a. / Seasonally adjusted figures.
Source: INEGI and Banco de México.

Employment: In line with the adjustment in the growth outlook, the 2019 forecast for the increase in the number of IMSS-insured workers has been revised, from an interval of 670 and 770 thousand jobs in the previous Report, to one between 620 and 720 thousand jobs. For 2020, the interval is adjusted from one between 690 and 790 thousand jobs in the previous Report to one between 650 and 750 thousand jobs.

[1] In addition, analysts surveyed in the Blue Chip report of February 2019 expect that industrial production in the United States increase 2.8 and 1.7% in 2019 and 2020, respectively. These numbers compare with those reported in the previous report of 2.7 and 1.8%.

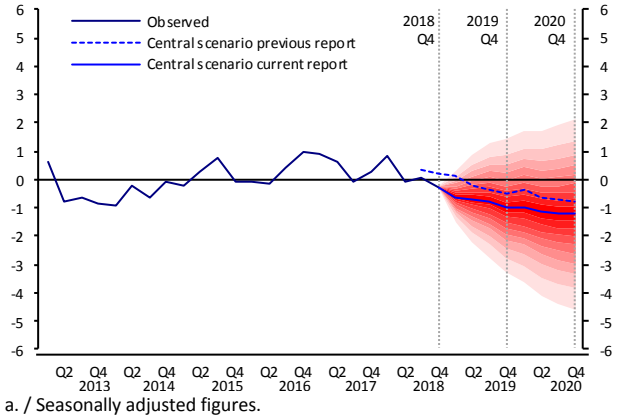
[2] In particular, with the information available for the previous Report, the 2018 third quarter seasonally-adjusted quarterly growth rate was 0.83% and the expected growth rate for the fourth quarter was 0.55%. In contrast, with the information published by INEGI on February 25th, the growth rate for the third quarter of 2018 was revised to 0.61% and the fourth quarter growth rate was reported to have been 0.25%.

Chart 3
Fan Chart: Output Gap Estimate, s. a.
Percentage of potential output



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

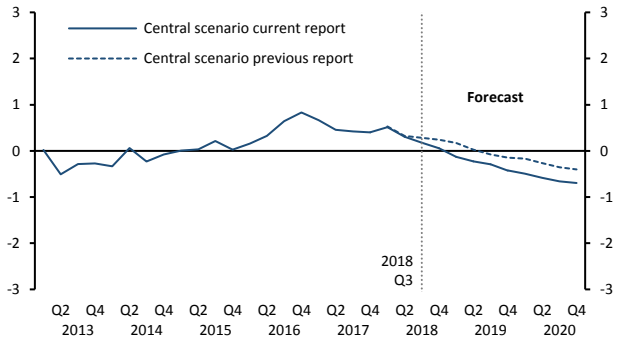
Chart 4
Fan Chart: Output Gap Estimate excluding the Oil Sector, s. a.
Percentage of potential output



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

Current account: For 2019, the deficits of the trade balance and the current account are expected to amount to US$ 11.8 and 25.2 billion , respectively (0.9 and 2.0% of GDP, in the same order), which compare to the previous Report projections of US$ 14.1 and 28.8 billion, respectively (1.1 and 2.3% of GDP, in the same order). For 2020, the trade balance and current account deficits are expected to amount to 14.0 and 28.0 billion US dollars, respectively (1.0 and 2.0% of GDP, in the same order), lower figures than the previous Report projections of US$ 15.1 and 31.5 billion, respectively (1.1 and 2.3% of GDP, in the same order).

Chart 5
Quarterly Slack Indicator



Notes:
i) The estimated performance of this indicator is consistent with the forecasts for GDP growth excluding the oil sector.
ii) It is not feasible to calculate a fan chart for the quarterly slack index due to the procedure with which its forecast was estimated.
Source: Banco de México.

Balance of risks for growth: Despite the revisions to the growth outlook, persisting risk factors imply that the balance of risks for economic activity continues to be biased to the downside. Among the downward risks in the forecast horizon, those standing out are:

i. That the current environment of uncertainty that has been affecting investment persists or deteriorates and that, as a consequence, firms postpone or cancel their investment plans, or consumers cut down on spending as a precautionary measure.

ii. That the process of ratification and implementation of the trade agreement reached with the United States and Canada is delayed, causing greater uncertainty and thus affecting investment.

iii. Despite the observed progress in different trade negotiations, the risk that an escalation in trade tensions, or the adoption of greater protectionist measures worldwide, affect growth, investment and trade at a global level, as well as international financial markets, to the detriment of economic activity in Mexico, persists.

iv. That episodes of volatility in international financial markets are observed, derived from, among other factors, greater trade tensions worldwide, unexpected increases in the reference rates of major central banks or a disorderly adjustment in their balance sheets, a lower risk appetite, a

contagion from other emerging economies, or geopolitical events that might reduce the sources of financing.

v. That the world economy and global trade decelerate more than expected.

vi. That a deterioration in the credit rating of Mexico or of State-owned productive companies is observed and, particularly, that there is a generalized downward revision by rating agencies of Pemex debt rating, thus complicating the financial situation of the company.

vii. That the effect on economic activity of events such as the fuel shortages, the railroad blockings in Michoacán, or the labor conflicts in Tamaulipas turn out to be greater than anticipated, or that new episodes of this nature occur.

Among the upward risks to growth in the forecast horizon, those standing out are:

i. That the announcements related to the trade agreements reached with the U.S. and Canada lead to a noticeable investment recovery.

ii. That a greater-than-expected dynamism of industrial production in the United States favors the performance of Mexican manufacturing exports.

iii. That a greater-than-expected dynamism of aggregate demand is observed, stemming from higher consumption spending, or that some productive sectors face better conditions to increase their investments.

Inflation: Considering the monetary policy stance and the horizon at which it operates, as well as the available information on inflation determinants, including the current economic environment and the phase of the business cycle, forecasts for annual headline inflation are similar to those released in late November in the previous Report, and continue to anticipate that annual headline inflation will reach levels around Banco de México's target in the first half of 2020. The most significant revision concerns the first quarter of 2019, as a result of a more favorable trajectory than anticipated of agricultural product prices in January and in the first half of February. Regarding core inflation, it is expected that it follows a path similar to the one presented in the previous Report, given that, despite the relatively less tight slack conditions in the forecast horizon, a more favorable evolution of the exchange rate and downward pressures from the fiscal incentives implemented at the Northern border, forecasts reflect core inflation's resilience to decline and the additional challenges involving the possible effects of the significant adjustment to the minimum wage. Core inflation is thus anticipated to lie at levels around 3% from the first semester of 2020 (Table 1, Chart 6 and 7).

Table 1
Headline and Core Inflation Forecasts
Annual change in percent

	2019					2020			
	IV	I*	II	III	IV	I	II	III	IV
CPI									
Current report	4.8	4.1	4.3	3.8	3.4	3.5	3.1	2.8	2.7
Previous report	4.7	4.4	4.4	3.8	3.4	3.3	3.1	3.0	
Core									
Current report	3.7	3.5	3.6	3.4	3.2	3.2	2.9	2.8	2.7
Previous report	3.7	3.6	3.6	3.4	3.1	3.0	2.9	2.7	

*/ Forecast as from February 2019.
Source: Banco de México and INEGI.

This forecast does not consider events that may affect the base for the economy's price formation process. It is worth noting, nonetheless, that the current environment involves medium- and long-term risks that could affect it.

The aforementioned forecasts are subject to risks in the horizon at which monetary policy operates, from which those standing out are:

To the upside:

i. That the exchange rate comes under pressure stemming from external or domestic factors.

ii. That new pressures on energy prices or on agricultural product prices arise.

iii. That an escalation of protectionist and compensatory measures takes place worldwide.

iv. That public finances deteriorate.

v. Considering the magnitude of the recent minimum wage increases, in addition to their possible direct impact, there is also the risk that said increases bring about wage revisions that exceed productivity gains and give rise to cost pressures, affecting formal employment and prices.

vi. The persistence shown by core inflation could give rise to a greater resistance of long-term inflation expectations to decline.

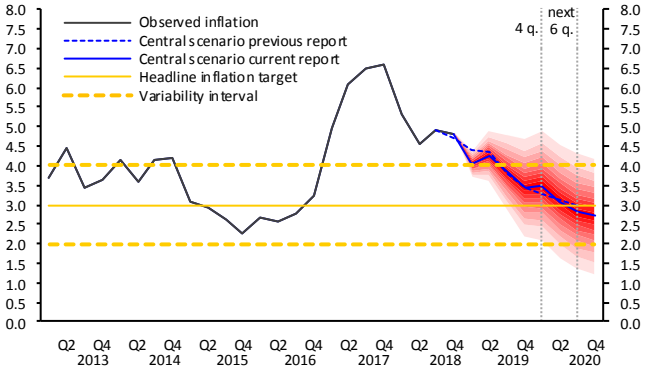
To the downside:

i. That lower price fluctuations in some of the goods included in the non-core subindex are observed.

ii. That slack conditions widen more than expected.

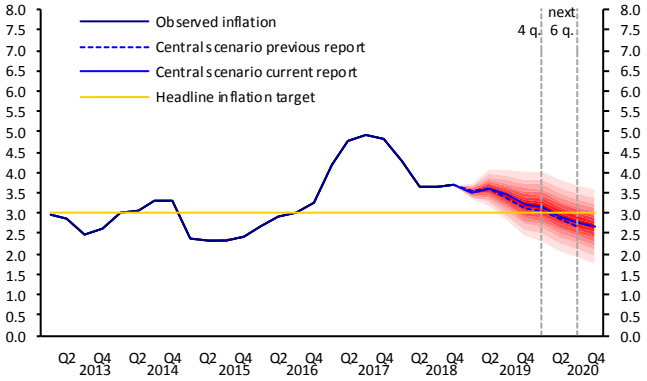
Taking into account all of the above, it is considered that the balance of risks for the forecasted path of inflation remains upward biased in an environment of high uncertainty.

Chart 6
Fan Chart: Annual Headline Inflation 1/
Percent



1/ Quarterly average of annual headline inflation. The next four and six quarters are indicated, using as a reference the first quarter of 2019, that is, the first and third quarters of 2020, respectively, time frames in which the monetary policy transmission channels fully operate.
Source: Banco de México and INEGI.

Chart 7
Fan Chart: Annual Core Inflation 1/
Percent



1/ Quarterly average of annual core inflation. The next four and six quarters are indicated, using as a reference the first quarter of 2019; that is, the first and third quarters of 2020, respectively, time frames in which the monetary policy transmission channels fully operate.
Source: Banco de México and INEGI.

To guide its monetary policy actions, Banco de México's Governing Board follows closely the development of inflation with respect to its forecasted trajectory, taking into consideration the adopted monetary policy stance and the horizon at which monetary policy operates, as well as available information on inflation determinants and on medium- and long-term inflation expectations, including the balance of risks for such factors. At the same time, monetary policy must respond prudently if for diverse reasons the uncertainty faced by the economy increases considerably. In the presence and possible persistence of factors that, by their nature, involve risks to both inflation and its expectations, monetary policy will be adjusted in a timely and firm

manner in order to achieve the convergence of inflation to its 3% target, as well as to strengthen the anchoring of medium- and long-term inflation expectations so that they attain such target.

It is important to highlight that, as described in the box *Evolution of Medium- and Long-term Inflation Expectations*, given the shocks that have affected inflation in recent years, a de-anchoring of long-term inflation expectations has not been observed, although they have become more concentrated around 3.5%, a level above the 3% target. Likewise, long-term core inflation expectations have increased at the margin and have come close to the current levels of headline inflation expectations. Considering the above, Banco de México must continue assessing the evolution of inflation expectations in order to detect in a timely manner any pattern that might affect the convergence of inflation to its 3% target, and to lead these expectations to lie persistently around such target.

For Mexico to attain a more dynamic and sustainable growth that increases the welfare of the population, it is necessary to maintain a sound macroeconomic framework and to correct structural and institutional problems that have prevented the country from achieving higher levels of productivity and that have discouraged investment. Thus, efforts to structurally strengthen public finances must continue in order to ensure their long-term sustainability and allow public investment spending to increase. In order to induce both domestic and foreign private investment, the institutional system of incentives must be reviewed so that value creation is prioritized, the adoption of cutting-edge technologies is encouraged, trade and investment openness is maintained, and economic competition is fostered. In particular, the institutional framework must allow prices to properly reflect market conditions so that resources can be allocated to their most productive uses. This will increase productivity, while allowing consumers to acquire goods at lower prices. In addition, as stated in previous Reports, policies to confront public insecurity, corruption and impunity, and that guarantee legal certainty and respect for private property, must be adopted. Reducing the economic costs caused by insecurity and corruption, besides promoting greater economic activity, would lead to a decline in consumer prices of different goods and services. A clear agenda on the measures that could be implemented to move toward these goals will provide greater confidence and certainty, making Mexico a more attractive destination for investment. By improving the economy's efficiency and fostering the rule of law, the country will be in a position to address different challenges that may emerge and to provide a higher quality of life to its population.

In this sense, the box *Measures Recently Announced by Banco de México and the Ministry of Finance to Boost the Financial Sector* describes the measures aimed at fostering financial inclusion, promoting competition in credit provision, favoring financing to firms, deepening the stock market, and generating more efficient means of payments.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