BANCO DE MÉXICO

Executive Summary

Quarterly Report October – December 2019

Summary

Throughout 2019, and especially in the second semester, annual headline inflation decreased significantly, reaching levels in line with Banco de México's point target towards the end of the third quarter and in the fourth one. This was mainly due to the reduction of non-core inflation, since core inflation, which better reflects medium-term price pressures in the economy, persistently remained at levels above the central bank's target, although it displayed slight declines. In this context, Banco de México followed a prudent monetary policy, using all available information and with the objective of having a policy stance that would lead to an orderly and sustained convergence of inflation to its target within the forecast horizon, thus strengthening confidence in the Mexican economy and enabling an orderly adjustment of domestic financial markets and economic activity.

Monetary policy actions were taken in an environment of high uncertainty generated by external and domestic factors. Regarding the former, during 2019 the global economy slowed gradually due to the effects of protracted trade tensions, increased geopolitical risks, and idiosyncratic factors. There were even episodes of volatility in international financial markets and inflation pressures decreased worldwide. In this context, several central banks adopted monetary policy easing actions, which contributed to a greater risk appetite. These actions took place especially towards the end of 2019, when trade tensions eased globally and the probability of a disorderly withdrawal of the United Kingdom from the European Union decreased, which led to lower financial volatility. The current environment is thus characterized by economic weakness, particularly regarding international trade and investment, and by looser global financial conditions. Recently, new risks for global growth and financial market stability have emerged, generated by the coronavirus (Covid-19) outbreak in China, which has spread to other countries.

Domestically, Mexico's financial markets performed favorably throughout 2019. The Mexican peso exchange rate remained relatively stable during most of the year, albeit with certain bouts of volatility, while domestic interest rates decreased. Economic activity declined slightly during the year, reflecting the weakness of the different aggregate demand components, and, as a result, slack conditions widened more than expected. The weakness of domestic economic activity during 2019 reflected both the effects of the lesser dynamism of US industrial activity on exports, and several external and domestic elements of uncertainty that affected the performance of investment and consumption.

During the reported period, between the third and the fourth quarter of 2019, average annual headline inflation decreased from 3.31% to 2.94%. In December, it even reached 2.83%, its lowest level since August 2016 and the second lowest record for a year-end since Mexico's Consumer Price Index (INPC, for its acronym in Spanish) was first published in 1969. In early 2020, however, annual headline inflation rebounded, reaching 3.52% in the first fortnight of February. These developments largely reflect the behavior of annual non-core inflation, which decreased from an already particularly low level of 1.87% in the third quarter to 0.86% in the fourth one, the lowest level on record for a quarter. This, in turn, was associated with lower annual growth rates of agricultural and livestock and energy product prices. At the beginning of 2020, annual non-core inflation increased, registering 3.03% in the first half of February, as a result of higher annual rates of change in fruit and vegetables prices, as well as of an upward effect resulting from the base of comparison in gasoline prices, which decreased in early 2019 as a result of the VAT reduction in the Northern border area. In turn, annual core inflation continues to show resistance to decline. It registered an average of 3.78% in the third quarter and 3.64% in the fourth one. In the first half of February 2020, it reached 3.69%, influenced upwards by the increase in the excise tax on cigarettes and sugary beverages (IEPS, for its acronym in Spanish).

The box *Inflation Indicators More Related to Supply Factors* computes price subindexes of goods and services belonging to core inflation that respond more closely to supply factors, namely changes in: i) energy prices; ii) the exchange rate, and iii) wages. In order to identify which goods and services belong in each subindex, Phillips curves are estimated for all items in core inflation. The behavior of the computed subindexes suggests that some supply shocks could be offsetting the effect of economic slack on core inflation.

Regarding monetary policy decisions, in each of the meetings in August, September, November, and December 2019 and February 2020, Banco de México lowered the target for the overnight interbank interest rate by 25 basis points, reaching a level of 7.0%. In its decisions, the Governing Board highlighted the levels displayed by headline inflation, its outlook within the horizon in which monetary policy operates, the greater amount of economic slack, and the behavior of external and domestic yield curves.

During the period covered by this report, the international financial environment was characterized by a significantly lower uncertainty associated with: i) trade tensions between China and the United States in view of the US-China Phase 1 agreement; ii) the approval by the United States of the new US-Mexico-Canada Agreement (USMCA); and iii) the approval of the agreement for the withdrawal of United Kingdom from the European Union. The above, along with accommodative monetary policy stances in the main advanced economies and the stabilization of certain leading indicators of world economic activity, led to looser financial conditions that increased investors' risk appetite. Nevertheless, recently, the coronavirus (Covid-19) outbreak in China and its contagion to other countries has created volatility in financial markets and might be a factor that affects global activity more than initially expected. In this context, world economic growth continued to slow down, reflecting the effects of the uncertain environment regarding trade and geopolitical tensions and several idiosyncratic factors in some major economies, which affected trade, manufactures and, particularly, investment. While headline inflation rebounded slightly in most advanced economies due to the increase in energy prices in the last part of 2019, it remained below the targets of their respective central banks, whereas core inflation remained at lower levels. In this environment, growth expectations for the global economy point to a slight recovery in 2020. Nonetheless, the balance of risks for economic activity in the short, and, especially, in the medium term, remains biased to the downside in view of possible new episodes of global trade tensions, a worsening of geopolitical and social conflicts in several world regions, higher economic costs stemming from natural disasters associated with environmental factors, and a weakening of world economic activity due to the effects of the coronavirus outbreak.

Growth in advanced economies has been slowing down in recent years despite the accommodative monetary policy stances of their central banks and loose international financial conditions. The box *Investment and Uncertainty in Advanced Economies* analyzes the effect that greater uncertainty in economic policy has had on the behavior of private non-residential investment, using two methodological approaches for this purpose: a panel data model and a non-linear VAR model. The results from both models suggest that investment in advanced economies in recent years has been significantly affected by the higher uncertainty, which has even offset the positive influence that accommodative monetary policies have had on investment.

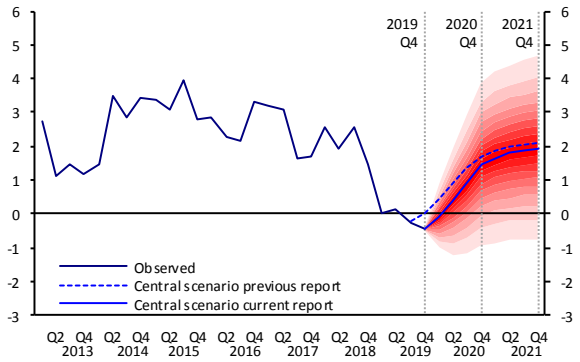
As for the domestic environment, the moderate downward trend that Mexico's economic activity has been on for several quarters persisted during the fourth quarter of 2019. Thus, in 2019 as a whole the economy contracted slightly. In particular, investment is expected to have continued trending downwards and private consumption to have lost dynamism vis-à-vis the rebound observed at the end of the third quarter. As for manufacturing exports, they exhibited a downward change in trend. In this context, slack conditions are estimated to have continued to widen.

Banco de México's expected macroeconomic scenario is the following:

GDP growth: The outlook for Mexico's economic growth for 2020 is revised from an interval of 0.8-1.8% to one of 0.5-1.5%. For 2021, GDP growth is expected to be in an interval of 1.1-2.1%, which compares to the interval of 1.3-2.3% published in the previous Quarterly Report (Charts 1 and 2).[1] The revision for 2020 responds, in part, to a lower-than-previously-expected growth base, due, in turn, to the slight decline in economic activity reported during the fourth quarter of 2019. This outlook anticipates a more gradual recovery of domestic demand throughout the forecast horizon, in a context in which the global economy continues showing weakness and US industrial production expectations have been revised downwards once again.[2] There is a high degree of uncertainty regarding this outlook, as the Mexican economy is expected to continue facing a complex environment throughout the forecast horizon. The uncertainty regarding the possible effects of the coronavirus outbreak on world economic activity and, especially, on global value chains stands out.

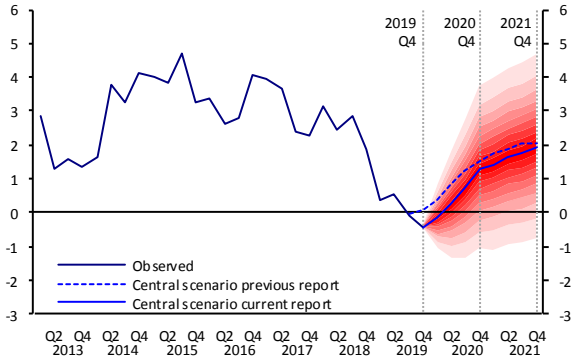
Regarding the economy's cyclical position, slack conditions are again expected to remain loose throughout the forecast horizon (Charts 3, 4, and 5).

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



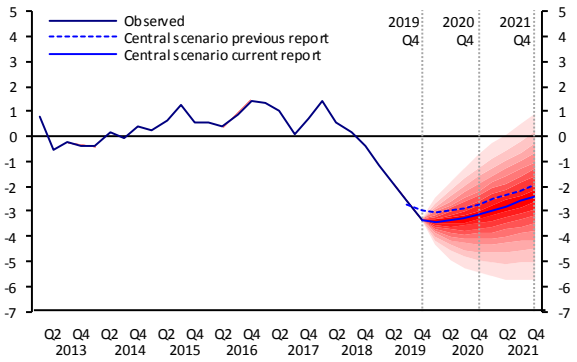
s. a. / Seasonally adjusted figures.
Source: INEGI and Banco de México.

Chart 2
Fan Chart: GDP Growth Excluding Oil Sector, s. a.
Annual percent



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

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

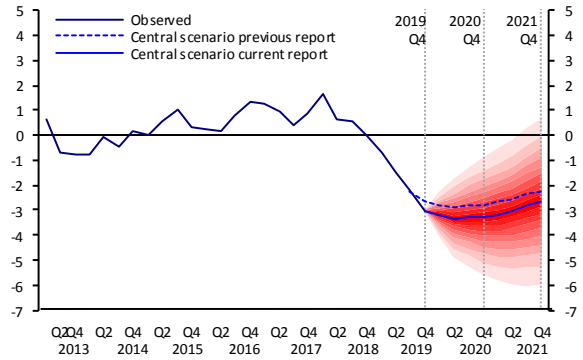


s. a. / Seasonally adjusted figures.
Source: Banco de México.

[1] Since 2020 is a leap year, it will have one additional day, as compared to 2019. As a result, annual GDP growth rate estimated with original data will be higher than that estimated with seasonally adjusted data, as the latter controls for said effect. Likewise, 2021 will have one day less than 2020, as a result of which the annual GDP growth rate estimated with original data will be lower than that estimated with seasonally adjusted data. As a reference, in 2016 and 2017 the difference between both growth rates was close to three tenths of a percentage point.

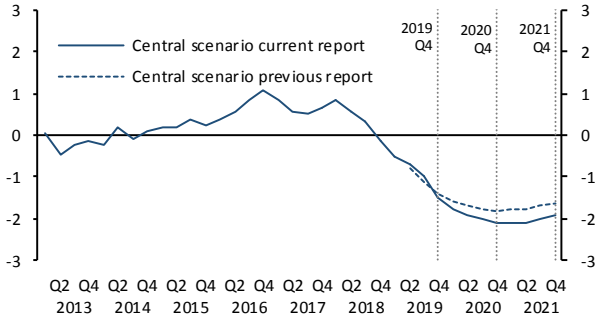
[2] According to analysts surveyed by Blue Chip in February 2020, US industrial production is expected to grow 0.4 and 1.5% in 2020 and 2021, respectively, figures that compare to 0.7 and 1.5% published in the previous Report.

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



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

Chart 5
Quarterly Slack Indicator



Notes: i) In the base scenario of the present Report, the forecast begins in Q4 2019. In the case of the central scenario of the previous Report it started in Q3 2019. ii) The estimated performance of this indicator is consistent with the forecast for GDP growth excluding the oil sector. iii) 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.

Employment: The forecast for the number of new IMSS-insured jobs for 2020 is adjusted from a range of 500-600 thousand jobs in the previous Quarterly Report to one of 440-540 thousand jobs. For 2021, a range of 470-570 thousand jobs is expected, which compares to that of 510-610 thousand jobs of the previous Quarterly Report.

Current account: For 2020, trade and current account deficits of 5.9 and 11.6 billion US dollars are expected, respectively (0.4 and 0.9% of GDP, in the same order), forecasts which are below those presented in the previous Quarterly Report of 10.9 and 18.1 billion US dollars, respectively (0.8 and 1.4% of GDP, in the same order). In turn, for 2021, trade and current account deficits of 13.5 and 20.6 billion US dollars are anticipated, respectively (1.0 and 1.5% of GDP, in the same order), as compared to the forecasts of 15.6 and 23.7 billion US dollars, respectively (1.1 and 1.7% of GDP, in the same order).

Balance of risks to growth: In an environment of marked uncertainty, the persistent external and domestic risk factors cause the balance of risks for economic activity in Mexico to remain biased to the downside. Among the downward risks in the forecast horizon, the following stand out:

i. An escalation of trade tensions that may affect global growth, investment and trade, and international financial markets, to the detriment of economic activity in Mexico. Although in the short term this risk has subsided, due to the USMCA ratification by the United States and the Phase 1 trade agreement reached between the United States and China, a certain degree of uncertainty prevails regarding the date on which the USMCA will enter into force, while, in a context of presidential elections in the United States, differences between this country and its main trade partners persist.

ii. That a greater-than-expected slowdown of world economic activity and global trade is observed due to the effects of the coronavirus outbreak in China, or once the fiscal stimuli currently implemented in the United States expire, or as a result of a lower-than-expected US industrial production.

iii. That episodes of volatility in international financial markets occur as a result of: a) a lower risk appetite, possibly associated with geopolitical events, the effects of the coronavirus outbreak worldwide, or a new escalation of trade tensions at the global level; b) a possible contagion from other emerging economies, particularly in light of an environment of political and social uncertainty in several countries.

iv. That the recovery of economic activity is delayed as a result of a greater and more persistent weakness of aggregate demand components than anticipated. In particular, that the environment of domestic uncertainty, that has been affecting investment, persists, and that this causes firms to postpone their investment plans or consumers to

cut down on their spending as a precautionary measure.

v. That the sovereign credit rating or that of Pemex deteriorate further, which could affect access to financial markets.

vi. That public spending is lower than expected.

Among the upward risks to growth in the forecast horizon are:

i. That the final stage of the USMCA ratification and its implementation enable levels of investment that are higher than expected.

ii. A greater-than-expected dynamism of industrial production in the U.S. that would contribute to higher Mexican manufacturing exports.

iii. That a greater-than-foreseen dynamism of aggregate demand is observed, due to growth of consumer spending, or due to some productive sectors face better conditions to increase their investments in case certain risk factors, both global as domestic, decrease.

The Mexican economy has faced high uncertainty in recent years. The box *Impact of Uncertainty on Consumption and Investment in Mexico* introduces a Macroeconomic Uncertainty Index for Mexico that associates greater uncertainty with an increase in the difficulty to predict the future behavior of the economy and uses it to show that high uncertainty has contributed significantly to the loss of dynamism of consumption and, especially, of investment.

Inflation: With respect to the previous Quarterly Report, annual headline inflation forecasts are revised slightly upwards starting from the second quarter of 2020. This adjustment is due to the upward revision in non-core inflation due to higher-than-previously-expected changes in the prices of agricultural and livestock goods, an effect partially offset by expectations of lower energy price increases with respect to the previous Quarterly Report, associated to lower international references; as well as by the estimated effect of the minimum wage increase in January 2020 on the rest of wage revisions and on the price formation process, partly offset by expectations of a greater economic slack. Thus, annual headline inflation is expected to remain at levels lower than 3.4% in the forecast horizon and to lie at 3% in the first quarter of 2021. Likewise, the trajectory of annual core inflation is adjusted slightly upward, although it maintains a downward trend and is expected to lie at 3% in the fourth quarter of 2020 (Table 1, Charts 6 and 7).

Table 1

Headline and Core Inflation Forecasts

Annual change in percent

	2019		2020				2021			
	III	IV	I	II	III	IV	I	II	III	IV
CPI										
Current report[1/]	3.3	2.9	3.3	3.3	3.4	3.2	3.0	3.0	3.1	3.0
Previous report[2/]	3.3	3.0	3.5	3.1	3.1	3.0	2.8	2.9	2.9	
Core										
Current report[1/]	3.8	3.6	3.6	3.3	3.2	3.0	2.9	2.9	2.9	2.9
Previous report[2/]	3.8	3.6	3.6	3.2	3.1	2.9	2.8	2.9	2.9	

[1/] Forecast from February 2020.

[2/] Forecast from November 2019.

Source: Banco de México and INEGI.

In the horizon in which monetary policy operates, inflation forecasts are subject to the following risks:

To the upside:

i. Core inflation's resistance to decline.

ii. That the minimum wage increase leads to wage revisions above productivity gains in different segments of the employed population, thus generating cost-related pressures and affecting formal employment and prices.

iii. That the peso exchange rate is under pressure due to external factors —such as a reduction in risk appetite in international financial markets or the electoral process in the United States— or by domestic ones.

iv. Increases in agricultural and livestock prices greater than expected.

v. That public finances deteriorate.

To the downside:

i. That the international prices of energy goods decrease further given the possibility of a global decelerating environment, partly influenced by the coronavirus outbreak.

ii. A widening of slack conditions or their impact on core inflation being greater than foreseen.

iii. That the peso exchange rate appreciates in a greater magnitude.

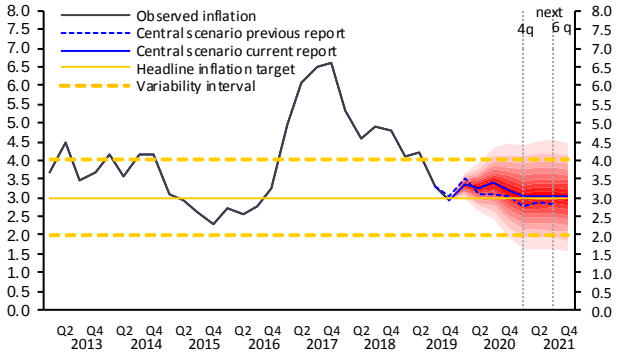
In this context, uncertainty persists regarding the balance of risks for the referred trajectory of inflation.

The box *Considerations on the Effect of the 2019 Minimum Wage Increase on Prices* presents an estimate of the effect of the January 2019 minimum wage increase and the reduction in the VAT rate in the Northern Border Free Zone (ZLFN, for its acronym in Spanish) on inflation. The econometric results indicate that the minimum wage increase had a statistically significant impact on inflation in both the ZLFN and the country as a whole, which were partially offset by the VAT reduction in the ZLFN.

Chart 6

Fan Chart: Annual Headline Inflation[1/]

Percent

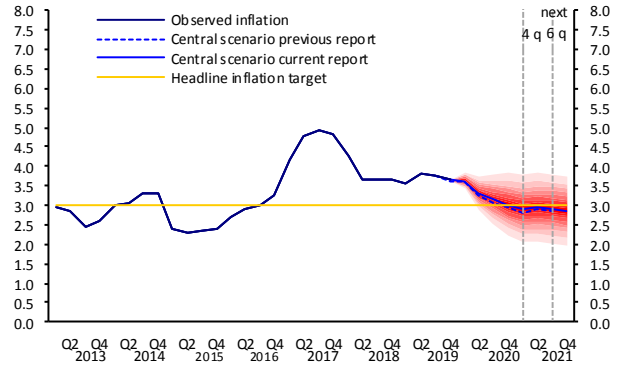


1/ Quarterly average of annual headline inflation. The next four and six quarters are indicated, using as a reference the first quarter of 2020, that is, the first and the third quarters of 2021, respectively, time frames in which the monetary policy transmission channels fully operate.
Source: Banco 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 2020 that is, the first and the third quarters of 2020 and 2021, 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 closely monitors the development of inflation vis-à-vis its forecast trajectory, considering the adopted monetary policy stance and the time frame in which it operates. In this process, it considers available information on all inflation determinants as well as medium- and long-term inflation expectations, including the balance of risks for such factors. Monetary policy must respond prudently if, for any reason, the uncertainty faced by the economy increases significantly. By doing so, an orderly convergence of inflation to its target is fostered along with the anchoring of medium- and

long-term inflation expectations at levels consistent with such target. With these actions, Banco de México seeks to attain its constitutional mandate of ensuring the stability of the national currency's purchasing power.

In order to consolidate a low and stable inflation, in an environment in which price formation and slack conditions in the economy are subject to risks, the Governing Board will continue to follow closely all factors and elements of uncertainty that have an impact on inflation and its outlook, and will take the necessary actions, based on incoming information, so that the policy rate is consistent with the orderly and sustained convergence of headline inflation to Banco de México's target, within the horizon in which monetary policy operates. In the presence and possible persistence of factors that, by their nature, involve risks to inflation and its expectations, monetary policy will be adjusted in a timely and firm manner to achieve the convergence of inflation to its 3% target and to strengthen the anchoring of medium- and long-term inflation expectations for them to attain such target.

In an environment of economic weakness and marked uncertainty, the progress in the North American trade relationship has reduced the uncertainty associated with one of the factors that had been negatively affecting investment in Mexico. In particular, the fact that the region's economic integration is maintained -and that in the future, it deepens- should enable greater levels of investment in the country, driven by those projects that had been postponed given the uncertainty over trade policy, by new business opportunities, as well as by an environment of greater risk appetite worldwide. In order to fully benefit from the trade policy progress, from Mexico's inclusion in global value chains, and to revamp investment and growth in Mexico, it is key to boost confidence in the country, strengthen the economy's fundamentals, and address the obstacles that have prevented the economy from achieving greater medium-term growth. Actions to reduce uncertainty in the domestic economy need to be taken in order to improve the perception of the business climate in the country and to help investment to recover. It is also important to implement actions that address the factors that have prevented investment from growing for several years and which have also contributed to the low levels of productivity in the economy, to the detriment of its potential growth. In particular, measures should be taken to generate incentives that foster competition, value creation and a higher resource allocation efficiency. In addition, it is necessary to implement policies to strengthen the rule of law, and, thus, it is essential to continue tackling insecurity, corruption and impunity, and guaranteeing legal certainty, the enforcement of the legal framework and respect for private property. All of these efforts would enable capital accumulation and productivity growth, making it possible to generate better-paid jobs in a sustainable manner, and would contribute to address from a more solid basis the economic challenges posed by the prevailing adverse and complex international environment.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