BANCO DE MÉXICO®

Executive Summary

Quarterly Report October - December 2023

Summary*

During the period covered by this Report, the external environment was characterized by a moderation in the rate of growth of world economic activity, which nevertheless remained resilient, as well as by a disinflation process that continued advancing globally. International monetary and financial conditions remained tight. Domestically, the Mexican economy expanded at a robust pace of 3.2% in 2023, although it decelerated in the last quarter of the year. The labor market remained strong throughout the year. Both headline and core inflation were significantly below the peaks registered in the current inflationary episode that resulted from the shocks of the pandemic and the military conflict in Ukraine. However, the environment remained challenging. Headline inflation stayed above the central bank's target and the core component still registered relatively high levels, although it continued decreasing. In this context, in the monetary policy meetings of the period covered by this Report, Banco de México left the reference rate unchanged at 11.25%. Thus, this rate has remained at that level since March 2023. Throughout this inflationary period, the central bank has reaffirmed, through its actions and communication, its forceful commitment to achieving its price stability mandate.

During the fourth quarter of 2023, global economic activity expanded at a more moderate pace than in the previous quarter, although it remains resilient. In general, growth was similar to that observed in the third quarter for advanced economies and there was lower dynamism for emerging ones, although there continued to be heterogeneity in the dynamics of economic activity across countries. In the last quarter of the year, the US economy grew at a moderate rate, which, however, was higher than expected and relatively dynamic. China grew at a slower rate than in the previous quarter, while the euro area remained stagnant. For 2024 as a whole, forecasts of international organizations point to a similar growth in global economic activity compared to estimates for 2023. As for global inflation, during the fourth quarter of 2023, although headline inflation declined in most major economies, it remained above their respective central banks' targets and, in some cases, rebounded in the last month of the year. In addition, the core component continued decreasing gradually during the quarter. In this environment, risks to the global disinflationary process persist. In economies such as that of the United States, this is primarily associated with the resilience of economic activity and the strength of the labor market, as well as with the effects that could derive from an escalation in geopolitical conflicts.

The box *Effect of oil price shocks on the US and euro area consumer price indices* presents evidence, through econometric models, that increases in the oil prices associated with both changes in supply conditions and increases in demand for its use as inputs have upward effects on the overall consumer price indices of both economies. The results on the core indices reveal that the upward effects are lower in the case of the United States, and not statistically significant for the euro area.

During the period covered by this Report, central banks' decisions regarding their monetary policy rates were heterogeneous. Most central banks in advanced economies left their reference rates unchanged in their most recent decisions, while a large number of those in emerging economies announced reference rate cuts. Central banks highlighted, in general, that future rate adjustments will be data-dependent. Some of them announced that they are prepared to make additional adjustments, if necessary, to bring inflation back to their target levels.

* 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.

The box *Response of Mexican financial markets to US monetary policy decisions* shows, through an econometric exercise, that a downward revision in expectations of the future path of the federal funds rate, based on the Federal Reserve's decisions, tends to appreciate the peso and reduce its volatility, while Mexico's sovereign risk premium and medium- and long-term interest rates tend to decrease. Subsequently, through an event study analysis, these variables are shown to have indeed reacted in that direction in response to the Federal Reserve's November and December announcements, which implied a downward revision in the expected path of the federal funds rate.

The decline in inflation in some countries has contributed to the expectation of less restrictive monetary policy stances than anticipated at the end of the third quarter of 2023. This has been reflected in the fact that, as of November 2023, global sovereign interest rates decreased, mainly those for the medium and long terms, although as of January 2024 these began to increase moderately. In line with the evolution of sovereign interest rates, during the reported quarter, there was a generalized depreciation of the US dollar, which was partially reversed as of January 2024. In line with the behavior of international financial markets, interest rates of government bonds in Mexico, mainly those for the medium and long terms, adjusted downwards. Likewise, the Mexican peso appreciated against the US dollar.

Domestically, economic activity exhibited low growth in the fourth quarter of 2023. However, for 2023 as a whole, Gross Domestic Product (GDP) registered a robust expansion of 3.2%, in a context in which some of the effects caused by the pandemic continued fading, the US economy remained resilient, and progress in various public infrastructure projects continued. The significant deceleration at the end of 2023 with respect to the dynamism observed in the first three quarters of the year reflected a marginal decrease in industrial production and the low growth of tertiary activities, after the high growth rates exhibited by both sectors in the previous two quarters. The point estimate of the output gap remained in positive territory, although it narrowed at the margin and continued without being statistically different from zero. Looking ahead, the Mexican economy is expected to resume a faster pace of growth, supported by the resilience shown by domestic spending and the announced fiscal policy stance.

The box *Recent evolution of bank financing to the private sector in different economies* shows that, in recent quarters, credit to the private sector in Mexico has grown at higher rates than in other economies, both advanced and emerging. Although there are several factors that could explain the differences across countries, the box shows that one of them seems to be the sustained expansion of private sector credit demand in Mexico, in a context of an economic recovery that lagged, but is relatively dynamic, compared to other economies.

Between the third and fourth quarters of 2023, annual headline inflation in Mexico decreased from 4.63 to 4.41%. This performance reflected the continued reduction in core inflation, which more than offset the increase in non-core inflation. In particular, the upward trend in non-core inflation contributed to a rebound in annual headline inflation from November 2023 to January 2024, reaching 4.88% in the latter month. In the first fortnight of February 2024, non-core inflation reversed somewhat, which, together with the decline maintained by core inflation, contributed to causing annual headline inflation to fall to 4.45%.

Between the referred quarters, annual core inflation, which better reflects the inflation trend, decreased from 6.16 to 5.30%, registering 4.63% in the first fortnight of February 2024. Nevertheless, within its components, a differentiated behavior continued being observed between merchandise and services inflation. As of January 2024, the former has declined for fourteen consecutive months, as the effects of the shocks associated with the pandemic, the military conflict in Ukraine, and the appreciation of the

Mexican currency, have been dissipating. In contrast, services inflation remained at high levels and still does not show a clear downward trend. It continues being affected by pressures related to operating costs derived from the pandemic and the aforementioned conflict, which are being passed on to consumer prices as demand for services recovers after the lockdown. Annual non-core inflation rose from 0.10 to 1.79% between the third and fourth quarters of 2023 and to 5.24% in January 2024, reaching 3.93% in the first fortnight of February of this year.

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 outlook that continues to prevail. Although it acknowledged the disinflation process in the country, aided by the monetary policy stance attained and the easing of shocks, the Board considered that the latter continued having an incidence on inflation. Under these conditions, headline inflation, although it located at significantly lower levels than those observed during 2022 and the first months of 2023, remained above the central bank's target. Meanwhile, although the core component continued trending downwards, it persisted at relatively high levels. Likewise, the balance of risks for their expected paths over the forecast horizon remained biased to the upside.

The Board will thoroughly monitor inflationary pressures as well as all factors that have an incidence on the foreseen path for inflation and its expectations. In the next monetary policy meetings, it will assess, depending on available information, the possibility of adjusting the reference rate. It will take into account the progress in the inflation outlook and the challenges that prevail. It will also consider the incidence of both the restrictive policy stance that has been maintained and that prevailing in the future on inflation throughout the horizon in which monetary policy operates. Actions will be implemented in such a way that the reference rate remains consistent, at all times, with the trajectory needed to enable an orderly and sustained convergence of headline inflation to the 3% target during the foreseen horizon. The central bank reaffirms its commitment to 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: The perspectives on GDP growth in this Report are similar to those presented in the previous Report. Although in the fourth quarter of 2023 Mexico's economy decelerated more than expected, in the first three quarters of that year it had exhibited a dynamic performance, and thus growth for the year as a whole was robust. Despite this deceleration, the expected path for economic growth along the forecast horizon is similar to that foreseen in the previous Report. In particular, the expectation that growth of economic activity will be biased towards the first half of the year is maintained. Higher public spending with respect to the previous year is anticipated to lead to higher overall domestic spending, considering both direct and spillover effects on private consumption and investment. In the second half of the year, economic activity is expected to decelerate, in line with the evolution observed in previous electoral years. As for external demand, it is expected to show weakness during the year.

Although the anticipated dynamics of economic activity in 2024 do not change significantly, the lower-than-expected growth in the last quarter of 2023 induces an arithmetic effect of a lower base of growth for 2024. This results in a revision of the point estimate of the GDP forecast for 2024 from 3.0% in the previous Report to 2.8% in the current Report (Chart 1a and Table 1).[1] The range of expected GDP

[1] The year 2024 will have one additional day compared to 2023 because it is a leap year. This will cause the annual GDP growth rate calculated with original figures (2.8%) to be higher than the one calculated with seasonally adjusted data (2.5%). The year 2025 will be one day shorter than 2024; therefore, the annual GDP growth rate calculated with original figures (1.5%) will be lower than the one calculated with seasonally adjusted figures (1.8%).

growth for the year is adjusted to one between 2.2 and 3.4%.

By 2025, the fiscal consolidation effort is expected to be reflected in a lower domestic spending. In contrast, external demand is anticipated to gain importance, given the expectation of a better performance of the US economy in 2025, compared to the previous year. The central estimate of GDP growth for 2025 is 1.5%, the same rate as in the previous Report. In 2025, GDP is expected to grow between 0.7 and 2.3%. Throughout the forecast horizon, the ongoing nearshoring process of some businesses to Mexico is anticipated to boost economic activity, while acknowledging the high uncertainty as to its magnitude and effects.

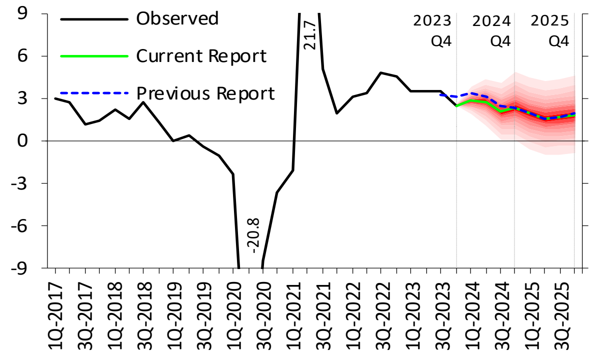
Table 1
Forecasts for GDP growth
Annual percent

Year	Central	Interval
2024	2.8	Between 2.2 and 3.4
2025	1.5	Between 0.7 and 2.3

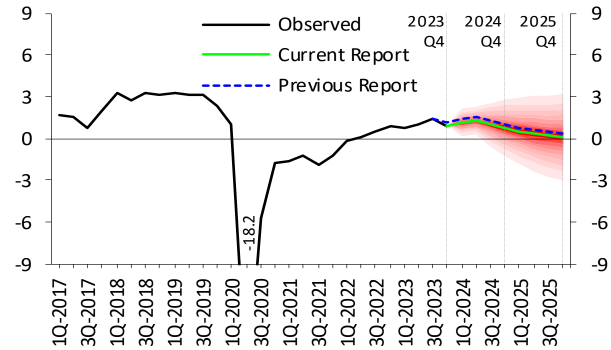
Note: Not seasonally adjusted forecasts. The central estimates for 2024 and 2025 compare with the previous Report's forecasts of 3.0 and 1.5% for each year. Intervals compare to those published in the previous Report of 2.3 and 3.7% for 2024 and 0.7 and 2.3% for 2025. Mexico's GDP increased 3.2% in 2023 with figures that are not seasonally adjusted.
Source: Banco de México.

Regarding the cyclical position of the economy, the estimate of the output gap is expected to remain in positive territory, slightly below the level presented in the previous Report. This gap is estimated to be relatively stable during the first half of 2024, as compared to the levels observed in the second half of 2023, to subsequently narrow along the remaining forecast horizon (Chart 1b). The estimation of this unobservable indicator is subject to a high degree of uncertainty.

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 Q1 2024. In the previous Report, it started in Q34 2023.
Source: a) INEGI and Banco de México. b) Banco de México.

Employment: Table 2 presents the forecasts for IMSS-insured jobs. In view of the loss of dynamism observed in the creation of said jobs, forecasts for this indicator for 2024 and 2025 are adjusted downwards compared to the previous Report.

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

Year	Interval current report	Interval previous report
2024	Between 580 and 760	Between 610 and 810
2025	Between 530 and 730	Between 550 and 750

Note: In 2023, the number of IMSS-insured jobs increased by 662 thousand jobs.
Source: Banco de México.

The box *Indicator of non-employed population that can potentially become employed* provides a measurement of the immediate availability of labor in the economy, based on different empirical propensities with which groups of unemployed individuals and those out of labor force tend to become employed from one quarter to another. Given the robust recovery of employment, this indicator has decreased considerably after the initial shock of the pandemic. In addition, the population's gradual aging has contributed to an increase in the number of retired and pensioned individuals. The latter has also contributed to the decline of the indicator, as this group has a lower probability of transitioning into the labor force.

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	2024	2025
Trade balance		
% of GDP	Between -1.3 and -0.9	Between -1.5 and -1.0
Billions of dollars	Between -25.6 and -17.6	Between -27.9 and -17.9
Current account		
% of GDP	Between -1.2 and -0.5	Between -1.5 and -0.6
Billions of dollars	Between -22.6 and -10.1	Between -27.2 and -11.2

Note: Figures for 2024 compare with those of the previous Report of a trade balance of between -27.8 and -19.6 billion dollars (-1.5 and -1.1% of GDP) and a current account balance of between -24.3 and -11.6 billion dollars (-1.3 and -0.6% of GDP). Figures for 2025 compare with the previous Report's figures of a trade balance of between -26.8 and -17.4 billion dollars (-1.5 and -1.0% of GDP) and a current account balance of between -23.4 and -7.4 billion dollars (-1.3 and -0.4% of GDP). In 2023, the trade balance was -5.5 billion dollars (-0.3% of GDP) and the current account balance was -5.7 billion dollars (-0.3% of GDP).
Source: Banco de México.

Risks to growth: Risks to growth of economic activity over the forecast horizon are considered to remain balanced. Among the risks to the downside in the forecast horizon, the following stand out:

i. That, despite the resilience that the US economy has shown, it grows less than expected, to the detriment of Mexico's external demand.
ii. That the escalation of several geopolitical conflicts in different regions of the world negatively affects the global economy or international trade flows.
iii. That tighter-than-expected financial conditions and/or episodes of volatility in international financial markets materialize, affecting financial flows to emerging economies.
iv. That public spending provides a lower-than-expected boost to economic activity.
v. That investment spending in Mexico is lower than expected or insufficient to support the growth of the economy, particularly in the long term. Among other reasons, this could occur because numerous electoral processes worldwide could generate greater uncertainty, affecting global investment.
vi. That severe weather phenomena, such as extreme temperatures or cyclones, adversely impact Mexico's economic activity.

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

i. That growth of the US economy is greater than expected, which would favor Mexico's external demand.
ii. That the Mexican economy shows greater resilience than expected.
iii. That, within the USMCA framework, the global reconfiguration of production processes provides a greater-than-expected boost to investment.
iv. That public spending results in a higher-than-expected boost to economic activity.

Inflation: The disinflationary process in Mexico is expected to continue, although it is foreseeable that it will keep unfolding in a complex and uncertain environment. In this Quarterly Report, forecasts for headline and core inflation remain unchanged compared to those announced in the Monetary Policy Statement of February 8, 2024. With respect to the previous Report, the expected trajectories for both indicators are adjusted upwards during 2024, while estimates corresponding to 2025 remain unchanged (Chart 2). Thus, although these indicators are anticipated to decline slightly more gradually in 2024, headline inflation is still expected to converge to the target during the second quarter of 2025. In addition, core inflation is anticipated to continue decreasing throughout the forecast horizon and to register levels close to 3% during the same quarter (Table 4 and Chart 3).

The foreseen downward trajectory for headline and core inflation considers Banco de México's monetary policy actions, as well as the expectation of a continued easing of different pressures on inflation. In this regard, the decline in merchandise inflation should be acknowledged, in view of the moderation in the effects of the shocks that have affected it and the lower levels of the exchange rate compared to those observed at the beginning of 2023. On the other hand, services inflation has ceased to increase, while it remains high and still does not show a clear downward trend. Nevertheless, the mitigation of global shocks is foreseen to become more evident in its evolution over the coming quarters.

The upward revision of headline inflation in 2024 reflects the slightly higher levels anticipated for core inflation during said year compared to the previous Report's estimates. It also considers higher levels of non-core inflation during the first two quarters of 2024. In the case of core inflation, its upward adjustment is associated with a somewhat higher persistence in the price variations of services. While slightly higher price variations in food merchandise are considered, they are offset by the lower inflation levels of non-food merchandise prices. Regarding the upward adjustment of non-core inflation, it reflects supply shocks in some fruit and vegetables, which are not anticipated to be long-lasting, so their impact on the change in headline inflation concentrates in the first quarters of the forecast horizon.

The annual rate of change and annualized seasonally adjusted quarterly rate of change of headline and core indices are presented in Table 4 and Chart 4. Since annual rates are influenced over twelve months by short-term shocks on inflation, their reduction is slower than that of seasonally adjusted quarterly rates. Over the forecast horizon, some volatility is observed in the projections of the latter for 2024 for both headline and core inflation, while in both cases they are at considerably lower levels than those observed in 2023. In the case of core inflation, they are consistently close to 3% in 2025, and for headline inflation, they are around 3% starting from the second quarter of that year.

Although inflation is anticipated to continue trending downwards, significant challenges and risks persist in the future. The possibility of the effects of the shocks on inflation lasting longer or of additional shocks occurring and exerting upward pressures 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 inflation, the following stand out:

To 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 foreign exchange depreciation, possibly as a result of events of volatility in international financial markets.

iii. Higher cost-related pressures that could be passed on to consumer prices.

iv. That the economy shows a greater-than-expected resilience, which could contribute to a more gradual reduction in inflation than expected.

v. Climate-related impacts that could affect some products' prices.

vi. An escalation of geopolitical conflicts that could cause disruptions in global production chains.

To the downside:

i. A lower-than-anticipated economic activity at a global level, in the United States or in Mexico, which could lead to lower pressures on Mexican inflation.

ii. That the pass-through of cost-related pressures to prices is limited.

iii. That the lower levels registered by Mexico's exchange rate with respect to the beginning of 2023 contribute more than anticipated to ease certain pressures on inflation.

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

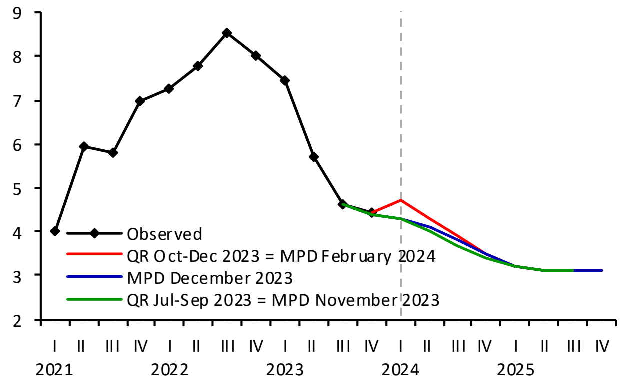
	2023		2024				2025			
	III	IV	I	II	III	IV	I	II	III	IV
CPI										
Current Report = Monetary Policy Statement of February 2024 1/	4.6	4.4	4.7	4.3	3.9	3.5	3.2	3.1	3.1	3.1
Previous Report = Monetary Policy Statement of November 2023 2/	4.6	4.4	4.3	4.0	3.7	3.4	3.2	3.1	3.1	
Core										
Current Report = Monetary Policy Statement of February 2024 1/	6.2	5.3	4.6	4.1	3.7	3.5	3.2	3.1	3.1	3.1
Previous Report = Monetary Policy Statement of November 2023 2/	6.2	5.3	4.5	3.9	3.5	3.3	3.2	3.1	3.1	
Memo										
Annualized seasonally adjusted quarterly variation in percent 3/										
Current Report = Monetary Policy Statement of February 2024 1/										
CPI	4.4	5.2	5.0	2.8	3.1	3.2	3.6	2.7	3.1	3.1
Core	4.6	4.4	4.1	3.4	3.2	3.4	3.0	3.0	3.2	3.2

1/ Forecast starting February 2024. It corresponds to the forecast published in the Monetary Policy Statement of February 8th 2024.
2/ Forecast starting November 2023. It corresponds to the forecast published in the Monetary Policy Statement of November 9th 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

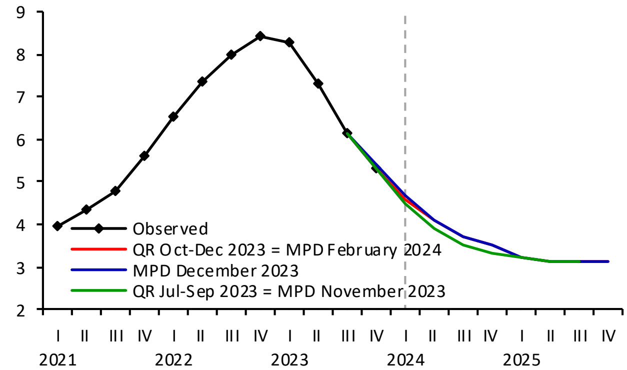
Annual headline inflation forecasts [1/]

Percent



Annual core inflation forecasts [1/]

Percent



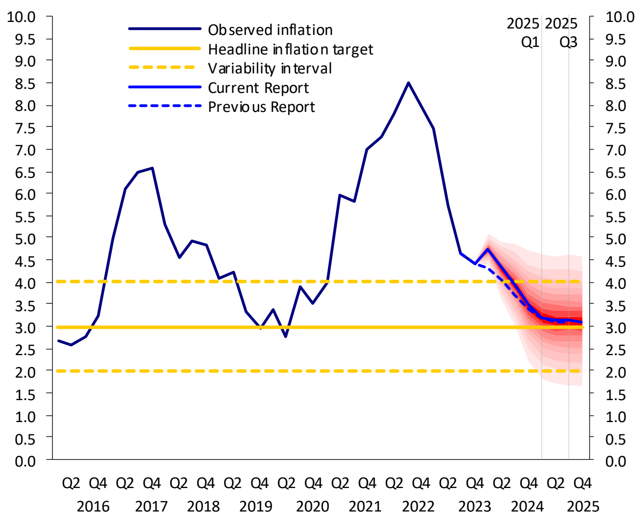
1/ Annual percentage change of quarterly average indices. QR refers to Quarterly Report and MPD refers to Monetary Policy Decision. Vertical line corresponds to first quarter of 2024.

Source: Banco de México and INEGI.

Chart 3

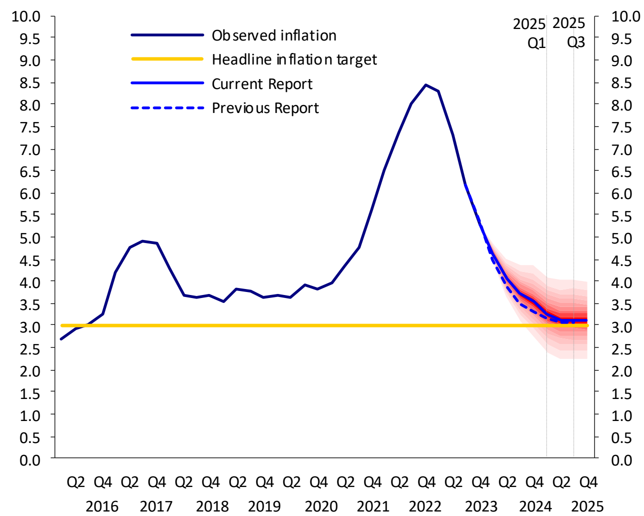
a) Fan chart: annual headline inflation [1/]

Percent



b) Fan chart: annual core inflation [1/]

Percent



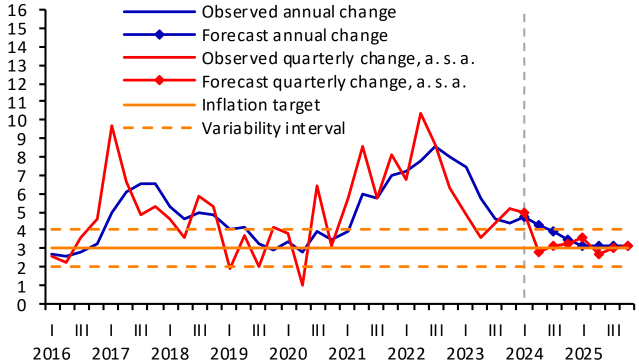
1/ Annual percentage change of quarterly average indices. The next four and six quarters are indicated with vertical lines, using as a reference the first quarter of 2024, that is, the first quarter of 2025 and the third quarter of 2025, respectively, to indicate the time frames in which the transmission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

Source: Banco de México and INEGI.

Chart 4

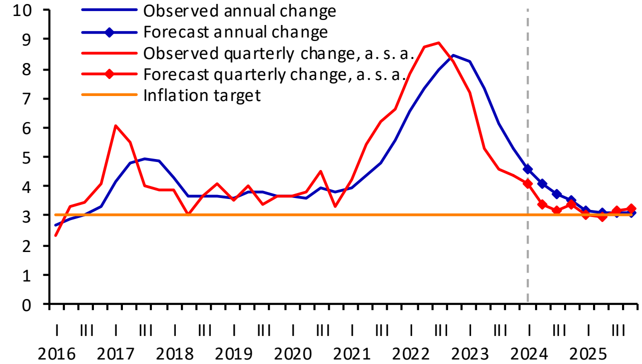
a) Headline index

Quarterly change, annualized and s.a., and annual change in percent 1/



b) Core index

Quarterly change, annualized and s.a., and annual change in percent 1/



s.a./ seasonally adjusted figures.
a.s.a./ annualized seasonally adjusted figures.
1/ Calculated using the quarterly average indices.
Vertical line corresponds to first quarter of 2024.
Source: Banco de México and INEGI.

In 2023, the Mexican economy exhibited resilience and higher-than-anticipated growth. Although the Mexican economy is expected to exhibit a higher growth rate compared to its historical average, supported by domestic spending and the announced fiscal stance, and, to a lesser extent, by the reconfiguration of global value chains, the current year will continue posing different challenges. In this context, it is essential to maintain sound macroeconomic fundamentals, including fiscal discipline, a monetary policy focused on price stability, a healthy financial system, a well-capitalized banking sector, sustainable external accounts, and a flexible exchange rate. 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 to lead inflation to its 3% target and ensure the anchoring of inflation expectations.

Additionally, to strengthen its domestic market and capitalize on the potential opportunities associated with trade openness, Mexico must continue to adopt measures that boost productivity and ensure the efficient allocation of resources in the economy. Similarly, strengthening the rule of law would contribute to fostering an environment conducive to investment and productive activity. The above would not only contribute to better prepare Mexico’s economy to face any adverse shocks that may arise but would also establish solid foundations to achieve greater economic growth in a sustainable manner. All this would result in a greater development of the national economy and, ultimately, in an improved well-being for the Mexican population.

BANCO DE MÉXICO®

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