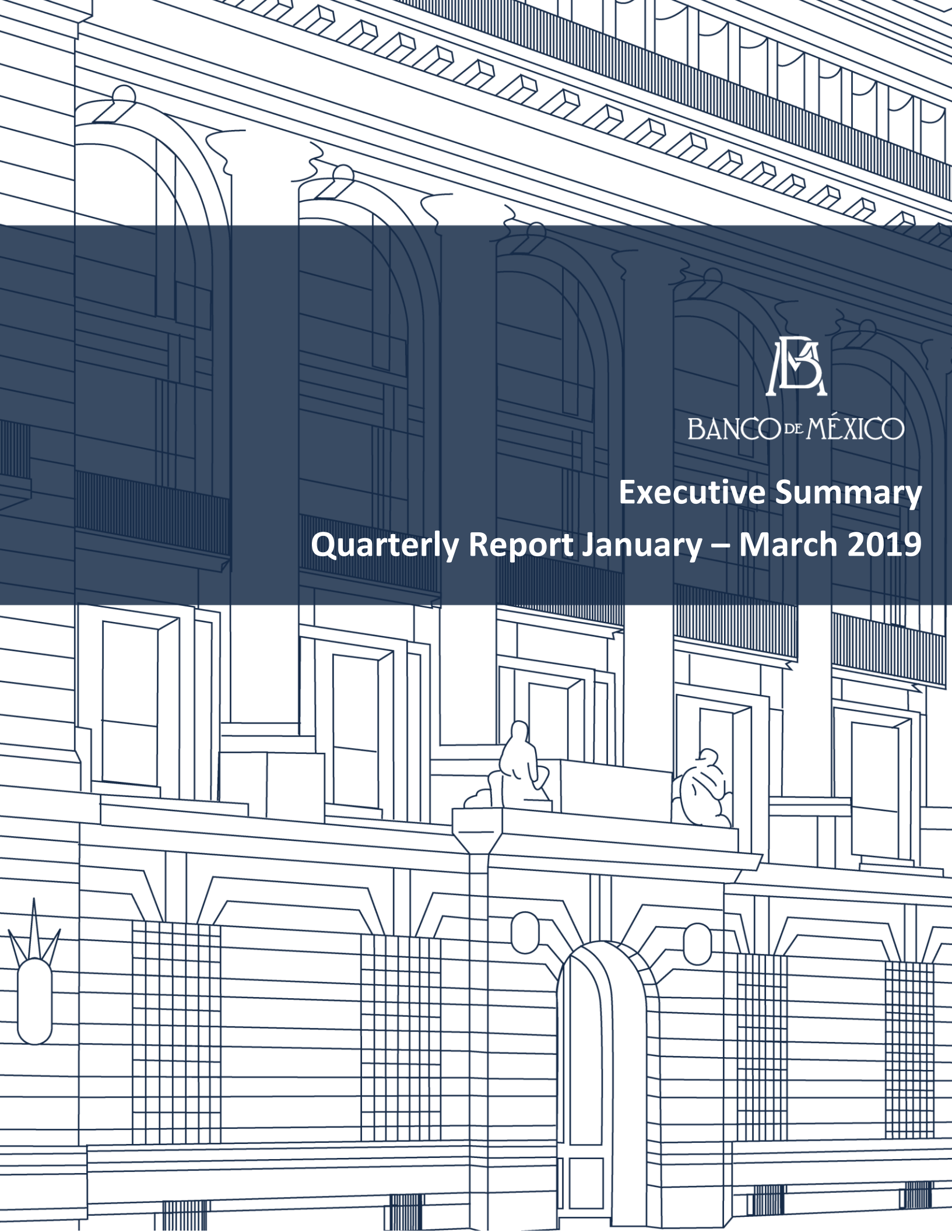


BANCO DE MÉXICO

Executive Summary

Quarterly Report January – March 2019

Summary

Banco de México has conducted monetary policy in a complex environment for inflation, in which since 2017 several shocks of considerable magnitude have kept it at levels above the 3% target. Although annual headline inflation decreased in the first months of 2019, the reduction was largely due to the evolution of non-core inflation, given that core inflation continued showing resistance to decline. Moreover, starting from March both headline and core inflation have increased once again, even after controlling for seasonal effects, although such developments are expected to be transitory. Thus, inflation remains at high levels, it is subject to significant uncertainty, and its trajectory of convergence towards the central bank's target could be affected by different risk factors. Indeed, after headline inflation registered in December 2017 its highest level since May 2001, its downward and convergent trajectory towards the target has been slower than initially expected, as a result of some additional shocks and the greater persistence exhibited by core inflation. In the fourth quarter of 2018, risks to inflation increased as a result of domestic factors. In particular, domestic financial markets registered high volatility, the exchange rate depreciated and risk premia increased. Banco de México has pursued a monetary policy stance aimed at maintaining medium and long-term inflation expectations anchored, and that enables the convergence of inflation to its target within the estimated forecast horizon. The timely and firm response of monetary policy has sought to strengthen confidence in the Mexican economy, attain the convergence of inflation to its target and promote an orderly adjustment in the domestic financial markets and, therefore, in economic activity.

Since the end of 2018 and during the first months of 2019, the Mexican economy has faced a rebalancing of challenges. On the one hand, the outlook of a long pause in the pace of monetary policy normalization in the major advanced economies has led to more favorable conditions for emerging economies in international financial markets, which, together with perspectives of a solid macroeconomic framework in Mexico, contributed to a better performance of domestic financial markets. Accordingly, a certain improvement in the Mexican economy's sources of financing was observed, especially in fixed income instruments, although such flows remain at moderate levels. Recently, trade tensions between the U.S. and China have escalated and episodes of capital flows towards lower risk assets have been observed. Thus, the external environment has become more uncertain. On the other hand, there are different domestic challenges, such as uncertainty over the credit outlook of Pemex and the effects of some changes in public policy in certain sectors, like the labor and energy sectors, on investment, economic activity and inflation. In this context, the Mexican economy faces a complex environment in which headline inflation declined in the first quarter of the year, albeit having increased in April, and core inflation located in April and during the first half of May above the levels observed at the end of the previous year.

During the first quarter of 2019, as anticipated, average annual headline inflation declined in relation to the last quarter of 2018. Core inflation was slightly above the expected level. Indeed, the decline in annual headline inflation was due mainly to the decline in non-core inflation, while core inflation remained at levels above 3.50%, increased in April and within its components, the rate of change in the prices of food merchandise and several services has been increasing. In particular, between the fourth quarter of 2018 and the first quarter of 2019, headline inflation declined from an annual average of 4.82% to 4.10%, although it increased to 4.41% in April and in the first half of May registered 4.43%. The quarterly average of non-core inflation went from an annual change of 8.32% to 5.84% between the last quarter of 2018 and the first quarter of 2019. Although the significant decline in non-core inflation was largely related to the lower annual growth of energy prices, this behavior has started to revert since the second half of February 2019, putting annual non-core inflation under pressure once more, which reached a level of 6.08% in April and 6.41% in the first half of May. This occurred even despite the fact that certain fuel prices were adjusted at a lower rate than their international references. Meanwhile, the average annual change of core inflation was 3.68% in the last quarter of 2018, 3.56% in the first quarter of 2019, 3.87% in April and 3.77% in the first

half of May. Thus, core inflation has shown resistance to decline, while risks associated to its performance continue to be perceived. These are related to certain inputs, such as commodity prices and wage increases, which could generate cost pressures.

The box *Relationship Between Services Inflation and Higher Production Costs in the First Quarter of 2019* presents estimates suggesting that the recent dynamics in services prices have been to a large extent affected by the indirect impact of both the increase in energy prices and the higher wages on the economy. Thus, although the increased economic slack has led to lesser pressures on services inflation, the higher production costs have had an opposite effect.

The box titled *Influence of Competition on Retail Prices and Markups in the Market for Gasoline* illustrates three stylized facts on the evolution of the market for regular gasoline: (1) the higher is the degree of competition, the lower are the prices and the markups; (2) when wholesale prices decrease, retail prices take longer to adjust than wholesale prices, raising markups during the adjustment period; and (3) when wholesale prices decrease, retail prices decline faster for gas stations that face a higher degree of competition.

Regarding monetary policy decisions, during the period analyzed in this Report, Banco de México decided to keep the target for the Overnight Interbank Interest Rate unchanged. In particular, in the meetings of February, March and May 2019, the Governing Board maintained the target for the Overnight Interbank Interest Rate at 8.25%. In these decisions the Board highlighted that economic activity in Mexico grew at a low rate at the end of 2018 and that the weakness the Mexican economy had exhibited since the fourth quarter of 2018 became exacerbated in the first quarter of 2019, associated with both external and domestic factors, some of which were transitory. For this reason, it mentioned that the balance of risks for growth has become more uncertain and remains biased to the downside. Regarding the risks to inflation, the Board mentioned that although there has been an intensification of certain downside risk factors, such as the greater economic slack, there are others that could make inflation remain at high levels and, thus, deviate from its foreseen path. These factors relate to those that have prevented core inflation from decreasing.

Delving in the external conditions faced by the economy during the analyzed period, world economic activity exhibited a modest recovery in the first quarter of 2019, after having presented a decelerating trend during the second half of 2018. The global economy has been affected by the negative effect of the trade disputes between the United States and China as well as the uncertainty generated by different political, geopolitical and idiosyncratic factors on business confidence, trade and investment.

In addition, global growth expectations for 2019 and 2020, both among economic analysts and international institutions, have continued to be revised downwards, reflecting a lower than expected rate of growth of economic activity for both the major advanced economies and some emerging economies. In this environment, inflationary pressures continued moderating in most advanced economies and in some emerging ones. The aforementioned environment has reinforced expectations that the Federal Reserve and other major central banks will adopt a more accommodative monetary policy. However, risks to global economic growth are still biased to the downside, especially the impact of the recent escalation of trade tensions between the U.S. and China and the possibility of such tensions spreading to other regions, that the weakness of some of the major economies continues for a period longer than anticipated, that new episodes of volatility in international financial markets take place, and that certain political and geopolitical risks intensify.

In this respect, the box *Evolution of Negotiations Regarding the United Kingdom's Decision to Leave the European Union (Brexit)* details how such process turned out to be complex, generating a number of delays and an increasingly deteriorating political environment. This led the Prime Minister Theresa May to announce her resignation as leader of Britain's Conservative Party effective on June 7. Looking forward, a number of scenarios may occur, such as a Brexit deal, another delay, a second

referendum or a no-deal exit, which would have different impacts on the economic performance of the United Kingdom, the European Union, and the rest of the world. In particular, a no-deal exit would negatively affect world economic activity, trade, and production chains at the regional and global levels, and could lead to higher volatility in international financial markets and to adjustments in the configuration of the international banking system.

The weakness of the Mexican economy has been due to both external and domestic factors. In particular, manufacturing exports continued to decelerate during the first quarter of 2019, in an environment of a weakening of world trade and persisting trade tensions among different countries and regions.

In this regard, the box *Effect of U.S. Tariff Measures Imposed on China on Mexico's Share in U.S. Imports* shows that, although trade disputes between China and the U.S. appear to have contributed to a higher share of Mexico in U.S. imports, such recent progress is explained not only by the higher tariffs imposed by the U.S. on Chinese products, but also by a previous upward trend observed in Mexico's share, possibly associated to the depreciation of the real exchange rate and to an increase in oil exports, item in which China does not compete in the U.S. market.

Furthermore, investment is also estimated to have remained weak, despite having registered a significant increase in January, given that this increase was concentrated in a few specific sectors such as gasoline pipeline repairs, the remodeling and expansion of oil platforms and to greater spending on private housing construction in some regions of Mexico– and that timely indicators signal that investment once again exhibited weakness over the rest of the quarter.

The weak performance of investment over several years can be partly associated with the challenges Mexico continues to face. In this regard, the box *Factors that Might Hinder Mexico's Economic Growth According to Analysts' and Businesses' Opinions* describes such challenges. Among those standing out are the obstacles generated by persistent governance issues and by the weak rule of law.

Moreover, since late 2018 and early 2019, private consumption has registered a certain loss of dynamism as a result of both a weak consumption of goods and a certain slowdown in the consumption of services, which at the beginning of the year intensified due to temporary factors, among which the fuel distribution problems, the blocking of railways in Michoacán, and the labor conflicts in Matamoros stand out. Regarding the economy's cyclical position, slack conditions eased towards the end of 2018 and in early 2019. In particular, estimates of the output gap for the period analyzed by this Report, both including and excluding the oil sector, were below those observed in previous quarters. However, this has not translated into a decline in core inflation, as other factors have put upward pressure on it.

Banco de México's expected macroeconomic scenario is as follows:

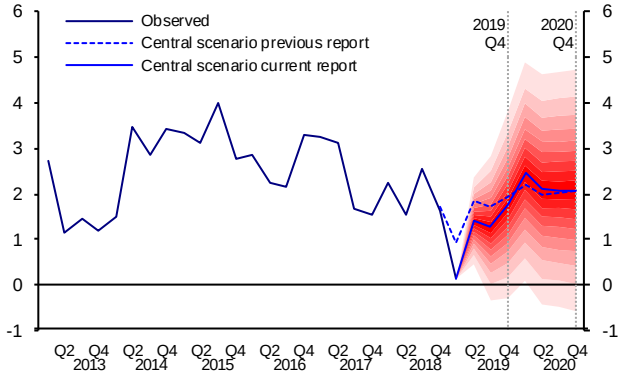
GDP growth: The economic activity outlook for 2019 in Mexico has been revised from an expected growth of between 1.1 and 2.1% in the previous Report to one between 0.8 and 1.8%. For 2020, a GDP growth range of between 1.7 and 2.7% continues to be expected (Chart 1 and 2).[1] The adjustment for 2019 mainly reflects that the economy's performance during the first quarter of 2019 was weaker than expected which, as mentioned, is partly associated with the effects of several transitory factors. In the same vein, although the economy is expected to resume its growth path, driven by positive contributions from both domestic and external demand, the latter could decelerate at a higher rate than expected due to a moderation in global economic growth and, particularly, in US industrial

[1] Since 2020 will be a leap year, it will include an additional day vis-à-vis 2019. For this reason, the annual growth rate of GDP estimated with original data will be higher than that estimated with seasonally adjusted data, since the latter controls for such an effect. As a reference, in 2016, the difference between these two growth rates was of three tenths of a percentage point.

production.[2] Additionally, any recovery in investment is foreseen to be gradual. These forecasts consider that a sound macroeconomic framework and sustainable public finances will be maintained.

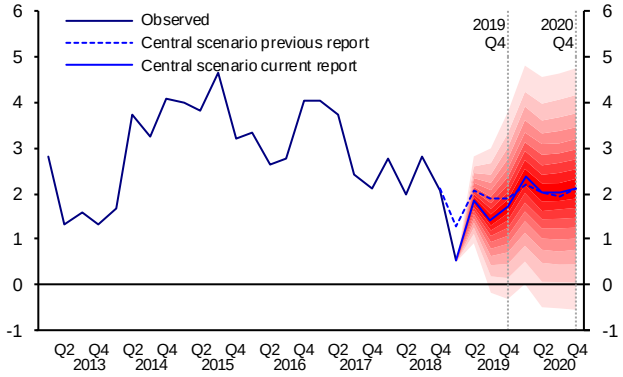
Regarding the economy's cyclical position, it is still anticipated that slack conditions will remain loose to some extent throughout the forecast horizon (Charts 3, 4 and 5).

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

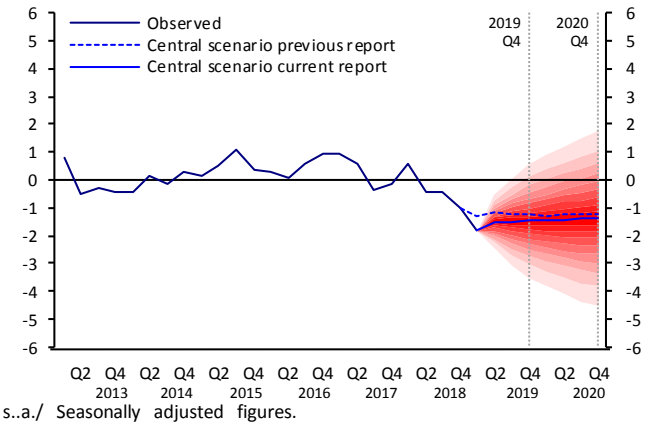


s..a./ Seasonally adjusted figures.
Source: INEGI and Banco de México.

Employment: In line with the adjustment in the outlook for growth and with the lower dynamism observed in the creation of IMSS-insured jobs, the growth forecast for the latter indicator for 2019 has been revised from between 620 and 720 thousand jobs in the previous Report, to between 530 and 630 thousand jobs for the present Report. For 2020, the forecast remains unchanged at a range of between 650 and 750 thousand jobs.

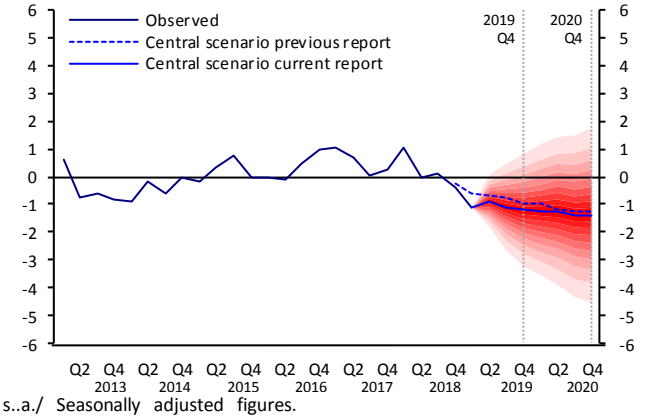
The box *Considerations Regarding Mexico's Labor Reform in 2019* details the main aspects of the recently approved labor reform, which includes significant changes to the functioning of the labor market.

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



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

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



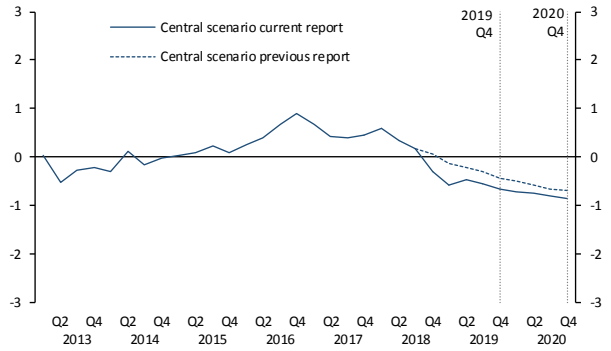
s..a./ Seasonally adjusted figures.
Source: INEGI and Banco de México.

Current Account: For 2019, the deficits of the trade balance and the current account are expected to amount to 13.5 and 24.3 billion US dollars, respectively (1.0 and 1.9% of GDP, in the same order), as compared to the previous Report projections of 11.8 and 25.2 billion US dollars,

[2] According to the Blue Chip Survey of Professional Forecasters of May 2019, US industrial production for 2019 and 2020 is expected to grow 2.2 and 1.6%, respectively, below the 2.8 and 1.7% growth rates published in the previous Quarterly Inflation Report.

respectively (0.9 and 2.0% of GDP, in the same order). For 2020, the trade balance and current account deficits are expected to amount to 13.7 and 25.6 billion US dollars, respectively (1.0 and 1.9% of GDP, in the same order), as compared to those of the previous Report of 14.0 and 28.0 billion US dollars, respectively (1.0 and 2.0% of GDP, in the same order).

Chart 5
Quarterly Slack Indicator



Notes: i) In the central bank's base scenario for the present Report, the forecast begins in Q1-2019. In the case of the previous Report, it began in Q4-2018. 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.

Balance of risks for growth: The Mexican economy continues facing risks, which, should they materialize, may have negative effects on growth. Thus, due to the persisting domestic and external risks, the balance of risks for economic activity within the forecast horizon has become more uncertain and remains biased to the downside. Among the downward risks that stand out are:

i. Persisting uncertainty regarding the possibility of new trade disputes, an escalation of those currently prevailing or the adoption of greater protectionist measures worldwide that may have an impact on growth, investment, global trade as well as on international financial markets, in detriment of Mexico's economic activity.

ii. That episodes of volatility in international financial markets arise as a result of several factors: a) greater trade tensions worldwide that lead to a lower risk appetite; b) possible inflationary surprises that lead to unexpected increases in the reference rates of the main central banks; c) a possible contagion from other emerging economies; and d) geopolitical events that might reduce the sources of external financing.

iii. That a greater-than-expected slowdown of the world economy and of global trade is observed once the fiscal stimuli currently implemented in some of the major economies, mainly in the United States, expire or that such slowdown responds to a greater than expected deceleration in US industrial production.

iv. That the process of ratifying and implementing the United States-Mexico-Canada trade agreement (USMCA) is delayed and generates more uncertainty, thus affecting investment.

v. That the current environment of domestic uncertainty that has been affecting investment deteriorates, leading some firms to delay or forgo their investment plans or that consumers reduce their spending as a precautionary measure.

vi. That the credit rating of Pemex is downgraded, complicating the company's financial situation, or that credit rating agencies revise downwards the credit notes of other State-owned companies or of Mexico's sovereign rating.

vii. That new hurdles to the production and distribution of goods and services arise (such as strikes or by the blocking of communication routes or restrictions to the distribution of fuels as well as by greater delays in the US-Mexico border crossings).

Among the upward risks to growth that stand out are:

i. That the USMCA is formalized, triggering greater investment.

ii. That a greater than expected dynamism of industrial production in the United States contributes to improve the performance of Mexican manufacturing exports.

iii. That a greater-than-foreseen dynamism of aggregate demand is observed, due to an increase in consumer spending or that some productive sectors face better conditions to increase their investments.

Table 1
Headline and Core Inflation Forecasts
Annual percentage change

	2019				2020					2021
	IV	I	II	III	IV	I	II	III	IV	I
CPI										
Current report[1/]	4.8	4.1	4.3	4.0	3.7	3.8	3.2	3.1	3.0	3.0
Previous report[2/]	4.8	4.1	4.3	3.8	3.4	3.5	3.1	2.8	2.7	
Core										
Current report[1/]	3.7	3.6	3.8	3.6	3.4	3.4	3.0	3.0	3.0	3.0
Previous report[2/]	3.7	3.5	3.6	3.4	3.2	3.2	2.9	2.8	2.7	

1/ Forecast as from May 2018.
2/ Forecast as from February 2019.
Source: Banco de México and INEGI.

Inflation: Forecasts for annual headline inflation are adjusted slightly upwards, as compared to the previous Report, due to higher expected energy prices arising from the dynamics in their international references, and to the recent increases in core inflation. Nevertheless, although the increase in headline inflation affects the forecasts for the shorter term, such effect is expected to be transitory, and thus the forecast shows a convergence to Banco de México's target in the third quarter of 2020. The upward adjustment of annual core inflation forecasts is largely due to evolution of the prices of housing services and services other than housing and education, which have registered higher levels than those foreseen. Such evolution may be associated with possible cost-related pressures, including the increases in fuel prices and the higher increases in wages. Nevertheless, core inflation is still expected to reach the 3% target in the second quarter of 2020 (Table 1 and Charts 6 and 7). It should be noted that the current environment presents medium- and long-term risks that may affect the evolution of inflation. In addition, in the horizon in which monetary policy operates, inflation expectations are subject to risks, among which the following stand out.

To the upside:

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

ii. That additional pressures on energy prices or on agricultural and livestock product prices arise, especially in those prices where their international references have been under upward pressure.

iii. That an escalation of protectionist and compensatory measures worldwide materializes.

iv. That public finances deteriorate.

v. That, given the magnitude of the increases to the minimum wage, in addition to their possible direct impact, there is the risk that these bring about high wage revisions in several sectors. In fact, in some sectors such increases have exceeded productivity gains, which could give rise to cost pressures, thus affecting formal employment as well as contributing to keep core inflation at high levels and preventing the increased slack in the economy from translating into lesser inflationary pressures.

vi. That the persistence shown by core inflation leads to a greater resistance to decline of medium- and long-term inflation expectations.

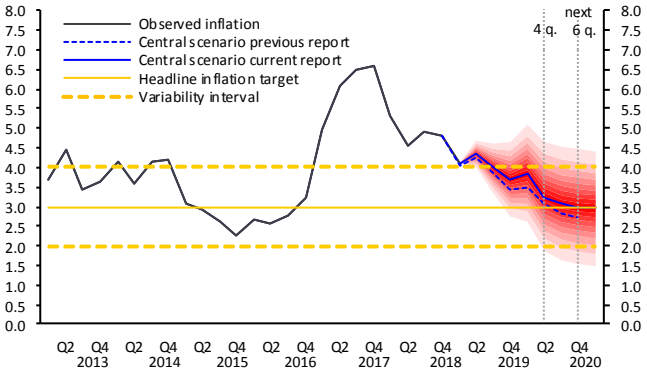
To the downside:

i. That the prices of certain goods included in the non-core subindex register lower variations.

ii. That slack conditions widen more than expected.

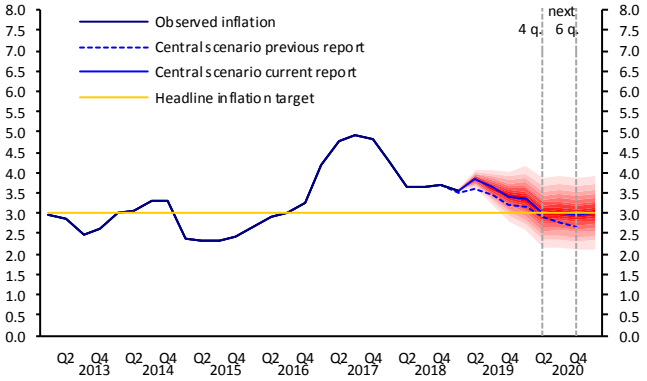
Thus, although there has been an intensification of certain downside risk factors, such as the increased slack in the economy, there are others that could make inflation remain at high levels and, therefore, make it deviate from its foreseen path, given the factors that have restrained core inflation from decreasing. For this reason, in an environment of high uncertainty, it is deemed that the balance of risks for inflation relative to its forecast still remains to the upside.

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 second quarter of 2019, that is, the second and fourth 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 second quarter of 2019, that is, the second and fourth quarters of 2020, respectively, time frames in which the monetary policy transmission channels fully operate.
Source: Banco de México and INEGI.

To address the challenges and lags that the Mexican economy faces, it is necessary to adopt and maintain policies that establish sound foundations for the growth of the country, and to correct structural and institutional setbacks that have prevented it from attaining a higher productivity and discourage investment. In this regard, as it has been pointed out in previous Reports, it is a priority to strengthen the rule of law, so that, in addition to fighting insecurity, corruption and impunity, competent authorities guarantee legal certainty, compliance to the legal framework, and respect for private property. In like manner, a clear agenda with long-term policy goals that promote an adequate microeconomic functioning, competition, and a greater efficiency in the use of the economy's resources, together with a sound macroeconomic framework characterized by both fiscal discipline and price stability, would contribute to build greater certainty and confidence in the country. This would allow to promote investment, raise productivity and increase the country's growth potential, which would result in a greater well-being for all Mexicans.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