BANCO DE MÉXICO

Executive Summary

Quarterly Report April – June 2018

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Summary

Throughout 2018, Banco de México has conducted monetary policy in an environment of high uncertainty caused by both external and domestic factors. At the international level, trade tensions have built up among several economies, interest rates in the U.S. have increased, and the U.S. dollar has exhibited a generalized strengthening related to a greater divergence in both the observed and expected performance of the main advanced economies. This situation has generated expectations that the U.S. Federal Reserve will continue normalizing its monetary policy stance at a faster pace than other developed economies' central banks. In these conditions, international financial markets underwent bouts of volatility and exhibited lower appetite for risk and, therefore, asset prices in emerging economies exhibited negative returns. During the period analyzed, at the domestic level, the environment that prevailed in the Mexican economy was that of uncertainty and volatility related to the lack of agreements in the NAFTA renegotiations and to Mexico's elections.

In this context, during the first five months of the year annual headline inflation fell. However, starting in June some of the upward risks signaled in the previous Quarterly Report materialized. This led to significant hikes in non-core inflation, which still remains at high levels. This, in turn, has affected the speed at which headline inflation converges to its target. After posting 5.31% during the first quarter of 2018 and 4.55 and 4.51% in April and May, respectively, average annual inflation rebounded to 4.65% in June and to 4.81% in July and during the first half of August. As for non-core inflation, it exhibited greater-than-anticipated price increases in some energy products, mainly gasoline and LP gas, which, since June have followed a higher growth trend. Another risk that materialized during most of the second quarter of 2018 was the depreciation of the Mexican peso, attributed to the referred external and domestic factors. However, since mid-June, this depreciation trend has reverted due, among other factors, to the monetary policy actions implemented by Banco de México; the perception of an improvement in the NAFTA negotiations; and, a lesser uncertainty after the federal elections' results. As for core inflation, it continued on a downward trajectory in line with its forecasts, during the period covered by this Report. The behavior exhibited by this price subindex is due to the easing of the economy's cyclical conditions, resulting from the contraction of economic activity in the second quarter, to the referred exchange rate appreciation, and to the monetary policy actions implemented by Banco de México, which prevented the different shocks on inflation from generating second-round effects on the economy's price formation process. Average annual core inflation thus registered 4.29% during the first quarter of 2018, 3.67% during the second quarter, and 3.60% during the first half of August.

During the reference period, Banco de México conducted monetary policy with the objective of maintaining inflation expectations anchored and reinforcing the declining trend of annual headline inflation to its target. In particular, during its meetings of April and May 2018, the Governing Board unanimously voted to leave the target for the overnight interbank interest rate unchanged at 7.50%. The Board considered that, according to the information available at that moment, the monetary policy stance was consistent with the decreasing trend followed by annual headline inflation towards its target, although, as stated above, non-core inflation still remains at high levels. However, as specified before, as of June, some risks to inflation materialized. Thus, given the deterioration in the balance of risks to inflation and the materialization of certain risks that could delay the convergence of inflation to its target, in its June meeting the Governing Board decided to adjust the monetary policy stance by raising the target for the overnight interbank interest rate by 25 basis points to 7.75%. Subsequently, domestic financial markets performed favorably and the depreciation that the Mexican peso had been observing during the previous months reverted. The recent shocks that have affected inflation are transitory; the economy's cyclical conditions have eased and they are expected to continue doing so at an even faster rate than previously estimated –which would imply lesser demand-related pressures on inflation–; and, core inflation's expected trend remains downward. Considering the above, in its August meeting, the

Governing Board decided to maintain the target rate unchanged.

Delving in the external conditions faced during the analyzed period, the world economy continued to expand, although there is an increasing divergence in the main advanced economies' performance. In particular, the fact that economic activity in the U.S. grew at a higher rate under conditions of reduced slack is noteworthy. This could trigger higher inflation pressures, which stands in contrast with conditions of lesser growth and moderate inflation pressures in other advanced economies. Although for the remainder of 2018 and 2019 the outlook for world economic growth is favorable, downward risks to global economic growth have increased both in the short and medium terms. This is due to the escalation of trade disputes, the possible tightening of financial conditions, and the persistence of geopolitical and idiosyncratic risks. These factors have contributed to raise uncertainty and volatility levels and, therefore, to a lower appetite for risk at the global level, reduced capital flows to emerging economies and, in turn, to the depreciation of their respective currencies.

Regarding the exchange rate during the reference period, from the end of March to the first half of June 2018, the Mexican peso had a spike in its volatility and depreciated 12.6%. Some of the external factors that contributed to these results are the generalized strengthening of the U.S. dollar and the presence of risks to international trade, which affected most emerging economies' currencies. Domestic factors, such as the uncertainty related to NAFTA renegotiations and Mexico's electoral process also contributed to this outcome. In contrast, from the second half of June to the end of August, the peso appreciated 9.9%. This reflected: i) the effect of Banco de México's monetary policy actions; ii) the perception of an improvement in NAFTA negotiations; and, iii) a lower degree of uncertainty after the results of Mexico's presidential elections.

Interest rates in Mexico increased for all terms during the reported period, especially medium-term ones, although these increases have partially reversed starting from mid-June. In this regard, adjustments in short-term interest rates were in line with the raise in the target for the overnight interbank interest rate in June, while increases in longer-term rates were attributed to upward adjustments in external interest rates. Hence, the yield curve remained relatively flat while its slope (defined as the difference between the 10-year and 3-month interest rates) continued relatively stable.

At the domestic level, in the second quarter of 2018, economic activity in Mexico presented a contraction with respect to the first quarter. This development contrasts with the expansion observed over the previous two quarters and reflected the reversal of the dynamism that investment had registered from December 2017 to March 2018, especially in the construction sector. The weakness of exports also contributed to the above, while consumption maintained a positive performance. As a result, slackness conditions apparently loosened in the analyzed period, though conditions in the labor market remain tight.

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

GDP growth: The contraction of the Mexican economy during the second quarter of 2018 showed a weakening of economic activity greater than anticipated in the previous Report. Mexico is expected to continue facing a complex environment, characterized by possibly increasing trade tensions worldwide, higher external interest rates and a strong U.S. dollar, as well as scenarios of contagion from other emerging economies, which may lead to a persistent weakness in the different components of private demand and exports. The recent statements of a preliminary understanding for the modernization of the trade agreement with the U.S. have contributed to a reduction of the uncertainty that the Mexican economy has been facing. Domestically, there is uncertainty related to the change in the incoming administration and to the challenges of implementing the public policy agenda. In addition, the weakness shown by the oil production platform in recent years is expected to continue. In this context, the GDP growth forecast interval for 2018 has been adjusted from between 2.0 and 3.0% in the previous Report, to between 2.0 and 2.6% for this Report. In turn, the expected growth interval for 2019 has been modified from 2.2 and 3.2% in the previous Report to 1.8 and 2.8% for this Report. These

projections consider the prevalence of a solid macroeconomic framework, characterized by sustainable public finances and policies that foster investment and productivity growth.

With respect to the cyclical position of the economy, based on the estimated trajectory of output, the tightness conditions are expected to continue easing, even at a faster rate than previously anticipated. In particular, both the estimate of the output gap excluding the oil sector and the quarterly slack indicator are expected to continue declining throughout the forecast time frame.

Employment: Consistent with the anticipated evolution of the economy, the forecasts for the number of IMSS-insured jobs for 2018 and 2019 have been revised downwards. In particular, an increase of between 670 and 770 thousand jobs is forecast for 2018, in contrast with the estimation of between 680 and 780 thousand jobs of the previous Report. For 2019, an increase of between 670 and 770 thousand jobs is anticipated, a lower range with respect to the 690 and 790 thousand jobs estimated in the previous Quarterly Report.

Current Account: For 2018, the deficits in the trade balance and the current account are anticipated to amount to US$ 13.4 and 23.7 billion, respectively (1.1 and 1.9% of GDP), which are lower than the projections of the previous Report of US$ 14.0 and 25.2 billion, respectively (1.1 and 2.1% of GDP). For 2019, deficits in the trade balance and the current account are estimated to be US$ 14.1 and 27.9 billion respectively (1.1 and 2.1% of GDP), which compare to US$ 15.0 and 30.5 billion, respectively (1.1 and 2.3% of GDP), of the previous Report.

In view of the continued uncertainty surrounding the Mexican economy, the balance of risks to growth maintains a downside bias.

The main downward risks for the forecast time frame are:

i. That the escalation of protectionist measures worldwide affects global economic growth and international trade negatively, particularly in Mexico.

ii. That volatility spikes emerge in international financial markets, due, among other factors, to inflation surprises in the U.S. that generate higher-than-expected increases in interest rates in that country, to a possible contagion from other emerging economies, or to geopolitical events that may constrain the sources of financing.

iii. That the environment of uncertainty which has been affecting investment persists, prompting various businesses to delay their investment plans in Mexico and leading Mexican consumers to cut down their spending as a precautionary measure.

Some of the upward risks to growth in the forecast time frame are:

i. That the recent statements of an understanding related to the modernization of the trade agreement with the U.S. reinvigorate investment.

ii. That a greater-than-anticipated dynamism of the U.S. industrial production favors the performance of Mexican manufacturing exports.

iii. That a greater-than-expected public spending is observed.

In addition to the above risks, the Mexican economy is facing a number of additional risks that, in case of materializing, could not only affect cyclical growth, but also negatively influence potential growth in the medium and long run. Some of these risks are:

i. That the continued weakness of investment that has prevailed for several years has a more marked effect on Mexico's productive capacity and on the rate of the adoption of new technologies.

ii. That the protectionist measures, those already implemented or new ones, negatively affect the participation of certain economies (including Mexico) in the global value chains.

iii. That the competitiveness of the Mexican economy is affected by a number of external and domestic factors, such as corporate tax cuts in the U.S.

iv. That public safety issues, corruption, impunity and the lack of the rule of law, along with their consequent negative impacts on investment and economic activity, worsen.

Inflation: The inflation forecasts presented in this Report consider that the greater-than-anticipated increases in energy prices, particularly gasoline and LP gas, in an environment in which non-core inflation is already at high levels, will affect the trajectory of annual headline inflation expected during 2019. However, its effect is estimated to be transitory. Therefore, the convergence trajectory of headline inflation towards its target is expected to be delayed, essentially due to the developments of non-core inflation. In the current environment, in which annual non-core inflation has remained persistently above 3% and in which it has faced additional significant shocks and high volatility, the process of reducing annual headline inflation towards its 3% target set by Banco de México has been affected. Core inflation is the component which best reflects Banco de Mexico's monetary policy stance. Therefore, in the current juncture, the Governing Board will monitor this indicator closely. In this context, annual core inflation is expected to continue subsiding, a result of both the monetary stance and the projected easing of the cyclical conditions of the economy. In the same vein, core inflation is expected to reach 3% in the third quarter of 2019. In turn, annual headline inflation is anticipated to approach its 3% target during the remainder of 2018 and in 2019, and will come close to this target during the first half of 2020 (Table 1 and Charts 1, 2, 3, and 4).

To complement the fan charts that are usually included, we present boxplots to illustrate both the central trend and the range of values at which headline and core inflation may lie. Each diagram consists of a box that is bound by an interquartile range that represents the middle 50% of the distribution mass and two whiskers determined by 1.5 times the size of such range. The median, corresponding to the forecast value, is identified at the center of the box as the measure of the central trend and the interquartile range functions as a dispersion measure.

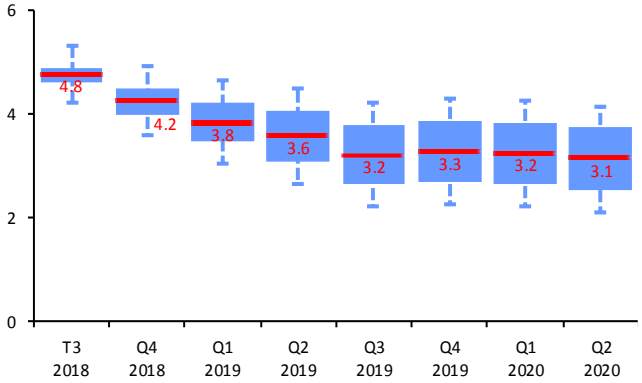
In addition, Chart 5 displays the different contributions of core and non-core inflation groups to annual headline inflation, as compared to the forecast presented in the last Report. The upward adjustment is largely attributed to the greater expected contribution of adjustments in energy prices to annual headline inflation, as compared to that anticipated in the previous Report, mainly during the next four quarters. Regarding the contributions of core inflation, merchandise prices have been slightly revised upwards for the short term, indirectly triggered by energy price spikes, although in the time frame in which monetary policy operates they have been adjusted downwards. Lesser tightness conditions of the economy, as well as the adopted monetary policy stance are factors that contribute to this result.

Table 1
Headline and Core Inflation Forecast
Annual change in percent

	2018			2019				2020	
	II	III	IV	I	II	III	IV	I	II
CPI									
Current Report	4.6 *	4.8	4.2	3.8	3.6	3.2	3.3	3.2	3.1
Previous Report	4.6	4.3	3.8	3.3	3.1	3.1	3.1	3.1	
Core									
Current Report	3.7 *	3.6	3.5	3.3	3.2	3.0	2.9	3.0	2.9
Previous Report	3.7	3.6	3.4	3.2	3.2	3.1	3.0	3.0	

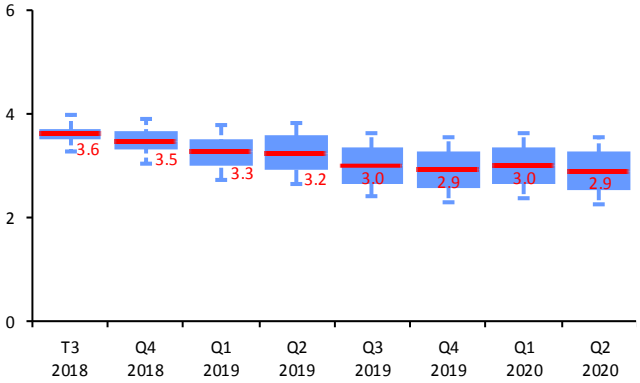
*/ Observed data.
Source: Banco de México and INEGI.

Chart 1
Box Plot: Forecast for Annual Headline Inflation
In percent



Source: Banco de México.

Chart 2
Box Plot: Forecast for Annual Core Inflation
In percent



Source: Banco de México.

The balance of risks to inflation maintains its bias to the upside, in an environment of a high degree of uncertainty. Some of the upward risks to the above projections in the forecast time frame are:

i. That the Peso comes under pressure due to an environment of higher external interest rates and the U.S. dollar's strength, as well as to uncertainty factors in the external and domestic environments. If the Mexican economy faces a scenario that requires an adjustment of the real exchange rate, Banco de México will ensure that it is carried it out in an orderly manner and without second-round effects on the economy's price formation process.

ii. That further increases in some energy prices and in the prices of agricultural products are observed. As a result, non-core inflation could jeopardize the convergence of inflation to its target.

iii. That protectionist and compensatory measures escalate at the global level, which would affect inflation negatively.

iv. That greater-than-anticipated public spending reduces the speed at which core inflation declines.

v. If wage negotiations are not congruent with productivity gains, they could become a source of cost pressures in the economy.

Downside risks:

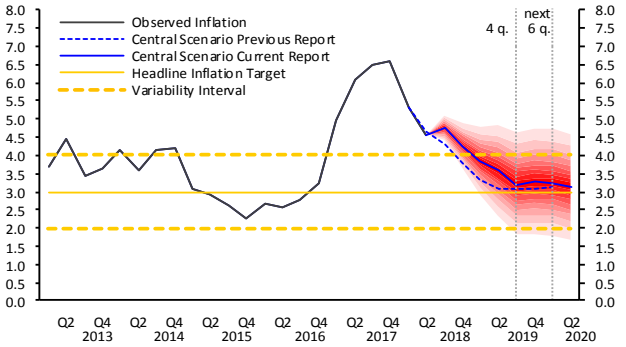
i. The possibility of the peso appreciating if the outcome of the recent statements of a preliminary agreement for the modernization of the trade treaty with the U.S. is favorable.

In the same vein, some of the risks that could affect the inflation outlook in the long run are:

i. That the real exchange rate shows a greater trend towards depreciation, given an unfavorable external environment regarding financial and trade conditions.

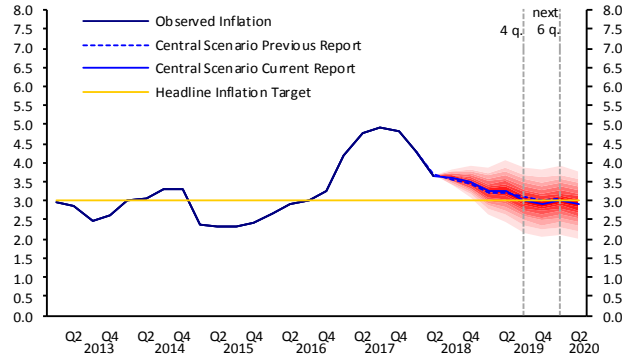
ii. That a situation of structurally weak public finances arises.

Chart 3
Fan Chart: Annual Headline Inflation 1/
In percent



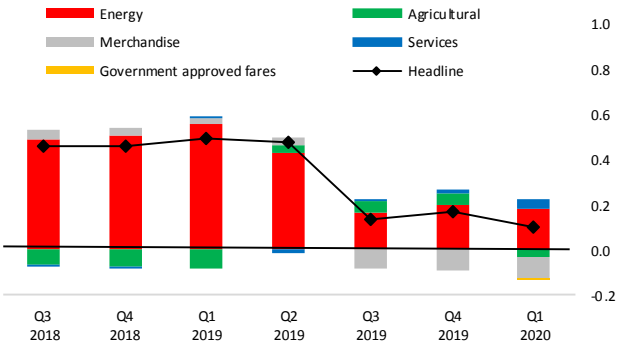
1/ Quarterly average of annual headline inflation. The next four and six quarters are indicated, using as a reference the third quarter of 2018, that is, the third and the first quarters of 2019 and 2020, respectively, time intervals over which monetary policy transmission channels fully operate.
Source: Banco de México and INEGI.

Chart 4
Fan Chart: Annual Core Inflation 1/
In percent



1/ Quarterly average of annual headline inflation. The next four and six quarters are indicated, using as a reference the third quarter of 2018, that is, the third and the first quarters of 2019 and 2020, respectively, time intervals over which monetary policy transmission channels fully operate.
Source: Banco de México and INEGI.

Chart 5
Differences in Contributions to the Forecast of Annual Headline Inflation
(Current Report vs Previous Report)



Source: Banco de México.

iii. That investment weakens further and the lack of productivity growth continues, which, in view of the expansion of certain aggregate demand components, would make inflation reduction more difficult. This could also be attributed to the deterioration of public safety conditions, corruption, and the lack of legal certainty in Mexico.

To guide its monetary policy actions, Banco de México's Governing Board closely monitors the development of inflation vis-à-vis its forecast trajectory, taking into consideration the monetary policy stance adopted and the horizon in which monetary policy operates, as well as the available information on all inflation determinants and medium- and long-term inflation expectations, including the balance of risks. The Governing Board will maintain a prudent monetary policy stance and will continue to follow closely the potential pass-through of exchange rate fluctuations on prices, the monetary policy stance relative to that of the U.S., and the evolution of slack conditions in the Mexican economy. In the presence and possible persistence of factors, that, by their nature, may involve risks to inflation and inflation expectations, the monetary policy stance will be adjusted in a timely and firm manner to attain the convergence of inflation to its 3% target, and to strengthen the anchoring of medium- and long-term inflation expectations to reach this target.

To take on the challenges that the Mexican economy may face and to address the social gaps and the needs of millions of Mexicans, policies that allow the country to reach its potential based on solid fundamentals, such as fiscal discipline, price stability, trade openness and the actions that have been taken to enhance economic efficiency should be encouraged. Thus, it is key to ratify the commitment to maintain a solid macroeconomic framework as a basis for an economic policy that fuels the growth of the Mexican economy. It should be acknowledged that macroeconomic stability in itself, despite being necessary, is not sufficient to generate greater economic growth. It is also necessary to tackle structural and institutional problems that may prevent the country from increasing its productivity, keeping in mind that, ultimately, the only way to generate better-paid jobs and to reduce poverty in a sustainable manner is via greater productivity. Indeed, various sectors of the Mexican economy have market structures that, instead of promoting competition and value creation, have favored rent extraction, protecting the interests of a few particular agents, rather than of consumers. Similarly, it is necessary to invest in projects that could provide the country with the infrastructure that contributes to strengthen the domestic market and to further exploit Mexico's export vocation throughout the country. In addition, as stated in previous Quarterly Reports, it is imperative to make progress in areas other than the economic ones, above all those related to public safety conditions and legal certainty. Indeed, improving public safety would lower the operational costs currently faced by businesses, encourage investment and private consumption, and facilitate transportation and goods distribution.

Meanwhile, strengthening the legal certainty in terms of property rights would contribute to an environment of higher investment. Thus, the policies that improve public safety, curb corruption, improve the governance of public institutions and guarantee full respect for private property are key to achieving a higher welfare of the Mexican population.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