BANCO DE MÉXICO

Executive Summary

Quarterly Report January – March 2018

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Summary

After having closed 2017 at its highest level since May 2001, over the first months of 2018 annual headline inflation has notably decreased in a manner consistent with this Central Institute's forecast published in the previous Quarterly Report. Indeed, annual headline inflation declined from 6.77% to 4.46% between December 2017 and the first fortnight of May 2018. This evolution reflects the monetary policy actions implemented by Banco de México that have contributed to prevent the generation of second round effects on the price formation process of the economy, as a result of inflationary shocks. Thus, medium- and long-term inflation expectations have remained anchored, albeit above 3.0%, and the adjustment of the Mexican peso has been orderly in an environment of uncertainty, which included tighter foreign financing to the economy since over three years ago. In this respect, monetary policy has operated, among other channels, through its effect on the interest rate spreads between Mexico and the U.S., thus allowing, through the risk-taking channel, the orderly adjustment in the exchange rate market.

The decrease in headline inflation in the reference period also reflects the fading of the effects on annual inflation by the increases in energy prices that took place in January 2017. Both core inflation and, especially, the growth rate of merchandise prices, and non-core inflation have exhibited a clear downside trajectory so far this year.

In this context, in the period covered by this Report, Banco de México has sought to maintain a monetary stance that keeps inflation expectations anchored and reinforces the downward trend of annual headline inflation towards its target in the forecast horizon. Given the deterioration in the inflation outlook at the end of 2017, and considering the expectation of tighter monetary conditions in the U.S. economy, in the February 2018 policy meeting the Governing Board decided to recalibrate the monetary stance by raising the target for the overnight interbank interest rate by 25 basis points to a level of 7.50%. Subsequently, in the April and May policy meetings the Governing Board voted to maintain the target rate unchanged, considering that the monetary policy stance adopted was congruent with the downward trend of annual headline inflation towards its target in the forecast horizon.

The monetary policy stance of Banco de México during this period was determined in a global context of higher uncertainty. Indeed, although in the first quarter of the year the expansion of the world economy remained solid and broad-based, and for the rest of 2018 and 2019 this trend is set to persist, risks to the global economy in the medium and long terms have increased. Among these risks are higher volatility in international financial markets, in view of possible additional inflationary surprises across a number of advanced economies, especially in the U.S.; the escalation of protectionist measures and the materialization of some geopolitical events. Some of these risks have recently started to be reflected in greater volatility in financial markets, higher interest rates, the appreciation of the U.S. dollar against the main currencies, a lower appetite for risk, moderate capital flows to emerging economies and a considerable depreciation in most currencies of those economies, which are facing increasingly tighter financing conditions.

In relation to the performance of the exchange rate in the period covered by this Report, between the beginning of January and mid-April 2018 the Mexican peso appreciated against the U.S. dollar, and its volatility relented. In part, this was associated to: i) Banco de México's monetary policy stance; ii) the generalized weakness of the U.S. dollar during this period; and iii) the perception of an improvement in the NAFTA negotiations. However, from mid-April to date the volatility of the Mexican peso has increased, and it has depreciated considerably. Among the factors that affected it are higher interest rates in the U.S. and the generalized strengthening of the U.S. dollar, as well as such domestic factors as the uncertainty related to the NAFTA renegotiation and to the elections in Mexico.

Regarding the performance of interest rates in Mexico over the period analyzed in this Report, short-term interest rates (shorter than one year) increased in line with the rise in the target for the overnight

interbank interest rate. Although medium- and long-term interest rates closed the period at levels similar to those observed in late 2017, they strongly declined between the beginning of the year and mid-April, and later increased.

At the domestic level, in the first quarter of 2018, the economic activity in Mexico kept recovering, and even registered a higher growth rate than that observed during the previous quarter. The dynamism of the services sector and the recovery in the industrial activity especially supported the said rebound. This adjustment is in contrast with the slowdown registered during the first three quarters of 2017 and with the weakness in some aggregate demand components (especially investment) displayed up to the third quarter of that year. In particular, in the first quarter of 2018 exports maintained high dynamism, private consumption kept expanding, although at a lower rate than in the previous quarters, and investment rebounded with respect to the weakness observed since late 2015. In this context, slack conditions in early 2018 generally seem to have remained tight.

Regarding the macroeconomic scenario forecast by Banco de México, the following is notable:

GDP Growth: The forecast for economic growth in Mexico has not been modified with respect to that published in the previous Quarterly Report. Thus, for 2018 GDP is estimated to grow between 2.0% and 3.0%, while for 2019 GDP is still expected to expand between 2.2% and 3.2%. Derived from the greater-than-anticipated dynamism of economic activity in the first quarter of 2018, the growth for 2018 could lie in the upper range of the abovementioned interval. The expected growth trajectory for the rest of the year and for 2019 is based on the expectation of a moderate recovery of private investment and spending on certain public infrastructure projects, as well as the strengthening of external demand, which would continue to support economic activity in Mexico. These forecasts assume that the authorities remain committed to preserving a solid macroeconomic framework, along with sustainable public finances and policies to promote investment and productivity growth.

Taking into account that the forecasts for GDP consider the growth of the economy to be close to its potential, and with the balance of risks biased to the downside, it is expected that the current tight slack conditions in the economy will relax throughout the forecast horizon. In particular, it is anticipated that the positive levels of the output gap estimate, which excludes the oil sector, and of the quarterly slack indicator will decline gradually over the next quarters, and the estimate of total output gap is expected to remain at levels close to zero. Therefore, in the forecast horizon, no additional tightening of slack conditions in the economy that significantly affects inflation is expected.

Employment: The forecasts for the number of IMSS-affiliated jobs remain unchanged for 2018 and 2019 relative to the previous Report. In particular, in 2018 an increase of between 680,000 and 780,000 jobs is expected, while for 2019 growth of between 690,000 and 790,000 jobs is projected.

Current Account: For 2018, deficits in the trade balance and the current account are anticipated to amount to 1.1% and 2.1% of GDP, respectively (US$14.0 billion and US$25.2 billion, in the same order), which are similar to the projections in the previous Report (US$13.7 billion and US$ 25.9 billion, in the same order). For 2019, deficits in the trade balance and the current account are estimated to be 1.1% and 2.3% of GDP, respectively (US$15.0 billion and US$30.5 billion, in the same order), which compare to 1.2% and 2.3% of GDP released in the previous Report, respectively (US$15.0 billion and US$30.5 billion, in the same order).

Despite the recovery at the end of 2017 and in early 2018, the Mexican economy is still facing important downward risks, given the persistence of uncertainty prevailing in the economy. Therefore, the balance of risks for growth maintains its bias to the downside, especially in the medium term.

The main downward risks in the forecast horizon are:

i. Uncertainty associated to the NAFTA renegotiation and the electoral process in Mexico cause a number of businesses to delay their investment plans in Mexico or prompt Mexican consumers to cut down their spending as a precaution. Regarding the NAFTA renegotiation, this risk could be exacerbated as said process extends.

ii. Volatility bouts in international financial markets, derived, among other factors, from inflation surprises in the U.S. that generate higher-than-expected increases in interest rates in that country, or from geopolitical events that constrain the sources of financing.

One of the main upward risks to growth in the forecast horizon is:

i. Uncertainty over NAFTA renegotiation is resolved, reinvigorating investment in a sustained manner.

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

i. An unfavorable outcome in the NAFTA negotiations for the Mexican productive sector, or, even, that they lead to its cancellation.

ii. An escalation of protectionist measures worldwide, which would negatively affect the global economic growth and the place of certain economies (including Mexico) in the global value chains.

iii. A number of factors (external or domestic) affect competitiveness of the Mexican economy. Among them are corporate tax cuts in the U.S. and public safety issues in Mexico.

Inflation: The decline in inflation during the first four and a half months of 2018 is consistent with the forecast presented by Banco de México in its October-December Quarterly Report. Based on available information and considering the current monetary policy stance, in the horizon in which monetary policy operates the inflation performance is expected to be similar to that projected in said forecasts. That is, the forecasts for headline inflation presented in this Report are consistent with those announced in the previous one. Within this projection, most recent data signal a relatively more favorable trajectory for core inflation, essentially due to the better-than-estimated evolution of merchandise prices, which is offset by an estimation of a slightly higher non-core inflation, derived from relatively higher prices of some energy products, as compared to those anticipated in the previous forecast (Table 1).

Table 1
Headline and Core Inflation Forecast
Annual change in percent

	2018				2019				2020
	I	II	III	IV	I	II	III	IV	I
CPI									
Current report	5.3 *	4.6	4.3	3.8	3.3	3.1	3.1	3.1	3.1
Previous report	5.5	4.8	4.3	3.8	3.2	3.0	3.1	3.2	
Core									
Current report	4.3 *	3.7	3.6	3.4	3.2	3.2	3.1	3.0	3.0
Previous report	4.4	4.0	3.8	3.6	3.3	3.2	3.1	3.0	

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

Annual headline inflation is expected to subside, approach its 3.0% target throughout the year and stay close to that target in 2019. During 2018, as mentioned above, the trajectory of core inflation is expected to show a slightly better than anticipated performance. Hence, annual core inflation is forecast to continue declining gradually to consolidate its convergence to 3.0% during 2019. The above estimates consider an orderly evolution of the exchange rate, absence of labor market-related pressures and that non-core inflation will keep subsiding during the remainder of 2018 at the anticipated pace (Chart 1 and Chart 2).

This scenario is subject to risks. The main upward risks are:

i. That the exchange rate continues to be under pressure due to an environment of higher external interest rates, U.S. dollar strength, and uncertainty associated with both the NAFTA renegotiation and Mexico's elections this year.

ii. Shocks in agricultural product prices and upward pressures in the prices of certain energy goods.

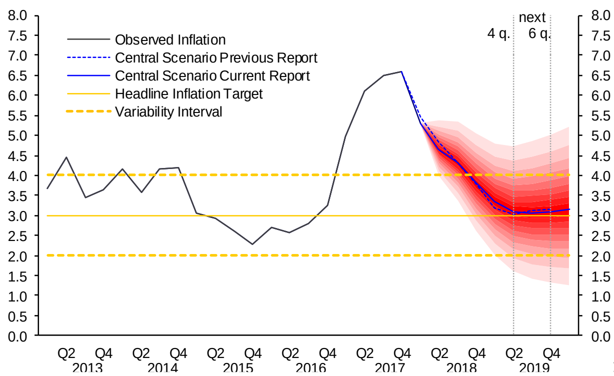
iii. Given the economy's cyclical conditions, unit labor costs could lead to inflationary pressures.

Downside risks:

i. The possibility of the peso appreciating if NAFTA negotiation is favorable.

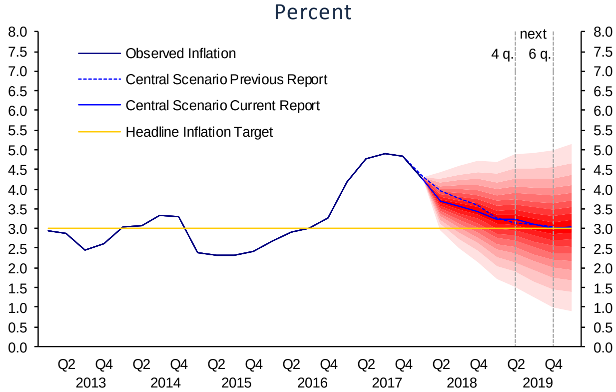
The balance of risks for inflation relative to the expected trajectory maintains an upward bias associated to the described risks, in an environment characterized by high uncertainty.

Chart 1
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 2018, that is, the second and the fourth quarters of 2019, time intervals over which monetary policy transmission channels fully operate.
Source: Banco de México and INEGI.

Chart 2
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 2018, that is, the second and the fourth quarters of 2019, time intervals over which 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 follows the development of inflation vis-à-vis its anticipated trajectory, taking into account the monetary policy stance adopted and the horizon in which monetary policy operates, as well as available information on all inflation determinants and medium- and long-term inflation expectations, including the balance of risks. Looking ahead, 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 slack conditions in the Mexican economy. In the presence of factors that, by their nature, may involve risks to inflation and inflation expectations, if needed, monetary policy will be conducted in a timely and firm manner to attain the convergence of inflation to its 3.0% target and to strengthen the anchoring of medium- and long-term inflation expectations to reach this target.

The adopted monetary policy stance, combined with the attainment of the fiscal objectives and the resilience of the financial system has contributed to the continued growth of the Mexican economy, despite a number of severe and simultaneous shocks it has faced. The strengthening of the macroeconomic framework in Mexico also placed the country in a better position to face a complex environment, while in the short and medium terms important risks persist. However, to take on the challenges that may arise and to enhance the economy's ability to tackle negative shocks, it is key that Mexico further strengthens its macroeconomic stance, particularly relative to the structural situation of its public finances. Similarly, actions should be adopted that help enhance competitiveness of the country and that foment higher productivity of the economy. Efforts should also be made to increase infrastructure development and to consolidate the recovery of investment levels. Additionally, as stated in previous Reports, it is important to undertake reforms and broad actions that improve public safety, legal certainty and economic competition, all of which would be beneficial for investment and economic growth, in an environment of low and stable inflation, for the benefit of the Mexican population.

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