BANCO DE MÉXICO

Executive Summary

Quarterly Report October – December 2017

Summary

During 2017, inflation was strongly influenced by a series of shocks of considerable magnitude, both external and domestic, pushing it to close the year at levels not observed since 2001. At the beginning of that year, inflation started to reflect the effects of the Mexican peso depreciation, mainly as a result of the uncertainty over the future of the bilateral relations between Mexico and the new U.S. administration. During the first part of the year, inflation was also affected by other factors, including: higher energy prices, particularly gasoline and LP gas prices, higher public transportation fares, and higher prices for some agricultural products. Even as inflation began to trend downwards in September 2017, in the last few months of the year, additional shocks pushed headline inflation up to 6.77 percent in December. Some of these shocks were: higher prices for LP gas and certain fruits and vegetables; additional depreciation of the Mexican peso; and the effect of the change in the calendar of the minimum wage increase, effective in December rather than in January. Notably, these shocks occurred in an environment of relatively tight cyclical economic conditions, which could affect the pace at which core inflation is declining. In January 2018, annual headline inflation dropped significantly, with a strong decrease in non-core inflation and also in core inflation, albeit of a smaller magnitude. This was a consequence of the previously implemented monetary policy actions and of the fact that some energy price increases this year were lower than last year's hikes. Nonetheless, non-core inflation at the beginning of the year continued to reflect the shocks that had occurred at the end of 2017, pushing up headline inflation expectations for the end of 2018, while medium- and long-term expectations stayed around 3.50 percent.

Banco de México adjusted its monetary stance during 2017, raising the target for the Overnight Interbank Interest rate by 125 basis points between January and June 2017, which then remained unchanged until November. However, in the December 2017 and February 2018 policy meetings, the Board of Governors voted to raise the target interest rate by 25 basis points in each meeting, to reach a level of 7.50 percent. These actions took into account the additional deterioration of inflation given the described circumstances, the objective of maintaining a monetary stance that would prevent second-round effects from affecting the price formation process and reinforce the downward inflation trend towards its target, as well as the cyclical conditions of the economy as outlined before. In the last monetary policy decision, it was stressed that the higher target rate considered the expectation of tighter monetary conditions for the U.S. economy.

The above measures were taken in a context in which, although world economic activity continued a generalized expansion and growth projections have been adjusted upwards, a number of risks persist, both economic and geopolitical, which could negatively affect the global context. In particular, faster-than-anticipated normalization of monetary policy across advanced economies is likely, especially in the U.S., possibly triggering a more volatile environment in international financial markets and restricting financing conditions, especially in emerging economies. This risk has strengthened due to the potential inflation pressures, that could be triggered by the recently approved tax cuts and higher public spending in the U.S. Indeed, this fiscal stimulus, in the context of an apparent absence of slackness in the U.S. economy, conflicts with the expectation of gradual U.S. monetary normalization and has fuelled considerable increases in the rates of 10-year and 30-year U.S. treasury bonds this year, leading to downward adjustments in the main stock indexes, albeit from high levels.

In the period analysed by this Report, the Mexican peso depreciated against the U.S. dollar and its volatility increased considerably. Among the factors that pressured the exchange rate at the end of 2017 was the uncertainty related to: i) the U.S. monetary policy normalization

process, the approval of the fiscal package in the U.S., and its final ratification in December 2017; ii) the renegotiation of NAFTA, and iii) a number of domestic events related to the electoral process in Mexico. Nonetheless, since early January the Mexican peso has appreciated slightly, which was associated with the monetary policy actions implemented by Banco de México, a somewhat improved environment in NAFTA negotiations and the generalized weakness of the U.S. dollar. Given the factors that affected liquidity in the foreign exchange market and generated higher volatility, in October and December 2017 the Foreign Exchange Commission announced measures that sought that the foreign exchange market continued to function in an orderly manner. Interest rates in Mexico displayed high volatility and increases for all terms in the reference period. These adjustments were affected both by reference rate increases in short-term interest rates and by pressures in longer-term foreign interest rates.

In the last quarter of 2017, the Mexican economy expanded considerably, propelled by the performance of the services sector, in particular. This stands in contrast with a contraction in the third quarter, in the wake of the September earthquakes and of a major decline in the oil production platform in that same month. Regarding the components of aggregate demand, exports continued to perform favorably and private consumption still displays a positive trend, albeit with signs of a slight deceleration. In contrast, investment remained weak. It should be noted that the Mexican economy has been going through an atypical economic cycle for several years, caused by the impact of unprecedented external economic conditions, as well as by the type of shocks that have affected it. This has made the assessment of cyclical conditions more difficult, particularly of slack conditions in the economy and their role in price formation. In this context, a set of slackness indicators suggests that economic cyclical conditions have been tightening, especially in the labor market and consumption, although in general they appear to have started to relent moderately.

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

GDP growth: The forecasts for economic growth in Mexico for 2018 and 2019 remain unchanged with respect to those published in the previous Report. GDP is still estimated to grow between 2.0 and 3.0 percent in 2018. In 2019, the economy is projected to expand between 2.2 and 3.2 percent. These forecasts consider that, although the foreign demand faced by Mexico could benefit from higher growth expectations (both for the U.S. industrial production and for global trade), the prevailing uncertainty around the terms that will regulate Mexico’s trade relations in North America could continue to negatively affect the evolution of investment. In line with the slack conditions described above, and considering that economic growth is expected to be close to its potential, the cyclical conditions are estimated to remain at levels similar to the current ones.

Employment: In line with the recent evolution of the economy and growth forecasts, in 2018 and 2019 the forecasts for the number of IMSS-affiliated jobs remain unchanged relative to the previous Report. Thus, for 2018 an increase of between 680,000 and 780,000 jobs is expected, while for 2019 growth of 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 percent of GDP, respectively (US$13.7 billion and US$25.9 billion, in the same order). These forecasts compare to the projections in the previous Report of 1.0 and 2.1 percent of GDP, respectively (US$13.1 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 1.2 and 2.3 percent of GDP, respectively (US$15.0 billion and US$30.5 billion, in the same order), which compare to 1.1 and 2.3 percent released in the previous Report (US$14.5 billion and US$30.6 billion, respectively).

The main downward risks to economic activity are:

i. Delays in NAFTA renegotiations or an unfavorable outcome for the Mexican productive sector. In particular, an agreement that would lead to a new pattern of trade relations that affects the formation of global value chains could hurt not only growth in the short term, but also the long-term growth potential.

ii. Bouts of volatility in international financial markets, derived from the process of normalization of U.S. monetary policy or from other factors could lead to lower sources of financing.

iii. Volatility increases in domestic financial markets, associated with the electoral process in Mexico.

iv. Competitiveness of the Mexican economy is affected by several factors (external or domestic), such as corporate tax cuts in the U.S. and public safety issues in Mexico.

The main upward risks to growth are:

i. Uncertainty over NAFTA renegotiations is resolved, reinvigorating investment, possibly even across the sectors that heretofore have been excluded from the Agreement.

ii. The implementation of structural reforms yields greater-than-expected results. In this regard, certain progress should be noted, including positive results in rounds of bidding for exploration and extraction of hydrocarbons, which are expected to lead to greater investment over the coming years and higher production in the medium term.

Despite a slightly improved balance of risks to growth as a result of the moderation in some of the most adverse risks and of the economic growth resumption in the last quarter of 2017, it is still biased to the downside. The downward trajectory of investment observed for several years, combined with the weakness it may maintain in the future, points to downward risks to economic growth in the medium and long term.

Inflation: Given the recent performance of inflation, the expected evolution of its determinants, the current monetary policy stance and the horizon at which it operates, headline inflation is forecast to continue to subside, approaching the 3.0 percent target over the course of the year, attaining it by the first quarter of 2019, and staying close to its target in the remainder of 2019. The delay in this trajectory is, in part, associated with the arithmetic effects of price increases in some energy products and fruits and vegetables, which affected non-core inflation in the last few months, along with the cyclical position of the economy, which could be influencing the pace of the core inflation decline. The estimated trajectory of core inflation is expected to continue to subside gradually, attain levels close to 3.0 percent in the first quarter of 2019 and consolidate convergence to that level during the remainder of the year (Table 1). These projections are based on the assumptions of an orderly exchange-rate performance, the absence of labor market-related pressures, and a sharp decline in non-core inflation during

2018, as long as the type of shocks that affected it last year do not take place again (Charts a and b).

Table 1
Headline and Core Inflation Forecast
Average annual quarterly rate in percent 1/

	2018				2019			
	I	II	III	IV	I	II	III	IV
CPI								
Current report	5.5	4.8	4.3	3.8	3.2	3.0	3.1	3.2
Previous report	4.6	4.1	3.6	3.0	3.1	3.3	3.1	3.0
Core								
Current report	4.4	4.0	3.8	3.6	3.3	3.2	3.1	3.0
Previous report	4.2	3.9	3.6	3.5	3.3	3.2	3.1	3.1

1/ Annual inflation for each quarter is estimated by comparing the average index of the quarter to the average index of the same quarter of the previous year. These figures can differ from the simple average of annual inflations of each month in the corresponding quarter.
Source: Prepared by Banco de México.

These forecasts are subject to risks. The main upward risks are:

i. Currency depreciation in response to, for example, unfavorable outcomes during NAFTA negotiations, negative market reaction to U.S. monetary policy actions, tighter conditions in international financial markets, or volatility related to the 2018 electoral process.

ii. New unfavorable shocks on agricultural product prices.

iii. Spikes in some energy product prices due to increases in international reference prices or to lack of competition in some markets.

iv. Given the absence of slack in the economy, especially in the labor market, the evolution of unit labor costs could put pressure on inflation.

Among downward risks are:

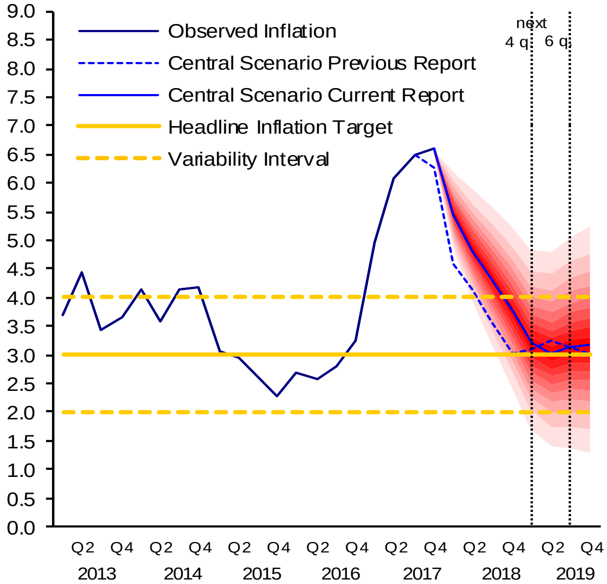
i. Currency appreciation due to a favorable outcome in NAFTA negotiations.

ii. Lower-than-anticipated economic growth.

The balance of risks for inflation maintains an upward bias, associated with the risk scenarios described above, in an environment of high uncertainty.

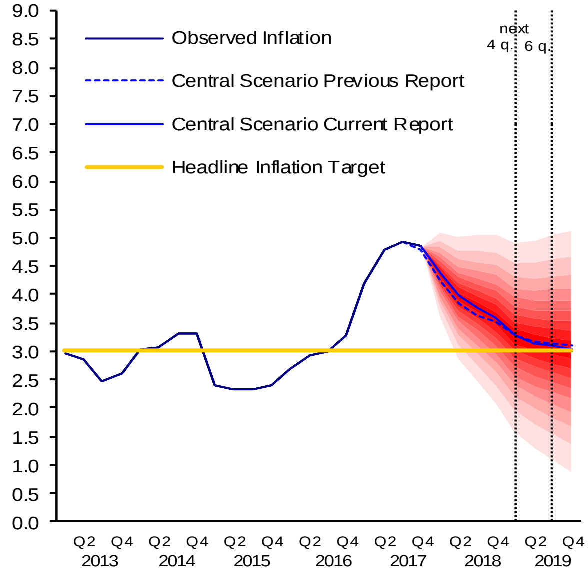
Fan Charts

a) Annual Headline Inflation 1/
Percent



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

b) Annual Core Inflation 1/
Percent



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

In this environment, the Board of Governors will keep monitoring inflation closely with respect to its expected path, taking into consideration the horizon at which the monetary policy operates, as well as available information on all determinants of inflation, its expectations over medium and long term, including the potential pass-through of exchange rate fluctuations on prices, the monetary stance of Mexico relative to the U.S. and the evolution of slackness in the economy. In the face of risks to inflation and inflation expectations, if required, monetary policy will act in a timely and robust manner to reinforce the anchoring of medium- and long-term inflation expectations and to achieve convergence to the 3 percent target.

Thanks to the monetary policy actions implemented to keep medium- and long-term inflation expectations anchored, combined with the attainment of fiscal objectives in 2017 and commitment to reach the goals set for 2018, as well as the persistent resilience of the financial system, the Mexican economy is in a better position to face possible adverse scenarios. The early renewal of Mexico's Flexible Credit Line with the International Monetary Fund for the next two years should also be highlighted as recognition of Mexico's solid macroeconomic framework. In the future, it is crucial, in addition to pursuing a prudent and firm monetary policy, to implement the measures fomenting greater productivity, and that the authorities move forward in the consolidation of sustainable public finances.

In this context, so far, the strengthening of the macroeconomic framework in Mexico has contributed to the continued growth of the Mexican economy, despite a number of severe and simultaneous shocks it has faced. Nonetheless, risks for the Mexican economy prevail in the short and medium terms. To take on the challenges that may arise, it is key for Mexico to adopt the required measures to attain a more efficient allocation of resources and boost its productive capacity. Likewise, actions that help achieve higher productivity and enhance competitiveness should be sought. Efforts should also be made to revert the downward investment trend and to increase infrastructure development. 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 result in a better environment for investment and economic growth, in lower inflation and a higher welfare for the Mexican population.

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