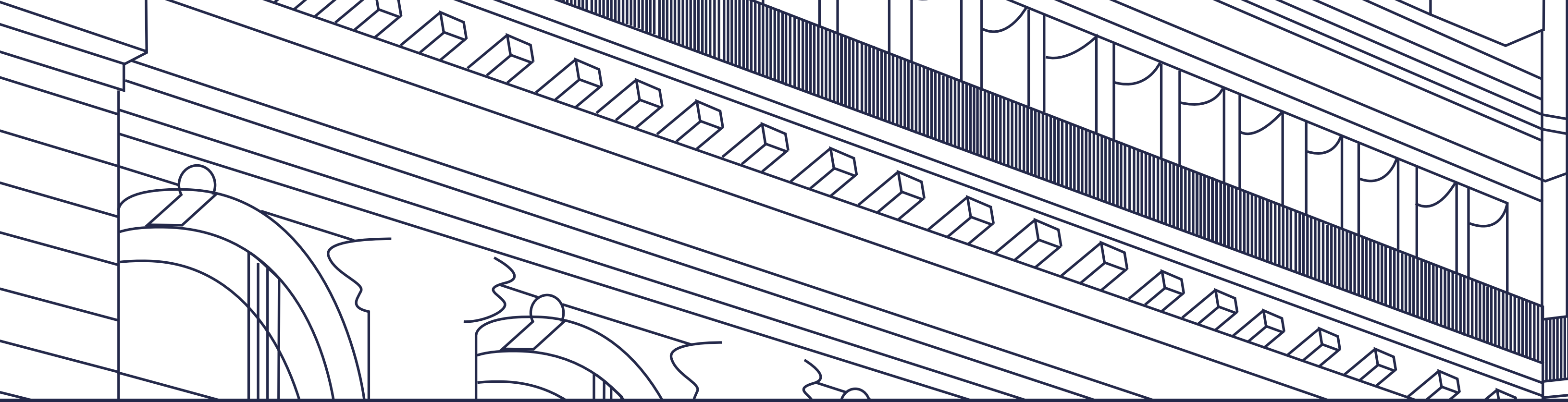

BANCO DE MÉXICO®

Minutes number 75

Meeting of Banco de México's Governing Board on the occasion of the monetary policy decision announced on April 21, 2020

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FOREWARNING
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1. PLACE, DATE AND PARTICIPANTS

1.1 Place: Meeting held by virtual means.

1.2. Date of Governing Board meeting: April 20, 2020.

1.3. Participants:
Alejandro Díaz de León-Carrillo, Governor.
Irene Espinosa-Cantellano, Deputy Governor.
Gerardo Esquivel-Hernández, Deputy Governor.
Javier Eduardo Guzmán-Calafell, Deputy Governor.
Jonathan Ernest Heath-Constable, Deputy Governor.
Arturo Herrera-Gutiérrez, Secretary of Finance and Public Credit.
Gabriel Yorio-González, Undersecretary of Finance and Public Credit.
Elías Villanueva-Ochoa, Secretary of the Governing Board.

Prior to this meeting, preliminary work by Banco de México's staff analyzing the economic and financial environment as well as the developments in inflation and the determinants and outlook for inflation, was conducted and presented to the Governing Board (see Annex).

2. ANALYSIS AND RATIONALE BEHIND THE GOVERNING BOARD'S VOTING

International environment

All members pointed out that the COVID-19 pandemic and the measures adopted to prevent its spread have affected world economic activity considerably. Most members indicated that in the last weeks the virus has spread rapidly, and **one** member noted that some countries appear to have managed to contain the pandemic. **Another** member stated that open economies that are integrated into global value chains and with a high exposure to services provided person-to-person are more affected by the production shutdowns stemming from the isolation measures. On the demand side, he/she considered that households' and firms' spending and income are being very affected. He/she added that numerous firms are facing a highly uncertain environment regarding the demand for their goods and services. He/she mentioned that production constraints and impacts on demand will lead to a significant fall in employment, aggravating the economic contraction.

All members pointed out that the complex worldwide economic situation has led to significant revisions of economic expectations, which incorporate a large contraction of productive activity in the first half of 2020. Most members stated that declines in economic activity of the magnitude that is anticipated, have not been seen since the Great Depression. One member pointed out that it is estimated that the impact will be larger in advanced economies, which would intensify the world demand shock. He/she added that among emerging economies, Latin American economies would be affected the most as a result of lower commodity prices, a large informal sector, and fragile fiscal positions.

Some members emphasized that, although a significant recovery is expected in 2021, this is subject to considerable risks, including: i) the uncertainty regarding the timing, conditions and the pace of the economy's reopening; ii) the possibility of a reemergence of epidemiological outbreaks in the absence of a vaccine or effective treatment; iii) a greater caution to resume activities, and iv) that the damage to the production apparatus and the supply chains turns out to be difficult to revert, especially if the financial systems are considerably affected. **All members noted that the outlook for the world economy remains strongly biased to the downside.**

Most members mentioned that the impact to economic activity has propitiated a sharp fall in commodity prices, especially of crude oil. Most members added that, given the lower demand and a practically nil storage capacity, even negative figures were registered in the futures' contracts to be settled next month. One member specified that this occurred despite the agreements achieved recently among the main oil producers. **Another** member mentioned that inflation pressures are contained in most countries, and underlined that inflation expectations implied by market instruments for the main economies remain below those registered at the beginning of the year.

Given the described environment, most members stated that several central banks of advanced and emerging economies lowered their interest rates significantly. Most members mentioned that currently several advanced

economies register close to zero or even negative interest rates. One member added that said measures seek to influence not only the risk-free rate, but also the risk premia faced by firms, lowering the cost of credit and thus generating confidence. He/she highlighted that central banks in emerging economies are expected to continue easing their monetary policy stances, reaching close to zero or negative real interest rates.

Most members pointed out that several central banks have also implemented extraordinary measures to foster the well-functioning of their financial systems. Most members emphasized the measures to stabilize foreign exchange markets, the asset purchase programs, and the actions to strengthen both the liquidity facilities available for financial intermediaries and the channels of credit provision. One member highlighted that the US Federal Reserve included corporate debt with a wide range of credit ratings in its asset purchase program.

Most members stated that several countries have implemented fiscal measures to mitigate the adverse effects on employment and on households' and firms' income. One member mentioned that the adoption of said measures also seeks to prevent a risk aversion spiral in financial markets. **Some** members highlighted that the support to households and firms has reached significant amounts as a share of GDP in the main advanced economies. **One** member indicated that said measures in advanced economies will be mainly financed with public debt.

Most members emphasized that the adverse environment has generated an increase in risk aversion, worsening global financial conditions and leading to a recomposition of investors' portfolios towards lower-risk assets. Most members pointed out that stock markets in various countries have been significantly affected by the realignment of portfolios towards safe haven assets. However, most members acknowledged that during the last month there was a slight improvement in international financial markets following the announcement of monetary, fiscal and financial support measures, although **some** mentioned that a fragile and volatile environment persists. **One** member pointed out that there are considerable potential pressures on global financial markets in addition to those stemming from the current situation, such as the reemergence and escalation of trade, political and geopolitical tensions.

Most members stressed that in this context emerging economies have registered significant capital outflows. Most members mentioned that this has led to a depreciation of their currencies and to volatility in their foreign exchange markets, as well as to pressures on stock indices and interest rates. Some members mentioned that capital outflows this year have accumulated the highest amount on record. **One** member added that this was exacerbated by the fall in commodity prices and in other sources of external revenue, such as those related to tourism and remittances. **Another** member mentioned that inflation pressures derived from the exchange rate adjustment are contained in most of these countries. He/she stated that most central banks in emerging economies have lowered their interest rates significantly so far this year. He/she also noted that expectations for the policy rate average in these economies for the end of 2020 are below 3.5%, which implies that emerging economies are adopting accommodative monetary policy stances with close to zero or even negative real interest rates.

Economic activity in Mexico

Most members agreed that the pandemic is an unprecedented shock. One member stated that the macroeconomic outlook has changed radically since the last monetary policy decision. **Another** member pointed out that this is due to the supply and demand shocks caused by social distancing and the economic lockdown. **One** member mentioned that Mexico currently has over 8 thousand confirmed COVID-19 cases and around 700 deaths, and that the peak of infections is expected to be reached in the next weeks. **Another** member stated that the absence of a treatment, the rapid spread of the outbreak, and the fatality of the pandemic have serious human and economic implications.

As for domestic economic activity, most members stated that supply has been affected by interruptions in the production of goods and services, as well as by the closure of businesses. Meanwhile, demand has been affected by lower consumption, as a result of a decline in individuals' incomes and of fewer spending opportunities, as well as by lower investment and lower external demand, partly due to the deceleration of the US economy. Some members noted the effect of the fall in crude oil prices. **Most members mentioned that the impact of the shock can already be observed in a number of variables, such as: i) consumer and business confidence indicators; ii) credit and debit card**

spending; iii) manufacturing orders; iv) purchasing managers' indices; v) vehicle sales; vi) air and land transportation, and vii) hotel occupancy and tourist flow. One member added that economic activity had already been exhibiting a persistent weakness, as shown by spending and production indicators for the first quarter of the year.

With respect to the labor market, most members highlighted the deterioration observed in the employment figures reported by the IMSS. Some members highlighted that, in March, formal employment registered the greatest monthly decline on record. **One** member pointed out that, during that month's contraction, the losses in the services and construction sectors and in the manufacturing industry stand out. **Another** member added that, between March 13 and April 6, 347 thousand formal jobs were lost, more than the total amount of jobs created in 2019. He/she considered that at such rate by the end of April approximately 700 thousand jobs would be lost, as compared to the 2009 crisis, when around 600 thousand jobs were lost over a 12-month period. In this context, **one** member mentioned that the main danger we face is a loss of employments in the short term that will not be able to be recovered in the medium term, sentencing a share of the population to a situation of structural poverty.

All members pointed out that, in view of the impact of the pandemic, Mexican economic activity is anticipated to contract significantly during the first half of the year, while acknowledging that the magnitude and duration of the pandemic's effects are still unknown, and that available information is still limited. One member stated that various indicators allow to foresee a severe weakening of the services sector. He/she added that automotive production contracted over 24% in annual terms in March, which signals an important deterioration of manufacturing activity. He/she specified that this scenario could deteriorate as a consequence of the extension of the social distancing measures. In this context, he/she mentioned that some specialists anticipate a contraction of up to 34% in annualized terms in the second quarter. **One** member emphasized that concerns over the severity of the economic contraction grow week after week and are reflected in the continuous downward revisions to forecasts, including those of multilateral organizations. **Another** member pointed out, in order to provide a sense of the size of the adjustment in the economic projections, that at the moment of the March monetary policy decision the median forecast of the survey conducted by a commercial bank anticipated GDP growth for 2020 and for 2021 of 0.7 and 1.6%, respectively, while currently these figures are at -5 and 1.8%, respectively, and that additional downward adjustments are being observed at the margin. **One** member highlighted that the forecast range for 2020 and for 2021 is atypically wide, lying between -9 and -3.9% and between 0.4 and 5.5%. **Some** members stated that a recession is expected with a significant impact on the labor market and on production. **One** member noted that, unlike the 2019 stagnation, when the greatest impact came from international trade and from manufacturing activity, on this occasion the most significant contraction is anticipated to take place in the non-manufacturing sector, especially in services and commerce, which will have more severe repercussions on employment and occupation. **Another** member considered that due to a lower external demand, a lower income of the population, the loss of confidence, and the risk for investment associated with the deterioration of economic conditions, the impact on demand will be deeper and longer than that on supply, which he/she mentioned would be transitory. **One** member noted that in 2020 the Mexican economy may register its greatest contraction since the Great Depression.

All members agreed that the balance of risks to growth is significantly biased to the downside. Most members stated that this balance is characterized by high uncertainty, given that the duration and depth of the pandemic are uncertain. In this respect, **one** member mentioned that this recession will considerably affect the labor market, production and practically all sectors of the economy. **Another** member mentioned the following among the main risks: i) that the impact on production is prolonged; ii) lower incomes and a greater impact on employment, and iii) a sharp contagion phase that would significantly affect all sectors of economic activity and the income of both private and public sectors, leading to a deterioration of credit risk, which could lead to financial and solvency problems. **One** member added that the effects of the pandemic could worsen if the economic policies aimed at mitigating them are insufficient. **Some** members mentioned that there is uncertainty about the strength of the recovery, once it begins. **One** member mentioned that if the expectation that the US economy will recover relatively fast in 2021 materializes, it should contribute to strengthen Mexico's economic activity, although that would depend on the degree to which the initial economic weakness affects productive capacity and the financial system. He/she emphasized that the latter highlights the importance of implementing measures in different spheres aimed at supporting them.

He/she warned that available evidence is insufficient to assess with adequate confidence margins the future trajectory of domestic production activity.

Most members agreed that slack conditions are widening considerably and that the effects of the pandemic will significantly widen the negative output gap. One member estimated that this gap will be much wider during the present and the following year as compared to what was contemplated a few weeks ago. **Another** member considered that this will imply lower inflationary pressures.

Inflation in Mexico

All members highlighted the recent decline in headline inflation, stressing that it was largely due to a reduction in its non-core component. One member noted that deflation was observed in March with respect to February, a phenomenon that had not been observed in such a period in Mexico's recent history.

Most members considered that the decline in non-core inflation was mainly due to the fall in energy prices. Some members mentioned that agricultural and livestock product prices increased. However, **one** member considered that these increases will be transitory because this type of shocks fade after a few months, and because said products currently experience a greater retail demand as a result of the social isolation measures.

As for core inflation, most members stated that it decreased slightly in March. One member pointed out that the monthly change in this component was lower than the average change in recent years, although **another one** highlighted that the rates of growth of prices in certain items remain above 4.5%.

With regards to inflation expectations, **one** member noted that these have still not changed considerably as a result of the pandemic. He/she stated that expectations drawn from surveys remain anchored at levels close to 3.5%, both for different definitions and different terms. **Some** members indicated that medium-term expectations continue above target. Meanwhile, **one** member mentioned that breakeven inflation has decreased.

Most members mentioned that headline inflation is likely to decline in the short term. Said members mentioned that this decrease will basically stem from the lower gasoline prices. Some members noted that it will also result from a lower core inflation. **One** member pointed out that the latter could partly result from the effect of the pandemic on items such as tourism services. **Another** member stated that annual inflation is foreseen to decrease once more and lie below the target at the end of April. **One** member noted that during the next months it will remain close to or even below the target.

Some members mentioned that, although different factors can affect headline inflation at different moments, it is expected to converge to Banco de México's target within the time frame in which monetary policy operates.

As for the risks to inflation, most members argued that these are associated to the effects of the pandemic on the economy and that inflation would be subject to both upward and downward pressures. First, they highlighted the downward pressures caused by the widening of the negative output gap and, in the short term, by lower energy prices. One member stated that the fall in these prices tends to have lasting direct and indirect effects on inflation. **Another** member asserted that social distancing is already disrupting the provision of certain services, and that their price variations could decrease. **Second, most members mentioned the upward pressures stemming from the peso exchange rate depreciation, which will depend on its magnitude and persistence. Some** members mentioned that in the short term the supply shocks derived from the impact on the supply chains and, in general, from production disruptions, would exercise upward pressures on inflation. **One** member estimated that these likely upward pressures have been more than offset by the above referred downward pressures. **Another** member expressed that the upward adjustment in the peso exchange rate will have a relatively limited impact on inflation, considering what multiple studies suggest. He/she considered that, in such a complex situation as the current one, upward risks to inflation should not be overestimated, in particular, those associated to the exchange rate.

Most members indicated that uncertainty as to the balance of risks for inflation has increased significantly. Some of them pointed out that an uncertain environment for inflation prevails especially in the long term. One member noted that the uncertainty is associated to: i) possible changes in consumption patterns and their effects on price formation; ii) the magnitude and duration of shocks; iii) the persistence of adverse conditions in the financial markets; iv) the effects of disruptions in global value chains and a possible shortage of certain goods, and v) possible second round effects in case the exchange rate depreciation is perceived to be permanent. **Another** member stated that, although he/she agrees that the net effect of the recent shocks on inflation is uncertain, given the scale of the expected fall in output, the probability that the demand shock will prevail has increased, although in an environment characterized by significant risks. **One** member considered that the balance of risks for inflation in Mexico is clearly biased to the downside. **Another** member specified that this balance is biased to the downside in the short term. He/she underlined that uncertainty prevails in the medium and long terms as a result of the following: i) the price index loses relevance given that there is a sector of the economy that is unable to consume freely; ii) it is unknown what the price dynamics will be once the lockdown measures are raised; iii) a significant percentage of the decline in inflation is due to the non-core component, which could revert, and iv) medium-term inflation expectations remain above the target. He/she mentioned as an additional factor the loss of efficiency in measuring inflation and other economic indicators, due to data collection problems generated by the social distancing measures. He/she pointed out that although remote methods to conduct surveys are being proposed, this methodological change implies a lower quality of information and of assessment of the current juncture.

Macrofinancial environment

Most members highlighted the deterioration of domestic financial markets generated by the shocks associated with the pandemic, while they acknowledged that a slight improvement has been recently observed, although risks to their performance continue. Some members pointed out that markets continue to exhibit a significant degree of volatility. **All members underlined the depreciation of the peso exchange rate**. **Some** members stated that, among emerging economy currencies, the Mexican peso is one of those with the greatest cumulative depreciation in the year. **One** member pointed out that, since Banco de México's past monetary policy decision, the peso exchange rate reached a new historical high of 25.77 Mexican pesos per dollar. He/she also mentioned that trading spreads in the foreign exchange market widened to unprecedented levels. He/she stated that in the above described environment there has been a transition from a long to a short position in short-term foreign exchange instruments denominated in Mexican pesos. **Another** member considered that, although the depreciation of the Mexican peso exchange rate is partly explained by factors that have affected emerging economies in general, the presence of idiosyncratic factors is clear, as evidenced by the recent downgrade in the sovereign and in Pemex's credit ratings. **One** member stated that the depreciation of the peso exchange rate has taken place despite the high interest rate spread with respect to the US Federal Reserve.

As to fixed income markets, the majority of members mentioned that, after having increased significantly, interest rates of government securities have decreased, although they still remain volatile. One member pointed out that the slope of the yield curve increased, as term premia continue to reflect concerns about factors related to domestic policies. **Some** members highlighted that significant outflows of foreign capital were observed. **One** member specified that, during March, an outflow of 6 billion US dollars was observed, a figure never observed before for a single month. **Most members noted that risk premia increased considerably**. **One** member highlighted that those for 5-year credit default swaps (CDS) registered the largest increase in the year among the main emerging economies. **Another** member stated that these instruments halted their upward trend after Banco de México's latest monetary policy decision.

Most members warned that the adverse environment the domestic economy is facing resulting from the pandemic and the lower oil prices is worsened by idiosyncratic factors. **In this context, most members highlighted the recent downgrade of the sovereign and Pemex's credit rating by three agencies. The majority of members pointed out that one of them lowered the sovereign debt rating to one level above losing the investment grade and that two of them placed Pemex's debt rating below investment grade.** In this regard, **one** member noted that such adjustments responded to concerns regarding: i) the fall in oil prices; ii) the fragility of public finances; iii) Pemex's financial sustainability, and iv) the weakening of institutions due to domestic policy. He/she added that although the market had already discounted these adjustments, additional sales of such assets by investors can be expected, leading to a greater tightening of Pemex and the country's financing conditions, which could hinder economic recovery once the health emergency is over. **Another** member mentioned that the fall in oil prices has resulted in a reduction of Pemex's revenues and profitability, as well as in a higher risk premia on its bonds.

The majority of members highlighted the importance of fiscal measures under the current situation, although they pointed out that fiscal sustainability must not be jeopardized. In this regard, **one** member mentioned that there is a reduced margin due to the fragility of both public finances and Pemex, as reflected by the credit rating downgrades observed in the last few days. **Another** member pointed out that fiscal measures that address the effects of the sanitary emergency and support micro, small-, and medium-size firms and the lowest income households are imperative. He/she added that, for this purpose, a reassessment of the priorities is necessary as well as the implementation of schemes that allow for a greater participation of the private sector in public investment projects with high social and economic returns. **One** member considered that currently there is a limited margin to negotiate additional debt issuances. He/she mentioned that there is room for flexibility in monetary policy and thus reduce the government's financial cost. He/she mentioned that, only in 2019, the interest, commissions and expenses on the public sector's debt amounted to 900 billion pesos, that is, nearly 4% of GDP. He/she concluded that reductions in the monetary policy rate might also contribute to the health of public finances by liberating space to increase public debt and therefore stimulate the economy.

In light of an adverse situation as the currently faced, most members highlighted the importance of maintaining sound macroeconomic fundamentals and adopting actions that promote a better adjustment of financial markets and of the economy overall. Similarly they noted that in this environment, it is essential to generate public policies that guarantee certainty for private investment. In this regard, said members expressed their concerns about the deterioration of the rule of law and the persistent insecurity, which leads to an unfavorable environment for investment. Some members noted that the external shocks worsened the problems that were already underway, which were mainly the result of the lack of confidence stemming from public policy decisions, of the deterioration of the rule of law, the institutional framework and public security. **One** member mentioned that March was the most violent of the last 18 months, by number of executions and homicides. There is no productive apparatus that can withstand insecurity conditions of such magnitude; it is an imperative agenda that must be addressed in order to reactivate the economy. In this regard, he/she mentioned that no fiscal or monetary policy measure will be able to render the expected benefits if there is no confidence to invest. **Another** member considered that all of the above factors, along with the perception of insufficient fiscal efforts to face the external shocks, have contributed to undermine the environment for private investment and have increased doubts regarding the country's growth potential over the next years and its implications for public finances. He/she highlighted that this situation is further worsened by concerns over the uncertain outlook for Pemex and the possible depletion of resources from the Budget Revenue Stabilization Fund (FEIP) in the near future, raising investors' doubts about the viability of maintaining the investment grade status for sovereign debt. He/she stated that a deep reorientation of the economic strategy is fundamental to overcome the current crisis and strengthen the country's growth outlook in the long term.

Monetary Policy

In light of the COVID-19 pandemic's expected impact on inflation, economic activity and financial conditions, all members agreed on lowering the overnight interbank interest rate by 50 basis points to 6%. Similarly, they agreed on implementing additional measures to foster an orderly behavior of financial markets, strengthen the channels of credit provision in the economy, and provide liquidity for the sound development of the financial system. Most members pointed out the importance of providing a timely response given the rapidly changing circumstances.

One member stated that the trade-offs associated with the inflation outlook should be assessed in an environment that, although being uncertain as to the magnitude and persistence of the shocks it is subject to, it will clearly register a significant economic contraction. **Another** member pointed out that, considering the balance of factors affecting inflation and, in particular, the higher probability that the demand-related shock on inflation will prevail over others that operate in the opposite direction, a lower policy rate is consistent with the convergence of inflation to the 3% target within the time frame in which monetary policy operates. He/she also considered that the proposed reduction will allow for an adequate balance between the margins that have become available for monetary policy and the risks that continue to be observed. **One** member added the importance of communicating clearly that given the observed inflation the main purpose of lowering the policy rate is to support the functioning of financial markets in face of the uncertainty and volatility generated by the pandemic, and that its main objective is other than to foster consumption and investment.

Another member pointed out that, in an environment where slack conditions are widening, the expected rate of return on capital is lower, and, to avoid distortions in the credit market, it is convenient that the rate at which investment projects are financed is adjusted downwards, which calls for easing monetary policy. He/she noted that the above would improve financial conditions, which is a necessary although not sufficient condition to reactivate credit. He/she also stated that even though the relative monetary policy stance is only slightly restrictive, despite the high interest rate spread with the United States, the absolute policy stance is above the short-term neutral rate, when it should already be below it. **Some** members considered that the upward adjustment in country risk indicators shows that the relative monetary policy stance does not have an ample margin, as often believed. **One** member added that the increase in capital outflows also suggests that said margin is not ample. **Another** member added that monetary conditions in several economies have eased considerably, and thus the relative monetary policy stance remains wide vis-à-vis other economies, including those emerging economies that have a higher credit risk than Mexico's. Nevertheless, he/she mentioned that, in light of the magnitude of the shock on economic activity and the increase in risk aversion, interest rate spreads have not been determinant in the portfolio adjustments observed. He/she highlighted that even the currencies and instruments with more liquid and deeper markets may have registered higher capital outflows. However, the same member emphasized that, as risk appetite normalizes, interest rate spreads may be more relevant.

One member pointed out that at this moment domestic financial markets are being mostly affected by investors' concerns regarding the weak performance of real economic activity, and to a lesser extent by interest rate spreads. He/she stated that so far this year the Mexican peso has been one of the currencies with the worst performance despite the high interest rate spread between Mexico and the US Federal Reserve. He/she added that the foreign exchange depreciation in economies with low interest rate spreads has been smaller than in economies with high interest rate spreads. He/she argued that this could be reflecting investors' expectations about the accommodative monetary policy in the former economies allowing them to have a faster recovery and a lower contraction of real economic activity. He/she pointed out that an argument in favor of maintaining a high interest rate spread is to note that the volatility-adjusted spread has decreased. Nevertheless, he/she added that considering that exchange rate volatility might be partly the result of the high interest rates and their impact on economic activity, the recent behavior of the foreign exchange spread calls precisely for the opposite action, i.e., to promote an even greater reduction of interest rate spreads. In the same regard, he/she mentioned that the higher risk premia observed does not limit the margin for lowering the monetary policy rate and rather constitutes an additional reason for continuing to do so, as a substantial reduction would allow to offset the effect of the higher risk premia by maintaining or even lowering the cost of credit to firms. He/she added that in light of the capital outflows registered over the last weeks, concerns about monetary policy easing likely propitiating a significant depreciation of the peso exchange rate must be ruled out. He/she stated that other Latin American economies have significantly lowered their interest rate spreads, without this having implied greater depreciations than the Mexican peso's. He/she also noted that the decision to lower the monetary policy rate by 50 basis points in March had positive effects on financial markets. Said member mentioned that interest rates of government securities decreased for all terms. He/she stated that when a monetary policy easing is perceived as a risk for inflation, long-term interest rates tend to increase reflecting the upward adjustment in inflation expectations. For this reason, he/she argued that the recent behavior of interest rates reflects that the market is not anticipating inflationary pressures associated with a less restrictive monetary policy stance. He/she pointed out that there is a wide room to continue lowering the policy rate, favoring financial markets and without generating inflationary pressures.

Most members agreed that monetary policy by itself will not be able to solve the difficulties generated by the shocks that are affecting the economy. One member argued that the credit channel is ineffective to reactivate the economy. He/she highlighted that Banco de México is most willing to contribute to face this pandemic, within the limits allowed by its institutional framework, without undermining its primary objective or independence, and maintaining its credibility. **Another** member added that, although the measures of monetary policy easing are essential in the current context, overcoming the crisis requires adequate public health and fiscal actions. He/she added that monetary policy can only contribute to long-term economic growth by generating the conditions for macroeconomic stability. He/she noted that its impact on economic activity is modest even throughout the cycle, due to the characteristics of the Mexican financial system. He/she also emphasized that, when facing shocks like the current one, monetary policy has limitations to mitigate the fluctuations of economic activity. He/she stated that a set of policies aimed at fostering both an adequate environment for private investment and productivity growth are needed to boost economic growth.

One member considered wrong to believe that low interest rates cannot contribute to the economic recovery. He/she added that the cost and access to credit for micro, small- and medium-size firms, which are those that generate most of the jobs and which will be the most affected by the pandemic, would be highly favored by a significant reduction in interest rates. He/she argued that fiscal policy could also contribute to this; however, if the government's borrowing costs remain high, the room for implementing a fiscal stimulus would be limited. He/she considered that high interest rates affect the health of public finances by increasing their financial cost. However, he/she mentioned that there is room for flexibility in monetary policy and thus to reduce the government's financial cost.

The majority of members pointed out that the outlook for monetary policy remains complex. The majority highlighted the combination of a sharp contraction of economic activity, both upward and downward pressures on inflation, and volatility in financial markets. One member highlighted the importance of identifying the different dilemmas that monetary policy faces, of monitoring the scenarios that materialize, and defining the most convenient monetary policy adjustments. **Some** members underlined the importance of having more timely data to monitor which scenarios will materialize.

Most members pointed out the importance of Banco de México acting with prudence. One member indicated that some risks associated with public finances and Pemex’s financial situation have materialized and thus that it is necessary to act with caution. **Another** member mentioned that given the expected trends, there are conditions to consider a further monetary policy easing, even in the short term. However, due to the risks for inflation and the high volatility in the financial markets, it will be necessary to proceed with caution. **One** member indicated that several risk factors prevail that could have negative consequences on the credibility of the central bank’s commitment to the inflation target. He/she stated that given the economic emergency and the current level of inflation, the emphasis must be set upon providing the necessary liquidity and prevent any affectations to financial stability. **Another** member mentioned that, under the present situation, the most prudent monetary policy is to substantially lower the policy rate, so that the real interest rate is below its neutral level as soon as possible, without discarding the possibility of moving towards a real rate close to zero or even negative. He/she added that not doing the above or postponing it for too long would be an unwise decision, as it would affect the Mexican economy at a time of economic crisis, would deteriorate financial markets, and would jeopardize price stability.

All members acknowledged that the global and domestic macroeconomic environment has changed considerably over the last weeks, and that in order to respond promptly it was necessary to make a monetary policy decision out of the programmed schedule and accompany it with additional measures to foster an orderly behavior of financial markets, strengthen the channels of credit provision, and provide liquidity for the sound development of the financial system. One member argued that given the emergency, multiple economic agents, firms and households, must rely on financing sources to be able to offset the reduction in their income as a result of the social distance measures. The fall in income together with greater risk aversion, can result in a segmented financial market in which only lower-risk and large-sized issuers have access to financing. He/she highlighted that, under the current environment, the proper functioning of credit channels indeed becomes more necessary. He/she added that in a context of mandatory shutdowns in the production lines of goods and services, the reduction of interest rates may have a lesser effect on aggregate demand in the short term. In this context, he/she added that in order to strengthen the financial system and provide greater liquidity to the payment systems, it is necessary to: i) improve the functioning of financial markets, strengthening their price discovery process in a wide range of assets; ii) provide sufficient liquidity and prevent its segmentation, in order to foster the sound development of the financial system, and iii) strengthen the channels of credit provision, in order for financing to reach a wide number of creditors. In particular, through measures that i) grant more liquidity to the daily funding market at the opening of markets and to expand the collateral eligible for financing facilities; ii) expand the terms and types of instruments with which banks can carry out repo agreements with Banco de México, in order to provide more liquidity and strengthen the secondary market of said securities, as well as to carry out operations aimed at promoting a better functioning of the government securities' yield curve, and iii) provide resources to banks so that they can grant credit to micro, small- and medium-size firms, as well as to households affected by the pandemic.

Another member underlined that by enabling the financial system to fulfil its role in mobilizing loanable funds, these measures will help the economy to absorb the real shock of the pandemic in an orderly manner. **One** member highlighted that such measures are necessary given the volatility registered by domestic financial markets. In this regard, he/she mentioned that these actions would help to improve trading conditions in the fixed income market, which have deteriorated significantly despite the generalized decreases in the yields on government securities. The same member pointed out that in light of a crisis like the current one, the central bank must act on several fronts to contribute to preserve financial stability conditions and incentivize the expansion of banking credit which, besides alleviating the impact of the pandemic, support the strengthening of confidence.

Another member stated that prior to the measures announced in this monetary policy decision, other actions had already been taken such as reducing the monetary regulation deposit and making some credit facilities more flexible, in addition to increasing financing in foreign currency by taking advantage of the credit swap line with the US Federal Reserve. He/she mentioned that some of the actions of the new package aim at expanding the collateral eligible for accessing liquidity facilities and for widening the coverage to development banks. He/she also pointed out that the package includes measures to strengthen the credit channels and the programs carried out jointly with the Ministry of Finance to ensure the proper functioning of the bond market, in order to improve the banking sector's positioning given the large amount of capital outflows. He/she stated that in accordance with the Foreign Exchange Commission, the package incorporates foreign exchange hedges with non-domiciled counterparties. Said member stated that the Banking Liquidity Regulation Committee has implemented, among other measures, countercyclical macroprudential policies by temporarily loosening minimum liquidity requirements. He/she argued that, with these actions, financial institutions will be able to ensure a better balance given the disruptions in their financial positions, especially if the higher number of non-performing loans affects their liquidity. He/she added that the complex situation demands implementing decisive actions, many of which are unprecedented. He/she stated that, despite these measures, the fall in economic activity is so deep and complicated that it may reveal or exacerbate existing structural flaws. Thus, this extraordinary situation requires acting more boldly and far beyond the traditional schemes.

3. MONETARY POLICY DECISION

Considering the risks resulting from the COVID-19 pandemic for inflation, economic activity and financial markets, major challenges arise for monetary policy and for the economy in general. In light of the foreseen implications, and with the presence of all its members, Banco de México's Governing Board decided unanimously to lower the target for the overnight interbank interest rate by 50 basis points to a level of 6%. The Governing Board also decided to implement additional measures to foster an orderly behavior of financial markets, strengthen the credit channels and provide liquidity for the sound development of the financial system.

The Governing Board will take the necessary actions on the basis of incoming information so that the policy rate is consistent with the orderly and sustained convergence of headline inflation to Banco de México's target within the time frame in which monetary policy operates. Perseverance in strengthening the macroeconomic fundamentals and adopting the necessary actions, regarding both monetary and fiscal policies, will contribute to a better adjustment of domestic financial markets and of the economy as a whole.

4. VOTING

Alejandro Díaz de León-Carrillo, Irene Espinosa-Cantellano, Gerardo Esquivel-Hernández, Javier Eduardo Guzmán-Calafell and Jonathan Ernest Heath-Constable voted in favor of lowering the overnight interbank interest rate by 50 basis points to 6%.

ANNEX

The information in this Annex was prepared for this meeting by the staff of Banco de México's General Directorate of Economic Research and General Directorate of Central Bank Operations. It does not necessarily reflect the considerations of the members of the Governing Board as to the monetary policy decision

A.1. External conditions

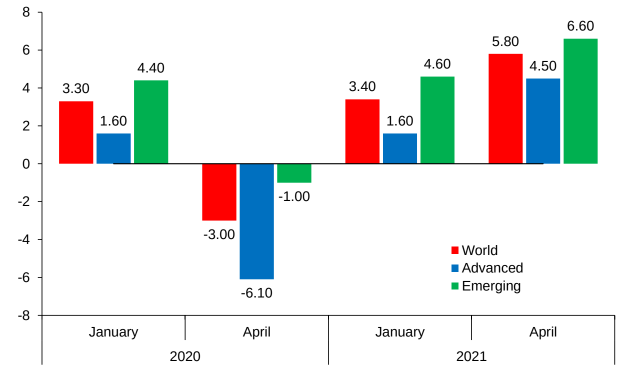
A.1.1. World economic activity

The COVID-19 pandemic and the measures adopted to prevent its spread have continued to affect world economic activity. This has led to significant revisions to the world economy's growth outlook, which include a large contraction of productive activity in the first half of 2020 and a recovery in 2021 (Chart 1). Such outlook faces a high degree of uncertainty and its balance of risks is strongly biased to the downside. Lower global economic activity also led to a sharp fall in commodity prices, especially of crude oil. As to the prices of the latter, despite the agreement recently reached among several producers to decrease its supply, they have not recovered due to expectations of lower demand and lack of storage capacity. In this context, the lower energy prices and aggregate demand have led to a decline in inflation in most economies, and in several of them it remains below the targets of their respective central banks.

The economic emergency has led several central banks of both advanced and emerging economies to continue to considerably lower their interest rates and to implement new extraordinary measures to foster the well-functioning of their financial systems. Similarly, several countries have continued to implement fiscal stimulus measures to mitigate the adverse effects of the pandemic on employment and on households and firms' income.

In this environment, global financial conditions have deteriorated, leading to a recomposition of investors' portfolio towards lower risk assets, as well as to a reduction in holdings of emerging economies' assets. This adjustment has led to a depreciation of these economies' currencies and to a high volatility in their foreign exchange markets.

Chart 1
Real GDP Growth Forecasts
Percent



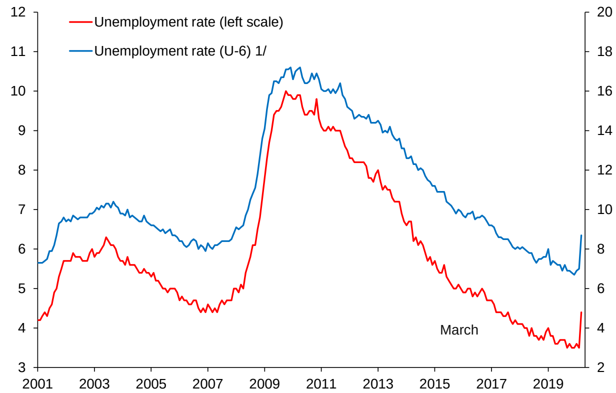
Source: IMF, World Economic Outlook (January and April 2020).

In the United States, GDP growth is expected to contract during the first quarter of the year due to the negative impact on supply chains and to a fall in consumer and private investment spending. Indeed, a severe contraction in retail sales was registered in March, while indicators on existing home sales and equipment production point to a contraction in residential and business investment. In addition, consumer confidence and construction indices, as well as others available indicators for April, suggest that economic activity will deteriorate further during the second quarter of the year.

US industrial production contracted in March at a monthly rate of 5.4% in light of the shutdown of manufacturing plants due to the health emergency. This behavior reflected falls in its three main subsectors, standing out the 6.3% fall in manufacturing production, the largest fall since February 1946. Some indicators available for April, such as the manufacturing sector Purchasing Managers' Index (PMI) of the Federal Reserve Banks of New York and Philadelphia, plummeted, thus suggesting that the sector's weakness could intensify in the future.

US labor market indicators deteriorated significantly in light of the measures to contain the COVID-19 spread. In particular, in March 2020 employment in the non-farm sector contracted by 701,000 jobs, its greatest fall since March 2009. The unemployment rate increased from 3.5% in February to 4.4% in March (Chart 2). Initial unemployment claims increased by around 22 million in the four weeks ending on April 11, foretelling that a strong fall in employment and a significant increase in the unemployment rate will be observed in April.

Chart 2
USA: Unemployment Rate
Percent, s.a.



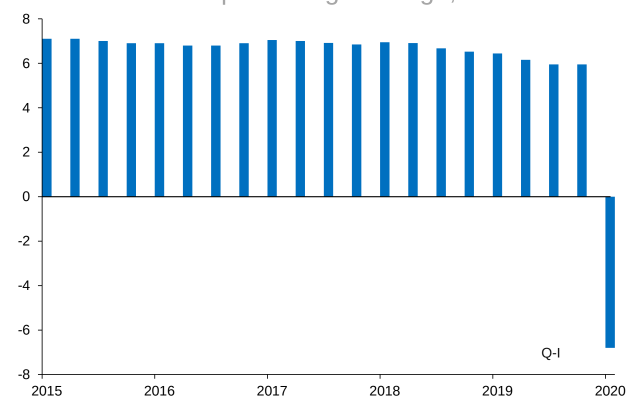
s. a. / Seasonally adjusted figures.
1/ Includes part-time and discouraged workers.
Source: Federal Reserve Economic Data (FRED).

In the euro area, available indicators point to a contraction of economic activity in the first quarter of this year. Although available figures for February for employment, retail sales and industrial production still do not fully reflect the effects of the measures adopted to contain the pandemic spread, leading indicators, such as the Purchasing Manager's Indices (PMIs), plummeted in March, reflecting said effects on several economies of the region. Similarly, consumer confidence and economic sentiment indices contracted that month, with the latter pointing to a greater impact on the services sector. In this context, economic activity in this region is anticipated to contract significantly during the first half of the year.

In Japan, available information suggests another GDP contraction in the first quarter of the year. Leading indicators, such as PMIs registered in March a fall in the manufacturing sector, most sharply in the services sector. Net exports are expected to register a negative contribution due to the impact on global supply chains and to the lower global demand. Similarly, private consumption is expected to decrease as a result of the measures to contain the pandemic.

In emerging economies, the latest information suggests a significant deterioration of economic activity during the first quarter of the year, particularly in Asian economies that are highly integrated to China and in commodity exporting countries. Chinese economic activity fell by 6.8% at an annual rate during the first quarter of the year, its first decline in four decades (Chart 3). It is worth noting that the most recent data on this country, such as that for industrial production, retail sales and fixed asset investment, recovered in March as the spread of COVID-19 has been mitigated and production and commercial and service activities have gradually restarted, which may lead to a rebound of that economy during the second quarter of the year. In Latin America, the economic weakness is anticipated to have intensified during the first quarter of 2020 as a result of the measures to contain the virus outbreak, the weakening of global demand, the capital outflows, and the fall in commodity prices. Such weakness is expected to further intensify during the second quarter.

Chart 3
China: Gross Domestic Product
Annual percentage change, s.a.



s. a. / Seasonally adjusted figures.
Source: Haver Analytics.

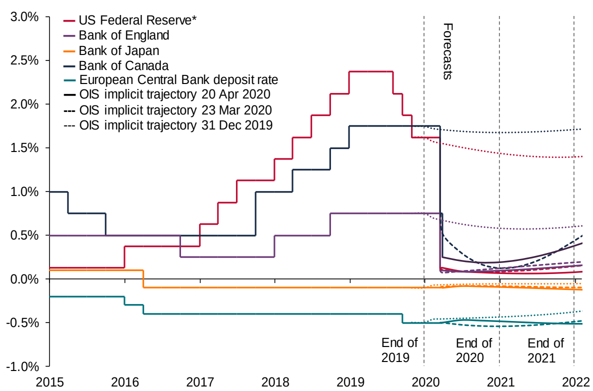
International commodity prices registered mixed behaviors since Mexico's latest monetary policy decision. In particular, crude oil prices decreased significantly due to expectations of a lower demand for crude oil due to the pandemic's worldwide impact. Although the main oil producing countries reached in mid-April a new agreement on production cuts for the next years, crude oil prices continued to fall. In particular, the fast reduction of available oil storage capacity, along with the expiration of crude oil contracts for May delivery, led WTI oil future prices to fall to negative figures for the first time in history. Although the prices of industrial metals and of some grains slightly recovered as a result of China relaxing its lockdown measures, they remain at levels below those seen at the beginning of the pandemic.

A.1.2. Monetary policy and international financial markets

Headline inflation in most advanced economies decreased in March mainly as a result of the fall in energy product prices and lower aggregate demand due to the pandemic, and remained below the targets of their respective central banks. Core inflation has also declined recently, also reflecting the effects of the fall in economic activity. Inflation expectations drawn from financial instruments remained at low levels. In most emerging economies inflation also declined for the same reasons.

In this environment, several central banks of advanced and emerging economies continued to lower their policy rates significantly and to implement extraordinary measures to promote the well-functioning of their financial systems. Expectations drawn from market instruments continued to anticipate that central banks will maintain highly accommodative monetary policy stances (Chart 4). Since Mexico's latest monetary policy decision, several central banks of emerging economies have announced cuts to their policy rates, in some cases during unscheduled meetings, such as the Philippines, China, South Africa, Poland, Czech Republic, Peru, Chile, Colombia, and Israel, among others. Some central banks announced new liquidity measures and interventions in financial markets to foster their proper functioning.

Chart 4
Reference Rates and Implied Trajectories in OIS Curves*
Percent



*/ OIS: Fixed floating interest rate swap where the fixed interest rate is the effective overnight reference rate.
* In the case of the US observed reference rate, the average interest rate of the federal funds target range is used (0.0% - 0.25%).
Source: Prepared by Banco de México with Bloomberg data.

Some of the monetary policy decisions by the main central banks that stood out during the period include:

i) After an unscheduled decision taken in mid-March, the Fed's federal funds rate remained at a range of 0%-0.25%. The Fed announced complementary measures to those previously implemented to provide liquidity, support the credit needs of businesses, and foster the well-functioning of financial markets. These measures include, among others, the purchase of assets for the amount that is required, including mortgage-backed securities, and an increase in repo transactions. The Fed also announced new credit facilities for primary and secondary market participants in corporate debt and term asset-backed securities. It also implemented the Paycheck Protection Program Liquidity Facility (PPPLF) and municipal liquidity facility, among others. Finally, to provide liquidity in US dollars, it increased the frequency of its FX swap transactions with other central banks and established a repo facility for central banks and international monetary authorities that allows them to exchange Treasury bonds for US dollars.

ii) The European Central Bank (ECB) has not modified its monetary policy stance since its March meeting, where it left its policy rates at levels close to zero. In addition to the previously established measures, such as the long-term refinancing operations (LTROs) and purchases of additional assets, the ECB recently announced new actions to provide liquidity to banks, including adjusting the rules on warranties to access liquidity provision transactions and increasing risk tolerance in credit provision through its refinancing operations.

iii) In its last March meeting, the Bank of England left its policy rate at 0.1%, after having lowered it by 65 basis points in its previous two unscheduled meetings and having announced new term and corporate financing schemes. It also announced that it will continue to increase by 200 billion pounds sterling the size of its previously announced bond portfolio asset purchase program, for a total of 645 billion pounds sterling.

iv) The Bank of Japan has not adjusted its monetary policy stance since its unscheduled meeting in March, in which it left its short-term policy interest rate unchanged at -0.1% and its long-term interest rate (indexed to its 10-year bond) at 0%, and announced several measures to increase the provision of funds to financial markets. It recently announced additional measures to maintain repo market stability.

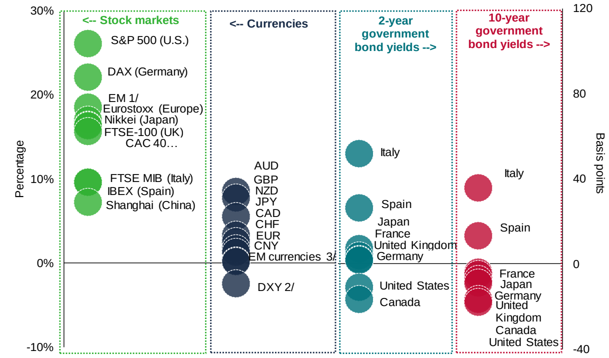
v) After having lowered its policy rate twice in March, the Bank of Canada announced a third 50-basis point cut at the end of the month, lowering that rate to 0.25%. In its April meeting, it left it unchanged, while announcing changes in its term repo transaction facility and new purchases of commercial paper, regional bonds, corporate bonds and government bonds in the secondary market, among other measures.

In addition to the above described monetary policy measures, several countries have continued to implement fiscal stimulus measures to mitigate the adverse effects on employment and on households and firms' income. Overall, such measures include direct transfers, wage subsidies, deferments for tax or loan payments, and improvements in unemployment insurance, among others.

The evolution of the COVID-19 pandemic and concerns about its impact on world economic activity led to a significant deterioration of global financial conditions in late February. In particular, the main stock indices of advanced economies fell significantly, corporate credit spreads widened considerably, and interest rates of government securities of advanced economies decreased. However, since Banco de México's latest monetary policy decision, the previously mentioned measures and the incipient stabilization of the pandemic spread in some countries gave rise to a less pessimistic sentiment that partly reversed the adjustments observed so far during the year. Thus, since Banco de Mexico's past monetary policy meeting, the main stock indices of advanced economies registered gains; the yield spreads of corporate bonds decreased; the US dollar depreciated against most currencies; and interest rates of advanced economies showed mixed adjustments (Chart 5). Nevertheless, volatility in international financial markets persists (Chart 6). In this context, there has been a recomposition of investors' portfolios towards lower risk assets and a reduction in the holdings of emerging economies' assets, which has led to a depreciation of the currencies of these economies and to a high volatility in their foreign exchange markets (Chart 7).

Looking ahead, the behavior of financial markets will be largely influenced by the evolution of the pandemic, the magnitude of its effects on economic activity and on specific sectors, such as the crude oil market, as well as by policy responses aimed at promoting the well-functioning of financial markets.

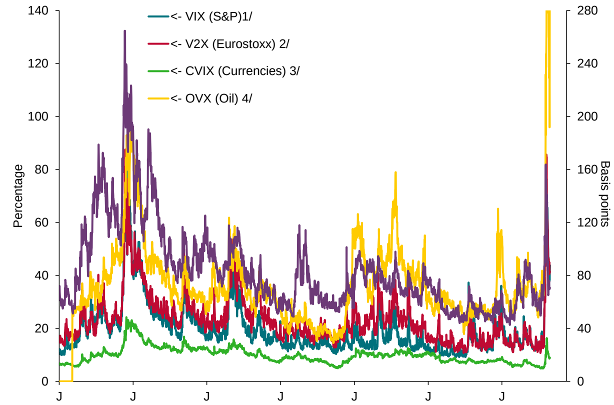
Chart 5
Change in Selected Financial Indicators from March 23 to April 20, 2020
Percent, basis points



1/ MSCI Emerging Markets Index (includes 24 countries).
2/ DXY: Weighted average of the nominal exchange rate of the six main world-traded currencies (calculated by Intercontinental Exchange, ICE) with the following weights: EUR (57.6%), JPY (13.6%), GBP (11.9%), CAD (9.1%), SEK (4.2%), and CHF (3.6%).
3/ J.P. Morgan Index constructed from a weighted average of the nominal exchange rate of emerging economies' currencies with the following weights: TRY (8.3%), RUB (8.3%), HUF (8.3%), ZAR (8.3%), BRL (11.1%), MXN (11.1%), CLP (11.1%), CNH (11.1%), INR (11.1%), and SGD (11.1%).
Source: Bloomberg and ICE.

It is worth highlighting that a high degree of uncertainty prevails about the intensity and duration of the global shock that the pandemic represents. In this regard, several risks related to the health crisis persist, such as: i) that both the pandemic and the consequent lockdown measures are extended or intensified; ii) that the tightening of financial conditions continues or increases and that this permeates to real economic activity and to financial stability; and, iii) that a slower than expected recovery of world demand occurs, with a gradual recovery in households and firms' spending, in light of the possibility of a new intensification of the pandemic or a disruption in global supply chains, thus affecting investment and employment levels in a more lasting way. In addition, other risks persist, such as: i) the possibility of a new escalation of trade tensions; ii) a worsening of geopolitical, social and political conflicts in several regions of the world; and iii) the risk of greater and more frequent economic costs due to natural disasters attributed to environmental factors.

Chart 6
Selected Implied Volatility Indexes
Percent, basis points



1/ VIX: Weighted index of 1-month implied volatilities of S&P500 options published by the Chicago Board Options Exchange. 2/V2X: Weighted index of 1-month implied volatilities of Euro Stoxx50 options published by Deutsche Borse and Goldman Sachs. 3/CVIX: 3-month implied volatility index of most traded FX rates with the following weights: EURUSD: 35.9%, USDJPY: 21.79%, GBPUSD: 17.95%, USDCHF: 5.13%, USDCAD: 5.13%, AUDUSD: 6.14%, EURJPY: 3.85%, EURGBP: 2.56%, and EURCHF: 1.28%. 4/ OVX: Weighted index of 1-month implied volatilities of crude oil options (CBOE Crude Oil Volatility Index). 5/ MOVE: Index of US Treasury yield volatility implied by current prices of 1-month at-the-money options on 2-year, 5-year, 10-year and 30-year Treasuries, calculated by Merrill Lynch.
Source: Banco de México with Bloomberg data.

Chart 7
Emerging Economies: Financial Assets Performance from March 19 to April 20, 2020
Percent, basis points

Region	Country	Currencies	Equity markets	Interest rates 2Y	Interest rates 10Y	CDS
Latin America	Mexico	-0.05%	-1.90%	-160	-117	15
	Brazil	-4.33%	15.57%	-233	-146	-41
	Chile	0.91%	21.64%	-43	-69	-39
	Colombia	2.73%	31.10%	-101	-127	-81
Emerging Europe	Russia	4.59%	11.00%	-229	-213	-100
	Poland	2.55%	11.15%	-43	-39	-4
	Turkey	-6.07%	16.14%	-183	-114	-121
	Czech Republic	2.85%	19.39%	-24	-5	-5
	Hungary	2.81%	11.64%	50	4	-2
Asia	Malaysia	0.94%	15.86%	-23	-15	-77
	India	-2.03%	11.88%	-76	-103	18
	Philippines	0.63%	24.01%	-25	-28	-71
	Thailand	0.33%	21.28%	-19	-42	13
	Indonesia	3.14%	11.46%	1	-22	-67
Africa	South Africa	-7.96%	28.68%	-105	-133	-21

Note: Interest rates correspond to interest rate swaps for 2-year/10-year maturities. In the case of Argentina, rates in US dollars are used since they are the most liquid ones and those that reflect more adequately the performance of the fixed income market in that country.
Source: Bloomberg.

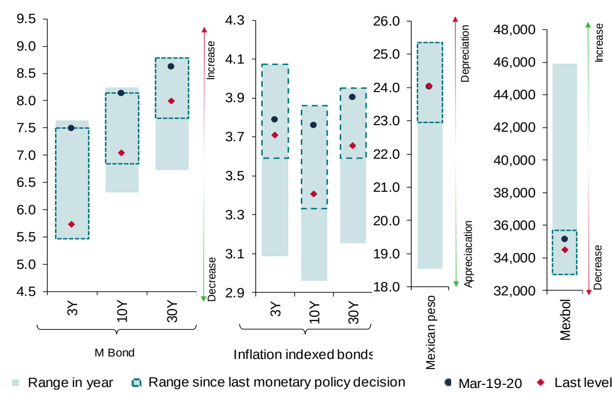
A.2. Current situation of the Mexican economy

A.2.1. Mexican markets

Since Banco de Mexico's previous monetary policy decision, although domestic financial markets have shown a slight improvement, significant risks to their performance persist. In addition, three rating agencies downgraded the sovereign and Pemex's credit ratings and two of them ranked the latter below investment grade. Thus, the prices of financial assets in Mexico showed a mixed behavior that was differentiated by asset class (Chart 8). This took place in an environment where a sentiment of caution towards emerging economies by investors prevailed.

The peso exchange rate fluctuated in a broad range of 22.89-25.77 pesos per US dollar, with the latter representing a new historical intraday high. Nevertheless, in the last weeks the peso exchange rate stabilized at around 24.00 pesos per US dollar, in a context where both FX spot and forward outright trading conditions remained deteriorated (Chart 9). It is worth pointing out that Banco México, using the mutual and temporary swap lines agreed with the US Federal Reserve, carried out two credit auctions for 5 billion US dollars each, with the purpose of providing liquidity in this currency to the country's credit institutions and ensure a better functioning of the USD funding market.

Chart 8
Mexican Markets' Performance
Percent, pesos/US dollar and index



Source: Prepared by Banco de México.

Chart 9
Mexican Peso Exchange Rate with Moving Averages

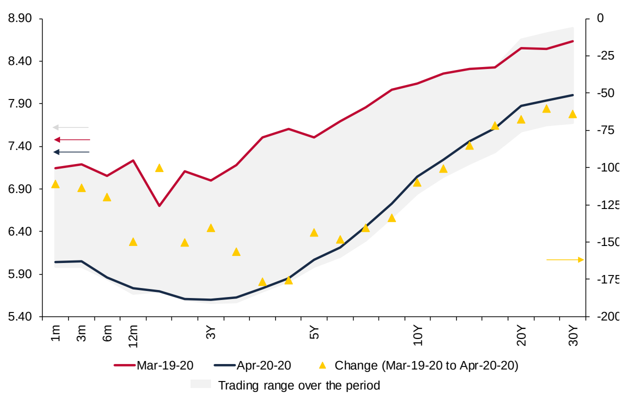
Pesos/US dollar

Source: Prepared by Banco de México.

After having increased considerably in this period, interest rates of government securities decreased up to 176 basis points throughout the entire yield curve, with short- and medium-term rates registering the greatest adjustments, although they remain volatile (Chart 10). Such adjustments took place in a context where trading conditions continued to slightly deteriorate.

Chart 10
Nominal Yield Curve on Government Securities

Percent, basis points

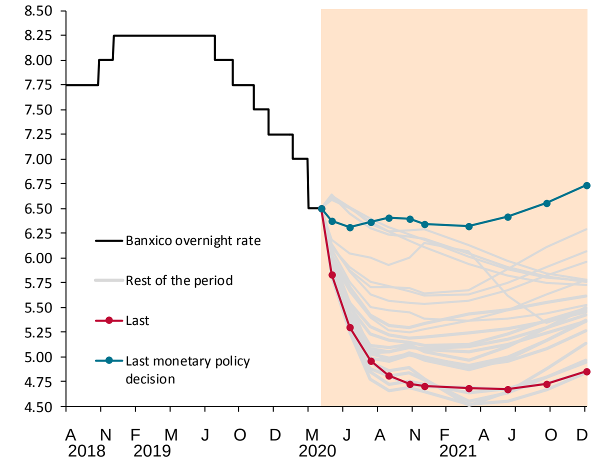


Source: PIP.

As to expectations regarding the path of the monetary policy target rate, information implied in the Interbank Equilibrium Interest Rate (TIIE) swap curve discounts a 75-basis point cut for the scheduled monetary policy decision of May, while private sector forecasters surveyed by Citibanamex are expecting a 50-basis point cut. For the end of 2020, market variables are anticipating a target rate of around 4.70% (Chart 11), while the median of surveyed forecasters remained at 5.50%.

Chart 11
Banxico Overnight Interbank Rate Implied in TIIE IRS Curve

Percent



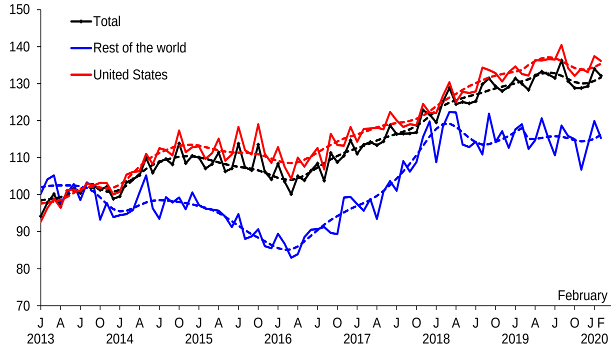
Source: Prepared by Banco de México with Bloomberg data.

A.2.2. Economic activity in Mexico

At the beginning of 2020, and prior to the COVID-19 spread, the stagnation that Mexico's economic activity has registered for several quarters continued. In this context, since the virus outbreak at the end of the first quarter economic activity has been negatively affected. Said negative impact is foreseen to have intensified in April and to extend for a period that is difficult to determine, and to lead to a significant contraction of economic activity in the first half of the year and to an overall decline of aggregate demand components.

In January – February 2020, manufacturing exports showed an improvement associated with a slight recovery of automotive exports, while the lackluster growth in the rest of manufacturing exports persisted. By destination, exports to both the United States and the rest of world slightly recovered (Chart 12). Nevertheless, looking ahead, the greater weakness of the world economy, as well as the impact of the measures to contain the COVID-19 spread on domestic production and supplies' availability, will significantly affect the Mexican export sector.

Chart 12
Total Manufacturing Exports
Indices 2013 = 100, s. a.

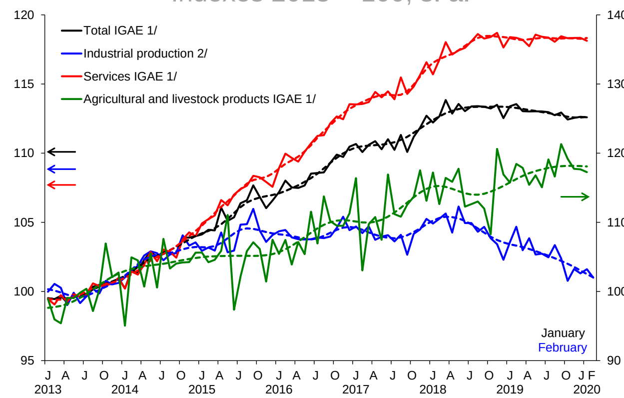


s. a. / Seasonally adjusted series and trend series based on data in nominal US dollars. The former is represented by a solid line and the latter by a dotted line.
Source: Prepared by Banco de México with data from the Tax Administration Service (SAT, for its acronym in Spanish), the Ministry of the Economy (SE, for its acronym in Spanish), Banco de México, the National Institute of Statistics and Geography (INEGI, for its acronym in Spanish), Mexico's Merchandise Trade Balance, and the National System of Statistical and Geographical Information (SNIEG, for its acronym in Spanish).

In January 2020, private consumption continued to exhibit sluggishness, mainly associated with the stagnation of consumption of domestic goods and services. Timely indicators of consumption suggest that said aggregate remained weak prior to the COVID-19 spread. In particular, in February retailer's earnings and sales of manufacturing industries that are more related with consumption in the domestic market continued to show an unfavorable performance. In addition, the adoption of measures necessary to contain the pandemic have already resulted in significant effects on other indicators, such as the strong contraction in the sales of light vehicles in March. Although gross fixed investment somewhat recovered in January –due to the slight rebound in construction, given that spending in machinery and equipment continued trending downwards–, like consumption, it is expected to be significantly affected since the end of the first quarter due to the greater uncertainty and the economic impact associated with the pandemic.

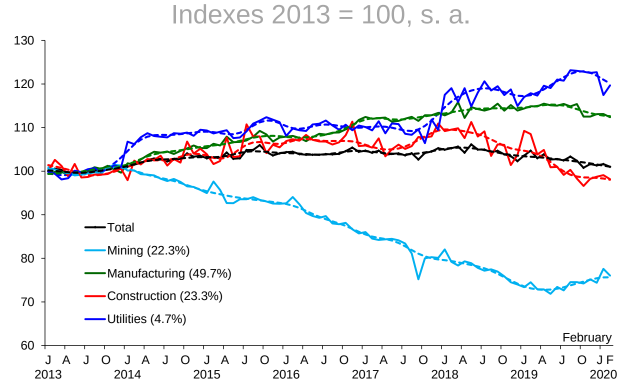
As for production, the downward path followed by industrial production and the lackluster performance of services persisted at the beginning of 2020 (Chart 13). Within the industrial sector, although a recovery was observed in transportation equipment manufacturing during the first quarter of the year, overall manufacturing continued trending downwards, while construction remained at low levels (Chart 14). In contrast, mining continued to recover, mainly driven by greater oil extraction. Tertiary activities continued to stagnate in January 2020, mostly reflecting the decline in retail trade, transportation, and mass media information services, although the rest of services also exhibited weakness. The negative performance of productive activity is expected to have intensified by the end of the first quarter and to deepen even further in the second quarter, due to the shutdown of several sectors to comply with the official measures to deal with the health emergency.

Chart 13
Economic Activity Indicators
Indexes 2013 = 100, s. a.



s. a. / Seasonally adjusted and trend series. The former is represented by a solid line and the latter by a dotted line.
1/ Figures up to January 2020.
2/ Monthly industrial activity indicator figures up to February 2020.
Source: Mexico's National Accounts System (SCNM, for its acronym in Spanish), INEGI.

Chart 14
Industrial Activity 1/
Indexes 2013 = 100, s. a.

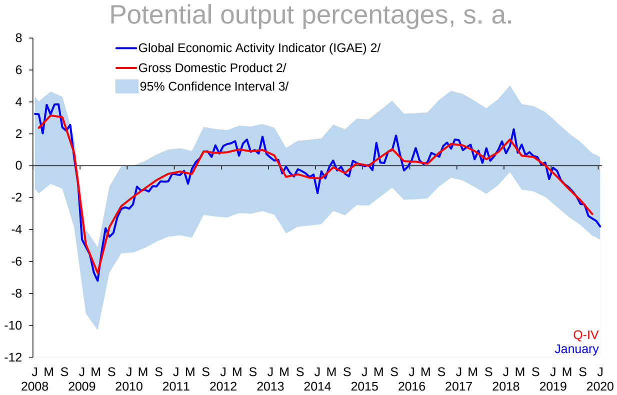


s. a. / Seasonally adjusted and trend series. The former is represented by a solid line and the latter by a dotted line.
1/ Figures in parentheses correspond to their share in the total in 2013.
Source: Mexico's National Accounts System (SCNM, for its acronym in Spanish), INEGI.

As to the economy's cyclical position, it is clear that slack conditions are widening considerably, reflecting the persisting weakness of economic activity registered at the beginning of 2020 and the effects of the measures aimed at containing the spread of COVID-19 (Chart 15). As to the labor market, in January – February 2020 both the national and urban unemployment rates followed an upward trend and stood at levels above the average for 2019 (Chart 16). The unfavorable performance in the creation of IMSS-insured jobs that had been observed intensified significantly due to the pandemic's effects, leading to the loss of 350,000 jobs between March and the first week of April, according to an announcement from the Ministry of Labor and Social Welfare (STPS, for its acronym in Spanish). Finally, as a result of the behavior of productivity and real average earnings, unit labor costs in the manufacturing sector remained at particularly high levels in February (Chart 17).

Chart 15
Output Gap Estimates [1/]
Excluding Oil Industry [4/]

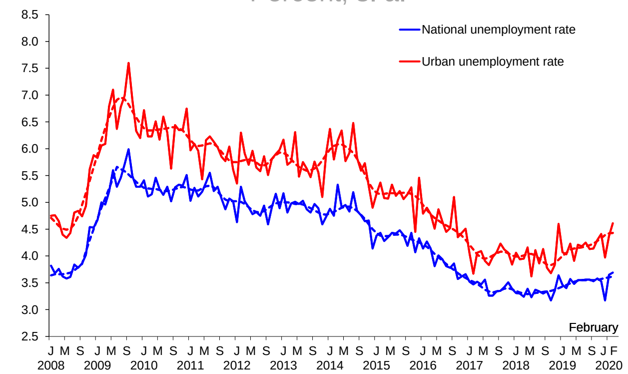
Potential output percentages, s. a.



s. a. / Calculations based on seasonally adjusted figures.
1/ Output gap estimated with a tail-corrected Hodrick-Prescott filter; see Banco de México (2009), "Inflation Report (April-June 2009)", p.74.
2/ Fourth quarter of 2019 GDP figure and January 2020 IGAE figure.
3/ Output gap confidence interval calculated with a method of unobserved components.
4/ Excludes both oil and gas extraction, support activities for mining, and petroleum and coal products' manufacturing.
Source: Prepared by Banco de México with INEGI data.

Chart 16
National Unemployment Rate and Urban Unemployment Rate

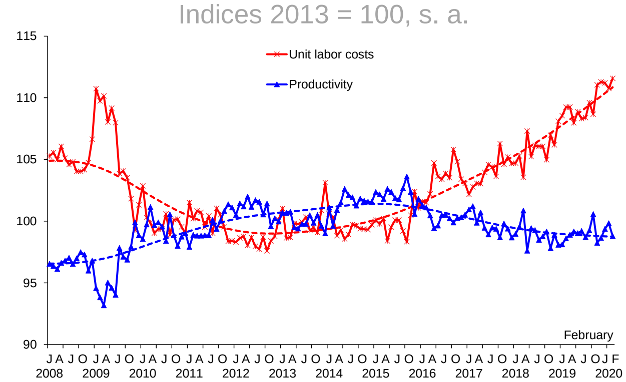
Percent, s. a.



s. a. / Seasonally adjusted and trend series. The former is represented by a solid line and the latter by a dotted line.
Source: National Survey of Occupations and Employment (ENOE, for its acronym in Spanish), INEGI.

Chart 17
Productivity and Unit Labor Costs in the Manufacturing Sector[1/]

Indices 2013 = 100, s. a.



s. a. / Seasonally adjusted and trend series. The former is represented by a solid line and the latter by a dotted line. Trend series estimated by Banco de México.
1/ Productivity based on hours worked.
Source: Prepared by Banco de México with seasonally adjusted data from the Monthly Survey of the Manufacturing Industry and from industrial activity indicators from INEGI's National Accounts System (Sistema de Cuentas Nacionales de México).

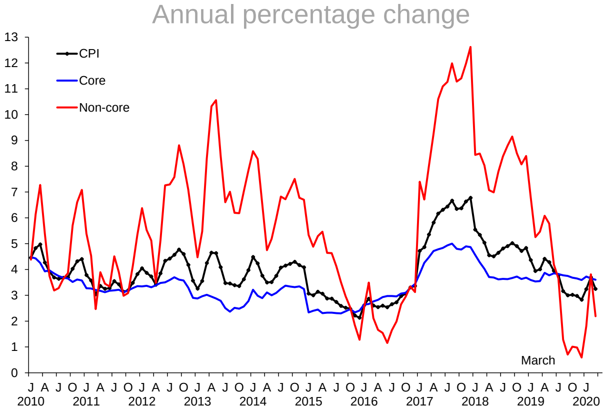
In February 2020, domestic financing to the private sector continued showing a reduction in its growth rate. Within it, financing to private firms contracted. This trend is explained by lower bank credit and domestic debt issuance. As to the household segment, both mortgages and consumer credit continued to decelerate. As for interest rates, those of firm financing decreased, in line with the reduction of the overnight funding interest rate. In turn, interest rates of mortgages remained at levels close to those of December 2019, when such rates decreased vis-à-vis those that had been observed since the second quarter of 2017. In the segment of consumer credit, and with figures to December 2019, interest rates of credit cards remained unchanged as compared to previous months, while those of personal loans increased. With regards to portfolio quality, firm and mortgage delinquency rates remained at low levels, while those related to consumption did not change significantly and remain at high levels.

As a result of the contingency stemming from the COVID-19 pandemic, there is the risk that the loanable funds market deteriorates over the next months, both because some creditors may have difficulties in meeting their obligations and because some credit institutions may restrict financing as a precautionary measure. To face this scenario, during March and April, the authorities announced several measures aimed at temporarily alleviating the financial burden of creditors with banks and with the National Housing Fund (Infonavit, for its acronym in Spanish).

A.2.3. Development of inflation and inflation outlook

The COVID-19 pandemic and the measures adopted to contain its spread are starting to affect the evolution of inflation. The most evident effect is the fall in energy product prices, which has led to a decline in non-core inflation, although incipient pressures, both downward and upward, on the prices of certain goods and services related to core inflation were observed and would appear to be associated with changes in their relative demand as a result of the contingency. Thus, between February and March 2020, annual headline inflation decreased from 3.70 to 3.25% (Chart 18 and Table 1).

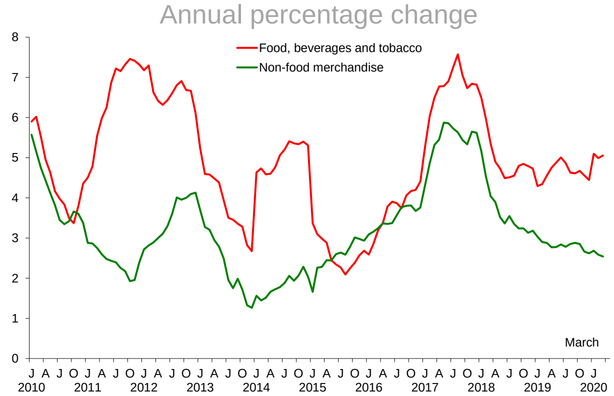
Chart 18
Consumer Price Index
Annual percentage change



Source: Banco de México and INEGI.

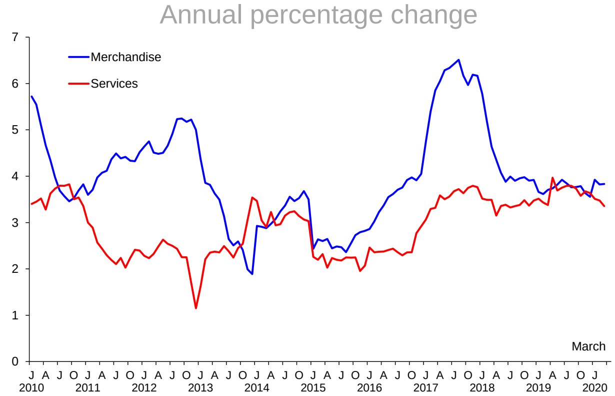
Annual core inflation stood at 3.66% and 3.60% in February and March 2020, respectively. In particular, the annual rate of change of merchandise prices remained practically the same, at 2.82 and 2.83% in those two months. Within it, as a result of the health crisis, a slight rebound in the annual rates of change of food merchandise prices was observed, while that of non-food merchandise prices continued to decrease (Chart 19). The annual rates of change of the subindex of services prices decreased from 3.48 to 3.35% (Chart 20), with the decreases in services other than education and housing standing out. In this regard, the decline in the annual rate of change of tourist services being noteworthy, reflecting the lower demand for this type of services due to the health emergency.

Chart 19
Merchandise Core Price Subindex
Annual percentage change



Source: Banco de México and INEGI.

Chart 20
Merchandise and Services Core Price Subindex
Annual percentage change

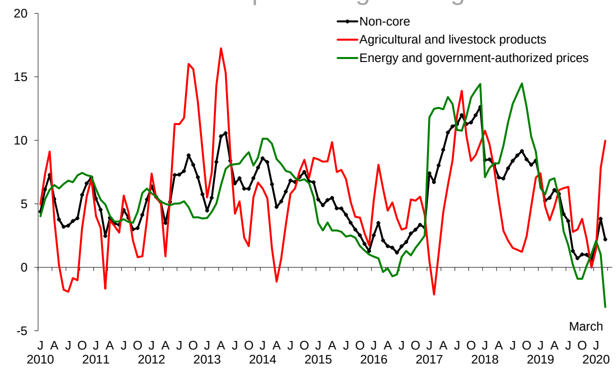


Source: Banco de México and INEGI.

Between February and March 2020, non-core inflation declined from 3.81 to 2.19% (Chart 21 and Table 1). Mixed behaviors were observed in its components. Oh the one hand, important reductions were observed in the annual rates of change of energy product prices, which fell from -0.54 to -6.36% in these months. This result was largely influenced by the lower variations in gasoline prices, which in turn reflected the sudden decreases of their international references. In contrast, the annual rates of change of agricultural and livestock product prices increased from 7.82 to 9.96%, with the recent acceleration exhibited by the annual rates of change of its two components (fruits and vegetables and livestock products) standing out.

As to inflation expectations drawn from Banco de México's Survey of Private Sector Forecasters, the median for headline inflation for the end of 2020 increased from 3.53% a 3.64% between February and March. For its part, those for the medium and long term remained at 3.50%. As to the medians for core inflation expectations for the short, medium and long term, they all remained at around 3.50%. Finally, breakeven inflation increased in the same period, due to an increase in inflation risk premium and marginal increases in long-term inflation expectations implied in market instruments. However, both breakeven inflation and inflation risk decreased during the first weeks of April.

Chart 21
Non-core Price Subindex
Annual percentage change



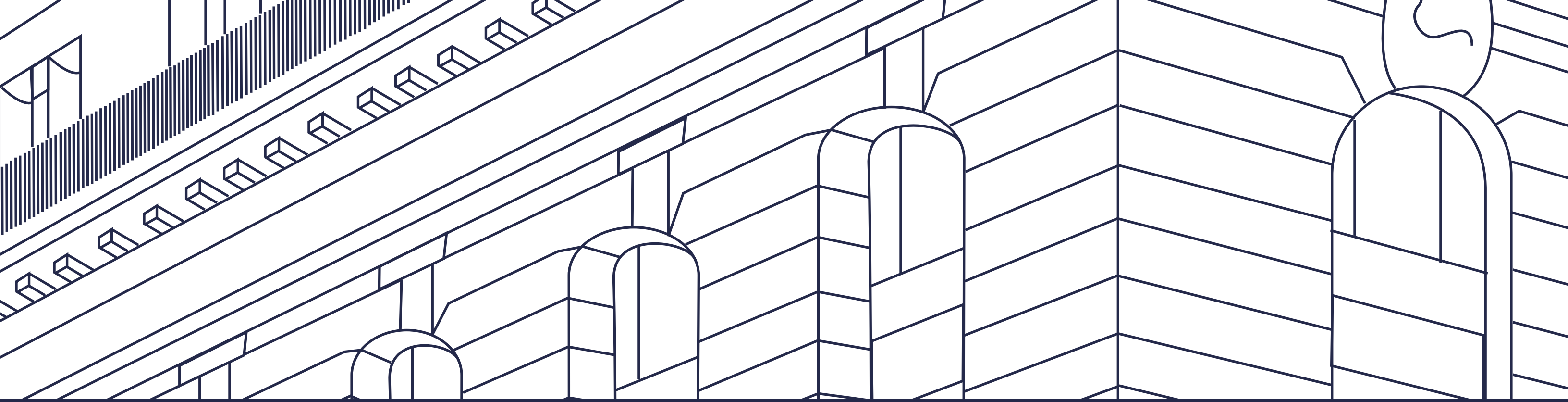
Source: Banco de México and INEGI.

In the current environment and as result of the COVID-19 pandemic, inflation would be subject to pressures on two fronts. To the downside, those stemming from the widening of the negative output gap and, in the short term, from the decline in energy prices, particularly of gasoline; to the upside, those resulting from the depreciation of the peso exchange rate, which will depend on its magnitude and persistence. Although these factors may impact headline inflation at different moments, inflation is expected to converge to Banco de México's target within the time frame in which monetary policy operates. Nevertheless, uncertainty as to the balance of risks for inflation has increased significantly.

Table 1
Consumer Price Index and Components
Annual percentage change

Item	January 2020	February 2020	March 2020
CPI	**3.24**	**3.70**	**3.25**
Core	**3.73**	**3.66**	**3.60**
Merchandise	**3.92**	**3.82**	**3.83**
Food, beverages and tobacco	5.10	4.99	5.05
Non-food merchandise	2.68	2.58	2.54
Services	**3.51**	**3.48**	**3.35**
Housing	2.93	2.94	2.93
Education (tuitions)	4.69	4.55	4.58
Other services	3.78	3.72	3.47
Non-core	**1.81**	**3.81**	**2.19**
Agricultural and livestock products	**1.44**	**7.82**	**9.96**
Fruits and vegetables	-1.76	11.23	13.47
Livestock products	4.45	4.91	7.00
Energy and government-authorized prices	**2.08**	**1.01**	**-3.13**
Energy products	0.86	-0.54	-6.36
Government-authorized prices	5.07	4.86	4.98

Source:INEGI



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