BANCO DE MÉXICO®

Minutes number 82

Meeting of Banco de México's Governing Board on the occasion of the monetary policy decision announced on February 11, 2021

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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: February 10, 2021.

1.3. Participants:
Alejandro Díaz de León-Carrillo, Governor.
Galia Borja-Gómez, Deputy Governor.
Irene Espinosa-Cantellano, Deputy Governor.
Gerardo Esquivel-Hernández, 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

Most members mentioned that global economic activity continued to recover at a more moderate and heterogeneous rate across countries and sectors. Some members stated that the global economy's dynamism is reflected in the recovery of international trade and industrial production. **One** member noted that the rate of recovery has been greater than anticipated by most analysts. **Another** member pointed out that the economic recession in 2020 is the most severe in recent history. He/she added that social distancing measures led to changes in consumption patterns, labor relations, production processes, supply chains and human capital formation. He/she emphasized that fiscal and monetary authorities have taken measures to preserve economic stability. **One** member stated that the performance of the economies is associated with the severity of the effects from the pandemic and with the differences in the relief programs. In this regard, he/she noted that the countries that received more support in 2020 registered smaller contractions than originally estimated.

Most members stated that the global economy is expected to continue recovering in 2021 in view of the foreseen progress in vaccination strategies and of the fiscal and monetary stimuli. Some members considered that differences in these factors could lead to a heterogeneous recovery across countries and regions. **Most members underlined the improvement in the global growth forecasts for 2021. Some** members indicated that IMF projections point to a 5.5% expansion for this year. In this regard, **one** member noted that within advanced economies only the United States would manage to offset in 2021 the fall registered in 2020. He/she added that, within emerging economies, estimates of a fast recovery for Asia contrast with those for Latin America, which is expected to recover at a slower rate.

Most members highlighted the risks for global economic growth associated with the evolution of the pandemic and the measures to contain it, in particular, the recent implementation of new mobility restrictions in various countries. One member considered that this has exerted greater pressures on vaccine production and distribution and on relief measures for households and firms. In this context, **another** member considered that the aforementioned countries will continue to show economic weakness during the first quarter of the year. He/she added as risks: i) the significant increase in government and corporate debt; ii) an increase in bankruptcies of firms affected by the pandemic; iii) the imbalances in stock markets; and iv) the intensification of geopolitical and social conflicts. He/she considered that, given the high level of uncertainty, the balance of risks for global growth remains biased to the downside.

Most members stated that inflation in advanced economies remains below their central banks' targets. One member noted that in some of these economies inflation has accelerated. **Some** members pointed out that in advanced economies inflation is anticipated to remain at low levels, although **one** member added that in 2021 and 2022 it is expected to begin converging to its target. In the case of the United States, **some** members mentioned that, in view of the fiscal and monetary stimulus programs, inflation expectations have been revised upwards. **One** member highlighted that these are at levels above those registered a year ago. **Another** member mentioned the heterogeneous behavior of inflation, where in early February the expected 5-year average inflation in five years in the United States exceeded 2.3%, while, in contrast, in the euro area and Japan it registers 1.34 and -0.13%, respectively. **Some** members noted that in emerging economies inflation has exhibited a heterogeneous behavior, although **one** member highlighted that it is at relatively low levels. **Another** member pointed out that in some of these economies upward pressures persist due to the higher food prices, the supply shock and foreign exchange depreciation. **One** member mentioned that, in emerging economies, inflation rates are estimated to be below their historic average figures. **On the other hand, most members mentioned that commodity prices rose. Some** members underlined that this was due to the increase in oil prices, which responded to an improvement in the growth outlook. **One** member added that inventory figures for US crude oil also contributed to the aforementioned.

All members mentioned that the central banks of advanced economies reiterated their intention to maintain accommodative monetary policy stances for an extended period. One member pointed out that the federal funds rate is anticipated to remain unchanged in 2021 and 2022. He/she added that the new monetary strategy of the Federal Reserve will allow inflation to be above 2% for a certain time and to maintain low or negative real interest rates for a longer period. As for emerging economies, he/she mentioned that their respective central banks continued to maintain accommodative policy stances, with a negative ex-ante real interest rate in most cases. He/she indicated that most central banks of emerging economies are expected to maintain their reference rates unchanged during 2021.

Most members highlighted the expectation that fiscal stimulus in advanced economies is extended. Some members recalled the case of the United States. **One** member pointed out that the results of the electoral process in the United States have favored this expectation for that country.

Most members agreed that global financial markets have exhibited a positive behavior mainly in view of expectations of a large fiscal stimulus package in the United States. Some members noted that the mitigation of political factors also contributed to the above. In this regard, **one** member mentioned that this evolution was affected by the final stage of the electoral process in the United States. and by the agreement on the United Kingdom's exit from the European Union. **Some** members added the progress in the vaccination process in different countries. In this context, **one** member mentioned that market optimism has contributed to the decline in credit risk premia. **Another** member considered that the rise in virus infections and the challenges related to the vaccination process have contributed to episodes of volatility.

Most members highlighted the increase in risk appetite among investors. Some members pointed out that the main stock indices registered gains, that corporate bond spreads decreased, and that government securities' interest rates increased moderately, especially longer-term ones. **One** member mentioned that the US dollar fluctuated in a narrow range and that portfolio flows concentrated in the Asian region. **Another** member added that emerging economies' currencies appreciated and that, looking ahead, financial markets are expected to continue exhibiting positive behavior given the progress in the vaccination process, the reopening of economic activities, and the continuation of fiscal and monetary stimuli.

One member noted, from a medium-term perspective, that since the beginning of the pandemic capital flows to emerging economies as well as the terms and conditions of access to markets have been influenced by: i) the favorable trend of global risk appetite; ii) liquidity conditions and the evolution of the yield curve in the US market; and iii) the recent measures to integrate China's financial sector to international markets. Regarding the second factor, he/she stated that international markets have benefitted from the Federal Reserve's support measures, which granted ample liquidity, leading to a marked reduction in interest rates. However, he/she added that longer-term rates have rebounded in view of the outlook for greater fiscal stimuli. As for the third factor, he/she pointed out that China's inclusion in global fixed income indices, along with interest rates above those in other economies and a lower foreign exchange risk, have contributed to a significant recomposition of capital flows to that economy. He/she stated that the above poses challenges to emerging economies, given that global financial conditions operate as an additional restriction on the domestic adjustment of these economies, which also face multiple pandemic-related challenges and a limited margin of maneuver for policy implementation.

Some members considered that international financial markets are subject to different risks, especially the abovementioned related to global activity. **One** member added that they remain fragile and subject to a correction or even to possible capital outflows from emerging economies.

Economic activity in Mexico

All members highlighted that timely figures indicate that GDP fell 8.3% in annual terms in 2020. One member pointed out that this result implied a better performance than what had been expected by most analysts in mid-2020. **Another** member emphasized that the annual contraction of GDP in 2020 is the most severe in decades. **Most members mentioned that the economic recovery continued during the fourth quarter of 2020, although at a lower rate than in the third. Some** members stated that it has been heterogeneous, with differences in the recovery rates of domestic demand as compared to those of external demand. **One** member added that available information suggests that activity will have shown a decline in early 2021 and that this situation is consistent with the recent intensification of the pandemic.

Regarding demand, all members emphasized that the recovery has been driven mostly by the external sector. Most members highlighted the differentiated performance of imports and exports, highlighting the positive performance of the latter, particularly manufacturing exports. Some members mentioned that in December these grew at a seasonally adjusted annual rate of 8.84%. **One** member noted that the aforementioned differentiated performance led to a significant trade surplus.

All members highlighted that investment remains weak. Most members underlined that it is at levels below those registered prior to the pandemic. One member pointed out that it has been the weakest item of aggregate demand. **Another** member pointed out that in November it contracted 11.35% in annual terms. **One** member noted that most of its components remain close to 15% below the levels prior the pandemic, except for residential housing construction. **Another** member underlined that private investment has fallen 25% since 2018, while public investment has contracted 54% since 2009.

Most members highlighted that consumption has been recovering gradually, although still lagging considerably with respect to pre-pandemic levels. Some members added that its sluggish recovery is still influenced by the unfavorable conditions in the labor market. **One** member pointed out the weakness of consumption despite the high level of remittances. **Another** member stated that consumption components have followed a heterogeneous behavior. He/she mentioned that consumption of non-durable goods has recovered at a favorable rate, while consumption of services and durable goods remains depressed. **One** member mentioned that consumption can be expected to lose dynamism in December 2020 and January 2021 and that it may even decline.

Regarding supply, most members highlighted the heterogeneous recovery of the different sectors. One member mentioned that, at a sectoral level, the primary sector exhibited a favorable performance in 2020, by growing 2% in annual terms, while the secondary sector was the one that fell the most, followed by the tertiary sector. However, he/she mentioned that secondary activities have recovered faster than tertiary ones. **Another** member stated that, after contracting markedly in April, industrial production has been recovering, and as of November has accumulated six months with positive monthly variations, registering an annual contraction of 3.25% in said month. He/she added that in November manufacturing, construction and services registered annual contractions of 1.16, 7.97 and 4.49%, respectively. He/she emphasized that services that require physical presence were the most affected. He/she pointed out that, based on information as of November, only 12.1% of productive subsectors have recovered or exceeded the level of activity registered prior to the pandemic, while 64.4% of them contracted up to 5% and 23.5% registered a contraction larger than 5%. **One** member considered that available information suggests a new weakening of industrial activity and services, which reinforces expectations of a slow and heterogeneous recovery.

As for the labor market, most members acknowledged that recently its recovery lost dynamism and that an environment of weakness persists. Some members highlighted that labor participation, unemployment and underemployment rates remain deteriorated. **One** member mentioned that at the end of 2020 there were 19 million individuals in need of a full-time job, 2.1 million of which corresponded to open unemployment, 9.4 million were in disguised unemployment, and 7.5

million were underemployed. He/she added that, although the extended unemployment rate has decreased significantly since April, it was 17.9% in December, a level above those registered in previous crises. He/she underlined that the pandemic has intensified the precarious situation of the labor market, mainly affecting low-wage earners, women and young people. He/she mentioned that these figures point to a significant decline in households' disposable income, a determining factor in the difficulty for regaining their consumption levels. **Another** member mentioned that, between February and April of 2020, the total employment rate decreased by 12.5 million jobs. He/she added that, although it increased by 9.7 million between May and October, it fell once again by 130,000 jobs between November and December. **Some** members pointed out the impact on formal employment. **One** member stated that, in seasonally adjusted terms, at the end of 2020 IMSS-insured jobs were 786,693 below those registered in February. **Another** member argued that, while formal jobs susceptible to social interaction continue to be highly affected, those that are more related to external demand have exceeded their pre-pandemic levels.

The majority of members noted that the economic recovery will take place at a moderate pace. One member pointed out that this is partly due to the new restrictions on mobility. **Another** member considered that, given expectations of greater fiscal stimuli in the United States, external demand is expected to continue being a significant driver of Mexico's economic recovery. **One** member stated that the recovery will be heterogeneous, with a strong external sector but with consumption and investment below pre-pandemic levels. He/she highlighted that public investment and consumption will be the components the least capable of supporting the recovery due to the fiscal restrictions they face. He/she mentioned that, considering the comparison base effect, growth expectations for 2021 are relatively low and suggest a weak recovery of domestic demand, given expectations that external demand will continue to exhibit dynamism. He/she warned about the possibility of observing negative growth rates once again during the first quarter of the year due to the return to the red phase of the lockdown in many states. He/she highlighted that, even in an optimistic scenario of 6% growth at the end of 2021, GDP would be 3.0% below its level of 2019.

Most members pointed out that productive activity continues to operate under ample slack conditions, although **some** members stated that the latter have been reducing. **One** member added that the speed at which the output gap has been reducing appears to have decreased. **Some** members noted that although available information suggests a greater pace of recovery in 2021, ample slack conditions are anticipated throughout the time frame in which monetary policy operates.

The majority of members agreed that an uncertain environment with downward risks to economic activity persists, due mainly to the evolution of the pandemic. One member stated that the number of monthly infections and deaths associated with the pandemic reached a maximum level in January and that there are no signs that this pattern will decrease soon. He/she highlighted that it would take time to achieve the necessary percentage of vaccination coverage required to return to normality. He/she added that, given the scarcity of vaccines and the logistical problems associated with their distribution, in the best-case scenario the impact of vaccination would be noticeable towards the end of the year, which could lead to irreversible damage for many firms. **Another** member underlined the importance of considering the possible impact of the pandemic on the productive apparatus in order to be able to estimate the effects on potential growth. **One** member highlighted as risks to growth: i) the negative effects on the inputs supply for production; ii) the volatility of financial markets; iii) the deterioration of the credit portfolio quality; iv) lower public revenues that may affect the sovereign risk outlook and the conditions of access to financial markets; and v) more elements of uncertainty affecting investment. **Another** member considered that the balance of risks for economic activity has improved at the margin, although it remains biased to the downside.

Inflation in Mexico

Most members mentioned that annual headline inflation decreased from 4.09% in October 2020, its highest level in that year, to 3.54% in January 2021. Some members stated that the inflation figure of 3.15% registered at the end of 2020 was favorable. **One** member mentioned that this represented positive behavior as compared to the forecast for the end of the year that was available some months ago. He/she added that services and energy prices contributed significantly to the positive behavior of headline inflation at the end of 2020. **Another** member pointed out that inflation has been marginally above the central bank's point target. **One** member mentioned that inflation figures of the last months reflect the different pressures and volatility to which inflation has been subject and that said pressures have been greater within its components.

The majority of members mentioned that the rise in non-core inflation in January contributed to the aforementioned increase in headline inflation. They highlighted the increase in the annual rate of change of energy prices, particularly those of gasoline and LP gas. One member pointed out that energy prices were affected by their international references. However, he/she added that the Ministry of Finance (SHCP) announced the implementation of stimuli to contain the increase in gasoline prices. **Another** member underlined the decrease in the annual rate of change of agricultural and livestock products' prices, mainly attributed to the greater reductions in fruit and vegetable prices.

Most members stated that the pandemic has implied considerable changes in relative prices, exerting upward pressures on merchandise inflation and downward pressures on services inflation. One member mentioned that this change in relative prices occurred in an environment of a significant widening of slack conditions and exchange rate adjustment at the beginning of the pandemic. He/she also noted that the gap between merchandise and services inflation reflects the nature of the shocks the economy has been subject to.

The majority of members mentioned that core inflation increased between December and January. One member stated that the core component overall exhibited favorable behavior at the beginning of the year and that its monthly increase in January was in line with its historical average, although its annual comparison continues to be affected by the increases during the past year associated with the pandemic. **Another** member noted that slack conditions have influenced inflation downwards, mainly in those components that are more sensitive to the economy's cyclical position. Thus, supercore inflation has decreased. He/she added that the exchange rate adjustment, which was considerable during the initial phase of the pandemic, contributed to an increase in the items of core inflation that are more exposed to exchange rate fluctuations.

Some members underlined that the declines in services prices have moderated. **One** member pointed out that an important deceleration is observed in the prices of services related with arts, entertainment, recreation, education and tourism activities. **Some** members highlighted the recent decreases in the inflation of merchandise prices, particularly food merchandise. In this regard, **one** member considered that there are signs pointing to the stabilization of such prices, which registered increases close to 7% during the second half of 2020, but are now starting to reverse such trend. He/she added that this is partly due to the dissipation of the excise tax (IEPS, for its acronym in Spanish) on some high-calorie and alcoholic beverages, as well as on tobacco. **Some** members stated that supply and demand shocks stemming from the pandemic have started to fade. **One** member noted that the effect of the *Buen Fin* sales campaign on non-food merchandise has apparently come to an end, which confirms its transitory nature.

Most members highlighted that medium- and long-term inflation expectations remain stable, although above 3%. Some members pointed out that those for the end of 2021 increased slightly. As for inflation expectations drawn from market instruments, **one** member mentioned that the average of 1-to-10-year expectations is at levels close to the 3% target. He/she added that such levels had not been observed since 2013. **Another** member noted that breakeven inflation and inflation risk premia implicit in the spreads between nominal and real market instrument rates has remained stable. He/she pointed out that the 3-year breakeven inflation rate is below its historical average. In this context, **some** members considered that inflation expectations remain anchored.

All members mentioned that a transitory increase of headline inflation during the second quarter of the year, associated with the arithmetic effects of the reduction of energy prices last year, is expected to take place. They pointed out that headline and core inflation are anticipated to converge to 3% within the time frame in which monetary policy operates. Some members added that core inflation is expected to be around 3% as of the second half of this year. **One** member highlighted that this component would continue to be affected in the short term by the recomposition of relative prices within it. Regarding the non-core component, **some** members mentioned that its recent increases are expected to fade. **One** member stated that these increases are not anticipated to generate second-round effects. **Another** member mentioned that although an increase in energy prices was observed in January, the federal government's price policy for these goods will contribute to keep inflation under control in the following months. **One** member noted that the future evolution of core inflation will respond mainly to the economic cycle conditions.

However, he/she considered that non-core inflation will remain, as always, subject to considerable fluctuations.

As for upward risks to inflation, **some** members pointed out the possibility of greater increases in the international prices of some products, including energy goods. However, they stated that there are mitigating factors such as the domestic policy for gasoline prices. **Some** members mentioned the risks of various cost-related pressures for firms. **One** member highlighted possible episodes of foreign exchange depreciation. He/she also warned about the risk of core inflation pressures generated by the recomposition of spending towards merchandise. **Another** member added that, since mid-2018, and despite the ample amount of slack in the economy, core inflation has exhibited a strong resistance to decline and that it is too early to assume that the gradual reversion of changes in the relative prices of merchandises and services will necessarily lead to lower inflationary pressures.

As for downward risks to inflation, **some** members mentioned the possibility of a decline in prices due to the depth and persistence of slack in the economy, as well as a foreign exchange rate appreciation. **One** member added that said appreciation might be due to a greater risk appetite by investors or to an improvement in the perception of Mexico’s fiscal position. **Another** member highlighted the effects of greater social distancing measures and lower inflationary pressures worldwide. **Some** members considered that the balance of risks for the projected trajectory of inflation remains uncertain. **One** member stated that said balance has remained stable, despite the increase of inflation in January.

Macrofinancial environment

Some members noted that domestic financial markets performed favorably, sustaining, and in some cases, extending the gains registered since May 2020. **One** member stated that this has been supported by sound macroeconomic fundamentals. **Another** member considered that domestic financial markets exhibited a mixed performance, with moderate adjustments and trading conditions that remain deteriorated.

The majority of members mentioned that the Mexican peso exhibited relatively stable behavior. One member mentioned that analysts expect it to remain at a level of around 20 pesos per US dollar this year and the next. Regarding the stock market, **another** member noted that its index has increased since the last monetary policy decision. **One** member mentioned that so far this year it has remained practically unchanged. As for interest rates on government securities, **some** members noted that they have decreased. **One** member highlighted that the largest declines have been in medium-term rates and that the short end of the yield curve has flattened.

Most members highlighted that the sovereign risk premium has continued to decline. Some members added that it is at levels similar to pre-pandemic levels. **One** member considered that the decline in global risk aversion has contributed to the aforementioned. However, he/she stated that rating agencies have warned about the increase in idiosyncratic risks. **Another** member mentioned that foreign capital inflows to government bonds have fluctuated, but have remained at an adequate level, in a context of a lower need for external savings given the current account surplus. **One** member pointed out that there has been an increase in the percentage of holdings of Mexico's sovereign debt in most of the global funds that invest in the country. **Another** member considered that although government securities’ outflows have moderated, they ended the year at historically high levels of nearly 19 billion US dollars. He/she added that risks for financial markets persist and that new episodes of volatility stemming from trade, geopolitical and financial factors that could affect the exchange rate cannot be ruled out. **One** member noted that, in addition to the influence of the US yield curve as the risk-free curve, financial conditions of other economies, especially China, are now added as an alternative destination for capital flows. **Another** member stated that the balance of risks for financial markets has remained stable.

Regarding public finances, **some** members agreed that their situation constitutes a risk factor. **One** member pointed out that some indicators do not adequately reflect their risks. He/she added that the fiscal balance could deteriorate due to: i) lower economic activity; ii) greater spending pressures associated with the prolongation of the pandemic; iii) additional requirements to capitalize Pemex; and iv) sovereign rating downgrades, all in face of the depletion of contingency funds. Nevertheless, **some** members considered that Mexico's fiscal policy, unlike other economies, has maintained a manageable debt level, which is a positive element for macroeconomic stability. **One** member noted that the fiscal position and the favorable performance of inflation in the last two years reveal the authorities' commitment to preserve economic fundamentals. He/she noted that Mexico’s fiscal position has been favored in relative terms due to the levels of indebtedness of most countries in 2020, in contrast with those observed in the country. He/she mentioned that according to structural indicators of public finances, such as the budgetary balance and the public debt-to-GDP ratio, Mexico will emerge from the pandemic in a better condition than other emerging economies, and even better than countries with higher credit ratings. However, **another** member argued that while efforts to have a responsible fiscal balance are valuable, it would be desirable to observe, within the limits of fiscal responsibility, a budgetary reallocation that would allow for meeting the contingent needs.

Most members mentioned that financing to the private sector continued to decline. One member noted that this was due to less debt issuance and lower bank lending. He/she added that delinquency rates increased, mainly of consumer and business loans, although they remain at low levels. **Another** member stated that as of December 2020, consumer financing contracted by -8.1% in annual terms while corporate financing did so by -4.3%. He/she considered it worrisome that credit to SMEs remains stagnant without showing signs of recovery at the margin. He/she pointed out that this could be due to supply factors and to credit terms that apparently continue to be unattractive. He/she mentioned that although development banks have implemented guarantee programs to support credit to firms, a considerable amount of these stimuli have remained unallocated. **One** member stated that, according to Banco de México's Survey on General Conditions and Standards in the Banking Credit Market (EnBan, for its acronym in Spanish), credit approval expectations for the first quarter of 2021 foresee a tightening. However, he/she mentioned that interest rates associated with bank credit have followed the behavior of the bank funding rate, which influences the credit conditions for households and firms. He/she added that domestic sources of financial resources remained at high levels during the fourth quarter of 2020. **Another** member highlighted the predominance of domestic sources of financing over external ones and the increase in financing to the public sector.

One member underlined the need for a firm macroeconomic strategy that generates confidence, promotes an orderly adjustment of the national economy to the shocks that have affected it, and fosters the proper functioning of domestic financial markets and of the financial system. **Another** member noted that the sluggish behavior of private investment observed since 2018 mainly responds to institutional and structural factors. He/she considered that economic reactivation necessarily requires actions in the field of the rule of law, legal certainty, security and the fight against corruption and impunity. He/she highlighted three events that have affected investor's confidence: i) the initiative to modify Banco de México's Law. In this regard, he/she mentioned that although the new measures announced aim to solve the problems referred to in this initiative, its risks may not dissipate while its discussion in the legislative branch continues; ii) the preferential initiative on the Electricity Sector Law, which modifies the current contract terms and cancels the transition to clean energies; and iii) the suspension of the highway project tenders currently underway.

Monetary policy

Considering that incoming information allows for adjusting the reference rate, while maintaining inflation forecasts in line with the trajectory converging towards the central bank's target, all members agreed to lower the target for the overnight interbank interest rate by 25 basis points to a level of 4.00%. Looking ahead, the majority of members pointed out that monetary policy implementation will depend on the evolution of the factors that have an incidence on headline and core inflation, on their foreseen trajectories, and on their expectations.

One member argued that, considering the magnitude of the supply, demand and financial shocks related to the pandemic, monetary policy in emerging economies, such as Mexico's, should contribute to maintain inflation at low levels around its target, promote the proper functioning of financial markets and financial system stability, and contribute to a sustained economic recovery. He/she pointed out that in order to achieve this, it is important that the behavior of interest rates along the yield curve leads to an orderly adjustment in the different expenditure items, in domestic financial markets, and in external capital flows. He/she stated that such adjustment must consider the relevant external financial conditions and the behavior of medium- and long-term domestic risk premia. He/she emphasized that for emerging economies, such as Mexico's, which need to complement their domestic savings with external sources of financing, it is important to maintain a stable macroeconomic environment in order to attract and retain capital, as well as to have the necessary financial conditions for an orderly adjustment of the economy.

He/she considered that in the context of shocks associated with the pandemic, exchange rate depreciation, fiscal pressures and uncertainty regarding sovereign credit ratings, one of the greatest challenges for monetary policy has been to allow for an adjustment of relative prices, avoiding a deterioration of inflation expectations and the price formation process, as well as second-round effects, in order to maintain a sustained low and stable inflation and reduce inflationary risk premia. He/she pointed out the importance of facilitating a foreign exchange adjustment so that, after dampening the significant financial shock, it remained orderly, and would also lead to a partial reversion of the initial impact, thus contributing to an adjustment of the economy under better conditions. He/she argued that this strategy has allowed for lower interest rates along the entire yield curve and highlighted that reductions in long-term interest rates in Mexico compare favorably with those of other emerging economies. Finally, he/she pointed out that risks for inflation, economic activity and financial markets pose major challenges for monetary policy and the economy in general.

Another member mentioned that, based on available information, the determinants of price increases in the country are in line with the orderly and sustained convergence of inflation to its target. He/she added that medium- and long-term inflation expectations from Banco de México's latest survey do not indicate an upward trajectory, while breakeven inflation and inflation risk implicit in market instruments have remained stable, which indicates that inflation expectations remain well-anchored. He/she pointed out that the pause that took place allowed for confirming the fading of inflationary pressures that were present in the middle of last year as a result of supply-, demand- and financial-related shocks. He/she pointed out that information available in January 2021 as well as the future outlook do not suggest an increasing price dynamic that would lead to a breach of the price stability mandate. He/she stated that, therefore, on this occasion, there is a specific window of opportunity, within the time frame in which monetary policy operates, that allows for reducing the intrinsic costs in the financial system and in economic activity that arise from maintaining a restrictive monetary policy stance in an economic scenario with ample slack conditions.

One member pointed out that the evolution of inflation and its expectations, as well as an uncertain balance of risks, impose challenges for estimating the future trajectory of inflation and for monetary policy implementation, and that for this reason it is crucial to follow a risk management approach that favors prudence. He/she recalled that the pause was extended in December to confirm whether inflation, mainly core inflation, had started following a downward trend. In this regard, he/she considered that given that the recent increase in inflation is due to the non-core subindex, that a more moderate recovery is expected in the first half of the year, that the balance of risks for activity continues to be biased to the downside and that the exchange rate remains relatively stable, there is some margin of maneuver to lower the rate without compromising the convergence of inflation to the target. However, he/she noted that significant risks persist, such as the vulnerability of public finances and possible episodes of volatility, which could affect the peso exchange rate and have an impact on inflation. Regarding the exchange rate, he/she considered that factors such as the sovereign rating downgrade, the electoral process in June and domestic public policies that generate uncertainty could exert exchange rate pressures and impose greater stress on the monetary policy stance.

He/she pointed out that the limits of monetary policy must be acknowledged because, although an accommodative policy stance can help to reactivate the economy, it is not enough by itself. He/she stated that under the current circumstances, it is difficult to assume that an additional monetary policy easing would result in a significant boost to economic activity. In this regard, he/she recalled that between 2016 and 2018 the reference rate increased by 500 basis points to a level of 8.25% and it was at that point when gross private investment reached its peak, while from that time up to now it has contracted 25% in real terms. He/she added that monetary policy's room for maneuver to boost consumption is limited in the absence of fiscal support to avoid the closing of companies, job losses and the consequent decrease in credit to households and firms, especially SMEs, due to the increase in risk perception of financial institutions. The monetary policy implemented by Banco de México, both through the reference rate and the measures to provide liquidity and facilitate credit lending, has contributed to confront the shocks derived from the pandemic within the scope of its competence.

Finally, he/she emphasized that the present monetary policy decision does not compromise the downward trajectory of inflation and pointed out that in the current environment of high uncertainty, this decision does not constitute a guide for future actions. In his/her opinion, the most effective tool to facilitate the orderly adjustment of the economy to real shocks is to underpin public confidence in future monetary policy decisions maintaining price stability as their priority.

Another member considered that the reduction in the reference rate can contribute to strengthen the economic recovery without jeopardizing the inflation target. He/she added that this reduction should not be interpreted as the end of monetary easing, since several indicators suggest that such easing is still insufficient. He/she pointed out that Mexico is one of the few economies in the world with a positive ex-ante real interest rate. He/she highlighted that in most central banks in both advanced and emerging economies lowered their reference rates during 2020 significantly, reaching, in many cases, negative real rates. He/she pointed out that while the ex-ante real interest rate in Chile is around -2.5% and in Colombia it is -1%, in Mexico it is between 0.75% and over 1%, depending on the measure used to calculate expected inflation. He/she also mentioned that the components of aggregate demand that usually depend on the level of interest rates are those that currently exhibit the worst performance. He/she highlighted that i) light vehicle sales contracted 20% in annual terms; ii) credit card purchases remain 10% below their expected level; iii) credit to SMEs contracted 8% in real annual terms; and iv) investment in November 2020 was in real terms 12% lower than during the same period of 2019. In this regard, he/she considered that the need for further monetary easing is evidenced by the difference in the recovery rates of domestic demand in relation to external demand. He/she mentioned that domestic demand remains weak, while external demand has recovered rapidly and that this difference is due to the fact that the former is directly affected by domestic monetary policy, which still remains restrictive in relation to the economic conditions, while the latter is benefited by the fiscal and monetary stimuli in other economies. He/she emphasized that the ex-ante real interest rate is important for investment and consumption decisions. He/she argued that during a recession, if this rate does not decrease sufficiently to stimulate aggregate demand, there is a risk of deepening and prolonging a fragile economic situation with the consequent economic and social costs. Finally, he/she considered that the Governing Board must remain attentive to a new opportunity to continue the monetary easing process.

One member pointed out that further monetary easing is still needed to support the economic recovery. He/she noted that given the lack of fiscal support, the recessionary situation and the anticipated slow recovery, monetary easing should continue although he/she acknowledged that monetary policy is not the ideal instrument to drive the recovery. He/she noted that the absolute and relative monetary policy stances still allow for some room to lower the reference rate. He/she stated that the highly accommodative monetary policy worldwide, lower risk aversion and the low level of the neutral short-term interest rate favor low domestic rates. He/she pointed out that the fiscal stance does not represent a risk for price stability, since maintaining a conservative stance on public prices even serves to relieve pressures on inflation. He/she mentioned that although the fiscal stance has not been counter-cyclical, there will not be excessive indebtedness as in other countries, which will contribute to relieve pressures on the exchange rate and promote the sound development of financial markets.

He/she considered that the benefits of a more accommodative stance are increasingly marginal and that this could have undesirable consequences for financial stability. He/she added that one constraint to credit growth is its weak demand for investment projects in the face of factors unrelated to monetary policy, such as the economic slack and the environment of uncertainty. He/she pointed out that an excessively loose stance reduces the incentive to save, the availability of funds for investment and the profitability of the banking system, which may lead to a relaxation of credit standards. He/she mentioned that lowering the reference rate may distort the risk calibration implicit in the prices of firms' financial assets by artificially increasing the valuation of those that are not profitable. He/she also expressed concern that the reduction in inflation has mostly been due to the non-core component, rather than the core component, despite the ample amount of slack in the economy. He/she pointed out that an increase in average wages is anticipated, this in the context of a reduction in corporate profits, and that inflation expectations are above target, which reflects the risk of them unanchoring. He/she emphasized that in view of the foreseen temporary increase in the trajectory of inflation in the coming months, caution is required when assessing the convenience of increasing the pace of monetary easing. He/she stated that unfortunately the opportunity to intensify the accommodative policy stance in November and December was missed, and that there is a last window of opportunity to implement a greater monetary policy loosening aimed at mitigating the effects of the economic recession, before facing a period that promises to be difficult. He/she considered that, over the next few months, actions must be taken cautiously, given that under the current conditions, monetary policy may be limited once more, with significant risks for the unanchoring of inflation expectations and for the central banks credibility. In this context, he/she pointed out that a pause may become more necessary as time passes by and that this decision will be the result of a careful reflection, before the inflation bubble that is anticipated for the second quarter arises, and in a scenario in which a lower persistence in inflation compared to the projected trajectory is not observed. He/she added that there is now a window of opportunity for a further monetary easing, which will help to mitigate the effects of the recession, before facing a period that will be difficult.

3. MONETARY POLICY DECISION

The risks for inflation, economic activity and financial markets pose major challenges for monetary policy and for the economy. In this regard, it is necessary to enable an orderly adjustment that allows for a change in relative prices, without affecting the price formation process and inflation expectations. Considering that incoming information allows for a monetary policy adjustment, while maintaining inflation forecasts in line with the converging trajectory to the 3% target, with the presence of all its members, the Governing Board decided unanimously to lower the target for the overnight interbank interest rate by 25 basis points to a level of 4.00%. Looking ahead, monetary policy implementation will depend on the evolution of the factors that have an incidence on headline and core inflation, on their foreseen trajectories within the forecast horizon, and on their expectations.

The Governing Board will take the necessary actions based on incoming information in order for the policy rate to be consistent with the orderly and sustained convergence of headline inflation to the 3% target within the time frame in which monetary policy operates. It is necessary to safeguard the institutional framework, strengthen the macroeconomic fundamentals and adopt the necessary actions on both monetary and fiscal policy fronts, to enable a better adjustment of domestic financial markets and of the economy as a whole.

4. VOTING

Alejandro Díaz de León-Carrillo, Galia Borja-Gómez, Irene Espinosa-Cantellano, Gerardo Esquivel-Hernández and Jonathan Ernest Heath-Constable voted in favor of lowering the target for the overnight interbank interest rate by 25 basis points to 4.00%.

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.

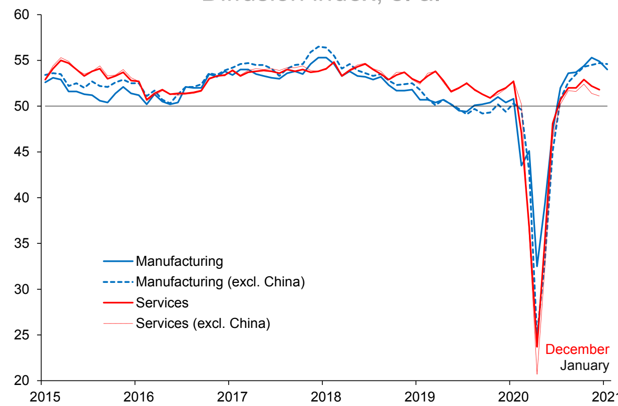
A.1. External conditions

A.1.1. World economic activity

Available information for the fourth quarter of 2020 suggests that world economic activity continued to recover, albeit at a more moderate pace than in the third and with heterogeneity across countries and sectors. In several countries, economic recovery has been affected by the resurgence of COVID-19 cases and the imposition of new lockdown measures, which have mainly affected the services sector. In contrast, international trade and global industrial activity continued to recover. Leading and higher frequency indicators suggest that in certain countries, economic activity may continue to remain weak at the beginning of this year (Chart 1).

Inflation worldwide has reflected the economic effects generated by the pandemic and the measures adopted to contain it. In advanced economies, inflation remains below their respective central banks' targets, while in emerging countries it has shown a more heterogeneous behavior. In this environment, the authorities have maintained and, in some cases, even increased or extended, their fiscal and monetary stimulus measures to mitigate the adverse effects of the pandemic. Likewise, central banks reiterated their intention to maintain accommodative monetary policy stances for an extended period. The above factors, along with conditions of ample liquidity stemming from highly accommodative monetary policies, continued to contribute to the favorable performance of financial markets, albeit with some episodes of volatility.

Chart 1
Global: Purchasing Managers' Index (PMI) Production Component
Diffusion index, s. a.



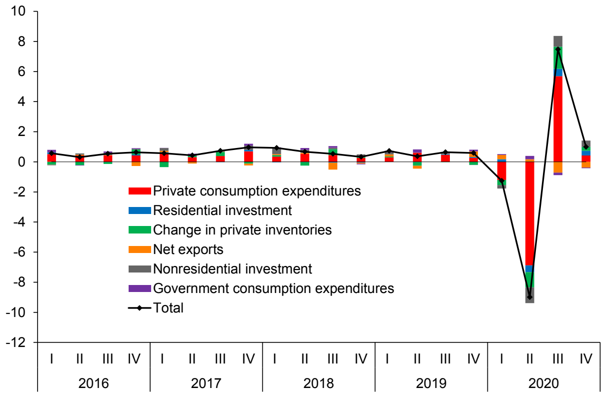
s. a. / Seasonally adjusted figures.
Source: Markit.

In the United States, economic activity continued to recover during the fourth quarter of 2020, although at a more moderate pace than in the third, with the seasonally adjusted quarterly growth rate decreasing from 7.5% to 1% (Chart 2).[1] Growth during the fourth quarter reflected mainly the continued rebound of both business and residential investment, as well as of inventory accumulation. The expansion of private consumption decelerated, which may be associated with the resurgence of COVID-19 cases and the negative impact of the expiration of some government support packages on disposable personal income. Despite the recovery registered during the second half of 2020, GDP still remains 2.5% below the levels observed prior to the pandemic.

The pace of expansion of US industrial production accelerated in December, by growing at a seasonally adjusted monthly rate of 1.6%, reflecting largely the growth in electricity and gas generation caused by a rebound in the demand for heating. Mining continued to be driven by the increased pace of oil and gas drilling and extraction, while manufacturing activity continued to recover gradually. In this context, the Purchasing Managers' Index of the manufacturing sector (PMI) continued to increase in January, suggesting that this sector would continue growing at the beginning of 2021.

[1] In seasonally adjusted annualized quarterly terms, US GDP grew 33.4% during the third quarter of the year and 4% during the fourth.

Chart 2
United States: Real GDP and its Components
Quarterly percentage change and contributions in percentage points, s. a.



s. a. / Seasonally adjusted figures.
Source: Bureau of Economic Analysis (BEA).

The US labor market recovered at the beginning of 2021, although at a moderate pace. In particular, the non-farm payroll increased by 49,000 jobs in January, after registering a fall of 227,000 jobs in December. This weak recovery of employment was the consequence of falls in some sectors, such as transportation and warehousing, manufacturing, construction, retail sales and accommodation and food services, given that other activities, such as professional, financial and retail trade services, continued to exhibit dynamism in terms of job creation. The unemployment rate decreased from 6.7% in December to 6.3% in January, due partly to the lower labor participation rate. As for initial unemployment insurance claims, after having increased since the end of November to a level of 927,000 new claims in the week ending on January 9, they decreased once again to 779,000 new claims in the week ending on January 30.

At the end of December 2020, a new relief package for an amount of USD 935 billion was approved in the United States to support its economic recovery. In January 2021, the new administration also announced the proposal of a new fiscal stimulus package for USD 1.9 trillion, which, if approved, would extend the duration of supplemental unemployment benefits, increase the amount of direct payments, and allocate more resources for fighting the pandemic, among other measures.

In the euro area, economic activity contracted at a seasonally adjusted quarterly rate of 0.7%, after having grown 12.4% during the third.[2] A heterogeneous behavior across euro area countries and sectors was observed, reflecting differences in the magnitude of the resurgence of COVID-19 infections and in the containment measures implemented. As for the labor market, the unemployment rate remained unchanged at 8.3% between November and December. The latest indicators, such as those of consumer confidence and PMIs, suggest that social distancing measures will continue to affect economic activity at the beginning of 2021.

In the United Kingdom, after GDP having grown at a seasonally adjusted quarterly rate of 16% during the third quarter of 2020,[3] timely indicators point to a weakening of economic activity during the fourth quarter. This weakening would reflect a moderation in business investment and, to a lower extent, of public spending, as well as the effects on private consumption associated with new lockdown measures in some regions of the country. As for the labor market, the unemployment rate increased from 4.9% in August-October to 5.0% in September-November. In addition, indicators such as the PMI and others related to mobility suggest a greater weakening of economic activity at the beginning of this year. Worth mentioning is the preliminary EU-UK Trade and Cooperation Agreement (TCA) signed on December 24, 2020. Despite this agreement, a memorandum of agreement between both parties over missing aspects, particularly those regarding financial services, remains to be reached.

In Japan, available indicators to the fourth quarter suggest that economic activity moderated after having expanded at a seasonally adjusted quarterly rate of 5.3% in the third quarter.[4] Some indicators of consumption deteriorated starting on December due to the suspension of tourism subsidy programs and the reestablishment of new restrictions on businesses in response to the rise in COVID-19 cases. In contrast, exports and investment recovered. As for the labor market, the unemployment rate remained unchanged at 2.9% between November and December. The state of emergency announced at the beginning of 2021 is expected to intensify the weakness of the Japanese economy during the first quarter of 2021. In this

[2] In seasonally adjusted annualized terms, euro area GDP grew 2.8% during the fourth quarter and 59.9% during the third.

[3] In seasonally adjusted annualized terms, UK GDP grew 81.1% during the third quarter of the year.

[4] In seasonally adjusted annualized terms, Japan GDP grew 22.9% during the third quarter of the year.

regard, PMIs decreased in January, remaining at contractionary levels.

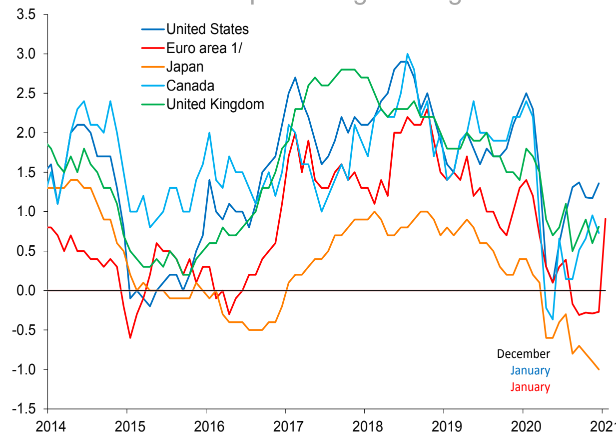
In emerging economies, available indicators to the fourth quarter of 2020 suggest that this group of countries also continued to recover, albeit at a more moderate and heterogeneous pace across countries and sectors. In China, GDP accelerated its rate of growth, from an annual rate of 4.9% during the third quarter to 6.5% during the fourth. The favorable performance of that economy has contributed to a rebound in other Asian emerging economies. In contrast, the pace of recovery of Latin American economies moderated, partly reflecting the reestablishment of mobility restrictions implemented to face resurgence of COVID-19 infections.

Since México's previous monetary policy decision, international commodity prices have shown increases in general, although some of them moderate. In particular, oil prices were driven by Saudi Arabia's decision to implement an additional cut in its oil production in February and March 2021, as well as the recent fall in US crude oil inventories and the optimism led by expectations of a new fiscal stimulus package in the United States. Grain prices have been driven by lower crop yields in the United States due to the changing climate conditions that have affected harvest lands. Finally, the increase in industrial metal prices has moderated due to a lower dynamism of world economic activity associated with the reestablishment of lockdown measures in several countries.

A.1.2. Monetary policy and international financial markets

Inflation worldwide continues to be subject to the economic effects stemming from the pandemic and the measures implemented to contain it. During the fourth quarter of 2020, headline inflation in some of the major advanced economies showed some stabilization, reflecting the effect of subsidies and tax cuts that were implemented in some countries, as well as the persistent weakness of services prices (Chart 3). Inflation in these economies remains below their respective central banks' targets. After having decreased as a result of the health crisis, inflation expectations for these economies drawn from financial instruments have shown a slight recovery overall, reaching levels above or around those registered at the beginning of 2020, except for Japan.

Chart 3
Selected Advanced Economies: Headline Inflation
Annual percentage change

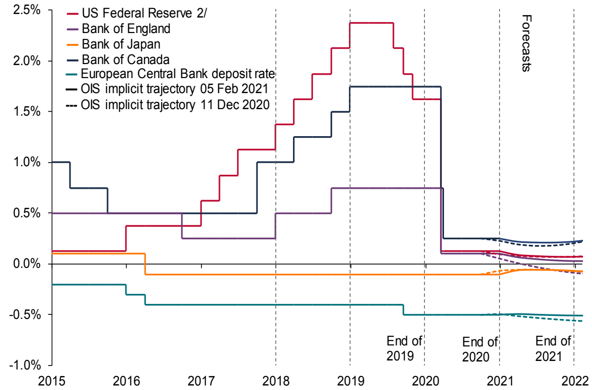


1/ Data of January is an estimate.
Source: Bureau of Labor Statistics, Eurostat, Bank of Japan, Statistics Canada, Office of National Statistics.

While headline inflation remains below pre-pandemic levels in most emerging economies, it showed a heterogeneous behavior during the fourth quarter of 2020, with increases and decreases registered in a similar number of economies. For instance, in some countries such as Colombia, Hungary and Poland downward pressures stemming from the pandemic continued to affect the prices of certain goods and services. In contrast, in other countries, including Brazil, Russia and Turkey, inflation has risen due largely to the increase in food prices, supply shocks, and the effects of the depreciation of their currencies.

In this environment, the central banks of major advanced economies maintained their reference interest rates at historically low levels and continued to use their balance sheets to preserve favorable financing conditions and thus support the provision of credit, promote economic activity, and ensure the convergence of inflation to their respective long- term targets. They also reiterated their intention to maintain accommodative monetary policy stances for an extended period until inflation reaches their targets in a sustained manner. In this context, expectations drawn from market instruments continue to anticipate that these central banks will maintain highly accommodative monetary policy stances (Chart 4).

Chart 4
Reference Rates and Implied Trajectories in OIS Curves[1/]
Percent



1/ OIS: Fixed floating interest rate swap where the fixed interest rate is associated to the effective overnight reference rate.
2/ For the observed reference rate of the U.S. the average interest rate of the target range of the federal funds target range (0.0% - 0.25%) is used.
Source: Banco de México with data from Bloomberg.

Among the recent monetary policy decisions, the following stand out:

i) In its January meeting, the Federal Reserve left unchanged its range for the federal funds rate at 0-0.25% and reiterated that it will be appropriate to maintain this range until labor market conditions have reached levels consistent with its maximum employment estimate and inflation has increased to 2% and is on track to moderately exceed this target for some time. It also stated that it will maintain the current pace of its asset purchase program at least until substantial progress has been made in terms of its maximum employment and price stability objectives. In this regard, the Federal Reserve Chairman pointed out in a press conference that it is still early to discuss the date when the Fed will reduce its asset purchase program. In this context, with data to February, the trajectory implied from federal fund futures does not reflect adjustments to the reference rate between 2021 and 2023.

ii) In its January meeting, the European Central Bank reaffirmed its highly accommodative monetary policy stance and maintained its refinancing rate, key deposit facility rate and key lending facility rate at 0.0, -0.5 and -0.25%, respectively. It reiterated that these interest rates are expected to remain at or below their current levels until inflation forecasts converge robustly to a level sufficiently close but below the 2% inflation target, and that this convergence has been consistently reflected in core inflation dynamics. It also maintained its asset purchase programs unchanged and pointed out that, if financial conditions remain favorable, it might not be necessary to fully use the total amount of its pandemic emergency purchase program (PEPP) (€1,850 billion) and that said amount may be recalibrated to help offset the negative impact of the pandemic on the trajectory of inflation.

iii) In its January meeting, the Bank of Japan left its short-term policy interest rate unchanged at -0.1% and its long-term interest rate (indexed to its 10-year bond) at around 0%. It also extended by one year the deadlines for loan disbursements under the Fund-Provisioning Measure to Stimulate Bank Lending and the Fund Provisioning Measure to Support Strengthening the Foundations for Economic Growth. As for the revision of its monetary policy framework, the Governor of that institution reiterated that, although such central bank considers that the yield curve control has worked properly and does not require adjustments, its operations are being reviewed in order to achieve a more effective and rapid monetary easing.

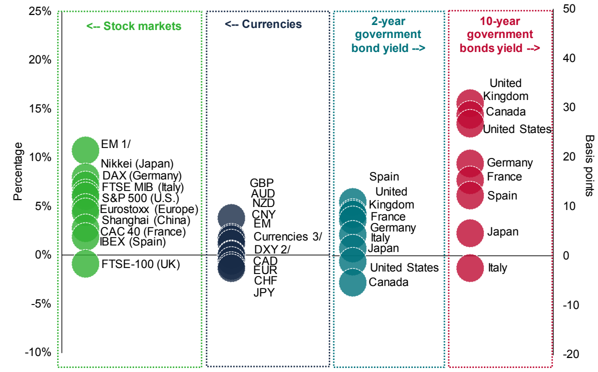
iv) In its February meeting, the Bank of England kept its reference interest rate unchanged at 0.10%, the amount of its asset purchase at £875 billion, and the stock of sterling non-financial investment-grade corporate bond purchases at £20 billion. In the minutes of said meeting, the Monetary Policy Committee considered that although it does not want to send a signal about an intention to establish a negative interest rate sometime in the future, it would be appropriate to start preparations in the financial system to have the capacity to operate in an environment of negative interest rates in the eventuality that this measure is adopted by that central bank. It also pointed out once again that it has no intention to tighten its monetary policy stance at least until there is clear evidence that significant progress is being made in eliminating the excess slack in the use of productive capacity and achieving a 2% inflation target in a sustainable manner.

Since Banco de México's previous monetary policy decision, all central banks of the main emerging economies left their reference interest rates unchanged, except for Turkey, which increased it. Likewise, in general, these central banks decided to maintain measures to provide credit, supply liquidity and foster the well-functioning of financial markets.

In the context of world economic activity described above, international financial markets overall performed favorably, associated with high liquidity conditions stemming from the accommodative monetary policy stances implemented in systemically important economies, the global progress in the production and application of vaccines against COVID-19, the conclusion of the US election process, the approval of a fiscal stimulus package in the United Sates at the end of 2020, the expectation of an approval of a significant package of additional fiscal stimuli proposed by the new US administration, and the signing of a trade agreement between the United Kingdom and the European Union at the end of 2020. However, during the period, there were some episodes of greater volatility and lower risk appetite due to the increase in the number of COVID-19 infections in several countries, the emergence of strains that are more virulent, the announcement of new mobility restrictions, and some delays in the production and distribution of vaccines worldwide. In this environment, financial assets of advanced economies registered positive adjustments during the period. On the one hand, most of the main stock indices registered gains, while the US dollar had limited adjustments in foreign exchange markets. On the other hand, interest rates on long-term government bonds exhibited moderate increases, with the case of the United States standing out (Chart 5). As for emerging economies, they registered net capital inflows, both to fixed-income and equity assets, although with some volatility. The stock markets of these economies continued having gains at the end of 2020, although some falls were registered in January, while their currencies registered mixed and differentiated adjustments by region (Chart 6).

Looking ahead, risks to world economic growth and to the stability of international financial markets persist. These risks are associated with the evolution of the pandemic; delays in the production and distribution of vaccines; the high levels of public and private borrowing; problems of business insolvency and bankruptcies; possible distortions in the valuation of some financial assets; a worsening of geopolitical and social conflicts in different regions of the world; the effects of environmental degradation; the sufficiency of fiscal stimuli; and the effects on potential GDP in some economies.

Chart 5
Change in Selected Financial Indicators from December 11, 2020 to February 5, 2021
Percent, basis points



1/ The MSCI Emerging Markets Index consists of 24 countries. 2/ DXY: a weighted average estimated by the Intercontinental Exchange (ICE) of the nominal exchange rate of the main six currencies operated globally 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 is constructed with the weighted average by 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.

Chart 6
Emerging Economies: Financial Assets Performance from December 11, 2020
Percent, basis points

Region	Country	Currencies	Equity markets	Interest rates 2Y	Interest rates 10Y	CDS
Latin America	Mexico	-0.30%	1.22%	-18	-13	-11
	Brazil	-6.78%	3.97%	80	34	-5
	Chile	-0.38%	9.55%	18	23	-4
	Colombia	-3.25%	-0.52%	-42	4	4
Emerging Europe	Russia	-1.89%	4.96%	19	9	6
	Poland	-1.40%	3.36%	8	21	-8
	Turkey	9.51%	12.03%	4	-22	-97
	Czech Republic	1.74%	10.03%	26	29	-1
	Hungary	-1.82%	7.62%	14	33	-1
Asia	China	1.40%	5.53%	-15	2	0
	Malaysia	-0.42%	-6.60%	-3	-7	-1
	India	0.93%	11.39%	65	67	1
	Philippines	0.05%	-3.06%	-2	25	1
	Thailand	0.00%	2.28%	6	14	0
	Indonesia	0.55%	4.56%	48	8	6
Africa	South Africa	1.43%	9.54%	12	-10	1

Note: Interest rates correspond to swap rates of two and ten years, except for Indonesia, Turkey, Colombia and Mexico, where government securities with said terms are used as a reference.
Source: Bloomberg.

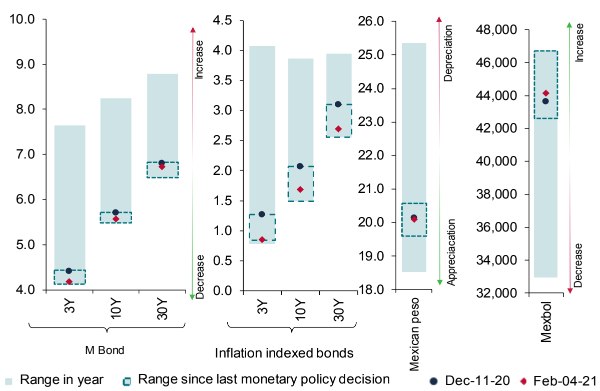
A.2. Current situation of the Mexican economy

A.2.1. Mexican markets

Since Banco de México's previous monetary policy decision to date, the prices of financial assets in Mexico traded in a narrow range (Chart 7).This occurred in an environment in which there are still concerns at the global level regarding the increase in COVID-19 cases, the rate of vaccine production, distribution and application, and in which expectations of developed economies' central banks maintaining an accommodative monetary policy stance for an extended period persist.

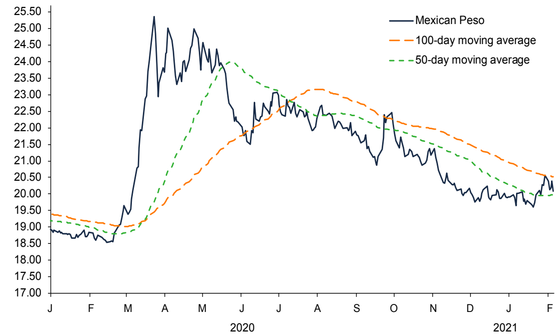
The Mexican peso fluctuated in a range between 19.60 and 20.60 pesos per dollar, ending the period with a depreciation of 0.60% (Chart 8). This occurred in a context in which both spot and forward trading conditions deteriorated with respect to the period of the previous monetary policy decision, although they improved relative to the levels observed in March 2020.

Chart 7
Mexican Markets' Performance
Percent, MXN/USD and index



Source: Prepared by Banco de México.

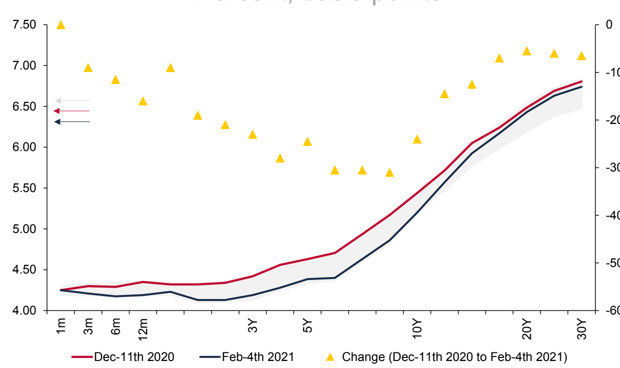
Chart 8
Mexican Peso Exchange Rate with Moving Averages
MXN/USD



Source: Prepared by Banco de México.

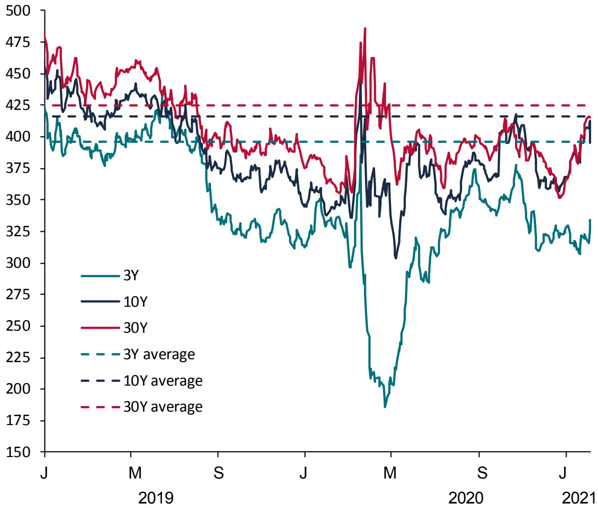
Interest rates of government securities exhibited reductions in all terms, the most notable of which were in the short- and medium-term part of the yield curve (Chart 9). As a result, the 3 year – 30 year spread increased by 22 basis points. The yield curve of real rate instruments exhibited a similar dynamic, albeit one of a greater magnitude than that observed in nominal rates. In this context, breakeven inflation and inflation risk premia implicit in the spreads between nominal and real market instruments have registered important increases since December's monetary policy decision (Chart 10). Such adjustments took place in an environment where trading conditions improved with respect to those observed in the period of the previous monetary policy decision.

Chart 9
Nominal Yield Curve of Government Securities
Percent, basis points



Source: PIP.

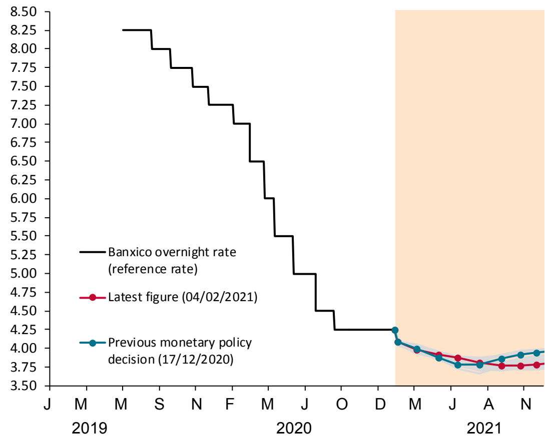
Chart 10
Breakeven Inflation and Inflation Risk Implicit in Government Securities' Interest Rate Curves
Basis points



Source: PIP.

As to expectations regarding the trajectory of the monetary policy rate, information implied by the Interbank Equilibrium Interest Rate swaps curve (TIIE, for its Spanish acronym) discounts with a 64% probability that the target rate will decrease by 25 basis points for the monetary policy decision of February (Chart 11). In a related manner, the consensus of forecasters surveyed by Citibanamex expect the reference interest rate to lie at 4.00%. For the end of 2021, market variables anticipate a level of 3.80% for the target rate, while the median of the aforementioned survey among forecasters lies at 3.75%.

Chart 11
Banxico's Overnight Interbank Rate Implied in TIIE IRS Curve
Percent



Source: Prepared by Banco de México with Bloomberg data.

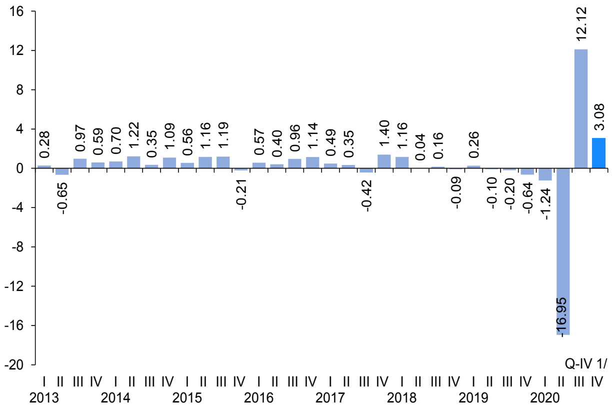
A.2.2. Economic activity in Mexico

According to Mexico's GDP flash estimate published by INEGI, during the fourth quarter of 2020, economic activity continued to recover, although at a more moderate rate than in the third quarter and remaining below pre-pandemic levels (Chart 12). Economic activity is estimated to have weakened at the end of 2020, due to the intensification of the pandemic and of new restrictions on production and mobility implemented by different states in order to deal with it.

As for external demand, after having recovered considerably during the third quarter, during the October-December period exports continued to perform favorably, registering at the end of 2020 figures above those of February. This recovery derived from the dynamism of both automotive exports and the rest of manufacturing exports, mainly to the United States (Chart 13).[5]

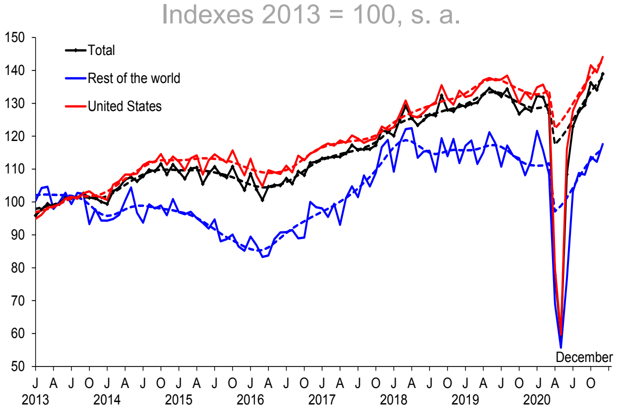
[5] Refers to the value of merchandise exports in current US dollars. This value differs from that reported for goods exports by Mexico's System of National Accounts (SCNM, for its Spanish acronym), given that the latter represents the value added, measured in constant pesos.

Chart 12
Gross Domestic Product
Quarterly percentage change, s. a.



s. a. / Seasonally adjusted figures.
1/ Data for the fourth quarter 2020 refers to the quarterly GDP flash estimate published by INEGI.
Source: Mexico's System of National Accounts (SCNM, for its Spanish acronym), INEGI.

Chart 13
Total Manufacturing Exports
Indexes 2013 = 100, s. a.

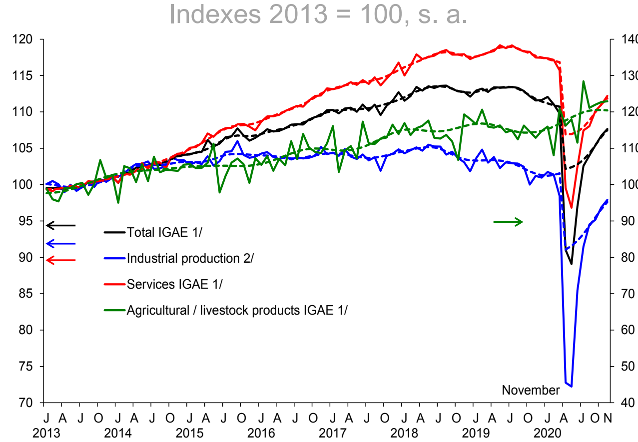


s. a. / Seasonally adjusted series and trend series based on data in nominal US dollars. The former is represented by a solid line and the latter by a dotted line.
Source: Prepared by Banco de México with data from the Tax Administration Service (SAT, for its Spanish acronym), the Ministry of the Economy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

According to its monthly indicator, private consumption continued to recover gradually in November 2020. Within its components, the item of imported goods and services rebounded significantly, while that of domestic goods and services continued to recover slowly. Timely indicators suggest that this indicator weakened by the end of 2020 and in early 2021. In particular, in December and January, sales reported by the National Association of Self-Service and Department Stores (ANTAD, for its Spanish acronym) contracted significantly, reversing most of the recovery observed during the second half of 2020, while during the same period light vehicle sales exhibited a lack of dynamism. In November, gross fixed investment continued to slowly recover, although still remaining significantly below the levels reported at the beginning of 2020. Within this indicator, both investment in construction and spending on machinery and equipment continued to gradually recover.

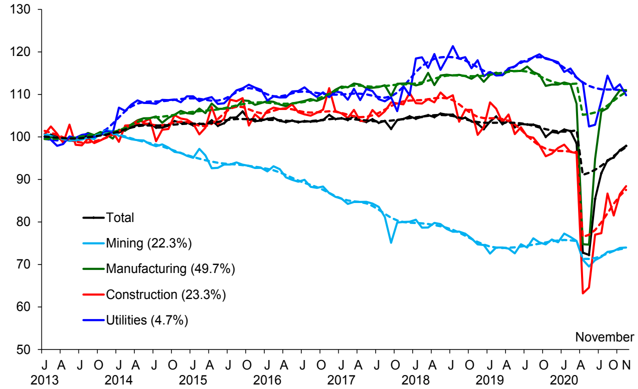
As for production, in November 2020 productive activity continued to follow a moderate recovery, although at a slower rate and still remaining below pre-pandemic levels (Chart 14). In particular, tertiary activities continued to gradually improve, albeit heterogeneously across its sectors. Increases in transportation services and mass media information; in trade; and in temporary accommodation and in food and beverage services stood out. In contrast, educational, health care and professional, corporate and business support services decreased. The performance of industrial activity was associated with the moderate recovery of construction, while the growth rate of mining and, mainly, manufacturing, decelerated considerably (Chart 15).

Chart 14
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.
Source: Mexico's System of National Accounts (SCNM, for its Spanish acronym), INEGI.

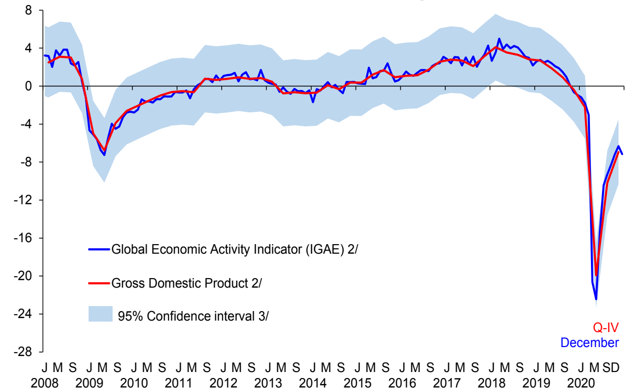
Chart 15
Industrial Activity Indicators [1/]
Indexes 2013 = 100, s. a.



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 parenthesis correspond to their share in the total in 2013.
Source: Mexico's System of National Accounts (SCNM, for its Spanish acronym), INEGI.

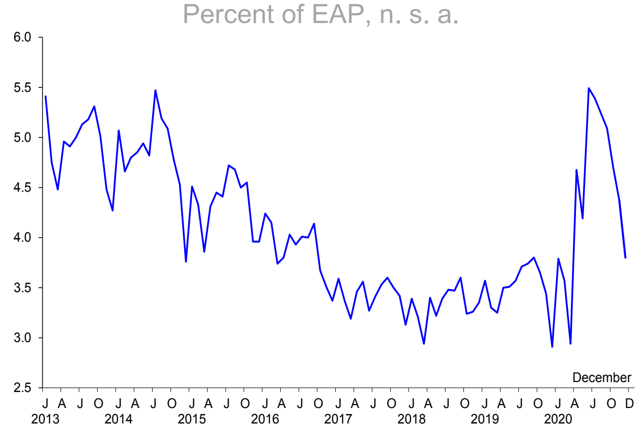
As to the economy's cyclical position, slack conditions narrowed gradually in October and November, and they are anticipated to have shown a slight reversal in December, remaining considerably wide (Chart 16). In November and December, different labor market indicators stalled the moderate recovery observed during the previous months. Although both national and urban unemployment rates continued to decline (Chart 17), they did so in a context in which labor participation and employed population decreased for two consecutive months. In addition, the population out of the labor force that is available for work increased. The creation of IMSS-insured jobs continued to gradually recover, registering in late 2020 levels significantly below those of February, in seasonally adjusted terms. Finally, in November unit labor costs in the manufacturing sector were slightly above the level registered prior to the health emergency (Chart 18).

Chart 16
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", pág.74.
2/ GDP flash estimate figure as of the fourth quarter of 2020; IGAE figures as of December 2020; consistent with the flash estimate.
3/ Output gap confidence interval calculated with a method of unobserved components.
4/ Excludes both oil and gas extraction, support services for mining, and petroleum and coal products' manufacturing.
Source: Prepared by Banco de México with INEGI data.

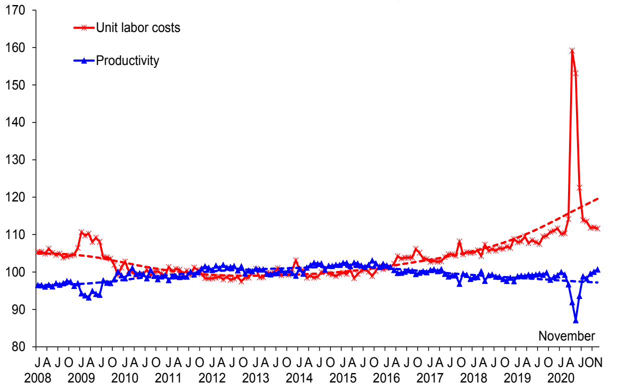
Chart 17
National Unemployment Rate
Percent of EAP, n. s. a.



n. s. a. / Not seasonally adjusted (original series).
EAP/ Economically active population.
Source: Prepared by Banco de México with data from ENOE, ETOE (from April to June 2020), and ENOE new edition ($ENOE^N$) from July to date.

Chart 18
Productivity and Unit Labor Cost in the Manufacturing Sector [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/ Productivity based on hours worked.
Source: Prepared by Banco de México with seasonally adjusted data of teh Montly Manufacturing Industry Survey and industrial activity indicators of Mexico's System of National Accounts (*Sistema de Cuentas Nacionales de México*,SCNM, INEGI.

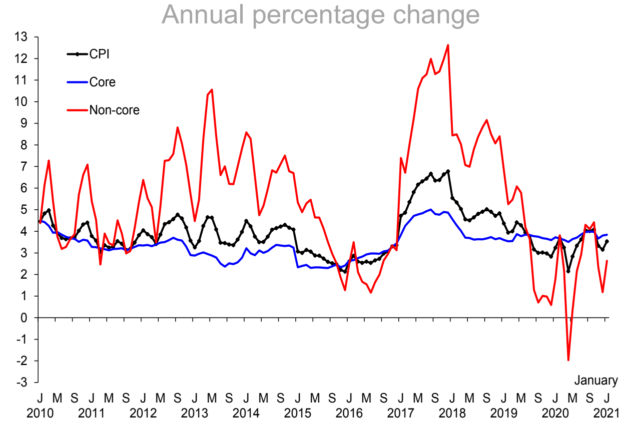
In December 2020, domestic financing to firms contracted at an annual rate for the seventh consecutive month, extending the loss of dynamism that had been observed since May 2020. This was mainly due to a reduction in bank lending both to smaller firms –segment that decreased in annual terms since the first quarter of 2019–, and to large firms –segment that during the fourth quarter of the year continued to show weakness in its demand for this type of financing vis-à-vis pre-pandemic levels–. Similarly, lending conditions remain tight for the two segments of firms as compared to the beginning of the pandemic. At the same time, corporate debt issuance by issuing firms has decreased since October, after the greater dynamism observed during the third quarter. As to credit to households, for the second consecutive quarter the housing portfolio continued to rebound, due to an increase in mortgage lending. Performing bank credit portfolio for consumption continued contracting in all segments, except for payroll loans, in a context in which credit granting conditions to households remain generally tight. Interest rates of bank credit to firms have generally followed the dynamics of the bank funding rate. Similarly, while the margins of intermediation remain at levels above those observed prior to the pandemic, at the margin these have shown an incipient trend to decrease. In November, interest rates of mortgages continued following the downward trend observed during 2020, while those of credit cards remained stable in October, just as it had been the case throughout the year. As to portfolio quality, corporate and mortgage loan delinquency rates showed an incipient increase, despite remaining at low levels, while those for consumption remained at high levels and increased for the third consecutive month, after having declined during the previous months.

A.2.3. Development of inflation and inflation outlook

Between November 2020 and January 2021, annual headline inflation went from 3.33 to 3.54%. This result is explained by an increase of close to 12 basis points in the contribution of the core component and of nearly 8 basis points in the contribution of the non-core index (Chart 19 and Table 1).

Chart 19
Consumer Price Index

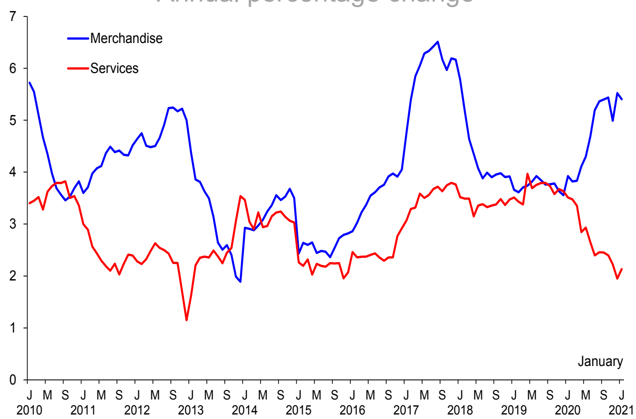
Annual percentage change



Source: Prepared by Banco de México and INEGI data.

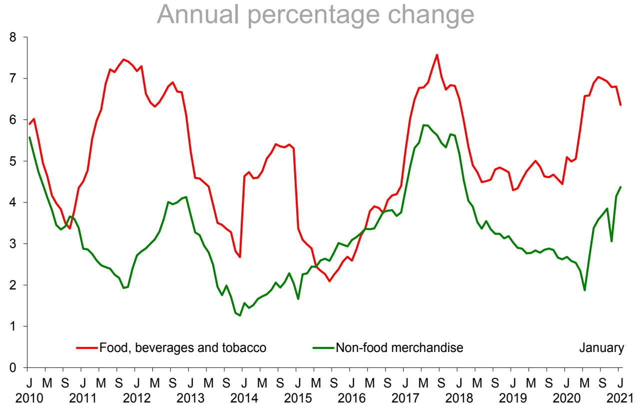
Core inflation continued to be affected by the shocks stemming from the COVID-19 pandemic and which have been reflected in an adjustment in relative prices, with upward pressures on merchandise inflation and downward pressures on services inflation. Specifically, between November 2020 and January 2021, annual core inflation increased from 3.66 to 3.84%. Within it, annual inflation of merchandise prices rose from 4.99 to 5.41% (Chart 20), driven by the behavior of annual non-food merchandise inflation. During the reference period, the latter went from 3.06 to 4.37%, although in November it exhibited volatility associated to the *El Buen Fin* sales campaign. In contrast, annual inflation of food merchandise decreased from 6.79 to 6.36% between November 2020 and January 2021, partly as a result of the fading out of the effects of the increase in the excise tax (IEPS, for its Spanish acronym) on cigarettes and sugary drinks at the beginning of 2020 (Chart 21). Annual inflation of services has generally followed a downward trend, by registering levels of 2.22 and 2.13% during the referred period, in response to the effects of the measures adopted to contain the COVID-19 pandemic and to the related decline in the demand for many of these services, such as housing, education, food, and tourism.

Chart 20
Merchandise and Services Core Price Sub-index
Annual percentage change



Source: Banco de México and INEGI.

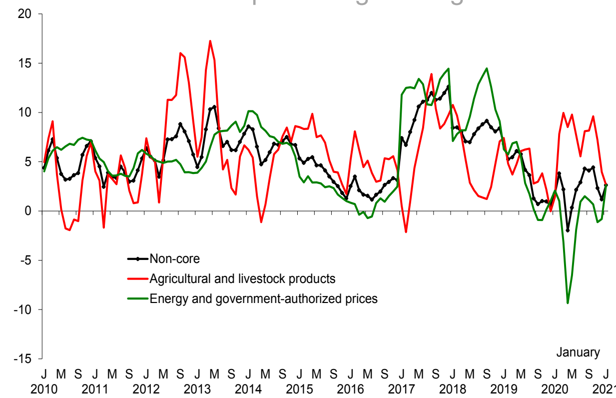
Chart 21
Merchandise Core Price Sub-index
Annual percentage change



Source: Prepared by Banco de México with INEGI data.

Annual non-core inflation rose from 2.33 to 2.63% between November 2020 and January 2021 (Chart 22 and Table 1). This mainly reflected the higher annual changes in energy prices, from -3.05 to 2.66% during this period, and which offset the observed fall in inflation of fruits and vegetables.

Chart 22
Non-core Price Sub-index
Annual percentage change



Source: Prepared by Banco de México with INEGI data.

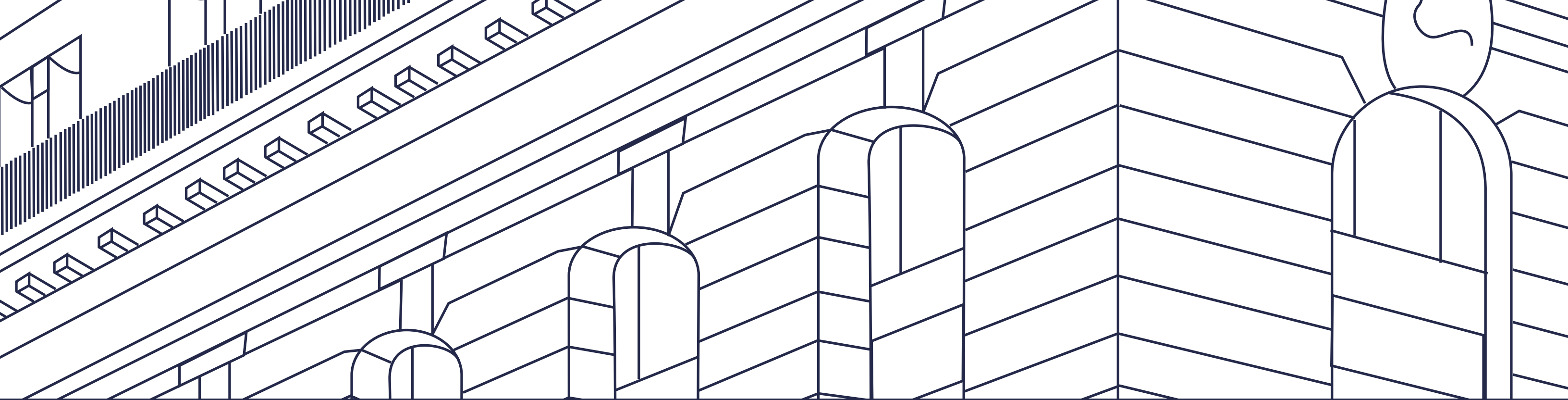
As for inflation expectations drawn from Banco de México's Survey of Private Sector Forecasters, between December and January, the medians for headline and core inflation for the end of 2021 increased from 3.60 to 3.66%, and from 3.50 to 3.57%, respectively. The medians for headline and core inflation for the medium and long terms remained around 3.50%. Finally, breakeven inflation and inflation risk increased since the previous monetary policy decision.

Regarding the expected trajectory of headline inflation, increases in headline inflation are anticipated during the second quarter of the year, mainly associated with the arithmetic effects of the fall in energy prices of last year, and a downward trajectory starting in the second half of the year. Similarly, core inflation is expected to be around 3% as of the third quarter of this year. These forecasts are subject to short- and medium-term risks. To the downside: i) a greater-than-expected effect due to the negative output gap or to greater social distancing measures; ii) lower inflationary pressures worldwide; and iii) foreign exchange appreciation. To the upside: i) core inflation pressures generated by the recomposition of spending; ii) episodes of foreign exchange depreciation; and iii) various cost-related pressures for firms. The balance of risks for the projected trajectory of inflation is uncertain.

Table 1
Consumer Price Index and Components
Annual percentage change

Item	November 2020	December 2020	January 2021
CPI	**3.33**	**3.15**	**3.54**
Core	**3.66**	**3.80**	**3.84**
Merchandise	**4.99**	**5.52**	**5.41**
Food, beverages and tobacco	6.79	6.80	6.36
Non-food merchandise	3.06	4.14	4.37
Services	**2.22**	**1.95**	**2.13**
Housing	2.09	2.00	1.94
Education (tuitions)	2.11	2.11	1.59
Other services	2.37	1.87	2.42
Non-core	**2.33**	**1.18**	**2.63**
Agricultural and livestock products	**7.20**	**3.96**	**2.64**
Fruits and vegetables	9.50	0.10	-3.89
Livestock products	5.32	7.20	8.42
Energy and government-authorized prices	**-1.13**	**-0.81**	**2.62**
Energy products	-3.05	-2.53	2.66
Government-authorized prices	3.46	3.31	2.54

Source:INEGI.



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Document published on February 25, 2021