



BANCO DE MÉXICO®

Minutes number 84

**Meeting of Banco de México's Governing Board on the occasion of
the monetary policy decision announced on May 13, 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: May 12, 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.
Gabriel Yorrio-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

The majority noted that global economic activity continues to recover heterogeneously across countries, associated with vaccine availability and the amount of stimulus spending. Some members added structural factors of each economy. **One** member mentioned that most timely indicators of global economic activity show significant rebounds. **Some** members noted that economic activity and labor markets in various countries and regions are still affected by social distancing measures.

Most members highlighted the increase in global growth expectations, particularly in the United States, given its significant fiscal stimulus. Some members mentioned that the International Monetary Fund (IMF) growth expectation for that country in

2021 is 6.4%. **Some** members added that, among advanced economies, the US economy is expected to be the only one with a positive output gap in 2021 and 2022. **One** member added that this will allow it to reach its pre-pandemic output level towards the end of this year. **Another** member underlined that additional support packages are being evaluated, with infrastructure spending for up to 10 years, which also include tax increases to partially offset the higher levels of spending. **Some** members pointed out that the recovery is expected to be weaker in the euro area and Japan. **One** member stated that it is expected that it will take until 2023 for many emerging economies to regain their pre-pandemic levels.

Among the risks to global economic activity, most members highlighted those associated with the pandemic and a higher-than-expected increase in inflation. Some members mentioned that there could be disruptions in production and supply chains. **One** member emphasized the importance of ensuring a broad and inclusive distribution of vaccines that would contribute to an orderly reestablishment of these chains. He/she warned that, otherwise, the recovery will continue to be heterogeneous and would favor the emergence of disruptions in the provision of inputs or commodities, with unfavorable effects on output and prices. **Another** member added the uncertainty about the type of inflationary pressures that may arise in the United States as a risk. **As for the risks for emerging economies, most members pointed out those associated with the vaccination process, more restrictive financial conditions, and idiosyncratic factors.**

All members pointed out that global inflation rose due to recent pressures on commodity prices, especially energy-related ones, and to base effects, and cost-related pressures. Most members added that supply chain disruptions and the economic recovery process also exerted an influence. Some members stated that pressures on world inflation are anticipated to be limited and transitory due to economic and labor market weakness and the fading of base effects. **One** member mentioned that the most recent forecasts by international organizations suggest that price pressures will be short-lived, due to the wide slack conditions in most economies, and to the gradual fading away of base effects. **Another** member highlighted the impact of the recovery of economies of systemic importance such as China and the United States. **One** member added supply factors, including poor harvests and precautionary stockpiling. **Some**

members noted that in most advanced economies, headline and core inflation remain below their targets, except for the United States, Canada and the United Kingdom. **One** member noted that in these countries the increases in inflation have been considered to be transitory. **Most members mentioned that higher levels of inflation are expected in the United States.** **One** member stated that the positive output gap that is expected for the US economy could exert upward pressures on inflation and interest rates. Regarding emerging economies, he/she noted that in most of them inflation has increased recently due to the increase in commodity prices, to supply shocks, and to exchange rate depreciations.

Most members mentioned that greater pressures on prices could arise as a result of disruptions in production and supply chains. **Some** members noted that due to the effects derived from the pandemic, these chains are less resilient and have less capacity to absorb increases in demand without exerting pressures on prices. **One** member mentioned that world inflation is expected to be higher than at the beginning of the year. He/she noted that several global companies have warned about the possibility of raising their prices in 2021 and 2022 due to higher input costs, and he/she considered that the balance of risks for global inflation has deteriorated. **Another** member added that it is foreseeable that the supply of raw materials will tend to increase, thus contributing to lower inflationary pressures. He/she considered that since pressures on prices are transitory, longer-term inflation expectations should not be affected. He/she considered that for emerging economies, it will be important to monitor that the increase in inflation is indeed transitory and pointed out that inflation expectations for 2022 reveal, in general, lower levels than those anticipated for 2021. He/she added that the fact that some of the main economies have made progress with the vaccination and containment of the pandemic, has led to more favorable growth expectations and increases in the demand for various inputs. He/she considered that, in a context of global disruptions in supply chains, it is logical that the heterogeneous economic recovery process is also resulting in some bottlenecks in the provision of inputs. He/she stated that these price increases, however, should be understood as associated to supply factors. He/she added that as the normalization of activities progresses, supply chains are foreseen to begin to realign and prices will adjust to levels compatible with those prevailing prior to the pandemic.

Most members mentioned that central banks in advanced economies reiterated their intention to maintain accommodative monetary policy stances. **Some** members pointed out that, in its latest policy decision, the Federal Reserve considered that there is still some way to go before achieving its targets. **One** member added that the Fed reinforced its expectation of a moderate increase in inflation, with no increases to its reference rate until 2023. **Another** member argued that the Federal Reserve has been very emphatic regarding the importance of fully understanding the character and the implications of the recent inflationary pressures. He/she recalled that, in its latest decision, that institution highlighted the transitory nature of the increase in inflation, explaining that inflation is expected to exceed 2%, and making it clear that such result is due to the low comparison base and to bottlenecks that limit the response of supply given the recovery of spending. He/she mentioned that the president of the Federal Reserve explicitly recognized that this temporary increase in inflation does not meet the conditions to begin a reduction in the monetary stimulus. He/she pointed out that it is necessary to remember the highly accommodative nature of the new monetary policy strategy adopted by the Federal Reserve. He/she noted that, because inflation has remained persistently below 2% in the past, such institution will now allow inflation to remain moderately above 2% for some time. He/she considered that this implies that the Federal Reserve will not increase its interest rates, nor will it reduce the level of its asset purchases in a mechanical way when inflation increases beyond 2%. He/she added that the Fed pointed out that labor market conditions are not close to meeting its definition of maximum employment.

Some members mentioned that central banks in some emerging economies have started to reduce their monetary stimulus. They argued that in those economies the monetary policy stance had been relaxed aggressively, leading to exchange rate or inflationary pressures. **One** member pointed out that the currencies of some of these economies have exhibited a significant cumulative depreciation during the year. He/she added that the rebound in inflation prompted some central banks in emerging economies to conclude their monetary easing cycle and begin increasing their reference rates. He/she mentioned that the expectation of a tighter monetary policy in economies facing inflationary pressures persists. **Another** member considered that such pressures are strictly local and that they should not be extrapolated to economies that have acted in a more cautious and prudent manner, such as Mexico.

He/she added that the majority of central banks in emerging economies still maintain strongly accommodative monetary policy stances and are expected to continue doing so at least for the rest of 2021, and that for these reasons, they continue to register negative ex-ante real interest rates.

Most members mentioned that financial markets exhibited a more stable behavior. They noted that, after having increased significantly due to the expectation of higher inflation in the United States, longer-term interest rates in that country have stabilized. They pointed out that the main stock markets registered gains, some of them reaching historically high levels. They added that the US dollar appreciation was contained. One member noted that this environment is explained by factors such as the consistency in the Federal Reserve's announcements regarding the continuation of the monetary stimulus and the economic recovery. He/she considered that looking ahead, these factors will continue to support financial markets.

Some members mentioned that, since the last monetary policy decision, financial markets in emerging economies exhibited a more orderly behavior. These members noted that capital flows to these economies continued. **One** member pointed out that flows to fixed-income assets continued and that those to equities continued to be channeled mainly to the Chinese economy. **Another** member pointed out that equity markets in emerging economies registered gains, while interest rates on government bonds remained relatively stable, although with some fluctuations.

Most members agreed that one of the risks for financial markets is the evolution of inflation, particularly in the United States. One member mentioned that global financing conditions could suddenly tighten as a result of an inflationary surprise in that country. In this regard, **another** member emphasized the uncertainty about whether inflationary pressures in the United States will be moderate and transitory, or of considerable magnitude and more persistent. He/she pointed out that the eventual reduction in asset purchases by the Federal Reserve is a risk factor for fixed-income markets. Meanwhile, **one** member considered that the lack of confidence in the market regarding the possibility that the Federal Reserve adopts a less accommodative policy, while still manifesting itself in recent days, has begun to decline given the consistency in the actions and the rhetoric of that institution. **Some** members added the risk of

adjustments in the prices of certain financial assets. **One** member added that public and private debts, which have reached record highs, might not be sustainable.

Regarding emerging economies, **another** member stated that the global environment implies both the benefits of a higher external demand and the risks of tighter and more volatile financial conditions. He/she specified that the fiscal stimulus in the US economy will support the recovery, which is especially important for economies that are more integrated to that economy and have smaller spending stimulus programs. Nevertheless, he/she considered that should a greater-than-expected increase in US inflation take place, interest rates would be under pressure at a global level. He/she pointed out that to the extent that this occurs, emerging economies will face greater difficulties in attracting and retaining capital, possible exchange rate adjustments, and upward pressures on yield curves. In the same vein, he/she added the challenges associated with the inclusion of China in several global fixed income indices. He/she detailed that an environment of high uncertainty prevails in financial markets due to the interaction of several unprecedented factors: i) a health-related shock, unrelated to the economic or financial cycles; ii) a highly differentiated fiscal stimulus; iii) the negative impact on global and domestic supply chains; iv) the change in the Federal Reserve's monetary policy strategy, for which financial markets do not have direct precedents to extrapolate possible monetary policy actions, making the adjustment more volatile; and v) a heterogeneous global recovery across countries and sectors, with differences in yield curves, exchange rates, and external accounts.

Economic activity in Mexico

All members agreed that economic recovery in Mexico has been heterogeneous across sectors and regions. Most members mentioned that the pace of recovery decelerated during the first quarter of the year, due to higher levels of contagion and reimposed mobility restrictions in early 2021, as well as supply disruptions of certain inputs. **Some** members emphasized that economic activity showed a higher growth rate towards the end of the first quarter of the year. **Some** members attributed the improvement in different activity indicators following an easing of mobility restrictions to a lower number of contagions and to greater advance in the vaccination process. **One** member highlighted that a positive quarterly growth was registered during said period despite the halting

of business activity and the aforementioned supply chain disruptions.

Regarding demand, most members agreed that the recovery continues to be driven by the external sector. One member pointed out that during the first quarter of the year non-automotive manufacturing exports to the United States stood out, given that automotive exports contracted in January and February. He/she highlighted that forecasts for industrial production in the United States increased as a result of the approved fiscal stimulus, and that therefore external demand is foreseen to continue contributing significantly to Mexico's recovery. He/she added that the external accounts reflected the relative strength of exports and the lag in the recovery of imports that led to a large trade surplus, which is estimated to decrease over the following quarters.

Most members mentioned that, although consumption has recovered slightly, it remains below pre-pandemic levels. They highlighted that consumption has been supported by the higher level of remittances and that consumer confidence has been improving. One member pointed out that the recovery was faster in nondurable consumption goods, spurred by remittances, the wage bill and government transfers. He/she pointed out that, in contrast, both services consumption and consumption of domestic durable goods still show a strong contraction. **Another** member considered that latest data on remittances and the consumer confidence index suggests that the process of recovery of private consumption will continue over the next months. **Some** members highlighted the improvement, at the margin, of timely indicators related to commercial activity and consumption. **Most members highlighted that investment continues to show lack of dynamism.** One member stated that in February it was 7.42% below the level registered at the beginning of 2020, and that it has been weak for several years. **Another** member emphasized that the government has not done enough to offset the sense of uncertainty prevailing in the business sector regarding the respect for the rule of law, and that for this reason a vigorous recovery in investment is not anticipated.

As for supply, all members highlighted the heterogeneous pace of recovery across sectors. One member underlined that the subsectors that continue showing a contraction of over 5% in their monthly activity with respect to pre-pandemic levels account for around 27.8% of GDP. He/she stated that in March industrial production accumulated ten

months of positive monthly changes. **Some** members emphasized the impact of the shortage of semiconductors on the automotive industry. **One** member pointed out that this has diminished the performance of the industrial sector and of exports. **Another** member mentioned that, after leading the recovery, manufacturing contracted in January and February, although in March it performed better. He/she added that in March construction was still at levels of monthly activity that were over 8% lower than those recorded in early 2020. **Most members highlighted the weakness in the services sector and the differentiated performance among its subsectors.** **Some** members pointed out that face-to-face services continue to be significantly affected.

Most members noted that the labor market has been recovering, although it still exhibits deterioration with respect to pre-pandemic levels. One member mentioned that, despite the fact that the National Survey on Occupation and Employment (ENOE, for its Spanish acronym) of March shows that the labor participation rate has recovered to 58% of the population, after having fallen below 48% during the pandemic, it is still below the levels recorded in early 2020. **Another** member pointed out that both formal and informal employment, which between February and April 2020 contracted by 12.5 million workers, by March 2021 had recovered 10.5 million workers, and one million of them were added during the first quarter of the year. He/she added that by April, IMSS-insured jobs were at levels 2.6% lower than those registered in February 2020. **Some** members noted that the asymmetric recovery across sectors and types of jobs has been unfavorable in terms of gender, affecting women to a greater extent than men. **One** member argued that the sectors that expanded the most are related to industry, which has allowed employment among men to recover, while the slowdown in services has made the labor recovery among women more difficult. He/she detailed that, since educational activities remain in distance-learning format, the unpaid workload for women has increased, which could considerably amplify labor gender inequality.

Most members pointed out that there is still slack in the economy. **Some** members pointed out that the underemployment rate is 14%, a figure twice the level normally observed. **One** member highlighted that the output gap is estimated to be of around 6%. **Another** member underlined that slack conditions in January and February are estimated to have widened slightly, and to have resumed a decreasing trajectory as of March. He/she added that slack in the

labor market remains ample and, over the following months, additional direct and indirect effects will be incorporated as a result of the reform to the Federal Labor Law on the subject of outsourcing. **Some** members noted that, considering the economic contraction of 2020, ample slack conditions are foreseen for the economy as a whole, with significant differences across sectors. **One** member argued that, due to the pandemic's impact, measuring economic slack poses significant challenges, given that estimates of potential GDP and the Non-accelerating Inflation Rate of Unemployment (NAIRU) rate could be distorted. He/she considered that, in view of a considerable economic contraction, potential GDP is probably overestimated, which suggests a less negative output gap. Similarly, he/she noted that the open unemployment rate could be an inadequate indicator to illustrate a labor imbalance. Indeed, estimating the natural employment rate using the open unemployment rate has turned it into an irrelevant and dangerously mistaken reference. With an economy that is extremely weak it would seem that the open unemployment rate lies below the level of the natural unemployment rate, which is counterintuitive after observing the situation of economic activity. He/she stated that, in order to adequately calibrate the labor market's pressures onto prices, a metric is needed which corrects for the structural changes experienced by the population that is economically inactive but available for work, as a result of the pandemic.

Most members highlighted that higher growth is foreseen for the year and that growth forecasts for 2021 have been adjusted upwards. They mentioned that this stems from the fact that the recovery rate is anticipated to accelerate driven by the strength of external demand. Some members mentioned advances in the vaccination process. One member noted the gradual reopening of economic activities and another member added that recently the economy has performed better than expected.

Most members agreed that the balance of risks for growth has improved and that it is now more equilibrated. Among risks to the upside, they mentioned a possible increase in external demand, given the improved outlook for world growth. One member added the possibility of observing greater revenues from remittances. He/she added that a greater external demand combined with the United States-Mexico-Canada Agreement (USMCA) could stimulate investment.

Some members underlined the possibility of greater progress in the vaccination program.

Among risks on the downside, most members highlighted those related to the evolution of the pandemic, along with possible delays in the vaccination campaign. One member added the volatility in financial markets and the negative impact on input supply chains. Another member mentioned the risk associated with the next electoral process due to a renewed environment of risk aversion.

Inflation in Mexico

All members mentioned that annual headline inflation increased significantly and more than expected, reaching 6.08% in April. They highlighted that this increase mainly resulted from the effect of a low comparison base for energy prices. Most members added that pressures on commodity prices and cost-related pressures also contributed to the above. One member highlighted the outsized increase in the prices of some specific products and emphasized that the increase in inflation does not imply a generalized increase in all prices. Most members pointed out that an increase in inflation had already been anticipated. One member noted that the level of April had not been recorded since December 2017. Some members considered that inflation continues to be impacted by pandemic-related effects. One member stated that changes in the consumption basket have implied that there are distortions in the measurement of inflation.

Most members mentioned that the component which exerted the most pressure on headline inflation in April was non-core inflation, which registered 12.3%. One member underlined that this level is the highest since late 2017. Another member emphasized that it is the second highest on record in the last 20 years. He/she noted that between January 2019 and June 2020 this component registered atypically low values, below the mean of the last ten years, and that a reversal had thus been anticipated for some time. Most members highlighted the arithmetic effect of energy prices. Some members emphasized a greater-than-estimated increase in these goods' prices. One member noted that, between April 2020 and April 2021, gasoline prices rose 35%, mainly due to a low comparison base. Another member pointed out the disproportionate increase in LP gas prices and in the prices of certain agricultural and livestock product prices.

Most members noted that in April the core component registered 4.13%. Some members underlined that it exceeded the upper limit of the variability interval. Regarding its components, most members indicated that merchandise inflation remains the main source of pressure, particularly non-food merchandise inflation. Some members mentioned that food merchandise inflation decreased, although one member stated that it remained high. Another member pointed out the economy confronts an acceleration in the prices of non-food merchandise, mainly those sensitive to energy prices and to the exchange rate. Most members noted that services inflation has increased. One member highlighted that, although tourism services' inflation and food related services inflation rose in light of a certain reopening of activities, housing and education services' inflation continued to decline. Another member mentioned the pressures on merchandise prices, which were only partially offset by the lower pressures on services prices.

Some members mentioned that super core inflation remains around 3%, suggesting that pressures on prices do not derive from the cyclical position of the economy. One member added that indicators which exclude extreme price variations show that price increases of a wide range of products are being contained by the economic slack. He/she noted that the median of core inflation in April was below 3.25% and therefore half of the products that make up this index registered inflation rates below said level. He/she added that 30% of goods and services in the Consumer Price Index (CPI) registered inflation rates below 2%. He/she thus considered that inflation is contained and that its recent increases do not imply a generalized increase in prices, but rather they respond to contextual factors or to specific goods.

Another member considered that a measurement problem is being confronted, which leads to a loss of perspective about the inflationary phenomenon and the slack conditions. The weak response of inflation to economic slack that is observed in the data could be the result of distortions in the estimation of potential output and the output gap. If the potential output is overestimated, in reality the output gap is less negative than is suggested by the gap measured in the traditional way, and slack conditions are not as ample as they seem. He/she added that if that were so then the gap, as traditionally measured, and core inflation are not consistent with each other. He/she warned that this explains, in part, the weak response of prices to the phase of the economic cycle. Moreover, he/she added that the distortions in the

estimation of the NAIRU based on the open unemployment rate lead to the equivocal conclusion that the open unemployment rate lies below the estimate of the natural unemployment rate, which would imply inflationary pressures. **Some members mentioned that the pandemic generated significant adjustments in price formation. They highlighted the reassignment of household spending, which enabled a change in relative prices in favor of goods and against services. One member added that the shutdown of the economy led to problems in supply chains and generated additional costs for firms that had to adapt in an environment of greater social distancing. He/she added the historical fall in energy prices that has resulted in the base effect observed in 2021. He/she considered that even though these supply shocks continue to affect domestic inflation, they are expected to be transitory.**

Most members pointed out that inflation expectations for 2021 rose and those for the medium and long terms remained stable at levels above the 3% target. One member noted that this is in line with the transitory nature of the recent increase in inflation. He/she mentioned several surveys in which inflation expectations for the following 12 months and for the end of 2022 remain at around 3%. Another member highlighted that expectations for the end of 2021 are above the 3% target and those for 12 months and the end of 2022 remain stable and below the levels observed in other inflationary episodes. He/she added that during such episodes, short-term expectations had been more susceptible to being affected by inflationary shocks, because, due to their nature, they are highly sensitive to observed data, which does not necessarily imply a de-anchoring of inflation expectations. One member underlined that inflation expectations for 2022 collected by Banco de México have remained above 3.5% for nine consecutive months. Most members stated that inflation expectations drawn from market instruments are at levels close to 3%. However, some members noted that they have increased at the margin. One member mentioned that, for the 1-10 year average, inflation expectations were at 3.1%. Another member stated that breakeven inflation premia decreased marginally for the 10- and 30-year nodes, which suggests that the market also estimates that the current pressures are transitory.

All members pointed out that the revised forecasts for headline and core inflation display short-term levels above those published in the Quarterly Report October-December 2020, but emphasizing that both are still expected to

converge to the 3% target starting in the second quarter of 2022. Most members pointed out that inflationary pressures are expected to be transitory. One member emphasized that the arithmetic effects associated with the fall in energy prices last year, will continue to affect annual inflation rates for some time. He/she added that, although the most recent annual variations have been above the expected, a turning point in the evolution of inflation is foreseen in April. **Another** member stated that a higher non-core inflation is anticipated due to adjustments in the inflation trajectories of livestock and agricultural products as well as energy products. He/she added that a higher core inflation is also expected due to the increase in merchandise and services prices, which should be partially offset by a greater appreciation of the Mexican peso. **One** member noted that core inflation is expected to start decreasing as of the third quarter of the year. **Another** member considered that the expected trajectory of this component remains highly uncertain.

Among the upward risks to inflation, most members highlighted the possibility of external inflationary pressures, cost-related pressures or a reallocation of spending, as well as possible episodes of exchange rate depreciation. One member pointed out that increases in transportation costs and logistics issues in production chains contribute to increase the prices of imported inputs. **Some** members mentioned the significant persistence of core inflation. **One** member pointed out that this has been observed despite the tight monetary policy stance implemented prior to the pandemic and ample slack conditions during the COVID-19 emergency. **Some** members pointed out the rise in commodity prices as an additional risk. **One** member noted that expectations of an appreciation of the Mexican peso appear to be optimistic and may be reversed due to external and internal factors, which would generate pressures that could further divert the foreseen trajectory of inflation. Likewise, he/she pointed out that the foreseen trajectory for core inflation remains highly uncertain, given that the impact on the composition of expenditure may persist to the extent that the pandemic continues and mobility restrictions are maintained.

Most members warned about the impact of droughts on livestock and agricultural production, which would exert upward pressure on non-core inflation. **Some** members foresee inflationary pressures on services prices as health restrictions are lifted. **One** member added that this

would lead to the fading of the favorable effect that services inflation has had in offsetting the high levels of merchandise inflation. **Another** member added the risk of the deterioration of inflation expectations hindering the accelerated decline in inflation and its convergence to the target in the time frame envisaged. He/she considered that upward risks will be present in the short and medium terms. **One** member expressed his/her view that the delay of said convergence could lead to a de-anchoring of inflation expectations, which are already above the upper limit of the variability interval.

Regarding risks on the downside, most mentioned the effects stemming from the negative output gap. **One** member highlighted the risk of greater social distancing measures and the possibility of an exchange rate appreciation. **Another** member noted that the risk of exchange rate depreciation has decreased due to the improvement in financial markets. He/she added that gasoline prices have stabilized in line with the federal government's pricing policy and that, therefore, looking ahead, their contribution to inflation will be more limited.

Most members considered that the balance of risks that might affect the anticipated path for inflation within the forecast horizon is biased to the upside. **One** member stated that this bias is clear given the behavior of inflation and its expectations. He/she added that the risks for non-core inflation are also biased to the upside due to: i) the possibility of supply shocks associated with a lower availability of fuels; ii) negative impact on livestock and agricultural production; and iii) demand-related pressures, driven by the increase in consumption and the reactivation of the US economy. **Another** member mentioned that the balance of risks for headline inflation has deteriorated. **One** member considered that, on balance, beyond the increase that can be anticipated for the end-of-year figure, inflation risks are relatively stable.

Macrofinancial environment

Most members mentioned that domestic financial markets have exhibited a more stable behavior. **One** member considered that this is due to improved expectations for economic growth in Mexico and worldwide. **Another** member stated that the Federal Reserve has been categorical in conveying its monetary policy message, contributing to an orderly adjustment of markets. He/she added that the risks for financial markets observed at the

time of the previous monetary policy decision have been dissipating.

The majority of members noted that the Mexican peso appreciated slightly. One member considered that this reflects a greater appetite for risk worldwide and the greater weakness of the US dollar. He/she highlighted that the Mexican currency performed more favorably than other emerging market currencies. He/she added that in some economies aggressive monetary easing cycles have put their exchange rates under stress, which required substantial interventions to stabilize their value. Despite this, he/she noted that some of these currencies have depreciated significantly this year. He/she stated that, in contrast, the Mexican peso has shown less volatility, a moderate cumulative depreciation, and has not required exchange-rate interventions. He/she considered that this should be attributed to a responsible macroeconomic framework and a prudent approach to monetary policy. However, he/she pointed out that the positive behavior of the Mexican peso could be affected by episodes of volatility stemming from the dynamics of the US long-term bond market or the upcoming electoral process in Mexico.

Most members mentioned that foreign investors' holdings of government bonds continued to decline. Some members noted that foreign investors have shown preference for Asian economies' assets. One member pointed out that, over the past eighteenth months, China has absorbed two-thirds of the fixed-income flows to emerging economies. He/she considered that while this adjustment associated with China's inclusion in global fixed-income indices may be transitory, while weights in investment portfolios are recalibrated, the lack of participation of foreign investors in Mexico's primary auctions for government securities continues to stand out. Another member noted that nominal government bond yields increased, in a context of deteriorated trading conditions and limited interest for this type of assets by foreign and local investors, who have shown caution given the external and domestic conditions. In this regard, he/she highlighted the uncertainty about the monetary policy actions that the Federal Reserve may take and, at the margin, a decrease in the liability management operations by the Ministry of Finance (SHCP). One member mentioned that a steepening of the yield curve has been observed, given expectations of higher inflation in the United States. He/she argued that this has been reflected in lower risk appetite and in capital outflows. He/she noted that so far these outflows have occurred under conditions that have allowed for

an orderly adjustment of rates and the exchange rate. He/she added that the surplus observed in the balance of payments' current account has served to accommodate the outflows, while the banking sector has absorbed the reduction in foreigners' holdings due to the search for investment options to replace the lower credit placement. He/she considered that this situation may change in view of the expected reversal of the current account surplus and the limits of banks' absorption capacity, especially in view of an eventual improvement in credit placement. Another member stated that the equity market continued to show capital inflows and that, in view of the greater stability of financial markets, the sovereign risk premium decreased. He/she pointed out that the yield curve in Mexico exhibited a mixed behavior, with a decrease in the short end and increases in the medium and long ends. One member added that the interest rate on 10-year bonds registered fluctuations, reaching levels below 6.5%. **Regarding the stock market, most members noted that the Mexican IPC index registered gains.** One member stated that this was due to a positive balance in the corporate reporting season.

The majority of members noted that financing to the private sector continues to decline and that credit standards have worsened. Some members stated that credit to firms continues to decrease and expressed concern regarding this situation. One member mentioned that this has been observed for four consecutive quarters. He/she added that, in terms of its annual variation, consumer credit has fallen in practically all of its segments. Some members stated that only housing credit showed positive growth. One member pointed out that in March, credit to Small and Medium-sized Enterprises (SMEs) decreased by 12% at an annualized rate. He/she added that according to Banco de México's Survey on General Conditions and Standards in the Banking Credit Market (EnBan, for its Spanish acronym), it has become more difficult to obtain credit from commercial banks. Another member noted that the intermediation margins of interest rates to firms remain at higher levels than prior to the pandemic. One member mentioned that delinquency rates remain at relatively low levels. He/she stated that, in terms of resource use, public sector financing dominates, while credit to the private sector remains deteriorated, despite the decline in interest rates. Some members pointed out that firms' and households' demand for liquidity persists. One member considered that this is due to precautionary reasons. Another member added that domestic sources continued to expand, while external sources continue showing lack of dynamism.

Monetary policy

All members agreed to maintain the target for the overnight interbank interest rate at 4.00%. This, considering the inflation forecasts, the risks they are subject to, as well as the need to consolidate a downward trajectory for headline and core inflation to the 3% target. They highlighted that the recent shocks that have affected the evolution of inflation pose challenges for the implementation of monetary policy, so that the adjustment in relative prices takes place in an orderly manner, and so that an impact on the price formation process and on inflation expectations is avoided. The majority of members emphasized that in a highly uncertain environment such as the current one, a prudent approach is required. Finally, they reiterated that, looking ahead, monetary policy implementation will depend on the evolution of the factors that have an incidence on inflation, on its foreseen trajectories within the forecast horizon, and on its expectations.

One member highlighted the complex environment for monetary policy. He/she pointed out that the effects of supply, demand and financial shocks associated with the pandemic are still being confronted. In this context, he/she considered that in small open emerging economies, which need to supplement their domestic savings with external sources of financing, it is even more important to maintain a solid macroeconomic environment that attracts capital and fosters an orderly adjustment in the economy. In this regard, he/she mentioned that monetary policy should contribute to such adjustment by maintaining inflation low and around its target, containing increases in risk premia and in medium- and long-term interest rates, as well as the exchange rate adjustment. He/she pointed out that the recent shocks that have affected inflation imply greater challenges for monetary policy implementation, in order to ensure that the adjustment of relative prices is orderly and to avoid affecting the price formation process and inflation expectations. For this reason, it is necessary for Banco de México to maintain a prudent monetary policy stance that favors a downward trajectory for headline and core inflation towards the 3% target.

Another member stated that, despite the significant progress in counteracting the pandemic and its effects on the economy, important risks and challenges prevail. He/she noted that the supply shocks that have occurred are expected to be transitory. Consequently, he/she emphasized that it

is important to reflect on monetary policy's response capacity to this type of events, especially when inflationary pressures do not seem to arise from aggregate demand. In this context, he/she mentioned that the central bank needs to ensure that inflation expectations remain anchored so that these shocks do not lead to second-round effects. In this regard, he/she pointed out that although very short-term inflation expectations have deteriorated, medium- and long-term expectations remain stable, which indicates that, as a whole, they are anchored. Finally, he/she emphasized the importance of paying special attention to the evolution of commodity and services prices, with the aim of guaranteeing the convergence of inflation to its goal.

One member stated that for this monetary policy decision, in addition to the economic and financial information available, there are other factors that gain relevance, such as the high sensitivity of Mexican assets to financial conditions in the United States, the decline of government bond holdings by the foreign sector, which has affected local market conditions, and a more intense competition for investor's resources, who have revealed a growing interest in Asian markets. He/she added that domestic factors could compromise the convergence of inflation towards the target within the horizon in which monetary policy operates. In this regard, he/she referred to the risks for headline and non-core inflation. He/she argued that the observed tightening in financial conditions, despite the reduction in the reference rate and weak fiscal support, reduces the room for maneuver for monetary policy. He/she stated that the monetary policy statement should communicate clearly that with this decision there will be space to update the projections based on available information and take the necessary actions to achieve a downward, sustained and convergent inflation trajectory. This is due to the risk that since the last monetary policy decision, inflation expectations could be contaminated, which could affect the effectiveness of monetary policy and undermine the credibility of the commitment to price stability. He/she noted that the prudent monetary policy approach that has been followed, allows the Mexican economy to be in a better position to face the challenges of the economic recovery.

Another member noted that the current economic cycle is not a traditional one, with unusual effects for decision making. He/she mentioned that several unobservable indicators, such as the output gap, the NAIRU rate, and the neutral real rate are biased and present challenges for their adequate interpretation. He/she stated that the real neutral rate was

estimated to be around 2.6%, but because of the pandemic, it probably decreased, and thus the space for lowering the reference rate would be larger than currently considered. However, he/she added that there is uncertainty regarding this indicator and that it is necessary to wait for sufficient information in order to be able to make reliable estimates and act with certainty. He/she pointed out that there is an inconsistency in the level of the real interest rate, since if it is very high, it should, by inhibiting economic activity, have a beneficial effect on inflation. However, if the negative output gap is less wide than estimated, a higher real rate would be needed to lower core inflation. He/she mentioned that this is somewhat contradictory considering Mexico's current situation. For this reason, it is necessary to be more analytic and careful of the current circumstances and of its implications for monetary policy. Given all of the above, he/she pointed out that a pause is necessary to unravel the distortions in the economic information and to act with greater certainty. He/she argued that given the passivity of fiscal support in the face of the severe economic recession, monetary support is more than necessary. However, he/she considered that due to the adverse outlook for inflation, with a balance of risks biased to the upside, and to the uncertainty in the economic parameters, the reference rate should be maintained at its current levels for as long as necessary. The above in order to guarantee the convergence, recompose expectations and reaffirm the priority mandate of price stability, since otherwise it will be difficult to grant greater stimuli.

One member mentioned that it is important to understand that global and domestic inflationary pressures are mainly of a transitory nature, which implies that monetary policy stances should not necessarily be tightened in light of such pressures, but rather they should focus on avoiding inflation expectations from becoming contaminated or second-round effects on price setting from taking place. He/she added that the global economy is very fragile after more than a year of being affected by the pandemic. He/she considered that the economic recovery is still incipient and cannot be jeopardized, since this could deteriorate the growth and financial indicators' outlook. He/she stated that interrupting the global or domestic economic recovery could result in significant and lasting damage. For this reason, he/she considered it important to maintain, as far as possible, an accommodative monetary policy stance for as long as necessary. He/she mentioned that in the case of Mexico this would allow

for the recovery of consumption and investment, which are the most affected aggregate demand components. He/she pointed out that this would also allow maintaining appropriate conditions for the recovery of credit, especially to SMEs, which are the entities that require it the most in order to survive or expand. In this regard, he/she emphasized that the message that this Central Institute should send is one of caution and at the same time, it should contribute to reassure the markets through a better understanding of the nature of the current economic situation.

3. MONETARY POLICY DECISION

In a highly uncertain environment, the risks for inflation, economic activity and financial markets pose major challenges for monetary policy. Given the recent shocks that have affected inflation, it is necessary for the adjustment in relative prices to take place in an orderly manner so that an impact on price formation and inflation expectations is avoided. With the presence of all its members, the Governing Board decided unanimously to maintain the target for the overnight interbank interest rate at 4.00%. This, considering the abovementioned inflation forecasts, the risks they are subject to, as well as the need to consolidate a downward trajectory for headline and core inflation to the 3% target. Looking ahead, monetary policy implementation will depend on the evolution of the factors that have an incidence on inflation, on its foreseen trajectories within the forecast horizon, and on its 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 maintaining the target for the overnight interbank interest rate at 4.00%.

ANNEX

The information in this Annex was prepared for this meeting by the staff of Banco de México's Directorate General of Economic Research and Directorate General 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

Global economic activity continued to recover at a heterogeneous pace across countries, according to their vaccine availability and stimulus spending programs. Recovery has also been heterogeneous across sectors, with an initial greater rebound of industrial production, world trade and the manufacturing sector, and, subsequently, of services, (Chart 1). Global inflation increased, reflecting recent pressures on commodity prices, especially energy-related, as well as base effects and some cost-related pressures. In most advanced economies, headline and core inflation remain at low levels. In some of these economies, inflation expectations were revised upwards recently. The main central banks reiterated that they will maintain accommodative monetary stances, while some advanced countries, particularly the United States, have announced additional fiscal stimuli proposals. After exhibiting a more stable behavior since the second half of March, by mid-May financial markets once again registered fluctuations, albeit within a narrow range, due to a greater-than-expected increase in US inflation. Looking ahead, among the risks to world economic activity and to the stability of global financial markets, those associated with the pandemic and a sustained and higher-than-expected increase in inflation stand out.

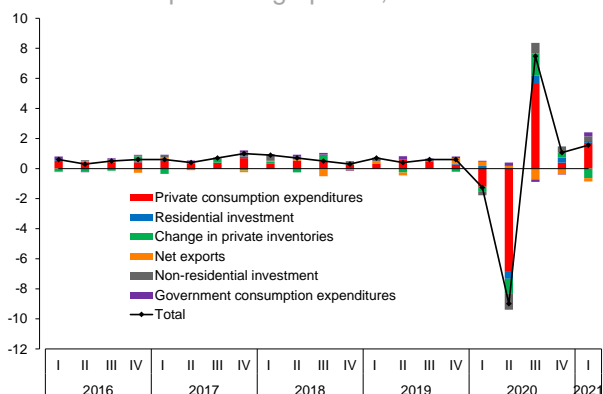
Chart 1
Global: Purchasing Managers' Index (PMI)
Production Component
Diffusion index, s. a.



In the United States, economic activity accelerated its rate of expansion by growing from a seasonally adjusted quarterly rate of 1.1% during the fourth quarter of 2020 to 1.6% during the first quarter of 2021 (Chart 2).¹ This growth reflected the expansion of private consumption, public spending and investment. This occurred in an environment of significant advances in the vaccination process, of easing of certain lockdown measures, and of a large fiscal stimulus. Net exports contributed negatively as a result of a significant expansion of imports. Business expectations also improved after the announcement at the end of March of an additional stimulus proposal for USD 2.65 trillion, known as the American Jobs Plan, that is still under discussion and that considers aspects such as investment in infrastructure, tax credits and spending on research and development, to which the American Families Plan proposed at the end of April would be added.

¹ Expressed in annualized terms, US seasonally adjusted GDP grew at a rate of 4.3% during the fourth quarter of 2020 and of 6.4% during the first quarter of 2021.

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) and Blue Chip (March 2021).

After having contracted in February due to the negative impact of frosts in several regions of the country, US industrial production resumed its expansion in March, growing at a monthly rate of 1.4%. Within it, manufacturing activity and mining expanded at monthly rates of 2.7 and 5.7%, respectively, as a result of the normalization of weather conditions. Timely indicators, such as the Purchasing Managers' Index (PMI) of the manufacturing sector, suggest that the recovery of manufacturing activity may continue during the second quarter of the year. However, looking ahead, the prevailing shortage of semiconductors could continue to negatively affect global manufacturing activity.

The US labor market continued to recover during March and April. The non-farm payroll registered monthly increases of 770,000 and 266,000 jobs in March and April, respectively. Improvement in the items of accommodation and food services, arts, entertainment and recreation, education and public administration stood out. Despite this recovery, employment figures were still 8.2 million below pre-pandemic levels. The unemployment rate declined from 6.2% in February to 6.1% in April. Initial unemployment insurance claims continued to moderate, reaching 498,000 new claims during the week ending on May 1, the lowest level since the beginning of the pandemic.

² In seasonally adjusted terms, euro area GDP registered a quarter-on-quarter annualized variation of -2.7% during the fourth quarter of 2020 and of -2.5% during the first quarter of 2021.

In the euro area, after having contracted 0.7% at a seasonally adjusted quarterly rate during the fourth quarter of 2020, GDP decreased 0.6% during the first quarter of this year.² This reflected the fall registered in most of the region's main economies, as a result of the impact of new cases of infections and the reimposition of social distancing measures in several countries on consumption and investment, as well as the high uncertainty associated with delays in the vaccination process. As for the labor market, the unemployment rate decreased from 8.2% in February to 8.1% in March. Timely indicators, such as consumer and business confidence indicators and Purchasing Managers' Indices, suggest that activity may reactivate during the second quarter of the year in view of expectations of an acceleration in the vaccination process and the use, in some countries, of resources from the European Union's pandemic recovery fund.

In the United Kingdom, after having grown at a seasonally adjusted quarterly rate of 1.3% during the last quarter of 2020, economic activity contracted 1.5% during the first quarter of 2021.³ This deterioration reflected the implementation of measures to contain the resurgence of infections, which mainly affected services, such as education, retail sales, food and accommodation. In this environment, the unemployment rate declined from 5.0% in January to 4.9% in February. Purchasing Managers' Indices for both the manufacturing and services sectors suggest that this economy began to recover by the end of the first quarter, in line with the easing of containment measures, the advances in the vaccination process, and a decline in the number of COVID-19 cases.

In Japan, available indicators suggest that economic activity weakened during the first quarter of this year, after having expanded at a seasonally adjusted quarterly rate of 2.8% during the fourth quarter of 2020.⁴ This reflected a deterioration in services consumption due to the COVID-19 state of emergency announced during the first quarter of 2021, although consumption of durable goods maintained its dynamism. Industrial activity continued to be supported by the recovery of external demand, which has favored the sound performance of exports. As for the labor market, the unemployment rate decreased from 2.9% in February to 2.6% in March. Looking ahead, although

³ In seasonally adjusted terms, UK GDP contracted at a quarter-on-quarter annualized rate of 5.9% during the first quarter of 2021, after having grown 5.2% during the fourth quarter of 2020.

⁴ In seasonally adjusted terms, Japan GDP grew at a quarter-on-quarter annualized rate of 11.7% during the fourth quarter of 2020.

leading indicators point to a recovery, the extension of the state of emergency in some regions of Japan due to the increase in the number of COVID-19 cases may continue to affect economic activity.

In the main emerging economies, available indicators suggest a slowdown and, in some cases, possibly a contraction during the first quarter of the year. This reflects relatively slower advances in the vaccination process and smaller stimulus programs. In Asian emerging countries, timely information indicates that economic activity continued to grow at the beginning of 2021, albeit at a more moderate pace than in the fourth quarter of 2020. In particular, China's quarterly GDP growth moderated, by decreasing from 3.2% during the fourth quarter of 2020 to 0.6% during the first quarter 2021. This mainly reflected the tighter restrictions to mobility across regions and the partial withdrawal of certain economic stimulus measures. In Latin America and Emerging Europe, available indicators suggest a contraction of economic activity in several economies at the beginning of the year, as a result of the significant upsurge of COVID-19 cases, especially in Peru, Brazil, Hungary and the Czech Republic, while the economies of Ecuador, Israel and Russia have continued to recover at a moderate pace.

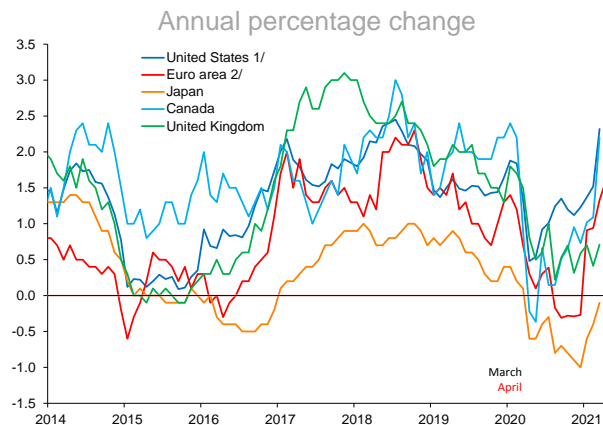
International commodity prices continued to increase since Mexico's previous monetary policy decision, although with episodes of volatility. In particular, oil prices were driven by several factors, such as a renewed optimism in global economic recovery and the gradual reopening of certain economies. This partly offset the downward pressures associated with the announcement by OPEC and other producers in early April of a gradual increase in their production and the latent risks for oil demand due to the resurgence of the COVID-19 pandemic in India. More recently, during the first weeks of May, oil prices were affected by temporary disruptions in the fuel transportation system in the East Coast of the United States. Industrial metal prices rose, especially iron prices, as a result of a greater demand due to the recovery of global industrial activity and the optimism generated by the eventual approval of new fiscal stimulus packages in the United States and disruptions in global supply chains. Lastly, grain prices resumed their upward trend due to an increase in global demand and adverse weather conditions that affected crops, especially in the United States and South America.

A.1.2. Monetary policy and international financial markets

World inflation increased, reflecting recent pressures on commodity prices, mainly energy-related, base effects and some cost-related pressures. In most of the main advanced economies, headline and core inflation remain at low levels, although recently in the United States and Canada headline inflation was above their central banks' targets (Chart 3). Inflation expectations implied by financial instruments somewhat stabilized in April, after having registered an upward adjustment during the first quarter of the year. However, by mid-May, inflation expectations for the United States rose once more due to a higher-than-expected increase of inflation in that country in April.

In the main emerging economies, most countries registered inflationary pressures due to higher commodity prices, arithmetic effects, supply shocks, and the effects of the depreciation of their currencies. However, in some economies, such as Peru and India, headline inflation decreased, mainly due to a slowdown in their food price inflation.

Chart 3
Selected Advanced Economies: Headline Inflation



1/ Refers to the personal consumption expenditures deflator.

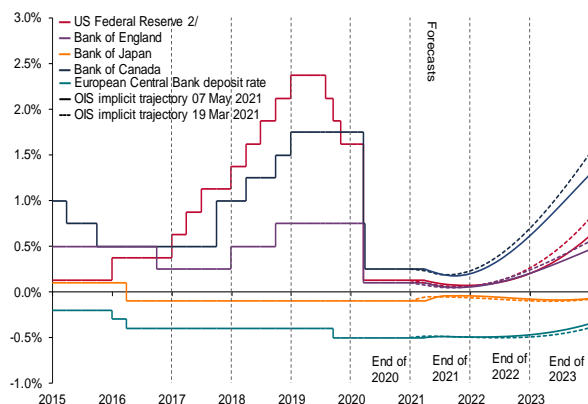
2/ April figure is a preliminary estimate.

Source: Bureau of Labor Statistics, Eurostat, Bank of Japan, Statistics Canada, Office of National Statistics.

The central banks of the major advanced economies maintained their reference rates unchanged at levels around zero. They also continued to use their balance sheets, adjusting the pace of asset purchases in some cases, to preserve favorable financing conditions and, thus, support the provision of credit, boost economic activity, and seek the convergence of inflation to their respective long-term targets. Central banks also reiterated that they will

maintain accommodative monetary policy stances until inflation reaches their respective 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, although for a longer-term horizon they incorporate expectations of a moderate increase in interest rates by some central banks (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 rate (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 April meeting, the Federal Reserve (Fed) left its target range for the federal funds rate unchanged at 0-0.25% and reiterated that it would be appropriate to maintain it 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 until substantial progress has been made towards its maximum employment and price stability goals. In this regard, the Chairman of the Fed's Board of Governors pointed out that the economy is still very far from meeting these goals and that achieving substantial improvements will probably take some time. In this context, both the consensus of private forecasters and the implied trajectory of federal funds rate futures suggest that said central bank will maintain its reference

rate unchanged during 2021 and 2022, although financial instruments incorporate expectations of a moderate increase for longer horizons.

ii) In its April meeting, the European Central Bank 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 until this convergence is consistently reflected in core inflation dynamics. It also left its asset purchase programs unchanged and noted that, in line with the adjustment made in the previous meeting, purchases under the Pandemic Emergency Purchase Program (PEPP) are expected to continue at a significantly higher pace than in the first months of the year.

iii) In its April meeting, the Bank of Japan left its short-term policy rate unchanged at -0.1% and its long-term interest rate (indexed to its 10-year bond) at around 0%, reiterating that it will continue with its asset purchase program. It also mentioned that it will continue to support the financing of firms and the stability in financial markets through the special program to support financing in response to COVID-19, an ample provision of liquidity, both in domestic and foreign currency, and purchases of Exchange-traded Funds (ETFs) and Japan Real Estate Investment Trusts (J-REITs). This central bank ratified that it will not hesitate to adopt additional easing measures if necessary and that it expects interest rates to remain at or below their current levels.

iv) In its May meeting, the Bank of England kept its reference rate unchanged at 0.10%, the stock of sterling non-financial investment-grade corporate bond purchases at £20 billion, and the target for its asset purchase at £875 billion. In the minutes of said meeting it was pointed out that, as expected since the announcement of its current program of government bond purchases in November 2020, the pace of these purchases will slow down from £4.4 billion to £3.4 billion per week. In this regard, it specified that this operational decision should not be interpreted as an adjustment to the monetary policy stance. The Bank of England reiterated that it does not intend to tighten its monetary policy stance, at least until there is clear evidence that significant progress is made in eliminating excess slack in productive

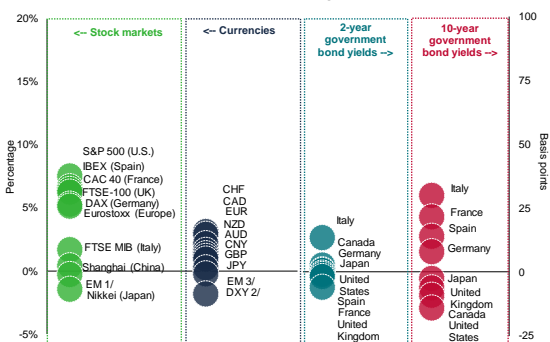
capacity and in reaching its 2% inflation target in a sustained manner.

Since Banco de México's previous monetary policy decision, the central banks of the main emerging economies left their reference rates unchanged, except for Russia and Brazil, which raised it. They also maintained their measures to provide liquidity and foster the well-functioning of financial markets.

In the global environment described above and following Mexico's previous monetary policy decision, international financial markets exhibited a more stable behavior (Chart 5 and Chart 6). Moderate gains were registered in most of the main stock indices, while in foreign exchange markets the US dollar weakened slightly against most currencies of both advanced and emerging economies, although some currencies, such as those of Argentina, Colombia and Turkey, depreciated. Long-term government bond interest rates fluctuated within a narrow range during the period. Most emerging economies registered net capital inflows, albeit at a more moderate rate than at the beginning of this year.

Considering the features of the health and economic crises, along with the adjustments in the monetary policy framework of some of the main central banks in advanced economies, there is still a high level of uncertainty regarding the evolution of international financial markets during the recovery phase. In this regard, there are several risks to international financial market stability. These include the possibility that the recovery of some advanced economies with large fiscal stimuli or greater disruptions of supply chains give way to a more sustained and higher-than-anticipated increase in inflation in some advanced economies, leading to abrupt increases in interest rates and to an early withdrawal of monetary stimuli that may tighten global financial conditions. There are also concerns regarding possible distortions in some financial assets' valuations, which could lead to a sudden adjustment in their prices. The above factors may intensify problems of business insolvency and bankruptcies in the sectors most affected by the pandemic as well as the vulnerabilities associated with the high levels of public and private debt accumulated in recent years. Emerging economies will also face considerable challenges due to the greater absorption of financial resources by the public sectors of countries with large fiscal stimulus programs and the greater participation of China in emerging economies fixed-income assets as a result of its inclusion in the main global investment indices.

Chart 5
Change in Selected Financial Indicators from March 19, 2021 to May 7, 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
Selected Emerging Economies: Financial Assets Performance from March 19 to May 10, 2021
Percent, basis points

Region	Country	Currencies	Equity markets	2-year interest rates	10-year interest rates	CDS
Latin America	Mexico	3.08%	4.72%	23	3	-5
	Brazil	4.92%	5.00%	38	59	-20
	Chile	3.44%	-4.86%	44	23	0
	Colombia	-5.97%	-3.22%	15	-2	15
Emerging Europe	Russia	0.22%	6.76%	21	2	-8
	Poland	3.43%	9.66%	6	20	-3
	Turkey	-14.22%	-4.51%	158	368	82
	Czech Republic	4.05%	3.22%	-2	-20	-1
	Hungary	4.91%	0.85%	-20	1	-1
Asia	China	1.46%	0.69%	-20	-10	7
	Malaysia	0.12%	-2.60%	4	-36	6
	India	-1.15%	-0.71%	-45	-18	15
	Philippines	1.56%	-1.84%	-58	-27	7
	Thailand	-0.77%	1.55%	-2	-23	0
	Indonesia	1.46%	-5.98%	-45	-40	-1
Africa	South Africa	4.61%	4.71%	-74	-32	-8

Note: Interest rates correspond to swap rates at the specified terms, except for Hungary, where government securities with 3-year (instead of 2-year) maturities were used as a reference. For Colombia and the Philippines, a 2-year swap rate is used.

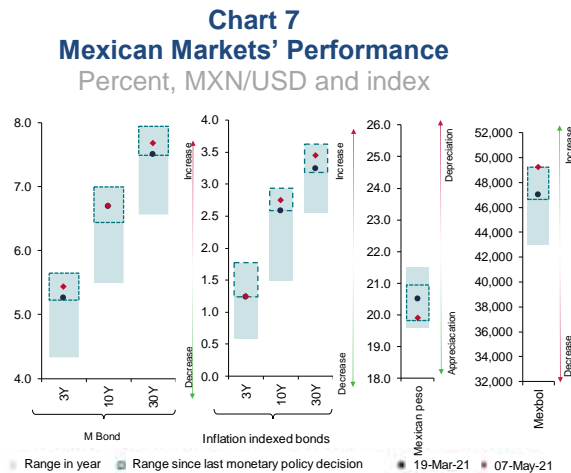
Source: Bloomberg.

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 exhibited a mixed behavior (Chart 7). This occurred in an environment characterized by a stabilization of interest rates in the United States and other advanced economies, as well as a slight weakening of the US dollar.

The Mexican peso fluctuated between 19.82 and 20.95 pesos per dollar, ending the period with an appreciation of 2.0% (Chart 8). This occurred in a context in which both spot- and forward-trading conditions improved.



Source: Prepared by Banco de México.

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

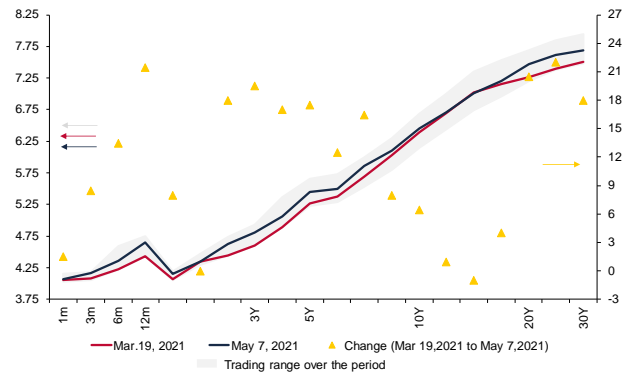


Source: Prepared by Banco de México.

Interest rates of government securities exhibited negative adjustments (Chart 9), with increases of up

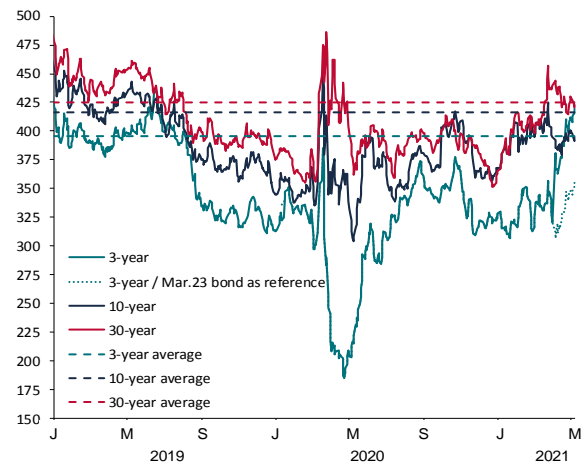
to 27 basis points along the yield curve. The yield curve of real rate instruments also followed a negative dynamic, registering increases of up to 30 basis points in the long-term part. In this context, breakeven inflation and inflation risk premia implicit in spreads between nominal and real interest rates of market instruments ended the period with declines since the previous monetary policy decision (Chart 10). These adjustments occurred in an environment where trading conditions continued to deteriorate during the reference period.

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

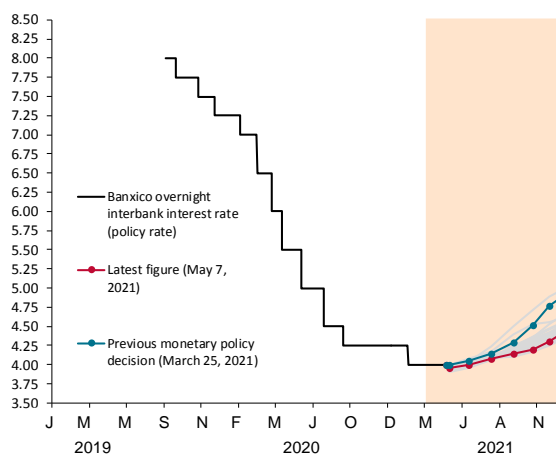


Source: PIP.

As for expectations regarding the trajectory of the monetary policy rate, information implied by the Interbank Equilibrium Interest Rate (TIIE, for its Spanish acronym) swaps assigns an 80% probability to the reference rate remaining unchanged for the

monetary decision of May (Chart 11). In a related manner, the median of the consensus of forecasters surveyed by Citibanamex anticipates the reference interest rate to be at 4.00% in the next monetary policy decision. For the end of 2021, market variables anticipate a level of 4.27% for the target rate, while the median of the aforementioned survey among forecasters lies at 4.00%.

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



Source: Prepared by Banco de México with Bloomberg data.

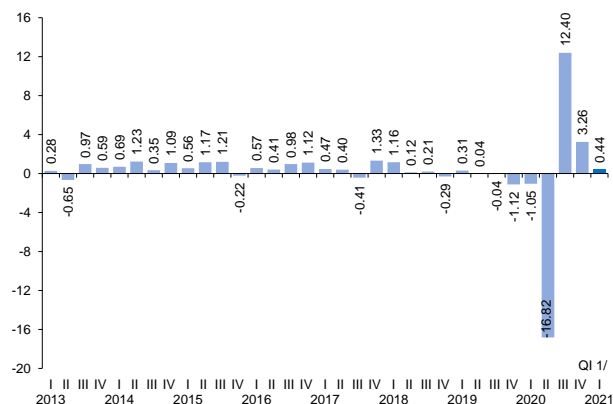
A.2.2. Economic activity in Mexico

According to Mexico's GDP flash estimate published by INEGI, during the first quarter of 2021 overall economic activity continued to recover, albeit at a slower pace (Chart 12). This was the result of various events that occurred during the first two months of the year due to the intensification of the pandemic since the end of last year and new restrictions implemented in certain states to contain it, in addition to some temporary disruptions in supply chains. Available information suggests that, although input shortages persisted in some industries in March, the reduction in the number of infections together with advances in the vaccination process has allowed for a gradual loosening of pandemic restrictions and for a more noticeable reactivation of economic activity as of that month.

As for external demand, during the first quarter of 2021 manufacturing exports decreased with respect to the previous quarter as a result of a reduction in automotive shipments and a certain slowdown in the

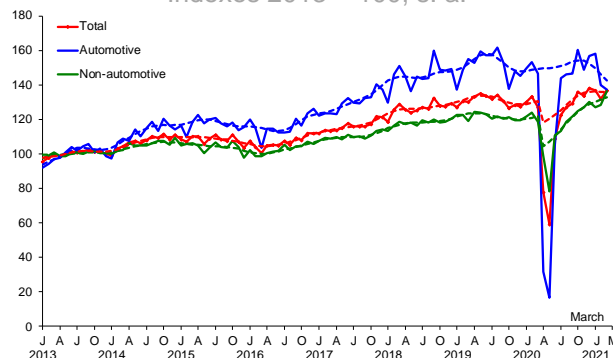
rest of exports during the quarter, although the latter rebounded in March (Chart 13).⁵ By destination, exports to the United States contracted slightly during the first quarter, while those to the rest of the world exhibited a lack of dynamism.

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



s. a. / Seasonally adjusted figures.
1/ Figure of Q1 2021 refers to the timely estimate of quarterly GDP 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), Information of national interest.

According to its monthly indicator, the pace of recovery of private consumption slowed during the January-February period, remaining below February 2020 levels. As for its components, consumption of

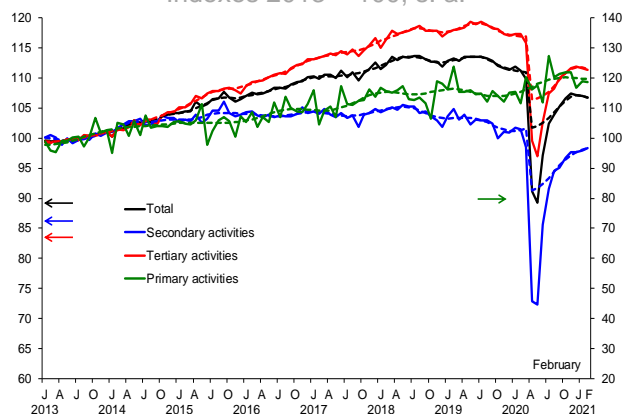
⁵ Refers to the value of merchandise exports in current US dollars. This value differs from that reported for goods exports by Mexico's System of

National Accounts (SCNM, for its acronym in Spanish), given that the latter represents the added value measured in constant pesos.

both national and imported goods performed more favorably, while that of services exhibited a lack of dynamism, remaining at low levels. Timely indicators suggest that private consumption continued to recover by the end of the first quarter and the beginning of the second quarter of the year. In particular, between February and April sales levels by the National Association of Self-Service and Department Stores (ANTAD, for its Spanish acronym) reversed the losses experienced in December and January, while in February and March light vehicle sales continued to recover, although in April they decreased. During the first two months of 2021, gross fixed investment reversed the decline observed at the end of the previous year, although it still remains below pre-pandemic levels. Within this indicator, both investment in construction and spending on machinery and equipment continued to gradually recover.

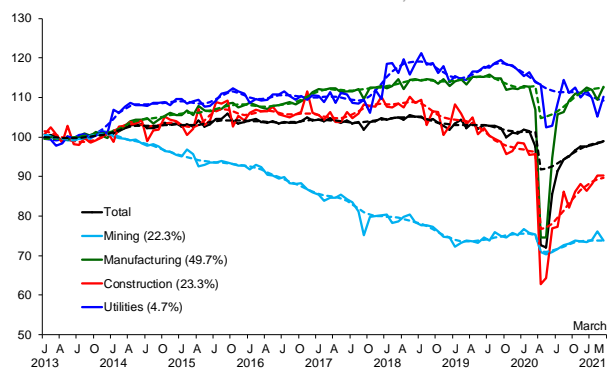
As for production, in January and February, tertiary activities decreased, while the weakness of the sector and the heterogeneity across its subsectors persisted (Chart 14). Transportation services and mass media information, financial and real estate services, commerce and temporary accommodation and food and beverage preparation services contributed negatively to the growth of this sector. In contrast, professional, corporate and business support services, government activities, and educational and health services made positive contributions. Nevertheless, according to information derived from the GDP flash estimate, services overall seem to have resumed a greater pace of recovery in March. Meanwhile, industrial activity showed an increase during the first quarter of the year, thus continuing its recovery. In March, manufacturing activity reversed the contractions observed during the first two months of 2021 due to the effects of various input shortages, particularly in the automotive sector. At the same time, construction halted its recovery at the margin, while mining reversed the rebound recorded in February and still remained weak (Chart 15).

Chart 14
Global Indicator of Economic Activity
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 ^{1/}
Indexes 2013 = 100, s. a.



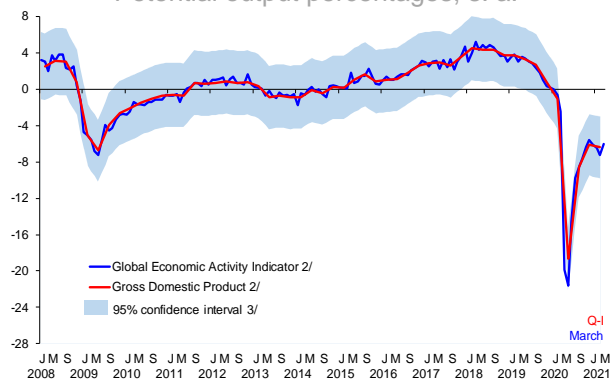
s. a. / Seasonally adjusted and trend series. The former is represented by a solid line and the latter by a dotted line.
^{1/} Figures in parenthesis correspond to their share in the total in 2013.
Source: Mexico's System of National Accounts (SCNM, for its Spanish acronym), INEGI.

As to the economy's cyclical position, slack conditions remained considerably wide in January and February, even exhibiting a slight loosening when compared to the end of last year (Chart 16). Available information suggests that by the end of the first quarter, this indicator resumed a trend of gradual reduction. Various labor market indicators continued to improve moderately in March. In particular, although both national and urban unemployment rates remained at relatively high levels (Chart 17), labor participation and the employed population continued to expand gradually, in a context in which the underemployment rate decreased as compared to the previous month. Similarly, in March and April the creation of IMSS-insured jobs continued to show a moderate recovery, although in April it was still

close to 540 thousand jobs below its pre-pandemic levels. Finally, in February, unit labor cost in the manufacturing sector increased, largely reflecting the decline in labor productivity associated with the contraction of the transportation equipment subsector due to the shortage of various inputs (Chart 18).

Chart 16
Output Gap Estimates ^{1/}
Excluding Oil Industry ^{4/}

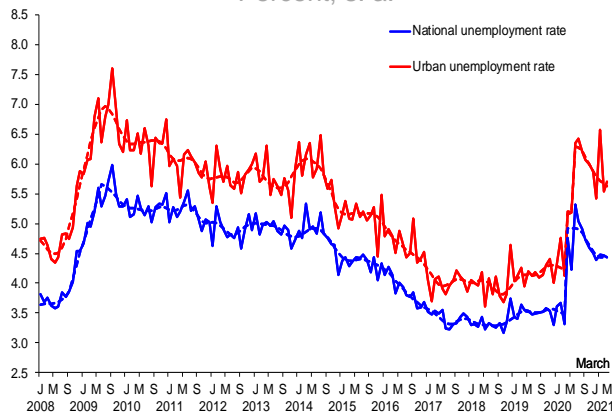
Potential output percentages, s. a.



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", p.74.
2/ GDP timely figures as of Q1 2021, and IGAE figures as of March 2021, in line with said timely figure.
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 and Urban Unemployment Rates

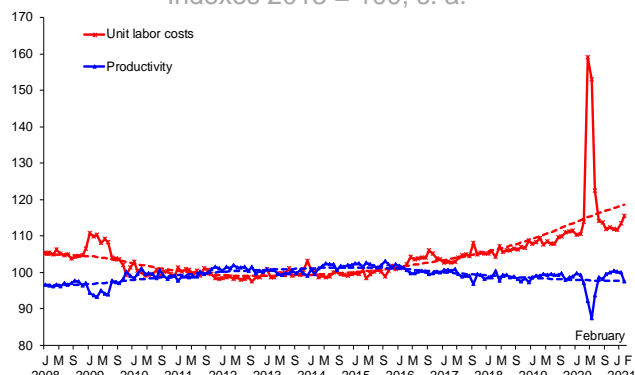
Percent, s. a.



s. a. / Seasonally adjusted series and trend series. The former is former is represented by a solid line and the latter by a dotted line.
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 Costs 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 the Montly Manufacturing Industry Survey and industrial activity indicators of Mexico's System of National Accounts (*Sistema de Cuentas Nacionales de México*, SCNM), INEGI.

In March 2021, domestic financing to firms registered a contraction at an annual rate for the fourth consecutive quarter. This has been partly the result of a reduction in bank lending to both smaller firms –a segment that has decreased in annual terms since the first quarter of 2019– and large firms –a segment that continues to show a lower demand for bank loans compared to the levels observed at the beginning of the pandemic–. Lending conditions for firms in general remain tight as compared to the beginning of the pandemic. On the other hand, net corporate debt issuance by issuing firms has been moderately negative since January of this year. As for credit to households, in line with its high level of demand, the housing portfolio continued to exhibit positive annual variations, although its growth moderated during the first quarter of 2021. At the same time, the performing portfolio of bank credit for consumption continued to contract in all segments, in a context where lending conditions for households remained tight.

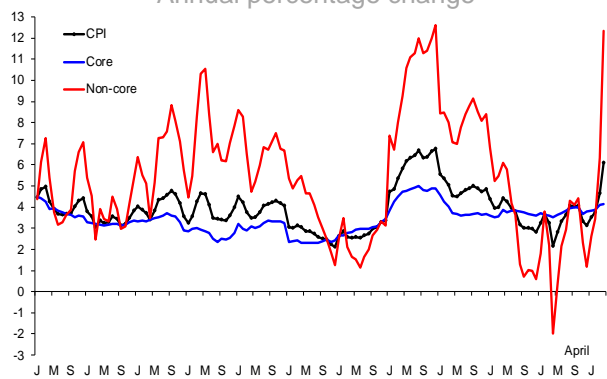
Interest rates of bank credit to firms have generally followed the dynamics of the bank funding rate. Intermediation margins remained above pre-pandemic levels, although exhibiting reductions in the last two quarters. In turn, during the first quarter of 2021, housing credit interest rates halted the downward trajectory observed in 2020, although they remained at levels around their historical lows. Meanwhile, credit card interest rates maintained the downward trend shown since October of last year. Intermediation margins, however, have increased

given the larger reductions to the reference rate. Regarding portfolio quality, in March corporate loan delinquency rates remained relatively stable and at low levels, while those of mortgage loans continued to increase, although also remaining at low levels. Lastly, consumer loan delinquency rates continued at high levels and did not register significant changes for the second consecutive month, after having increased in previous months.

A.2.3. Development of inflation and inflation outlook

Annual headline inflation increased from 4.67 to 6.08% between March and April 2021 (Chart 19 and Table 1). This result is mainly explained by the performance of the non-core component, which contributed with 136 basis points to this increase, while the core component did so with 5 basis points. The increase in non-core inflation reflected the higher incidence of gasoline inflation, due, in turn, to the arithmetic effect derived from the significant price reductions registered in April 2020 in the context of the onset of the pandemic.

Chart 19
Consumer Price Index
Annual percentage change



Source: Banco de México and INEGI.

Annual core inflation was 4.12 and 4.13% in March and April 2021, respectively. Within it, annual merchandise inflation decreased from 5.79 to 5.59% (Chart 20), as a result of the reduction from 6.48 to 5.88% of food merchandise, which contrasted with the increase from 5.04 to 5.28% of non-food merchandise. The latter due to cost-related pressures, such as increases in commodity prices or in inputs in general, the effects on production chains, and the evolution of the exchange rate (Chart 21). During the referred months, annual services inflation rose from 2.30 to 2.53%, a behavior associated with the higher inflation of services other than education and housing, which increased from 3.02 to 3.55%.

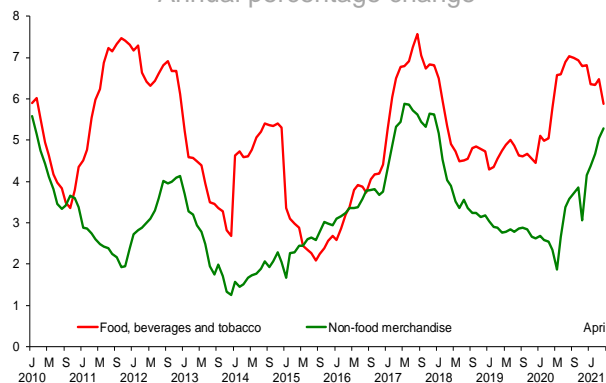
Within this category, the higher annual price variations in services related to food, tourism and entertainment stood out, possibly in the context of the reopening of these activities.

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

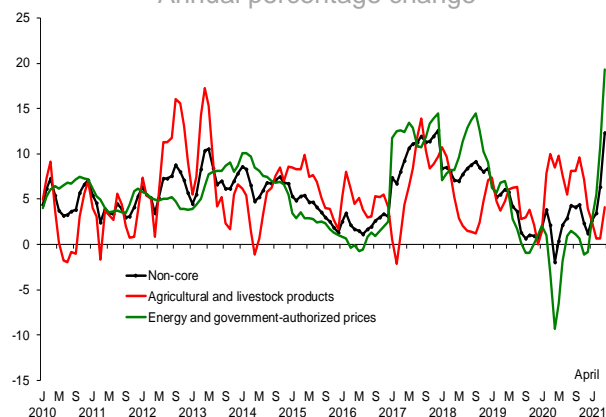


Source: Banco de México and INEGI.

Between March and April 2021, annual non-core inflation rose from 6.31 to 12.34% (Chart 22 and Table 1). This result was mostly associated with the increase from 14.55 to 28.02% in annual energy inflation. This increase mainly reflected the higher annual variation in gasoline prices, which escalated from 11.13 to 34.94% in the aforementioned period. This rise is mainly explained by an arithmetic effect of a low base of comparison, since in April 2021 the significant reductions in gasoline prices that took place in April of the previous year in the context of the beginning of the COVID-19 health crisis did not happen again. Annual inflation of livestock and agricultural products, on the other hand, also increased between March and April 2021, from 0.64 to 4.08%, as a result of higher annual variations in

the prices of fruits and vegetables, which registered rates of -8.82 and -0.83%, while those of livestock products fell from 9.10 to 8.20%.

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



Source: Banco de México and INEGI.

As for inflation expectations drawn from Banco de México's Survey of Private Sector Forecasters, between February and April, the median for headline inflation for the end of 2021 increased from 3.90 to

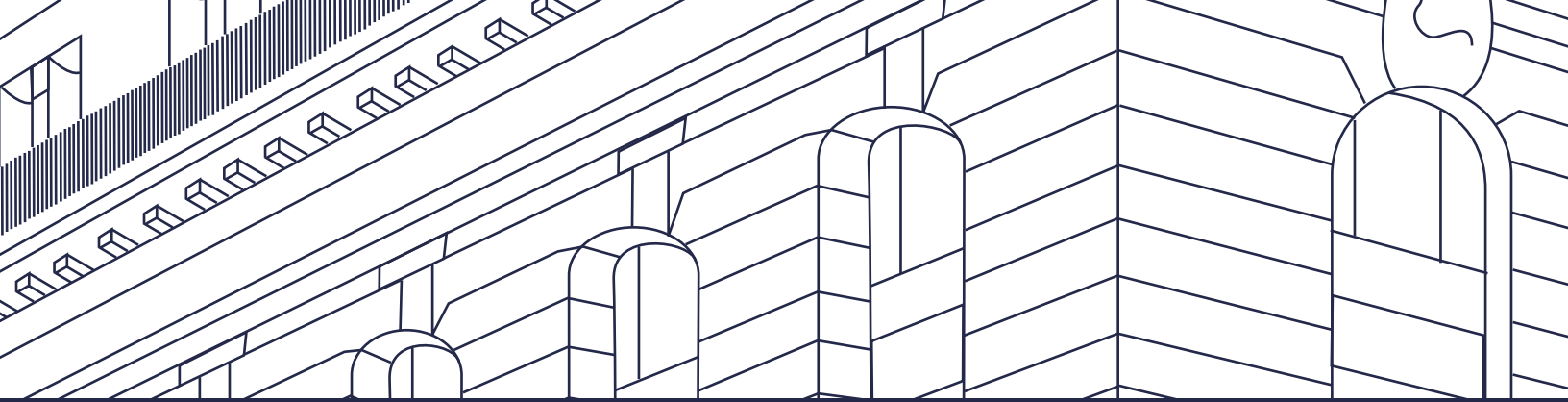
4.56%, while that for core inflation rose from 3.58 to 3.74%. In turn, those for the end of 2022 were revised from 3.51 to 3.60% for headline inflation and from 3.50 to 3.51% for core inflation. On the other hand, the medians for headline and core inflation expectations for the medium and long terms remained around 3.50%. Finally, breakeven inflation and inflation risk decreased since the last monetary policy decision.

The revised forecasts for headline and core inflation display short-term levels above those published in the last Quarterly Report. Nevertheless, both are still expected to converge to the 3% target starting in the second quarter of 2022. These forecasts are subject to risks. On the upside: i) external inflationary pressures; ii) cost-related pressures or a reallocation of spending; iii) persistence of core inflation; and iv) exchange rate depreciation. On the downside: i) effects stemming from the negative output gap; ii) greater social distancing measures; and iii) foreign exchange appreciation. The balance of risks that might affect the expected trajectory for inflation within the forecast horizon is biased to the upside.

Table 1
Consumer Price Index and Components
Annual percentage change

Item	February 2021	March 2021	April 2021
CPI	3.76	4.67	6.08
Core	3.87	4.12	4.13
Merchandise	5.54	5.79	5.59
Food, beverages and tobacco	6.34	6.48	5.88
Non-food merchandise	4.66	5.04	5.28
Services	2.06	2.30	2.53
Housing	1.85	1.79	1.73
Education (tuitions)	1.16	1.12	1.12
Other services	2.44	3.02	3.55
Non-core	3.43	6.31	12.34
Agricultural and livestock products	0.66	0.64	4.08
Fruits and vegetables	-8.57	-8.82	-0.83
Livestock products	9.01	9.10	8.20
Energy and government-authorized prices	5.50	10.73	19.30
Energy products	6.83	14.55	28.02
Government-authorized prices	2.38	2.16	2.21

Source: INEGI.



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