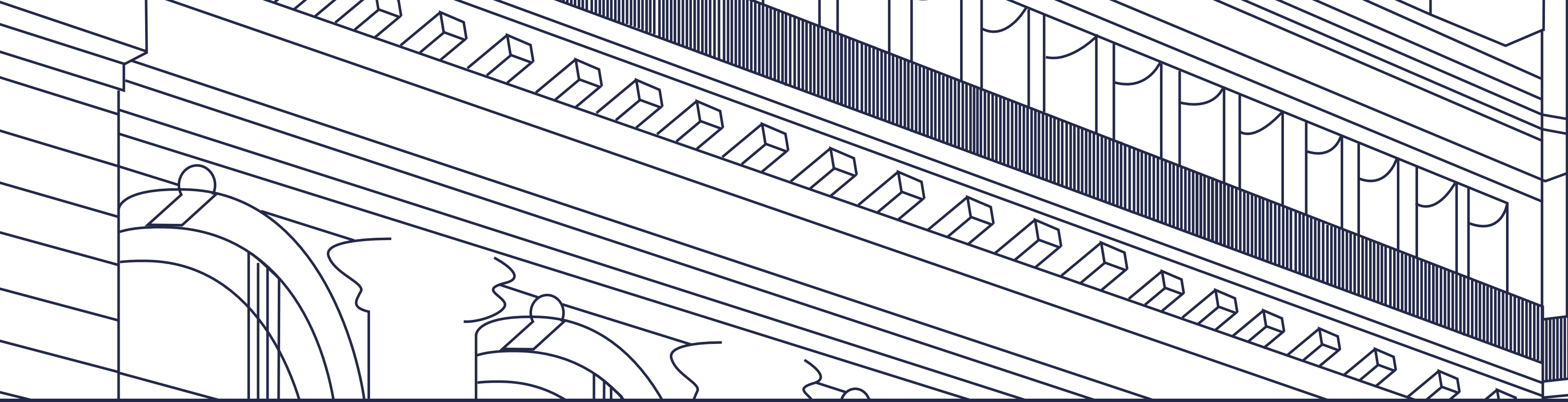

BANCO DE MÉXICO®

Minutes number 85

Meeting of Banco de México's Governing Board on the occasion of the monetary policy decision announced on June 24, 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: June 23, 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 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

The majority pointed out that global economic activity continues to strengthen, mainly because of vaccine availability and stimulus spending. They added that the economic recovery has been heterogeneous across countries, highlighting that China and the United States continue leading the global recovery. One member highlighted the improvement in Europe due to the process of reopening in several countries, while in Japan weak conditions prevail due to new confinement measures. He/she noted that emerging economies show a greater heterogeneity because of the upsurge of infections in some regions and a reduced room to provide additional stimuli. He/she added that ample slack conditions prevail in most economies. In this regard, **some** members stated that the recovery is still incomplete. **One** member considered that a complete recovery is still far from being attained and highlighted that several productive sectors, and especially employment, still remain below pre-pandemic levels. **Another** member pointed out that unemployment in middle- and low-income countries continues to be much higher than it was before the pandemic, with significant differences across sectors and by gender, with older women being the most affected. He/she mentioned that emerging economies continue facing obstacles to achieve a significant and sustained recovery.

The majority noted the upward adjustment in global growth forecasts, which is expected to continue to be supported mainly by the recovery in the United States and China. One member mentioned that the world economy is expected to grow faster in 2021 than in the last 48 years. **Another** member pointed out that the current recovery is foreseen to be the fastest since World War II. As for risks, **some** members mentioned those associated with the pandemic. **One** member added the risk of continued disruptions in production chains, which is anticipated until there is a complete normalization of activities around the world.

The majority mentioned that global inflation continued increasing as a result of pressures on various commodity prices, base effects, and cost-related pressures associated with bottlenecks in production. Some members added labor market pressures and higher transportation costs. **The majority pointed out that in some economies inflation is above the targets of their respective central banks. They noted that in the United States, the annual Consumer Price Index (CPI) inflation reached 5% in May, the highest figure since September 2008.**

Some members mentioned that inflation expectations are at high levels worldwide. **One** member highlighted that while market expectations in advanced economies have recently declined, they remain at higher levels than those recorded in 2019. **Another** member stated that in the United States, 2-year inflation expectations have been above 3% over the last weeks. **Some** members pointed out that inflation pressures are expected to be transitory. **One** member said that this perception is shared among international organizations, central banks and analysts, and that it is reflected in the implied trajectory according to various market instruments. He/she argued that this derives from the fact that the base effects are expected to fade, that the observed increases in international commodity prices are expected to stabilize and even revert, and that the pressures that are currently present in certain markets are expected to ease, in view of an eventual response from supply.

The majority highlighted the risk of supply chain disruptions being longer-lasting than anticipated and inflationary pressures being more persistent than anticipated. One member stated that, although these disruptions are considered to be transitory, a permanent destruction of the production capacity of certain links in global chains cannot be ruled out. He/she noted that, in such scenario, the shortage of inputs would have more serious and lasting consequences, exerting significant pressures on inflation. He/she added that, if the Federal Reserve normalizes its monetary policy more rapidly, this would exacerbate volatility in financial markets and accentuate inflationary pressures, especially in emerging economies. **Some** members added the presence of inflationary pressures stemming from the recovery of demand in the face of large fiscal stimuli, especially in the United States. **One** member considered that the balance of risks for global inflation has started to deteriorate. **Another** member emphasized that the effects associated with the pandemic are unprecedented and that their impact on economic activity and inflation is very uncertain. He/she added that the rate of infections and vaccine availability have been significant determinants of consumer confidence and labor markets. He/she pointed out that the disruptions caused by the pandemic are very different from those observed in other crises, and therefore it has been more complex to identify their short- and medium-term effects. In this regard, he/she mentioned that economic activity and inflation forecasts have not fully captured the challenges of the current situation. **One** member stated that the risk of a higher-than-expected inflation seems to have started to mitigate given the recent adjustments in commodity prices, food prices in particular. He/she mentioned that other sources of concern regarding the risk of higher inflation, such as disruptions in supply chains, higher freight costs, and labor market pressures are associated with unusual operating conditions caused by the pandemic. He/she sustained that it can be foreseen that as the normalization of activities continues, the operating conditions will also improve and wage pressures will begin to fade as a result of increases in labor supply.

The majority highlighted that the central banks of advanced economies left their monetary stimulus unchanged. One considered that less monetary stimuli are expected in the medium term. **The majority pointed out that in the Federal Reserve's latest monetary policy decision the forecasts for inflation and economic growth increased, as well as the expectations for the federal funds rate. One** member noted that the president of that central bank emphasized that some of the communication tools used, such as the so-called dot-plot, did not represent a decision or a plan of the Federal Open Market Committee (FOMC). **Most members added that such institution has begun to analyze an eventual reduction in its asset purchases.** In this regard, **some** members mentioned that any change will be announced in a timely manner in order to avoid sharp adjustments in financial markets. **Some** members emphasized that the Federal Reserve will maintain its current policy stance until the economy has made substantial further progress towards meeting its objectives. **One** member mentioned that it is important to remember that the Federal Reserve policy stance remains highly accommodative. He/she recalled that, although the members of its committee acknowledged an increase in inflation, they attributed said increase to transitory factors and reiterated that risks to economic recovery persist. He/she sustained that, even after incorporating the recent changes in the members' projections, the interest rate would remain at very low levels, at least, until the end of 2023. Regarding the new Federal Reserve monetary policy framework, he/she considered that it has allowed it to achieve historically low levels of real interest rates. He/she stated that this implies that it has successfully dealt with the problems associated with the lower limit of the reference rate, without affecting long-term inflation expectations and achieving a greater stimulus. As to the possibility of an anticipated tightening of monetary conditions, he/she considered it improbable that the Federal Reserve would act hastily, as it would affect the economic recovery. He/she mentioned that said entity has been very consistent in its narrative and highly coherent in its actions, and therefore it is unlikely that the withdrawal of monetary stimulus will occur before there are clear signs of a large and inclusive economic recovery. He/she mentioned that the above is compatible with analysts' expectations.

Some members mentioned that given the increases in inflation and its expectations, central banks in some emerging economies have adopted less accommodative policy stances. **One** member said that given the inflationary pressures, some monetary authorities are expected to continue withdrawing the stimulus. **Another** member stated that in most emerging economies monetary policy stances are foreseen to remain highly accommodative. He/she argued that although there are some cases where higher policy rates are expected towards the end of

2021, these are economies where the reference rate is close to zero or in which adjustments are explained by idiosyncratic factors. He/she added that in most of these economies real interest rates remain in negative terrain, even in those that are currently undergoing significant deviations of inflation from their target. He/she highlighted that this is partly due to the fact that inflationary pressures are considered to be transitory and that the increase in international commodity prices is a dominant factor on inflation in these economies, and therefore monetary policy cannot do much to counteract such pressures.

All members noted that after the Federal Reserve's monetary policy announcement, international financial markets exhibited some volatility. However, the majority considered that, in general, these markets have performed favorably. They highlighted the increases in equity markets, with some of them reaching all-time highs, as well as some stability in the foreign exchange and government securities' markets. Some members highlighted the flattening of the US yield curve. **One** member mentioned that such flattening incorporates the expectation of higher-than previously anticipated increases in short-term interest rates, which contributes to lower inflation expectations and inflation risk premia for longer-term rates. **Some** members highlighted that the latter exhibited some volatility. **One** member considered that, looking ahead, global financial conditions will continue to be favored by the Federal Reserve's accommodative policy stance.

As for emerging economies, **some** members said that the global environment implies a higher external demand for these economies, as well as higher inflationary risks. **One** member added that said environment also implies financial conditions that could be tighter and more volatile for these economies. He/she pointed out that as interest rates rise along the US yield curve, these economies will face greater difficulties in attracting and retaining capital, as well as exchange rate adjustments and pressures on short- and long-term interest rates. He/she stressed the challenges that each economy faces because of the evolution of the pandemic and the social effects that this has implied, as well as their macroeconomic characteristics. **Another** member highlighted that capital flows to fixed income assets in emerging economies registered moderate inflows, mainly to China, while those to equity assets registered moderate mixed flows.

Most members considered the possibility of higher-than-expected inflation being the main risk for global financial markets. One member pointed out that this would lead to an earlier-than-expected tightening of monetary policy, which could compromise economic recovery. **Another** member added that central baseline scenarios for the global economy show a greater recovery, although differentiated among countries, with uncertain effects on inflation and financial markets that are prone to generate episodes of volatility. He/she stated that high uncertainty prevails in financial markets, which is associated with the levels of inflation in the United States, its outlook, and its implications for the yield curve. He/she also stated that, according to surveys among investors, an additional risk for financial markets is a possible monetary policy mistake in that country.

Economic activity in Mexico

The majority of members highlighted that the Mexican economy recovered notably in March and moderated in April. One member noted that advances in the vaccination process have supported the reactivation of the economy. **Another** member emphasized that, although economic activity continues to improve, its recovery is still fragile and partial and the economy is far from its potential. **As for demand, most members agreed that the external sector continues to support the recovery.** In this regard, **one** member highlighted the reactivation of external demand, especially that from the United States. **Another** member pointed out that manufacturing exports, particularly automotive exports, continued to perform well. **One** member mentioned that external accounts show an increase in imports and a reduction in the trade balance surplus.

Most members stated that, although investment and consumption have improved, they still remain below their pre-pandemic levels. One member expressed his/her concern about the weakness and the particularly low levels of investment, while **another** member emphasized that this will affect economic recovery. **One** member mentioned that private consumption had an annual variation of -0.7% in March. **Another** member highlighted that it is 6% below the highest level reached in 2019. **One** member highlighted the weakness exhibited by consumption of domestic services and semi-durable goods. **Some** members noted that several indicators, such as consumer confidence, the real wage bill and remittances, have improved and have supported consumption. **One** member considered that these indicators suggest that the recovery of consumption will continue in the following months.

Regarding supply, the majority of members highlighted the heterogeneous behavior of different sectors. They noted that industrial production, particularly manufacturing, has been negatively affected by the shortage of semiconductors, especially in the automotive sector. One member mentioned that, as a result, the latter has continued to operate below its installed capacity. **Another** member noted that industrial activity was also affected by the loss of dynamism in construction. **Most members noted that tertiary activities continued to recover, albeit with high heterogeneity across subsectors. One** member added that trade-related activities have continued to improve, although he/she explained that their recovery continues to be slow. **Another** member stated that services are expected to continue recovering. However, he/she noted that accommodation and food services and arts, entertainment and recreation remain considerably affected.

Most members noted that the labor market continues to recover, although it remains deteriorated vis-à-vis its pre-pandemic levels. Some members highlighted that the labor participation rate increased in April. **One** member pointed out that it stood at 59.02%, a level higher than that of March, although below its pre-pandemic levels. He/she stated that in severe crises, it is the number of firms that go bankrupt what directly affects employment. In this regard, he/she mentioned that it is worrisome that from May 2019 to September 2020, over 20% of all the firms in the country closed, which contrasts with an increase in firm creation of only 12%, whereby Small and Medium-size Enterprises' (SMEs) were the most affected with a rate of business closures of 21.2% and a rate of firm creation of only 2.8%. **Another** member explained that, after contracting by 12.5 million between February and April 2020, formal and informal employment had recovered by 11.5 million in April 2021, two million of which had been reincorporated to the labor market during the first four months of the year. He/she added that, as of May 2021, IMSS-insured jobs were 2.45% below the levels of February 2020.

Most members pointed out that the underemployment rate declined in April. However, **some** members noted that currently it is at almost twice the usually observed level. **One** member underlined that the unemployment rate increased to 4.65% in April, which represents 2.7 million people. He/she added that this occurs in a context in which the Economically Active Population rose, reflecting the incorporation of both more employed persons and more people seeking employment. **Another** member noted that the Non-economically Active Population still includes around two million people available for employment above its pre-pandemic levels. **One** member highlighted that disaggregated data by sector and gender reinforce the outlook of an uneven and weak recovery of the labor market.

Most members stated that slack conditions are foreseen to persist in the economy as a whole. Some members highlighted the sharp differences between sectors. **One** member noted that slack is expected to diminish gradually. **Another** member noted that the negative output gap continues to be above 4% and is not expected to close before 2023.

Most members highlighted that, according to the Central Institute's forecasts, growth is expected to reach 6% in 2021 and 3% in 2022. One member noted that the dynamics of the growth rate for 2021 are partly due to a rebound effect generated by last year's contraction. **Some** members stated that the recovery would be driven by the strength of external demand, advances in the vaccination process, and the reopening of activities. **One** member mentioned that differences between sectors are expected to continue. **Some** members pointed out that the balance of risks for growth is equilibrated. **One** member stated that the risks described in the Quarterly Report January-March 2021 persist. **Another** member emphasized that the pandemic continues to be the most important challenge for economic activity. He/she added that Mexico's COVID-19 traffic light monitoring system has recently reversed in some states, which indicates that there is still uncertainty about the recovery.

Inflation in Mexico

The majority of members pointed out that inflation in Mexico continues to be affected by the direct and indirect effects of the pandemic. They mentioned that inflationary pressures are associated with base effects, as in the case of energy prices, with reallocation of spending, with pressures stemming from increases in international commodity prices, and with other supply pressures. Regarding the latter, **one** member stated that, in response to such pressures, the prices of wheat, corn and soybean by-products have increased. He/she added that the reallocation of spending generated an increase in mobile phone and internet services' prices. **Some** members mentioned that base effects, changes in consumption patterns, and increases in commodity prices, which explain the increase in inflation, are of a transitory nature.

Most members noted that inflation has been affected by supply pressures. One member stated that the prices of intermediate goods have increased considerably, which was reflected in the producer price index with increases that have not been observed in a long time and also highlighted the possibility of additional supply shocks, such as the observed pressures on the prices of basic food items. **Another** member pointed out that factors such as the differentiated reopening of activities across countries and sectors has had an impact on the provision of inputs, transportation and inventory management, leading to bottlenecks in production. He/she added that production costs have also increased due to the new sanitary and social distancing requirements in production processes, and the lower availability of labor. He/she added that suppliers of goods and services have shown a lower response capacity, as well as delays and product shortages. He/she argued that, due to the pandemic, supply has less capacity to absorb the growth in demand without exerting pressures on prices. **One** member considered that, due to the unprecedented nature of the crisis, it is difficult to foresee the size and duration of supply-related pressures and their interaction with demand patterns.

In this context, most members mentioned that headline inflation has been close to 6% and that it is significantly above Banco de México's target. One member argued that the current levels are due to the significant price changes that a reduced number of products have registered and, therefore, in his/her view, the 6% increase is far from being generalized. He/she noted that some prices that had registered the highest increases have already started to stabilize.

Regarding non-core inflation, **some** members mentioned that it was affected by a decrease in energy inflation and by upward pressures on livestock and agricultural product prices. **One** member pointed out that the latter have undergone pressures from adverse weather events and from a strong increase in their demand. **Another** member noted that non-core inflation has gone from 2.6% in January to double-digit levels since April.

Most members highlighted the rise in core inflation, which is associated with the increase in services inflation and the persistently high levels of merchandise inflation. Some members expressed their concern about core inflation's resistance to decline. They explained that since May 2018 it has remained around 3.8% and recently has trended upwards. **One** member emphasized that the core component has shown persistence despite the ample slack conditions. He/she noted that non-food merchandise inflation remains high, while food merchandise inflation increased. He/she added that an upward trend can be observed in the core component, which is foreseen to continue for several months. **Another** member highlighted that, while between April 2018 and February 2021, core inflation had not exceeded 4%, since March it has remained above that level. He/she argued that this component faces problems that go beyond base effects. He/she noted that, when controlling for seasonal effects, monthly inflation has increased rapidly in a considerable proportion of merchandises and services. He/she explained that the prices of certain merchandises, such as clothing and footwear, have been adjusted upwards to recover from the low profit margins registered during the pandemic. **One** member stated that the prices of 75% of merchandises are increasing at a rate of over 4% and show annual variations of around 6% as a whole. **Most members noted that, with the reopening of activities, services inflation has reversed the downward trend it had shown during most of 2020. One** member mentioned that it has increased consistently since the beginning of 2021. **Another** member added that this change in trend is a risk to inflation given that the depressed demand so far has contributed to contain price increases in this item. As the economy opens during the post-pandemic period, more pressures on these prices will be observed, derived from new consumption patterns.

This same member indicated that, although supercore inflation remains on target, it is an analytical concept that needs to be taken with caution. He/she recalled that it is interpreted as the one that responds more to the economic cycle. He/she mentioned that its current level of 3.1% indicates that, since the economy remained in the contraction part of the cycle for almost 3 years, the pressure on prices that are more susceptible to cyclical factors is low. However, he/she stated that this indicator does not show a level compatible with the inflation target, given that it only reflects 35% of the generic items of core inflation. He/she added that supercore inflation would have to show a higher level, in view of a higher economic growth rate, even if the latter were due to a base effect.

Most members pointed out that inflation expectations for the end of 2021 increased once again and that medium- and long-term expectations remained stable at levels above the 3% target. Some members mentioned that short-term expectations are the most sensitive to the observed data. **One** member indicated that inflation levels above those anticipated contributed to the increase in inflation expectations for this year and the next one. **Some** members highlighted that, based on different surveys, the median of expectations for the next 12 months remains close to 3%. **One** member added that said median even decreased gradually and is close to the target. He/she added that, although inflation expectations drawn from market instruments increased at the margin, they are still within the variability interval, which suggests that markets anticipate that the inflation increase will be transitory. In turn, **another** member detailed that in Banco de México's latest survey, specialists assigned a probability of 54% to inflation locating above 5.1% at the end of 2021, and a probability of 59% to inflation ending 2022 above 3.6%, which contradicts the projection that the target would be attained in mid-2022. In addition, he/she specified that, after new inflation data for June are released, analysts are anticipated to assign an even higher probability of inflation locating very much above the target level this year and the following one.

Most members mentioned that, after incorporating the recent behavior of inflation, the new expected trajectories for headline and core inflation for the following quarters are higher than those published in the Quarterly Report January–March 2021. He/she added that headline inflation is forecast to lie around the 3% target in the third quarter of 2022. One member recalled that, in the monetary policy release of May, headline and core inflation were anticipated to converge to the target in the second quarter of 2022. He/she added that in the Quarterly Report January-March 2021 it was stressed that the central forecast scenario for inflation excluded additional pressures and that their materialization would imply a more adverse scenario for inflation. He/she pointed out that, in the updated inflation forecast, the convergence of headline inflation to its target would be delayed until the third quarter of 2022 and that core inflation's convergence would also take longer. **Some** members highlighted that, since the previous monetary policy decision, the inflation trajectory for the following eight quarters has been revised significantly upwards. **One** member underlined that the central proposition of the last Quarterly Report and of many analysts is that the current inflationary pressures generated by shocks and the arithmetic effect derived from a low base of comparison are transitory, and thus they should begin to dissipate over the next twelve months. However, skepticism persists over the possibility of inflation converging to the target starting in the second quarter of next year. The aforementioned due to the high uncertainty and to a balance of risks for inflation biased to the upside. He/she expressed his/her concern about the magnitude of the deviation from previous forecasts being observed once again, in particular, regarding the convergence of inflation to its target. Inflation expectations could deteriorate given a continuous adjustment of the forecasts towards higher inflation.

Most members pointed out that inflation pressures are anticipated to be transitory. Some members highlighted the moderation in energy prices, the stabilization in international commodity prices, and that the effects related to reallocation of spending are one-off. **One** member mentioned the fading of increases in agricultural and livestock product prices. **Another** member mentioned that inflation dynamics in Mexico followed the global upward trend, although more noticeably. He/she pointed out that a reversal in the inflation trend starting from May had already been previously expected, due to the fading of base effects. Nevertheless, he/she pointed out that, after considering the most recent data, currently a new rebound in inflation is anticipated, which may continue until August or September, due to unanticipated factors, different from the base effect. He/she highlighted that, unlike other emerging economies, the increase in inflation in Mexico between January and May largely responded to structural factors. **One** member pointed out that, in line with the new forecasts, a very significant base effect could be observed during the fourth quarter of 2021. In addition, he/she stated that economic activity is estimated to moderate in 2022, coinciding in general terms with the moment in which some base effects of inflation will fade.

Among upward risks to inflation, most members highlighted the possibility of a higher external inflation, high persistence of core inflation, episodes of exchange rate depreciation, cost-related pressures or reallocation of spending. Some members added possible volatility episodes in financial markets. **One** member highlighted the risk of droughts exerting pressure on agricultural and livestock prices. **Another** member mentioned a more dynamic economic activity. **One** member considered that there are risks regarding the recovery of pent-up demand, especially in the service sector. Regarding downward risks, **some** members mentioned the effects of the negative output gap and greater social distancing measures. **One** member emphasized the possibility of an exchange rate appreciation.

Most members considered that the balance of risks that could affect the anticipated path for inflation within the forecast horizon is to the upside. One member mentioned that short and medium-term risks should be clearly differentiated. He/she pointed out that the balance of risks in the short term has deteriorated considerably. Nonetheless, he/she argued that medium-term risks, albeit remaining high, have improved given the stability of the exchange rate, the containment of energy prices, and a better outlook for international commodity prices. **Another** member highlighted that risks to non-core inflation are also biased to the upside, due to: i) new supply shocks associated to both increases in energy and commodity prices, and in transportation costs, and ii) pressures on agricultural and livestock product prices.

Macrofinancial environment

Most members indicated that domestic financial markets have exhibited a stable behavior. One member mentioned economic growth and its expectations, sound public finances, a lower current account deficit, and a less restrictive monetary policy stance among the factors that have contributed to said behavior. **However, the majority of members pointed out that the Federal Reserve's latest decision led to certain volatility. In this regard, they highlighted the recent exchange rate depreciation, after it attained a level close to 19.70 pesos per dollar.** However, one member highlighted that, at the margin, the Mexican peso has started to appreciate again.

Most members noted that shorter-term interest rates increased, while longer-term rates decreased. One member stated that this was due to expectations of a less accommodative monetary policy stance in the near future. **Some** members highlighted the favorable performance of the stock market. **One** member mentioned that default premia showed an improvement. **Another** member considered that although outflows of foreign investors' holdings of government securities have been absorbed by local financial intermediaries and investors, a cautious environment persists, which could translate into a lower appetite for local assets. **One** member recalled that China's inclusion in various global fixed income indexes has contributed to the fact that it has received two thirds of the fixed income flows towards emerging economies in the last 18 months. He/she stated that although part of this adjustment may be transitory, the low level of participation of foreign investors in primary auctions of government securities in Mexico stands out. **Another** member noted that greater external volatility and, in the medium term, lower monetary stimuli at a global level, could exert pressure on the exchange rate and affect capital flows.

The majority of members mentioned that bank credit has continued to contract. Some members highlighted the decline in consumer credit and in lending to SMEs. **One** member noted that this has occurred despite the ample liquidity available to banks. **Another** member added that this has taken place in an environment of tight financing conditions and that the decline in credit is also a result of lower demand due to a precautionary behavior and the lower payment capacity of SMEs in the face of the economic slowdown. He/she emphasized that only mortgage lending continues registering positive growth rates. **One** member pointed out that since 2016 lending has displayed a slowdown and that, since the beginning of the pandemic, it has contracted proportionally more than during the 2008-2009 financial crisis. He/she noted that, despite the measures taken by the authorities, credit so far has been weak and that intermediation margins are still above pre-pandemic levels.

Some members pointed out that recent studies show that, both in advanced and emerging economies, credit is highly important for a faster and more robust economic recovery, and that its absence will affect consumption and investment. **One** member stated that this would have negative consequences for the recovery of sales, for critical sectors such as construction, and that it could affect the reactivation of SMEs. **Another** member mentioned that, in a context of high uncertainty, a tightening of financial conditions could be counterproductive. In this regard, he/she considered essential to foster conditions that continue ensuring the efficiency and stability of the financial system, so that it encourages the adequate channeling of resources among economic agents. **One** member noted that the domestic sources of financing continued to expand at high rates in response to the demand for liquidity from households and firms. He/she added that in April and May there was a reactivation of corporate debt issuance in the domestic and foreign markets. Regarding credit risk, he/she mentioned that although delinquency rates remain at low levels, those corresponding to housing and corporate lending have increased. He/she considered it crucial for development banks to resume their countercyclical role as inducers of credit to the private sector in order to promote firms' recovery, mainly of SMEs, and to seize the space provided by their high capitalization levels.

Monetary policy

Most members of Banco de México's Governing Board highlighted that, although the shocks that have affected inflation are of a transitory nature, given their variety, magnitude, and the extended time frame in which they have been affecting inflation, they may pose a risk to the price formation process. They deemed necessary to strengthen the monetary policy stance by increasing the target for the overnight interbank interest rate by 25 basis points to 4.25%, to attain an orderly adjustment of prices and enable the convergence of inflation to its target. Some members voted for leaving the target unchanged at 4.00%. **The majority agreed 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 argued that in small open emerging economies, such as Mexico, which supplement their domestic savings with external sources of financing, it is essential to maintain a solid macroeconomic policy stance that fosters an orderly adjustment in the economy and attracts capital. In this regard, he/she stated that monetary policy should contribute to contain increases in risk premia along the yield curve, as well as possible adjustments to the Mexican peso exchange rate, in addition to maintaining low and stable inflation around its target. He/she also pointed out that the shocks that have recently affected inflation pose significant challenges to monetary policy implementation. He/she highlighted that it must be ensured that relative price adjustments take place in an orderly manner and that possible effects on the economy's price formation process and on inflation expectations are avoided. He/she added that the baseline scenario for inflation foreseen in the Quarterly Report did nor incorporate additional pressures, and that their materialization would imply a more adverse scenario for inflation. He/she highlighted that in said report the Governing Board indicated that it would determine its monetary policy stance with the aim of guaranteeing an orderly price adjustment and ensuring the convergence of inflation to the 3% target. In this regard, the most recent information clearly shows considerable additional pressures for headline and core inflation and a revision of its forecasts for the next eight quarters. He/she considered that a tightening of the monetary policy stance will contribute to a downward trajectory of headline and core inflation towards 3%.

Another member considered that the internal and external outlook for inflation has continued to deteriorate significantly. In particular, he/she pointed out that although inflationary pressures are largely, but not exclusively, explained by supply shocks, their transitory character can clearly turn out to be more lasting than previously anticipated. In view of this, he/she emphasized that it must be ensured that second-round effects are not generated and that the risk of expectations being contaminated or of the credibility of the Central Bank's commitment to the convergence of inflation to its target becoming deteriorated, is avoided. He/she pointed out that a significant correction in the observed data and in inflation forecasts cannot be ignored and requires a timely adjustment of the monetary policy stance. He/she stated that, although most analysts do not anticipate an increase in the reference rate in this decision, the minimum adjustment made is necessary and pertinent to give a clear and strong signal of the Central Bank's commitment to primary mandate. He/she added that price stability must be reinforced to avoid adverse consequences on the population, particularly on the most vulnerable. He/she emphasized the importance of the monetary policy statement mentioning the adjustment of inflation forecasts with respect to the trajectories in the last Quarterly Report, the delay in the convergence to the target, and that the balance of risks for inflation is biased to the upside. He/she added that this decision does not necessarily imply the beginning of a monetary tightening cycle but an adjustment, and that the following decisions will be taken accordingly, as new information emerges.

One member noted that the absolute and relative monetary policy stances suggest that the room for lowering the reference rate has been exhausted and that the monetary stimuli should even be reduced. He/she considered that signaling that the downward cycle will continue in order to support economic activity may be very risky. He/she stressed that when implementing monetary policy, the costs of the decisions taken should be evaluated. In the face of uncertainty due to unanticipated shocks or measurement problems in the indicators, the cost for price stability is lower when mistakenly maintaining a conservative position than when mistakenly taking a riskier position. He/she considered that the improved economic outlook reduces the need for further monetary stimulus measures. He/she added that the monetary policy stance that was needed in 2020, when the economy contracted 8.5% and inflation ended at 3.15%, is different from what is needed now, given that growth is expected to be 6% and inflation could close the year nearly at double its target level. The urgency that had previously favored the reduction in the reference rate loses more strength in light of the deterioration in the balance of risks to inflation. He/she pointed out that the credibility of monetary policy and the Central Institute's commitment to price stability must be maintained, avoiding any notion that the Central Bank has, a *de facto* dual mandate. He/she stated that recent and estimated future inflationary pressures, both domestic and external, in an international scenario prone to volatility and less accommodative monetary conditions worldwide, require immediate action. He/she pointed out that this decision shows that Banco de México is prepared to make difficult decisions, consistent with its primary mandate. He/she added that this will place the Central Bank in a better position to ensure that the expected trajectory for inflation materializes. He/she highlighted that given the uncertainty and a balance of risks for inflation that is clearly biased to the upside, in the following decisions it will be necessary to show resolve in order to avoid a de-anchoring of expectations and a greater vulnerability to external or internal shocks.

Another member mentioned that the monetary policy stance has been calibrated in an unprecedented context, ensuring the convergence of inflation to its target within the horizon in which monetary policy operates. He/she noted that, given that the economy is in a non-traditional cycle, there are no structural demand pressures that imply generalized price increases. He/she pointed out that it is important to reflect on monetary policy ability to respond to the supply shocks being confronted, considering that there are factors that are beyond the control of the monetary authority and that in the short term may have an impact on inflation. He/she stated that the Central Bank should seek to keep medium- and long-term inflation expectations anchored in order to avoid second-round effects. In this regard, he/she mentioned that, according to estimates, monetary policy implementation had, up to that point, maintained medium- and long-term inflation expectations anchored. He/she considered the importance of monitoring that this continues to take place, and that monetary policy should be conducted in such a way as to enable the orderly convergence of inflation to its target. He/she noted that the best way to meet this objective is by following the prudent, cautious, gradual and predictable approach that has characterized monetary policy. He/she emphasized that acting in a prudent and gradual manner is not synonymous with being tolerant, and that the Central Bank has the tools and experience to act in a timely manner, and even preemptively, if necessary, in order to ensure that inflation converges to its target in the horizon in which monetary policy operates.

One member argued that, if the reference rate remains unchanged, the inflation target would not be jeopardized, because the factors that account for its recent increase are not only exogenous but also transitory. He/she stated that, in reality, monetary policy can do very little to offset price pressures caused by base effects and by external factors. He/she recalled that, when pressures are demand-related, monetary policy can be more efficient, but that with an atypically high output gap and a labor market barely recovering, this type of pressures are limited, and that for this reason the current pressures actually come from abroad or are supply-related. He/she mentioned that, in contrast, an early withdrawal of the monetary stimulus would imply major costs for the economy in a context in which the recovery is still incipient and fragile. He/she stressed that said cost would fall on the margins of the economy that are currently more damaged, affecting the recovery of credit and removing an essential support for the reactivation of many small- and medium-size enterprises, and delaying the still incipient recovery of the aggregate demand components most affected by the pandemic: private consumption and investment. Finally, he/she recalled that Banco de México's goal is to preserve low and stable inflation, in an efficient manner, that is, not at all costs, but rather at the lowest cost possible. In this regard, he/she considered that in the current juncture, Banco de México must emphasize and inform comprehensively and clearly about the transitory nature of the ongoing inflationary shocks, which would contribute to provide certainty to markets as to the framework of monetary policy implementation and would reinforce the anchoring of inflation expectations without harming the possibilities of economic recovery.

3. MONETARY POLICY DECISION

Although the shocks that have affected inflation are expected to be of a transitory nature, given their variety, magnitude, and the extended time frame in which they have been affecting inflation, they may pose a risk to the price formation process. In this context, it was deemed necessary to strengthen the monetary policy stance in order to avoid adverse effects on inflation expectations, attain an orderly adjustment of relative prices, and enable the convergence of inflation to the 3% target. With the presence of all its members, the Governing Board decided by majority to increase the target for the overnight interbank interest rate by 25 basis points to 4.25%. Two members voted for leaving the target unchanged at 4.00%. 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, Irene Espinosa-Cantellano, and Jonathan Ernest Heath-Constable voted in favor of increasing the target for the overnight interbank interest rate by 25 basis points to 4.25%. Galia Borja-Gómez and Gerardo Esquivel-Hernández voted in favor of leaving the target for the overnight interbank interest rate unchanged at 4.00%.

5. DISSENTING OPINIONS / VOTES

Vote. Galia Borja-Gómez

Inflation has been subject to significant pressures in recent months. Most of them, however, seem to be associated with supply-related problems and to changes in consumption patterns, as a result of the pandemic -which remains the most important challenge- and thus I believe will hardly be solved through monetary policy. It is reasonable to conclude that these pressures are transitory and will decrease over time, as long as inflation expectations remain well anchored. Up to now, there is no evidence that medium- and long-term inflation expectations have been affected by the observed inflation shocks, and they are consistent with the time frame in which monetary policy operates. Under economic circumstances of high uncertainty, an unpredictable tightening of the monetary policy stance could be interpreted as a change in the cycle rather than a reinforcement of the current policy stance, which would lead to an even greater tightening of local financial conditions, and therefore be counterproductive. In my opinion, and given the non-traditional cycle we face, the best way to meet our constitutional objective is to be consistent with our communication and monetary policy approach, which has been characterized for being prudent, cautious, gradual, and predictable.

Vote. Gerardo Esquivel-Hernández

I believe the decision to raise the interest rate was hasty. Although it is true that inflation is significantly above the Central Bank's target, it is also true that this is mainly due to base effects and supply-related factors. This implies two things: first, that these effects are transitory and, second, that monetary policy can do little to address them. A similar explanation had been put forward just three weeks earlier in the Quarterly Report. I therefore consider that this decision suggests an abrupt change in narrative, which sends the signal of an erratic and unpredictable behavior by the Bank. The fact that no analyst had anticipated a rate increase also points in that direction. On the other hand, it has been said that the rate increase could contribute to anchor inflation expectations. However, this abrupt change could also have an undesirable and counterproductive effect on inflation and its expectations by suggesting that shocks are of a more permanent nature, which could negatively affect the price formation process.

ANNEX

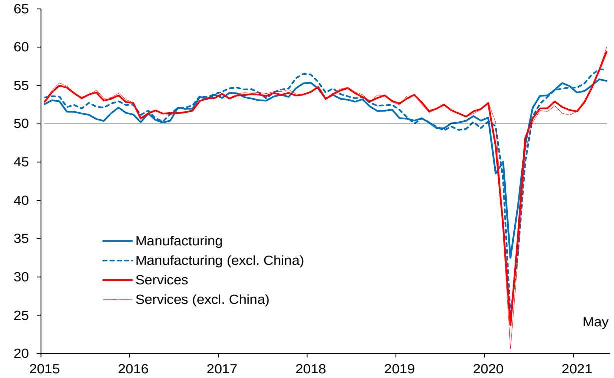
The information in this Annex was prepared for this meeting by the staff of Banco de México's Directorate General of Economic Research and Directorate General of Central Bank Operations. It does not necessarily reflect the considerations of the members of the Governing Board as to the monetary policy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

A.1. External conditions

A.1.1. World economic activity

Available indicators suggest a rebound in the pace of recovery of world economic activity during the second quarter of this year, although heterogeneity across countries persists, due to differences in vaccine availability and in stimulus spending. In most economies, international trade and industrial production continued to expand, despite some disruptions to supply chains caused by the shortage of some inputs. The pace of recovery in the services sector strengthened as a result of the reopening of activities (Chart 1). Global inflation continued to increase, due to pressures on various commodity prices, base effects, and other cost-related pressures associated with bottlenecks in production. In most advanced economies, headline and core inflation have increased, with the former rising above its target in some cases. The fact that in the United States annual CPI inflation reached 5% in May, the highest figure since September 2008, is noteworthy. The central banks of major advanced economies left their monetary stimuli unchanged, although it is estimated that these could be kept for a shorter period. Thus, after a period of stability, financial markets registered some volatility after the Federal Reserve released its latest monetary policy decision, reflecting uncertainty about the future evolution of monetary policy in the United States. Among the main risks to world economic activity and to the stability of global international financial markets, those associated with the pandemic and with higher levels of inflation hastening the withdrawal of monetary stimuli stand out.

Chart 1
Global: Purchasing Managers' Index Production Component
Diffusion Index, s.a.



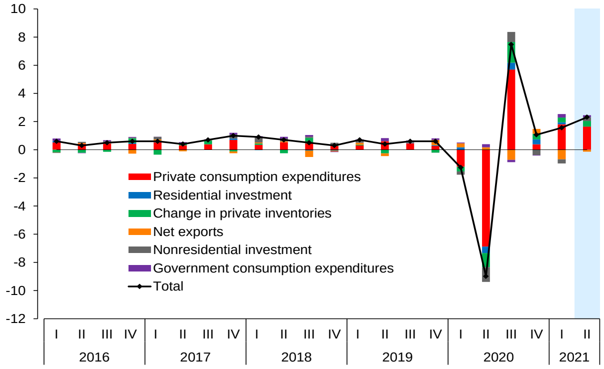
s. a. / Seasonally adjusted figures.
Source: Markit.

In the United States, available indicators point to an accelerated growth of economic activity, after its GDP expanded at a seasonally adjusted quarterly rate of 1.6% during the first quarter of 2021 (Chart 2).[1] In particular, consumption and investment are expected to continue contributing to an expansion during the second quarter. The continued strength of private consumption has been associated with advances in the vaccination process, the easing of several social distancing measures, and the significant stimulus programs implemented in that country. Available figures on international trade suggest a lower negative impact on growth from net exports due to the recent recovery in exports.

US industrial production continued growing at a slightly faster pace, from a seasonally adjusted monthly rate of 0.1% in April to 0.8% in May. This recovery reflected an expansion in its main components. In particular, after having contracted 0.1% in April, manufacturing activity grew at a monthly rate of 0.9% in May, reflecting mostly a rebound in automotive production, although it continues to face a shortage of inputs, particularly of semiconductors. Although the Purchasing Managers' Indices (PMIs) of the manufacturing sector suggest that the recovery of this sector may continue in the following months, other indicators, such as the New York Empire State Manufacturing Index, indicate that the shortage of labor and inputs may affect its pace of growth.

[1] Expressed as a quarterly annualized rate, US seasonally adjusted GDP grew at a rate of 6.4% during the first quarter of 20201.

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



Note: The shaded area refers to the Blue Chip forecasts for June 2021.
s. a. / Seasonally adjusted figures.
Source: Bureau of Economic Analysis (BEA) and Blue Chip.

The US labor market continued to recover during May. The non-farm payroll increased by 559,000 jobs in May, with the improvement in the sectors of leisure and hospitality, educational services, healthcare and social assistance standing out. However, employment figures remained 7.6 million below pre-pandemic levels. In that context, although the unemployment rate declined from 6.1% in April to 5.8% in May, initial unemployment insurance claims rebounded to 412,000 in the week ending June 12, after having registered 375,000 new claims during the previous week. It is worth noting that several surveys on the labor market among firms have recently reflected difficulties in filling some vacancies.

In the euro area, after GDP contracted 0.3% at a seasonally adjusted quarterly rate during the first quarter of 2021,[2] consumer and business confidence indicators suggest a recovery in economic activity during the second quarter, given the gradual reopening of services and expectations of a faster vaccination process. As for production, manufacturing activity has continued to recover, although automotive production continues to be affected by the shortage of semiconductors. PMIs for both the manufacturing and services sectors also point to a recovery of the economy during the second quarter of the year. As for the labor market, the unemployment rate declined from 8.1% in March to 8.0% in April.

In the United Kingdom, available indicators suggest a recovery of economic activity during the second quarter of 2021, after GDP contracted at a seasonally adjusted quarterly rate of 1.5% in the first.[3] This recovery is associated with the rebound in consumption, as a result of the reopening of stores deemed non-essential and hospitality services, as well as with the improvement in household confidence due to significant advances in the vaccination process and a decline in the number of COVID-19 cases during the quarter. Industrial production decreased in April, mainly reflecting a reduction in mining and manufacturing production, with the fall in pharmaceutical and automotive production standing out. In this environment, the unemployment rate decreased from 4.9% in February to 4.7% in April.

In Japan, available indicators suggest that economic activity recovered during the second quarter of the year, after having contracted at a seasonally adjusted quarterly rate of 1.0% during the first quarter.[4] Consumption of durable goods continued to expand in April, while spending on non-durable goods and services deteriorated once more in light of the announcement of the third COVID-19 state of emergency. Industrial activity continued to expand, supported by the demand for machinery and equipment, thus regaining the level observed at the end of 2019, despite the fall in automobile production due to supply shortages. As for the labor market, the unemployment rate increased from 2.6% in March to 2.8% in April.

In emerging economies, indicators point to a differentiated performance during the second quarter, reflecting the rebound in the number of COVID-19 cases in some regions and the withdrawal of stimulus in China. In emerging Asian countries, timely information suggests that economic activity in China continued to expand, albeit at a more moderate pace, while in India, activity was severely affected by the health crisis. In emerging Europe, available indicators suggest a recovery of economic activity, while in Latin America several economies are expected to contract, especially those of Argentina, Brazil and Colombia, due to slower progress in containing the COVID-19 pandemic and in the case of Colombia due to the recent social turmoil.

[2] In annualized terms, euro area GDP registered a quarter-on-quarter seasonally adjusted variation of -1.3% during the first quarter of 2021.
[3] In annualized terms, UK GDP contracted at a quarter-on-quarter seasonally adjusted rate of -5.9% during the first quarter of 2021.
[4] In annualized terms, Japan GDP grew at a quarter-on-quarter seasonally adjusted variation of -3.9% during the first quarter of 2021.

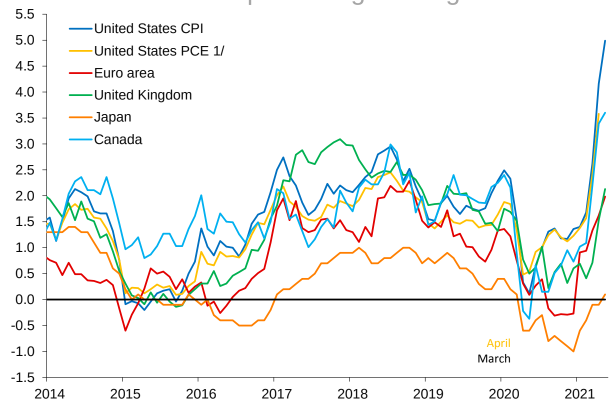
International commodity prices registered a mixed behavior since Mexico's previous monetary policy decision. On the one hand, oil prices continued to be driven by optimism regarding the recovery of fuel demand in view of the resumption of activities in several economies and by the decision of the Organization of Petroleum Exporting Countries (OPEC) and other producers to maintain until July their current plan to gradually increase production. On the other hand, after having reached relatively high levels in early May due to the recovery of global industrial activity and disruptions in the global supply chains, industrial metal prices exhibited narrow adjustments. Finally, grain prices declined during the period as a result of more favorable weather conditions, especially in the western region of the United States.

A.1.2. Monetary policy and international financial markets

Global inflation continued to increase, reflecting upward pressures stemming from rises in various commodity prices, mainly energy commodities, arithmetic effects associated with a low base of comparison, and other cost-related pressures associated with bottlenecks in production. Headline inflation in some advanced economies, such as the United States, Canada, the euro area and the United Kingdom, was around or above their central banks' targets (Chart 3). The fact that in the United States annual CPI inflation reached 5% in May, the highest figure since September 2008, is noteworthy. Core inflation recently registered increases in most of these economies, although it remains at low levels. In most of the main advanced economies, after having increased slightly during the first half of May, 5-year forward inflation expectations for the following 5 years drawn from financial instruments have remained relatively stable, although in some cases additional slight increments have been registered recently. However, in most economies in this group, they remain at levels above those observed at the beginning of the year.

In the main emerging economies, inflation continued to rise, largely due to the higher commodity prices and the effects of a low base of comparison, as a result of which headline inflation remained above its central banks' point target or the midpoint of their target range. In addition, in most of these economies, core inflation has increased recently, in the abovementioned economic context.

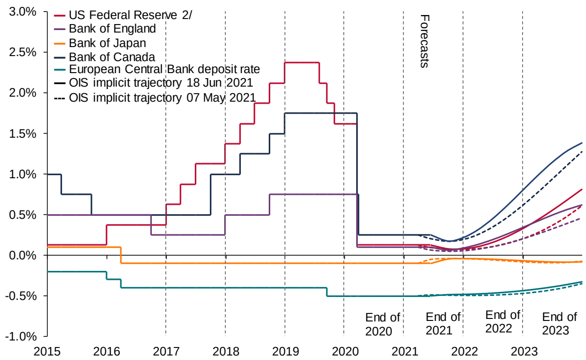
Chart 3
Selected Advanced Economies: Headline Inflation
Annual percentage change



1/ The personal consumption expenditure deflator is used.
Source: Bureau of Labor Statistics, Eurostat, Bank of Japan, Statistics Canada, Office of National Statistics.

The central banks of the major advanced economies left their reference interest rates unchanged at levels around zero. Likewise, they continued using their balance sheets to preserve favorable financing conditions and to seek the convergence of inflation to their respective long-term targets. These central banks reiterated that they will maintain accommodative monetary policy stances until inflation reaches their targets in a sustained manner. However, the recent forecasts of some of these banks anticipate increases in reference interest rates earlier than previously anticipated. In turn, expectations drawn from financial instruments in some cases incorporate interest rate increases for the end of 2022 and 2023 (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 June 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 far from making a substantial progress in attaining these goals, which has been considered as a necessary condition to announce an adjustment to its asset purchase program. He added that any decision to adjust said program will be announced in advance and that its intention is that the process is orderly, methodic and transparent. Additionally, he suggested that the Federal Open Market Committee (FOMC) still expects the inflation increase to be transitory, despite the uncertainty regarding the moment when the temporary inflation pressures will start moderating. He pointed out that there is a risk that inflation will be higher and more persistent than anticipated, and, that in the event that the trajectory of inflation or long-term inflation expectations deviate materially and persistently from the levels consistent with its target, the central bank will be prepared to adjust its monetary policy stance. In this context, the medians of forecasts by the Committee published in June show the following adjustments: an upward revision of growth expectations for 2021 and, to a lesser extent, for 2023, as well as a marginal decrease in the expected unemployment rate for 2022. Although inflation expectations for this year were significantly revised upwards from 2.4 to 3.4%, headline inflation is foreseen to reach 2.1% in 2022 and 2.2% in 2023, which suggests that the increase in inflation is anticipated to be transitory. Regarding the reference rate, the median of forecasts suggests that it will increase by 50 basis points during 2023, as compared to previous forecasts that did not include any increments for that year. In response, the implied path in financial instruments for the federal funds rate was adjusted upwards, particularly for 2022 and 2023, incorporating the expectation of around three increases by the end of 2023. In that same meeting, the Federal Reserve extended its temporary liquidity lines in US dollars with nine central banks until December 2021 and increased the interest rate applied to the banks' reserve balances and the one used in their repurchase operations.

ii) In its June 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 that this convergence is consistently reflected in core inflation dynamics. It also left its asset purchase programs unchanged and reiterated that it expects net purchases under the Pandemic Emergency Purchase Program (PEPP) to continue during the next quarter at a significantly higher pace than in the first months of the year. In this regard, the president of said central bank pointed out that any discussion on the termination of the program would be premature.

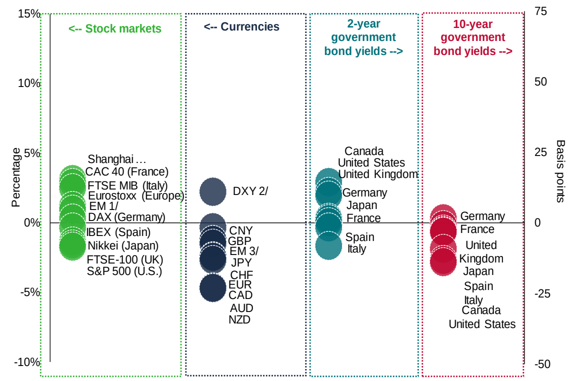
iii) In its June meeting, the Bank of Japan left its short-term policy rate unchanged at -0.1% and its long-term interest rate (indexed to its 10-year bond) at around 0%. It also announced the extension until March 2022 of its purchases of commercial paper and corporate bonds, as well as its Special Program to Support Financing in Response to the Novel Coronavirus (COVID-19).

It reiterated that it will continue to support corporate financing and to maintain stability in the financial markets through this special program, as well as through an ample liquidity provision, both in domestic and foreign currency, and through purchases of Exchange-traded Funds (ETFs) and Japan Real Estate Investment Trusts (J-REITs). Said central bank ratified that, if necessary, it will not hesitate to take additional easing measures and that it expects interest rates to remain at or below their current levels. Said central bank also considered appropriate to introduce a new fund-provisioning measure, through which it provides funds to financial institutions for investment or loans granted to address climate change issues. It noted that this measure will be probably launched within 2021 and that its preliminary outline will be announced in its July meeting.

Since Banco de Mexico's previous monetary policy decision, most central banks of the main emerging economies left their reference interest rates unchanged. However, some pointed out the need of assessing the convenience of recalibrating how expansive their monetary policy should be, while others tightened their policy stances further. In particular, in June the central banks of Brazil, Russia, Hungary and the Czech Republic increased their interest rates by 75, 50, 30 and 25 basis points, respectively. In addition, the central banks of this group of economies continued to implement measures to provide liquidity and foster the well-functioning of financial markets.

In the global environment described above, since Mexico's previous monetary policy decision international financial markets exhibited a stable behavior during most of the period, in a context in which the central banks of major advanced economies maintained accommodative monetary policies and pointed out that the recent rise in inflation is partly due to transitory factors, while lockdown measures have been reduced in several countries. However, recently, a higher volatility and a tightening of financial conditions has been observed, in view of a sooner-than-previously-expected withdrawal of the Federal Reserve monetary stimulus. In this context, stock markets registered mixed results, after some stock market indices reached maximum historic levels (Chart 5). The US dollar strengthened against most advanced and emerging economies' currencies. Long-term government bond interest rates in the main advanced economies showed decreases during most of the period, while most short-term interest rates increased, thus leading to flattening yield curves. In turn, interest rates in emerging economies showed mixed adjustments (Chart 6). In this context, since Mexico's previous monetary policy decision capital flows to fixed income assets in emerging economies, mainly of the Asian region and, particularly, China, registered moderate net inflows, although there were episodes of capital outflows from equity assets in some economies.

Chart 5
Change in Selected Financial Indicators from May 7 to June 18, 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 May 10, 2021 to June 18, 2021
Percent, basis points

Region	Country	Currencies	Equity markets	2-year interest rates	10-year interest rates	CDS
Latin America	Mexico	-3.22%	0.91%	26	6	6
	Brazil	3.40%	5.33%	54	22	-5
	Chile	-7.72%	-6.53%	52	92	16
	Colombia	-0.13%	-4.15%	18	0	10
	Peru	-6.10%	-11.36%	-28	66	9
Emerging Europe	Russia	1.50%	2.98%	92	8	-2
	Poland	-1.41%	4.57%	23	4	2
	Turkey	-6.12%	-5.06%	33	-7	2
	Czech Republic	-2.01%	4.77%	14	-14	1
	Hungary	-0.97%	8.39%	50	10	2
Asia	China	-0.82%	2.95%	13	-3	1
	Malaysia	-1.01%	-0.74%	-11	18	1
	India	-1.03%	6.21%	39	2	-8
	Philippines	-1.72%	8.07%	-10	-30	0
	Thailand	-1.68%	0.82%	1	7	-1
	Indonesia	-1.62%	0.34%	-26	20	0
Africa	South Africa	-1.70%	-4.26%	62	42	-9

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 where used as a reference. For Colombia and the Philippines, a 2-year swap rate is used.
Source: Bloomberg.

Given the characteristics of the health and economic crisis, along with the adjustments in the monetary policy framework of some of the main central banks in advanced economies, there is still high uncertainty regarding the evolution of international financial markets and the risk of new episodes of volatility during the recovery phase of the pandemic. In this regard, several risks to the stability of international financial markets persist. These include the possibility that the economic recovery in some advanced economies, supported to a large extent by substantial fiscal stimuli, or that greater disruptions in supply chains lead to higher levels of inflation, hastening the withdrawal of the monetary stimulus, which could tighten global financial conditions and generate pressures for emerging markets. Concerns also persist regarding possible distortions in some financial assets' valuations, which could lead to a sudden correction in their prices. In addition, vulnerabilities related to the high levels of public and private debt accumulated in recent years could intensify.

In addition to the risks to global financial conditions, emerging economies face an increased absorption of financial resources by the public sectors of those advanced economies that have large fiscal stimulus programs and by China's greater participation in emerging economies' fixed income assets due to its inclusion in the main global investment indices.

A.2. Current situation of the Mexican economy

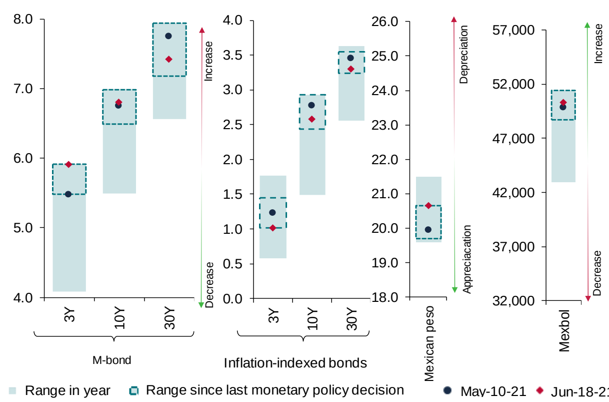
A.2.1. Mexican markets

Since Banco de México's previous monetary policy decision to date, financial asset prices in the country exhibited a mixed behavior with a negative bias (Chart 7), in an environment characterized by a greater sensitivity to financial conditions in the United States. In this regard, expectations of less accommodative monetary policies by advanced economies continued to gain strength as a result of a rebound in both their inflation rates and inflation expectations.

Regarding the Mexican peso, it fluctuated in a range between 19.70 and 20.66 pesos per dollar, ending the period with a depreciation of 3.22% (Chart 8). This occurred in a context in which both spot- and forward-trading conditions improved slightly.

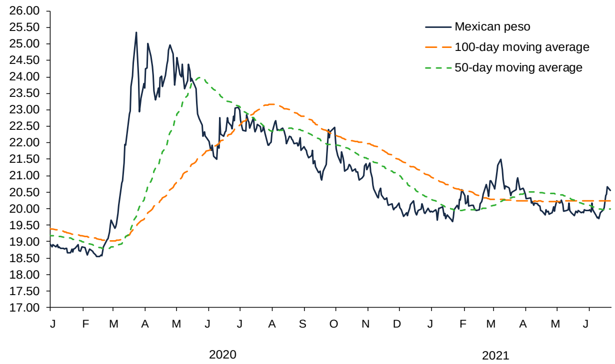
On the other hand, on June 16 Banco de México announced jointly with the US Federal Reserve the extension of the swap line until December 31, 2021 for an amount of 60 billion dollars.

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



Source: Prepared by Banco de México.

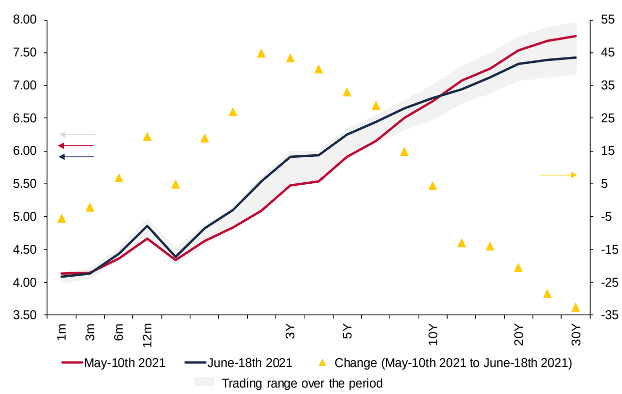
Chart 8
Mexican Peso Exchange Rate with Moving Averages
MXN/USD



Source: Prepared by Banco de México.

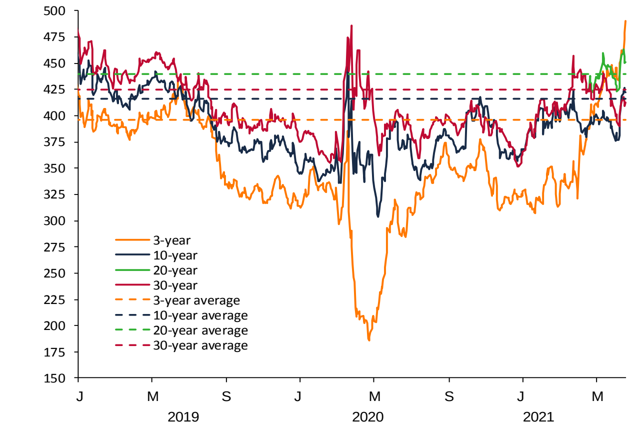
Interest rates of government securities exhibited a mixed behavior (Chart 9), with a flattening dynamic reflected in increases of up to 35 basis points in the short-term part of the yield curve, and decreases of up to 37 basis points in longer-duration instruments. The yield curve for real rate instruments exhibited a positive dynamic, with decreases of between 28 and 68 basis points in the short-term segment. In this context, breakeven inflation and inflation risk premia implicit in spreads between nominal and real rates of market instruments showed mixed adjustments with respect to the March monetary policy decision (Chart 10). These adjustments occurred in an environment in which trading conditions improved during the period between Mexico's monetary policy decisions.

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



Source: PIP.

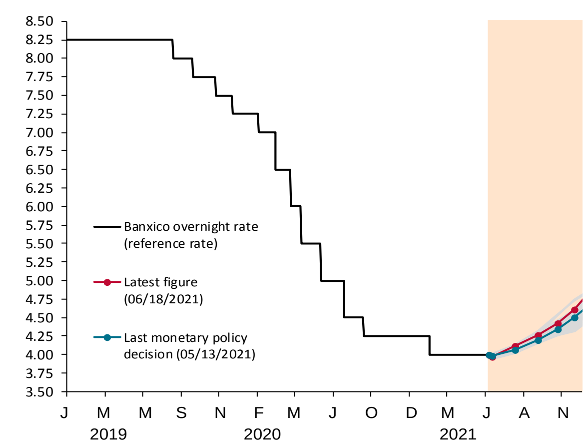
Chart 10
Breakeven Inflation and Inflation Risk Implicit in Government Securities' Interest Rate
Basis points



Source: PIP.

Regarding expectations for the trajectory of the monetary policy reference rate, information implied by the Interbank Equilibrium Interest Rate (TIIE, for its Spanish acronym) assigns an 88% probability to the reference rate remaining unchanged in June's decision (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 target rate of 4.61%, while the median of the aforementioned survey expects it to be 4.00%.

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



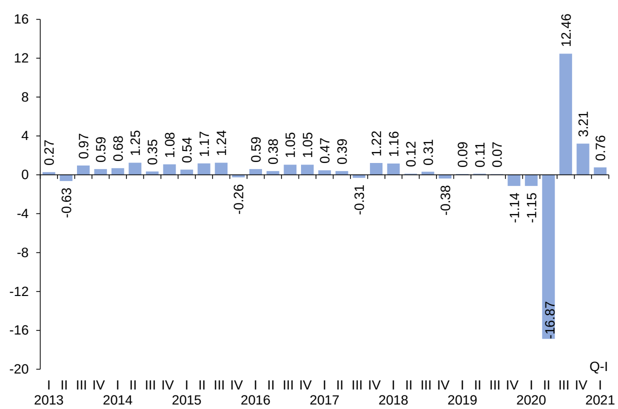
Source: Prepared by Banco de México with Bloomberg data.

A.2.2. Economic activity in Mexico

During the first quarter of 2021, the recovery of economic activity slowed down (Chart 12), although in March it registered a significant rebound, mainly driven by the evolution of tertiary activities in response to the loosening of restrictions to contain the pandemic. Available indicators suggest a moderation of the recovery in April. During the rest of the year, economic activity is expected to resume its recovery path.

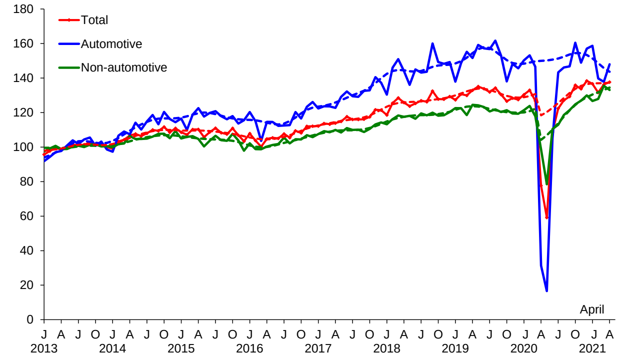
As for external demand, in April automotive exports partially recovered from the decline registered in February and March, while the rest of manufacturing exports remained at high levels (Chart 13). By destination, exports to the United States showed a loss of dynamism in April, while those to the rest of the world rebounded, reversing the decline observed in March.[5]

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



s. a. / Seasonally adjusted figures.
Source: Mexico's System of National Accounts (SCNM, for its Spanish acronym), INEGI.

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



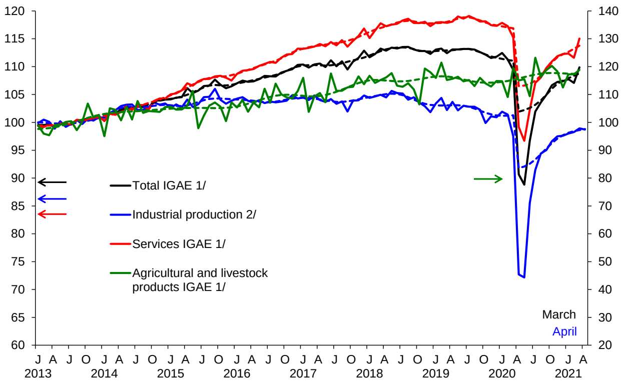
s. a. / Seasonally adjusted series and trend series based on data in nominal US dollars. The former is represented by a solid line and the latter by a dotted line.
Source: Prepared by Banco de México with data from the Tax Administration Service (SAT, for its Spanish acronym), the Ministry of the Economy (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, in March private consumption reactivated after having decelerated in previous months, although it remained below the level reported in February 2020. Consumption of goods, both imported and national, reversed the decline of the previous month, while consumption of services rebounded, although it remains at low levels. In March, gross fixed investment continued to show a gradual recovery, although it remained below its pre-pandemic level. Within it, the machinery and equipment component maintained its recovery pace, while construction slowed down.

As for production, in March tertiary activities recorded a significant rebound, generalized across all sectors (Chart 14). Among the services that performed better that month were temporary accommodation and food and beverage preparation services; transportation and mass media information services; wholesale commerce; leisure and other services; and financial and real estate services. In April, industrial activity contracted as a result of a loss of dynamism in construction and the impact on manufacturing caused by the shortage of certain inputs, especially of semiconductors in the automotive industry. At the same time, although mining grew at the margin, it remained at low levels (Chart 15).

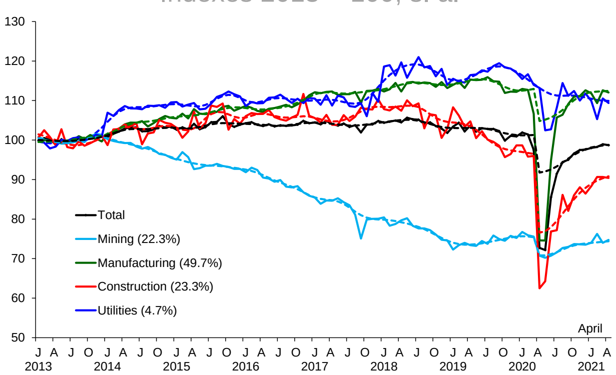
[5] Refers to the value of merchandise exports in current US dollars. This value differs from that reported for goods exports by Mexico's System of National Accounts (SCNM, for its acronym in Spanish), given that the latter represents the value-added measured in constant pesos.

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.
1/ Figures to March 2021
2/ Figures to April 2021 of the Monthly Indicator of Industrial Activity.
Source: Mexico's System of National Accounts (SCNM, for its Spanish acronym), INEGI.

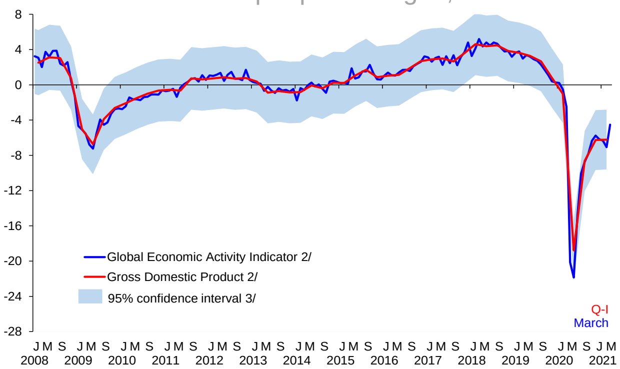
Chart 15
Industrial Activity [1/]
Indexes 2013 = 100, s. a.



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.

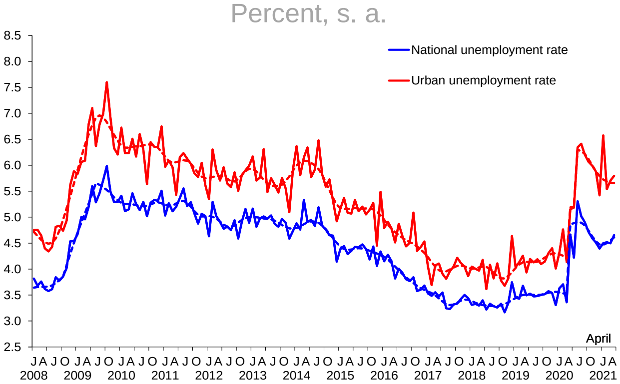
Regarding the economy's cyclical position, slack conditions for the economy as a whole remained significantly ample in the first quarter of 2021 (Chart 16), with sharp differences across sectors. In April, although the labor market remained affected, various indicators of said market continued showing a gradual improvement. In particular, although the national and urban unemployment rates increased (Chart 17), this occurred in a context of higher labor participation and higher levels of employment. In turn, in May, the number of new IMSS-insured jobs continued to recover, although it remained around 500 thousand below its pre-pandemic levels, according to figures without seasonal adjustment. Finally, despite the decline in March and in April, unit labor costs in the manufacturing sector remained above the levels reported prior to the pandemic (Chart 18).

Chart 16
Output Gap Estimates [1/]
Excluding Oil Industry [4/]
Potential output percentages, s. a.



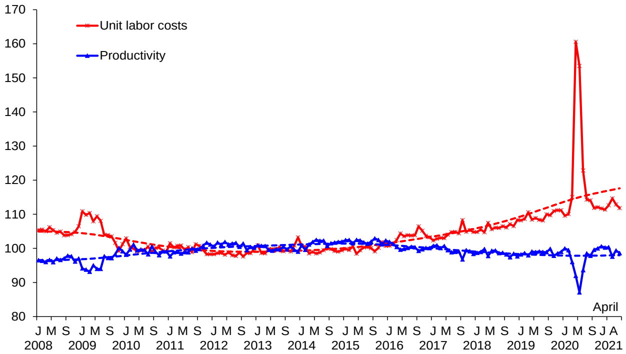
s. a. / Calculations based on seasonally adjusted figures.
1/ Output gap estimated with a tail-corrected Hodrick-Prescott filter; see Banco de México (2009), "Inflation Report, April-June 2009", p.74.
2/ GDP timely figures as of Q1 2021, and IGAE figures as of March 2021, in line with said timely figure.
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 and trend series. The 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 with seasonally adjusted data of the Monthly Manufacturing Industry Survey and industrial activity indicators of Mexico's System of National Accounts (*Sistema de Cuentas Nacionales de México*, SCNM), INEGI.

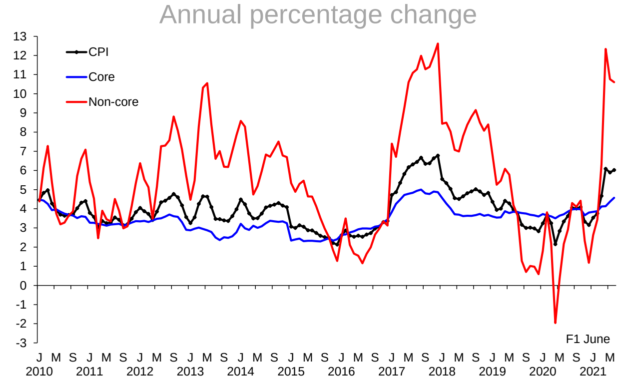
In April 2021, domestic financing to firms continued to contract in real terms at an annual rate. This has been partly the result of a reduction in bank lending to both smaller-size firms –a segment that has decreased since the first quarter of 2019– and large-size firms –a segment that continues to show a lower demand for bank loans compared to the levels observed at the beginning of the pandemic–. Lending conditions for companies in general continued to be tight compared to those at the beginning of the pandemic. During the April-May period, corporate debt issuance by firms recovered, after having remained stagnant during the first quarter of the year. As for credit to households, the housing portfolio continued to show positive real annual variations, in line with its high demand, although its growth moderated in the first four months of 2021. At the same time, banks' performing consumer loan portfolio continued to decrease at a real annual rate in all segments, in a context in which lending conditions for households remained tight.

Interest rates of bank credit to firms have generally followed the dynamic of the bank funding rate. Intermediation margins continued above pre-pandemic levels. In turn, mortgage interest rates remained at levels around their historical lows. Meanwhile, in February, credit card interest rates continued the downward trend followed since October of last year. However, intermediation margins have increased, given the larger reductions to the reference rate. Regarding portfolio quality, in April corporate loan delinquency rates remained relatively stable and at low levels. Mortgage loan delinquency rates did not register significant changes after the moderate upward trend observed since November 2020, and also remained at low levels. Lastly, although consumer loan delinquency rates have decreased at the margin, they remain at high levels.

A.2.3. Development of inflation and inflation outlook

Between April and the first fortnight of June 2021, annual headline inflation shifted from 6.08% to 6.02% (Chart 19 and Tabla 1). Although non-core inflation contributed 40 basis points to the downside, this effect was almost completely offset by the upward incidence of 34 basis points on core inflation. The observed reduction in non-core inflation was mainly due to the fact that the arithmetic effect derived from the significant decline in gasoline prices in April 2020 continued to reverse. In turn, the impact of the pandemic on supply chains and on productive processes of various goods and services caused additional shocks on core inflation.

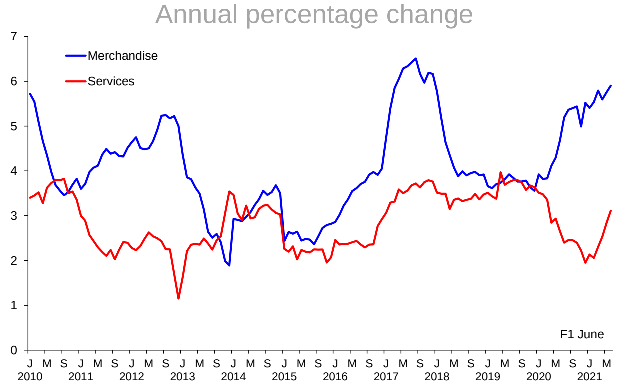
Chart 19
Consumer Price Index
Annual percentage change



Source: Banco de México and INEGI.

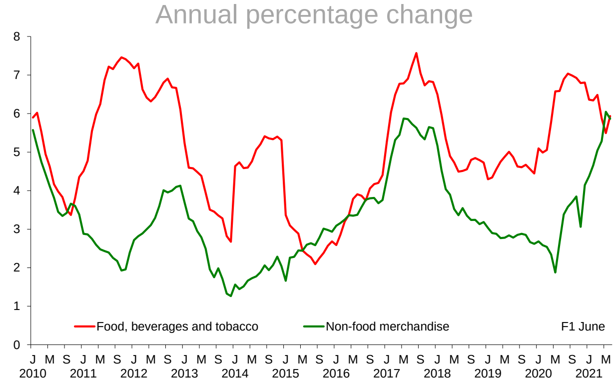
Annual core inflation increased from 4.13% to 4.58% between April and the first fortnight of June, with increments in inflation of both merchandise and services. In the case of merchandise, its annual inflation rose from 5.59% to 5.90% in the aforementioned period (Chart 20). Within it, annual inflation of food merchandise increased from 5.88 to 5.94%, and that of non-food merchandise, from 5.28 to 5.87% (Chart 21). Regarding the latter, the higher annual inflation of apparel, footwear and accessories was particularly noteworthy, which was associated with a base effect due to the price reductions registered by this item during the previous year. In general, non-food merchandise inflation continues to face cost-related pressures, such as increases in commodity and input prices in general, production chains bottlenecks, and fluctuations in the exchange rate. Annual inflation of services increased from 2.53 to 3.11% in the referred period. In this regard, the increase from 3.55 to 4.58% in the annual price variation of services other than education and housing stood out, which resulted largely from the higher price increases in food, tourism and entertainment services. This contrasts with the low levels of annual inflation of housing, which went from 1.73 to 1.94%, as well as in education, which shifted from 1.12 to 1.14%.

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



Source: Banco de México and INEGI.

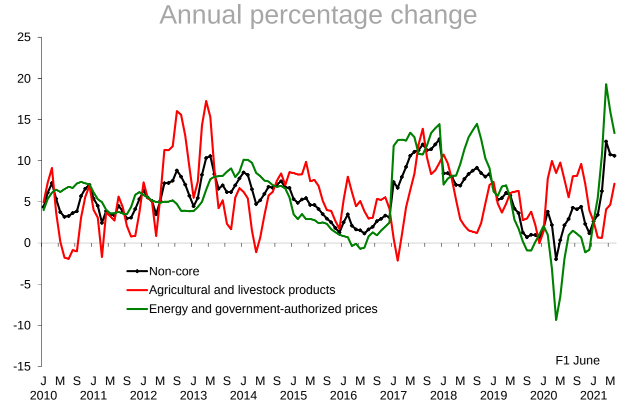
Chart 21
Merchandise Core Price Sub-index
Annual percentage change



Source: Banco de México and INEGI.

Annual non-core inflation decreased from 12.34 to 10.61% between April and the first fortnight of June 2021 (Chart 22 and Tabla 1). This result was mainly associated with the reduction from 28.02 to 18.54% in annual energy inflation. This, in turn, was the result of lower annual variations in gasoline prices, which went from 34.94 to 18.43% during this period, reflecting the fading of the arithmetic effect of the significant decreases in their prices in April of last year. On the other hand, annual inflation of agricultural and livestock products increased from 4.08 to 7.22% during the same period, driven by the increase from -0.83 to 2.30% in the annual inflation of fruits and vegetables and from 8.20 to 11.48% in inflation of livestock products.

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



Source: Banco de México and INEGI.

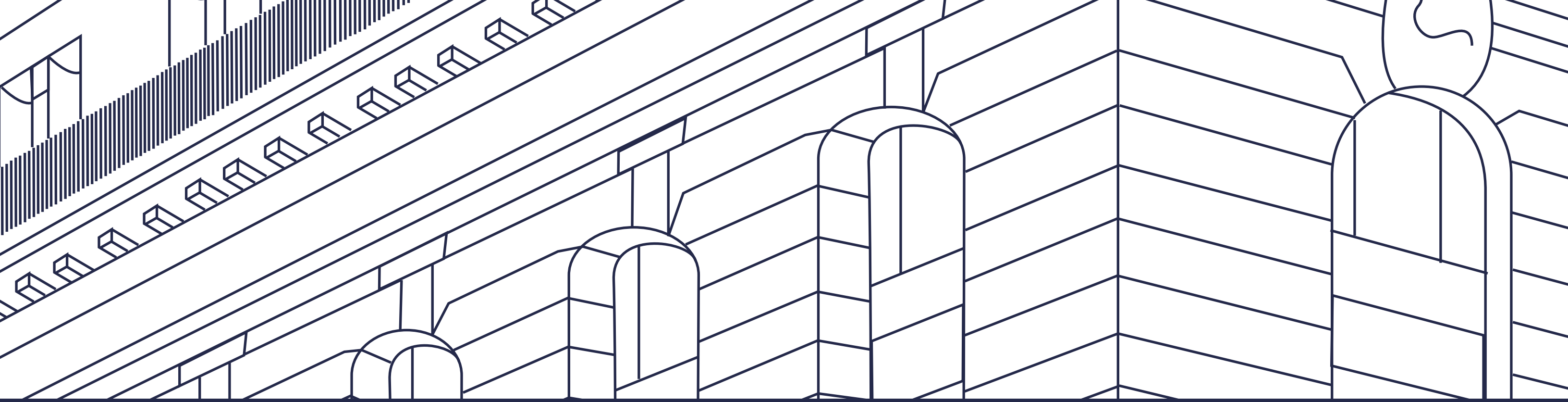
As for inflation expectations drawn from Banco de México's Survey among Private Sector Forecasters, between April and May, the median for headline inflation for the end of 2021 increased from 4.56 to 5.00%, while that corresponding to core inflation went from 3.74 to 3.91%. In turn, the medians for the end of 2022 were adjusted from 3.60 to 3.61% for headline inflation, and from 3.51 to 3.60% for core inflation. The medians of headline and core inflation expectations for the medium and long terms remained around 3.50%. Finally, the compensation for inflation and inflation risk estimated with market instruments registered some volatility. In particular, although it had declined after the last monetary policy decision, it has rebounded significantly since the first week of June.

After incorporating the recent behavior of inflation, the revised expected trajectories for headline and core inflation for the next quarters are above those published in the last Quarterly Report. Thus, headline inflation is now expected to converge to the 3% target during the third quarter of 2022. These forecasts are subject to risks. On the upside: i) external inflationary pressures; ii) cost-related pressures or reallocation of spending; iii) core inflation persistence; iv) exchange rate depreciation; and v) that the drought exerts pressure on agricultural and livestock product prices. On the downside: i) effects stemming from the negative output gap; ii) greater social distancing measures; and iii) exchange rate appreciation. The balance of risks that might affect updating the anticipated path for inflation within the forecast horizon is biased to the upside.

Tabla 1
Consumer Price Index and Components
Annual percentage change

Item	April 2021	May 2021	1st fortnight June 2021
CPI	**6.08**	**5.89**	**6.02**
Core	**4.13**	**4.37**	**4.58**
Merchandise	**5.59**	**5.76**	**5.90**
Food, beverages and tobacco	5.88	5.49	5.94
Non-food merchandise	5.28	6.05	5.87
Services	**2.53**	**2.84**	**3.11**
Housing	1.73	1.86	1.94
Education (tuitions)	1.12	1.12	1.14
Other services	3.55	4.08	4.58
Non-core	**12.34**	**10.76**	**10.61**
Agricultural and livestock products	**4.08**	**4.67**	**7.22**
Fruits and vegetables	-0.83	-3.63	2.30
Livestock products	8.20	12.23	11.48
Energy and government-authorized prices	**19.30**	**15.97**	**13.36**
Energy products	28.02	22.96	18.54
Government-authorized prices	2.21	2.25	2.74

Source:INEGI.



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