BANCO DE MÉXICO®

Minutes number 77

Meeting of Banco de México's Governing Board on the occasion of the monetary policy decision announced on June 25, 2020

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 24, 2020.

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

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

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

International environment

All members mentioned that the COVID-19 pandemic and the measures adopted to prevent its spread have affected world economic activity considerably. Some members added that these have had an important impact on employment. **One** member emphasized the repercussions on manufactures, on processes integrated into global value chains, and person-to-person services. He/she pointed out that the damage has been immediate and abrupt, both to supply and demand.

Some members stated that sanitary measures have proven to be somewhat effective in reducing contagion, with differentiated results across jurisdictions. In this context, they noted that the main advanced economies started reopening their activities. **One** member stressed that Latin America has become the epicenter of the crisis, given that, among other factors, the high degree of informality and poverty hinder compliance of social distancing measures.

Most members stated that the contraction of economic activity observed during the first quarter intensified during the second, although in May certain indicators for various economies exhibited some improvement. One member expressed that the deterioration during the second quarter is likely to be lower than previously anticipated. **Another** member argued that retail sales along with certain leading indicators in advanced economies, such as the purchasing managers' and consumer confidence indexes, remain at levels much lower than those registered prior to the pandemic.

All members pointed out that in this context multilateral organizations and analysts have once again revised their economic expectations for 2020 downwards. Some members mentioned that falls in world GDP of between 4.9 and 6% are anticipated. **One** member stated that it is reasonable to expect that the world's economic recovery will be slower than previously estimated.

Most members underlined that a recovery is expected during the second half of the year and in 2021, although said expectations are subject to a high degree of uncertainty. Among risks to world economic activity, most members mentioned a second outbreak of infections. Some members added the risk that fiscal relief measures are insufficient or are withdrawn prematurely. **One** member noted the significance of the latter risk for economies showing considerable levels of indebtedness. **Some** members mentioned the possibility of additional episodes of turmoil in international financial markets. **Some** members added the possibility of political and social instability associated with the deterioration of socioeconomic conditions. **One** member mentioned the resurgence of trade disputes and the presidential elections in the U.S. In this context, **some** members pointed out that the balance of risks for world economic growth remains biased to the downside.

Some members mentioned that weak global demand has brought about contractions in commodity prices, especially of energy products. **One** member stated that this has affected public revenue and emerging economies' terms of trade. **Another** member pointed out that although these prices are still at low levels as compared to the beginning of the year, their quotes have improved and market instruments suggest stability in the future.

Most members mentioned that in advanced economies headline and core inflation are below their central bank's targets. Some members stated that in most economies, including emerging ones, inflation has declined due to a lower demand for a wide range of goods and services. They pointed out that this occurred despite the supply constraints and the increases in the prices of food and medical services. **One** member added that a low inflation trajectory is anticipated at the global level, while **another** one added that in emerging economies expectations drawn from market instruments remain at low levels.

In view of the described environment, most members highlighted that central banks in advanced and emerging economies have eased their monetary policy stances. The majority of members added that different monetary authorities have expanded their asset purchasing programs and their financing schemes to promote the well-functioning of their financial systems. Likewise, most members stated that different central banks have expressed their readiness to maintain easing measures for as long as necessary or even to strengthen them. Some members stressed that the Federal Reserve projections estimate the federal funds target range to remain between 0 and 0.25% at least until 2022. **One** member added that said central bank announced the possibility of implementing a yield curve control scheme. **Another** member noted that in most emerging economies central banks have continued to ease their monetary stances and that real interest rates in these countries are currently close to 0% or are even at negative levels.

Most members stated that various countries have adopted important fiscal stimulus measures to mitigate the adverse effects on employment and on households' and firms' incomes. One member expressed that certain advanced economies, by having a reserve currency and well-developed institutions, have managed to promote a significant and broad range of relief measures for employment and guarantee programs for businesses and households. He/she added that in emerging economies a greater heterogeneity is observed regarding the amount and the type of implemented measures.

All members highlighted that, since the last monetary policy decision, global financial markets have exhibited a positive behavior, reflecting the effects of the fiscal, monetary and financial stimulus measures adopted by the advanced economies and the gradual reopening of their productive activities. Most members highlighted the lower risk aversion, the increase in stock market indexes, the appreciation of currencies against the US dollar, a certain reduction in government bond yields, and an increase in commodity prices. Some members recalled that initially the pandemic had propitiated an increase in risk aversion, a deterioration of financial conditions and a recomposition of investors' portfolios. **One** member pointed out that, despite the recent improvement, different analysts have warned about a possible overvaluation of equity markets and that certain studies indicate an increase in the rate of default of high-yield bonds.

Most members stated that financial markets in emerging economies showed a positive performance as well. However, the majority of members specified that equity markets continue registering outflows, which, according to **one** of them, denotes a persisting sentiment of risk aversion. **Some** mentioned that inflows in fixed-income instruments were observed. Nonetheless, **one** member considered that the demand for such instruments remains weak, as well as the fragility and the low depth in financial markets of emerging economies, which have been affected by the important economic contraction as well as by the fall in commodity prices and other revenues from abroad. He/she underlined that during this period of higher uncertainty, these economies registered exchange rate and interest rate pressures, increases in risk premia, falls in stock market indexes and capital outflows. He/she added that agencies have downgraded the credit ratings of multiple sovereign issuers and firms, exacerbating the financial shock and the risk aversion process in a pro-cyclical fashion. **Another** member mentioned that the fiscal front in emerging economies continues to be a risk factor, since a deterioration both in the balances as well as in the debt to GDP ratio is expected, due to the budgetary pressures arising from the stimulus programs and decreased economic activity.

Most members mentioned that global financial conditions will remain subject to the evolution and the effects of the pandemic, and therefore the environment of uncertainty is expected to persist. One member noted that the dynamics of contagion associated with the pandemic can deteriorate and affect once again economic activity and markets, with the consequent impact on firms and households' solvency as well as on the less-sound financial intermediaries.

Economic activity in Mexico

All members made reference to the severe deterioration of economic activity in Mexico. Most members pointed out that it contracted significantly during the first quarter of the year and that, according to available information, the impact of the pandemic intensified in April. Some members stated that an important fall is estimated for the second quarter. **One** member indicated that it would be deeper than expected since, because of the duration of the pandemic, the reopening of economic activities has been more gradual than anticipated. He/she considered that, although limited available information and high uncertainty make an accurate analysis of the recent performance of economic activity difficult, different indicators show a smaller contraction, or even a slight recovery, at the beginning of May, although starting from very low levels, mainly as a result of the gradual reopening of the economy.

Most members pointed out that the lockdown measures have affected aggregate demand. One member stated that, at the end of the first quarter, consumption and investment contracted 1.2 and 9.5%, respectively. He/she added that these are estimated to have continued declining as a result of uncertainty and the large loss of employment.

Most members highlighted that different indicators that fell in April, such as the National Association of Self-Service and Department Stores (ANTAD, for its acronym in Spanish) sales, light vehicles sales and gasoline consumption, showed certain improvement in May. One member added that during the latter month, spending on credit cards registered an annual fall of 34%. As for external demand, **some** members indicated that imports and exports decreased considerably in April. **One** member mentioned that automotive exports fell 79%.

From the supply side, most members indicated that in April industrial production contracted 29.6% in annual terms, reflecting disruptions in global value chains and production shutdowns. Some members pointed out that manufacturing production and construction decreased 35 and 38% in annual terms, respectively, and highlighted the weakness of the services sector. **One** member underlined the contraction in entertainment, accommodation and food preparation services.

As to the labor market, most members emphasized the significant fall in employment figures. The majority of members pointed out that, according to INEGI data, considering both formal and informal workers, job losses amounted to 12.5 million in April. One member indicated that over 10 million correspond to the informal sector and that most jobs lost had incomes of two minimum wages or less, which indicates that the most vulnerable sector of the population has been particularly affected. **Some** members pointed out that during the first five months of the year around one million IMSS-insured jobs were lost. **One** member added that withdrawals from personal Afore accounts due to unemployment reached historical maximum levels. **Another** member added that, according to INEGI's Telephone Survey of Occupation and Employment, the national unemployment rate is currently at 4.7%.

Most members highlighted the rise in the number of underemployed workers as well as in the population that is not economically active, but is available for work. One member expressed that the lower labor participation partially explains why the unemployment rate did not increase so much. **Another** member pointed out that, if individuals that are "available" for work are considered as part of the economically active population, the "concealed" unemployment rate would be 25.4% of the labor force. He/she added that if underemployed workers are included as well, the rate for the indicator known as the labor gap would reach 50.6%. **One** member underlined that the number of individuals either unemployed, available for work or underemployed, increased by over 20 million between March and April. **Another** member argued that, considering the number of businesses that have closed down permanently, based on the number of those that have withdrawn their registration at the IMSS, it can be concluded that a large part of the current unemployment is permanent, since these are not jobs that may be regained during the reactivation of the economy.

Most members stated that, although the reopening of certain economic sectors and regions in May and June will foster a slight recovery of economic activity, the impact has been considerable and uncertainty persists. The majority of members added that indicators of manufacturing orders and of business and consumer confidence are at low levels. One member indicated that implementation of the USMCA and the anticipated recovery of the US economy should support investment, but that this would hardly be sufficient to raise it to the required levels, given the perception by the corporate sector of an important worsening of the business climate. He/she asserted that in the next months investment is unlikely to support the economic recovery significantly. **Another** one mentioned that economic activity is expected to improve gradually during the second half of the year, as the pandemic is brought under control and the economy is reopened.

All members underlined that the growth outlook has deteriorated. Most members indicated that for 2020 there are even projections of a two-digit contraction. Some members specified that the IMF has recently adjusted its forecast from -6.6 to -10.5%. **One** member added that the consensus of analysts' forecasts has been adjusted from -7.5 to -8.3%. **Another** member mentioned that there is a broad dispersion in the projections, which reflects high uncertainty, and that downward revisions for 2020 have not been offset by the corresponding upward adjustment in expectations for 2021, which point to a modest recovery. **One** member stated that a very deep recession is currently being observed, with a slow and complex "U"-shaped recovery, due to the severe deterioration of investment and consumption. He/she added that the possibility of a second COVID-19 outbreak, or that the sanitary and economic measures are simply insufficient, has increased the risk of a "W"-shaped economic recovery. **Another** member pointed out that the duration and depth of the economic contraction depends on the suspension of economic activities established by the authorities as well as on self-imposed restrictions by the productive agents, which, in turn, will depend on progress in the development of a therapy or a vaccine against the virus.

Most members agreed that the balance of risks for growth remains significantly biased to the downside. The majority of members stressed the risk of a new COVID-19 outbreak. One member cautioned that it could lead to financial and solvency problems. **Some** members emphasized the risk that the health measures that have been adopted to contain the epidemic are not sufficient. **One** member indicated that a high rate of contagion has been observed in Mexico. **Another** member noted that the estimated date on which the health crisis will reach its peak in Mexico has been repeatedly delayed, which combined with the experience in other countries suggests that the risk of new outbreaks once the process of economic reopening deepens is high. On the other hand, **some** members mentioned the lack of a balanced policy approach, particularly on the fiscal front, to foster the economic recovery. **One** member underlined that the potential implications to the productive apparatus can have a prolonged effect on employment and consumption levels.

Most members agreed that economic slack has widened significantly. Some members added that the recent decline in growth forecasts allows to anticipate that the negative output gap will continue widening. **One** member emphasized that the output gap is at levels unseen since the 2008-2009 financial crisis.

Inflation in Mexico

Most members mentioned that annual headline inflation rose from 2.15 to 3.17% between April and the first fortnight of June 2020 due to increases in both its non-core and core components. Most members agreed that the recent performance of inflation is associated with demand- and supply-related shocks derived from the pandemic. Some members stated that the weakness of domestic demand has been reflected in lower price variations of different goods and services. **One** member pointed out that for several months headline inflation has been close to its target, mainly as a result of fluctuations in the non-core component, since core inflation has not declined. **Another** member recalled that in May headline inflation remained below the target for the second consecutive month. **One** member pointed out that the referred shocks have led to a recomposition of relative prices, which has led to higher food prices to the detriment of the most vulnerable households, a phenomenon that is not adequately reflected in the CPI, considering the weights used in its measurement.

Delving into the evolution of non-core inflation, most members emphasized that energy prices contracted in annual terms, although **some** members stated that these have increased recently. **Most members noted the increase in fruit and vegetables prices. One** member pointed out that such increase is due to a comparison base effect and to transitory factors. He/she considered that the effect of low energy products' prices prevails over the rebound in fruit and vegetables prices.

As to core inflation, most members highlighted the rise in food merchandise prices, due to possible supply problems and to a reallocation of household's spending in light of the health emergency. Some members underlined that core inflation remains at high levels. **One** member considered that the persistence of this component, despite the economic contraction and the higher levels of economic slack, suggests that increases in some line items such as food merchandises, have outweighed the reductions observed in non-food merchandise and services prices. **Another** member pointed out that social distancing is interrupting the provision of several services, whose price variations are decreasing. **One** member noted that three of the five major core inflation components registered annual rates of change below 3% in the first fortnight of June: housing, non-food merchandises and services other than education and housing. He/she added that educational services prices registered an annual inflation above the inflation target, which is explained by the fact that said prices tend to be fixed in August, and that thus, it will not be until that month that an adjustment will be observed in said indicator. He/she considered that the only component with a really unfavorable behavior is that of food merchandises, which has increased due to a reallocation of household spending and to disruptions in the supply of certain goods. Nevertheless, he/she pointed out that at least part of these effects may possibly disappear once consumption and supply of said merchandises return to normal.

Most members noted that headline inflation expectations for the end of 2020 remain at levels near the target, and those for the medium and long terms have remained relatively stable, although at levels above 3%. One member stated that headline inflation expectations for 2020 increased from 2.90 in April to 3.07% in May. **Another** member added that medium- and long-term core inflation expectations also lie close to 3.5%. He/she highlighted that it is surprising that core inflation expectations for the next five to eight years have increased to such level in the course of this year, which suggests the risk of them becoming unanchored. He/she noted that, although he/she does not agree with these projections, they reveal the uncertainty that prevails regarding the behavior of inflation and, particularly, the potential of new shocks on prices, as well as the risk of the peso exchange rate being subject to pressures, due to external or domestic factors. **One** member pointed out that inflation expectations drawn from both surveys and market instruments increased slightly after the publication of the latest monetary policy decision and the latest Quarterly Report. Thus, he/she argued that it is essential that the central bank communications do not validate a pessimistic outlook on the economy since this affects the perception of private agents.

As to the expected trajectory for inflation, **another** member pointed out that the central bank baseline scenario expects that it will lay around the target within the horizon in which monetary policy operates. He/she added that, if the adequate performance of both global and domestic financial markets and of the peso exchange rate continues, it may contribute to a trajectory slightly below the one published in the latest Quarterly Report. **One** member stated that annual inflation would lie at levels close or even below the target for the remainder of 2020. He/she mentioned that the lower oil prices, the weakness of aggregate demand, a stable exchange rate, and a low pass-through would contribute to this. Similarly, **another** member mentioned that headline inflation shows an important decline since last year and short-term inflation expectations lie at around 3% for the end of the year, mainly motivated by the widening of the output gap in negative territory. **One** member considered that it is not foreseeable that headline inflation will converge to the target during the rest of 2020 or the beginning of 2021, given the possible behavior of non-core inflation. He/she added that, in the absence of further shocks, core inflation should start to reflect in that span of time the impact of the wide negative output gap. He/she pointed out that it is reasonable to anticipate that headline inflation will converge to the target during the second half of 2021, although inflation expectations show that private sector forecasters are not incorporating such scenario.

Regarding the risks for inflation, **some** members highlighted the downward pressures stemming from a greater than expected impact of the wider negative output gap and from downward inflationary pressures worldwide. As to upward risks, **some** members mentioned additional episodes of foreign exchange depreciation, as well as logistical and supply-related problems concerning certain goods and services. **One** member added the possibility of the increase in labor costs in previous months affecting inflation. He/she noted that although inflation remains at low levels, there are upward pressures on items that affect lower-income households. He/she also highlighted that uncertainty worsens due to measurement challenges stemming from the impact of the lockdown. He/she stated that difficulties in price collection may imply challenges to the comparability of indicators and lower information quality.

Most members pointed out that the balance of risks for inflation remains uncertain. In this regard, **one** member noted that the supply and demand shocks faced are passed on to the price formation process through different channels that generate both upward and downward pressures; thus, the net effect is uncertain. **Another** member emphasized that the outlook for the global and domestic economy remains uncertain and subject to bouts of high volatility. In this regard, he/she considered that the balance of risks for inflation vis-à-vis the updated outlook remains uncertain. He/she mentioned that the final result of factors that could put downward or upward pressures on inflation will depend on the intensity of the effect of each of them, in an environment of deep economic weakness both globally and domestically. He/she added that, if the financial shock remains contained, the effects of the significant widening of the negative output gap could predominate in a longer-term horizon. **Another** member expressed his/her view that, in light of the uncertainty about the evolution of the pandemic and economic activity, and of pressures on prices in both directions, downward pressures prevail over upward pressures on inflation, and that it is very likely that they will continue to do so.

Macrofinancial environment

Most members noted that, since the latest monetary policy decision, there has been an improvement in the performance of domestic financial markets. Some members highlighted that this was partly due to the measures adopted by Banco de México. **One** member mentioned that external factors, particularly a greater optimism about the performance of advanced economies due to the gradual resumption of productive activities, have also contributed importantly to said results. **Most members pointed out that the peso exchange rate appreciated and interest rates on government securities, particularly for short terms, have decreased moderately. Some** members added that the sovereign risk continued to adjust downwards and that the stock market showed an improvement.

Nevertheless, most members noted that risks persist and capital outflows have continued, although at a slower pace vis-à-vis what was observed some weeks ago. Some members pointed out that accumulated figures indicate outflows higher than USD 13 billion in fixed income. In this regard, **one** member underlined that total government securities held by non-residents currently amount to around USD 90 billion. **Another** member added that cumulative figures for the year show zero flow in the case of equity instruments. **Some** members warned that trading conditions remain deteriorated in the FX and fixed income markets. **One** member stated that the Mexican peso remains among the emerging economies' currencies with the largest annual depreciation and that the balance of the net foreign exchange-rate position continued to widen negatively. He/she mentioned that the steepening of the yield curve suggests that there are still concerns about idiosyncratic factors. As to risks for domestic financial markets, **some** members highlighted the persisting challenges over the situation of Pemex and public finances, as well as the institutional weakening. Regarding external risks, **one** member mentioned that those stemming from the pandemic, the relationship between the United States, China and other countries, and the US presidential election stand out.

Most members highlighted that, in this adverse environment, perseverance in strengthening the macroeconomic fundamentals and adopting the necessary actions, regarding both monetary and fiscal policies, will contribute to a better adjustment of domestic financial markets and of the economy as a whole. One member added that the adverse shocks that the economy is facing must be mitigated to contain the impact on employment and to preserve productive capacity. The above within a framework that maintains the sustainability of public finances, a low and stable inflation, as well as a sound and well-capitalized financial system.

Some members noted that in April budgetary revenues were below the programmed amount, and that even after considering the use of resources from the Budget Revenue Stabilization Fund (FEIP, for its acronym in Spanish) and other extraordinary revenues, public finances are expected to show a significant deterioration during the year. In particular, **one** member highlighted that the shortfall in oil revenues including oil hedges, and tax revenues excluding those from the excise tax (IEPS, for its acronym in Spanish), would be between 2.2 and 3.0% of GDP at the end of 2020. He/she mentioned that such shortfall would be partially offset with the use of non-recurring revenues from the FEIP and with the recovery of financial assets from funds and trusts.

Most members expressed concern on Pemex's situation. In particular, **one** member warned that the shortfall in public revenues may widen in the face of additional capitalization requirements by the state-owned company, due to its financial problems, the sharp fall in its sales and the continuation of non-profitable projects, the financial burden and risk of which concentrate on the federal government. **Another** member highlighted that the need to design a long-term solution for Pemex's problems has increased. He/she added that, in the absence of specific measures in said direction, as well as in general to permanently strengthen government revenues, it would not be convenient to seek greater support from fiscal policy to face the pandemic, taking into account the expected decline in the FEIP balances and the resulting increase in the vulnerability of public finances. Although he/she acknowledged that there is also the option of an important reallocation of public spending, he/she considered that no support for adjustments of such nature is perceived.

As for sovereign credit rating revisions and possible additional downgradings, **one** member warned that these have resulted in tighter financial conditions for both government and firms. He/she stated that the recently observed corporate debt issuances continue to be insufficient to roll-over short-term debt that has being maturing during the year and that, for this reason, firms have resorted to commercial banks. He/she stated that even though credit channels continue to function in an orderly manner and do not show warning signs, the delinquency rates of consumption and corporate portfolios in the segment of small- and medium-sized firms (SMEs) have risen. He/she mentioned that according to the latest Financial Stability Report, at the beginning of the pandemic the banking system overall was in a solid position; however, some smaller banks could face problems. He/she added that without decisive fiscal supports, firms and households' situation could rapidly deteriorate regardless of the availability of resources and the level of interest rates.

When analyzing the longer-term macroeconomic situation, **another** member stated that the outlook for investment, which is fundamental for the potential growth of the economy, is worrisome. He/she warned that investment has been following a downward trend since mid-2018 and is currently at levels similar to those at the beginning of 2011. He/she mentioned that although the pandemic recently influenced this behavior, the main determinants have been the situation of public finances and an environment which is considered unfavorable for private investment by the business sector. He/she highlighted that, for the first time since 2011, Mexico is no longer part of the list of the main 25 foreign investment destinations in a survey conducted by a consulting firm. He/she underlined the business sector's persisting concern for the country's rule of law and insecurity situation, the deterioration of the institutional framework, and the orientation of some public policies, among other aspects.

Monetary policy

Taking into account the referred risks for inflation, economic activity and financial markets, and based on the foreseen scenarios and on the room for maneuvering that on balance these provide to monetary policy, all members agreed to lower the target for the overnight interbank interest rate by 50 basis points to a level of 5%.

One member pointed out that monetary policy faces challenges in two dimensions: the deep economic contraction associated with the pandemic and its effects on inflation, and the impact of the financial shock of global risk aversion on the peso exchange rate and investment portfolios. The above considering that domestic financial markets are highly integrated to international markets, where the Mexican peso is one of the few emerging economies' currencies that is fully convertible, with 80% of its volume traded among non-residents, which implies low operating costs for holding short- or long-term positions in pesos. He/she highlighted that, to the extent that the relative importance of global risk factors decreases, idiosyncratic elements such as the economic and financial soundness, the growth outlook, and remaining an attractive destination for investment, will gain relevance once again to avoid abrupt adjustments in portfolios. In this context, he/she argued that the monetary policy stance should consider both the economy's cyclical position and its influence on inflation, as well as the financial conditions required for macroeconomic stability and an orderly adjustment in financial markets and in the financial system. He/she added that, considering that the financial and economic activity shocks operate at different horizons, it is important to mitigate the financial shock in the best possible way, in order to have greater room for maneuver to face the impact of the shock on economic activity. He/she stated that to the extent that an orderly adjustment of financial markets is achieved, it will be possible to maintain a domestic inflation process in line with the global trend towards lower inflation.

As for the determinants of capital flows to emerging economies, **some** members pointed out that insofar as global risk aversion decreases, idiosyncratic factors may gain relevance. **Some** members argued that in this context the spread between domestic and external interest rates may gain greater importance in offsetting idiosyncratic risks and avoiding net capital outflows. **One** noted that there is recent evidence that this is already happening. **Another** member noted that a considerable number of emerging economies have reduced their interest rate spread more than Mexico, without jeopardizing their financial markets or inflation targets. He/she added that there is evidence showing that capital flows also depend on growth expectations, and therefore to the extent that a lower interest rate contributes to growth, it could contribute to maintain or attract greater capital flows. He/she stated that the increase in long-term asset holdings by the US Federal Reserve implies a *de facto* decrease of its interest rate, meaning that it is not necessarily correct to measure the interest rate spread vis-à-vis the federal funds rate. In this regard, he/she argued that a less restrictive monetary policy could contribute to reduce the risk of a very deep economic fall, which would contribute to a better performance of financial markets. **One** member noted that several indicators show that, with the monetary policy decisions taken in the last months, the interest rate spread adjusted by exchange rate volatility vis-à-vis other emerging economies has narrowed considerably. He/she stated that this is important for an economy as open to capital flows as that of Mexico, and where its currency is frequently used to hedge risks in other emerging economies due to its high liquidity. He/she warned that this brings to the fore the limitations of making direct comparisons between interest rate levels in Mexico and other emerging economies. He/she also pointed out that, unlike Mexico, in most major emerging economies headline and core inflation are below their respective central banks' targets. He/she also highlighted that, given the inflation levels and the high volatility of the peso exchange rate, the latter may have significant implications for the attainment of the inflation target in Mexico, despite its low pass-through.

Most members considered that monetary policy should continue to incorporate all available information and consider the persisting environment of uncertainty. Some members stated that all challenges and dilemmas that monetary policy is facing must be identified and a wide range of scenarios must also be considered. **One** member argued that, in light of the downward revisions to economic growth for this year, the wider economic slack, the appreciation of the peso and the recent evolution of inflation, there is some room to continue easing monetary policy. He/she noted that the challenge is how to manage such room. In this regard, he/she emphasized that in face of the global and domestic uncertainty no scenario, neither benign nor of additional deterioration, can be ruled out; thus, monetary policy should be conducted with extreme caution, continuing with a gradual approach, monitoring the latest information to update forecasts and maintain room for maneuver to take the necessary actions in a timely and prudent manner. In this context, he/she added that it is essential to monitor the persisting risks, some of which have already started to materialize. Among the risks to be considered, in addition to the aforementioned, he/she highlighted: i) the volatility stemming from domestic or external factors that may affect the peso exchange rate and its impact on inflation forecasts; ii) the persistence of core inflation at high levels, despite the increased amount of economic slack and the uncertainty about the net effect of supply- and demand-related shocks, and iii) idiosyncratic risks, in particular, weak public finances for 2020 and 2021 and the vulnerable financial situation of Pemex, in a context in which the loss of the investment grade of the sovereign credit rating is not ruled out. **Another** member stated that, although there appears to be additional room to reduce the policy rate, it is to be expected that risks are also increasing and thus any adjustment in such direction should be based on that assumption. In this regard, he/she highlighted that in addition to the important tightening of interest rate spreads relative to other emerging economies, and the volatility to which the peso is subject, it is essential to consider that the balance of risks for inflation remains uncertain; that long-term inflation expectations continue above the target; that core inflation is not yielding; and that the possibility of an unanchoring of long-term expectations for this component has increased.

One member argued that in terms of the absolute monetary policy stance, slack conditions offer room for further monetary easing. He/she stated that in the face of a crisis of unprecedented magnitude, a much laxer monetary policy stance would support the weak economic activity. He/she added that in terms of the relative policy stance, lower risk premia open up the possibility for a smaller spread. Nonetheless, he/she pointed that said room could face limitations in the future, since such premia could be underestimating global risks. He/she pointed out that possible medium-term negative effects on the macrofinancial framework, resulting from easing the monetary policy that is needed in the short term, should also be considered. He/she highlighted that a terminal rate will eventually be attained and an excessive reduction in the interest rate could discourage savings, domestic and foreign, which are scarce in the country. In particular, foreign capital has shown, even before the increase in risk aversion due to the pandemic, a decline in its enthusiasm for investing in this country. He/she underlined that an excessively low interest rate could affect bank savings, the exchange rate and could distort the prices of other financial assets, which in the medium term could have implications for financial stability.

The same member stated that the adjustment of interest rates will depend on the evolution of risks and on the behavior of the economic cycle. He/she added that given the economic outlook, the lack of fiscal support and the fragile foundations for the decline in inflation, the strategy will be to consider daily incoming information as the best guide in the future. He/she stated that the scope of monetary policy and the room for maneuver must be taken into account to sensibly respond to the uncertainty. Among the referred scope, he/she mentioned the implementation of programs to provide liquidity, increase the flexibility of the regulatory framework, loosen prudential measures, and other tools to strengthen the functioning of the financial system. He/she considered that so far the response to uncertainty is to continue the process of monetary easing by lowering the reference rate in a fixed amount, at a constant speed, which markets can fully anticipate.

Another member considered that in light of the significant economic contraction that is foreseen and the challenges that this implies, the central bank must act cautiously but firmly and use all the instruments at its disposal. This implies for the real interest rate to possibly be taken to levels close to zero or even negative before the end of the year, as long as the inflation rate remains close to target. He/she indicated that the central bank must be willing to act in case signs of a significant deterioration of economic-financial conditions arise, and that this includes taking actions in unscheduled dates.

Most members considered important to continue implementing measures to strengthen the credit provision channels, provide liquidity and foster the well-functioning of the financial system. **Some** members considered that said measures could be more effective with a lower policy rate. **One** member stated that the policy rate has an impact on economic activity through various channels, including the credit channel. He/she added that in the current juncture, the availability of credit is crucial to prevent solvent firms from going bankrupt due to liquidity problems, and therefore the central bank measures to facilitate lending to small- and medium-sized firms are appropriate. However, he/she considered that if these are not accompanied by a sufficiently low interest rate, economic agents will not have incentives to acquire credit and their demand will remain limited. He/she mentioned the importance of avoiding that the Central Bank actions in one dimension (credit facilities) be limited by its actions in another dimension (interest rates). **Another** member added that the persistence of risk aversion and pressure in financial markets point to the need to ensure adequate liquidity levels in markets and lax monetary conditions.

Some members pointed out the importance of Banco de México focusing on fulfilling its primary mandate. **One** member stated that monetary policy's best contribution during the recovery phase is to fulfil this mandate and thus avoid households' purchasing power from further deteriorating. He/she mentioned that the central bank needs to monitor the circumstances that reduce the purchasing power of low-income households and that worsen the severe loss of income of the unemployed population. **Another** member stated that monetary policy's best contribution to strengthening public finances is to focus on fulfilling its mandate, as this leads to sustained reductions in interest rates along the yield curve and ultimately fosters economic growth. He/she argued that if the support to public finances were to be perceived as part of monetary policy's reaction function, markets would rapidly consider it as a situation of fiscal dominance, which would affect the central bank's credibility and the level of medium- and long-term interest rates, with substantial negative effects on the fiscal accounts and on the Mexican economy.

One member pointed out that the central bank communications must highlight the need for maintaining inflation at low levels, especially in the items of greater relevance for the population, such as food merchandise, in order to prevent inflation expectations from becoming unanchored. **Another** member pointed out that the monetary policy statement must emphasize that, by taking into account new downward revisions to growth expectations, the policy decision is consistent with the convergence of inflation to the target within the time frame in which monetary policy operates. He/she added that it must emphasize that Banco de México will remain attentive to incoming information to continue acting, as it has done so far, with timeliness and caution.

3. MONETARY POLICY DECISION

Taking into account the referred risks for inflation, economic activity and financial markets, major challenges arise for monetary policy and for the economy in general. Based on the foreseen scenarios, and considering the room for maneuvering that on balance these provide to monetary policy, with the presence of all its members, Banco de México's Governing Board decided unanimously to lower the target for the overnight interbank interest rate by 50 basis points to a level of 5%.

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

4. VOTING

Alejandro Díaz de León-Carrillo, Irene Espinosa-Cantellano, Gerardo Esquivel-Hernández, Javier Eduardo Guzmán-Calafell and Jonathan Ernest Heath-Constable voted in favor of lowering the target for the overnight interbank interest rate by 50 basis points to a level of 5%.

ANNEX

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

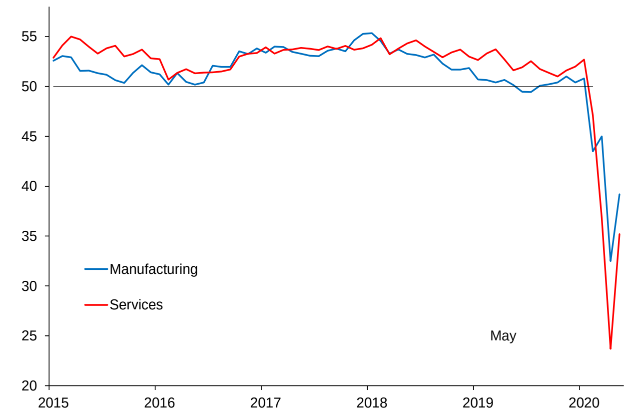
A.1. External conditions

A.1.1. World economic activity

The COVID-19 pandemic and the measures adopted to prevent its spread have considerably affected world economic activity. The contraction of economic activity observed in the first quarter intensified during the second, although some indicators from various economies exhibited some improvement in May (Chart 1). Headline and core inflation in the main advanced economies are below their respective central bank's targets. In this context, monetary authorities have lowered interest rates to historically low levels and have used their balance sheets to foster an orderly functioning of financial markets. Likewise, several countries have implemented important fiscal stimulus measures to mitigate the adverse effects on employment and on households' and firms' income.

Several multilateral organizations and analysts have again revised downwards their economic expectations for 2020, incorporating a bigger contraction of economic activity, with a recovery in 2021. Given that the economic impact stems from the pandemic dynamics, such expectations continue to be subject to a high degree of uncertainty. Other risk factors present are the possibility of an escalation of trade and geopolitical conflicts among some major economies; the possibility of a deterioration of households', firms' and financial institutions' financial situation; and a worsening of the social conflicts recently registered in different countries.

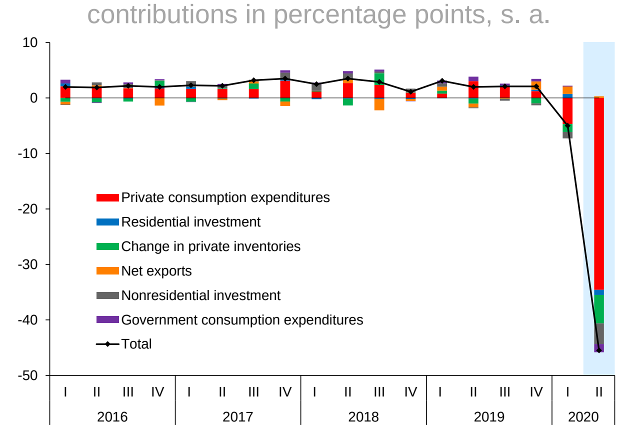
Chart 1
Global: Purchasing Managers' Index (PMI) Production Component
Diffusion index, s. a.



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

In the United States, available indicators point to a sharper fall in GDP growth during the second quarter of the year, reflecting a greater weakness in private consumption and business investment, generated mainly by lockdown measures, which had a particularly severe impact in April (Chart 2). Although some activity and leading indicators, such as retail sales, industrial production, and housing starts, recovered slightly in May, after having plummeted in April, most remain below the levels observed prior to the pandemic.

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



s.a. / Seasonally adjusted figures.
Note: Second quarter figures were drawn from GDP Now.
Source: Bureau of Economic Analysis (BEA), Federal Reserve Bank of Atlanta.

In April, US industrial production fell 12.5% (at a monthly rate), the highest drop in the history of this indicator. This reflected the closing of activities in most sectors, with the nearly total shutdown of manufacturing activities standing out. In May, industrial activity improved marginally, registering a monthly growth of 1.4%, driven by a slight recovery in manufacturing activity due to the gradual reopening of most productive sectors. Although certain available indicators to June, such as the Purchasing Managers' Index (PMI) of the manufacturing sector and the manufacturing indices of the Federal Reserve Banks of Philadelphia and New York, suggest that such reactivation trend will continue, industrial activity is expected to continue exhibiting lower levels during the second quarter of the year vis-à-vis those observed prior to the pandemic.

Although in May the non-farm payroll increased and the unemployment rate decreased in the United States, the labor market in that country continued to show a sharp deterioration. In particular, 2.5 million new jobs were created in May, only partly reversing the 22.6 million jobs that were lost in March and April. In turn, the unemployment rate was 13.3% in May, after having registered a rate of 14.7% in April 2020, nearly 10 percentage points above its February's level. On the week ending on May 9, current unemployment insurance claims reached the highest level since they first started to be registered in 1967. Although they have been decreasing since that date, they still remain at historically high levels.

In the euro area, after GDP growth contracted at a seasonally adjusted annualized quarterly rate of 13.4% in the first quarter of the year due to the measures implemented to contain the COVID-19 spread, timely indicators point to an even further contraction during the second quarter. In particular, available indicators to April, such as retail sales and industrial production, contracted significantly. Nevertheless, available leading indicators to May and June reflect a slight improvement as a result of the gradual reopening of activities. Despite this adverse environment, the unemployment rate rose slightly from 7.1% in March to 7.3% in April, still registering relatively low levels. This is partly explained by the implementation of several job retention schemes in the region.

In Japan, GDP contracted at a seasonally adjusted annualized quarterly rate of 2.2% in the first quarter of the year due to the negative impact of the pandemic on domestic and external demand. Some indicators available to April and May suggest that the deterioration of economic activity may extend to the second quarter, even despite the gradual normalization of certain activities observed at the end of May. Nevertheless, the unemployment rate remains at low levels, increasing from 2.5% to 2.6% between March and April.

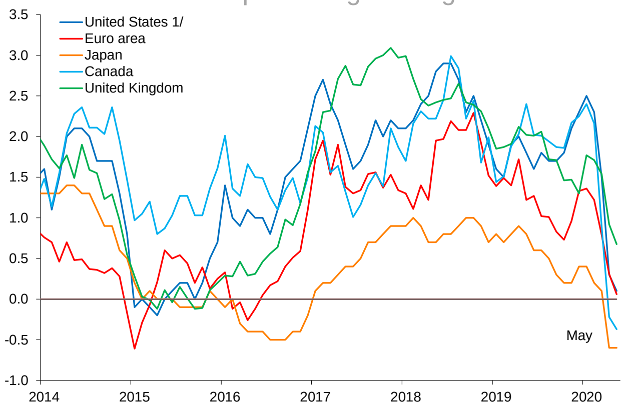
In emerging economies, the latest information indicates that economic activity may deteriorate further during the second quarter of the year, although with differences among countries. In China, economic activity indicators slightly recovered in May, registering increases in industrial production, a rebound of fixed investment, and a lower contraction of retail sales. Nevertheless, recent coronavirus outbreaks in that country's capital have increased the uncertainty about the possibility of implementing new mobility restrictions that may affect economic activity. For its part, most Latin American economies may be significantly affected by restrictions on productive activity to contain the COVID-19 spread as well as by idiosyncratic factors, among which those of Argentina and Brazil stand out.

Since Mexico's previous monetary policy decision international commodity prices adjusted upwards, although they have accumulated considerable losses during the year. In particular, crude oil prices have been supported by production cuts by Organization of Petroleum Exporting Countries (OPEC) members and other producers. The easing of lockdown measures in some countries and the decrease in US crude oil inventories have also contributed to the recovery of said prices. In the last weeks industrial metal prices have increased due to the gradual restart of industrial production worldwide. Finally, grain prices increased slightly due to expectations of greater global demand and restrictions on grain exports that remain in place in Russia.

A.1.2. Monetary policy and international financial markets

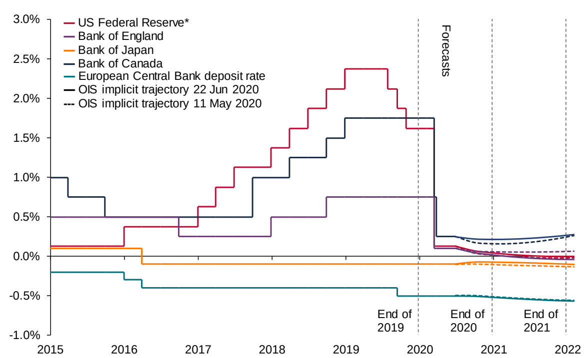
In most advanced economies, headline and core inflation continued to decrease due to the low energy product prices and the lower pace of economic activity (Chart 3). Thus, inflation rates in these economies remain far below their respective central banks' targets, standing close to zero in some cases and even below that level in others. In addition, inflation expectations drawn from both financial instruments and surveys remain at low levels. In most emerging economies, headline and core inflation also registered lower levels in April, mainly reflecting the impact of lower economic activity levels. In this environment, several central banks of advanced and emerging economies adopted historically low interest rates and have used their balance sheets to foster the well-functioning of their financial markets. Looking ahead, expectations drawn from market instruments continue to anticipate that central banks will maintain highly accommodative monetary policy stances (Chart 4).

Chart 3
Selected Advanced Economies: Headline Inflation
Annual percentage change



1/ Refers to the Consumer Price Index (CPI).
Source: Haver Analytics.

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



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

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

i) In its June meeting, the US Federal Reserve (the Fed) left unchanged its range for the federal funds rate at 0%-0.25% and reiterated that it expects to maintain the funds target range at its current level until the economy overcomes the recent events. In addition, it highlighted that to foster credit to households and firms it will increase its holdings of Treasury securities and residential and commercial mortgage-backed bonds at least at the current pace in order to support the well-functioning of markets. Prior to its decision, the Fed also announced an extension to its Main Street Lending Program to allow that a larger number of small- and medium-sized firms receive economic support. The median of projections of the Federal Open Market Committee (FOMC) reflected expectations of a contraction of GDP growth in 2020 and a rebound in 2021. Such projections also anticipate lower headline and core inflation levels and higher unemployment rates for 2020, 2021 and 2022 as compared to the prior projections published in December 2019. In this context, the medians of FOMC projections suggest that the reference rate will be left unchanged until 2022. Only two members are anticipating an increase in that year. In this environment, both market variables as well as the consensus of forecasters consider that the Fed will leave the reference rate unchanged by the end of 2020 and 2021.

ii) In its June meeting, the European Central Bank (ECB) left its policy rates unchanged, maintaining its refinancing rate, key deposit facility rate and key lending facility rate at 0.0, -0.5 and -0.25%, respectively. At this meeting, it announced an increase in its pandemic emergency purchase program (PEPP), from €750 billion to €1,350 billion, extending it to June 2021 or until the Monetary Policy Committee considers that the crisis phase is over. In addition, it pointed out that bond maturities associated with the PEPP would be reinvested until the end of 2022. The ECB also left its asset purchase program unchanged. Likewise, it restated that interest rates will remain at their current levels or below until inflation attains its symmetric target in a sustainable manner. Finally, that central bank highlighted that, with the adjustments to its monetary policy stance, it would promote bank financing to the private sector.

iii) In its unscheduled meeting of May and its June meeting, the Bank of Japan left its short-term policy interest rate unchanged at -0.1% and its long-term interest rate (indexed to its 10-year bond) at around 0%. Nevertheless, as part of its special program to face the coronavirus impact, in its May meeting it announced an additional measure to provide funds to small- and medium-sized firms for up to ¥30 trillion. In June it also increased two of the special corporate operation facilities, estimating that they would amount to ¥110 trillion (approximately USD 1 billion). The Bank of Japan's Governor pointed out that interest rates may remain at the current levels until 2023, warned that the COVID-19 has had a greater-than-expected impact on the economy, and noted that that central bank is prepared to expand its actions if necessary.

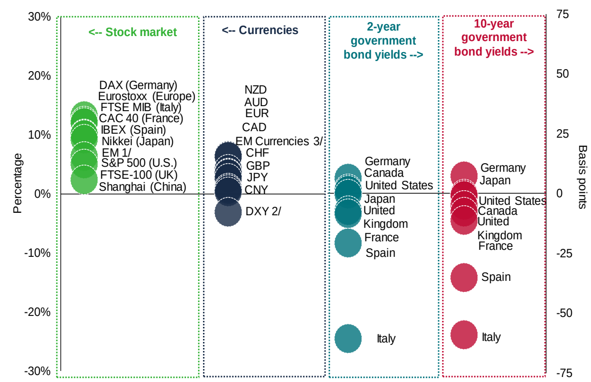
iv) The Bank of England left its policy rate unchanged at 0.10%, while announcing an increase in government bond purchases for £100 billion, increasing the total size of its asset purchase program to £745 billion. It anticipates that this level will be reached at the end of the year, which, given the stabilization of liquidity conditions, would imply a lower pace of purchases vis-à-vis previous months. Looking ahead, that central bank mentioned that it will continue to monitor market conditions, take additional measures to drive economic activity, and ensure the sustained return of inflation to its 2% target.

v) In its June meeting, the Bank of Canada left its reference rate unchanged at 0.25%. In a context where financing conditions improved as of March, that central bank reduced the frequency of its repurchase (repo) operations and purchase of bankers' acceptances. It also pointed out that it remains ready to adjust the characteristics of its repurchase program if the development of financial markets requires it. It confirmed its commitment to continue with its mass asset purchases until economic recovery resumes a sustainable path. Likewise, in its statement it emphasized that any additional measures will be adjusted to provide the necessary monetary stimulus to attain the inflation target.

Since Banco de México's previous monetary policy decision, several central banks of emerging economies announced additional cuts to their reference rates, with those of Brazil, Colombia, Hungary, Indonesia, Romania, South Africa and Turkey standing out.

International financial markets exhibited a positive behavior during the period after Banco de México's last monetary policy decision, largely driven by the gradual reopening of economic activity in the major advanced countries and the publication of certain economic figures that revealed a slight recovery vis-à-vis the historic lows reached in March and April. Additionally, the fiscal, monetary and financial stimulus measures adopted by advanced economies continued to provide a significant support to financial markets. In this environment, a climate of lower risk aversion and volatility in stock exchange, foreign exchange, and fixed income markets was observed. The US dollar weakened against most currencies and stock indexes rose, while interest rates of government bonds registered limited adjustments in general (Chart 5). Nevertheless, since mid-June, financial markets have exhibited volatility once again due to concerns of a possible second wave of coronavirus outbreaks –particularly in light of the increase in new cases in China, the United States and Japan– and debate over a possible overvaluation of stock markets. In this context, emerging economies continued to register capital outflows, while most of their currencies appreciated against the US dollar and their stock markets registered improvements (Chart 6).

Chart 5
Change in Selected Financial Indicators from May 11 to June 22, 2020
Percent, basis points



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

Looking ahead, the behavior of international financial markets will depend to a great extent on the implementation of measures to contain the COVID-19 spread and the capacity to mitigate the negative impact of the pandemic on economic activity. In addition to the above, other risk factors that may lead to new episodes of tightening in global financial conditions persist, including the high valuations of certain financial assets; the increase in sovereign and corporate debt levels; the resurfacing of political tensions between the United States and China; and the US election process.

Chart 6
Emerging Economies: Financial Assets Performance from May 11 to June 22, 2020
Percent, basis points

Region	Country	Currencies	Equity markets	Interest rates 2Y	Interest rates 10Y	CDS
Latin America	Mexico	5.27%	2.05%	-22	-9	-73
	Brazil	8.72%	22.14%	-5	-71	-51
	Chile	1.03%	5.64%	-14	-30	-17
	Colombia	4.04%	5.19%	-28	-6	-164
	Argentina	-3.61%	6.14%	-239	-70	-396
Emerging Europe	Russia	5.40%	4.43%	-56	-33	-61
	Poland	5.21%	13.00%	-17	-6	-4
	Turkey	3.12%	16.18%	-86	-127	-148
	Czech Republic	6.28%	4.74%	8	11	-5
	Hungary	4.48%	6.79%	-27	-5	-6
Asia	Malaysia	1.53%	9.04%	-4	24	-37
	India	-0.60%	10.05%	-25	-18	-75
	Philippines	0.49%	11.42%	2	13	-21
	Thailand	3.59%	6.49%	16	13	-19
	Indonesia	5.34%	6.54%	-72	-88	-82
Africa	South Africa	5.93%	8.01%	-35	-55	-111

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

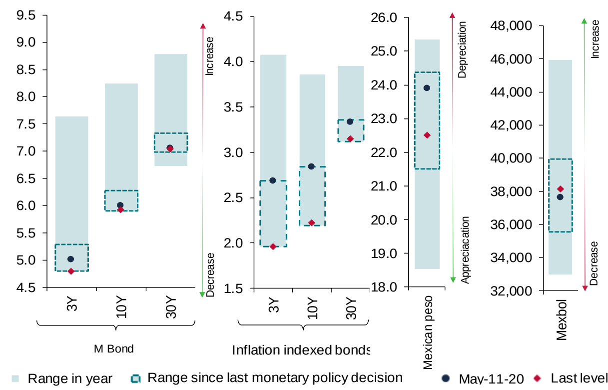
A.2. Current situation of the Mexican economy

A.2.1. Mexican markets

Since Banco de Mexico's previous monetary policy decision to date, the prices of financial assets in Mexico followed a positive behavior, in line with the dynamics observed in emerging markets overall (Chart 7). This took place in an environment where a decline in risk aversion was observed as a result of the slowdown in COVID-19 infection rates and the gradual reopening of economic activity in developed countries. Nevertheless, an environment of high uncertainty and caution by investors continues to be perceived due to the additional adverse effects that may stem from the pandemic and the risk of renewed outbreaks in some regions.

As for the peso exchange rate, it traded in a wide range of 21.50-24.30 MXN/USD and appreciated 5.27% during the period (Chart 8). This took place in a context where both realized and implied trading conditions improved, although they remained at relatively deteriorated levels vis-à-vis those of January.

Chart 7
Mexican Markets' Performance
Percent, pesos/US dollar and index



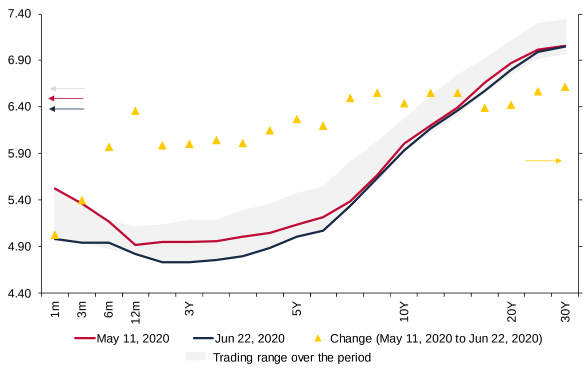
Source: Prepared by Banco de México.

Chart 8
Mexican Peso Exchange Rate with Moving Averages
Pesos/US dollar

Source: Prepared by Banco de México.

Interest rates of government securities decreased for all maturities, the most noteworthy being those in the short end of the yield curve (Chart 9). The yield curve of real-rate instruments exhibited decreases in all nodes. It is worth noting that such dynamics took place in a context where trading conditions improved at the margin.

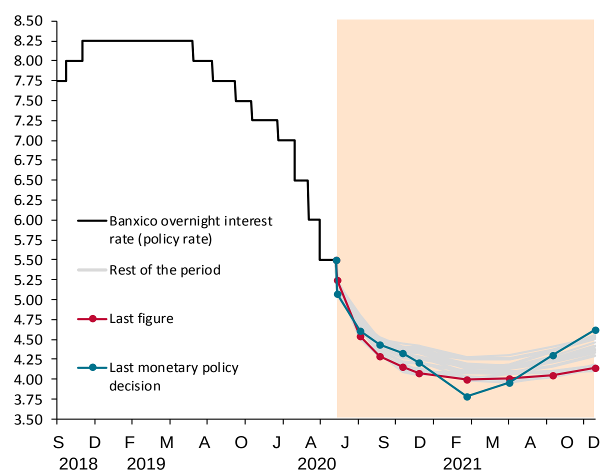
Chart 9
Nominal Yield Curve on Government Securities
Percent, basis points



Source: PIP.

As to expectations regarding the path of the monetary policy target rate, information implied by the Interbank Equilibrium Interest Rate (TIIE) swap curve discounts with a 60% probability a 50-basis point cut for the monetary policy decision of June (Chart 10). Likewise, private sector forecasters surveyed by Citibanamex are also expecting a 50-basis point cut. For the end of 2020, market variables are anticipating a target level of around 4.00%, while the median of surveyed forecasters expects a target level of 4.50%.

Chart 10
Banxico Overnight Interbank Rate Implied in TIIE IRS Curve
Percent

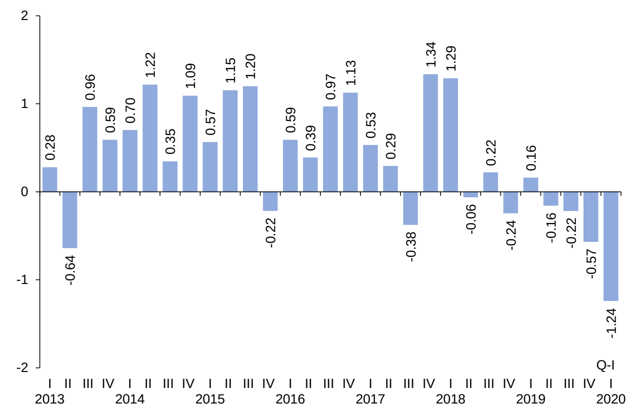


Source: Prepared by Banco de México with Bloomberg data.

A.2.2. Economic activity in Mexico

During the first quarter of 2020, productive activity contracted significantly, partly reflecting the marked weakness of the world economy and resenting in the last part of the period the initial impact of the measures adopted in Mexico to contain the COVID-19 spread (Chart 11). Available information indicates that the effects of the pandemic intensified in April. Although the reopening of some sectors and regions in May and June will promote a certain recovery of economic activity, the impact has been considerable and uncertainty persists.

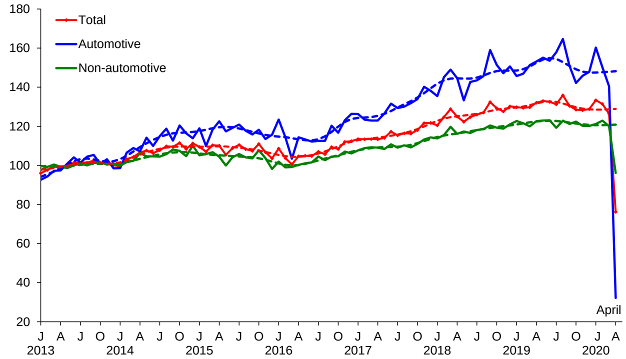
Chart 11
Gross Domestic Product
Quarterly percentage change, s. a.



s. a. Seasonally adjusted figures.
1/ The figure for the fourth quarter of 2019 refers to INEGI's GDP flash estimate.
Source: Mexico's National Accounts System (SCNM, for its acronym in Spanish), INEGI.

At the beginning of the second quarter of 2020, there was a significant contraction of Mexican manufacturing exports, in a context where both Mexico and other countries suspended several productive activities considered non-essential in light of the pandemic spread. Such contraction resulted from an overall reduction in this type of exports to both the United States and the rest of the world, with a significant fall in automotive exports standing out (Chart 12).

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

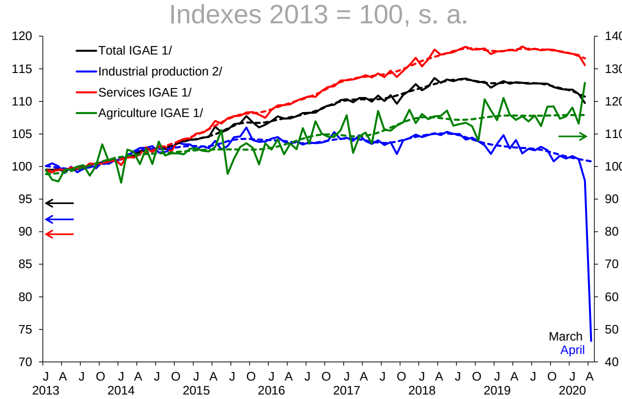


s. a. / Seasonally adjusted series and trend series based on data in nominal US dollars. The former is represented by a solid line and the latter by a dotted line.
Source: Prepared by Banco de México with data from the Tax Administration Service (SAT, for its acronym in Spanish), the Ministry of the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

In March 2020, the downward path of private consumption that was observed during the first two months of the year intensified considerably. This mainly reflected the contraction in the consumption of services due to the initial effects of the measures implemented to reduce the pandemic spread in the country. Timely information suggests that, at the beginning of the second quarter, significant additional effects on this aggregate were registered. In particular, in April the sales of manufacturing industries more related with domestic consumption declined considerably. In turn, despite the improvement in light vehicle sales observed in May, this indicator remained at low levels after the strong contraction exhibited in April. The weakness of gross fixed investment intensified considerably in March. Within such indicator, the negative trend of investment in machinery and equipment deteriorated further, while construction spending maintained an unfavorable performance, persisting at particularly low levels. Indicators related to this aggregate, such as capital goods imports, point to a greater deterioration of investment in the early part of the second quarter of 2020.

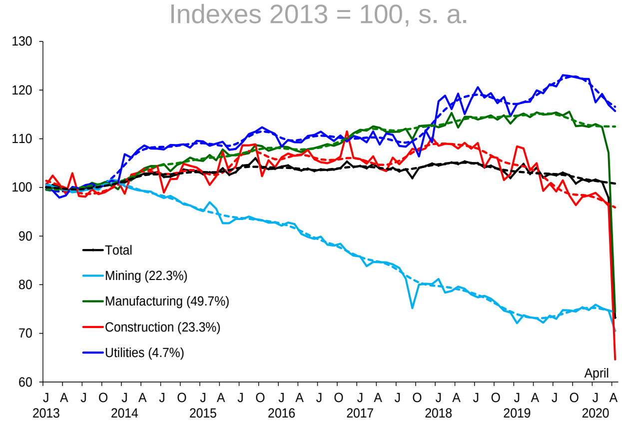
As for production, the downward path of services intensified further at the end of the first quarter, as a result of the initial impact of the pandemic and the measures adopted to contain its spread, while in April the downward trend of industrial activity intensified significantly, reaching its lowest level since 1996 (Chart 13). The fall in tertiary activities in March was explained mainly by the negative contributions of accommodation and food services; arts, entertainment and recreation and other services; transportation and mass media information services; retail and wholesale trade; and educational and health care and social assistance services. Within the secondary activities, both manufacturing and construction contracted significantly in April (Chart 14) largely due to the shutdown of most activities in these sectors during said month, as they were not considered to be essential by the authorities. Mining once again remained weak, which can be associated with both a significant decline in metallic and non-metallic minerals and a moderate decrease in crude oil extraction.

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



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

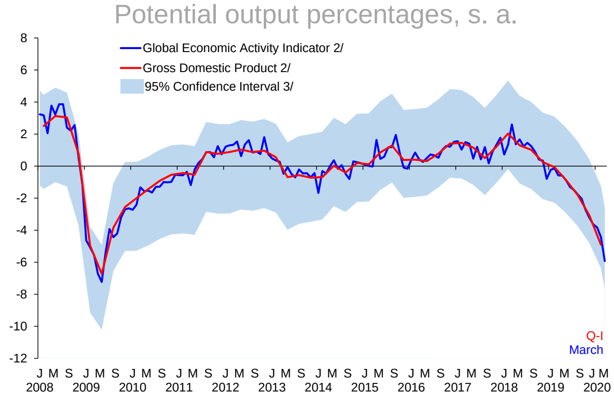
Chart 14
Industrial Activity [1/]
Indexes 2013 = 100, s. a.



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

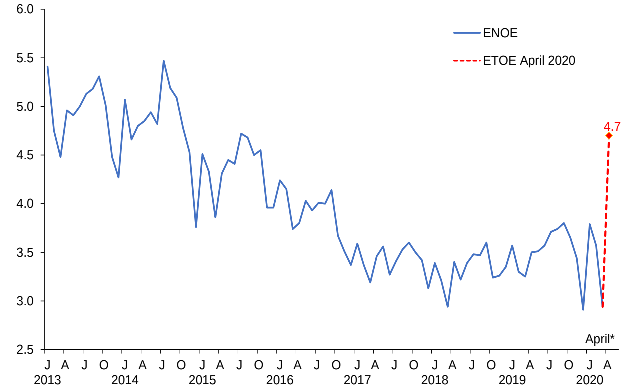
As to the economy's cyclical position, slack conditions widened at the beginning of the first quarter of 2020 (Chart 15) and are foreseen to have continued widening during the second quarter, with a balance of risks for growth remaining significantly biased to the downside. According to the results of INEGI's *Telephone Survey* on *Occupation and Employment* (ETOE, for its acronym in Spanish) there was a significant decline in employment in April, which was reflected in a considerable exit of people from the labor force and a significant increase in the unemployment rate (Chart 16). The fall in employment was due to a greater fall in informal vis-à-vis formal employment. Likewise, in May, IMSS-insured job creation continued to show a negative performance, registering a monthly decrease of 344,000 jobs with not-seasonally-adjusted figures and accumulating a loss of formal employment of slightly above one million jobs between March and May. Finally, the strong fall in production resulting from the temporary shutdown of activities in manufacturing sectors deemed non-essential as part of the measures to contain the COVID-19 outbreak, as compared to the relatively minor decline in total real earnings, led in April to an increase of unit labor costs in the manufacturing sector far above any other observed since it was first measured in 2007 (Chart 17).

Chart 15
Output Gap Estimates 1/
Excluding Oil Industry 4/
Potential output percentages, s. a.



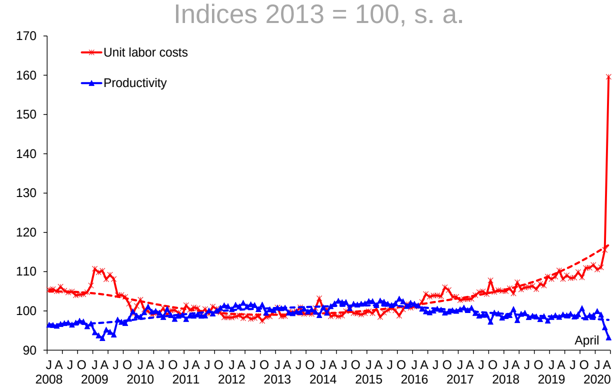
s. a. / Calculations based on seasonally adjusted figures.
1/ Output gap estimated with a tail-corrected Hodrick-Prescott filter; see Banco de México (2009), "Inflation Report (April-June 2009)", p.74.
2/ First quarter of 2020 GDP figure and March 2020 IGAE figure.
3/ Output gap confidence interval calculated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

Chart 16
National Unemployment Rate
Percent of EAP, n. s. a.



EAP: Economically Active Population.
n. s. a. / Not seasonally adjusted.
*/ The April 2020 figure, drawn from the Telephone Survey on Occupation and Employment (Encuesta Telefónica de Ocupación y Empleo, ETOE), cannot be fully compared to ENOE figures and is shown only as a reference.
Source: Prepared by Banco de México with data from ENOE up to March 2020 and from the ETOE up to April 2020.

Chart 17
Productivity and Unit Labor Costs in the Manufacturing Sector 1/
Indices 2013 = 100, s. a.



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

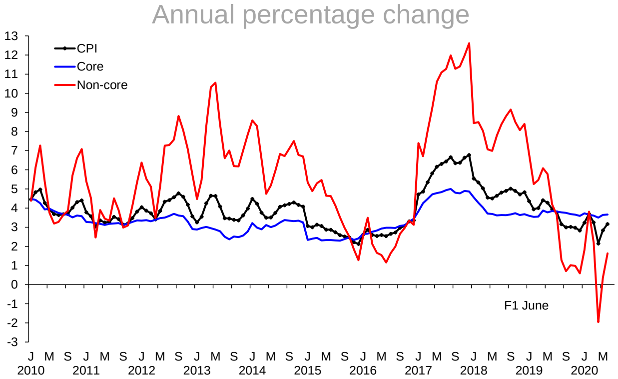
In April 2020, domestic financing to firms grew at a real annual rate for the second consecutive month, in contrast with the contraction exhibited during the first months of this year. Thus, once again an increase was observed in bank credit to firms, particularly large-sized firms, although said increase was smaller than that registered in March. In April, the domestic corporate debt market contracted significantly. As for credit to households, the mortgage segment grew at a rate similar to that of March, while the consumption segment continued to contract as has been doing since that month. As for interest rates, those of firm financing decreased in April, in line with the cut to the overnight funding interest rate, while, according to figures to March, interest rates of mortgages decreased. Regarding portfolio quality, firm and mortgage delinquency rates remained at low levels, while those related to consumption rose for the second consecutive month, thus increasing their already high levels.

As a result of the contingency stemming from the COVID-19 pandemic, the risk that the loanable funds market deteriorates over the next months persists, both because some creditors may have difficulties in meeting their obligations and because some credit institutions may decide to restrict financing as a precautionary measure. Given this complex outlook, in April Banco de México announced measures aimed at strengthening credit provision to micro, small- and medium-sized firms and individuals affected by the pandemic. In this regard, in June the central bank published the operating rules for the provision of resources to credit institutions in order to channel financing to the aforementioned agents.

A.2.3. Development of inflation and inflation outlook

Between April and the first fortnight of June 2020, annual headline inflation increased from 2.15 to 3.17%, which is explained by an increase of 88 and 14 basis points in the incidence of its core and non-core components, respectively (Chart 18 and Table 1).

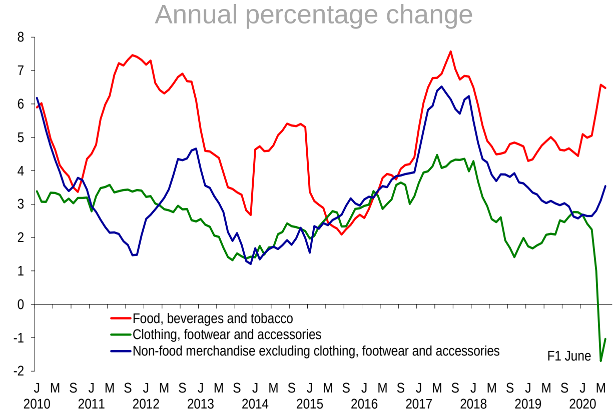
Chart 18
Consumer Price Index
Annual percentage change



Source: Prepared by Banco de México with data from INEGI.

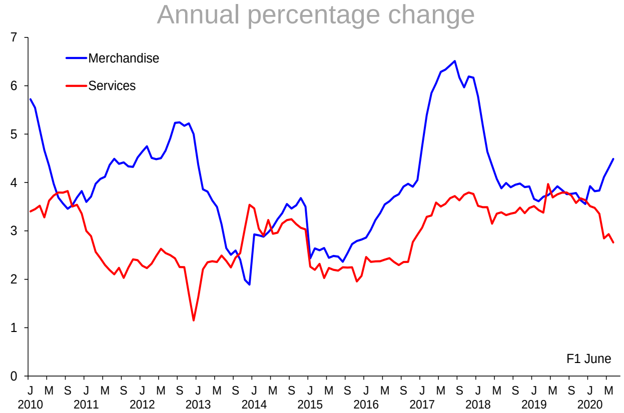
Annual core inflation increased from 3.50 to 3.66% between April and the first fortnight of June 2020, although within it there were both upward and downward pressures stemming from the effects of the health crisis on several spending items. On the one hand, the annual rates of change of food merchandise prices increased from 5.78 to 6.48% in this period, while those of non-food merchandise prices increased from 2.34 to 2.37%, although this item, excluding clothing and footwear, rose from 2.81 to 3.54% (Chart 19). In contrast, significant reductions were observed in clothing and footwear prices, with their annual rate of change declining from 1.00 to -1.04% between April and the first fortnight of June 2020. The annual rate of change of services prices decreased from 2.84 to 2.76% in the abovementioned period and lies at levels below those observed prior to the beginning of the pandemic, possibly due to the lower relative demand they are facing in the context of the health crisis (Chart 20).

Chart 19
Merchandise Core Price Subindex
Annual percentage change



Source: Prepared by Banco de México with data from INEGI.

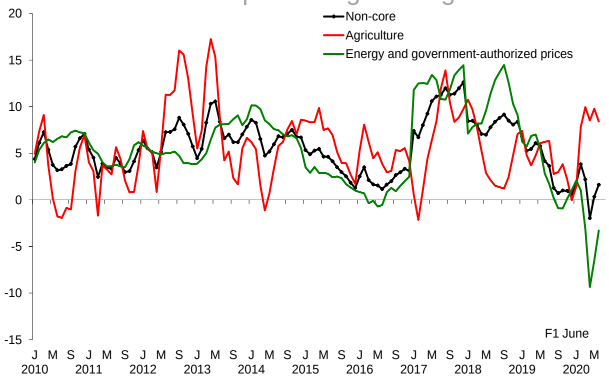
Chart 20
Merchandise and Services Core Price Subindex
Annual percentage change



Source: Prepared by Banco de México with data from INEGI.

Between April and the first fortnight of June 2020, annual non-core inflation increased from -1.96 to 1.63% (Chart 21 and Table 1). This result was mainly due to the increase in energy product and fruit and vegetable prices, which were partially offset by the decline in livestock product prices.

Chart 21
Non-core Price Subindex
Annual percentage change



Source: Prepared by Banco de México with data from INEGI.

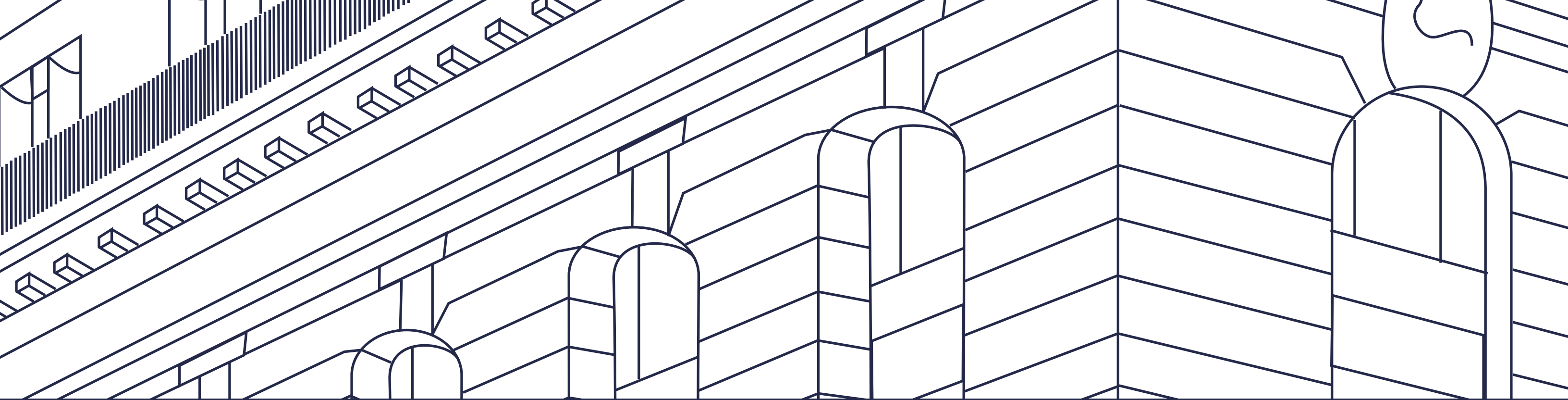
As for inflation expectations drawn from Banco de México's Survey of Private Sector Forecasters, between April and May the medians for headline and core inflation for the end of 2020 increased from 2.90 to 3.07% and from 3.34 to 3.50%, respectively. Those for the medium and long term headline inflation remained at 3.50%. As to the median for core inflation expectations for the medium term, it remained at 3.50%, while that for the long term rose from 3.45 to 3.49%. Finally, breakeven inflation decreased during the same period, although it continued to exhibit volatility, and, so far in June, it has had an important rise.

Among the risks for inflation, the following stand out. To the downside: a greater than expected impact of the widening of the negative output gap and lower inflationary pressures worldwide. To the upside: additional episodes of foreign exchange depreciation; and logistical and supply-related problems concerning certain goods and services, as well as higher costs associated with the adoption of sanitary measures. In this context, the balance of risks for inflation remains uncertain.

Table 1
Consumer Price Index and Components
Annual percentage change

Item	April 2020	May 2020	1st fortnight June 2020
CPI	**2.15**	**2.84**	**3.17**
Core	**3.50**	**3.64**	**3.66**
Merchandise	**4.11**	**4.30**	**4.49**
Food, beverages and tobacco	5.78	6.58	6.48
Non-food merchandise	2.34	1.88	2.37
Services	**2.84**	**2.93**	**2.76**
Housing	2.86	2.67	2.53
Education (tuitions)	4.57	4.51	4.47
Other services	2.47	2.83	2.61
Non-core	**-1.96**	**0.35**	**1.63**
Agricultural and livestock products	**8.52**	**9.79**	**8.42**
Fruits and vegetables	9.35	17.83	15.28
Livestock products	7.83	3.36	3.10
Energy and government-authorized prices	**-9.35**	**-6.51**	**-3.28**
Energy products	-15.20	-11.34	-6.55
Government-authorized prices	4.81	4.65	4.18

Source: INEGI.



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