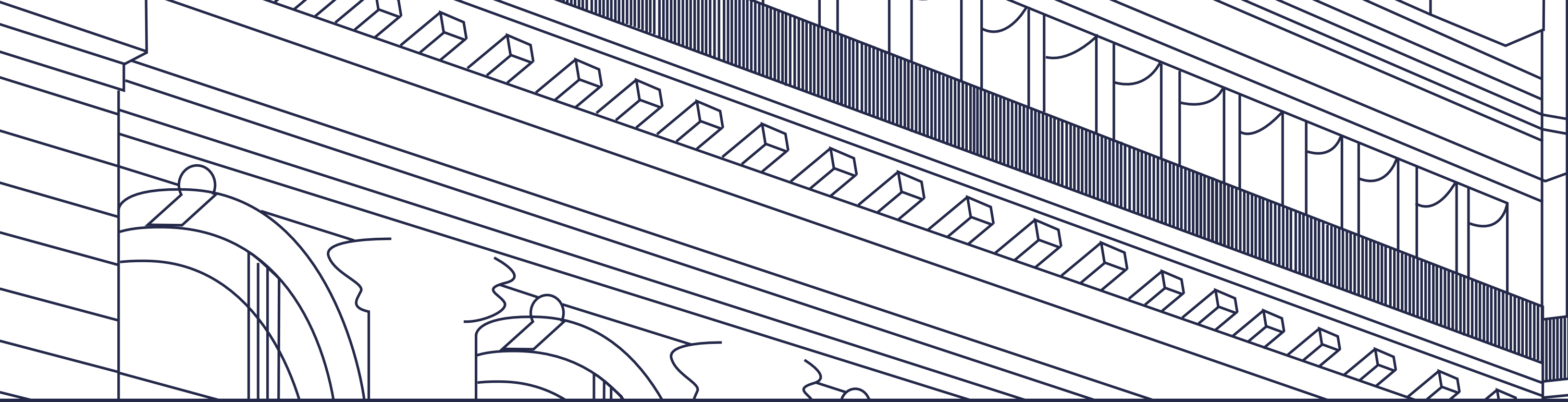

BANCO DE MÉXICO®

Minutes number 76

Meeting of Banco de México's Governing Board on the occasion of the monetary policy decision announced on May 14, 2020

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FOREWARNING
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1. PLACE, DATE AND PARTICIPANTS

1.1 Place: Meeting held by virtual means.

1.2. Date of Governing Board meeting: May 13, 2020.

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

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

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

International environment

All members pointed out that the COVID-19 pandemic and the measures adopted to prevent its spread have affected world economic activity considerably. In this context, **some** members noted that the confidence of economic agents decreased. **One** member argued that the disruption of global production chains and the fall in consumption and investment contributed to the above. **Another** member mentioned that production shutdowns have a larger effect on economies that are more open and integrated to global value chains, because the different phases of the pandemic hinder synchronized production, as well as tourism-dependent regions. He/she mentioned that economies' external demand has been affected by such situation, while domestic demand has been affected by lower households and firms' income which, in addition to the lockdown measures, has reduced spending. He/she added that all of the above is leading to a significant fall in employment, which will widen the economic contraction.

Most members pointed out that available information for the first quarter started to show evidence of an economic impact of large magnitude. Some members highlighted the strong contraction of economic activity in the euro area and the United States. **One** member underlined that the most worrisome indicator is the US unemployment rate, which exceeded 14% in April. He/she explained that although China's industrial production decreased in February, it recovered slightly in March.

Most members noted that the environment described above has led to downward revisions to economic expectations —unprecedented in the last decades— which include a strong contraction in 2020. Some members pointed out that the most significant global GDP contraction of this episode is expected for the second quarter of the year. **Some** members mentioned that drops in GDP not seen since the Great Depression are anticipated. **One** member highlighted the large magnitude of the revisions and the abrupt nature of the economic impact.

Most members underlined that a recovery is expected during the second half of 2020, which would extend to next year. However, most members emphasized that this is subject to considerable risks, such as: i) the uncertainty on the duration and severity of the effects of the lockdown measures, ii) the time needed to normalize productive activities, and iii) the possibility of new COVID-19 outbreaks. Some members mentioned additional risks, such as the resurfacing of tensions between China and the United States, as well as others of political and geopolitical nature. **One** member highlighted the danger of a double dip recession. **In this context, most members pointed out that the balance of risks for the global economic outlook remains biased to the downside.**

Most members mentioned that the impact on economic activity has resulted in a sharp fall in commodity prices, especially of crude oil. One member added that the latter registered historically low prices.

Most members pointed out that worldwide inflation continued to decline significantly, to levels below the central banks' targets. **One** member stated that inflation expectations have decreased. **Another** member noted that although inflation continues to register positive figures, the possibility of additional declines, and even of episodes of deflation, represent risk factors for the recovery of the world economy.

All members stated that in light of the described environment, several central banks lowered their interest rates significantly. **One** member pointed out that most advanced economies have nominal interest rates around 0% or negative, and that emerging economies overall set them near or below observed inflation, thus leading to real rates close to 0% or even negative. He/she underlined that, out of 17 emerging economies analyzed, nine have a target rate below or equal to 3%, five have rates between 3 and 5%, while Mexico, Russia and Turkey have rates above 5%. However, he/she stated that expected inflation for the end of the year in Russia and Turkey is high, while in Mexico it is already below 3%. For this reason, he/she mentioned that the real interest rate in Mexico is currently the highest among the group of seventeen emerging countries analyzed. He/she added that, for emerging economies, average expectations for policy rates for the end of 2020 continued to decrease, laying at 3%.

Most members pointed out that numerous central banks have also implemented other extraordinary measures to foster the well-functioning of their financial systems. One member highlighted that practically all central banks have emphasized in their statements the need to intensify the monetary stimulus to speed up the economic recovery process. **Another** member added that these measures' intent is for households and firms to be able to face their temporarily lower incomes as a result of the pandemic, as well as to avoid a credit contraction. As for the referred measures, **one** member underlined the risk that certain vulnerabilities that could jeopardize financial stability may arise or increase, as well as the challenges that could stem from certain legal difficulties in some regions.

Most members stated that numerous countries have implemented fiscal stimulus measures to mitigate the adverse effects of the pandemic. Some members noted that such stimuli have been greater than those implemented during the global financial crisis. **One** member specified that various authorities have approved direct relief measures and credit-guarantee programs. **Another** member stressed that there is the risk that these measures are insufficient to avoid a deeper and longer than expected recession.

Most members mentioned that this adverse environment has led to a greater risk aversion, a deterioration of global financial conditions, and to a recomposition of investors' portfolios towards lower-risk assets. Some members pointed out that as compared to the beginning of the year, stock markets of advanced economies have fallen considerably. **One** member noted that there were outflows from equity markets and high-risk corporate debt in the aforementioned economies. **Another** member added that these economies' currencies depreciated against the US dollar and that the spreads between corporate and sovereign bonds remain at high levels.

Most members highlighted that this environment has also led to unprecedented capital outflows from emerging economies, especially of fixed-income instruments. Most members added that these economies registered a depreciation of their currencies and volatility in their foreign exchange markets. One member explained that falls in commodity prices and other sources of external income intensified capital outflows. He/she argued that, in this context, rating agencies have downgraded several sovereign and corporate credit ratings, thus contributing to reinforce the financial shock and the risk aversion process in a pro-cyclical fashion. As for inflationary pressures stemming from foreign exchange adjustments, **another** member mentioned that these are contained in most economies, as suggested by the reduction in breakeven inflation.

Most members acknowledged that the actions adopted by advanced economies to provide liquidity and restore financing, as well as the announcements about a possible gradual reopening in some countries, have contributed to a more stable behavior of international financial markets in the last weeks. **One** member noted that although risk aversion decreased, it still remains at high levels. **Another** member stated that financial markets remain volatile.

Most members mentioned that global financial conditions will remain dependent on the outlook for the effects of the pandemic. The majority of members highlighted the risks of a more pronounced slowdown and a resurfacing of trade, political, and geopolitical tensions. One member added that it is possible that the recomposition of investors' portfolios towards safe-haven assets will continue and that bouts of extreme financial volatility in emerging economies will take place. **Another** member considered that the balance for financial risks is biased to the downside.

Economic activity in Mexico

All members pointed out that timely information shows that during the first quarter of the year economic activity in Mexico contracted significantly, which already incorporates effects

associated with the pandemic. Most members noted that the economy was already weak prior to the pandemic. Most members mentioned that, according to its flash estimate for the first quarter of the year, GDP fell 1.55% vis-à-vis the previous quarter, the largest fall since the 2008-2009 financial crisis. Some members mentioned that this contraction reflects the impact of the lockdown measures, the deceleration of external demand, and the disruption in value chains. **One** member considered that the effects of the lockdown and the subsequent fall in employment have not been fully reflected yet. He/she added that indicators based on information drawn from the payments system anticipate monthly falls of -4.5 and -9.5% for March and April, respectively.

Most members noted that the lockdown measures have affected aggregate demand and that various indicators point to a contraction of consumption and investment in March and April. Most members added that exports, including the automotive ones, decreased, while imports maintained their negative trend. **Some** members highlighted the contraction of imports of final goods and of machinery and equipment. **From the supply side, most members mentioned that several indicators suggest a contraction of services and of the industrial sector. Some** members stressed that business opinion surveys of various sectors, as well as the Purchasing Managers' Index (PMI) of the manufacturing and non-manufacturing sectors, have decreased to the lowest levels since records exist. **One** member highlighted that indicators of tourism and recreation services show that these sectors are being the ones most affected by the lockdown measures. **Another** member added that in the first quarter the industrial sector contracted and that manufacturing production decreased, while primary activities increased.

The majority of members stated that, although the magnitude and duration of the effects of the pandemic are still unknown, these are expected to intensify during the second quarter. One member pointed out that some rebound is expected starting in the third quarter, given the announcement that activities will resume, although the extent of said recovery is uncertain. **Another** member added that these effects are expected to persist during the second half of the year.

Most members mentioned that the labor market has been affected by the effects of the health crisis. Most members highlighted that 555,000 formal IMSS-insured jobs were lost in April. One member noted that in the year ending that month, 456,000 jobs were lost, and that the loss has disproportionally affected those workers that are paid up to two minimum wages, thus increasing the social cost of this health crisis. In addition, he/she highlighted the considerable increase of the underemployment rate. **Another** member added that a reduction of 130,000 jobs had already been observed in March. He/she added that the unemployment rate already reached 4.15% and that a significant increase in withdrawals of funds from individual retirement accounts for unemployment reasons was observed. **One** member underlined that between March 13 and April 30 over 750,000 formal jobs were lost, which indicates that, in less than two months, more formal jobs were lost than in twelve months during the worst part of the 2008-2009 crisis. He/she also mentioned that a significant loss of informal jobs should also be added. **Another** member stated that a fall of more than one million formal jobs is foreseen for this year. **Some** members mentioned that measurement challenges of labor indicators are anticipated, given that the National Institute for Statistics, Geography, and Information (INEGI, for its acronym in Spanish) is facing restrictions to conduct household surveys under the present juncture.

Most members pointed out that growth forecasts for 2020 continue to be revised downward. Some members mentioned that the consensus of private sector forecasters went from -6.7 to -7.5%, anticipating a moderate recovery in 2021. **One** member mentioned an expectations survey conducted among economists, in which the median is at -8.0% with a mode of -9.0%, and that other information sources are anticipating a double-digit contraction. He/she considered that micro, small-, and medium-sized firms will be the most affected and that the informal sector will be impacted in terms of income and labor opportunities, adding that greater levels of poverty are foreseen in all its dimensions. He/she pointed out that, although this is a worldwide trend, Mexico is considered to be one of the countries that will be affected the most. **Another** member explained that contention measures and uncertainty about the pandemic will continue to impact the consumption of services. He/she added that the lower employment and its effects on the wage bill will provide less support to consumption. He/she also stated that investment is expected to continue deteriorating.

Most members agreed that the balance of risks for growth is significantly biased to the downside and considered that it is subject to uncertainty, given that the duration and depth of the effects of the pandemic are unknown. Some members pointed out that mitigation measures and consumer confidence will depend on the development of a vaccine and an effective treatment. Said members highlighted the following risks: i) a prolonged impact on production due to the suspension of economic activities and the lack of supplies; ii) an increase in contagions or a second pandemic wave, which would lead to financial and solvency problems, and iii) lower households' and firms' incomes and a negative impact on employment. **One** member mentioned a possible permanent damage to the productive apparatus and to employment. **Some** members considered that the absence of a comprehensive support approach, particularly given the modest fiscal response, can lead to a slower recovery. **One** member added the absence of adequate incentives for private investment, a situation that has intensified recently due to the adjustments in the regulatory framework for the private sector's participation in the electric sector. **Another** member emphasized that this is worsened by the environment of legal uncertainty for private investment.

In this context, most members pointed out that slack conditions widened considerably and that they are expected to continue doing so. One member mentioned that the negative output gap is expected to reach levels not recorded since the 2008-2009 crisis.

Inflation in Mexico

All members mentioned that headline inflation decreased, stressing that in April it stood at 2.15%. Most members pointed out that this was due to the decline of non-core inflation, as a result of a lower annual change of energy prices, particularly of gasoline.

Most members mentioned that core inflation declined between March and April. Most members underlined the increase in the rates of change of food merchandise prices. The majority of members pointed out that this is due to both demand- and supply-related factors. Some members considered that core inflation continues to show a resistance to decline. **One** member considered that, although in aggregate terms annual non-food merchandise and services inflation is below 3%, core inflation is subject to generalized pressures. He/she stated that the trimmed mean indicator for this variable exhibits readings that are almost identical to those of the untrimmed variable. Likewise, he/she highlighted that in the case of services, after excluding the housing, education, tourism and telecommunication components, the growth rate of prices of the corresponding indicator is above 4%. **Another** member stressed that the core component registered its lowest level in 12 months and that most components declined considerably, showing lower persistence than the one observed last year. He/she underlined that services registered 2.84%, a level not seen since 2016 and that non-food merchandise registered 2.34%, the lowest rate since 2015. He/she added that the depreciation of the peso exchange rate has not affected the prices of non-food merchandise significantly, despite the fact that a significant share of them is imported. He/she added that housing prices registered an annual inflation of below 3%. He/she also pointed out that only two components of core inflation, education services and food merchandise prices, registered an annual inflation above that figure. Nevertheless, he/she underlined that in education services a slight decline with respect to previous months can be observed, while food merchandises are undergoing a peculiar and possibly transitory increase in their demand. In addition, production of some of these goods has been limited due to the lockdown measures, exerting upward pressures in their prices. **One** member stressed that, according to academic studies, the lockdown leads to radical changes in consumption patterns and that the disruption in some value chains reflects extreme changes within the price index, as shown by the increase in the subindex of food merchandise and the significant fall in tourism services prices.

Most members pointed out that short-term headline inflation expectations have decreased. Some members stated that, for the end of 2020, these are slightly below 3%. **One** member added that core inflation expectations also declined. **Most members mentioned that medium- and long-term expectations for headline inflation have remained relatively stable, although above the 3% target. One** member pointed out that these are within the variability interval and that they are expected to remain there. **Another** member indicated that the inflation risk premium implied in market instruments has declined. **One** member stated that there are marked contrasts for the different terms of this indicator, which highlights that it has limitations in assessing inflation expectations under circumstances like the current ones in financial markets, which are characterized by low liquidity levels and a deterioration of trading conditions overall.

Most members highlighted that inflation is anticipated to converge to Banco de México's target in the time frame in which monetary policy operates. Some members considered that inflation will be below the target by the end of the year. **One** member estimated that it will remain below 3% for the remainder of 2020. He/she indicated that this is supported in part by the prospects that energy prices will remain relatively low, due to a weak global demand for commodities. He/she pointed out that the increase in agricultural and livestock product prices observed in previous months has already started to reverse, and noted that prices of food products would decrease once the lockdown measures are lifted. **Another** member indicated that inflation is expected to increase in the following months and that it could attain levels above Banco de México's target in the second half of the year. He/she mentioned that the recovery of energy prices will exert upward pressures on the non-core component. He/she added that core inflation would be affected by an exchange rate that is more depreciated than was foreseen, and by supply shocks. Nevertheless, he/she stressed that given the significant contraction of demand in 2020, of a recovery that is foreseen to be moderate in 2021, and of consequent expectations of a wide negative output gap for both years, it is reasonable to anticipate that headline inflation will converge to its target in 2021, in an environment of both upward and downward pressures and of high uncertainty.

As to risks for inflation, most members mentioned downward pressures stemming from the considerable widening of the negative output gap and from the fall in energy prices. **One** member pointed out that social distancing is disrupting the provision of certain services, the price variation of which may decrease. **Another** member added the declines in agricultural and livestock prices and problems in measuring inflation, due to the change in the representative consumption basket during the pandemic. **Among upward risks, most members emphasized the possibility of a greater or more persistent depreciation of the exchange rate and possible disruptions in production chains and in the distribution of certain goods and services. Some** members highlighted the pressures on food merchandise prices. In particular, **one of them** emphasized that these pressures may be of such magnitude that they may exceed the effects of the economic slackness on prices. He/she added the base effect of non-core inflation due to the low levels that have been recently observed, a reversal in energy prices, and a greater pressure on agricultural and livestock product prices. **Another** member stated that although it has been argued that the exchange rate depreciation is an upward risk, it has not materialized in Mexico or in other emerging economies yet, in which inflation has declined. He/she added that although it has been argued that there could be cost pressures stemming from higher intermediate input prices, the IMF reported that annual inflation of commodities reached -31% in April, which represents an important deflationary force. **One** member pointed out that the effects of the lockdown on consumption patterns and on value chains, as well as the difficulties in collecting price data, make the reading of the price index more complicated, and that certain upward and downward pressures should therefore be analyzed carefully.

In this context, most members considered that the balance of risks for inflation remains uncertain. One member noted that this derives from the following: i) possible changes in consumption patterns and their effects on the price formation process, ii) the magnitude and duration of the fall in aggregate demand, iii) the disruption in global value chains and a possible shortage of certain goods, iv) the persistence of adverse conditions in financial markets that cause disorderly adjustments, and v) possible second-order effects if the exchange rate depreciation is perceived to be permanent. **Another** member stated that uncertainty over the referred balance of risks is high, considering that the significant contraction in demand will exert downward pressures on inflation, while supply shocks and the exchange rate depreciation could pressure it upwards. He/she pointed out that the outcome will depend on the intensity of each of the abovementioned pressures, as well as on the interaction among them. Meanwhile, **one** member considered that the magnitude of the economic contraction and the consequent widening of the negative output gap ought to have a greater impact than the exchange rate on the price setting process. In this situation, he/she considered that both upward and downward risks for inflation are well-balanced. **Another** member considered that inflation data of April, in particular the evolution of the core inflation components and the fall in non-core inflation, suggest that downward pressures on inflation are prevailing over upward ones.

Macrofinancial environment

Most members highlighted that unprecedented capital outflows have been registered and that foreign investors have reduced their government bond holdings by over MXN 250 billion. One member indicated that this was caused not only by the global environment, but also by idiosyncratic factors. **Another** member pointed out that since the previous monetary policy decision, capital outflows have continued, although at a slower pace. **One** member considered that the recomposition of investors' portfolios has contributed to generate tight financial conditions. **Another** member highlighted that the stock of foreign investment holdings in government bonds still represents close to USD 90 billion.

Most members stated that over the last weeks the performance of Mexican financial markets has improved. Nevertheless, the majority of members mentioned that deteriorated trading conditions persist. Some members indicated that debt and foreign exchange markets continue to show reduced depth and a shortage of liquidity. **One** member added that this has distorted interest rates in certain nodes of the yield curve. **Some** members mentioned that sovereign risk has adjusted slightly to the downside, although **one** member considered that concerns over different risk factors remain high. On the other hand, **some** members underlined that the stock market index increased nearly 6% in the last month. **One** member pointed out that marginal inflows by foreign investors to the stock market were observed. **Another** member mentioned that said market and credit default swaps (CDS) continue to show a significant deterioration with respect to the levels observed at the beginning of the year.

Most members mentioned that lower interest rates of government securities for all terms were observed. Most members specified that said reductions were influenced by the actions implemented by Banco de México. One member highlighted that during the last month interest rates decreased by over 100 basis points in some nodes of the yield curve. **Another** member pointed out that factors of concern, a steep yield curve, and the liquidation of positions, persist.

As for the exchange rate, all members mentioned the significant depreciation observed this year. Most members underlined that it remains high, although **some** of them indicated that it has recently traded in a narrower range. **One** member pointed out that in the last few months the exchange rate has traded in a wide range and that trading spreads and intraday volatility have remained high, with unfavorable levels of liquidity and depth. In addition, he/she pointed out that in the derivatives market, a net short position in short-term instruments is maintained. He/she highlighted that the Mexican peso remains among the emerging market currencies with the highest annual depreciation. He/she added that said deterioration is similar to that observed in the 2008-2009 financial crisis and more pronounced than during the Taper Tantrum and the 2016 US presidential elections. **Some** members stated that financial conditions will continue to be subject to the outlook for the effects of the pandemic.

Most members pointed out that this negative environment contributed to the downgrade of sovereign and Pemex's credit ratings. Some members noted that two rating agencies maintained a negative outlook for Mexico. **One** member mentioned that they warned about further adjustments in the near future and that some market participants debate over when the sovereign will lose its investment grade rating. As to Pemex, **some** members expressed that it was affected by the fall in oil prices. **One** member mentioned that in the first quarter of the year it registered an historic loss of MXN 562 billion, and that it requires a high capitalization. He/she stated that although the exchange rate depreciation had the greatest impact on the company, its structural issues have gained relevance in the context of low oil prices, the confirmation of its loss of investment grade, and low margin for maneuver in public finances. **Another** member stated that the International Monetary Fund had noted that one of the main risks is the need for additional financial support for Pemex. **One** member pointed out that if its business model is not reformulated, Pemex will continue to draw resources from the public treasury.

Most members mentioned that in view of the anticipated deficit increase and the fall in GDP, public debt is expected to increase as a fraction of GDP. One member added that this indicator will also increase due to the exchange rate depreciation. **Another** member mentioned that a shortfall of public revenue is foreseen for this year. He/she noted that even taking into consideration the use of resources from the Budget Revenue Stabilization Fund (FEIP), the oil hedge revenues, and a lower programmable spending, the primary deficit would amount to 0.8% of GDP. He/she mentioned that in the medium term revenue collection will depend on the recovery of public and private investment to levels above the low values registered in recent years. He/she added that the referred credit rating revisions have contributed to a greater tightening of financial conditions for both the government and Mexican firms. In this regard, he/she emphasized that recently government bonds have been issued in US dollars with an additional premia, and at a higher cost than the issuances in January. He/she added that the shortage of new issuance and of refinancing operations by the corporate sector reflects tight financial conditions and investors' risk aversion towards Mexican issuers.

In view of the current situation, most members highlighted the importance of fiscal support measures that do not jeopardize the sustainability of public finances. In this regard, some considered that measures to support the productive apparatus and to mitigate the effects of the pandemic have been insufficient. **Most members acknowledged that there is little room for maneuver due to the sovereign debt downgrades, as well as the fragility of public**

finances and of Pemex. Some members mentioned that the economic contraction and the higher deficit expected for this year limit the room for maneuver even more. **One** member considered that there is limited space to issue additional debt and to implement a countercyclical fiscal policy. Nevertheless, he/she noted that additional reductions in the interest rate could contribute, although to a limited extent, to reduce the financial cost of the government and to free up space for fiscal stimulus. Meanwhile, **another** member considered that Mexico still has good access to international markets and that the current space should be utilized.

Given the limited fiscal space, most members considered that efforts should be directed to a reallocation of the budget according to efficiency criteria. One member specified that said reallocation should be directed towards spending with an effect on the labor market in the short term. **Another** member stated that there are some margins for maneuver, such as the reallocation of public spending from controversial large-scale projects to priorities arisen as a result of the pandemic.

In light of an adverse juncture, most members highlighted the need to generate public policies that provide certainty to private investment, along with the importance of maintaining solid macroeconomic fundamentals. One member stated that the latter contributes to an orderly adjustment of Mexican financial markets and of the economy as a whole. He/she mentioned the need for a strategy to mitigate the negative shocks, which at the same time maintains low and stable inflation as well as a solid and well-capitalized financial system. **Some** members expressed their concerns about the uncertain environment for investment. In particular, they mentioned the recent modifications in the rules for private sector participation in electricity generation using renewable sources. **One** pointed out that this measure affects the process of competition and free market participation. He/she added that these actions come in addition to others that modified contracts' legal conditions after investments had been made, such as the cancellation of Mexico City's New International Airport (NAIM, for its acronym in Spanish), the Federal Electricity Commission's (CFE, for its acronym in Spanish) litigation over gas pipelines, the cancellation of the green-energy certificate system, and the suspension of the construction works for a new brewery plant. **Another** member considered that the health crisis, together with idiosyncratic factors, can reduce Mexico's potential growth to levels not seen in many years, which would imply high economic and social costs. Therefore, this calls for strengthening communication and collaboration links with the private sector in order to create an environment conducive to investment. He/she added that to overcome the challenges originated by the crisis and to foster economic growth in the long run, a balanced policy approach is required. He/she emphasized that this is important given the deterioration of economic fundamentals in Mexico.

Monetary policy

Taking into account the foreseen impacts on inflation, economic activity and financial markets resulting from COVID-19 and considering the room for maneuver that on balance these grant to monetary policy, all members agreed to lower the target for the overnight interbank interest rate by 50 basis points to a level of 5.50%.

Most members pointed out that some emerging economies that have lowered their policy rates rapidly, have suffered a depreciation of their currencies, even despite having intervened in their foreign exchange markets. One member added that in some of these economies long-term interest rates also increased, in a context in which they are decreasing in most other economies. He/she emphasized that the adoption in Mexico of a more aggressive monetary policy approach aimed at stimulating the recovery would imply incurring in high risks in exchange for a modest impact on economic activity for well-known and substantiated reasons. **Another** member considered that although calls for implementing more aggressive actions to ease monetary policy have emerged, following a gradual strategy is essential in view of the environment of high uncertainty and the relevance recently gained by idiosyncratic factors, which represent risks for financial and macroeconomic stability.

Some members considered that the present context grants a margin for lowering the policy rate further. Some members added that lower interest rates will contribute to a more effective functioning of Banco de México's previously announced facilities to foster credit provision. **One** member argued that in view of an unprecedented recession, an inflation near the lower range of the variability interval, and in the verge of undergoing a massive unemployment crisis, it is important to continue easing monetary policy. He/she pointed out that given the relative and absolute monetary policy stances, there is room for a significant easing of monetary policy and that the low levels of inflation provide a margin for such an adjustment. He/she added that although uncertainty about its expected path persists, this factor should not be over-dimensioned and should be given less emphasis given the plummeting of economic activity and the loss of millions of jobs, about which there already is certainty. He/she added that at the global level monetary policy is very lax, which contributes to compensate for the increases in risk premia.

Another member stated that the interest rate must be taken to more accessible levels in a relatively close horizon. He/she added that the cost and access to credit for micro, small-, and medium-sized firms —which are the ones that generate most of the jobs— are seriously affected during economic crises. He/she mentioned that if the effect of monetary policy on credit was limited, it would be necessary to resort to more drastic interest rate adjustments. He/she mentioned that the reductions to the policy rate that have already been implemented and which have decreased the interest rate spread with respect to the US Federal Reserve, have not led to a disorderly increase of the Mexican peso exchange rate, which means that there are other more important factors behind the behavior of said variable. He/she added that the target rate has been lowered at the same time that inflation expectations have declined. He/she stated that all of the above seems to indicate that looking ahead there is ample space to continue lowering the policy rate without generating inflationary pressures or jeopardizing the attainment of the inflation target.

One member argued that the monetary policy decision must not only assess the dilemmas associated with the outlook for inflation in an environment characterized by a significant economic contraction, but also consider those associated with the financial shock in terms of both its global and idiosyncratic components. In particular, he/she mentioned that for a relatively small and open emerging economy, the process for determining the monetary policy stance should consider both the economy's cyclical position and its influence on inflation, as well as the financial conditions that are being faced and its role in macroeconomic stability, including maintaining low and stable inflation. In particular, he/she highlighted: i) that it must be ensured that the yield curve adjusts in an orderly manner, without affecting long-term interest rates and maintaining inflationary risk premia at low levels; ii) that some of the effects of the lockdown and of the suspension of economic activities need to be considered, given that in the current environment the reduction of interest rates might have a lower or lagged effect on aggregate demand in the very short term, since the traditional channels of households and firms' spending are not operating normally, and iii) that although in the steepest phase of the financial and risk aversion-related shock, interest rate spreads were not relevant in the portfolio adjustments that took place, in the following phases they could gain more relevance. He/she stated that there are elements of stability in domestic financial markets, and for the financial system as a whole, that must be considered in order not to induce or worsen an adjustment of portfolios. He/she mentioned that this is relevant for Mexico, as it stands out among emerging economies for having financial markets that are highly integrated to international ones and for having a fully convertible currency, where 80% of the volume is traded among non-residents. Considering all of the above, he/she stated that it is necessary to identify the different challenges and dilemmas that monetary policy faces, assess the scenarios that materialize, and based on these elements define the most convenient adjustments to the monetary policy stance.

Another member considered that in the presence of a global shock and a substantial increase in risk aversion, the signals stemming from certain points of reference that are usually important for monetary policy implementation are now less obvious, which underlines the need for a cautious approach. In this regard, he/she highlighted less clarity regarding the impact of the interest rate spread with other economies. He/she argued that, similarly, in addition to the difficulties that are usually involved in estimating the neutral interest rate, it is likely that its use in the assessment of the monetary policy stance is limited in the current juncture. He/she emphasized that there is a greater than usual degree of uncertainty as to its magnitude and to the direction of the short-term deviations it may be showing versus its long-term level. The above, due to the lack of clarity regarding the relative importance of opposing effects on the neutral rate stemming from the various factors that are currently affecting the economy, among them the high level of uncertainty and the tightening of external financial conditions, which are probably combined with a lower potential growth.

Most members stated that the outlook for monetary policy continues to be uncertain and complex. One member considered that the degree of uncertainty regarding the evolution of the main macroeconomic aggregates, of financial markets and the external environment, and thus of inflation, is unusually high. He/she mentioned that, under these conditions, it is necessary to act with prudence and take advantage of the margins to reduce the interest rate to the extent that the trajectory of inflation allows it. **Another** member pointed out that although tensions in domestic financial markets have moderated, several warning indicators persist. He/she mentioned that the historical capital outflows as well as the increase in sovereign risk and the depreciation of the Mexican peso, are evidence of lower appetite for domestic assets.

Regarding future monetary policy decisions, **one** member pointed out that it is necessary to send a signal that monetary policy will continue easing depending on how the crisis evolves and of the possible deterioration of the economic and financial conditions. He/she mentioned that the speed at which the policy rate is lowered depends on: i) maintaining inflation at low levels and within the target; ii) the economic outlook, particularly, the effects of the pandemic; iii) the volatility of financial markets; iv) the risk that a very rapid reduction in interest rates leads to greater capital outflows, and v) idiosyncratic shocks such as a possible fiscal imbalance, a greater deterioration of credit ratings, increases in risk premia or other negative shocks to business confidence and governance. He/she added that decisive policy rate adjustments are needed in order to situate the monetary policy stance in a lax position and continually assess the possibility of making additional adjustments, even in unscheduled meetings. He/she added that monitoring the current situation constantly will allow for prompt and effective action. **Another** member considered that although he/she agrees that the evolution of the inflation determinants should allow for a further easing of monetary policy in the near future, in his/her opinion providing a more precise guide on the future path of monetary policy is complicated and even unwise in a context of such high uncertainty. **One** member was of the opinion that under the current juncture, the most prudent monetary policy would be to significantly lower the policy rate so that the real interest rate lays below its neutral rate as soon as possible, without ruling out the possibility of transitioning to a real interest rate close to cero or even negative. He/she added that not doing the aforementioned or postponing it for too long would be an unwise decision, as it would affect the domestic economy in a moment of crisis, it would harm financial markets and jeopardize price stability.

Most members mentioned the relevance of implementing of the measures aimed at fostering an orderly behavior of financial markets, strengthening the credit channels, and providing liquidity in order to continue enabling the sound development of the financial system. Some members added that said measures also aim at preventing disruptions in the payments system. **One** member added that they are intended to allow firms and households to have access to the financing they need in the face of a temporary reduction in their income. He/she mentioned that the announced measures amount to MXN 800 billion, equivalent to 3.3% of GDP. **Another** member highlighted that said measures need to be reinforced in three ways: i) by clearly communicating their scope and that they are being set within the limits imposed by the law; ii) by instrumenting them rapidly and effectively, and iii) by assessing their effects so that, if necessary, their duration and amount are increased in all extension and intensity, or even some additional measures are designed. He/she emphasized that immediate measures such as regulatory improvements, the easing of rules and regulations and a better governance do not have an impact on the fiscal deficit, but they do have an impact on the incentives for firms' to resort to the financial system in search for increased credit to maintain their working capital. He/she pointed out that in addition to the latter, Banco de México, within its capacity and legal powers, must continue collaborating with the public and private sectors for the sake of the economic recovery. However, the financial sector must also be very proactive so that these resources are channeled easily to firms. In this regard, Banco de México must coordinate itself closely with the private and public sectors so that the implemented policies are more effective. He/she indicated that it is of utmost importance to respond to the economic emergency within the powers of the Central Bank and to its maximum capacity to support the population and the economy. He/she mentioned that this requires acting decisively within the margin that its primary mandate allows it, by communicating the need to adopt a more accommodative policy stance considering the lag with which monetary policy operates. He/she added that the present crisis requires thinking innovatively and acting boldly. He/she considered that for this reason it is important to send a message of unity and commitment to solve the crisis. **One** member considered that, to allow that the facilities announced by Banco de Mexico foster credit provision in a more effective manner, it is necessary to move towards interest rates that are below their neutral level, in a relatively short horizon. He/she argued that, otherwise, the coverage of these measures will be rather limited.

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. Considering the room for maneuvering that on balance monetary policy has as a result of these implications, and with the presence of all its members, Banco de México's Governing Board decided unanimously to lower the target for the overnight interbank interest rate by 50 basis points to a level of 5.5%.

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 overnight interbank interest rate by 50 basis points to 5.5%.

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.

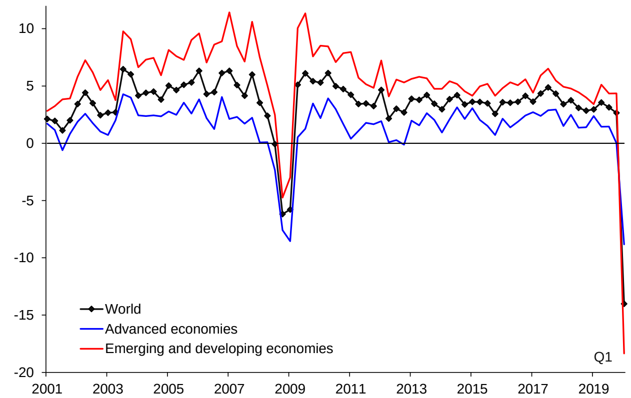
A.1. External conditions

A.1.1. World economic activity

The COVID-19 pandemic and the measures adopted to prevent its spread have considerably affected world economic activity (Chart 1). This has led to unprecedented revisions to the economic outlook, which incorporate a strong contraction of productive activity in 2020. In turn, this has resulted in a sharp fall in commodity prices, especially of crude oil. This environment led to a significant deterioration of global financial conditions, to a recomposition of investors' portfolio towards lower risk assets, and to the greatest contraction ever recorded of holdings of emerging economies' assets, especially of fixed-income instruments.

In this juncture, several central banks have significantly reduced interest rates and implemented other measures to foster the well-functioning of their financial markets. Likewise, several countries have implemented fiscal stimulus measures to mitigate the adverse effects on employment and on households' and firms' incomes. Such actions, along with the seeming reduction of contagion in some of the major economies, have recently resulted in an improvement of global financial conditions. Nevertheless, international financial conditions will continue to be subject to the outlook for the pandemic's effects, as well as to risk factors such as political and trade tensions between the United States and China.

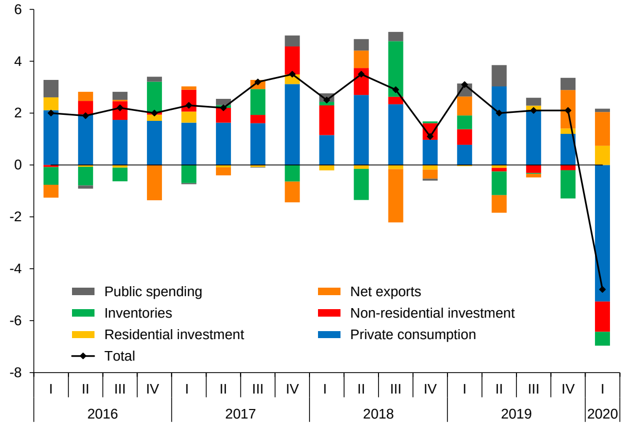
Chart 1
World GDP Growth
Annual percentage change, s. a.



s. a. / Seasonally adjusted figures.
Note: The sample of countries used accounts for 85.6% of world GDP measured by purchasing power parity. Forecasts are used for certain countries of the sample.
Source: Prepared by Banco de México with data from Haver Analytics, J. P. Morgan and International Monetary Fund (IMF).

In the United States, during the first quarter of the year GDP growth contracted at a seasonally adjusted annualized quarterly rate of 4.8%, after having grown 2.1% during the fourth quarter of 2019 (Chart 2). This contraction mainly resulted from the effects on supply chains caused by the pandemic and from the measures adopted to contain its spread. In particular, spending on private consumption, particularly on services, fell, while investment in equipment and structures continued to decrease. The negative impact of these aggregate demand components was partially offset by the positive contribution of residential investment, public spending, and net exports, the last as a result of a strong contraction of imports. It is worth noting that consumer and business confidence indices, as well as other available indicators to April, suggest that the stagnation of economic activity will intensify considerably during the second quarter of the year.

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



Source: Bureau of Economic Analysis (BEA).

During the first quarter of 2020, US industrial production registered its greatest fall since mid-2009, decreasing at an annualized rate of 7.4%. Industrial activity is expected to remain weak during the second quarter of the year, as suggested by some available indicators to April, such as the Purchasing Managers' Index (PMI). In particular, the falls in PMI and ISM's new orders components, from 42.2 to 27.1 and from 45.7 to 27.7 points, between March and April, respectively, stood out.

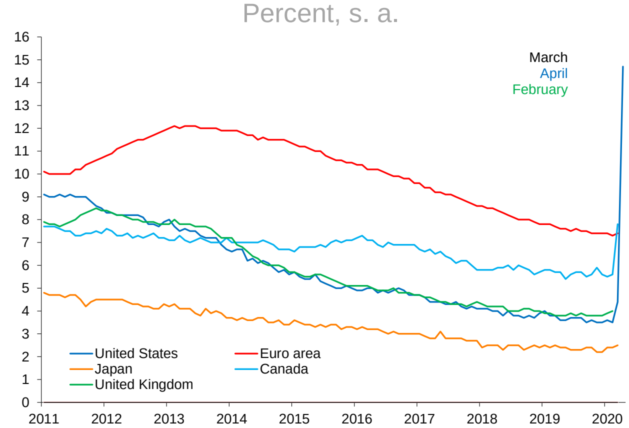
US labor market indicators showed a significant deterioration in April given the measures to contain the COVID-19 spread. In particular, the contraction of the non-farm payroll went from 870,000 jobs in March to 20.5 million in April, the latter being the largest fall ever registered. In turn, the unemployment rate increased from 4.4% in March 2020 to 14.7% in April. In relation with the above, unemployment insurance claims have continued to increase since the start of the pandemic, surpassing 22 million on the week ending on April 25.

In the euro area, GDP growth contracted at a seasonally adjusted annualized quarterly rate of 14.4% during the first quarter of the year, as a result of the weakness in consumption and investment stemming from the measures implemented to contain the COVID-19 spread. Despite this contraction, the unemployment rate increased only from 7.3% to 7.4% between February and March. Available leading indicators, such as the PMI, declined once more in April, reflecting the effects of the pandemic on several economies of this region. In particular, the services sector index reached its lowest level ever recorded.

In Japan, available information suggests a contraction of GDP during the first quarter of the year. In particular, industrial production contracted sharply in March due to the negative impact of the pandemic on domestic and external demand, particularly for manufacturing. Some indicators fell significantly during the same month, especially the PMI of the services sector and the Consumer Confidence Index, which reached their lowest levels ever registered. The above took place in a context where the state of emergency was extended to the beginning of June, thus suggesting that this economy will remain weak in the short term.

It is worth noting that the evolution of the pandemic, as well as the periods of adoption of contention measures, have led to a deterioration of labor markets in different advanced economies (Chart 3). Thus, the unemployment rate in some of these economies has already started to increase significantly and such reductions are expected to intensify in some countries in the short term.

Chart 3
Selected Advanced Economies: Unemployment Rate
Percent, s. a.



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

In emerging economies, the latest information suggests that the deterioration of economic activity will extend to the second quarter of this year. This is particularly evident in regions such as Latin America, where the COVID-19 started to spread faster since March and where social distancing measures continue to be implemented. As for China, after the incipient recovery registered in March, the PMI of the manufacturing sector decreased slightly in April, while that of the services sector increased slightly, reflecting a gradual normalization of activities after the lockdown was lifted.

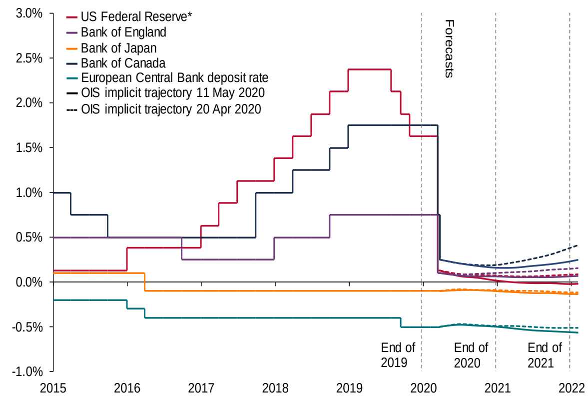
International commodity prices have registered an erratic behavior since the end of April. In particular, after WTI oil prices fell by 56 USD per barrel on April 20 reaching -37.6 USD per barrel due to the expiration of WTI crude oil future contracts for May delivery, the fall in global oil demand and expectations of a sharp reduction of storage capacity in Cushing, Oklahoma, prices have slightly recovered as a result of the new production cuts by Saudi Arabia and other Arab countries, although they remain low. Grain and industrial metal prices have recently registered some volatility due to uncertainty about world demand and the renewed tensions between the United States and China due to allegations regarding the origin and spread of COVID-19.

A.1.2. Monetary policy and international financial markets

In most advanced economies, headline and core inflation decreased mainly as a result of the fall in energy product prices. The decline in economic activity due to the pandemic has already started to be reflected in lower prices of certain goods and services. Inflation in these economies has thus been well below the targets of their respective central banks. In addition, inflation expectations drawn from both financial instruments and surveys remain at low levels. In most emerging economies, headline and core inflation also reached lower levels in March, mainly reflecting the effects of the lower economic activity.

In this environment, several central banks of advanced and emerging economies have continued to implement accommodative monetary policy stances, and in some cases, continued to lower their policy rates and to implement extraordinary measures to promote 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 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 April meeting, the US Federal Reserve left unchanged both the federal funds rate, at a range of 0%-0.25%, as well as its asset purchase program. It also expanded the coverage of some of the previously announced facilities to foster the well-functioning of financial markets. The Fed confirmed that it expects to maintain the funds target range at its present level until the economy overcomes the recent events, and emphasized its commitment to use all available tools to support the US economy, adding that it will continue to purchase assets in the amounts needed to support the well-functioning of markets as well as to continue the repurchase agreement operations. The Fed also pointed out that it will continue to monitor the implications of incoming information on economic activity, public health, the global economy and inflation. In this environment, both market variables and the consensus of forecasters foresee that this central bank will maintain the federal funds rate unchanged for the rest of 2020.

ii) In its April meeting, the European Central Bank (ECB) left its policy rates unchanged, maintaining its refinancing rate, key deposit facility rate and key lending facility rate unchanged, at 0.0%,

-0.5%, and -0.25%, respectively. At this meeting, it announced the temporary allotment of additional long-term loans and a series of improvements in the conditions of its long-term refinancing operations (TLTROs-III), which include the reduction of interests applied to these operations, the early start of the loan assessment period, and the easing of requirements for such operations. In addition, the ECB announced a new series of emergency longer term refinancing operations in response to the pandemic, known as pandemic emergency longer term refinancing operations (PELTROs).

iii) In its May meeting, the Bank of England left unchanged its policy rate at 0.1% as well as its bond portfolio asset purchase program. This decision was taken with a divided vote in which two Monetary Policy Committee members voted in favor of increasing the size of such program by £100 billion. In its minutes, the Bank of England acknowledged that, given the downward risks for economic activity in the medium term, greater actions may be required in the future. In this regard, in his first meeting as Governor of this central bank, Andrew Bailey pointed out that all options remain possible and that the quantitative easing (QE) program may be expanded in June.

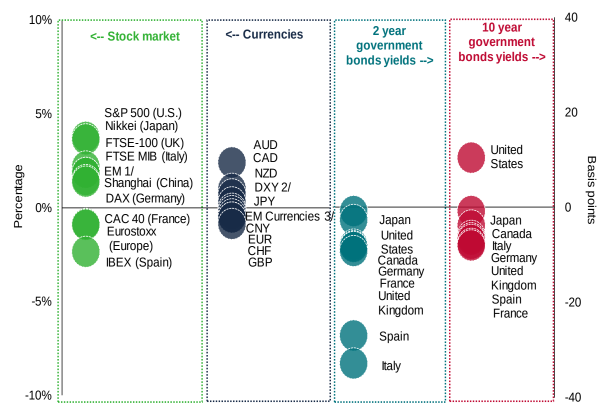
iv) In its April meeting, the Bank of Japan left its short-term policy interest rate unchanged at -0.1% and its long-term interest rate (indexed to its 10-year bond) at 0%. In addition, in light of the severe impact on economic activity and the tightening of financial conditions resulting from the COVID-19 pandemic, it decided to increase significantly the purchases of commercial paper and corporate bonds, as well as to ease the requirements of the funds provision facility for the corporate sector due to the health emergency. It also committed to increase its government bond purchases, eliminating the annual ¥80 trillion limit it had set before, in order to attain its 2% inflation target.

v) The Bank of Canada announced details of its program of asset purchases in the secondary market. It also revised the terms and conditions of its term repo transaction facility to include a 90-day term in addition to those announced previously.

Since Mexico's latest monetary policy decision, several central banks of emerging economies announced cuts to their policy rates, with those of Brazil, Colombia, Malaysia, Russia, and Turkey standing out. In addition, the Central Bank of India adjusted its loan facilities to support mutual funds, and the Central Bank of Malaysia (BNM) announced the injection of financial resources to ensure liquidity in financial markets.

Since Banco de Mexico's latest monetary policy decision, international financial markets exhibited a more stable behavior. This can be associated with the actions adopted by the largest advanced economies to provide liquidity and restore the well-functioning of financial systems. The above in addition to the slowdown observed in the number of contagions and deaths in the main advanced economies in the last weeks, which led several countries to start easing social distancing measures. Similarly, news about potential treatments against COVID-19, along with stimulus measures implemented by the authorities, led to a less pessimistic sentiment, which partly reverted the movements observed during the year. In this environment, moderate adjustments were observed in advanced economies' financial assets. Most main stock indices rose; interest rates of government securities traded in a narrower range, although with a downward bias; exchange rates exhibited mixed adjustments against the US dollar; and corporate bond spreads also registered mixed adjustments Chart 5).

Chart 5
Change in Selected Financial Indicators from April 20 to May 11, 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.

As to emerging economies, moderate adjustments were observed overall in a context of caution among investors given the adverse effects of the COVID-19 spread. Among these effects, the possibility of a further downgrading in the sovereign debt rating of several countries stands out. A moderate depreciation of most of their currencies was also observed, while investment flows to these economies continued to decrease (Chart 6).

Looking ahead, the behavior of international financial markets will largely depend on the measures taken to contain the virus spread and the capacity to mitigate the negative effects of the disease on economic activity. Likewise, the resurfacing of political and trade tensions between China and the United States may generate new episodes of volatility and risk aversion. Other risks also persist, such as the possibility of a worsening of geopolitical, social and political conflicts in various regions of the world; the risk of greater and more frequent economic costs due to natural disasters attributed to environmental factors; and a deterioration of households' and firms' financial situation due to the weakening of the world economy.

Chart 6
Emerging Economies: Financial Assets Performance from April 20 to May 11, 2020
Percent, basis points

Region	Country	Currencies	Equity markets	Interest rates 2Y	Interest rates 10Y	CDS
Latin America	Mexico	0.52%	9.30%	-66	-102	-51
	Brazil	-9.67%	0.93%	7	55	17
	Chile	3.53%	2.51%	-12	-22	-15
	Colombia	2.00%	-6.13%	-32	-38	-34
	Argentina	-2.10%	23.57%	1,377	161	-3,282
Emerging Europe	Russia	2.79%	4.58%	-46	-21	-37
	Poland	-1.33%	-1.70%	2	5	-1
	Turkey	-1.91%	-1.17%	-122	56	-38
	Czech Republic	-0.85%	4.64%	-23	-6	3
	Hungary	0.24%	6.02%	-8	-22	-2
Asia	Malaysia	0.87%	-2.18%	-9	6	3
	India	1.07%	-0.27%	-2	3	7
	Philippines	0.92%	-1.15%	-80	-75	0
	Thailand	0.95%	1.65%	-14	-7	-7
	Indonesia	3.36%	1.38%	15	19	2
Africa	South Africa	2.28%	2.77%	-53	-66	-2

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.

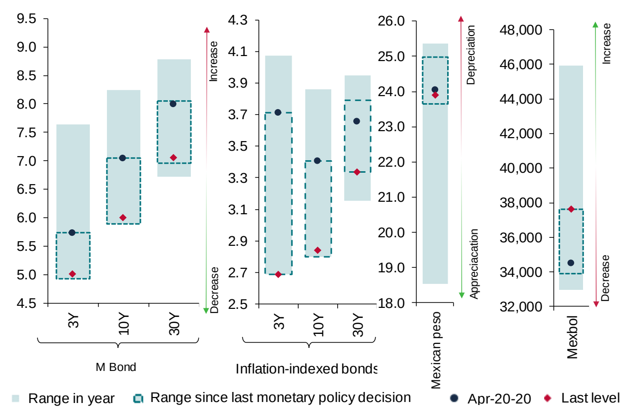
A.2. Current situation of the Mexican economy

A.2.1. Mexican markets

Since Banco de Mexico's previous monetary policy decision to date, the prices of financial assets in Mexico showed a stable behavior, in line with the overall dynamics observed in emerging markets (Chart 7). This took place in an environment where a sentiment of caution by investors prevailed towards the potential adverse effects that may stem from the COVID-19 spread.

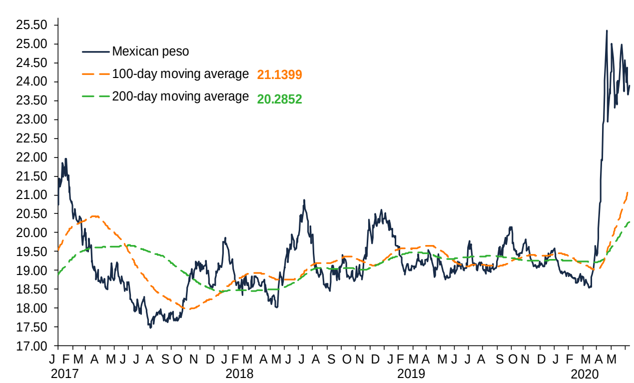
The Mexican peso exchange rate traded in a wide range, although narrower than in previous weeks, of 23.55-24.97 MXN/USD (Chart 8). Thus, during the period, the Mexican peso appreciated 0.5% against the US dollar, without standing out among its emerging market peers. This took place in a context where both FX spot and forward outright trading conditions improved vis-à-vis those of March, although they remain at relatively high levels.

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

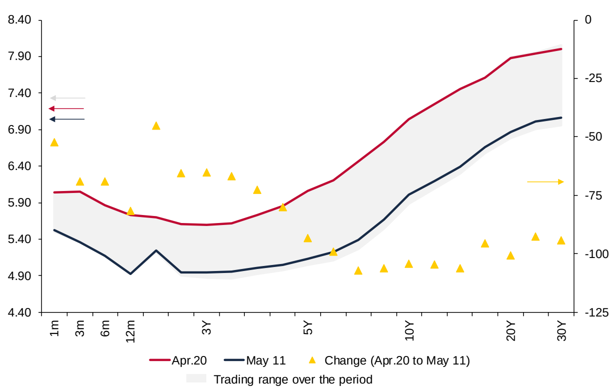


Source: Prepared by Banco de México.

Interest rates of government securities decreased up to 105 basis points throughout the entire yield curve, with medium-term rates registering the greatest adjustments (Chart 9). Worth noting is that such adjustments took place in a context where trading conditions improved at the margin.

In this context, on April 21, Banco de México announced two sets of measures aimed at fostering an orderly behavior of financial markets, strengthening credit granting channels, and providing liquidity for the healthy development of the financial system. Some of these measures are intended to diminish the possibility that credit institutions follow a pro-cyclical behavior, and to enable conditions that facilitate financial intermediaries fulfilling their priority role of providing financing to the economy, so that, in turn, such financing is channeled to micro, small-, and medium-sized firms as well as to households, which have experienced a temporary reduction of their income sources. With the purpose of promoting a proper functioning of the public debt market, Banco de México carried out a first government securities swap transaction, through which it received long-term (starting at 10 years) instruments and delivered other 3-year maturity instruments for MXN 4,615 million.

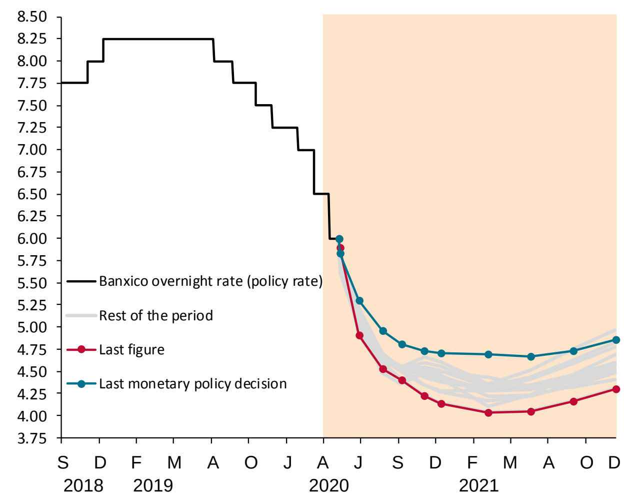
Chart 9
Nominal Yield Curve on Government Securities
Percent, basis points



Source: PIP.

As for expectations regarding the path of the monetary policy target rate, information implied by the Interbank Equilibrium Interest Rate (TIIE) swap curve practically discounts a 25-basis point cut for the monetary policy decision of May, while private sector forecasters surveyed by Citibanamex are expecting a 50-basis point cut. For the end of 2020, market variables are anticipating a target rate of around 4.00% (Chart 10), while the median of surveyed forecasters lays at 4.75%.

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

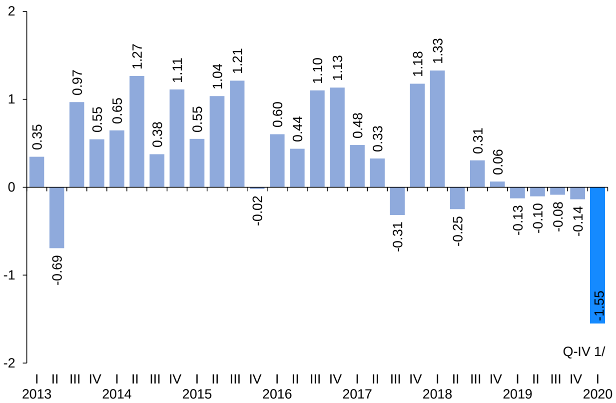


Source: Prepared by Banco de México with Bloomberg data.

A.2.2. Economic activity in Mexico

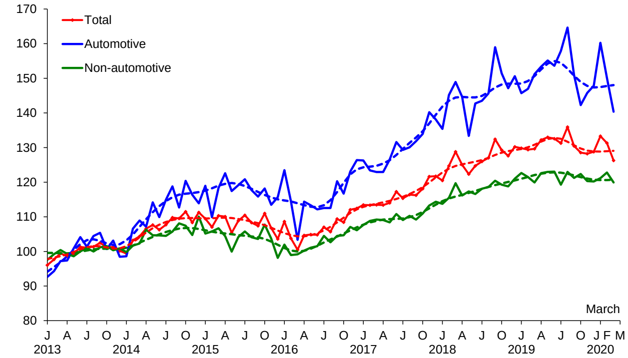
Although at the beginning of 2020, and prior to the COVID-19 spread, Mexico's productive activity maintained the stagnation observed for several quarters, in March the effects associated with the measures to contain the spread of the pandemic in the country began to materialize, along with the sharp weakness of the global economy and certain disruptions in global value chains that considerably affected the production of goods and services. Indeed, according to INEGI's GDP flash estimate, during the first quarter of 2020, Mexico's economic activity contracted significantly (Chart 11). Although the magnitude and duration of the effects of the pandemic are still unknown, they are expected to intensify during the second quarter and lead to important contractions of employment.

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.

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



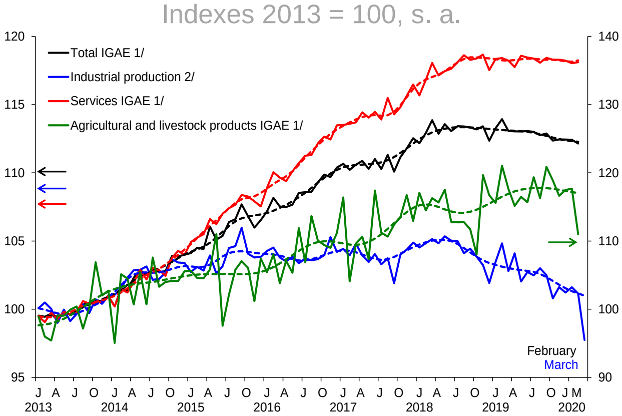
s. a. / Seasonally adjusted series and trend series based on data in nominal US dollars. The former is represented by a solid line and the latter by a dotted line.
Source: Prepared by Banco de México with data from the Tax Administration Service (SAT, for its acronym in Spanish), the Ministry of the 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).

At the end of the first quarter of 2020, the effects of the worldwide spread of the pandemic led to a decline in Mexico's manufacturing exports. In particular, automotive exports decreased significantly in March, in a context where several assembly plants suspended their activities in the second half of the month in response to the health emergency. In turn, the rest of manufacturing exports continued to exhibit a low dynamism due to the lackluster performance of exports to the United States and a strong contraction of those to the rest of the world (Chart 12). The greater weakness of the world economy, together with the decline in domestic production resulting from the effects of COVID-19 on the supply of inputs, are expected to continue affecting negatively and significantly the Mexican export sector, particularly during the second quarter of the year.

In February 2020, the sluggishness that private consumption had shown during the previous months continued. Timely information suggests this aggregate has been significantly affected since in March by the COVID-19 spread. In particular, National Association of Self-Service and Department Stores (ANTAD, for its acronym in Spanish) sales declined in March, reflecting the mixed impact of social distancing measures on the types of stores represented, given that department and specialized store sales fell significantly, while those of supermarkets rose considerably as a result of consumers' precautionary behavior. In turn, after having decreased more than 20% at a seasonally adjusted monthly rate in March, light vehicle sales contracted further at a rate of close to 50% in April. In the first two months of the year, gross fixed investment continued trending downwards, as a result of the poor performance of both machinery and equipment and construction. Timely indicators such as those of capital imports suggest that this item will also be significantly affected since the end of the first quarter by the greater uncertainty and the economic effects of the pandemic.

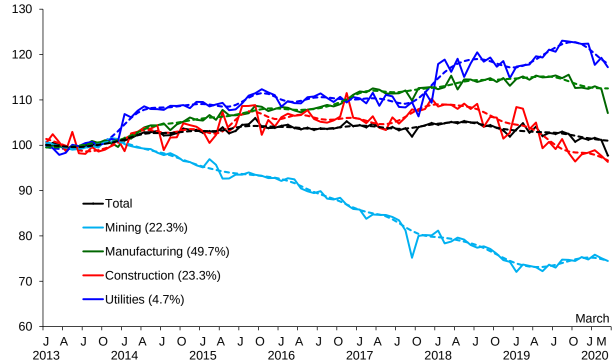
As for production, according to timely indicators, during the first quarter of 2020 the downward path that industrial production had been following since the beginning of 2018 intensified, while in March services were affected by the pandemic, after the lackluster growth they registered in 2019 and the beginning of 2020 (Chart 13). Within secondary activities, in March manufacturing contracted significantly, largely associated with the shutdown of activities in some sectors due to the shortage of imported inputs, mainly those from China, as well as to the unfavorable performance of the transportation equipment sector, mainly due to shutdowns in the automotive industry as a precautionary measure in response to the health emergency (Chart 14). Shutdowns in this industry extended to April, leading to a fall in final production of almost 100% during that month. The downward trend followed by construction intensified, while mining once again exhibited weakness, reflecting the fall in the metal and non-metal mineral production item, although an increase in crude oil extraction continued to be observed. The stagnation of tertiary activities at the beginning of 2020 was mostly explained by the negative contributions of transportation and mass media information services, although other services also exhibited weakness. Timely indicators show that the negative performance of services intensified in March, and is expected to have concentrated on activities such as arts, entertainment and recreation, accommodation, and food services.

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 February 2020.
2/ Monthly industrial activity indicator figures up to March 2020.
Source: Mexico's National Accounts System (SCNM, for its acronym in Spanish), INEGI.

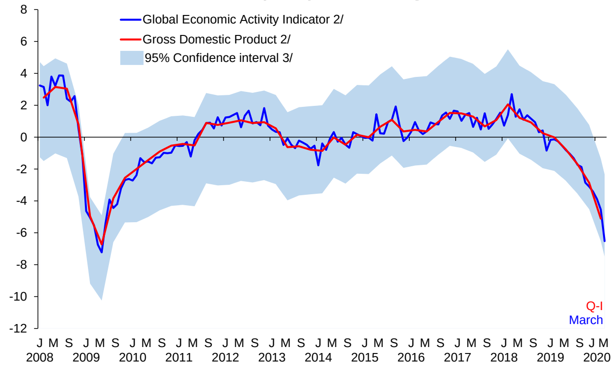
Chart 14
Industrial Activity 1/
Indexes 2013 = 100, s. a.



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.

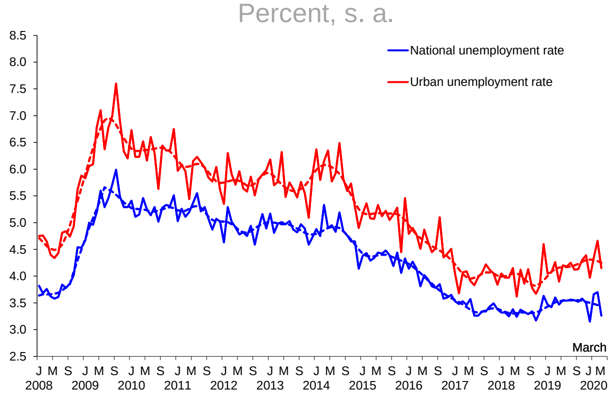
As to the economy's cyclical position, slack conditions continued to widen considerably towards the end of the first quarter of 2020, reflecting the persistent weakness that economic activity has registered for several quarters and the effects of the COVID-19 spread (Chart 15), in a context where the balance of risks for growth is significantly biased to the downside. As to the labor market, in January – March 2020, both national and urban unemployment rates remained at levels above the average for 2019, although they declined in March, despite the lower economic activity in that month (Chart 16). Similarly, the unfavorable performance of IMSS-insured job creation intensified significantly due to the effects of the pandemic, leading to the loss of 131,000 jobs in March and 555,000 in April, with non-seasonally adjusted figures.

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



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

Chart 16
National Unemployment Rate and Urban Unemployment Rate
Percent, s. a.



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

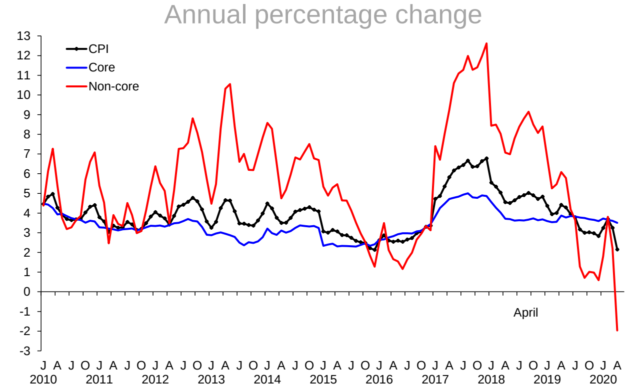
In the first two months of 2020, domestic financing to private firms continued to decelerate, and even contracted at an annual rate in real terms in February. In contrast, bank credit to large-sized firms, particularly to issuing firms, increased in March. Since that month, a sharp decline was observed in the activity of firm's domestic debt issuance market. Similarly, household credit continued loosing dynamism in March. In particular, consumer credit registered a real annual rate of change of practically zero. As for interest rates, those of firm financing decreased, in line with the reduction of the overnight funding interest rate. In turn, interest rates of mortgages decreased slightly vis-à-vis those of December 2019, when such rates decreased relative to the level observed since the second quarter of 2017. In the segment of consumer credit, and with figures to February 2020, interest rates of credit cards decreased slightly as compared to previous months. With regards to portfolio quality, firm and mortgage delinquency rates remained at low levels, while those related to consumption rose moderately at the margin.

As a result of the contingency stemming from the COVID-19 pandemic, there is the risk that the loanable funds market deteriorates in the next months, both because some creditors may have difficulties in meeting their obligations and because some credit institutions may restrict financing as a precautionary measure. Given the complex outlook, Banco de México announced several measures in April, including those aimed at strengthening the credit granting channels to micro, small- and medium-sized firms and individuals affected by the pandemic, through the provision of resources to banks and through lending facilities based on corporate securities collateral.

A.2.3. Development of inflation and inflation outlook

Between March and April 2020, annual headline inflation decreased from 3.25 to 2.15%, as a result of lower non-core inflation, which even stood at negative levels due to the significant fall in energy product prices, particularly of gasolines, in the context of the COVID-19 pandemic. Annual core inflation also declined, although in a lesser magnitude and with a mixed behavior of its components (Chart 17 and Table 1).

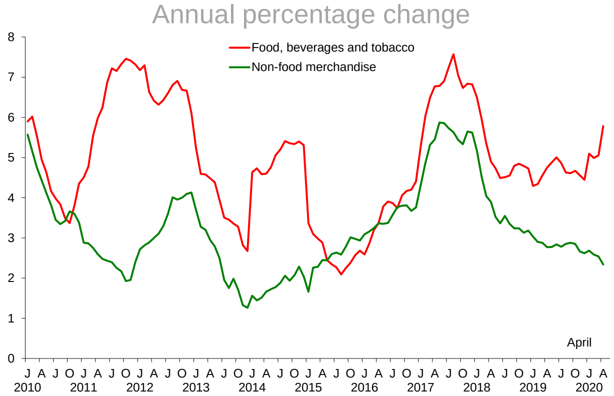
Chart 17
Consumer Price Index
Annual percentage change



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

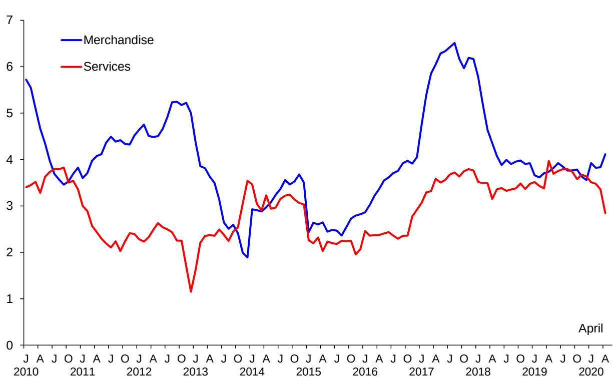
Indeed, annual core inflation decreased from 3.60 to 3.50% between March and April 2020, reflecting reductions in services and non-food merchandise prices, while food, beverages and tobacco prices increased. In particular, the annual rates of change of merchandise prices rose during the same months from 3.83 to 4.11%, driven by the increase of food, beverage and tobacco prices, possibly due to the higher relative demand associated with the health contingency. In contrast, the annual rates of change of non-food merchandise prices have continued to decrease, given that the lower relative demand for certain merchandises, such as clothing, may be offsetting the effect of the higher relative demand for others, such as medications and household products (Chart 18). The reduction from 3.35 to 2.48% in the annual rate of change of services prices during the same period (Chart 19) reflects the social distancing measures stemming from the COVID-19 pandemic, which have had a downside impact on tourist and food services prices.

Chart 18
Merchandise Core Price Subindex
Annual percentage change



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

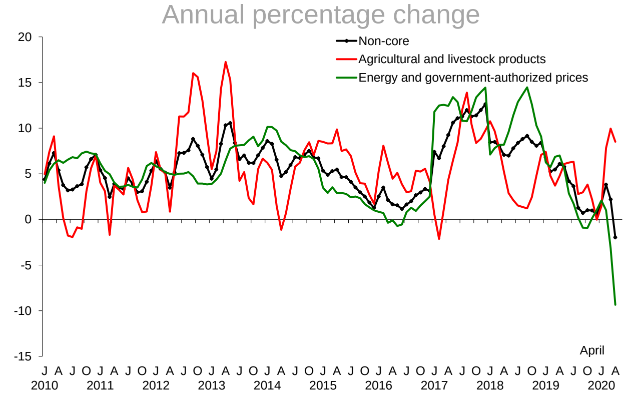
Chart 19
Merchandise and Services Core Price Subindex
Annual percentage change



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

Annual non-core inflation declined from 2.19 to -1.96% between March and April 2020 (Chart 20 and Table 1). This result is mainly explained by the sharp reduction of energy product prices, which registered annual rates of change of -6.36 and -15.20% in the same months. The above has largely reflected the historic falls in international references due to the price war and lower international demand in the context of the COVID-19 pandemic. In turn, the annual rates of change of agricultural and livestock product prices also decreased from 9.96 to 8.52% during the same months, due to the reduction in the annual rate of change of fruit and vegetable prices.

Chart 20
Non-core Price Subindex
Annual percentage change



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

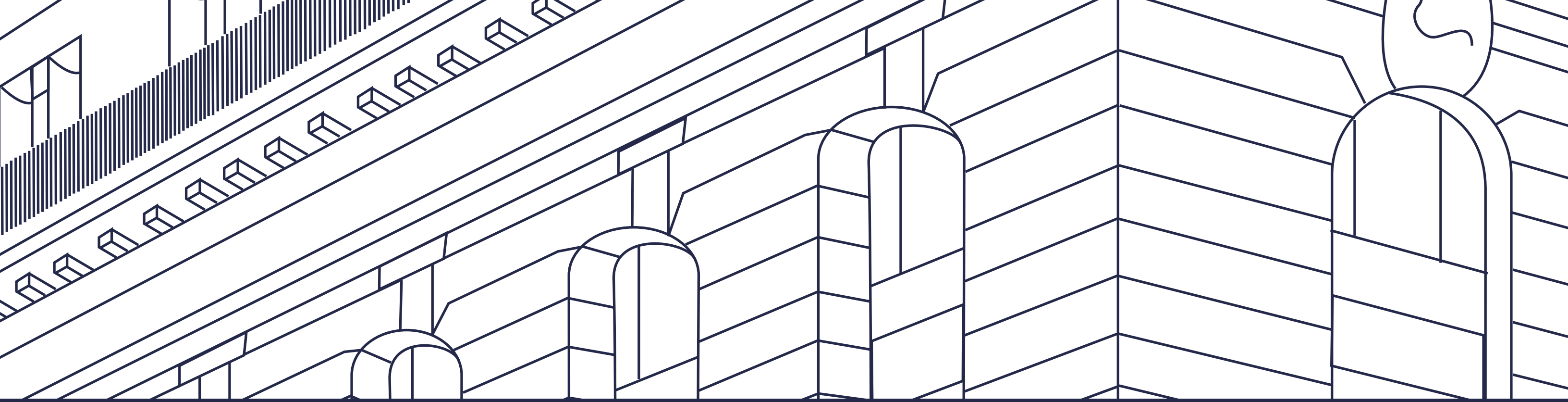
As to inflation expectations drawn from Banco de México's Survey of Private Sector Forecasters, between March and April, the medians for headline and core inflation for the end of 2020 decreased from 3.64 to 2.90% and from 3.50 to 3.34%, respectively. Those for headline inflation for the medium and long terms remained at 3.50%. As for the medians for core inflation expectations, those for the medium term remained at 3.50%, while those for the long term decreased from 3.48 to 3.45%. Finally, breakeven inflation decreased during the same period, with said behavior intensifying in the first days of May.

As for the risks to the foreseen trajectory of inflation, the most important to the downside are a significant widening of the negative output gap and the effects of the fall in energy prices. To the upside, a greater or more persistent depreciation of the peso and possible disruptions to chains of production and distribution of certain goods and services. In this context, the balance of risks for inflation remains uncertain.

Table 1
Consumer Price Index and Components
Annual percentage change

Item	February 2020	March 2020	April 2020
CPI	**3.70**	**3.25**	**2.15**
Core	**3.66**	**3.60**	**3.50**
Merchandise	**3.82**	**3.83**	**4.11**
Food, beverages and tobacco	4.99	5.05	5.78
Non-food merchandise	2.58	2.54	2.34
Services	**3.48**	**3.35**	**2.84**
Housing	2.94	2.93	2.86
Education (tuitions)	4.55	4.58	4.57
Other services	3.72	3.47	2.47
Non-core	**3.81**	**2.19**	**-1.96**
Agricultural and livestock products	**7.82**	**9.96**	**8.52**
Fruits and vegetables	11.23	13.47	9.35
Livestock products	4.91	7.00	7.83
Energy and government-authorized prices	**1.01**	**-3.13**	**-9.35**
Energy products	-0.54	-6.36	-15.20
Government-authorized prices	4.86	4.98	4.81

Source:INEGI.



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