BANCO DE MÉXICO®

Minutes number 78

Meeting of Banco de México's Governing Board on the occasion of the monetary policy decision announced on August 13, 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: August 12, 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

Most members stated that the global economy began to show a slight recovery in May and June, after having declined sharply in March and April, although **one** member pointed out that timely indicators for July indicate a moderation in the recovery rate. **Most members attributed the recovery of the global economy to the partial reopening of activities in certain economies**. **Some** members added the impact of fiscal and monetary stimuli. **One** member considered that the recent performance of economies also reflects: i) the dynamics of the pandemic, its contagion, and mortality rate; ii) the relative importance of the most affected sectors; iii) the flexibility of the labor market; iv) financial conditions and availability of funding, and v) the soundness of the financial system.

Some members underlined that economic activity is still far from the levels prior to the pandemic. **One** member stated that the strongest repercussions were registered in manufactures, person-to-person services, and small businesses. Regarding the labor market, he/she pointed out that in the U.S. the unemployment rate increased significantly in April and May, above 14%, and later declined to levels close to 10%. In contrast, in the euro area, in the United Kingdom and Japan, the unemployment rate increased moderately, and the use of job preservation programs increased.

Most members pointed out that a strong contraction is anticipated for this year and a moderate growth for 2021, although these projections are subject to high uncertainty. One member noted that, even though the recovery is foreseen to continue until the end of this year and during the next one, the magnitude of sequential increases is expected to moderate gradually. **Another** member stated that infection rates in advanced economies show large differences, which generates uncertainty regarding expectations of economic recovery.

Among risks to global economic activity, most members mentioned unfavorable dynamics of the pandemic. In this respect, they highlighted the upsurge of new cases in different countries. Some members highlighted the possibility that the pace of removal of restrictions to economic activity slows down or that said restrictions are implemented again. **One** member mentioned that heterogeneous results in the health sector could lessen the momentum and the sustainability of the recovery. He/she added the risk that the stimulus measures are withdrawn or reduced prematurely. Although this would hardly apply to monetary policy, considering the central banks' commitment to maintain accommodative monetary policy stances, he/she expressed concern over the fiscal measures, especially in contexts where the room for maneuver is limited or politicized.

Most members mentioned the risk of negative effects on financial markets. One member highlighted the possible contagion of the crisis to the financial system and to the sustainability of public finances, in view of the maximum historical levels of sovereign and corporate debts. **Another** member pointed out the possibility of higher delinquency rates of credits to businesses and households, although in some economies the relief programs have eased this risk. He/she added that low commodity prices imply lower public revenues and a deterioration in the terms of trade in various emerging economies. He/she noted that, unlike advanced economies that have a reserve currency, the higher public sector borrowing requirements in emerging economies will exert pressure on the availability of financial resources. Finally, **some** members mentioned the risk of a resurgence of trade conflicts, as well as political and geopolitical factors.

Most members mentioned that headline and core inflation in advanced economies are below the targets of their respective central banks. One member pointed out that this derives from the fact that the reduction in services prices have offset the rebound in energy prices. **Another** member stated that in the U.S. and the euro area a recomposition of spending was observed, with increases in food prices and falls in the prices of a broad range of services. He/she mentioned that despite the possible negative effects on supply, in those cases the weakness of demand has prevailed. He/she stated that the central banks in these economies expect inflation to remain at low levels for a long time. He/she added that the minimum levels at which short-, medium- and long-term interest rates are in these economies, reflect an expectation of weakness in demand and its deflationary effects.

Some members noted that in various emerging economies, inflation also remains at low levels. However, **one** pointed out that some of these economies show upward pressures, due to the higher prices of food merchandise and energy products, foreign exchange depreciations and other idiosyncratic factors. In this sense, he/she considered that there is heterogeneity in the behavior of inflation at the global level.

Given the described environment, most members emphasized that monetary authorities have maintained accommodative policy stances. They mentioned that different central banks have expressed their willingness to maintain easing measures for as long as necessary and even to reinforce them. Some members highlighted that the US Federal Reserve is anticipated to maintain the federal funds target range between 0 and 0.25% for a prolonged period and that, if necessary, it would be ready to expand its asset purchase programs. **One** member added that the Fed also announced the extension of some lending and liquidity facilities. Regarding emerging economies, **another** member highlighted that in most of them the reference rate is very close or below the latest inflation figure and that, on average, interest rates are expected to lie around 2.5% at the end of the year. **Some** members also highlighted the fiscal stimulus measures adopted in different countries to mitigate the negative effects on employment and on households' and businesses' incomes. **One** member mentioned the agreement that in this regard has been recently attained in the European Union.

Most members noted the positive performance of global financial markets, reflecting the effects of the fiscal, monetary and financial measures adopted in advanced economies, and the gradual reopening of productive activity in said economies. One member added that the improvement is also due to the relatively favorable evolution of the pandemic, as well as to recovery indicators and better-than-anticipated corporate results. **Some** members underlined the increase in stock indexes, the higher prices of precious metals, and the depreciation of the US dollar against a broad basket of currencies. **One** member added that the dollar even depreciated against emerging economies' currencies. However, **some** members stated that the financial conditions that prevailed prior to the pandemic have not been achieved. **One** member underlined that, in light of the mentioned risks, new volatility episodes may be observed. He/she added that, despite the relative stability in financial markets, the recent experience shows that adjustments stemming from changes in markets' sentiment can be disorderly.

Most members highlighted that emerging economies' financial markets also exhibited a favorable performance. One stated that in these economies, the financial shock was intensified by the fall in commodity prices and in other external revenues, which led to downgrades in the ratings and outlook of sovereign risk, thus strengthening the financial shock in a procyclical manner. Nevertheless, he/she stressed that this shock has moderated and that portfolio recomposition has been contained. **Another** member noted that risk appetite for fixed income assets has increased, although equity markets continue registering outflows. **Some** members noted that, despite this improvement, restrictive conditions and caution prevail in markets. **One** member emphasized that the gap between public sector borrowing requirements and the demand for fixed-income instruments persists. **Summing up, most members considered that global financial conditions will remain subject mainly to the effects of the pandemic and that an environment of uncertainty persists.**

Economic activity in Mexico

Regarding economic activity in Mexico, all members highlighted the deep contraction in view of the effects of the pandemic. In this regard, most members highlighted that during the second quarter the GDP flash estimate fell significantly, by 17.26% as compared to the previous quarter. Some members emphasized that this is the sharpest fall on record for this indicator. **One** member stressed that the economy has already been contracting for five consecutive quarters. **Some** members pointed out that economic activity registered its deepest contraction in April and that it bottomed out in May.

On the supply side, **some** members emphasized the contraction in the primary, industrial and services sectors. **One** member noted that in April and May, over 50% of subsectors registered annual falls of over two digits, which is higher than the figure observed in the two worst months of the 2009 and 1995 crisis. He/she highlighted the decline in industrial production of over 26% between March and May. He/she indicated that the use of installed capacity in the manufacturing industry in April and May fell by over 36% and, in some subsectors, by over 60%. **Another** member indicated that during the second quarter industrial activity and services dropped by 23.59% and 14.54%, respectively, while the primary sector contracted only 2.48%.

On the demand side, most members underlined the weakness of consumption and investment. One member emphasized the monthly contractions of 19.6 and 1.7% of consumption during April and May, respectively. **Most members pointed out that consumption and investment are foreseen to continue showing weakness, as a result of the pandemic's evolution, lower household income, and low confidence levels. Some** members added the lower availability of financing to households and businesses, although **one** mentioned that remittances have grown, thus supporting domestic spending. **Another** member argued that the lower dynamism of consumption and investment is accounted for by the fact that their determinants remain highly deteriorated. He/she considered that, as the pandemic and the economic recovery have evolved, it is becoming more evident that the consequences of the current crisis will go beyond those generated by the initial supply shock. **As for external demand, most members pointed out that in June exports recovered slightly, in view of the US economy reopening.** Thus, **some** members emphasized that the recovery of external demand and manufacturing production has been greater than that of domestic demand and services.

Most members pointed out that various indicators point to an economic recovery in June, although starting from low levels, in response to the reopening of some sectors, the loosening of restrictions to mobility and the recovery of external demand. Some members highlighted that the most significant rebound has been observed in the export-oriented industrial sector, while the growth of services has exhibited a greater lag. **One** member noted that industrial production registered a monthly rebound of 17.9% in June, although it still presents an annual contraction of 17.5%. **Another** member mentioned that, although information for July is limited, available indicators continue to show an upward trajectory, although from very depressed levels. **One** member pointed out that ANTAD sales went from registering an annual contraction of 14.8% in June to one of 10% in July.

Regarding the labor market, all members highlighted the significant impact on employment, although **some** members noted that recent data indicates a slight recovery. **One** member specified that, at the margin, the recovery has been concentrated in the informal sector. **Some** members mentioned that according to INEGI's Telephone Survey on Occupation and Employment, between April and June, 12 million full-time jobs were lost. **One** member stated that, out of these, about 7 million individuals were left unemployed and that the rest were reclassified as underemployed. **Another** member pointed out that the total number of unemployed, underemployed or workers who are not economically active but who are available to work reached almost 26 million in June, as compared to 12 million during the same month of 2019. **Some** members highlighted that during the first half of the year around one million formal jobs were lost. **One** member mentioned that, in this context, withdrawals from Afores related to unemployment continued to increase during June, reaching historical highs.

Most members mentioned that the open unemployment rate has increased, although **some** stated that said increase has been moderate, since a high number of individuals have left the economically active population. **One** member argued that this is due to the difficulty to find employment amid lockdown policies. He/she pointed out that when the increase of 7.3 million individuals who are available to work but economically inactive is considered as disguised unemployment, the extended unemployment rate rose from 12% in

March to 24.9% in June. He/she added that, when the underemployed are included in the extended unemployment, the concept of labor gap is attained, which registered 40% in June, twice as large as the figure of March, but below the 53% recorded in May, which indicates that it has already bottomed out. He/she warned that, given the definitive closure of businesses, it is not clear when the lost jobs will be recovered.

Most members highlighted that growth expectations have continued to deteriorate. They pointed out that even double-digit contractions are anticipated for 2020. One member pointed out that, according to Banco de México July's Survey of Private Sector Forecasters, the expected contraction for 2020 increased from 8.8 to 9.9%, and the expected growth for 2021 rose from 2.8 to 3.0%.

The majority of members underlined the uncertainty about economic recovery. They stated that it will depend on the containment of the pandemic, as well as on the development of a vaccine and an effective treatment. Some members mentioned that although a recovery is expected due to the easing of lockdown measures, it will be gradual and prolonged. **One** member noted that economic activity will remain depressed for a long period, with a greater negative impact on the labor market. He/she highlighted that, given a recession of a magnitude unseen in 88 years, a pattern of recovery is still not visible. He/she added that several scenarios suggest a period of between two and six years for GDP to recover to the level observed in 2018.

Among the risks for growth, **some** members mentioned the possibility that the impact on the production of goods and services and on firms' and households' incomes will continue. **One** member added that pressures on public revenue may affect the sovereign risk outlook and that households' and firms' solvency problems may put pressure on the financial system. In the external environment, in addition to the abovementioned global risks, **another** member included a slower than expected recovery in advanced economies, particularly in the United States. **One** member underlined that such risks are intensified by the modest support of fiscal policy and added that in light of the possibility of new COVID-19 outbreaks, a second episode of contraction cannot be ruled out. **Another** member mentioned that the degree of fragility of the economic recovery is high taking into account the medium- and long-term damage to businesses and investment, the latter of which was already affected before the health crisis emerged. **Most members pointed out that economic growth is subject to significant downward risks.**

Most members agreed that greater economic slack is expected within the time frame in which monetary policy operates. Some members stated that economic slack increased significantly due to the impact from the pandemic. They added that there is now a greater slack than that registered in previous crises, such as those of 2008-2009, 1995 and at the beginning of the eighties. **One** member mentioned that while in the worst month of 2009 the output gap was -7%, in April 2020 it was close to -24%.

Inflation in Mexico

Most members mentioned the increase of annual headline inflation, due to increases in both its non-core and core components. Some members pointed out that, despite the sharp economic weakness, the recent path of inflation has recently surprised to the upside. In this regard, **one** member considered that inflation dynamics should be analyzed, given that headline inflation and its components have registered levels consistently above forecasts, despite the wide economic slack and the peso exchange rate appreciation. He/she added that, in this context, the disinflationary effect attributed to the cyclical component of economic activity should be reconsidered. **Another** member considered that headline inflation's increase in July does not put price stability at risk. He/she stated that the recent increase should not distract us from the favorable evolution exhibited by several of its components.

The majority of members pointed out that the evolution of non-core inflation has responded mainly to the behavior of energy prices. They highlighted that these prices have increased after having fallen sharply in March and April, which has contributed to the rise of non-core inflation. One member stated that the above has occurred after this component registered in April a negative annual rate of change for the first time in history. **Another** member stated that, despite the increase in energy prices, they remain below the level registered at the beginning of the year. He/she added that the lower commodity prices, particularly of fuels, and their effect on production costs have a favorable impact on inflation.

All members mentioned that within core inflation, effects in opposite directions are observed, with a decrease in the annual rates of change of services prices and an acceleration in those of

merchandise, with high annual rates of change in food prices. Most members pointed out that services prices have reflected the weakness of demand. As for merchandise prices, they highlighted that these are being affected by supply and demand shocks and by the exchange rate adjustments. One member considered that these effects intensified the inflationary pressures on international food prices that have been observed since last year. These upward pressures in merchandise prices represent a significant rearrangement in relative prices given the slowdown of services prices. **Another** member noted that such pressures, which concentrated on food merchandises initially, have spread to non-food merchandises and considered worrisome that core inflation is following a higher than expected path, emphasizing that in July it reached its highest level in thirteen months.

Some members mentioned that the increase in food merchandise prices may be due to a change in consumption patterns as a result of the pandemic. **One** member considered that, although they may be putting upward pressures on the prices of these merchandises, disruptions in supply chains are transitory and that the exchange rate depreciation may explain only part of these price increases. He/she argued that such increases may be due to the existence of firms with market power, which, in face of an increased demand, may increase their prices and profit margins. He/she considered that this could also explain why inflation is greater in Mexico than in other countries with currencies that have depreciated in an equal or greater magnitude. He/she added that these factors act on the supply side and do not imply sustained shocks on prices, and, therefore, little can be done by monetary policy to contain them. He/she also mentioned that a weak demand may be putting downward pressures on the prices of some merchandise items, such as clothing and shoes, which have even registered deflation.

Most members stated that the recent inflation adjustments contributed to an increase of headline inflation expectations for the end of 2020, while those for the medium and long terms have remained at levels above the 3% target. One member noted that, after April, expectations for the end of 2020 have remained above Banco de México's target. **Another** member highlighted the contrast between the median of forecasters' expectations for 2021 and those of the Central Bank. He/she added that long-term expectations have become more firmly entrenched above the target, given the increasingly lower dispersion around 3.5% observed for headline inflation and the increase during this year of core inflation expectations, to practically 3.5%. He/she considered that prospects of a relatively high inflation until the second quarter of 2021 may make the reduction of inflation expectations more difficult. **Another** member argued that the general reading of different instruments that measure expectations is that these are contained despite the recent increase of inflation. He/she added that expectations drawn from market instruments lay at 3.2% for the 1-10 year average.

As for the future path of inflation, **one** member noted that Banco de México's scenario in the short term reflects the effects of some recently observed price adjustments. He/she pointed out that such adjustments have led to increases in core inflation and, in the case of non-core inflation, some comparison base effects are expected on energy prices. Nevertheless, he/she specified that, in the 12-24-month forecast horizon, both headline and core inflation are expected to lay around 3%. **Another** member stated that supply shocks are foreseen to fade over time and, in light of the outlook of a very wide negative output gap, it seems reasonable to anticipate that inflation will converge to the target during the second half of 2021. **One** member considered that the recent rise of inflation does not imply a major concern for inflation ahead. He/she mentioned that data for the second fortnight of July is consistent with these expectations since it shows signs of stabilization in energy prices and in food merchandise prices at the margin. **Another** member stated that the dynamics within the components of inflation has led to an upward adjustment of forecasts. He/she considered that the risk of inflation failing to converge to the target within the forecast horizon has increased and that deviations appear to be increasingly less attributable to transitory factors. He/she also highlighted that such deviations have a regressive impact since they mostly affect the lower income deciles.

One member noted that the behavior of inflation will reflect the effects of adjustments in relative prices that are taking place and those of the profound weakness of both global and domestic aggregate demand. He/she mentioned that these factors are also occurring in other economies, although in most of them the impact of a weak demand has prevailed. He/she stated that, in contrast with Mexico, in advanced and in a large sample of emerging economies, headline and core inflation lay at levels clearly below their target. He/she highlighted that, in such economies, both inflation and output gaps point in the same direction.

Regarding risks for inflation, **some** members mentioned to the downside a greater than expected impact of the negative output gap. As for upside risks, **some** members pointed out the possibility of additional episodes of foreign exchange depreciation. **One** member noted that this could be due to internal and/or external factors. **Some** members highlighted the risk of a de-anchoring of inflation expectations. **One** member stated that if short-term expectations continue to be revised upwards, they may affect long-term expectations, which remain above the target. **Another** member added that an additional deterioration from the supply side cannot be ruled out. **One** member considered that there is a risk that upward pressures on food merchandise prices persist and that they are not offset by other price reductions generated by the economic slack. He/she noted that, likewise, the downward path of inflation in the past year may currently exert upward pressures on prices due to a comparison base effect. **Another** member stated that the risks are limited due to: i) the deterioration of aggregate demand is of an unprecedented magnitude and will persist for an undetermined number of quarters; ii) the peso exchange rate has remained relatively stable for almost three consecutive months, and iii) the outlook for financial markets, although still uncertain, is better than during the worst moments of the pandemic. He/she pointed out that, for all of the above reasons, greater inflationary pressures associated to these factors are not anticipated. He/she added that, in line with their international references, fuel prices are expected to remain below the level registered at the beginning of the year, which will continue to exert downward pressures on the rest of goods and services prices through their impact on production costs. **In this context, most members agreed that the balance of risks for inflation remains uncertain.**

Macrofinancial environment

Most members mentioned that financial markets have exhibited a relatively stable behavior as a result of the lower risk aversion worldwide and the measures adopted by Banco de México. The majority of members highlighted the stability of the peso exchange rate and the reductions in interest rates throughout the entire yield curve. **Some** members added that the sovereign risk continued to decrease moderately and the stock market exhibited a slight downward adjustment. **Some** members pointed out that foreign investment outflows have diminished.

Nevertheless, **some** members highlighted that, despite such improvements, financial conditions have still not returned to their normal state. **One** member underlined that elements that call for caution persist. Among these elements, he/she mentioned that trading conditions remain deteriorated; that the negative balance of the net currency position continued to widen; and that outflows in fixed income instruments have accumulated over USD 15 billion so far this year, a figure that stands out among emerging countries. **Another** member stated that the peso may be subject to pressures in the following months due to idiosyncratic factors, including Pemex's situation, this and other challenges for public finances, and their impact on the sovereign credit rating, as well as a difficult external environment characterized, among other risks, by the US election process. **One** member mentioned that the country faces a sentiment of risk aversion due to the aforementioned election process, as well as to trade tensions and geopolitical conflicts. **Another** member noted that the economic growth outlook is a major determinant of financial markets and thus it is fundamental that it improves so that markets perform more favorably. **One** member added that, in a complex environment, a sound and sustainable macroeconomic stance that contributes to an orderly adjustment of financial markets and of the economy overall is required. The above, in a framework that maintains the sustainability of public finances, a low and stable inflation and a sound and well-capitalized financial system.

Some members pointed out that the situation of public finances is a risk factor. **Some** members highlighted that they are expected to deteriorate and that the public debt-to-GDP ratio is anticipated to increase. **One** member stated that this would occur due to the shortage of budgetary revenues which, even after taking into account the use of extraordinary resources, such as those from the Budget Revenue Stabilization Fund (FEIP) and oil hedges, may lead Public Sector's Borrowing Requirements to reach between 5 and 6% of GDP. **Another** member added that the main fiscal indicators are anticipated to be more unfavorable than those reported by the authorities in their latest report.

Most members expressed concern about Pemex's situation. **One** member emphasized that, in addition to its operational deterioration, the State-owned company will face large maturities that will probably call for an increased fiscal support. Thus, **some** members highlighted the risk of a downgrading of the sovereign and Pemex's credit rating. **One**

member pointed out that, according to a recent survey conducted by an investment bank, most investors surveyed estimate that the investment grade would be lost in 2021 or 2022. He/she highlighted the situation of Pemex and public finances as the main underlying factor. In this regard, he/she mentioned that the impact of the pandemic now adds up to the previously observed difficulties and that, if timely actions are not adopted, the costs will probably materialize relatively fast, in light of the markets' tendency to anticipate their reaction to this type of events. **Another** member highlighted that the possibility of losing the investment grade has already led to a tightening of financial conditions, and that, if it were to materialize, financing costs would increase even further.

Most members noted that the impact of the pandemic is already being reflected in financing to firms and households. Some members mentioned that delinquency rates of certain bank and non-bank loan portfolio segments have increased, although **one** member considered that the measures implemented by Banco de México have contributed to adequately absorb the shock. **Another** member mentioned that the real annual growth rate of financing has been decreasing and that in June it was even negative. He/she added that new credit card loans, car loans and payroll loans have declined sharply and bank credit to small firms decreased by more than 10 billion pesos during the first half of the year. He/she emphasized the reduction of new loans to firms with less than 100 employees. He/she also noted that lending conditions are now stricter and that interest rate spreads have increased, especially for small- and medium-sized firms.

Some members pointed out that the proposed pension system reform has positive elements for financial markets and for the Mexican economy in general. **One** member considered that the announcement helps to remove a factor of uncertainty, which was weighing on markets and sends the right signal that the reallocation of the government's contribution to lower-income workers will make it possible to increase the perceived and real value of a large number of formal jobs, without increasing firms' costs. He/she said that, for this reason, the reform will help to promote labor formality.

Some members mentioned that the current environment of public policies is unfavorable for stimulating private investment and that there is no counter-cyclical fiscal policy to support the productive sector. **One** member warned that the above not only hinders the economic recovery, but also increases the possibility of long-term damage to productive activities. He/she pointed out that the consequences for potential growth can be considerable, especially in view of the contraction of investment, which fell 16% from July 2018 to March of this year and an additional 32% in the following two months, and the need to implement a set of actions focused on increasing productivity.

Monetary policy

Considering the referred risks for inflation, economic activity and financial markets, and based on the foreseen scenarios, and considering the room for maneuvering that on balance these provide to monetary policy, most members agreed on decreasing the target for the overnight interbank interest rate by 50 basis points to a level of 4.5%. One member voted to lower the target to a level of 4.75%.

One member stated that monetary policy is facing challenges in two dimensions: the deep economic contraction and its effects on inflation, and the impact of the global financial shock. He/she added that in order to achieve an orderly adjustment of the economy, as well as low and stable inflation, it is necessary to promote the sound functioning of domestic financial markets, especially the foreign exchange and fixed-income markets, avoiding abrupt portfolio adjustments and capital outflows. He/she indicated that this offers a greater margin for maneuver, since the financial shock operates on a shorter horizon than the shock to economic activity. In this context, he/she pointed out that it is necessary to identify the challenges and dilemmas monetary policy faces, by incorporating all available information and considering a wide range of scenarios.

Another member considered it important for monetary policy to continue its easing cycle, without ruling out the possibility of reaching a real interest rate close to zero or even negative. He/she recalled that in the 2008-2009 financial crisis there was also a real shock and a financial shock, and that despite an increase in expected inflation, which surpassed 4%, the Governing Board began a cycle of monetary easing, which brought the real interest rate to negative levels in less than 10 months. He/she mentioned that the accommodative policy stance was maintained and intensified over the next few years, allowing the economy to recover, while financial markets were favored by the improved economic outlook, which led to an exchange rate appreciation, and there was a sustained decline in inflation expectations. He/she pointed out that the magnitude of the estimated output gap currently implies that it has been affected twice as much as during 2008-2009. He/she argued that this reflects the need for a real interest rate which contributes to improve the outlook on the economic recovery in the near future and at the same time remains compatible with price stability. He/she also considered that the economy would benefit from a less restrictive monetary policy, without implying putting price stability at risk. He/she pointed out that, on the contrary, monetary easing so far implemented by Banco de México has had a favorable effect on financial markets, given that the exchange rate has recovered lost ground and remained relatively stable over the last quarter. He/she argued that a lower interest rate would positively affect financing, which for some firms could make the difference between closing and surviving. He/she pointed out that, although firms' credit risk has increased, this implies that the risk-free rate should be further reduced to avoid an increase in their financial costs. He/she said that he/she does not believe that a more accommodative stance could lead to higher inflation or financial instability, but rather may end up being favorable for financial markets as long as it affects the economic outlook positively.

One member highlighted that the issue regarding the end point of the monetary easing cycle has gained relevance, especially in view of the possibility that the rate will remain at that level for a long period. He/she added that the economic and social crisis demands continuing decisively with the accommodative cycle to stimulate the economy. Nevertheless, the velocity at which we approach the cycle's endpoint is key to prevent premature and undesirable monetary policy reversions, which could take place upon the materialization of some of the existing risks. In that sense, the terminal reference rate and its trajectory will have to continue being determined according to the information provided by the circumstances. He/she pointed out that it is important to avoid premature and undesirable reversions in monetary policy, which might occur if some of the existing risks materialize. He/she added that most analysts anticipate the reference rate floor to be between 3% and 4.5%, which suggests that the market expects the easing cycle will not conclude yet. He/she argued that this is supported by the good performance of inflation, the stability of financial markets, and expectations of a long period in which the economy will remain depressed. He/she pointed out that the relative monetary policy stance offers certain room for maneuver, but it is more limited due to the risks in international markets. He/she mentioned that pressures on the Mexican peso and volatility may arise, since the three-month rate spread adjusted for exchange rate volatility is already in the average range of the emerging complex, and given the greater use of the peso as a FX hedge. He/she added that a lower yield also encourages capital outflows. He/she pointed out that as for the absolute monetary policy stance, the gap between the neutral and the reference rate, indicates that there is still room to maintain an expansionary policy. This, as a result of certain downward pressures on the neutral rate generated by structural and circumstantial causes, some of them related to the pandemic. He/she argued that monetary policy in the short term must counteract the effects of the pandemic on economic activity and employment, but always targeting the stabilization of inflation expectations. He/she expressed that the most effective defense for lower-income groups is to protect their purchasing power and to mitigate the impact on employment. He/she emphasized that it is necessary to ensure that inflation remains on a trajectory of convergence to its target and that short-term inflationary pressures yield. He/she stressed that otherwise it will be necessary to reflect more deeply on the scope and speed of the current downward cycle.

One member argued that the behavior of inflation expectations poses a challenge for the credibility of the inflation target and for monetary policy. He/she added that this situation could be the result of the economy's exposure to external shocks and the implementation of domestic policies, even in fields different from monetary policy. He/she indicated that the risks entailing additional interest rate cuts have intensified, due to persistent inflationary pressures and the potential implications of a lower interest rate differential in an economy that is very open to capital flows and with a highly liquid currency in global markets. Regarding this point, he/she stated that in order to compare the reference rate in Mexico with those of other emerging economies, the rates adjusted for foreign exchange risk must be considered. He/she argued that in the absence of capital flows that justify it, to determine the reference rate in Mexico according to its level in other emerging economies would be like trying to define the monetary policy of a country based on the inflationary performance of another. He/she added that the monetary policy stance in Mexico has played a key role in containing increases in long-term interest rates. He/she stressed that these are lower in Mexico than in several other emerging economies with lower reference rates. On the other hand, he/she pointed out that lowering the reference rate to a level of 4.5%

would place it below the range estimated for the neutral rate, although noting that the latter is most probably being affected upwards by the lower access to external financing and the increased uncertainty, and downwards by the likely decrease in potential growth. He/she stated that even though under these circumstances it is difficult to make an accurate assessment of the monetary policy stance based on this indicator, available information suggests that it is currently in expansionary territory. He/she considered that with a reference rate of 4.5%, the margins for additional reductions, if existent at all, would be significantly narrower. He/she stated that, due to the above, monetary policy must be even more cautious in the following months and, if available information suggests that there is still room for an additional easing, the adjustments should be expected to be more gradual than those observed in recent months. He/she highlighted that the cautious approach to monetary policy implementation adopted by the Central Bank has worked satisfactorily.

Another member indicated that Banco de México took a proactive role, responding in a timely and decisive way in face of the enormous challenges that the pandemic implied, in order to achieve its goals and its primary objective. He/she highlighted that in March the pace of monetary easing accelerated. In this regard he/she highlighted two considerations. First, given the nature of the shock, the priority was to guarantee liquidity and the well-functioning of markets. With this aim, extraordinary measures were announced, which had to be accompanied by a faster pace of monetary easing, acknowledging that by itself it would be insufficient to offset the collapse in economic activity. Second, there was a high degree of uncertainty regarding the evolution of inflation given the presence of factors that were operating in opposite directions. For such reason, actions were taken cautiously, following a gradual approach, taking into consideration incoming information in a timely way, and guaranteeing the convergence of inflation to its target within the time frame in which monetary policy operates. Nevertheless, he/she argued that the outlook has changed significantly, with a favorable performance of financial markets and what appears to be an inflection point for economic activity. In this context, he/she considered that the room for maneuver to continue with monetary easing has diminished given the higher risk that inflation may not converge to its target during the time frame in which monetary policy operates, as well as the greater sensitivity that capital flows to fixed income assets in Mexico have shown relative to other emerging economies. This, despite maintaining a less relaxed absolute and relative monetary policy stance. He/she mentioned the need to follow a strategy that allows for an adjustment of monetary policy as more information becomes available, and that the message must be that the Central Bank does not find the trajectory nor the levels of inflation that are being observed acceptable, in order to foster a convergence of inflation expectations to levels consistent with the 3% target.

The majority of members argued that other measures to accompany the extraordinary measures adopted by the Central Bank, such as guarantee programs, are necessary in order for these to work better. One member mentioned the need to maintain the availability of financing for firms and households, and that Banco de México has adjusted the announced measures and facilities accordingly. **Another** member pointed out that Banco de México has adopted a series of measures aimed at providing liquidity and intended to avoid a contraction of credit, and highlighted the guarantee programs implemented by development banks. He/she indicated that commercial banks must also do their part in order for the facilities announced by the Central Bank to fully achieve their objectives. He/she added that the soundness of the recovery will depend significantly on what commercial banks do or stop doing and highlighted that they must be part of the solution and not part of the problem. **One** member added the need to intensify the implementation and efficacy of Banco de México's additional measures. He/she pointed out that the improved functioning of these facilities must be guaranteed, by increasing liquidity and providing more credit at a lower cost. A more relaxed monetary policy will make the implementation of these measures more effective and also reduce the financial burden of firms. **Another** member stated that the weakness of bank credit highlights the need for complementing monetary policy actions as well as the measures to provide financing implemented by Banco de México with credit guarantees for priority sectors. He/she also pointed out that although the financial system overall maintains a sound position, it is necessary to ensure that financial authorities are able respond adequately to the potential challenges faced.

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, on this occasion, Banco de México's Governing Board decided by majority to lower the target for the overnight interbank interest rate by 50 basis points to a level of 4.5%. One member voted for lowering the target to 4.75%. Looking ahead, the available room for maneuver will depend on the evolution of the factors that have an incidence on the outlook for inflation and its expectations, including the effects that the pandemic might have on both factors.

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, 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 4.5%. Irene Espinosa-Cantellano voted in favor of lowering the target for the overnight interbank interest rate by 25 basis points to a level of 4.75%.

5. OPINIONS / DISSENTING VOTES

Vote. Irene Espinosa-Cantellano.

Starting in March, we announced measures to provide liquidity and, complementary to these, we also increased the pace of monetary policy loosening to face the shocks generated by the pandemic. Since then, financial markets have evolved favorably and economic activity appears to have crossed an inflection point. Inflation, however, continues to persist at levels above the target, it remains to the upside, it has recently exceeded its forecasts, and its expectations have increased. This behavior, in the midst of the most severe recession historically, suggests the need to reconsider the disinflationary influence attributed to the cyclical component of economic activity. In addition, despite the relative monetary policy stance, foreign investors' capital outflows stand out when compared with other emerging economies. This suggests a lesser room for monetary policy loosening. Consequently, we must adjust the pace to strengthen the convergence of inflation and its expectations to the 3% target.

ANNEX

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

A.1. External conditions

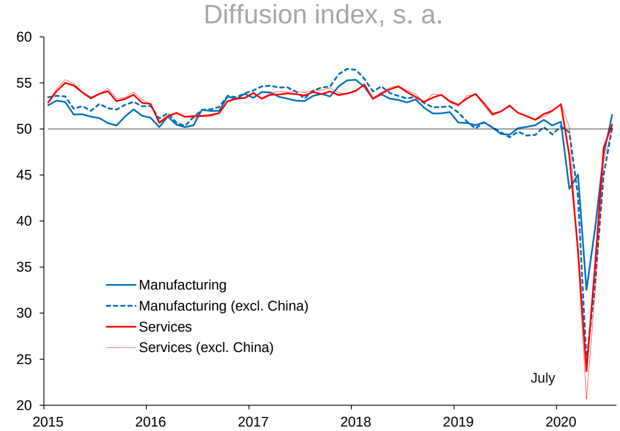
A.1.1. World economic activity

Available information indicates that, after having declined sharply in March and April, the global economy began to show a slight recovery in May and June. Services and manufacturing sectors purchasing managers' indexes indicate that this recovery continued in July (Chart 1). In general, the recovery of economic activity has been driven by the gradual loosening of lockdown measures and the significant fiscal, monetary and financial stimuli implemented by the systemically important economies. However, there is heterogeneity among countries in terms of the state of the pandemic's evolution, the measures to contain it, and the stimulus policies implemented. Although core inflation continued to fall in June, in several advanced and emerging economies headline inflation has increased slightly, reflecting higher energy and food prices. Nevertheless, in advanced economies, headline and core inflation lie below their respective central bank's targets.

In this context, the monetary authorities have kept interest rates at historically low levels and have continued to use their balance sheets to promote an orderly functioning of financial markets. Several countries have also announced additional fiscal stimulus measures to mitigate the adverse effects of the pandemic on employment and on household and firms' incomes. The monetary, fiscal and financial stimulus measures adopted in advanced economies, together with the gradual reopening of productive activities in some of these economies and the progress made in developing a vaccine against COVID-19, have contributed to the positive performance of financial markets, although these have not yet reached pre-pandemic levels and have continued to record certain periods of volatility associated mainly with increases in new cases of contagion in some of the main economies.

In this environment, multilateral organizations and analysts anticipate a strong contraction during this year, followed by moderate growth in 2021, supported by favorable financial conditions, accommodative monetary policies, and expansionary fiscal policies. These forecasts, however, are subject to a high degree of uncertainty about the pace and strength of the recovery in view of the possible tightening of lockdown measures due to the rise in the number of new infections in some countries and the possibility of the pandemic having long-term effects on global supply and demand.

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



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

In the United States, during the second quarter of the year GDP contracted at an annualized seasonally adjusted quarterly rate of 32.9%, after having fallen 5% during the first quarter (Chart 2). This fall can be explained by the strong contraction in private consumption due to the closure of businesses considered as non-essential during the lockdown measures. The contraction of private consumption mainly reflected the decrease in consumption of services, since the deterioration in consumption of goods was more moderate. Additionally, investment, both residential and business, declined as a result of greater uncertainty about the economic outlook and lower activity in various productive sectors. Net exports had a positive contribution to GDP growth, largely due to a decline in imports. Government spending made a positive contribution in light of the sharp increase in federal public spending, although the latter was partially offset by a drop in state and local government spending.

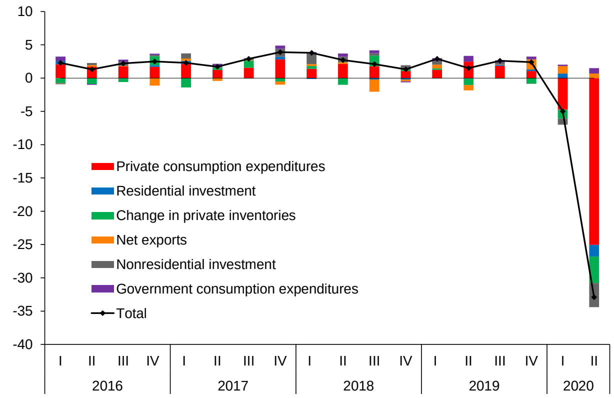
After having deteriorated sharply in April, certain indicators, such as retail sales, capital goods' orders and new home starts, began to recover in May, although they are still below pre-pandemic levels. However, certain timely indicators of consumer spending point to some weakening in July. As for the latter, one of the main risks faced by this economy is that the recovery that began in May could be interrupted by the possibility of renewed widespread lockdown measures in response to the upsurge in new cases of COVID-19 in that country. Another important risk factor is uncertainty about the implementation of the fiscal stimulus package announced by the US president in early August.

As for industrial production, it continued to recover, growing at a monthly rate of 5.4% in June, after having expanded 1.4% during the previous month. This was mainly supported by a rebound in the manufacturing sector and, to a lesser extent, by the gas and electricity sector. In particular, manufacturing production continued to recover driven by the reactivation of activity in some of its main sectors, especially the automotive one. In this context, certain indicators available as of July, such as the Purchasing Managers' Index (PMI) of the manufacturing sector, suggest that this sector will continue to recover.

Despite having gradually recovered since May, the labor market continues to show signs of weakness. In particular, although the unemployment rate declined from 13.3% in May to 10.2% in July, it remains well above pre-pandemic levels. Since May, the non-farm payroll has continued to gradually recover, with 6.6 million jobs created between June and July, after having contracted in March and April, although the pace of recovery moderated in the last month. Initial and current claims for unemployment insurance are still at high levels.

In the euro area, GDP declined 40.3% at an annualized seasonally adjusted quarterly rate during the second quarter, after having contracted 13.6% in the first quarter of the year. While most demand and production indicators showed a recovery in May and June, other indicators available for July, such as consumer confidence, exhibited some weakness. In this context, the unemployment rate increased moderately from 7.7% in May to 7.8% in June, largely as a result of the implementation of job retention schemes, as well as a lower labor force participation in several countries of the region.

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.
Source: Bureau of Economic Analysis (BEA),

In the United Kingdom, GDP weakened significantly more during the second quarter, falling 59.8% at an annualized seasonally adjusted quarterly rate, after having contracted 8.5% during the first quarter. This deterioration was mainly explained by the sharp contraction in household consumption, business investment and, to a lesser extent, public spending. However, more recent figures show that economic activity has gradually improved since May due to the lifting of social distancing measures, as reflected by the rebound in industrial production, construction and some services, especially those related to retail sales, restaurants and entertainment. The purchasing managers' indexes continued to recover in July, both in the manufacturing and services sectors.

In Japan, available indicators suggest that the deterioration of economic activity observed during the first quarter extended to the second quarter. However, available figures for retail sales and consumer sentiment from May onwards point to a rebound in consumption as the lockdown measures began to be lifted. Among the main external factors that have affected the Japanese economy are a weak world trade and restrictions on tourism. As for domestic factors, the gradual easing of lockdown measures from May onwards was reflected in an improvement in consumer sentiment in July, which could boost domestic consumption. On the production side, industrial activity showed a slight improvement in June, although it remains below pre-pandemic levels. Additionally, notwithstanding the recovery of the purchasing managers' indexes, both in the service and manufacturing sectors, these remain in contractionary levels, so uncertainty persists regarding the pace of economic recovery in that country.

In emerging economies, economic conditions have varied considerably depending on the spread of the pandemic, the effectiveness of the measures to contain it, and the economic stimuli implemented. In China, economic activity has continued to recover. In particular, GDP grew at an annual rate of 3.2% during the second quarter after contracting by 6.8% during the first quarter, although more timely indicators suggest that recently the pace of recovery has somewhat moderated. Most Latin American economies continued to be significantly affected by the lockdown measures and by restrictions on productive activity enacted to contain the pandemic, as the latter continues to spread rapidly in several countries of the region.

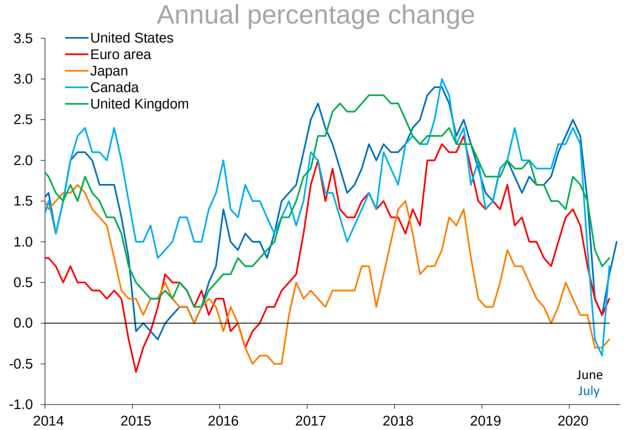
Since Mexico’s previous monetary policy decision, international commodity prices have, in general, trended upwards, partially offsetting the losses observed due to the pandemic. In particular, crude oil prices have been supported by production cuts by the Organization of Petroleum Exporting Countries (OPEC) and other producers, and by the gradual recovery of demand. The latter as a result of the gradual recovery of global economic activity, although concerns that an increase in contagions in various countries may slow the recovery of world growth have kept price increases contained. Meanwhile, in recent weeks, industrial metal prices have continued to rise due to the gradual restart of industrial production worldwide and the rebound of economic activity in China. In addition, prices of precious metals, such as gold and silver, reached record highs as a result of their safe haven status and the environment of low interest rates prevailing in the major advanced economies, the high uncertainty about world economic recovery, and a weak dollar. Finally, grain prices have experienced high volatility in the face of uncertainty about the outlook for global supply and demand for grains.

A.1.2. Monetary policy and international financial markets

In most advanced economies, headline and core inflation are below their respective central bank’s targets. However, headline inflation increased slightly in the face of the recent rise in energy prices (Chart 3), while core inflation has continued to fall in most of these economies, largely due to price reductions in services in those sectors most affected by social distancing measures. In this context, inflation expectations drawn from financial instruments, albeit recently increasing, remain at low levels.

In emerging economies, headline and core inflation showed a more heterogeneous behavior, reflecting a combination of factors. In fact, while the weakening of economic activity and the decline in some services prices generated downward pressures on inflation in most countries, some economies registered upward pressures generated by increases in food and energy prices, by the depreciation of their currencies, and by idiosyncratic factors.

Chart 3
Selected Advanced Economies: Headline Inflation
Annual percentage change



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

In this context, the main central banks have maintained highly accommodative monetary policy stances, keeping interest rates at historically low levels, and have continued to use their balance sheets to foster an orderly functioning of financial markets (Chart 4). Some of the monetary policy decisions by the main central banks that stood out during the period are:

i) In its July meeting, the US Federal Reserve left unchanged its range for the federal funds rate at 0%-0.25% and reiterated that it expects to maintain this current level until the economy overcomes the recent events. It highlighted that in the next months it will increase its holdings of treasury securities and residential and commercial mortgage-backed bonds at least at their current pace. In this meeting, the Federal Open Market Committee (FOMC) emphasized that economic activity and employment rebounded in recent months, although they remain below the levels registered at the beginning of the year and highlighted that the direction of the economy will depend significantly on the evolution of the pandemic. In this context, it extended until March 31, 2021 the temporary foreign currency liquidity swap lines with other central banks and the temporary repos for international monetary authorities that allows them to exchange Treasury bonds for US dollars. In addition, this institution modified some of its previously announced programs with the aim of providing greater access to credit, expanding the pool of eligible firms, and giving certainty that its stimulus measures will continue to be available to address COVID-19. In this environment, both market variables and analysts' consensus incorporate that the central bank will maintain the reference rate unchanged at the end of 2020 and 2021.

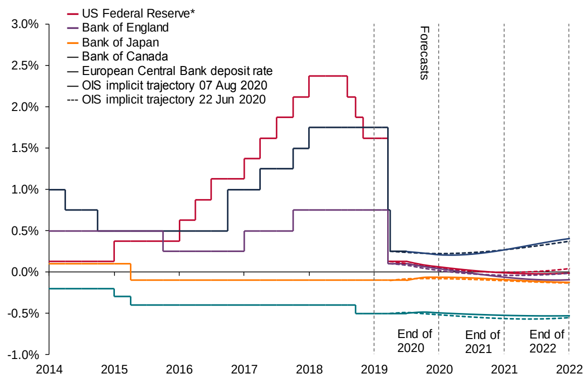
ii) In its July meeting, the European Central Bank (ECB) left its policy rates unchanged, maintaining its refinancing rate, key deposit facility rate and key lending facility rate at 0.0, -0.5 and -0.25%, respectively. It reiterated that these interest rates will remain at or below their current levels until inflation forecasts converge to a level sufficiently close but below the 2% inflation target, and that this convergence has been consistently reflected in core inflation dynamics. It also kept its asset purchase program unchanged and mentioned that it will continue with the Pandemic Emergency Purchase Program (PEPP) for a total of €1.35 trillion until June 2021 or until the Committee considers that the crisis phase has ended. It reiterated that maturing principal payments from securities purchased under the PEPP will be reinvested until at least the end of 2022 and that it will continue to provide liquidity through its refinancing operations.

iii) In its July 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%, and stated that it will continue its asset purchase program. Likewise, it will continue to support financing of firms and financial market stability through: i) the Special Funds Supplying Operations in Response to COVID-19, ii) a broad provision of yens and funds in foreign currency, and iii) purchases of funds listed on the stock exchange and real estate. This institution reiterated that it will not hesitate to take additional measures if necessary and that it expects interest rates to remain at or below their current levels.

iv) The Bank of England kept its reference interest rate unchanged at 0.10% in its August meeting and the amount of its asset purchase program at £745 billion. It indicated that it will continue to closely monitor the situation, standing ready to adjust its monetary policy in order to comply with its mandate, keeping under review the whole range of actions that could be implemented. It pointed out that the Committee does not intend to tighten its monetary policy stance until there is clear evidence that it is reducing excess productive capacity and moving towards its 2% inflation target in a sustainable manner.

v) In its July meeting, the Bank of Canada left its reference rate unchanged at 0.25%. With respect to the short-term liquidity programs announced in March, it indicated that these have had the anticipated effect, and that since market conditions have improved, their use has decreased. As to its forward guidance, it pointed out that it will keep its reference interest rate at levels close to zero until the slack has been reduced, so that the 2% inflation target is reached in a sustained manner. It stated further that in order to reinforce this commitment and keep interest rates low, it continues with large-scale asset purchases of at least CAD 5 billion per week in government bonds, continuing this program until economic recovery is clearly underway. Finally, it reiterated that it stands ready to provide further monetary stimulus as needed.

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

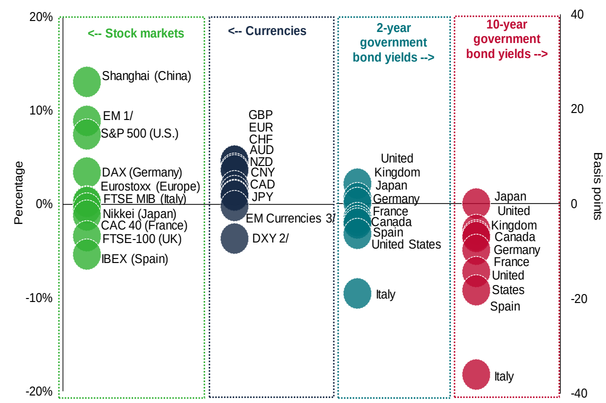


OIS: Fixed floating interest rate swap where the fixed interest rate is the effective overnight reference rate.
** In the case of the US observed reference rate, the average interest rate of the federal funds target range is used (0.0% - 0.25%).
Source: Prepared by Banco de México with Bloomberg data.

Since Banco de México's previous monetary policy decision, several central banks of emerging economies announced additional reference rate cuts, with those of Colombia, Hungary, Malaysia, Indonesia, the Philippines, and South Africa standing out. In addition, some banks maintain various measures to ensure the supply of liquidity, provide credit, and foster the sound functioning of financial markets.

In general, international financial markets continued to show a positive behavior since Mexico's last monetary policy decision, although they have not yet reached pre-pandemic levels and a volatile environment persists, subject to the evolution of the health emergency and its effects on global economic activity. The relative stability was driven by economic indicators that showed a slight recovery with respect to previous levels in response to the gradual reopening of productive activities, the publication of better-than-expected corporate reports, the continued fiscal, monetary and financial stimulus measures adopted in advanced economies, and certain progress in the development of a vaccine against COVID-19. In particular, risk aversion remained stable and there was less volatility in the stock, FX and bond markets in advanced economies. Most main stock indexes of these economies registered gains, some of them recovering most of the losses registered during the year. Interest rates on government bonds in advanced economies showed limited mixed adjustments. A compression in the yield spreads of European periphery countries against Germany stands out, while the US dollar continued to weaken against most currencies (Chart 5). Emerging economies, on the other side, recorded net capital inflows, mainly to fixed income assets, while their currencies exhibited less volatility and mixed adjustments against the US dollar and their stock markets recorded gains (Chart 6).

Chart 5
Change in Selected Financial Indicators from June 22 to August 7, 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.

Notwithstanding the relative stability of financial markets in recent weeks, further episodes of risk aversion cannot be ruled out. This will largely depend on the evolution of the pandemic, the process of vaccine development, approval and distribution, and the ability of governments to contain further waves of contagion and mitigate the negative effects on economic activity. In addition, other risk factors that could cause new episodes of tightening global financial conditions persist, including high valuations of some financial assets, increased sovereign and corporate debt levels, a new escalation of trade and political tensions between the United States and some of its partners, the worsening of geopolitical and social conflicts in various regions of the world, and the electoral process in the United States, among others.

Chart 6
Emerging Economies: Financial Assets Performance from June 22 to August 7, 2020
Percent, basis points

Region	Country	Currencies	Equity markets	Interest rates 2Y	Interest rates 10Y	CDS
Latin America	Mexico	0.61%	-0.31%	-31	-21	-20
	Brazil	-3.50%	7.80%	-25	-26	-45
	Chile	3.55%	-0.24%	3	-2	-16
	Colombia	-0.85%	-1.66%	-22	-35	-31
Emerging Europe	Russia	-6.73%	7.57%	1	-1	2
	Poland	5.18%	2.23%	-8	2	-9
	Turkey	-6.31%	-7.93%	313	232	105
	Czech Republic	5.79%	-2.14%	4	-1	-6
	Hungary	4.78%	-3.34%	-9	-19	-19
Asia	Malaysia	2.12%	4.43%	-35	7	-16
	India	1.43%	8.96%	-13	20	-45
	Philippines	2.18%	-7.90%	0	0	-9
	Thailand	-0.42%	-2.05%	9	-9	-1
	Indonesia	-3.36%	4.58%	-57	-52	-11
Africa	South Africa	-1.81%	4.66%	-23	-2	21

Note: Except for Mexico, interest rates correspond to interest rate swaps for 2-year/10-year maturities, respectively.
Source: Banco de México with PIP and Bloomberg data.

A.2. Current situation of the Mexican economy

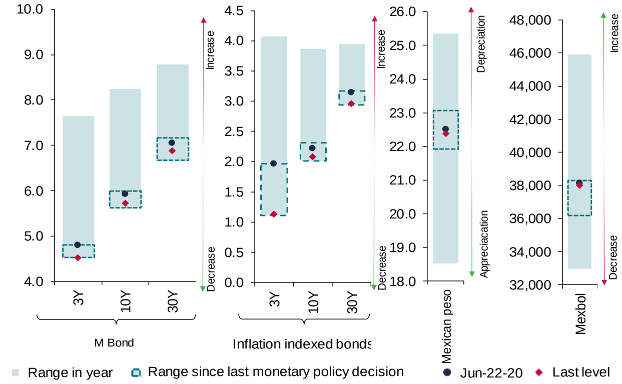
A.2.1. Mexican markets

Since Banco de Mexico's previous monetary policy decision to date the prices of financial assets in Mexico traded in a narrower range, differentiated by type of asset (Chart 7). Global and domestic financial conditions are expected to continue to be subject mainly to the effects of the pandemic.

In the particular case of the Mexican peso, it traded in a range between 21.96 and 23.08 MXN/USD, with its movements being more limited with respect to previous periods (Chart 8). The peso slightly appreciated 0.61% at the end of the period, while FX, spot and forward trading conditions remained at deteriorated levels, although they showed an improvement over those observed in March.

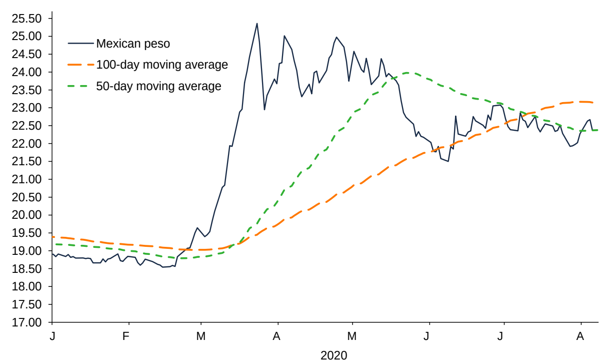
In line with the swap mechanism established between Banco de México and the Federal Reserve on March 19 this year, on June 22 the Exchange Commission instructed Banco de México to activate this mechanism and undertake two financing operations in US dollars for a total of USD 13 billion, with the aim of renewing maturing positions held during April and provide additional liquidity in US dollars.

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



Source: Prepared by Banco de México.

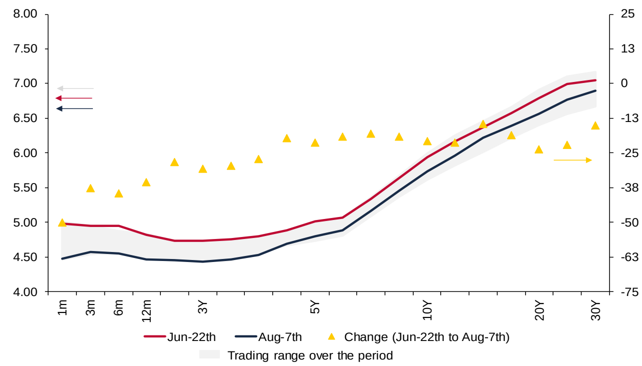
Chart 8
Mexican Peso Exchange Rate with Moving Averages
MXN/USD



Source: Prepared by Banco de México.

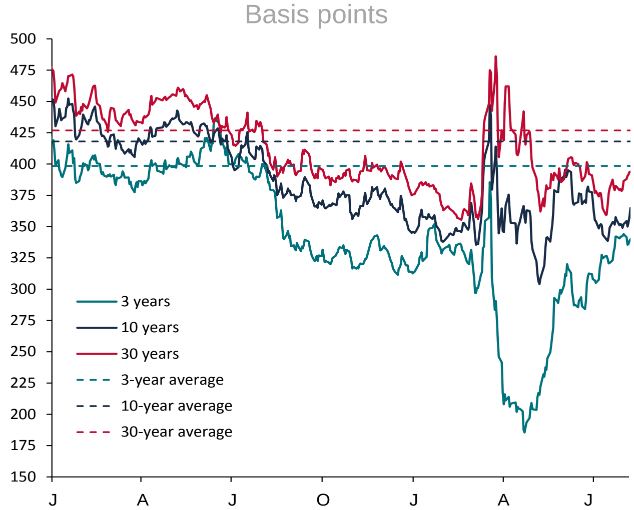
Nominal government bond yields decreased for all terms along the yield curve (Chart 9). Likewise, the yield curve of real-rate instruments decreased at all nodes. In this environment, breakeven inflation and inflationary risk implicit in the spreads between these market instruments registered differentiated changes, being more significant for short term ones (Chart 10). These movements occurred in a context where trading conditions further deteriorated, which can be associated with the summer season.

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



Source: PIP.

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



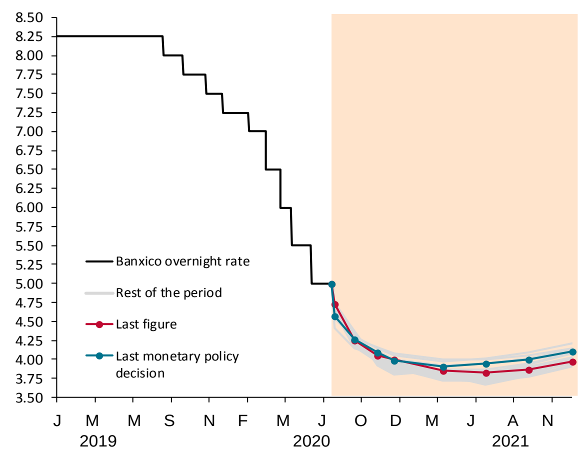
Source: PIP.

As for the evolution of the measures announced by Banco de México on April 21, the facility for longer-term government securities repurchase agreements used the total amount initially approved of 100 billion pesos.

Furthermore, in order to continue promoting the orderly behavior of financial markets and providing liquidity for the sound development of the financial system, Banco de México announced modifications to the corporate securities repurchase facility with respect to the cost, guarantees subject to repurchase agreements, and the term of the facility for new issuances, which has generated greater interest from financial intermediaries.

As to expectations regarding the path of the monetary policy target rate, information implied by the Interbank Equilibrium Interest Rate (TIIE, for its acronym in Spanish) swap curve discounts with a 60% probability a 50-basis point cut for the monetary policy decision of August (Chart 11). Private sector forecasters surveyed by Citibanamex are also expecting a 50-basis point cut. However, analysts' expectations display a larger variance. For the end of 2020, market variables are anticipating a target level of around 4.00%, while the median of surveyed forecasters expects a level of 4.50%.

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

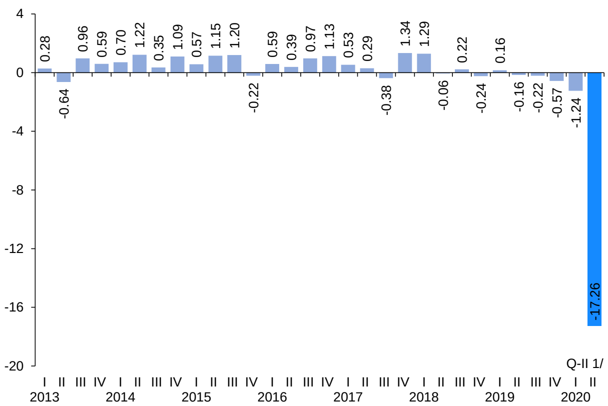


Source: Prepared by Banco de México with Bloomberg data.

A.2.2. Economic activity in Mexico

According to GDP's flash estimate published by INEGI, economic activity contracted deeply during the second quarter of 2020 (Chart 12), as the negative effects of the pandemic substantially intensified. In particular, in April sharp falls in the main components of aggregate demand, as well as in the production of goods and services, were registered. In May economic activity contracted further, albeit at a more moderate rate. Finally, various indicators point to a recovery in June starting from low activity levels, in response to the reopening of some sectors, the loosening of restrictions to mobility, and to a certain recovery of external demand, although an environment of uncertainty prevails.

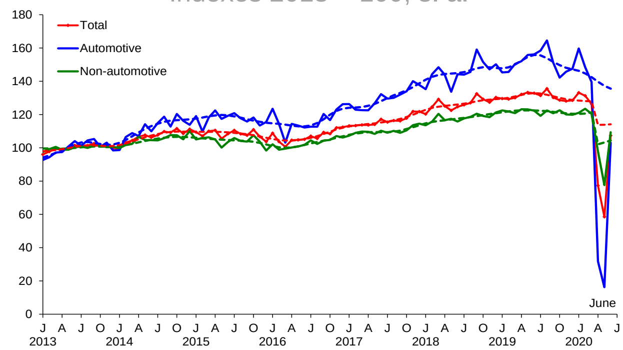
Chart 12
Gross Domestic Product
Quarterly percentage change, s. a.



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

As for external demand, the effects of the health emergency on Mexico's manufacturing exports continued in May, with an additional sharp contraction to the one observed in April. The strong reduction of automotive exports resulting from the shutdown of most operations of assembly and auto parts companies established in the country stands out. Subsequently, in line with the reopening of certain productive sectors since the end of May and the reactivation of economic activity in other countries, manufacturing exports registered some recovery in June, particularly those to the United States (Chart 13).

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

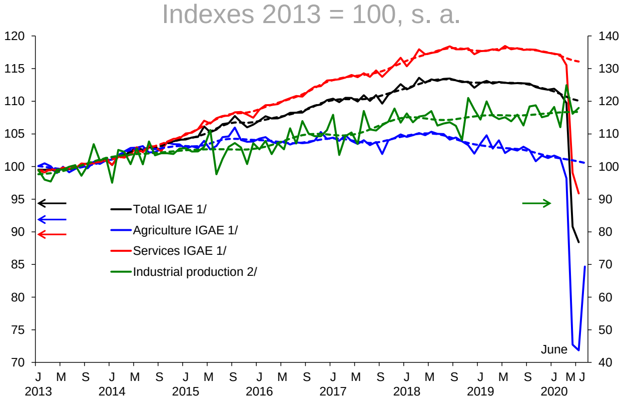


s. a. / Seasonally adjusted series and trend series based on data in nominal US dollars. The former is represented by a solid line and the latter by a dotted line.
Source: Prepared by Banco de México with data from the Tax Administration Service (SAT, for its Spanish acronym), the Ministry of the Economy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

At the beginning of the second quarter, the effects of the pandemic on private consumption intensified, as reflected by the sharp fall in its monthly indicator in April and a further, albeit more moderate, decline in May. Timely information suggests that a slight recovery of this indicator could be observed in June and July. Particularly, National Association of Self-Service and Department Stores (ANTAD, for its acronym in Spanish) and light vehicle sales grew in June and July. In April and May, gross fixed investment weakened significantly further, reaching its lowest level in the last 20 years. Within this indicator, investment spending on construction dropped markedly in April, while in May it showed a further marginal decline. At the same time, investment in machinery and equipment continued to weaken in May, after having deteriorated sharply in April. Indicators related to this aggregate, such as capital imports, suggest some progress towards the end of the second quarter, although remaining at particularly low levels.

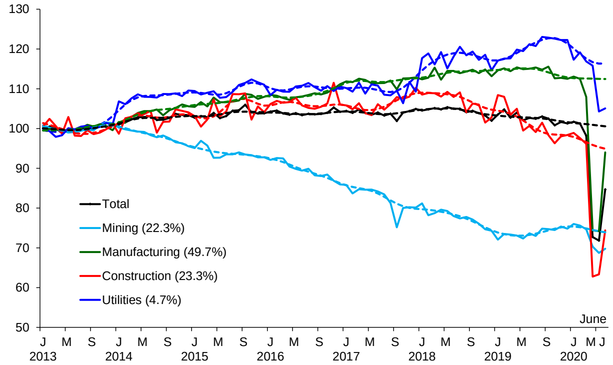
As for production, after the strong contraction in April, industrial activity fell again in May, although more moderately (Chart 14). In June, it rebounded, largely reflecting the loosening of measures to contain the pandemic and the resumption of various activities. Within secondary activities, a significant decline was observed during April-May, both in construction and almost all manufacturing subsectors, with a sharp fall in the transportation equipment sector standing out. In June, construction and manufacturing partially reversed this contraction, although both remained well below the levels observed before the health crisis (Chart 15). The weak performance of mining persisted, partially as a result of the scheduled cutback in crude oil production in May and June as part of Mexico's commitments to OPEC, as well as low levels of the non-oil mining sector. Tertiary activities were also highly affected in April and May by social distancing measures and the suspension of non-essential activities, showing a significant contraction in those months. This decline was due to widespread declines in its subsectors, except for the education and health services aggregate, which remained at levels similar to those of the previous quarter.

Chart 14
Economic Activity Indicators
Indexes 2013 = 100, s. a.



s. a. / Seasonally adjusted and trend series. The former is represented by a solid line and the latter by a dotted line.
1/ Figures as of May 2020.
2/ Figures as of June 2020 from the Monthly Industrial Activity Indicator.
Source: Mexico's National Accounts System (SCNM, for its acronym in Spanish), INEGI.

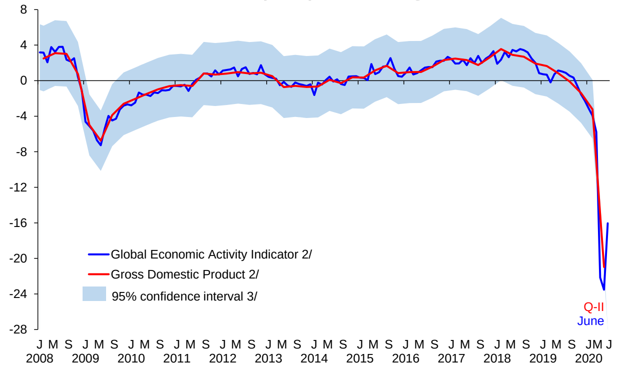
Chart 15
Industrial Activity 1/
Indexes 2013 = 100, s. a.



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

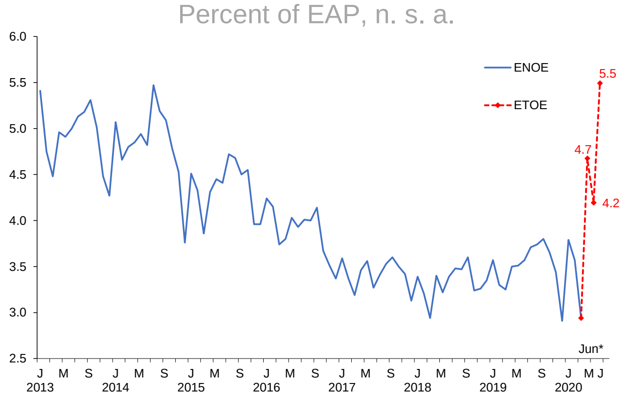
As to the economy's cyclical position, economic slack widened significantly during the second quarter of the year (Chart 16). According to the results of INEGI's Telephone Survey on Occupation and Employment (ETOE, for its Spanish acronym), in June several labor market indicators improved, when compared to April and May. In particular, the labor participation rate and employed population, both formal and informal, increased. The national unemployment rate also rose significantly, reflecting the increased active search for employment of people who had left the labor force due to the health emergency (Chart 17). In June, the creation of IMSS-insured jobs continued to perform negatively, with a decline of slightly above 83,000 jobs in June and a minor additional loss in July, registering a cumulative decline of slightly over 1.1 million jobs between March and July (not seasonally adjusted figures). Finally, although unit labor costs in the manufacturing sector decreased in May (Chart 18), they remained at particularly high levels, after having rebounded in the previous month due to the impact on employment and the temporary shutdowns to production caused by the pandemic and the suspension of activities.

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



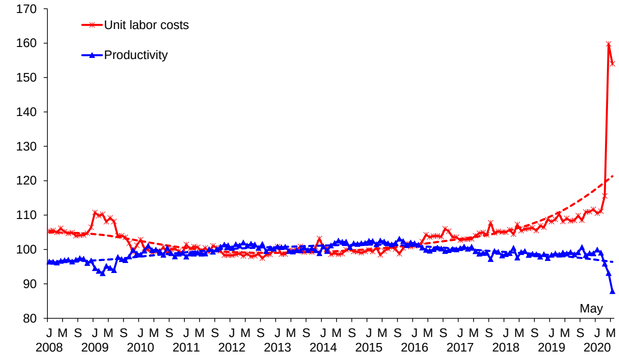
s. a. / Calculations based on seasonally adjusted figures.
1/ Output gap estimated with a tail-corrected Hodrick-Prescott filter; see Banco de México (2009), "Inflation Report (April-June 2009)", p.74.
2/ GDP figure as of the second quarter of 2020; IGAE figure as of June 2020.
3/ Output gap confidence 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 17
National Unemployment Rate
Percent of EAP, n. s. a.



EAP: Economically Active Population.
n. s. a. / Not seasonally adjusted (original series).
*/ The April to June 2020 figures 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 as a reference only.
Source: Prepared by Banco de México with data from ENOE up to March 2020 and from the ETOE from April to June 2020.

Chart 18
Productivity and Unit Labor Costs in the Manufacturing Sector [1/]
Indexes 2013 = 100, s. a.



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

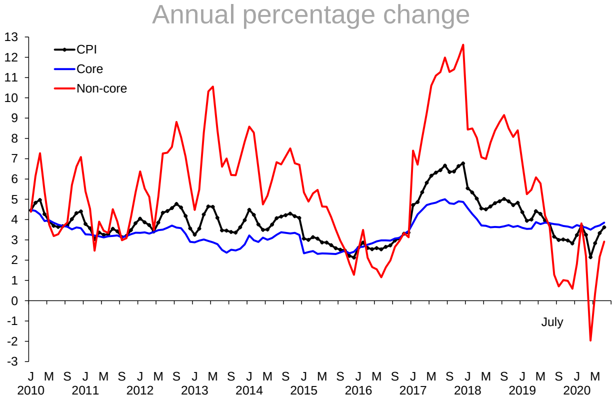
In June, domestic financing to firms contracted at an annual rate, offsetting the increase that had been observed in April. Although in March and April the growth rate of bank lending to large firms had intensified, it reverted in May and June. Bank credit to smaller-sized firms intensified the contraction observed throughout the year. The domestic market for corporate debt continued to show low levels of activity. Meanwhile, credit to households contracted in June, mainly as a result of the significant reduction in consumer credit, as well as the slowdown in mortgages. Regarding interest rates of bank credit to private firms, in June they declined, in line with the reduction in banks' overnight funding rate. However, a moderate increase is observed in the margins of intermediation of interest rates of new loans to firms. At the same time, interest rates of mortgages decreased in May, while, with figures to April, those of credit cards increased compared to February. Regarding portfolio quality, corporate and mortgage loan delinquency rates remained low, while those for consumption credits increased for the fourth consecutive month, thus further adding to their already high level.

In line with the measures announced by Banco de México to promote an orderly functioning of financial markets, strengthen the credit channels and provide liquidity for the sound development of the financial system, the adjustments announced in July to the facility that provides resources to banking institutions to channel credit to micro, small- and medium-sized firms and individuals affected by the pandemic; as well as the facility to finance banking institutions guaranteed by corporate loans, for financing micro, small- and medium-sized firms, stand out. The amendments allow participating institutions to carry out leasing and financial factoring operations with micro, small- and medium-sized firms, as well as to grant mortgage and automotive loans to individuals.

A.2.3. Development of inflation and inflation outlook

Between June and July 2020, annual headline inflation rose from 3.33 to 3.62%, which is explained by an increase of 19 and 10 basis points in the incidence of its core and non-core components, respectively (Chart 19 and Table 1).

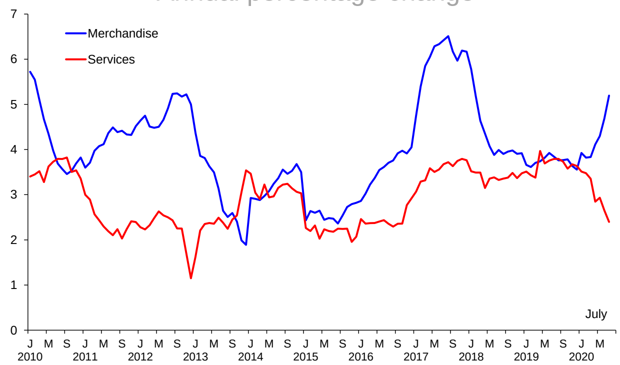
Chart 19
Consumer Price Index
Annual percentage change



Source: Banco de México and INEGI.

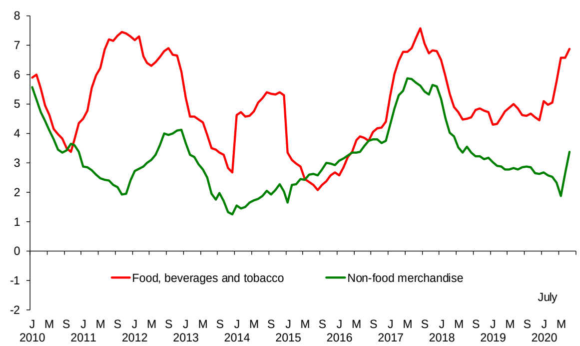
Annual core inflation rose from 3.71 to 3.85% between June and July 2020. In the context of the health crisis, there has been an important recomposition of its components, since upward pressures have been observed in merchandise inflation and downward ones in services inflation (Chart 20). Annual inflation of merchandise prices thus increased from 4.69 to 5.19% during that period, reflecting price increases in both food and non-food merchandises (Chart 21). In contrast, annual inflation of services fell from 2.65 to 2.40% between June and July 2020, to a large extent due to price reductions in tourist services as well as to the lower increases in housing prices, possibly reflecting the weakness of economic activity.

Chart 20
Merchandise and Services Core Price Subindex
Annual percentage change



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

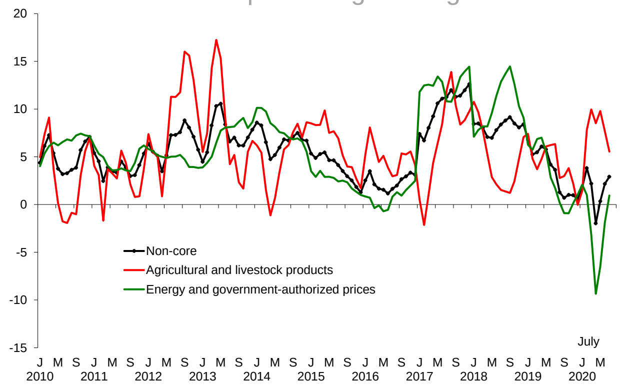
Chart 21
Merchandise Core Price Subindex
Annual percentage change



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

On the other hand, annual non-core inflation increased from 2.16 to 2.92% between June and July 2020 (Chart 22 and Table 1). This behavior is mainly explained by a certain rebound of energy prices, after having dropped considerably in April following the dynamics of their international references. The above was partially compensated by lower increases in agricultural and livestock product prices, particularly fruits and vegetables.

Chart 22
Non-core Price Subindex
Annual percentage change



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

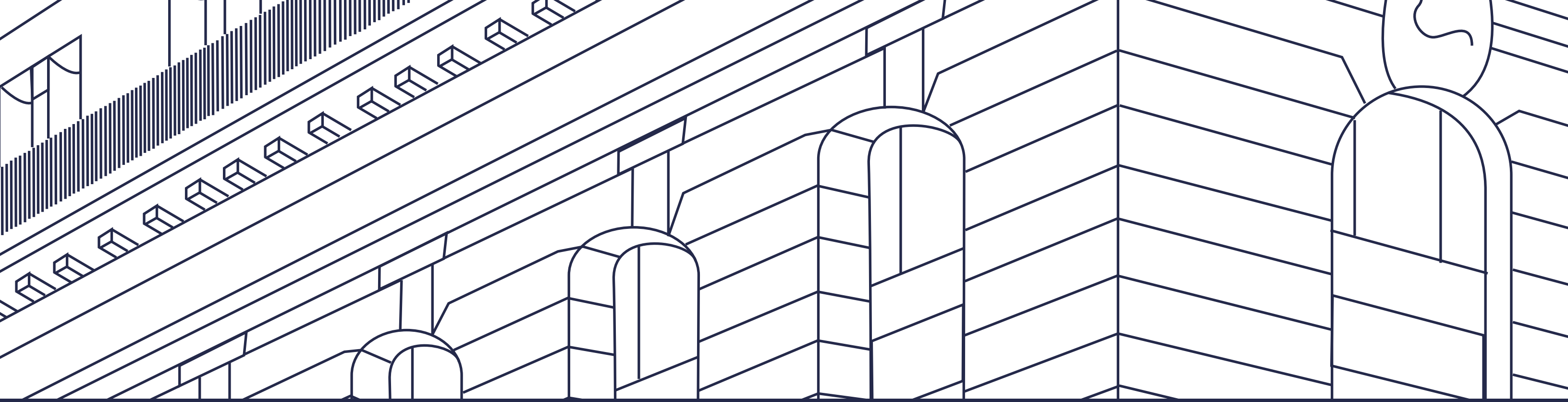
Regarding inflation expectations drawn from Banco de México's Survey of Private Sector Forecasters, between May and July the medians for headline and core inflation for the end of 2020 increased from 3.07 to 3.61% and from 3.50 to 3.73%, respectively. The medians of medium- and long-term expectations for headline and core inflation remained at 3.50%. Finally, breakeven inflation and inflation risk decreased since the last monetary policy decision, after having increased in June.

Although the recent increases in headline and core inflation affect their foreseen trajectories in the short term, both are expected to be around 3% within the 12-24 month forecast horizon. These forecasts are subject to considerable risks. To the downside: i) a greater than expected impact of the widening of the negative output gap; ii) downward inflationary pressures worldwide; and iii) social distancing measures reducing the demand for certain services. To the upside: i) additional episodes of exchange rate depreciation; ii) a greater persistence of core inflation; and iii) 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	May 2020	June 2020	July 2020
CPI	**2.84**	**3.33**	**3.62**
Core	**3.64**	**3.71**	**3.85**
Merchandise	**4.30**	**4.69**	**5.19**
Food, beverages and tobacco	6.58	6.59	6.89
Non-food merchandise	1.88	2.66	3.38
Services	**2.93**	**2.65**	**2.40**
Housing	2.67	2.49	2.38
Education (tuitions)	4.51	4.45	4.31
Other services	2.83	2.42	2.02
Non-core	**0.35**	**2.16**	**2.92**
Agricultural and livestock products	**9.79**	**7.69**	**5.55**
Fruits and vegetables	17.83	13.14	8.43
Livestock products	3.36	3.45	3.26
Energy and government-authorized prices	**-6.51**	**-1.90**	**0.95**
Energy products	-11.34	-4.57	-0.41
Government-authorized prices	4.65	4.17	4.01

Source:INEGI.



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