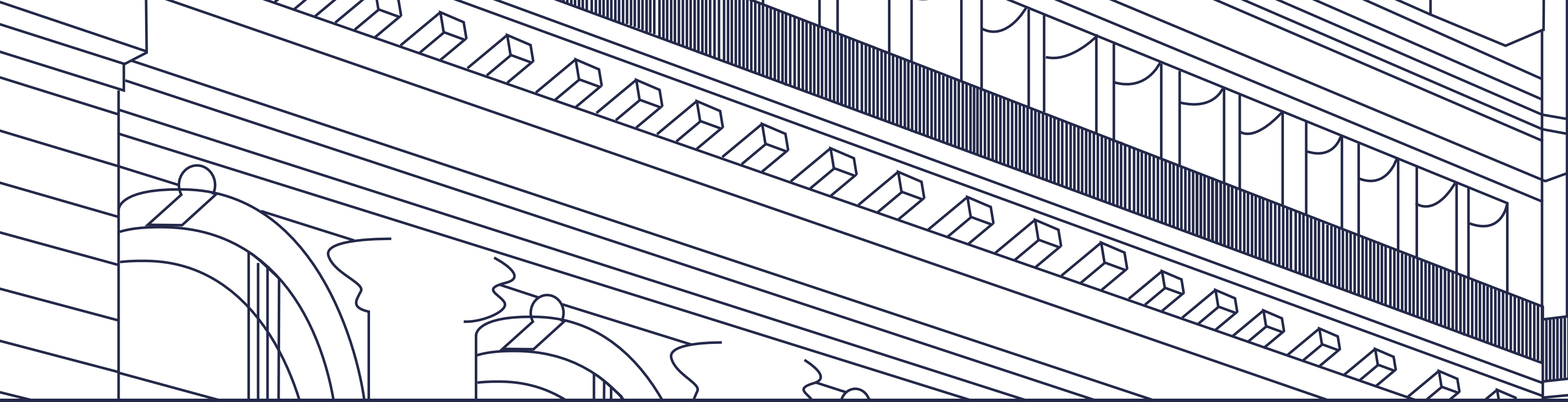

BANCO DE MÉXICO®

Minutes number 86

Meeting of Banco de México's Governing Board on the occasion of the monetary policy decision announced on August 12, 2021

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FOREWARNING
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1. PLACE, DATE, AND PARTICIPANTS

1.1. Place: Meeting held by virtual means.

1.2. Date of Governing Board meeting: August 11, 2021.

1.3. Participants:

Alejandro Díaz de León, Governor.
Galia Borja, Deputy Governor.
Irene Espinosa, Deputy Governor.
Gerardo Esquivel, Deputy Governor.
Jonathan Heath, Deputy Governor.
Rogelio Ramírez, Secretary of Finance and Public Credit.
Gabriel Yorio, Undersecretary of Finance and Public Credit.
Elías Villanueva, Secretary of the Governing Board.

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

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

International environment

All members mentioned that global economic activity continued to recover, and the majority pointed out the heterogeneity across countries, associated with vaccine availability, the evolution of the pandemic, and stimulus spending. One member stated that leading indicators suggest a moderation of the growth rate. He/she considered that the recovery should be taken with caution and added that the IMF announced a Special Drawing Rights (SDR) allocation of USD 650 billion to member states. **Another** member underlined that the recovery is still incomplete, indicating that employment figures remain, overall, below pre-pandemic levels.

Some members mentioned that the global economy is expected to grow in 2021 at the highest rate in the last five decades. They underlined that growth expectations for advanced economies have adjusted upwards while, in the case of emerging economies, they have been adjusted downwards, as a result of differences in the evolution of the pandemic and in the available space to provide stimulus spending. **One** member highlighted the large fiscal stimulus approved in the United States. **Among risks to the global economy, most members pointed out those associated with the spread of the Delta variant. One** member mentioned that less developed economies, or more labor-intensive ones, are still the most vulnerable. Among short-term risks, he/she mentioned a possible abrupt termination of the monetary stimuli because of persistent inflation increases and the subsequent tightening in international financial conditions, in addition to credit risks derived from high levels of government and corporate indebtedness.

All members mentioned that global inflation continued increasing, and most members highlighted that, in various economies, inflation is already above the targets of their respective central banks. Some members stressed that, in the United States, annual inflation is above 5%. **One** member stated that inflation expectations for this economy have increased and that the 10-year breakeven inflation rate exceeds the 2% target.

Among the factors that are affecting global inflation, most members emphasized the pressures on commodity prices, the shortage of inputs, logistical problems and the temporary mismatch between supply and demand which has affected production chains. Some members added also the reactivation of the world economy and stimulus spending. **One** member mentioned labor market distortions and **another** one climate-related factors, such as droughts. **Some** members highlighted that international organizations, central banks, and analysts agree that the factors that are affecting inflation are of a transitory nature. **One** member stated that medium- and long-term inflation expectations remain anchored, which implies that pressures are anticipated to be transitory. **Another** member added as evidence that inflationary pressures are transitory, the fact that labor market dynamics remain below pre-pandemic levels and the fall in the labor participation rate. He/she considered that the factors that exert pressure on inflation cannot operate indefinitely and stand in contrast with structural inflation determinants, such as globalization and technological change. He/she added that most monetary authorities at the international level have opted for communicating the nature of inflationary pressures and their monetary policy outlook, to contribute to the formation of expectations conducive to the gradual convergence of inflation during the following year. **One** member argued that, insofar as the process of economic normalization progresses, an increase in the global production of materials and inputs, a reestablishment of global value chains, and a decline in price pressures is anticipated. **Another** member pointed out that the global economy shifted from a sudden closure of activities, which caused businesses to reduce production capacity, to a scenario of vigorous spending expansion, with an irregular recovery and with significant disruptions in production. He/she underlined the recent slowdown in industrial production, especially in the manufacturing sectors that have very extended supply chains, which has propitiated multiple bottlenecks in production and adverse effects on prices. He/she added that the disruptions caused by the pandemic differ greatly from those observed in other crises, making it more difficult to identify their short- and medium-term effects. He/she mentioned that projections for economic activity, inflation and delinquency rates have not captured the effects of the pandemic and the challenges of the current juncture adequately.

Most members highlighted that central banks in advanced economies maintained their monetary stimulus. Some members stated that accommodative policy stances reflect the fact that these institutions consider pressures on prices to be transitory in nature. **Most members emphasized that the Federal Reserve maintains an accommodative policy stance, but with the possibility of decreasing its asset purchases in the near future. One** member highlighted that this institution announced that it would maintain its stimulus until greater progress is made in achieving its mandates. He/she added that, in view of the various statements of its members, and given an environment of high uncertainty, financial markets anticipate that the Federal Reserve will announce a decrease in its asset purchase program this year and that it will begin increasing interest rates in 2022 and 2023. **Another** member highlighted the strong decline in expectations for the federal funds rate for the end of 2024, which has affected long-term rates in advanced economies. He/she delved into the fact that the effective, sustained, and coherent communication strategy followed by the Federal Reserve has contributed to the assimilation of its new monetary policy strategy's highly accommodative tone by market participants, allowing news about the asset purchase program to have a limited impact on financial markets. **Some** members noted the importance of monitoring the Federal Reserve's decisions. **One** member emphasized that it is necessary to adequately anticipate the evolution of the balance between the Fed's goal of not inhibiting the recovery of the economy and of the labor market, and the need to respond to inflationary pressures unseen in decades, along with the difficulties in managing its balance sheet, which could affect the early withdrawal of its monetary stimulus. **Some** members added that the European Central Bank announced a symmetric inflation target, indicating that it could remain above 2% for some time. **One** member pointed out that this new monetary policy paradigm adopted by both the Federal Reserve and the European Central Bank will allow interest rates in advanced economies to remain at low levels for a longer period. **Another** member stated that, despite the central banks' commitment in advanced economies, except Canada, to maintain accommodative monetary policy stances for a long period, the higher levels of inflation have raised concerns among analysts regarding the possibility that they would transition to a tighter policy stance earlier than expected. **Some** members pointed out that those advanced economies that previously and during the pandemic registered inflation levels below their central banks' targets, have more room for maneuver and more time to begin withdrawing their stimuli. **One** member pointed out that, in the United States, this responds to structural factors, including demographic ones, which have contributed to reduce inflation, potential growth and the neutral interest rate, allowing for more patience in withdrawing the monetary stimulus. He/she added that in that economy, the atypically high levels of economic growth are also expected to be transitory, which has kept real interest rates at low and even negative levels throughout the entire yield curve. **Another** member argued that economies that registered inflation levels consistently above their targets during the health crisis, face greater restrictions and must act rapidly and decisively to attain the convergence of inflation to its target and to preserve their credibility. **One** member mentioned that this environment of gradual adjustment, and of a heterogeneous economic recovery with higher inflationary pressures, implies considerable challenges and risks that reduce the room for maneuver of fiscal and monetary policies in emerging economies. He/she pointed out that it is necessary to enable an orderly adjustment and to avoid both contaminating the price formation process as well as abrupt adjustments in portfolios and capital outflows.

Some members pointed out that several central banks of emerging economies have reduced their monetary stimulus. **One** member highlighted that the monetary authorities of these economies have modified their narrative, acknowledging that inflationary pressures could be more severe and less transitory than anticipated, and that some authorities have even acted, or expect to do so, in order to avoid an impact on the price formation process. **Another** member stated that most central banks in emerging economies maintain highly accommodative policy stances and negative real interest rates. He/she mentioned that, although in most of these economies limited increases in interest rates are expected in the next 12 months, for most of them those adjustments will not substantially modify their accommodative policy stances. He/she added that, in 13 out of 16 emerging economies analyzed, interest rates for the next 12 months are expected to be equal or below the current interest rate level in Mexico, and that only Brazil and Russia, which face idiosyncratic problems, have interest rates higher than in Mexico. **One** member underlined that in a broad sample of emerging economies, Mexico maintains one of the greatest deviations in headline and core inflation with respect to its target.

As for international financial markets, most members mentioned that the yield curves of government securities flattened, particularly in the United States. Some members pointed out that the main stock indices registered increases and that, in some cases, they reached historic highs. **One** member stated that the US dollar appreciated slightly. He/she noted that financial markets in emerging economies registered adjustments with a negative bias, capital flows to equity assets were moderate and mixed, and fixed income assets registered moderate inflows, mainly to China. He/she added that the preference for China's assets will continue posing a major challenge for the rest of emerging economies. **Another** member pointed out that for these economies the global environment implies taking advantage of the benefits of the dynamism of external demand, as well as facing the challenges of greater global inflationary pressures, of possible volatility episodes, and tighter financial conditions. He/she added that this is accompanied by idiosyncratic risks in these economies, which have increased after the pandemic. He/she stated that all of the above represents a challenge to attract and retain capital, as well as to enable an orderly adjustment of the exchange rate market and the yield curve. He/she underlined that it is essential for these economies to maintain a solid macroeconomic policy stance and for monetary policy to contribute to keep inflation around its target and to contain risk premia increases in the yield curve.

Economic activity in Mexico

All members highlighted that the recovery of the Mexican economy continued during the second quarter. One member pointed out that this has been driven by the services sector as the vaccination process has progressed. **The majority pointed out that the recovery remains weak and heterogeneous across sectors. One** member said that the health crisis is once again complicated and highlighted that the latest data suggests a slowdown in June. **Another** member added that the economy is 2.4% below its pre-pandemic levels.

On the demand side, the majority agreed that consumption continued to recover moderately. One member noted a certain improvement in consumer confidence and the favorable behavior of remittances. **Another** member said that there is a significant lag in the consumption of domestic services. **Most members highlighted the weakness of investment during the second quarter,** although **one** member considered that it continued to recover moderately. **Another** member pointed out that, in May, fixed investment was 15% below the highest level reached in previous years. **Regarding the external sector, most members highlighted the slowdown in exports, particularly manufacturing exports. One** member attributed this to problems related to the supply of key inputs, such as semiconductors. **Another** member noted that manufacturing exports registered a slight increase with respect to the previous quarter, as a result of price increases. **One** member stated that manufacturing exports are expected to continue benefiting from the recovery of external demand.

On the supply side, most members highlighted the heterogeneity across sectors, reflected in a reactivation of tertiary activities and a weakness of secondary activities. In this regard, **some** members pointed out that industrial production was affected negatively by the shortage of several inputs, mainly in sectors integrated into global chains. **One** member underlined the good performance of accommodation and transportation services.

Most members agreed that the labor market continues to recover. However, they considered that the employment reactivation is still incomplete and that the labor market faces significant challenges. One member noted that the total number of unemployed, underemployed and inactive people as a percentage of the potential Economically Active Population (PEA, for its Spanish acronym) is 26.3%, a level comparable to that observed during the 2009 financial crisis. **Another** member added that, in June, the labor market registered the same alternative open unemployment rate level than in May, which is above pre-pandemic levels. **One** member pointed out that the underemployment rate is over 12%, almost twice the level recorded in normal times. **Another** member mentioned that as of June, formal and informal employment was 700 thousand people below, and IMSS-insured workers were 400 thousand people below, their pre-pandemic levels. **One** member emphasized that the extent of the unemployment gap is still considerable, so it is important to keep in mind that labor market recovery could take longer in view of an eventual increase in infections. **Some** members added that gender-disaggregated data reinforce the view of an uneven recovery.

All members agreed that slack conditions are anticipated. In this regard, most of them highlighted the marked differences across sectors. Some members mentioned that, given the progress in economic activity, slack conditions continued tightening during the second quarter. **Some** members underlined that they still remain ample. **One** member stated that the output gap remains at 4%. He/she added that the economic recovery is still incomplete, which is evident when observing levels of slack in different sectors of the Global Economic Activity Indicator (IGAE, for its Spanish acronym). **Some** members highlighted the difficulty of estimating slack in light of the adverse effects on productive capacity. **One** member considered that slack is not likely to be as ample because business closures and operating restrictions imply a lower potential production capacity.

Most members highlighted that the economic recovery is expected to continue for the rest of the year. One member underlined that, given the advance in the vaccination process and the boost from external demand, growth forecasts for 2021 are expected to increase. **Another** member pointed out that consumer confidence, the wage bill, light vehicle sales, and sales reported by the National Retailers Association of Mexico (ANTAD, for its Spanish acronym) have started to decelerate, which could indicate a moderation in growth in the second half of 2021. He/she stated that the impact of disruptions on the industrial sector could affect GDP by more than one percentage point if these problems persist until the end of the year. **One** member emphasized that it is necessary to be attentive of the recovery maintaining its pace beyond the rebound effect, given that during June economic activity may have decelerated significantly. He/she added that the number of infections has increased and, although it is unlikely that social mobility will be restricted again, the reopening process may take longer.

Inflation in Mexico

All members agreed that global inflation and the effects on supply chains and production processes of various goods and services have exerted pressure on headline and core inflation. Some members highlighted the inflationary pressures coming from the United States. **One** member highlighted that while inflation has followed the upward trajectory of global inflation, it appears to have a more pronounced and generalized dynamic. He/she added that some analyses show how, since the beginning of the pandemic, the global factor's incidence on core inflation has been negative, while the incidence of the idiosyncratic component has been positive. **Another** member highlighted the recent increase in the prices of intermediate inputs for secondary sector activities. **One** member stated that, during 2021, the aforementioned effects and the lack of flexibility in production have predominated, which has reduced the resilience and capacity of supply to absorb a higher demand without exerting pressure on prices. He/she added that the current environment has been conducive for inflation to register multiple shocks. **Another** member stated that the contribution of import prices seems to explain to a greater extent the variation in core inflation and that given Mexico's economic integration with the rest of the world, global inflation could be a limiting factor for the behavior of domestic inflation, especially if its main trade partner is registering high levels of inflation. **Some** members mentioned that inflation has also increased due to changes in household consumption patterns and that, after having declined significantly in 2020, some prices are in a process of recovery in tandem with the gradual reopening. **One** member added that some CPI items have been affected by multifactor issues related with weather conditions and external factors.

The majority mentioned that in July annual headline inflation was 5.81%, while core inflation was 4.66%. They pointed out that inflation has remained above the central bank's target for several months. In this context, **some** members warned that inflation is at historically high levels. **Some** members highlighted that, in the last six months, more than 50% of the CPI components have registered seasonally adjusted annualized monthly variations higher than 4%. **Some** members pointed out the reduction in headline inflation in July versus previous months. **One** member stated that this result was due to a lower incidence of non-core inflation, which was partially offset by a higher incidence of core inflation. **Another** member mentioned that the new shocks have shaped inflation dynamics, offsetting the reductions stemming from arithmetic effects. He/she also noted that slack has had a diminishing effect in containing inflation.

Regarding core inflation, most members pointed out that it shows an upward trend due to a recovery in the demand for services and to additional pressures on merchandise. Some members highlighted that more than 50% of core inflation's components have registered variations higher than 4% in the last three months. **One** member stated that, according to an analysis of the inflationary process, pressures on the core component have tended to intensify, even after discounting the base effect. He/she stated that the moving averages of merchandise inflation are above 6%, despite a relatively benign environment in the currency market. **Another** member underlined that the above has taken place especially in the prices of said sub-index that are more susceptible to exchange rate pressures and to increases in energy prices. He/she highlighted that core inflation rates for May, June and July were the highest for similar months since 1999. He/she also added that the annualized monthly rates of inflation of food merchandise have registered levels around 10% in each of the three months. **One** member noted that, in July, more than 70% of the prices of the merchandise basket registered variations higher than 4%. **Some** members indicated that the non-core component decreased, supported by the decline in energy prices, which was partially offset by the higher variations of agricultural and livestock product prices.

Most members pointed out that expectations for headline and core inflation for the end of 2021 rose again and highlighted their increase for 2022. Some members pointed out that medium-term expectations were revised upwards. **Others** stated that they remain anchored. **One** member indicated that the latter are relatively contained at levels above the target and that this outlook is conditional on expectations of increases in the reference rate, which is foreseen to reach 5% by the end of 2021 and 5.4% by the end of 2022. He/she also noted that business prospects point to input supply problems and to an increase in inflation expectations for the next 12 months. **Another** member warned that the increase in short- and medium-term expectations entails the risk of contagion to longer-term expectations and of them becoming unanchored. He/she expressed his/her concern of core inflation expectations continuing to deteriorate and being above the upper limit of the variability range. He/she added that nowadays there is a greater probability of headline inflation reaching levels higher than 6% and core inflation reaching levels above 5% by the end of the year. He/she highlighted that the mean and median of core inflation expectations remain above 3.5% until 2023. **One** member noted that medium- and long-term inflation expectations remain well anchored and that those derived from market instruments for the 6 to 10-year average are below 3%. **Another** member added that so far this year there have been two major adjustments in these expectations, the first, in March, as a consequence of the increase in observed inflation, and the second, in June, after the monetary policy decision. **One** member stated that these expectations have increased less than in previous episodes of supply shocks. **Another** member highlighted the increase in compensation for expected inflation and inflation risk. He/she added that long-term expectations have remained anchored for some time at levels above the target. He/she said that they have remained stable during episodes of severe shocks. He/she considered that the resilience of these expectations is the result of Banco de México's credibility, as it has firmly and consistently stated that it will take the actions available to achieve the convergence of inflation to the target. **One** member stated that short-term expectations have been increasing since the previous monetary policy decision.

Most members noted that the revised forecasts for the expected trajectories of headline and core inflation are higher than those published in the latest Quarterly Report. Some members added that convergence to the target is now expected to be achieved in the first quarter of 2023. **One** member mentioned that the inflation trajectory had been revised upwards in the June decision, and that from his/her view, he/she remained skeptical that said convergence would be reached in the period proposed on that occasion. At present, in the face of additional shocks with levels of inflation, unseen in many years, the forecasts have been revised upwards and its convergence within the forecast horizon has been postponed. **Another** member noted that the most recent adjustment in the forecasts with respect to estimates published in the Quarterly Report January-March 2021, presents increases of 90 basis points for headline inflation in the fourth quarter of 2021 and the second quarter of 2022, and of 30 basis points in the fourth quarter of 2022. He/she added that the core inflation forecast increased by 110 basis points in the fourth quarter of 2021 and the second quarter of 2022, and by 10 basis points in the fourth quarter of 2022. He/she also noted that these forecasts assume less accommodative monetary conditions over the forecast horizon.

The majority of members pointed out that pressures on inflation are associated with shocks that are expected to be transitory. Nevertheless, the majority mentioned the risk that the price formation process is affected. One member considered that we can face shocks that might lead to knock-on effects with continuous pressures on prices of indefinite duration. Although these can be assimilated, we have to remain attentive so that they do not contaminate the formation of prices. He/she stated that the adjective "transitory" sends a diffuse message about the expected trajectory of inflation. He/she pointed out that recent supply shocks, such as the lack of production inputs, could last longer than anticipated and that there are pressures associated with the reopening process, such as the increase in services prices. He/she warned that such shocks seem to have generalized effects, rather than on a few goods. **Another** member highlighted that several items have been affected by the pandemic and by factors associated with the current juncture, and considered that such effects will be transitory despite the uncertainty about their duration. **One** member stated that the higher levels of inflation are explained by three transitory phenomena that should not be a cause of concern: i) the reversion of prices to their former trend due to the reopening of activities, which explains why high inflation rates are temporarily being registered; ii) global shocks leading to increases in international prices of commodities and various industrial inputs, which have had an atypical impact on a few products that have a significant influence on inflation; and iii) the change in household consumption patterns and readjustments in relative prices. He/she added that, in some cases, price increases will reverse as normalization continues, while in others they will remain in place, although their effect will tend to fade gradually because they are one-time increases.

Among upward risks to inflation, **some** members highlighted external inflationary pressures, especially from the United States. **One** member stated that these pressures are expected to continue to affect headline and core inflation in the second half of the year. **Some** members mentioned additional cost-related pressures. **One** member added the risks of core inflation's high persistence, a depreciation of the peso, and increases in agricultural and livestock product prices. He/she mentioned that, as long as the pandemic does not fade, it is foreseeable that further impacts on prices will be observed. He/she added that, although rains have reduced pressures on agricultural and livestock product prices, the United States is facing a severe drought, which could affect prices in Mexico. **Another** member noted that commodity prices have shown greater stability, and thus the risk of greater inflationary pressures from this source has been mitigated. He/she pointed out that the exchange rate has remained stable and is not under pressure from deteriorating external accounts or public finances, while energy prices have reached stability and gas prices have even decreased. He/she indicated that the economy continues exhibiting ample levels of slack, so no demand pressures are anticipated. He/she added that no additional risks to inflation are foreseen beyond those that have already materialized. **Some** members mentioned as downward risks the effects stemming from the negative output gap, additional social distancing, and an appreciation of the peso. **Most members considered the balance of risks to inflation within the forecast horizon to be biased to the upside.**

Macrofinancial environment

Most members highlighted the stability of the peso exchange rate and its better performance compared to other emerging-market currencies. One member pointed out that open emerging economies are very sensitive to both global inflationary pressures and monetary and financial conditions in advanced economies, particularly in the United States. He/she stated that the baseline scenario incorporated by financial markets considers global effects on inflation, and patience in the response of the central banks of advanced economies. He/she pointed out that for emerging-market economies such as Mexico, this implies first of all facing global inflationary pressures, and afterwards the tightening of global financial conditions, although there is still the risk of said adjustment occurring beforehand. **Another** member considered that the good performance of the Mexican peso was due to progress in the vaccination process, to an improvement in growth expectations, and to sound macroeconomic fundamentals. **Some** members noted the increase in interest rates, particularly for the shorter terms. **One** member added that, in line with the appreciation of the peso, Mexico's default premia improved. He/she mentioned that after the last monetary policy decision, one-year interest rates increased by as much as 75 basis points, well above the increase in the reference rate. He/she added that, in contrast to advanced economies, the long end of the yield curve also increased, and that the 10-year bond reached levels more than 30 basis points higher because of the market's overreaction to the decision. **Another** member noted that the eventual process of monetary normalization at a global level could have implications for the exchange rate and for capital flows, which could present greater outflows than those observed at this point. **Some** members pointed out that the stock market registered gains.

One member emphasized that a rating agency downgraded Pemex's credit rating once again, leaving it with a negative outlook. He/she added that according to the rating agency, despite the Federal Government's support, liquidity risk persists given the considerable requirements that the company will face due to its debt maturities, and highlighted the possible operational losses it would suffer due to the expansion of its refining capacity. He/she considered that the above shows the deterioration of its financial situation and represents a risk for public finances and the government securities market.

The majority of members noted that private sector financing continued to perform unfavorably, and mentioned the fall in lending to firms. Some members noted that this was due to a tightening in banks' lending standards. **One** member added that it also responds to lower debt issuance. **Another** member mentioned that credit to Small- and Medium-sized Enterprises (SMEs) contracted and showed no signs of improvement. **Some** members observed that consumer credit continued to decline and that mortgage lending has grown at a more moderate pace. **One** member noted that, in some sectors, credit has fallen by more than 20% as compared to pre-pandemic levels and that a contraction is observed, even in sectors that did not experience a recession. **Another** member pointed out that, in the second quarter, total sources of financing declined for the first time since the beginning of the pandemic, after having reached high and increasing annual flows. He/she added that this is explained by the fall in domestic sources of financing. **One** member stated that this is a matter of concern, given the relevance of credit for the recovery, and that it would be desirable to avoid a premature and counterproductive tightening of financial conditions in the face of the fragile recovery.

Monetary policy

Most members of Banco de México's Governing Board pointed out that, due to the variety, magnitude, and the extended horizon over which the shocks have affected inflation, they may pose a risk to the price formation process. For this reason, most members deemed necessary to strengthen the monetary policy stance by increasing the target for the overnight interbank interest rate by 25 basis points to 4.50%, in order to avoid adverse effects on inflation expectations and enable an orderly adjustment of relative prices. Most members highlighted that, in the next monetary policy decisions, the Governing Board will assess the factors that have an incidence on inflation, on its foreseen trajectory within the forecast horizon, and on its expectations. This, in order for the policy rate to be consistent with the orderly and sustained convergence of headline inflation to the 3% target, within the time frame in which monetary policy operates, and enable an adequate adjustment of the economy and financial markets.

One member noted that, in view of the unexpected monetary policy decision of June, there was a significant adjustment to the level of the reference rate for the end of the year anticipated by both markets and analysts. He/she expressed his/her view that this is not consistent with Banco de México's forecasts, nor with the communication released regarding the strengthening of monetary policy that the majority of the Governing Board opted for in the previous decision. He/she argued that bringing the policy rate closer to the levels expected by analysts and markets may imply tightening financial conditions more than required. He/she noted that, although such an increase would appear to leave the rate at its neutral level, there is currently no certainty that this level has changed due to the pandemic. He/she added that the lower end of the estimated range for the neutral rate may suggest to stop the rate increases before the levels that markets are expecting for the end of the year are reached. He/she pointed out that validating an upward cycle would aim at containing inflationary pressures on sources that are not necessarily monetary, so its success would require the contraction of prices whose inflation is already within the target or that are undergoing a recovery process. He/she considered that Banco de México's best contribution is keeping inflation expectations anchored, and for that purpose, the reference rate, which is the ideal instrument, is not the only instrument. It also has its communication, which must play a key role in times of uncertainty, when a timely, gradual and prudent monetary policy stance must be maintained. He/she stated that it continues to be relevant to point out that the decrease in inflation might synchronize with the horizon in which monetary policy operates, causing the mechanism of incidence of the policy stance to operate precisely at the moment when it would be least useful. He/she argued that, looking ahead, Banco de México must remain attentive to the evolution of commodity prices, the announcement of reductions in the Fed’s asset purchases, and to market trading conditions.

Another member stated that, given the broad consensus about the transitory nature of the rise in inflation, keeping the reference rate unchanged would not jeopardize the convergence process. He/she pointed out that the central bank's decisions and communication affect the beliefs about the evolution of inflation, and unexpected decisions affect their expectations. He/she argued that the origin of observed inflation should be explained, reiterating its transitory nature, which would give a signal of tranquility. He/she highlighted that this policy would be similar to that used by other central banks and to the one used by Banco de México when facing the supply shocks of 2012. He/she added that a pause would allow to continue granting stimulus to economic activity. He/she indicated that it is not advisable for central banks to respond to supply shocks as they cannot affect them directly. He/she pointed out that an increase in the reference rate has a generalized and negative impact on investment, consumption, employment, credit, and public finances. He/she mentioned that, prior to the consolidation of the anchoring of expectations, it was logical to respond to supply shocks. However, Banco de México’s actions allowed an anchoring of expectations and since the episode of 2012, it was no longer necessary to increase the rate because the control of inflation and its expectations was achieved with effective and consistent communication. In the episode of 2017, gasoline prices increased sharply, in a context of exchange rate depreciation and deteriorated external and fiscal accounts. He/she highlighted that the change in pricing policy worked as a coordination mechanism, which affected expectations. He/she added that in the current scenario, gasoline prices and the exchange rate remain stable, there is fiscal discipline and a trade surplus, and long-term inflation expectations remain anchored. He/she noted that the current conditions are more similar to those of 2012 than to those of 2017, and that the policy response should also be similar to the former. In his/her opinion it is not convenient to bring forward what could be interpreted as a cycle of normalization. He/she mentioned that the Fed is expected to begin the normalization process of its reference rate around mid-2023 and, thus, closing the relative position and bringing the local interest rate into neutral territory prematurely may have an impact on future macroeconomic and financial stability.

One member pointed out that with an inflation gap of three percentage points, if the reference rate is not increased, there would be no convergence in the foreseen horizon. He/she pointed out that progress in economic activity suggests the presence of a less amount of slack, which opens the possibility of strengthening the monetary policy stance without widening slack conditions. Also, given that the problem of measuring economic indicators persists, the output gap could be smaller than estimated, which reinforces the proposal of increasing the monetary policy reference rate. He/she explained that a reference rate of 4.50% is still an expansionary policy stance and lays below headline and core inflation figures. He/she considered that, at these levels, the ex-post real rate will remain negative until 2022 and that the ex-ante rate would remain at very low levels. He/she noted that monetary policy cannot affect supply shocks directly, but that actions should be taken against inflationary shocks regardless of their nature, in order to avoid second-round effects. A preventive adjustment reinforces the expectation that such effects will not be allowed. He/she expressed that one of the main transmission channels is the expectations channel, and that an image of complacency should be avoided. He/she argued that the success of the inflation-targeting regime resides in central banks not sacrificing the inflationary objective to achieve short-term growth targets. He/she highlighted that an interest rate trajectory that minimizes inflation and output gaps should be chosen. He/she pointed out that an optimal trajectory revolves around expectations that monetary policy will keep inflation stable and close to its target in the long term. He/she emphasized that overreactions in markets should be avoided, given that they may anticipate aggressive increases. Thus, it should be emphasized that inflation forecasts show a delay in the convergence to the target, which indicates that an additional strengthening of the monetary policy stance is needed, but does not necessarily imply an accelerated cycle of interest rate increases. He/she added that Banco de México must effectively communicate its reaction function and that its forward guidance should have clarity regarding three aspects of the interest rate's trajectory: its directionality, the magnitude of possible adjustments, and the timing of their implementation. He/she pointed out that, given the slack conditions, the inflationary outlook and the transitory shocks, it would appear that the new monetary policy stance may be sufficient for the time being and that further rate adjustments will depend exclusively on incoming data.

Another member argued that, given the complex environment, it is essential for Banco de México to act in a timely and decisive manner to reaffirm its commitment to its primary mandate. He/she stated that, failure to do so would require sharper adjustments in the future, with greater costs in terms of output and employment. He/she recalled that, although inflationary pressures are mostly, although not exclusively, explained by supply shocks, for which monetary policy has a limited scope of action, it is essential to strengthen the expectations channel, in order to avoid second-round effects, contamination of the price formation process, and to prevent an impact on the anchoring of expectations. He/she emphasized that the monetary policy action adopted, both in terms of magnitude and operating channel, does not seek to solve the effects of supply shocks, but is rather a fundamental signal that reinforces the commitment of convergence to the target. He/she warned that this is the central element in an inflation-forecast targeting regime, and that renouncing to this commitment means losing sense of the central bank's mandate. He/she highlighted that, given the still weak performance of the labor market, investment and domestic financing, and given the effects of the pandemic on inequality, Banco de México's role in achieving price stability is of vital importance to avoid worsening the situation of the most vulnerable part of the population, which suffers the effects of high inflation to a greater extent.

One member considered it essential for Banco de México to show and reinforce its commitment to its constitutional mandate to protect the purchasing power of the national currency. He/she pointed out that this is particularly important when considering the significant upward revisions to headline and core inflation forecasts, and that the outlook for economic activity reveals a faster growth rate and is likely to be revised upwards. He/she highlighted that since the target for the interbank interest rate has been used as the monetary policy instrument, it has been below core inflation on only three occasions: i) in 2009 during the global financial crisis, when core inflation was following a rapid downward trajectory; ii) in 2014 when core inflation was close to the target; and iii) from March to July 2021, when core inflation followed an upward trend for more than five months, deviating considerably from the target. He/she stated that maintaining a distinctly accommodative monetary policy stance and tolerating high inflation levels well above the target, could lead to a de-anchoring of price formation, erode Banco de México's credibility, and exert pressure on inflationary risk premia, thus increasing the financial cost of all economic agents, to the detriment of a sustained recovery. He/she argued that, although the shocks that have affected inflation are expected to be transitory, considering the simultaneity, magnitude and the extended horizon over which the shocks have affected headline and core inflation, as well as the high levels they have reached, there is a risk that the price formation process is affected. For that reason, it is essential to strengthen the monetary policy stance to keep medium and long-term inflation expectations anchored and enable a decreasing trend of inflation towards its target.

Some members pointed out that Banco de México's decision to publish inflation forecasts improves its communication channel. **One** member added that this is an exercise of transparency and accountability that puts the Central Bank at the forefront of communication.

3. MONETARY POLICY DECISION

Although the shocks that have increased inflation are expected to be transitory, due to their variety, magnitude, and the extended horizon over which they have affected it, they may pose risks to the price formation process. For this reason, it was deemed necessary to strengthen the monetary policy stance in order to avoid adverse effects on inflation expectations and enable an orderly adjustment of relative prices and the convergence of inflation to the 3% target. The Governing Board decided to increase the target for the overnight interbank interest rate by 25 basis points to 4.50%.

For the next monetary policy decisions, the Governing Board will assess the factors that have an incidence on inflation, on its foreseen trajectory within the forecast horizon, and on its expectations. This, in order for the policy rate to be consistent with the orderly and sustained convergence of headline inflation to the 3% target within the time frame in which monetary policy operates, and enable an adequate adjustment of the economy and financial markets.

4. VOTING

Alejandro Díaz de León, Irene Espinosa, and Jonathan Heath voted in favor of increasing the target for the overnight interbank interest rate by 25 basis points to 4.50%. Galia Borja and Gerardo Esquivel voted in favor of leaving the target for the overnight interbank interest rate unchanged at 4.25%.

5. DISSENTING OPINIONS / VOTES

Vote. Galia Borja

In the present conditions, I believe that increasing the target for the overnight interbank interest rate would validate interest rate expectations for the end of the year, associated with a controversial communication in June's decision. In my opinion, validating said expectations does not clarify the meaning of strengthening the monetary policy stance, could lead to a dynamic inconsistency in future decisions, and may imply a greater-than-necessary tightening of local financial conditions. In my opinion, inflation is being affected mainly by global inflation, as well as by distortions generated by the pandemic, such as bottlenecks, changes in consumption patterns, the recovery of prices, and multifactor elements related to weather conditions. Although there is little certainty as to how long these factors will last due to the unprecedented situation we are facing, I still believe these will be transitory in nature. In an environment of high uncertainty, opting for a policy stance based on gradual decisions allows to establish a better communication and avoids mistaking a strengthening with a cycle of interest rate increases, given that the end of this strengthening may coincide with a tightening of international financial and monetary conditions, in which it will probably be necessary to have more room for the use of monetary policy.

Vote. Gerardo Esquivel

There is broad consensus regarding the predominantly transitory nature of worldwide inflationary pressures. For this reason, and because an interest rate increase would have no effect on inflation stemming from supply shocks, I believe that maintaining the reference rate does not jeopardize the convergence of inflation to its target. On the contrary, raising it again could send the wrong signal that the current inflation is of a more permanent nature, which in turn could affect short- and medium-term expectations, as well as the price formation process. It should be kept in mind that the central bank's decisions and communication constitute a signal that affects economic agents' expectations. In this regard, I believe that, in the current context, the appropriate policy is to maintain the reference rate and explain with greater detail the origin and causes of observed inflation, reiterating its transitory nature. A strategy based on a careful and coherent communication is being used by other central banks in the present situation and was successfully used by Banco de México in 2012 in the face of similar supply shocks.

ANNEX

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

A.1. External conditions

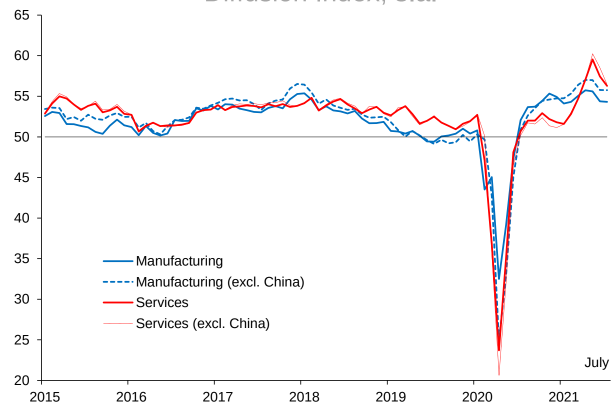
A.1.1. World economic activity

Global economic activity continued to recover during the second quarter of the year, with heterogeneity across countries, depending on vaccine availability, the evolution of the pandemic, and stimulus spending. Industrial production worldwide has shown less dynamism due to bottlenecks that have affected global supply chains, while the services sector has moderated its pace of recovery (Chart 1). Global inflation continued to increase significantly, due to pressures on commodity prices, base effects, and multiple bottlenecks in production. In most of the main advanced and emerging economies, inflation was above their central banks' targets.

In this environment, the central banks of the main advanced economies have maintained their monetary stimuli, although, in some cases, downward adjustments in the pace of asset purchases were announced and discussions regarding the eventual withdrawal of monetary stimuli continued, so their reduction is expected. The central banks of various emerging economies reduced their monetary stimulus. Financial markets registered certain stability, although a moderate increase in volatility was observed, particularly in fixed-income markets, due to concerns about the rapid spread of the Delta variant of the SARS-CoV-2 virus.

Among key global risks are those associated with the pandemic and inflationary pressures, as well as with monetary and financial conditions. In particular, the spread of the Delta variant or of new strains, in conjunction with the slow progress in the vaccination process in some countries, could delay global economic recovery. Moreover, a more persistent behavior of inflation at high levels could lead to a faster tightening of monetary policy.

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



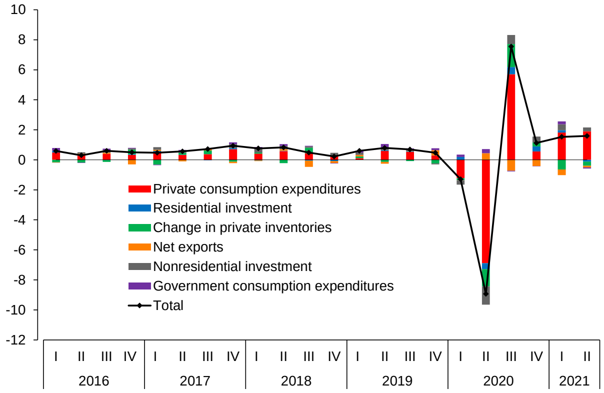
s. a. / Seasonally adjusted figures.
Source: IHS Markit.

In the United States, GDP maintained its pace of growth, from a seasonally adjusted quarterly growth of 1.5% during the first quarter of 2021 to 1.6% during the second (Chart 2).[1] The dynamism of private consumption and business investment, both driven by the reopening of commercial establishments, government support, and increased consumer and business confidence, contributed to said increase. In contrast, residential investment contracted and net exports continued contributing negatively to growth. It is worth noting that the US Senate recently passed an Infrastructure Investment and Jobs Act amounting to around USD 1.2 trillion over the next eight years, and there are also discussions on a budget proposal of around USD 3.5 trillion for social programs and climate change. If the Infrastructure Investment and Jobs Act is ratified by the House of Representatives and the budget proposal for social program spending is ratified by Congress, these packages could significantly contribute to US economic growth over the next years.

US industrial production moderated its expansion. After having grown at a seasonally adjusted monthly growth rate of 0.7% in May, it grew 0.4% in June. This was due to a 0.1% contraction in manufacturing activity in June, as a result of the fall in production of automobiles and auto parts due to a shortage of semiconductors. The Purchasing Managers' Index (PMI) of the manufacturing sector suggests that the sector could continue recovering in the next months, although at a moderate pace.

[1] Expressed as a quarterly annualized rate, US seasonally adjusted GDP grew at a rate of 6.3% during the first quarter of 20201 and of 6.5%% in the second.

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



s. a. / Seasonally adjusted figures.
Source: Bureau of Economic Activity (BEA).

The US labor market continued to recover during June and July. The non-farm payroll increased by 940,000 jobs on average during said period, a greater pace than that of 487,000 jobs registered, on average, between January and May. Significant progress was observed in the sectors related to accommodation and food services, art entertainment and recreation, educational services, professional, scientific and technical services, retail trade, and other services. However, the level of employment was still 5.7 million below its pre-pandemic levels. In addition, the vacancy rate remained at a high level given the slow pace of re-entry into the labor force. The unemployment rate decreased from 5.8% in May to 5.4% in July.

In the euro area, following the recovery of most of the region's economies, economic activity rebounded, expanding at a seasonally adjusted quarterly rate of 2.0% during the second quarter of 2021, after having contracted 0.3% during the first quarter.[2] Consumer spending recovered, supported by an improved labor market outlook, the high levels of consumer confidence, government support programs, progress in the vaccination process, and the reopening of economic activities. Business investment has been recovering, driven by a more optimistic environment and the expansion of domestic and external demand. The unemployment rate decreased from 8.0% in May to 7.7% in June. PMIs suggest that economic activity will continue to recover at a gradual pace during the third quarter.

In the United Kingdom, available indicators suggest that economic activity rebounded during the second quarter of 2021, after having fallen at a seasonally adjusted quarterly rate of 1.6% during the previous quarter.[3] This was the result of a strong increase in services, mainly those associated with accommodation and food services as a result of lower mobility restrictions. In this environment, the unemployment rate remained at 4.8% between April and May. PMIs for both the manufacturing and service sectors suggest that the UK economy will continue to recover, albeit at a moderate pace during the third quarter.

In Japan, available information suggests that, after having contracted at a seasonally adjusted quarterly rate of 1.0% during the first quarter of the year, economic activity remained weak during the second quarter.[4] This result is attributed to the decline in consumption, particularly of services, in light of the COVID-19 state of emergency declared during the period in some regions of the country. In contrast, other indicators, such as that of domestic orders for capital goods, suggest that investment has been recovering. Additionally, net exports of goods rebounded during the second quarter, supported by exports of semiconductor manufacturing machinery to other Asian economies. Industrial activity weakened, mostly reflecting supply bottlenecks and shortages of certain inputs worldwide. The unemployment rate decreased from 3.0% in May to 2.9% in June. PMIs indicate that manufacturing activity would grow at a moderate pace during the third quarter, while the services sector would continue to deteriorate, in line with the extension of the state of emergency in some regions.

In the major emerging economies, available indicators point to, in general, a weakening of economic activity during the second quarter of 2021, albeit with a heterogeneous behavior across countries, mainly depending on the evolution of the pandemic and the exposure of each country to the disruptions in global supply chains. In emerging Asian countries, economic activity has weakened due to the shortage of industrial inputs, the gradual withdrawal of some economic stimulus measures,

[2] In annualized terms, euro area GDP registered a quarter-on-quarter seasonally adjusted variation of -1.3% during the first quarter of 2021 and of 8.3% in the second.

[3] In annualized terms, UK GDP contracted at a quarter-on-quarter seasonally adjusted rate of -6.2% during the first quarter of 2021 and of 20.8% during the second

[4] In annualized terms, Japan GDP grew at a quarter-on-quarter seasonally adjusted variation of -3.9% during the second quarter of 2021.

and restrictions on mobility in countries such as India to contain the new wave of infections. In Latin America, indicators point to a deterioration of economic activity in most economies due to the upsurge in the number of infections. In emerging Europe, available indicators overall suggest a moderation in GDP growth, after the rebound registered during the first quarter.

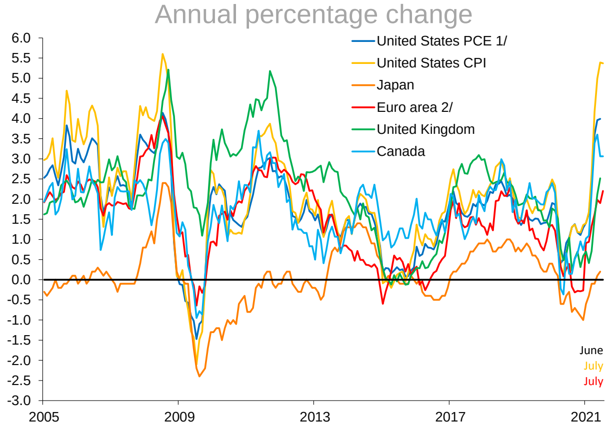
International commodity prices exhibited a mixed behavior since Mexico's previous monetary policy decision. In particular, during the first weeks of July, oil prices continued to be driven by the gradual recovery of global demand, due to the normalization of activities in a greater number of economies. However, later on they fell following the agreement between the Organization of the Petroleum Exporting Countries (OPEC) and other producers to increase oil production and due to the risk to global economic recovery posed by the upsurge in the number of contagions worldwide. The prices of natural and LP gas continued to increase during the period. This is explained by both a greater demand, in line with the global economic recovery, and supply-related problems associated with low inventory levels, the shutdown of gas extraction plants and gas pipelines in certain regions, and low exports of some of the main gas producers, among which Russia stands out. As for industrial metal prices, most of them increased, particularly during the second half of July, due to supply restrictions associated with disruptions in global supply chains. Nevertheless, in some cases, such as iron, prices have decreased recently due to a moderation in growth of industrial production worldwide. Finally, grain prices were subject to high volatility as a result of the uncertainty about weather conditions in the main producing countries and signs of a lower global demand.

A.1.2. Monetary policy and international financial markets

Global inflation continued to increase significantly, pressured by commodity prices, particularly those of energy products, and by other factors, such as the arithmetic effects stemming from a low base of comparison, and the persistence of multiple bottlenecks in production. Thus, headline inflation in the main advanced economies continued to rise, particularly in the United States, lying above their respective central banks' targets, except for Japan (Chart 3). In those economies, inflation has been influenced by structural factors, such as demographics, which have kept inflation and its expectations below their targets for prolonged periods. In light of the above, there is high uncertainty regarding the persistence of inflation in advanced economies, including a possibly heterogeneous evolution depending on differences in the speed of recovery of economic activity across countries. In this context, short-term inflation expectations drawn from surveys for this group of economies followed an upward trend. Likewise, expectations drawn for financial instruments for longer terms recently increased, after having remained relatively stable in previous months.

In the main emerging economies, headline inflation was, in many cases, above their central banks' targets. Core inflation has continued to increase in a context of a gradual recovery of demand and disruptions in global supply chains. Emerging economies that are more commercially integrated with those advanced economies that have recovered more rapidly and have registered larger increases in inflation face significant risks as there is the possibility that said increases turn out to be larger and more persistent than anticipated.

Chart 3
Selected Advance Economies: Headline Inflation
Annual percentage change

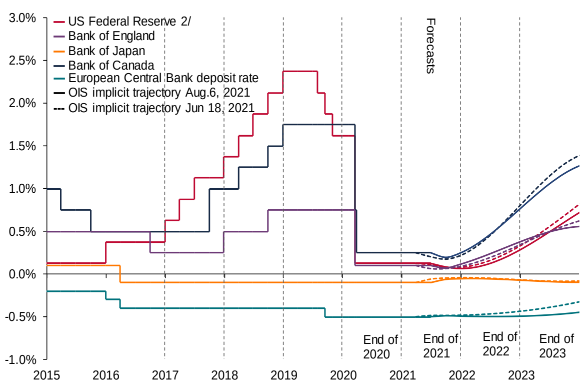


1/ The personal consumption expenditure deflator is used.
2/ Preliminary figure for July.
Source: Bureau of Economic Analysis, Eurostat, Bank of Japan, Statistics Canada, Office of National Statistics.

In this environment, the central banks of the major advanced economies left their reference interest rates unchanged at levels around zero. Most of them continued using their balance sheets to preserve favorable financing conditions and enable the convergence of inflation to their respective long-term targets, although some of them have already announced downward adjustments to the pace of their asset purchases. In particular, the Bank of Canada announced a second cut in its Asset Purchase Program (APP), from CAD 3 billion per week to CAD 2 billion, while the Reserve Bank of

New Zealand announced the termination of its APP. Most central banks of this group of economies also reiterated that they will be patient in withdrawing their accommodative monetary policy stances until inflation reaches their targets in a sustained manner, indicating that the recent increase in inflation is expected to be transitory. Despite the aforementioned, it is already foreseen that, in view of the economic recovery and the risk of higher levels of inflation, some central banks will reduce their monetary stimulus. Some institutions, like the US Federal Reserve (Fed), anticipate an increase in reference interest rates earlier than previously expected and have started to discuss an eventual reduction of their asset purchases. In this context, expectations drawn from financial instruments incorporate interest rate increases by mid-2022 and during 2023 for some of the main advanced economies (Chart 4).

Chart 4
Reference Rates and Implied Trajectories in OIS Curves[1/]
Percent



1/ OIS: Fixed floating interest rate swap where the fixed interest rate is associated to the effective overnight reference rate.
2/ For the observed reference rate of the U.S. the average interest rate of the target range of the federal funds rate (0.0% - 0.25%) is used.
Source: Banco de México with data from Bloomberg.

Among the recent monetary policy decisions, the following stand out:

i) In its July meeting, the Federal Reserve left its target range for the federal funds rate unchanged at 0-0.25% and mentioned that it would be appropriate to maintain it until labor market conditions have reached levels consistent with its maximum employment estimate and inflation has increased to 2% and is on track to moderately exceed this target for some time. It also reiterated that it will maintain the current pace of its asset purchase program until substantial progress has been made towards its maximum employment and price stability goals. In this regard, it also stated that the economy has made progress towards these goals and that the Federal Open Market Committee (FOMC) will continue to evaluate this progress in its next meetings. The Fed's Chairman expressed that the FOMC discussed how it could adjust the pace and composition of its asset purchases once economic conditions so warrant and pointed out that it will give advance notice of any adjustment to this program. He mentioned that there is a possibility that inflation turns out to be higher and more persistent than expected and that, in the event that the path of inflation or long-term inflation expectations deviate materially and persistently from levels consistent with its objective, the Fed will be prepared to adjust its monetary policy stance. In this context, the trajectory implied by financial instruments for the federal funds rate incorporates expectations of 2-3 increases by the end of 2023.

ii) At the beginning of July, the European Central Bank announced the adoption of a new monetary policy strategy that considers, among other elements: (i) a symmetric inflation target of 2% in the medium term; (ii) the possibility of requiring strong and persistent measures, as well as a transitory period in which inflation moderately exceeds its target, in episodes where the reference rate has been constrained by an effective lower limit; iii) that the Harmonized Index of Consumer Prices (HICP) remains an appropriate measure for assessing progress vis-à-vis the inflation target, although it recommended the gradual inclusion of owner-occupied housing costs in future inflation measures; iv) adjustments to its communication strategy and tools; and, v) the approval of an action plan to include climate change considerations into its monetary policy framework. This central bank noted that, looking ahead, it will periodically evaluate its monetary policy strategy, expecting to carry out a next assessment in 2025. In its most recent monetary policy meeting, it left its refinancing rate, key deposit facility rate and key lending facility rate unchanged at 0.0, -0.5 and -0.25%, respectively, and reiterated that asset purchases under the Pandemic Emergency Purchase Program (PEPP) will continue during the third quarter of 2021 at a significantly higher pace than in the first few months of the year. However, it adjusted its forward guidance on interest rates to reflect its new monetary policy strategy, noting that the Executive Board expects interest rates to remain at current or lower levels until inflation reaches 2% well before the end of its forecast horizon and in a sustained manner during the rest of it, and until it considers that progress in core inflation is sufficiently advanced to be consistent with the stabilization of inflation at 2% in the medium term, which could imply a transitory period in which inflation lays moderately above target.

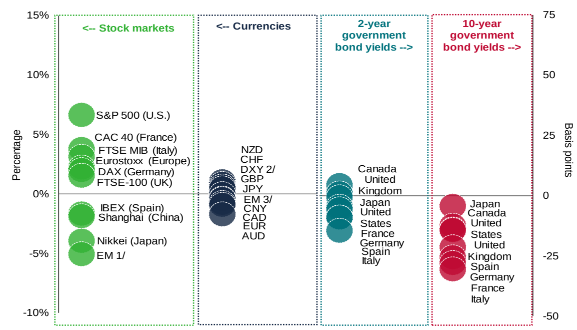
iii) In its June meeting, the Bank of Japan left its short-term policy rate unchanged at -0.1% and its long-term interest rate (indexed to its 10-year bond) at around 0%, as well as its asset purchase program. Said central bank ratified that, if necessary, it will not hesitate to take additional easing measures and that it expects interest rates to remain at or even below their current levels. In addition, it disclosed the preliminary outline of a new measure announced in its June meeting to provide funds to financial institutions, which seeks to support efforts to address issues associated with climate change.

iv) In its latest meetings, the Bank of England left its reference interest rate at 0.10% and its asset purchase program unchanged. In its August meeting it noted that, should the economy evolve in line with its central forecasts, a modest tightening of monetary policy over the forecast period would likely be necessary in order to be consistent with meeting the 2% inflation target on a sustainable basis over the medium term, which is anticipated to occur in the third quarter of 2022. Regarding its current asset purchase program, this central bank indicated that it expects it to conclude by the end of 2021, as previously mentioned. In addition, the Monetary Policy Committee is planning to suspend reinvestment of maturities when the reference rate reaches the 0.5% level and to begin selling assets once the reference rate reaches 1%, and subject to the economic conditions.

The monetary authorities of emerging economies, particularly those with close commercial links with the advanced economies that have recovered more rapidly, face additional challenges and have less room to maneuver regarding monetary policy implementation. In addition to domestic and idiosyncratic factors, such as increases in demand and currency depreciation, pressures from a higher and more persistent global inflation pose a risk to the price formation process in this group of economies. In an environment in which, unlike that of the major advanced economies, inflation and its expectations in emerging economies have not remained below their central banks' targets for prolonged periods, some central banks of this group of economies have reduced their monetary stimuli. In particular, the central banks of Russia, Hungary, Brazil, and the Czech Republic announced additional interest rate increases, while those of Mexico and Chile raised their rates for the first time since the beginning of the pandemic.

In the global context described above, and since Mexico's previous monetary policy decision, international financial markets exhibited limited adjustments (Chart 5), although episodes of greater volatility associated with, among other factors, concerns regarding the spread of new variants of the SARS-CoV-2 virus and several technical factors, were observed. In this context, the stock markets of most of the major advanced economies showed gains and some even reached historical highs driven by favorable corporate results, while emerging economy markets overall registered adjustments in a narrow range with a negative bias (Chart 6). In particular, Asian stock exchanges registered losses during the period, given expectations of a tighter regulation of China's technological sector, among other factors. In foreign exchange markets, the US dollar strengthened against most advanced economies' currencies during most of the period, although this trend has moderated in recent weeks. Emerging market currencies mostly registered a bias towards depreciation. In the main advanced economies, interest rates on long-term government securities decreased, although some increases have been recently observed. In this environment, since Mexico's previous monetary policy decision, moderate net capital inflows in emerging economies, mainly of the Asian region and, particularly, China, were registered.

Chart 5
Change in Selected Financial Indicators from June 18 to August 6, 2021
Percent; basis points



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

Chart 6
Selected Emerging Economies: Financial Assets Performance from June 2021
Percentage, basis points

Region	Country	Currencies	Equity markets	Interest rates 2Y	Interest rates 10Y	CDS
Latin America	Mexico	2.38%	1.59%	53	14	-3
	Brazil	-4.31%	-4.99%	151	63	17
	Chile	-5.32%	-0.28%	91	71	5
	Colombia	-5.28%	-1.59%	-41	0	6
	Peru	-3.58%	-6.96%	52	57	-1
Emerging Europe	Russia	-0.34%	0.15%	13	-17	-2
	Poland	-2.15%	3.59%	5	3	0
	Turkey	1.37%	3.10%	25	-13	8
	Czech Republic	-0.80%	6.70%	29	2	-4
	Hungary	-1.62%	3.10%	11	-7	-7
Asia	China	-0.18%	-0.98%	-26	-24	2
	Malaysia	-1.98%	-4.80%	-1	-5	6
	India	-0.22%	3.48%	-52	19	7
	Philippines	-3.49%	-2.85%	-7	-43	5
	Thailand	-5.73%	-3.81%	-5	-30	1
	Indonesia	0.45%	2.19%	-22	-28	2
Africa	South Africa	-2.44%	4.74%	-23	-6	14

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

Looking ahead, several risks to the stability of international financial markets persist. In addition to those related to the recovery of economic activity, the following stand out: i) a more sustained and higher than anticipated increase in inflation in some advanced economies resulting in an earlier-than-anticipated withdrawal of monetary stimuli, which could cause higher volatility in global financial markets, and particularly affect emerging economies that, in general, have less fiscal and monetary policy room to maneuver; ii) possible distortions of some financial assets' valuation that could lead to a sudden correction in their prices; and iii) an increase in public and private debt levels. In addition, emerging economies could possibly face greater challenges in the medium term as their sources of financing become more limited, in a context of a greater absorption of resources by advanced economies and because of China's participation in global investment indexes.

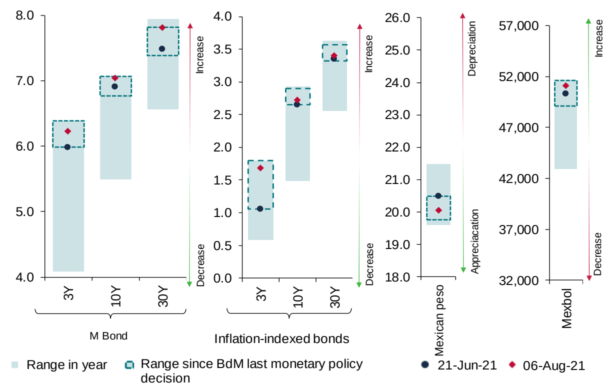
A.2. Current situation of the Mexican economy

A.2.1. Mexican markets

Since the last monetary policy decision to date, financial asset prices in Mexico exhibited a mixed behavior (Chart 7), in an environment of caution given the upsurge in COVID-19 cases around the world and uncertainty regarding the monetary policy stance of advanced countries. In this regard, as described in the previous section, a less accommodative monetary policy in advanced economies continues to be incorporated.

The Mexican peso fluctuated in a range between 19.77 and 20.49 pesos per US dollar, ending the period with an appreciation of 2.38% (Chart 8). This occurred in a context in which both spot- and future-trading conditions improved slightly.

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



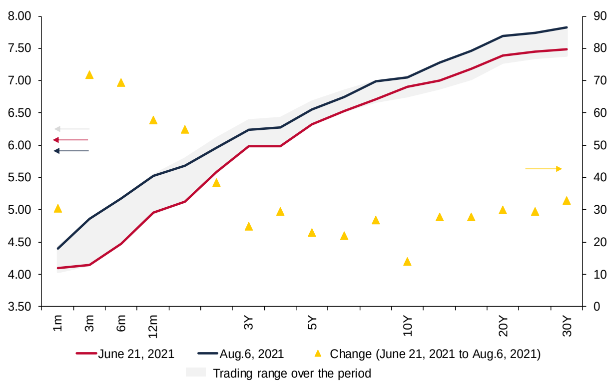
Source: Prepared by Banco de México.

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

Source: Prepared by Banco de México.

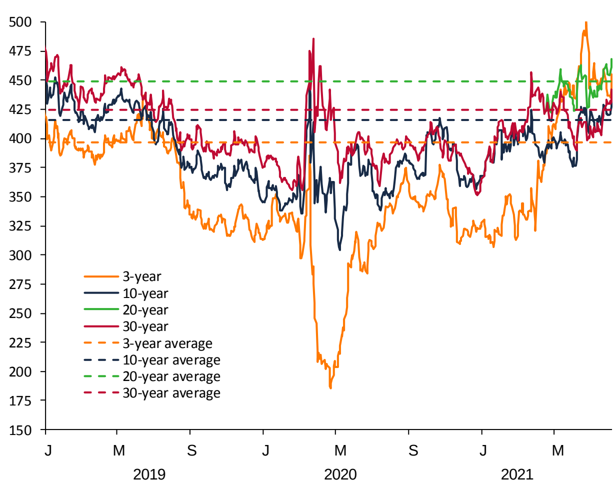
Interest rates of government securities exhibited a mixed behavior (Chart 9) with an upward and flattening trend of the yield curve, with increases of up to 62 basis points in the short-term part of the curve and increases of up to 33 basis points in longer-term instruments. The yield curve for real rate instruments showed a similar dynamic, with increases of up to 85 basis points in the short end of the curve and increases of up to 15 basis points in the long-term segment. In this context, breakeven inflation and inflation risk premia implicit in spreads between nominal and real rates of market instruments showed mixed adjustments with respect to the June monetary policy decision (Chart 10). These adjustments took place in an environment in which trading conditions in this market slightly improved during the period covering the monetary policy decision.

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



Source: PIP.
Note: The chart does not include bonds maturing in December 2021 and June 2022. CETES with similar maturities are considered.

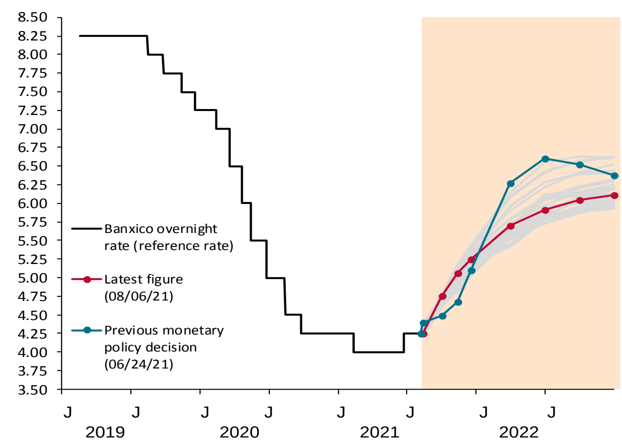
Chart 10
Breakeven Inflation and Inflation Risk Implicit in Government Securities' Interest Rate
Basis points



Source: PIP.

Regarding expectations for the trajectory of the monetary policy reference rate, information implied by the Interbank Equilibrium Interest Rate (TIIE, for its Spanish acronym) swap curve incorporates an increase of around 50 basis points in the reference rate between the August and September meetings (Chart 11). In a related manner, the median of the consensus of forecasters surveyed by Citibanamex anticipates the reference rate to be at 4.50% in the next monetary policy decision. For the end of 2021, market variables anticipate a target rate of 5.25%, while the median of the aforementioned survey expects a level of 5.00%.

Chart 11
Banco de México Overnight Interbank Rate Implied in TIIE IRS Curve
Percent



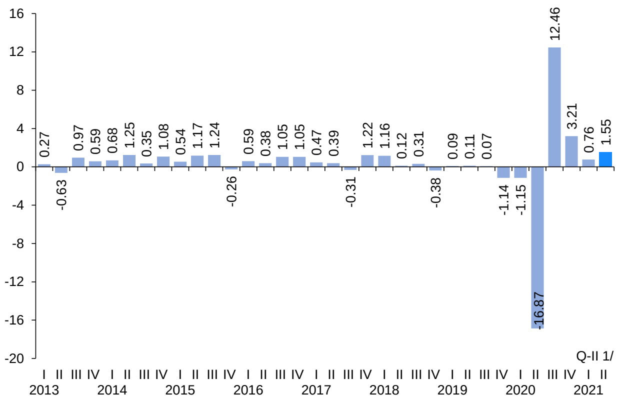
Source: Prepared by Banco de México with Bloomberg data.

A.2.2. Economic activity in Mexico

According to Mexico's GDP flash estimate, the Mexican economy continued to recover during the second quarter (Chart 12), with heterogeneity among sectors. In particular, services continued to reactivate throughout the quarter in an environment in which various services have been reopening in tandem with progress in the vaccination campaign, while industrial production has shown weakness in a context in which shortages of certain industrial inputs prevailed.

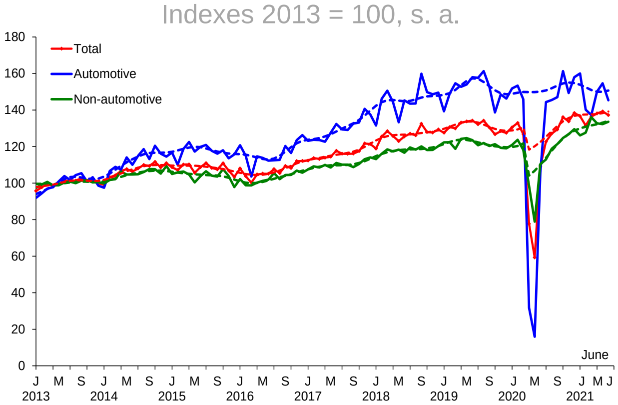
As for external demand, during the second quarter of 2021, manufacturing exports, both automotive and non-automotive, exhibited moderate growth as compared to the previous quarter (Chart 13). By destination, exports to the United States exhibited a loss of dynamism, while those to the rest of the world rebounded.[5]

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



s. a. / Seasonally adjusted figures.
1/ The figure for the second quarter of 2021 refers to the flash estimate of quarterly GDP published by INEGI.
Source: Mexico's System of National Accounts (SCNM, for its Spanish acronym), INEGI.

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

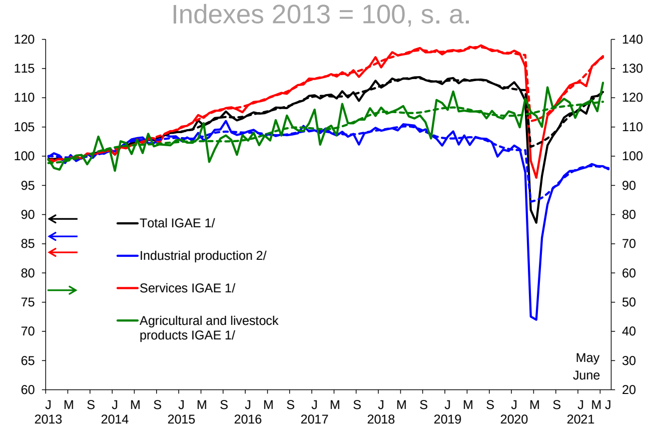


s. a. / Seasonally adjusted series and trend series based on data in nominal US dollars. The former is represented by a solid line and the latter by a dotted line.
Source: Prepared by Banco de México with data from the Tax Administration Service (SAT, for its Spanish acronym), the Ministry of the Economy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

According to its monthly indicator, private consumption continued to recover in May, although it remained below the level reported in February 2020. Within this indicator, consumption of goods continued to show high dynamism, attributed to its imports' component, while consumption of services remained on an upward trend. In May, gross fixed investment partially reversed the decline observed in April, although it continued to show a weak performance. The machinery and equipment component fell for the second consecutive month, halting its expansion after the relatively good performance it had exhibited during the first quarter of the year. In turn, investment in construction reactivated at the margin, although it remained below the levels reported in February 2020.

As for production, the flash estimate suggests that tertiary activities continued to reactivate, while industrial production showed weakness (Chart 14). During the April- May period, the services that mostly contributed to the growth of tertiary activities were professional, corporate and business support services; commerce; government activities; temporary accommodation and food and beverage preparation services; and educational and health services. The weak performance of industrial activity at the end of the second quarter was the result of a generalized deceleration of the subsectors that comprise it. In June, manufacturing fell for the third consecutive month, mainly as a result of the negative evolution of the transportation equipment sector due to the shortage of certain industrial inputs. Construction reversed the recovery observed in May, while mining exhibited a loss of dynamism (Chart 15).

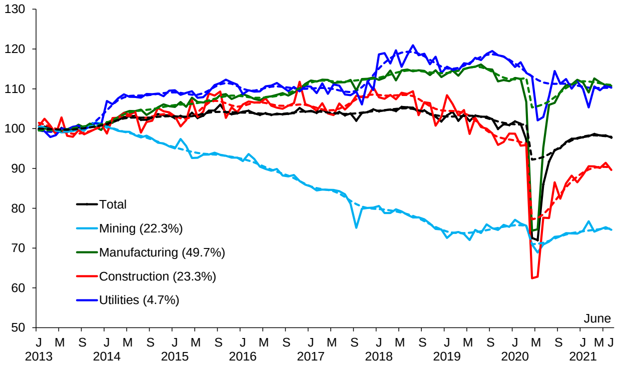
Chart 14
Global Indicator of Economic Activity
Indexes 2013 = 100, s. a.



s. a. / Seasonally adjusted and trend series. The former is represented by a solid line and the latter by a dotted line.
1/ Figures up to May 2021.
2/ Monthly Industrial activity Indicator figures up to June 2021
Source: Mexico's System of National Accounts (SCNM, for its Spanish acronym), INEGI.

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

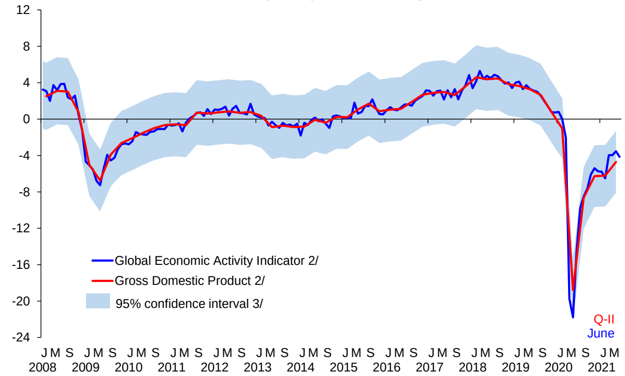
Chart 15
Industrial Activity 1/
Indexes 2013 = 100, s. a.



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

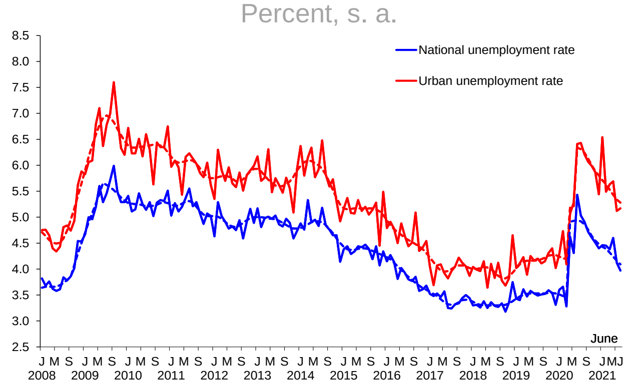
Regarding the economy's cyclical position, timely information suggests that during the second quarter of 2021, slack conditions for the economy overall were below those of the first quarter, although they remain significantly wide (Chart 16), with large differences across sectors. At the end of the second quarter, labor market indicators showed a mixed behavior. In particular, while the national unemployment rate decreased slightly and the employed population increased, labor participation decreased again while the urban unemployment rate rose slightly (Chart 17). In June, the number of new IMSS-insured jobs continued to recover, although it remained at around 430 thousand jobs below the level reported prior to the health emergency. Finally, after having fallen in March and April, unit labor costs in the manufacturing sector increased at the margin in May, remaining above pre-pandemic levels (Chart 18).

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



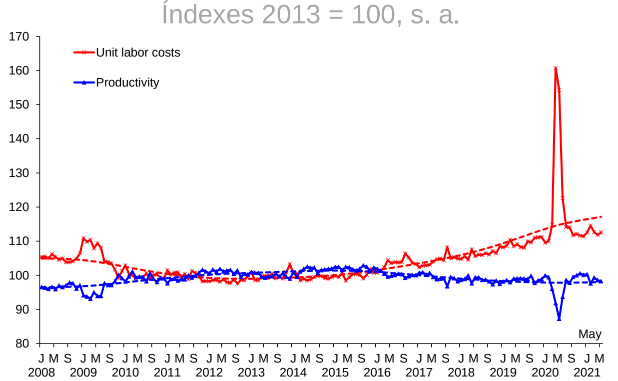
s. a. / Calculations based on seasonally adjusted figures.
1/ Output gap estimated with a tail-corrected Hodrick-Prescott filter; see Banco de México (2009), "Inflation Report, April-June 2009", p.74.
2/ GDP timely figures as of Q1 2021, and IGAE figures as of March 2021, in line with said timely figure.
3/ Output gap confidence interval calculated with a method of unobserved components.
4/ Excludes both oil and gas extraction, support services for mining, and petroleum and coal products' manufacturing.
Source: Prepared by Banco de México with INEGI data.

Chart 17
National and Urban Unemployment Rates
Percent, s. a.



s.a./ Seasonally adjusted series and trend series. The former is represented by a solid line and the latter by a dotted line.
Source: Prepared by Banco de México with data from ENOE, ETOE (from April to June 2020), and ENOE new edition ($ENOE^N$) from July to date.

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



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

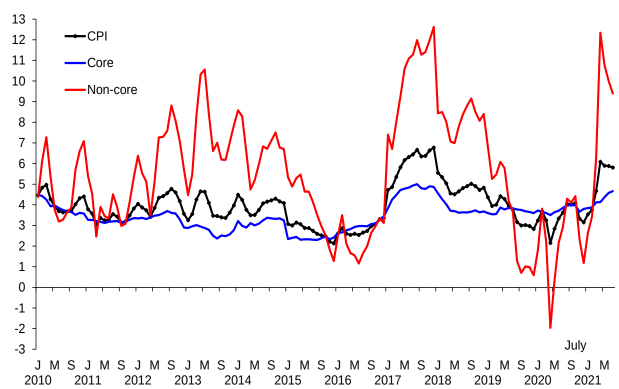
In June 2021, domestic financing to firms continued to contract in real terms at an annual rate. This has been partly the result of a reduction in bank lending to both smaller- and large-sized firms. Although the demand for credit from these companies remains at low levels, there has been an incipient recovery at the margin. Likewise, lending conditions for firms in general continued to be tight as compared to the beginning of the pandemic, although they have not presented additional restrictions so far this year. Meanwhile, during the second quarter of the year, net corporate debt issuance in the domestic market continued to show a low dynamism, thus extending the lackluster behavior observed during the first quarter of the year. As for credit to households, the housing portfolio continued to show positive real annual variations, although its growth has moderated throughout the year. At the same time, banks' current consumer loan portfolio moderated its contraction at an annual rate, with the greater dynamism of the credit card and payroll portfolios standing out at the margin. This, in a context characterized by a gradual recovery of household demand for credit and where lending conditions have not shown an additional tightening.

Interest rates of bank credit to firms have generally followed the dynamic of the bank funding rate. Intermediation margins have remained above pre-pandemic levels. In turn, mortgage interest rates remained at levels around their historic lows. Meanwhile, after having decreased in the previous months, credit card interest rates increased slightly in April, while in the rest of the segments they remained relatively stable. Thus, the margins of intermediation for consumer credit remain at higher-than-pre-pandemic levels. As for portfolio quality, the corporate loan delinquency rate declined in June and remained at low levels. After having followed a moderate upward trend since November 2020, the mortgage loan delinquency rate also declined and remains at low levels. Lastly, in spite of having declined for the fourth consecutive month, consumer portfolio delinquency rates remain at high levels.

A.2.3. Development of inflation and inflation outlook

Between June and July 2021, annual headline inflation fell from 5.88 to 5.81%. Non-core inflation contributed 13 basis points to this reduction, which was partially offset by a higher incidence of core inflation of 6 basis points (Chart 19 and Table 1). The decline in non-core inflation was associated with lower energy inflation, as the arithmetic effect of the significant decreases in gasoline prices in April 2020 continued to fade. Higher core inflation reflects the additional shocks that continue to affect it, such as disruptions in supply chains and in the production processes of various goods and services.

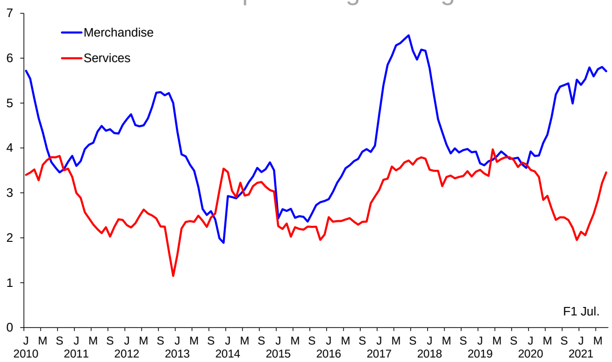
Chart 19
Consumer Price Index
Annual percentage change



Source: Banco de México and INEGI.

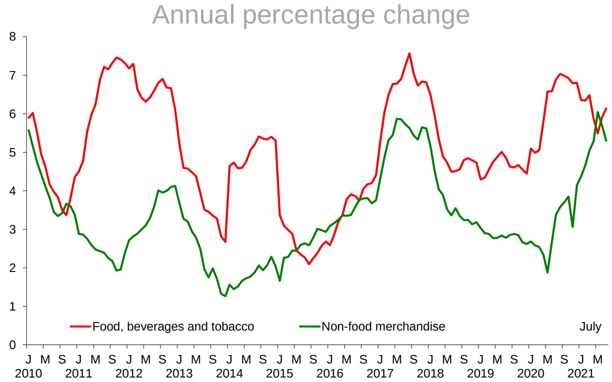
Indeed, between June and July 2021, annual core inflation increased from 4.58 to 4.66%. Annual merchandise inflation changed from 5.81 to 5.74% (Chart 20), reflecting an increase from 5.91 to 6.14% in food items and a reduction from 5.69 to 5.30% in non-food items (Chart 21). In turn, as demand for several of these services continued to recover, annual inflation of services further increased, from 3.22 to 3.46% in the referred period. Most of this behavior was due to the increase in the annual inflation of the other services category, which registered 4.78 and 5.17% during this period, with the higher annual variations in the prices of tourism, food and entertainment services standing out the most.

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



Source: Banco de México and INEGI.

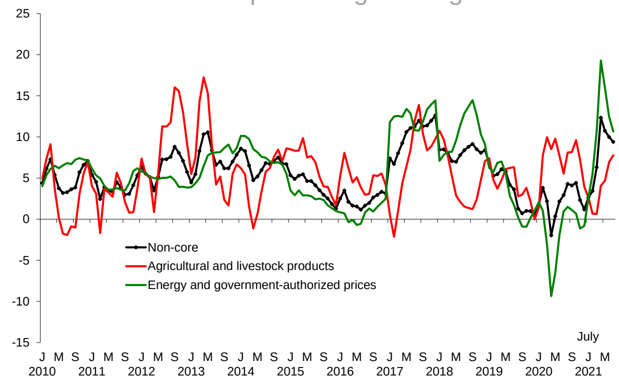
Chart 21
Merchandise Core Price Sub-index
Annual percentage change



Source: Banco de México and INEGI.

Annual non-core inflation decreased from 10.00 to 9.39% between June and July 2021 (Chart 22 and Table 1). This trend was mainly determined by the decrease from 17.13 to 14.41% in the annual inflation of energy products, as a result of lower annual variations in gasoline prices, which went from 15.85 to 9.69%, and which continue to reflect the fading of the arithmetic effect of the significant decreases in their prices in April of last year. Nevertheless, this was partially offset by the increase from 6.95 to 7.77% in the annual inflation of agricultural and livestock products.

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



Source: Banco de México and INEGI.

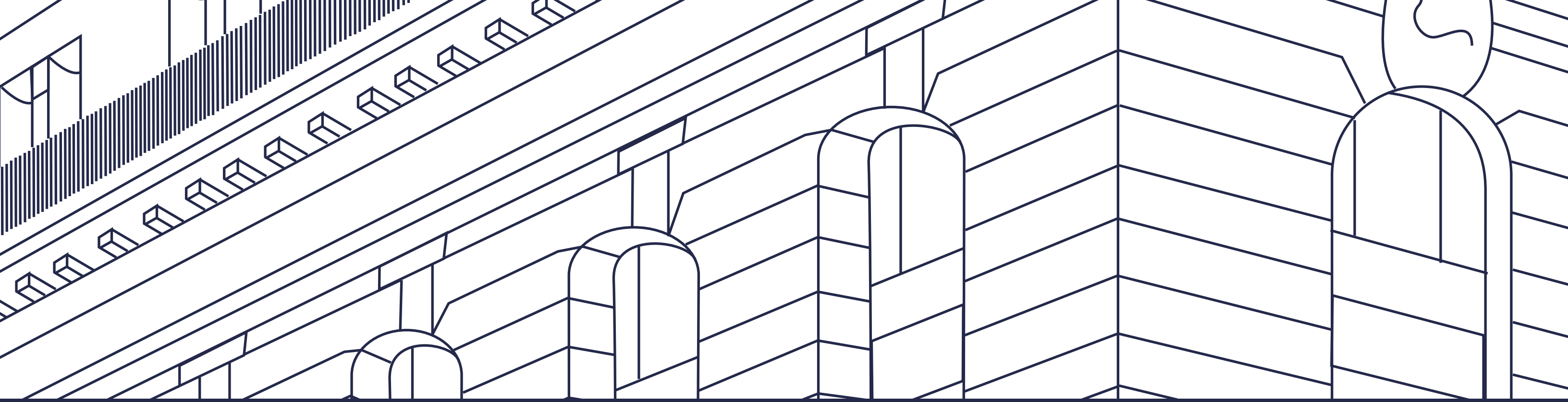
As for inflation expectations drawn from Banco de México's Survey among Private Sector Forecasters, between May and July, the median of expected headline inflation for the end of 2021 increased from 5.00 to 6.00%, while that corresponding to the core component increased from 3.91 to 4.66%. In turn, medians of expectations for the end of 2022 were adjusted from 3.61 to 3.67% for headline inflation, and from 3.60 to 3.68% for core inflation. On the other hand, the medians of headline and core inflation expectations for the medium and long terms remained around 3.50%. Finally, the compensation for inflation and inflation risk increased and remains at high levels. Within it, both inflation expectations and the inflation risk premium increased.

Considering the nature of the shocks that have affected headline and core inflation, these are expected to decrease, particularly for horizons of one year and beyond, and to converge to the 3% target during the first quarter of 2023. These forecasts are subject to risks and additional shocks. On the upside: i) external inflationary pressures; ii) cost-related pressures; iii) core inflation persistence; iv) exchange rate depreciation; and v) increases in agricultural and livestock product prices. On the downside: i) effects stemming from the negative output gap; ii) additional social distancing; and iii) exchange rate appreciation. The balance of risks for the trajectory of inflation within the forecast horizon is biased to the upside.

Table 1
Consumer Price Index and Components
Annual percentage change

Item	May 2021	June 2021	July 2021
CPI	**5.89**	**5.88**	**5.81**
Core	**4.37**	**4.58**	**4.66**
Merchandise	**5.76**	**5.81**	**5.74**
Food, beverages and tobacco	5.49	5.91	6.14
Non-food merchandise	6.05	5.69	5.30
Services	**2.84**	**3.22**	**3.46**
Housing	1.86	1.98	2.09
Education (tuitions)	1.12	1.15	1.23
Other services	4.08	4.78	5.17
Non-core	**10.76**	**10.00**	**9.39**
Agricultural and livestock products	**4.67**	**6.95**	**7.77**
Fruits and vegetables	-3.63	2.65	4.99
Livestock products	12.23	10.61	10.08
Energy and government-authorized prices	**15.97**	**12.45**	**10.67**
Energy products	22.96	17.13	14.41
Government-authorized prices	2.25	2.72	2.57

Source:INEGI.



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