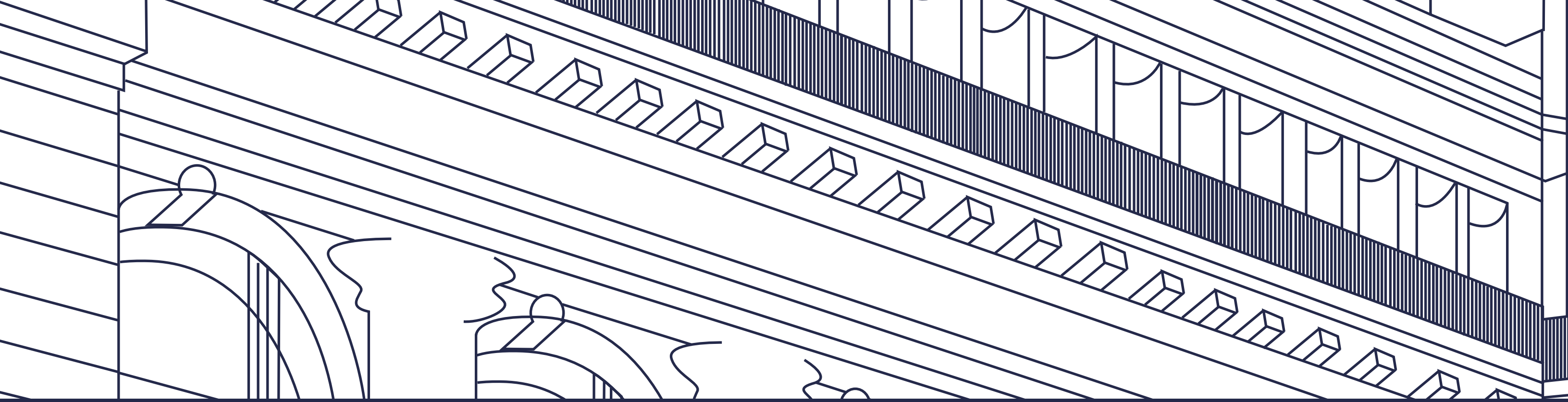

BANCO DE MÉXICO®

Minutes number 74

Meeting of Banco de México's Governing Board on the occasion of the monetary policy decision announced on March 20, 2020

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FOREWARNING

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1. PLACE, DATE AND PARTICIPANTS

1.1 Place: Meeting held through virtual means.

1.2. Date of Governing Board meeting: March 19, 2020.

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

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

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

International environment

All members pointed out that the world economy and its growth outlook deteriorated rapidly and significantly as a result of the COVID-19 outbreak. Most members agreed that the isolation measures adopted have contributed to the halt in economic activity, to supply chain disruptions, and to a decline of global demand. Some members mentioned that the pandemic has strongly affected the public health systems and social dynamics.

Some argued that the possibility of a global recession in 2020 has increased, while one pointed out that, in general, a recovery is expected for next year. **One** member considered that, given the magnitude of the shock and the impact that has already been reflected in some economic indicators, a significant contraction is foreseeable during the first quarter of 2020, which could continue into the next quarter. **Another** member considered that the length and depth of the recession would depend on the duration of the suspension of activities. **One** member mentioned that the variation in the magnitude of the revisions to growth forecasts reflects the uncertainty regarding the intensity, duration and consequences of the impact.

Among the risks to world economic activity, most members highlighted a greater-than-expected spread of COVID-19. One member underlined that, given the severity of the pandemic, it constitutes an unprecedented global risk factor. In particular, he/she emphasized the complexity of handling it, its rapid spread and the fatalities it can lead to.

Some members mentioned the escalation of trade tensions along with political and geopolitical tensions as additional risks. **One** mentioned the US electoral process. **Some** members pointed out that the balance of risks for the world economy is significantly biased to the downside.

All members mentioned that the prices of commodities, especially of crude oil, have plummeted. Most members underlined that this is due to the observed and anticipated reduction in demand and to disputes among the main oil producers. One member stated that headline and core inflation in advanced economies are expected to decline, due to the economic weakness and to the lower prices of primary goods. He/she mentioned that inflation in emerging economies could benefit from these factors, although it could also be affected to the upside by the depreciation of their exchange rates.

Given the described environment, all members mentioned that different central banks in advanced and emerging economies lowered their interest rates, in some cases ahead of schedule. Most members mentioned that the US Federal Reserve held two unscheduled meetings, in which it cut the federal funds rate by a total of 150 basis points, down to a range of 0-0.25%. Such members pointed out that, globally, other extraordinary monetary measures have also been implemented to mitigate the effects of the expected fall in domestic and external demand, and to guarantee the well-functioning of financial markets. In particular, they highlighted the

measures to provide liquidity and incentivize credit, as well as the purchase programs of the following assets: i) government bonds; ii) mortgage-backed securities; iii) corporate bonds; iv) non-financial firms' commercial papers; v) equity funds, and vi) real estate investment funds. Some members added that the US Federal Reserve established new liquidity swap lines with other central banks. **One** mentioned the decrease in the minimum reserve requirements for banks implemented by the US Federal Reserve. **Another** member mentioned that some central banks in emerging economies have taken measures to contain the depreciation pressures or to improve foreign exchange market trading conditions.

Most members pointed out that the governments of different economies have implemented expansionary fiscal policies aimed at reducing the impact of the pandemic, in order to support households and businesses. However, **one** member pointed out that the announced measures have failed to alleviate the nervousness among investors, which makes it essential to have firm and integral policies, capable of coordinating both fiscal and monetary efforts that guarantee income and employment in strategic sectors, and that are perceived as sufficient to reverse the shock on economic activity.

In this context, all members highlighted the significant deterioration of international financial markets, underlining the greater volatility and risk aversion. Some members indicated that the above is due to the uncertainty regarding the length of the pandemic and the extent of its effects. **Most members added that it is also the result of the fall in oil prices. Some** members mentioned that the deterioration of international markets is comparable to that observed during the 2009 global financial crisis. **One** member pointed out that this negative performance is expected to continue during the following months and underlined the high levels of the VIX index. **Most members noted that stock exchanges around the world have been negatively affected. One** member stated that in advanced economies considerable outflows from stock markets towards fixed income instruments have been observed. **Most members pointed out that emerging economies have also been affected, and emphasized the capital outflows that have exerted pressure on the exchange rates, interest rates and stock markets. Such members also noted that country risk indicators have deteriorated. One** member highlighted that lower crude oil prices are a risk factor, given that all oil and gas companies are facing additional falls in the value of their assets, equity and debt securities. **Another** one stated that the balance of risks for financial markets is significantly biased to the downside.

Economic activity in Mexico

Most members mentioned that timely information released prior to the pandemic-related events shows that domestic economic activity has remained weak. On the production side, **one** member noted that the deceleration of industrial activity, particularly of manufacturing, as well as the weakness of services, which registered a higher number of subsectors with annual contractions, persisted. As for domestic demand, he/she mentioned that all components remain weak, especially investment, and, more recently, consumption. He/she pointed out that regarding external demand, automotive exports increased at the beginning of the year, while the remaining sectors exhibited weakness.

Most members pointed out that technical shutdowns began to be observed across different sectors in March due to the shortage of inputs. Such members also noted that a significant impact on domestic demand is anticipated, in particular, on consumption and investment. Some members underlined the impact on domestic demand of the social distancing measures and the fear of contagion among the population. **One** member highlighted that, so far, economic activity and inflation indicators are still not reflecting the impact of the shocks caused by the pandemic and by the lower oil prices. He/she indicated that said shocks would materialize in a situation characterized by an inflation rate and its short- and long-term expectations above target, as well as by a weak economy.

Most members mentioned that the disruption in global supply chains and the restriction of flows of individuals and international goods will strongly affect tourism and services in general. Some members added that households will face a contraction in their income and will have fewer spending opportunities. **One** member noted that, based on the experience of the A (H1-N1) epidemic in 2009, indeed, the strongest impact might be perceived in certain segments of the services sector, such as education, restaurants, tourism, and transport. He/she added that businesses will face significant challenges such as lower revenues and high uncertainty regarding the demand for their goods and services, which can generate solvency and unemployment problems. **Some** members mentioned that the manufacturing export sectors will also be affected. **One** member highlighted the possible impact of the global pandemic on Mexico's external demand. **Another** one noted that additional technical shutdowns can occur due to the lack of inputs.

Most members noted that the impact of the pandemic on economic activity, in a context of a greater weakness of the global economy, leads to a deterioration of the growth outlook. Such members stated that, although it is not possible to accurately estimate the magnitude of the impact on economic activity, an economic contraction is foreseen for 2020. One member pointed out that this would result from a combination of different shocks, from both the supply and demand sides. **Some** members noted that their length and depth would depend on the duration of the suspension of activities. **One** member added that, based on data provided by the authorities, the impact of COVID-19 is expected to worsen during the second quarter and to extend for a yet undetermined period. He/she mentioned that analysts and international organizations' expectations for economic activity in 2020 and 2021 have been revised downwards. **Some** members specified that for 2020 these lie at a range of between -1% and slightly above -5%. **One** member noted that most estimates lie between -2 and -4%. **Another** member mentioned that estimates are still characterized by high uncertainty and a downward bias.

Most members considered that the balance of risks for growth is strongly biased to the downside. Some members signaled the risk of a greater contagion of COVID-19. **One** member mentioned the possibility of a more prolonged impact on world economic activity. Meanwhile, **some** members stated that there are a number of risks for local financial markets, which could negatively impact domestic economic activity. **One** member specified that a pronounced epidemic phase would significantly affect the income of both the private and public sectors, and would contribute to a deterioration of credit risk, which could lead to financial and solvency problems. He/she added that the shock of oil prices is particularly negative for economies with an important hydrocarbon sector, such as the Mexican one, which will make the adjustment of the economy more complex. Finally, he/she acknowledged that domestic factors that affect both confidence and the economic outlook persist.

As for the labor market, **one** member pointed out that the trend of lower job creation has prevailed. He/she added that, in the current context, employment is foreseen to be considerably affected. **Some** members considered that economic slack has increased. In view of the deteriorated growth outlook, **most members mentioned that an even greater-than-anticipated widening of slack conditions is foreseen.**

Inflation in Mexico

Most members mentioned that, between January and February, headline inflation increased, mainly due to a rebound in the non-core component. One member indicated that the latter was due to the comparison base effect and to pressures on agricultural and livestock product prices. **Another** member stated that the increase in the non-core index was anticipated, given expectations that the fall in agricultural and livestock product prices observed in 2019 would revert. As to the core component, **some** members highlighted that it has shown persistence. **One** member argued that this confirms that, despite the greater slack, other factors, such as wage increases, have prevented it from decreasing. Meanwhile, **another** member pointed out that this component remained on a slightly declining trend. He/she added that food merchandise inflation decreased after the increase observed in January, as a result of an adjustment to the Excise Tax (IEPS, for its acronym in Spanish), and that services inflation continued to decline.

Some members indicated that although inflation is expected to continue its trend to Banco de México's target in the time frame in which monetary policy operates, it could be slower and is subject to important risks, both to the upside and to the downside. **One** member stated that, in view of the deterioration of global and domestic conditions, inflation forecasts are subject to high uncertainty. **Another** member considered that the combination of supply and demand shocks, as well as higher uncertainty, will probably result in upward pressures on inflation in 2020.

As for inflation risks, most members mentioned that the expected widening of the negative output gap and the fall in international energy prices could imply downward inflation pressures. Nonetheless, such members considered that this could be offset by the upward pressure the peso exchange rate depreciation might exert on prices. One member argued that, even if the depreciation persists, it would occur in a context of economic contraction. He/she mentioned that the pass-through to prices will depend on the persistence of the exchange rate adjustment and on the economy's cyclical position. Among upward risks for inflation, **some** members mentioned the pressures stemming from the disruption of global value chains and from the shortage of certain goods as a result of the suspension of activities.

One member mentioned that a key price in the future developments of inflation is gasoline prices. He/she indicated that the international reference has declined by a greater percentage than the exchange rate depreciation, and thus the price of gasoline in Mexican pesos should decrease. He/she stated that this has already started to take place in different parts of the country. He/she added that, given its contribution to headline inflation and its role in the determination of other prices, the fall in energy prices would become an important downward bias for inflation.

In this context, **some** members considered that the uncertainty over the balance of risks for inflation has intensified. **One** member highlighted that, given the complex environment, both upward and downward risks have increased. **Another** member stated that there is uncertainty over the magnitude and the duration of different supply and demand shocks, as well as over the persistence of adverse conditions in financial markets, and therefore their effect on inflation in the short, medium and long terms is uncertain. **One** member considered that the balance of risks is biased to the upside. **Another** one mentioned that it is slightly biased to the downside due to the following: i) the shock on agricultural and livestock product prices usually fades in a few months; ii) the fall in energy prices; and iii) although the peso exchange rate has depreciated, commodity prices and the fall in aggregate demand will end up exerting a greater influence on inflation.

Macrofinancial environment

In an environment of greater risk aversion worldwide, most members highlighted that domestic financial markets exhibited a negative performance. **Some** members underlined the deterioration of trading conditions in these markets. In this context, **all members noted that the peso exchange rate depreciated significantly. One** member mentioned that this is explained by several factors, such as the greater risk aversion and the fall in oil prices, which also affected the exchange rate of other oil-exporting countries' currencies. **Some** members added that this depreciation was greater than that observed in most emerging economies and **one** member added that the depreciation of the peso exchange rate vis-à-vis other emerging currencies reflects idiosyncratic factors, such as the concerns regarding Pemex and public finances, as well as the respective credit ratings, and that other risks such as those stemming from the US elections persist.

The majority of members pointed out that interest rates of government securities increased significantly for all terms. One member added that over the last weeks, outflows by foreign investors have increased importantly. **Some** members highlighted that the stock market fell considerably. **Most members noted that risk premia increased sharply. One** member stated that the dramatic fall in oil prices contributed to such an increase, and thus Pemex continues to be a significant risk factor for public finances and raises an alarm regarding the possibility of a downgrade to the sovereign's credit rating in the near future. **The majority explained that, although interest rate spreads between Mexico and the United States widened, after adjusting for FX volatility, they have in fact been narrowing.**

Most members mentioned the possibility of implementing fiscal measures to address the needs of the health sector and support the population, firms and sectors that are most affected. Some members stated that, given the constraints that public finances face, the above is subject to a reallocation of public spending that carefully considers the priorities to allocate resources to. **Some** members argued that an option for the government is to use the sources of extraordinary revenues at its disposal, which would enable it to meet the public balance target. **One** member added the possibility of postponing the primary surplus target at least for this year and stated that both options would imply a greater debt-to-GDP ratio. He/she emphasized that fiscal policy faces the dilemma between acting or not and the need to meet its fiscal targets or not. **Another** member noted that, in response to the contingency, increased spending would exert greater pressure on public finances, which already are in a vulnerable situation, and thus the possibility of a countercyclical fiscal support package should necessarily be accompanied by a reassessment of priorities that allows for an efficient allocation of available resources immediately to the needs of the health sector, and, at a later stage, to the reactivation of economic activity in the strategic sectors affected, firms, and families, as well as to a vigorous public investment.

The majority of members warned that both the fall in oil prices and the lower economic growth increase fiscal accounts' vulnerability. In this context, they highlighted the importance of maintaining the sustainability of public finances. One member added that this would be achieved with measures that boost economic growth.

Most members pointed out that the already weak financial situation of Pemex became more complex due to the fall in oil prices. One member noted that an assessment of its current projects and a greater financial support by the federal government cannot be ruled out**. Another** member mentioned that, in light of the current juncture, Pemex's business plan should be re-assessed. **The majority emphasized that the situation of Pemex is a risk factor for public finances, underlining the possibility of a downgrading of both the sovereign and the State-owned company's credit rating. One** member stated that yield spreads on Pemex bonds have already increased considerably. Finally, **some** members pointed out that solving Pemex's problems should be given special attention at this moment.

Given an adverse juncture as the current one, the majority of members highlighted the importance of maintaining sound macroeconomic fundamentals and adopting actions that foster a better adjustment of financial markets and of the economy overall. Similarly, they pointed out that, in an environment as the one described above, it is even more relevant to generate public policies that provide certainty to private investment. In this regard, **some** members warned that it is important to avoid changing the rules for already made investments. They expressed concern about the impact on investment confidence of the scheduled public consultation to authorize the operations of a brewery, whose construction is already 80% completed. Such members added that, if the project is cancelled, the negative effect on the business climate would be even greater. **One** member added that the controversies in 2019 regarding gas pipeline contracts awarded to the private sector increased the negative sentiment among investors. He/she argued that no monetary or fiscal measure would have the expected benefits if there is no confidence to invest. **Some** members noted the concerns of the private sector regarding the prevailing challenges in terms of legal certainty, insecurity, and public policies' clarity. As for growth in the medium and long term, **one** member argued that: i) strengthening the rule of law; ii) increasing economic productivity; and, iii) promoting actions that improve confidence and investment expectations are essential.

Monetary policy

Given the foreseen impact of the shocks stemming from the COVID-19 pandemic, most members decided to move forward the date of the monetary policy announcement from March 26 to 20 and lower the target for the overnight interbank interest rate by 50 basis points to 6.5%, as well as to adopt other measures to provide liquidity and improve the functioning of domestic financial markets. One member voted for lowering the target to 6.75%. **One** member added that all available tools to fulfill the constitutional mandate of preserving the peso's purchasing power and ensuring the well-functioning of financial markets and payment systems must be used.

The majority of members pointed out that, considering the risks implied by the COVID-19 pandemic, significant challenges arise for monetary policy. In this regard, they highlighted that the economic outlook has deteriorated significantly, while the peso exchange rate has depreciated considerably, in an environment where risk premia and volatility in financial markets have increased. One member stated that, in light of the complex environment, the monetary policy decision must assess the trade-offs associated with the inflation outlook in an environment in which, despite the uncertainty as to the extent and persistence of the shocks it is subject to, it is highly likely that a significant economic contraction and recession occurs.

He/she added that the above takes place in a context where the monetary conditions in the major economies have eased considerably, and such economies have adopted a broad range of stimuli to revert the deterioration of their financing conditions. He/she also noted that the situation of the current monetary policy stance should also be considered, as such stance, despite having faced other shocks and their inflationary effects over the last years, and albeit being already in a downward adjustment process, is still at relatively high levels, in an economy that, in face of the COVID-19 pandemic, will suffer a very sizable impact that will lead it to a significant recession. He/she mentioned that, additionally, the financial shock also associated with the pandemic may imply upward risks for the price formation process due to the pressures associated with the depreciation of the peso exchange rate. In this regard, he/she highlighted that its pass-through to prices will depend on the persistence of the foreign exchange adjustment and on the economy's cyclical position, which is already characterized by a negative output gap that will widen considerably due to the pandemic shock.

Most members considered that, in light of the higher risk premia, the relative monetary policy stance may not have such an ample margin as may be perceived. One member argued that, despite the greater volatility and higher risk premia, the relative monetary policy stance still has certain room for maneuver; however, he/she acknowledged that the absolute monetary policy stance is close to the neutral rate. **Some** members highlighted that the Mexican peso has a high level of sensitivity due to its use as a hedge currency and, therefore, it should be taken into account that lowering short-term interest rates in Mexico reduces the cost of this type of transactions. **One** member pointed out that given an environment of foreign exchange instability, a greater interest rate spread is needed, which implies acting with extreme caution.

One member pointed out that a standard argument in favor of high interest rates is that they are a protective mechanism against risks, which allows for a better behavior of the exchange rate and that, ultimately, contributes to macroeconomic stability. However, he/she noted that those countries with greater interest rate spreads vis-à-vis the United States were those that recently suffered the most severe exchange rate depreciations, which is evidence against the above mentioned standard argument. He/she considered that some reasons explaining the above are i) that the high interest rates attract speculative capital that, in episodes of risk aversion, is the first to exit a market and at a speed that is usually greater than that at which it entered, so a gradual process of exchange appreciation could be followed by a sudden depreciation; ii) that maintaining a high real interest rate for a prolonged period erodes the macroeconomic foundations of the country, by decreasing consumption, investment and growth, and also affects public finances, which eventually impacts sovereign risk premia. He/she added that the lack of growth affects corporate earnings, which eventually affects equity markets. He/she noted that it should not be surprising that when the global economic outlook deteriorates, the most affected currencies are the ones of those economies that maintained very restrictive monetary policies, affecting the already deteriorated economic outlook. He/she stated that the economy is at a juncture where there are very worrying signs of a deterioration of economic activity, along with a stable, or even positive, outlook for inflation. He/she considered that, although the primary objective of Banco de México is to ensure the convergence of inflation to its target, this must occur with the lowest possible costs for the economy. He/she argued that continuing to maintain an overly restrictive monetary policy stance is very costly and risks the attainment of the inflation target itself. He/she noted that, given the economic outlook, and the downward risks to inflation, the Central Bank is responsible for minimizing the costs of monetary policy on the economy, and should therefore seek to move as soon as possible towards a neutral or even slightly accommodative policy stance. He/she noted that policy rates in some Latin American economies are at historically low levels.

Most members highlighted that monetary policy's ability to mitigate the fall in economic activity that might be observed is limited. One member argued that this is because, in Mexico, the credit channel of the monetary policy transmission mechanism is less effective due to the low level of financial inclusion and in the presence of supply shocks. Nevertheless, he/she stated that the reduction of the policy rate sends an important signal of commitment with the economic challenge that is being confronted. **Another** one mentioned that in light of the effect of real shocks, such as those stemming from COVID-19, the scope of action of monetary policy is centered on the policy rate and on fostering an orderly functioning of financial markets; however, it cannot by itself offset the real effects of the observed shocks. **One** pointed out that it is widely accepted that, in Mexico, the effect of interest rates on economic activity throughout the cycle is modest. He/she also underlined that most analysts consider that although central bank actions can reduce financial tensions, it is very unlikely that monetary policy has a relevant impact on the real sector's cyclical trajectory to confront shocks such as the one stemming from COVID-19. He/she stated that in the present juncture it is difficult to foresee a relevant response from consumers and firms to interest rate adjustments. He/she argued that in this type of cases the implementation of measures well targeted to the most affected sectors is more effective.

Most members highlighted that the policy that is the most effective in responding to the current conditions is fiscal policy. One member highlighted the importance of taking measures targeted directly to the fundamental causes of the crisis, that is, the public health problem. He/she indicated that it is difficult to expect a significant reduction in market uncertainty so long as important progress in that direction is not perceived. He/she pointed out that, simultaneously, other measures must be implemented that allow the productive sector and the financial system to avoid being severely damaged, which would allow for a fast recovery once the shock fades away. This member pointed out that the magnitude and nature of the financial crisis requires actions in different fronts and that monetary policy is only an instrument, and not the most important one. He/she added that actions to strengthen confidence in the authorities' capacity to overcome the current situation would increase monetary policy's margin of maneuver.

Some members emphasized the importance of Banco de México acting with prudence and caution. **One** member considered fundamental for the monetary policy statement to mention that the Central Institute will follow closely the evolution of the present juncture and, within its sphere of competence, will take actions so that the economy adjusts in an orderly way to the current conditions. **Another** member argued that the nature of the shocks stemming from the pandemic and the lower oil prices has relevant differences for the case of Mexico, as compared to those observed in advanced economies, which have very low inflation levels, and in most emerging economies, which have inflation levels below their respective targets. In this context, he/she mentioned that concerns for inflationary pressures are lower, or even non-existent, in these economies. In contrast, he/she noted that Mexico's monetary policy had already been facing a very complex situation due to a stagnant or slightly contracting economic activity being observed simultaneously with a relatively high inflation rate, and a situation of high uncertainty. He/she pointed out that, with the recent shocks, the degree of complexity has increased in all of these fronts. He/she added that, in circumstances of high uncertainty, it is preferable to err on the side of prudence. He/she mentioned that a downward correction to the policy rate is less problematic than an upward one, and that under the current conditions, the potential costs of excessively decreasing interest rates are greater than those of temporarily deferring their reduction. However, he/she acknowledged that the Central Bank must take advantage of the space that becomes available to further ease monetary policy, for instance, in light of clearer evidence that the demand shock will prevail over the other shocks, and that this is consistent with the convergence of inflation to the target during the period of influence of monetary policy. He/she added that the monetary authority must be ready to act in the way and direction so required, considering that the circumstances might change rapidly in any direction.

One member argued that when assessing the magnitude and speed of a downward adjustment to the policy rate that must be undertaken in the current contingency, three limiting factors must be taken into account: i) Mexico is a small and open economy that is facing an external shock and the margin offered by the world's lax external monetary policy is uncertain considering global risk premia and the sharp depreciation of the peso exchange rate; ii) monetary policy may have moderate effects given the sharp decline of economic activity under the current juncture; and iii) medium-term considerations of guaranteeing the convergence to the inflation target, given a balance of risks for inflation to the upside. Delving into said limiting factors, he/she pointed out that the Mexican economy currently faces an aggregate shock that has generated a reallocation of flows towards lower risk assets and currencies, and therefore an excessive reduction of the policy rate could exacerbate this phenomenon. He/she mentioned that the IMF recommends lowering interest rates to the extent possible and emphasizing forward guidance on the expected pattern of monetary policy. He/she underlined that, for emerging economies, this institution also recommends a balance between fostering growth and the evident need for liquidity to face external pressures. He/she added that this is the case of the Mexican economy, which by being linked to external markets, is more susceptible to adjustments in risk aversion. He/she underlined that the recent increases in this indicator have contributed to the significant depreciation of the peso exchange rate. In this regard, such member warned that even when econometric estimates suggest that the exchange rate pass-through to inflation is very low, the current levels of the peso exchange rate could affect inflation expectations. He/she also included the worsening of public finances as an additional risk factor that must be considered.

He/she elaborated on the fact that medium-term considerations together with a balance of risks for inflation to the upside prescribe some degree of prudence in the path towards a lax policy stance. Such member mentioned that it is necessary to have a medium-term strategy that considers both a balance of risks for inflation to the upside and the postponing of the convergence to the target, as it already occurred and was mentioned in the Quarterly Report October-December 2019. He/she pointed out that the unanchoring of inflation expectations must be avoided. In this regard, he/she considered that an excessive easing would send a wrong signal for the formation of inflation expectations, and might compromise the convergence of inflation to the target. Nevertheless, he/she also mentioned that the emergency situation that is being faced with the current pandemic suggest putting less emphasis in meeting the point inflation target in the short run.

Considering these limiting factors, this member indicated that the situation of crisis and emergency suggests that a significant reduction in the policy rate would be desirable. Nevertheless, in the proposal for the adjustment of the policy rate, he/she considered attaining a greater consensus in order to send a much clearer signal. He/she pointed out that a greater deterioration of financial markets will be considered in order to assess the need for implementing additional measures if required. He/she considered that in the present context of fragility and uncertainty, now more than ever Banco de México needs to remain vigilant to the current events and take into account relevant information for its decision making.

Regarding the possible measures to supply Mexican peso and US dollar liquidity, all members agreed that these would contribute to improve liquidity conditions and to the well-functioning of domestic financial markets. Given the very significant and erratic adjustments in asset prices, **one** member highlighted the need for improving market trading conditions and fostering a better price discovery process. **Another** member stated that given the worsening of financial markets and the risks associated for the instrumentation of monetary policy and financial stability, Banco de México needs to act promptly, and underlined the following actions: i) lowering the target rate; ii) complementary measures to improve liquidity conditions, allowing financial institutions to offset the external pressures and prevent disequilibria in their balances or involuntary increases in their risk exposures; iii) additional measures to foster an adequate functioning of financial markets, and iv) moving the monetary policy decision forward as much as possible with the implicit message of urgency and of emergency in response the crisis induced by the coronavirus. He/she mentioned that by guaranteeing liquidity in financial markets, the aim is to support aggregate demand determinants as well as consumers and firms' confidence. Thus, with these measures, a healthy behavior of the financial system is fostered. **One** member stated that now is the time to consider asset purchase programs like those adopted by other central banks. He/she mentioned that the latter makes sense given that part of the instability is due to the fall in oil prices originated by the combination of supply and demand shocks, where at least one of them is transitory. He/she added that the loss of value of some critical assets and the corresponding destruction of collateral must be avoided. He/she also mentioned that, under the current conditions, the measures to provide liquidity contribute to make more effective the transmission of monetary policy easing to the real economy.

Most members stated that actions to improve the well-functioning of markets had already been adopted in previous days. In particular, they pointed out that on March 9th, the Foreign Exchange Commission increased the size of its foreign exchange peso hedge program and auctions were carried out on March 12th and 18th. **One** member mentioned that these measures were taken to improve trading and liquidity conditions in the foreign exchange market and not based on the level of the peso exchange rate. **Some** members added that on March 19th, Banco de México announced the establishment of currency swap lines with the US Federal Reserve for up to 60 billion US dollars, for at least 6 months. **One** member stated that these swap lines are mutual and temporary mechanisms similar to those agreed between the US Federal Reserve and other central banks, including Banco de México, in 2008. He/she highlighted some of the benefits of the proposed measures: i) US dollar auctions contribute to a better functioning of the foreign exchange rate market, preventing possible distortions in US dollar financing, using the currency swap line agreed with the Federal Reserve; ii) the reduction in the cost of collateralized financing of more than twice the funding rate to one slightly above the funding rate, increases the peso-financing alternatives for the banking system; iii) the reduction of the monetary regulation deposit increases the availability of resources for commercial and development banks to address the additional financing requirements of households and firms; moreover, it offers important benefits by being implemented directly and implying a reduction of Central Bank liabilities rather than an increase in its lending; iv) the strengthening of the market makers program, which is a program sponsored by the Ministry of Finance and Public Credit and in which Banco de México participates as a financial agent, may offer market makers new alternatives to better manage their holdings of securities as well as additional incentives to purchase securities, thus improving operations in the government securities market and the conditions to buy/sell securities.

3. MONETARY POLICY DECISION

Considering the risks for inflation, economic activity and financial markets implied by the COVID-19 pandemic, significant challenges arise for monetary policy and for the economy in general. In light of the foreseen implications, with the presence of all its members, Banco de México's Governing Board decided by majority to lower the target for the overnight interbank interest rate by 50 basis points to 6.5%. One member voted for lowering the target to 6.75%.

The Governing Board will take the necessary actions on the basis of incoming information so that the policy rate is consistent with the orderly and sustained convergence of headline inflation to Banco de México's target in the time frame in which monetary policy operates. Perseverance in strengthening the macroeconomic fundamentals and in adopting the necessary actions, regarding both monetary and fiscal policies, will contribute to a successful adjustment of domestic financial markets and of the economy as a whole.

4. VOTING

Alejandro Díaz de León-Carrillo, Irene Espinosa-Cantellano, Gerardo Esquivel-Hernández, and Jonathan Ernest Heath-Constable voted in favor of lowering the overnight interbank interest rate by 50 basis points to 6.5%.

Javier Eduardo Guzmán-Calafell voted in favor of lowering the overnight interbank interest rate by 25 basis points to 6.75%.

5. DISSENTING OPINIONS/VOTES

Vote. Javier Eduardo Guzmán-Calafell

The COVID-19 pandemic, together with the fall in international oil prices, have increased the already complex challenges of monetary policy by exerting pressures in opposite directions for inflation and by raising uncertainty, as reflected in the latter's case by the peso exchange rate having undergone the greatest depreciation among emerging market currencies since mid-February. This situation, along with other domestic and external challenges, demand that monetary policy be implemented prudently, and taking into consideration that the impact of the interest rate on economic activity, modest for Mexico according to numerous calculations, is even more limited in the presence of shocks such as the one currently faced. With a diffuse scenario for inflation and a high level of nervousness in financial markets, I believe that lowering the policy rate by 25 basis points is preferable. In a rapidly changing environment, monetary policy must adjust at the time and in the magnitude required, and the Central Bank must continue to foster orderly conditions in domestic financial markets and in the foreign exchange market. Nevertheless, it is important to bear in mind that, in order to overcome the crisis, public health and fiscal actions need to be taken.

ANNEX

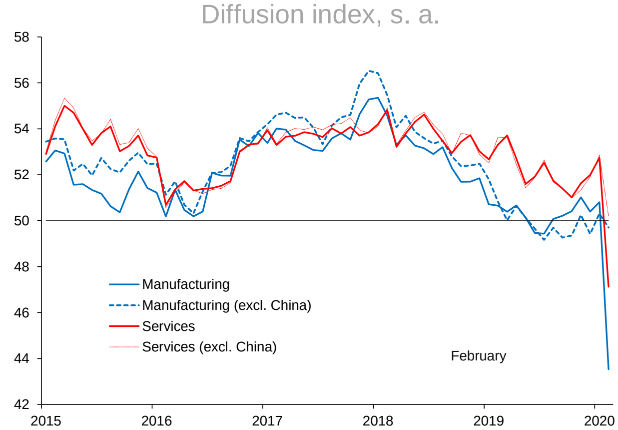
The information in this Annex was prepared for this meeting by the staff of Banco de México's General Directorate of Economic Research and General Directorate of Central Bank Operations. It does not necessarily reflect the considerations of the members of the Governing Board as to the monetary policy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

A.1. External conditions

A.1.1. World economic activity

The rapid global spread of the COVID-19 outbreak has severely affected the world economy's growth outlook and has led to a substantial deterioration of global financial conditions (Chart 1). The adoption of measures to face the health emergency has had an impact on supply chains and on sectors such as energy, tourism and transportation. In addition, the sharp increase in uncertainty has resulted in a strong deterioration of household and business confidence, which, in turn, will negatively affect investment and consumption. The sharp expected decline in world demand has also led to a fall in oil prices. The latter has been intensified by the breakdown of the agreement on oil production cuts between Saudi Arabia and Russia. Thus, forecasts for global growth for 2020 have been considerably revised downwards. Similarly, the balance of risks for growth has become significantly more negative in light of the high uncertainty about the scope of the global health crisis and its effect on the real economy, as well as its impact on international financial markets. All of the above has led several central banks of advanced and emerging economies to lower their interest rates, in some cases ahead of schedule. At the same time, other extraordinary monetary and fiscal measures have been implemented to mitigate the effects of the expected decline in internal and external demand, as well as to guarantee the proper functioning of financial markets.

Chart 1
Global Purchasing Managers Index: Manufacturing
Diffusion index, s. a.



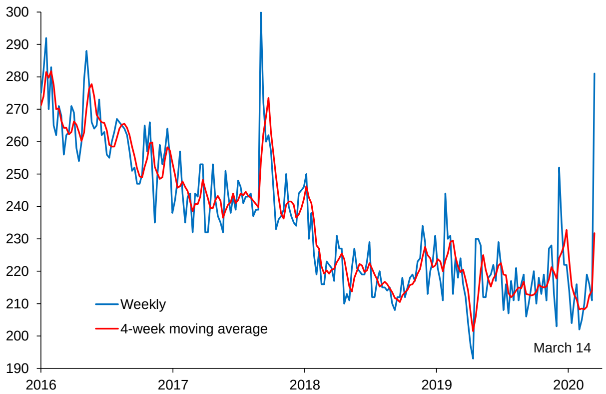
s. a. / Seasonally adjusted figures.
Source: Markit.

In the United States, GDP growth is anticipated to decrease significantly during the first half of the year due to the impact of the COVID-19 pandemic on supply chains and on the reduction of household and business confidence. In particular, the measures to contain the virus' spread and the possible negative effects of financial volatility on household wealth are anticipated to bring about a sharp reduction of private consumption. Similarly, the weakness in equipment-and-fixed-structures investment is expected to persist, given the uncertainty about the effects of the pandemic on economic activity. In March, the US government declared a national emergency and announced several measures aimed at addressing this situation. The government and Congress of that country are pondering a stimulus package of over 1 trillion US dollars to mitigate the effects of the health emergency.

Although data on US industrial production for February was still not reflecting evident effects from the COVID-19 outbreak, leading indicators available for March, such as the manufacturing sector Purchasing Managers' Index (PMI) (New York Empire State Bank and Federal Reserve Bank of Philadelphia), contracted significantly.

Available US labor market indicators for February exhibited relative strength. In particular, the growth of the non-farm payroll increased from 184,000 new jobs in December 2019 to 273,000 in February of this year, above the level necessary to absorb the growth of the labor force. The unemployment rate decreased from 3.6% to 3.5% between January and February. Nevertheless, unemployment insurance (UI) initial claims picked up by 70,000 on the week ending March 14, reaching 281,000 claims, the highest level in two years, thus suggesting a significant weakening of the US labor market during this period (Chart 2).

Chart 2
USA: Unemployment Insurance Initial Claims
Thousands, s. a.



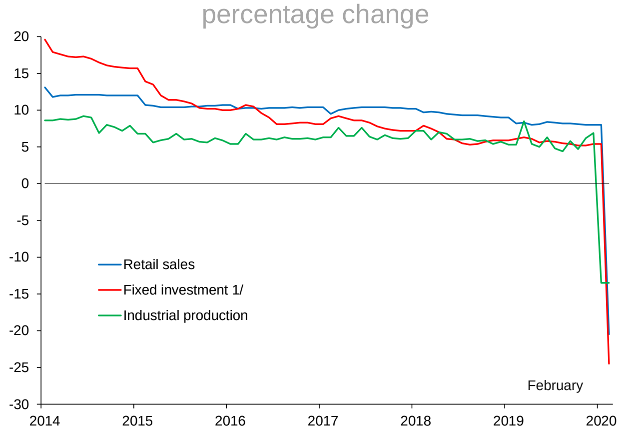
s. a. / Seasonally adjusted figures.
Source: US Department of Labor.

In the euro area, economic activity is expected to contract during the first half of the year because of the impact of the pandemic. Although economic confidence indicators and the composite PMI output index up to February were not yet reflecting said impact, the future output and export order components have decreased, suggesting a fall in demand. The greater delays in the delivery of inputs forewarn possible effects on supply chains. The European Commission proposed a 25 billion euro initiative and ratified its willingness to ease certain budget rules to face the economic emergency, while the European Investment Bank will mobilize 40 billion euros in financing to firms affected by the emergency.

In Japan, economic activity is expected to contract during the first quarter of 2020. This would be the second consecutive quarter of contraction for that economy and would be a reflection of a sharp fall in private consumption, particularly in services, due to the measures to contain the COVID-19 spread and of a negative contribution of net exports derived from supply chains disruptions. The Japanese government has channeled significant resources to the implementation of both prevention and control measures, as well as for supporting affected households and firms.

In emerging economies, leading indicators as well as the latest growth forecasts suggest that economic activity will weaken sharply during the first half of the year, particularly in those Asian economies that are highly integrated to China and in commodity exporting countries. In China, recent plant closures and mobility restrictions to contain the coronavirus spread led to a sharp contraction of economic activity during the first quarter of the year. In particular, significant contractions were observed in industrial production, retail sales and investment in fixed assets during the first two months of the year (Chart 3), while exports and imports also decreased considerably due to the temporary closure of factories and the interruptions in the transportation sector. In Latin America, although so far there is a smaller number of reported coronavirus cases registered vis-à-vis other regions, the measures to contain the virus, the weaker global demand, tighter external financing conditions, and the lower oil prices are expected to have a negative impact on GDP growth during the first half of the year.

Chart 3
China: Economic Activity Indicators
Annual change and accumulated annual percentage change



1/ Annual accumulated percentage change.
Source: Haver Analytics.

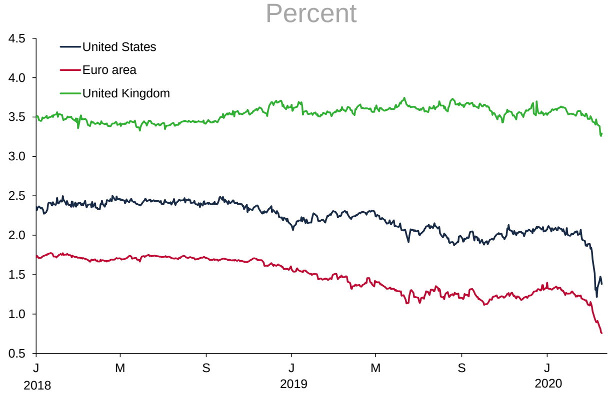
International commodity prices registered a sharp fall since Mexico's previous monetary policy decision. In particular, crude oil prices fell significantly as a result of the anticipated lower world demand for oil due to the global effects of the pandemic. Such fall intensified following the breakdown of the agreement on oil production cuts between Saudi Arabia and Russia, which generated fears that world crude oil supply would increase significantly in the next months in an environment of weak oil demand. Industrial metal prices decreased in light of expectations that the weakening of economic activity will lower the demand for manufacturing goods. Finally, grain prices fell sharply because of fears that contingency measures will weaken the international demand and international trade of grains, particularly of those associated with ethanol production.

A.1.2. Monetary policy and international financial markets

Headline and core inflation in advanced economies remain low and are expected to decrease in the coming months because of the fall of commodity prices, particularly crude oil prices, as well as other goods and services prices, as a result of the fall in global demand associated with measures to face the pandemic. Inflation expectations from surveys and financial instruments are already reflecting such dynamics (Chart 4). As to emerging economies, although headline inflation remains low in several countries, the number of countries where it has been above the target has increased. The recent pressures on their exchange rates may lead to higher inflationary pressures in a larger number of these countries.

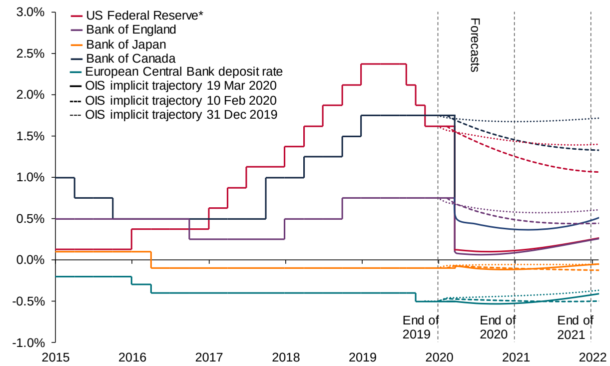
In this environment of low inflation and greater risks to the world economy in the short and medium term, central banks of major advanced economies have announced monetary easing actions and/or several measures to promote liquidity and credit flows in those economies and, in general, to ensure the well-functioning of financial markets. Expectations derived from market instruments anticipate that central banks will maintain a highly accommodative monetary policy (Chart 5). In emerging economies, several central banks have announced cuts to their interest rates, particularly Chile, Czech Republic, South Korea, Poland, Turkey, and Peru, among others. Similarly, several banks have announced liquidity measures and interventions in financial markets to face the greater volatility stemming from the pandemic and to ensure their proper functioning.

Chart 4
5-year-ahead Inflation implied by 5-year Inflation Swaps (Selected Countries)
Percent



Source: Bloomberg.

Chart 5
Reference Rates and Implied Trajectories in OIS Curves[1/]
Percent



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

Some of the monetary policy decisions of the main central banks during the period were the following:

i) In unscheduled meetings, the US Federal Reserve cut the policy rate twice, first by 50 basis points on March 3, and then by 100 basis points towards mid-March, lowering the federal funds target range to 0-0.25%. In addition, it expanded the amount of its repurchase agreement operations, while extending their term to 1- and 3-months for the remainder of March in order to address unusual disruptions in Treasury financing markets and US money markets. Similarly, it announced an increase in its holdings of Treasury securities by at least 500 billion dollars and in its holdings of mortgage-backed securities by at least 200 billion US dollars. It also announced actions to support the credit needs of American households and firms to ensure the well-functioning of financial markets. In order to reduce pressures on global US dollar funding markets, the Fed, in coordination with other central banks of advanced economies (United Kingdom, Canada, Japan, euro area and Switzerland), released adjustments to the US liquidity swap line, while announcing new liquidity swap lines with other central banks, including Banco de México, which will last for at least six months.

ii) In its March meeting, the European Central Bank (ECB) left its key policy rates unchanged, albeit announcing a package of measures to face the impact of the COVID-19 spread. In particular, it will temporarily conduct additional longer-term refinancing operations (LTROs), mainly for Small and Medium Enterprises (SMEs); additional net asset purchases of 120 billion euros in the remainder of the year; and will continue to reinvest the principal payments from the maturing securities purchased under the Asset Purchasing Program (APP) for an extended period. The ECB announced later a 750 billion euro Pandemic Emergency Purchase Program (PEPP) of public and private assets, which will last until the end of 2020 or until the COVID-19 crisis is over.

iii) In unscheduled meetings, the Bank of England cut twice its policy rate by a total of 65 basis points to 0.1%. It also increased by 200 billion the size of its asset portfolio to a total of 645 billion pounds sterling. It also introduced a new term financing scheme with incentives for SMEs, as well as a new corporate financing facility, and decreased the countercyclical capital buffer rate from 1.0% to 0%.

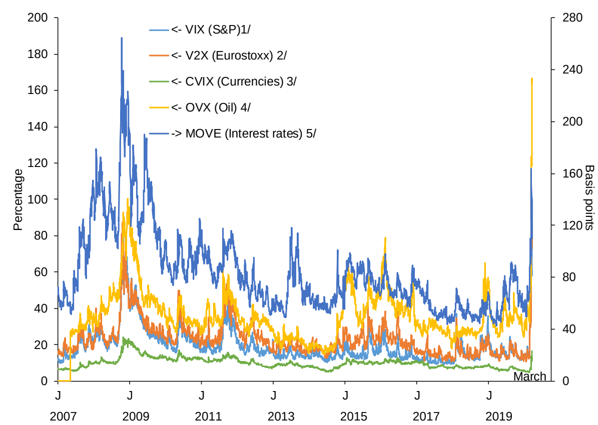
iv) The Bank of Japan adopted a more accommodative monetary policy stance in an unscheduled meeting in mid-March in which, while leaving its short-term policy interest rate unchanged at -0.1% and its long-term interest rate (indexed to its 10-year bond) at 0%, it announced several measures to ease its monetary policy by increasing the provision of funds through purchases of government bonds and the provision of funds in US dollars; granting facilities to corporate financing; and increasing its purchases of exchange-traded funds (ETFs) and Japanese real estate trust funds (J-REITs).

v) The Bank of Canada cut its policy interest rate twice in March, once in its scheduled monetary policy meeting and once in an unscheduled one. Both cuts were of 50 basis points each, lowering the policy rate from 1.75% to 0.75%. It also announced a mortgage bond purchase program for 500 million Canadian dollars per week until conditions so require. This central bank also took several measures to ensure liquidity in its funding market.

As a result of the evolution of the pandemic and concerns about its impact on world economic activity, financial markets registered a considerable increase in volatility (Chart 6), a higher sentiment of risk aversion by investors, a greater tightening of financial conditions, and a deterioration of liquidity conditions worldwide. The main stock indexes of advanced economies fell considerably; the US dollar appreciated against the rest of the currencies of advanced economies; interest rates of these countries registered mixed adjustments, with sharp falls in the United States and increases in Europe; and the spreads of corporate bonds vis-à-vis government bonds widened. The fall of the US 10-year bond rate since early 2020 stands out, registering historically low levels and temporarily inverted the slope of the yield curve in that country, although it turned positive once again in recent weeks (Chart 7). In this context, emerging economies registered capital outflows, both in fixed income and equity markets, with flows towards certain safe-haven assets (Chart 8). It is worth noting that despite the liquidity and credit measures implemented by several central banks, a negative behavior continues to be observed in international financial markets.

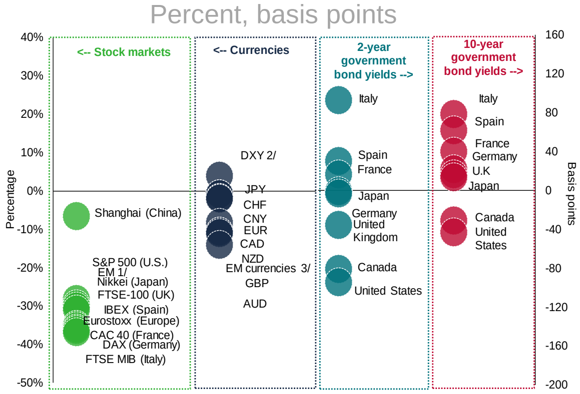
Looking ahead, the risk that the pandemic spread may extend or intensify prevails, possibly affecting global trade and economic growth more than anticipated. Greater episodes of volatility in financial markets stemming from the high uncertainty on the effectiveness of the measures adopted and the severity of the pandemic's economic effects cannot be ruled out, and there is a risk that the tightening of financial conditions may worsen the impact of this health emergency on the real economy. In addition to the above, several risk factors persist, including the possibility of a new escalation of trade tensions among some of the major economies as well as geopolitical events. The differences prevailing among members of the Organization of Petroleum Exporting Countries (OPEC) and other crude oil producers stand out as well.

Chart 6
Selected Implied Volatility Indexes
Percent, basis points



1/VIX: Weighted index of 1-month implied volatilities of S&P500 options published by the Chicago Board Options Exchange. 2/V2X: Weighted index of 1-month implied volatilities of Euro Stoxx50 options published by Deutsche Borse and Goldman Sachs. 3/CVIX: 3-month implied volatility index of most traded FX rates with the following weights: EURUSD: 35.9%, USDJPY: 21.79%, GBPUSD: 17.95%, USDCHF: 5.13%, USDCAD: 5.13%, AUDUSD: 6.14%, EURJPY: 3.85%, EURGBP: 2.56%, and EURCHF: 1.28%. 4/ OVX: Weighted index of 1-month implied volatilities of crude oil options (CBOE Crude Oil Volatility Index). 5/ MOVE: Index of US Treasury yield volatility implied by current prices of 1-month at-the-money options on 2-year, 5-year, 10-year and 30-year Treasuries, calculated by Merrill Lynch.
Source: Banco de México with Bloomberg data.

Chart 7
Change in Selected Financial Indicators from February 10 to March 19, 2020
Percent, basis points



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

Chart 8
Emerging Economies: Financial Assets Performance from February 10 to March 19, 2020
Percent, basis points

Region	Country	Currencies	Equity markets	Interest rates 2Y	Interest rates 10Y	CDS
Latin America	Mexico	-28.53%	-20.65%	79	161	185
	Brazil	-17.82%	-39.30%	96	199	235
	Chile	-8.31%	-33.41%	-58	24	105
	Colombia	-18.39%	-45.24%	-31	106	259
Emerging Europe	Russia	-23.45%	-25.69%	188	181	238
	Poland	-9.30%	-28.59%	-84	-57	20
	Turkey	-8.85%	-28.01%	58	254	310
	Czech Republic	-13.25%	-36.18%	-140	-72	17
	Hungary	-7.83%	-33.78%	-7	10	39
Asia	Malaysia	-6.43%	-20.94%	-41	-6	144
	India	-5.24%	-30.97%	-30	-18	137
	Philippines	-0.63%	-37.78%	-10	-20	117
	Thailand	-4.10%	-31.99%	7	41	28
	Indonesia	-16.05%	-31.03%	74	148	207
Africa	South Africa	-16.62%	-33.22%	-56	200	226

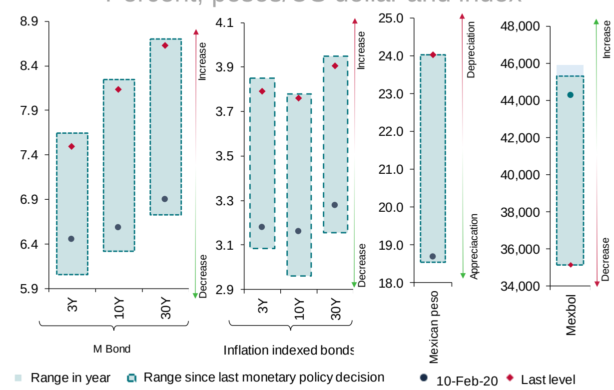
Note: Interest rates correspond to interest rate swaps for 2-year/10-year maturities. In the case of Argentina, rates in US dollars are used since they are the most liquid ones and those that reflect more adequately the performance of the fixed income market in that country.
Source: Bloomberg.

A.2. Current situation of the Mexican economy

A.2.1. Mexican markets

Since Banco de Mexico's previous monetary policy decision, financial asset prices in Mexico, as in other emerging economies, exhibited a negative performance (Chart 9). This occurred in an environment of high volatility and greater risk aversion generated by the potential worldwide negative effects of the COVID-19 spread, which were exacerbated by the fall in oil prices. Thus, the peso exchange rate fluctuated in a wide range of 18.52-24.65 Mexican pesos per US dollar, with the latter value representing a new historical intraday high (Chart 10). The above took place in a context where both FX spot and forward outright trading conditions deteriorated considerably. In this regard, in its first action since the end of 2017, the Foreign Exchange Commission announced an increase in the non-deliverable FX forwards program from 20 to 30 billion US dollars and has auctioned 4 billion of these instruments in the last two weeks. For their part, Banco de México and the US Federal Reserve established mutual and temporary swap lines for up to 60 billion US dollars. These new swap lines will support the provision of US dollar liquidity in Mexico and will remain effective for at least six months.

Chart 9
Mexican Markets' Performance
Percent, pesos/US dollar and index



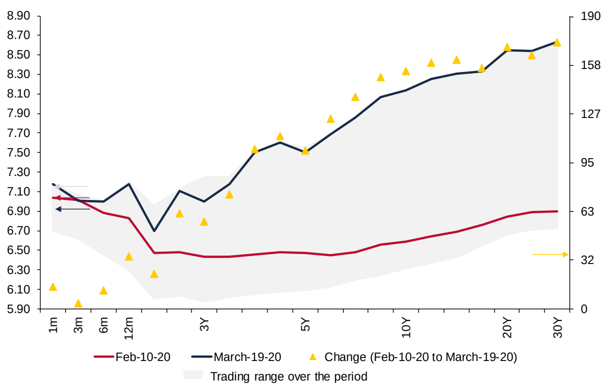
Source: Prepared by Banco de México.

Chart 10
Mexican Peso Exchange Rate and its Moving Averages
Pesos/US dollar

Source: Prepared by Banco de México.

Interest rates of government securities increased significantly, up to 174 basis points, throughout the entire yield curve, with long-term rates registering the greatest adjustments (Chart 11). Such adjustments took place in a context where trading conditions deteriorated significantly. In this environment, and for the purpose of contributing to the well-functioning of Mexican debt markets, the Ministry of Finance and Public Credit announced two exchange operations where it switched long-term government securities for short-term instruments totaling 76.8 billion Mexican pesos.

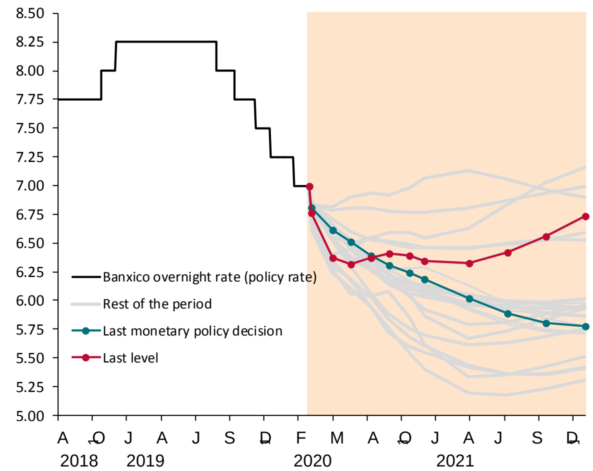
Chart 11
Nominal Yield Curve on Government Securities
Percent, basis points



Source: PIP.

As to expectations regarding the path of the monetary policy rate, information implied in the Interbank Equilibrium Interest Rate (TIIE, for its acronym in Spanish) swap curve practically discounts a 25-basis point cut for the March monetary policy decision, while private sector forecasters surveyed by Citibanamex are expecting a 50-basis point cut. For the end of 2020, market variables are anticipating a policy rate of around 6.50% (Chart 12), while the median of forecasters surveyed remained at 6.00%.

Chart 12
Banxico Overnight Interbank Rate Implied in TIIE IRS Curve
Percent

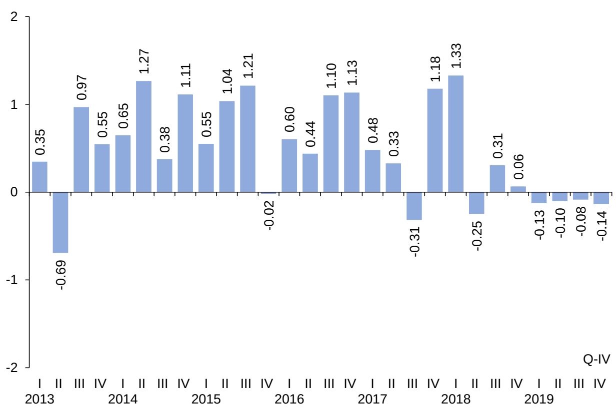


Source: Prepared by Banco de México with Bloomberg data.

A.2.2. Economic activity in Mexico

According to available information, in early 2020 and prior to the COVID-19 spread, the stagnation that Mexico's economic activity has been exhibiting for several quarters continued (Chart 13), although some indicators were suggesting a certain improvement up to February, which may have persisted in the absence of the pandemic. Indeed, the limited information available for February did not yet seem to reflect a significant impact from the pandemic, although some technical shutdowns began to be reported in March due to shortage of imported inputs, mainly those from China, as well as the cancellation of certain activities, mainly educational, recreational, and cultural. Similarly, in light of the domestic spread of the pandemic and the greater weakness of the global economy, the negative economic impact is expected to deepen in the second quarter of the year and to extend for a yet undetermined period.

Chart 13
Gross Domestic Product
Quarterly percentage change, s. a.



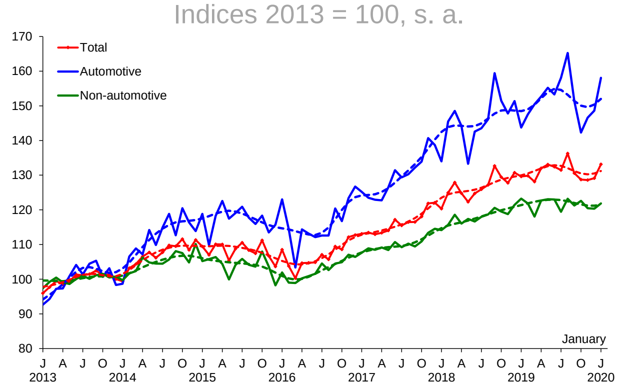
s. a. Seasonally adjusted figures.
Source: Mexico's National Accounts System (SCNM, for its acronym in Spanish), INEGI.

In January 2020, manufacturing exports improved vis-à-vis the weakness observed at the end of 2019. Such performance was mainly due to a rebound in automotive exports, both to the United States and to the rest of the world (Chart 14). Looking ahead, the greater weakness of the world economy is expected to have an unfavorable impact on the Mexican export sector.

In the last quarter of 2019 private consumption exhibited weakness due to stagnant consumption of domestic goods and services and the slower rate of consumption of imported goods. Timely indicators of consumption, such as sales of light vehicles, rose at the beginning of 2020, prior to the pandemic spread.

As for gross fixed investment, it remained on a downward path at year-end 2019. Within this indicator, both spending in construction and machinery and equipment exhibited weakness. Given the measures adopted to cope with the health emergency, both consumption and investment are expected to be significantly affected at the end of the first quarter.

Chart 14
Total Manufacturing Exports
Indices 2013 = 100, s. a.



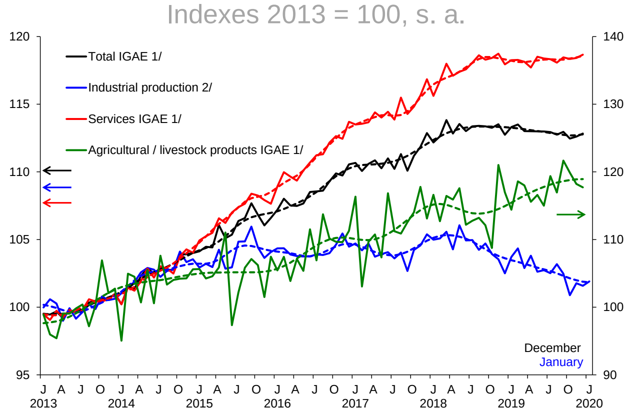
s. a. / Seasonally adjusted series and trend series based on data in nominal US dollars. The former is represented by a solid line and the latter by a dotted line.
Source: Prepared by Banco de México with data from the Tax Administration Service (SAT, for its acronym in Spanish), the Ministry of the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

Industrial production continued to exhibit weakness at the beginning of the first quarter of 2020, while services ended 2019 with lackluster growth (Chart 15 and Chart 16). The limited information available for February would appear not to reflect significant effects from the COVID-19 spread yet. Nevertheless, some technical shutdowns in certain manufacturing sectors were reported in March due to the shortage of imported inputs, mainly from China, and to technical shutdowns in the automotive industry as a preventive measure in light of the health emergency. Similarly, the cancellation of several activities, mainly educational, recreational, and cultural, was announced to support the social distancing measures. The negative economic impact caused by the pandemic is expected to intensify in the second quarter of the year and to extend for a still undetermined period.

As to the economy's cyclical position, a greater-than-anticipated widening of slack conditions is foreseen, with a balance of risks significantly biased to the downside (Chart 17). As to the labor market, in January 2020, the considerable contraction that national and urban unemployment rates had exhibited at the end of 2019 reverted (Chart 18), while the weakness in the creation of IMSS-insured jobs persisted. For its part, with information available at the fourth quarter of 2019, unit labor costs in the overall economy registered its highest level of the last years as a result of the behavior of productivity and real average earnings (Chart 19).

Chart 15
Economic Activity Indicators

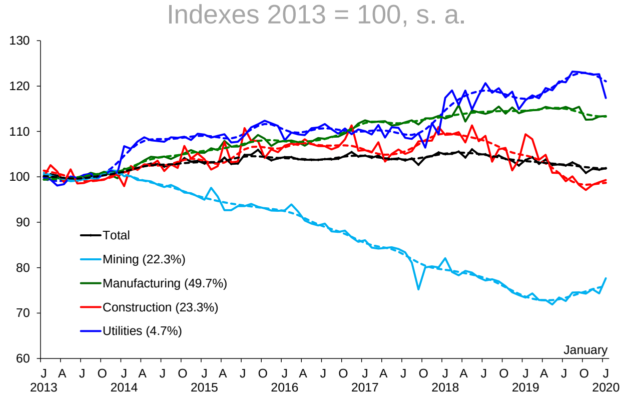
Indexes 2013 = 100, s. a.



s. a. / Seasonally adjusted and trend series. The former is represented by a solid line and the latter by a dotted line.
1/ Figures up to December 2019.
2/ Monthly industrial activity indicator figures up to January 2020.
Source: Mexico's National Accounts System (SCNM, for its acronym in Spanish), INEGI.

Chart 16
Industrial Activity 1/

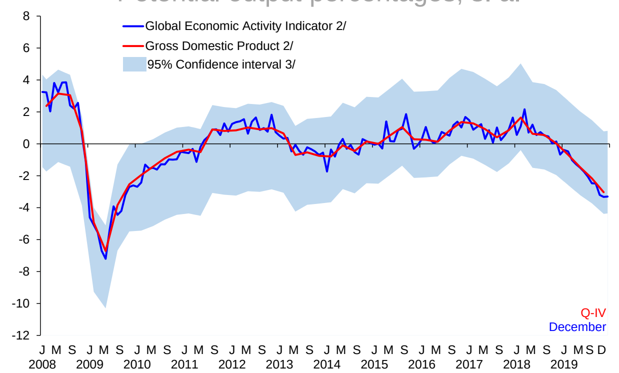
Indexes 2013 = 100, s. a.



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

Chart 17
Output Gap Estimates 1/
Excluding Oil Industry 4/

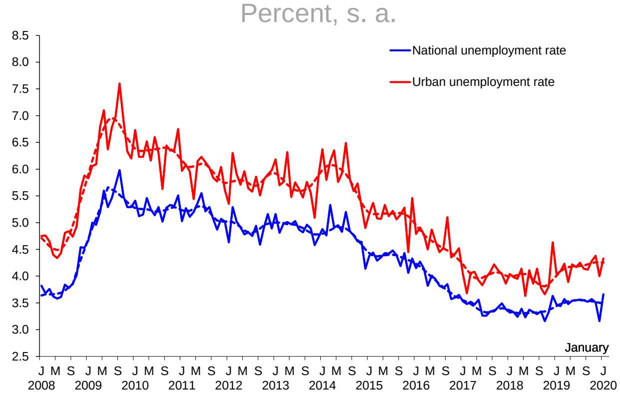
Potential output percentages, s. a.



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

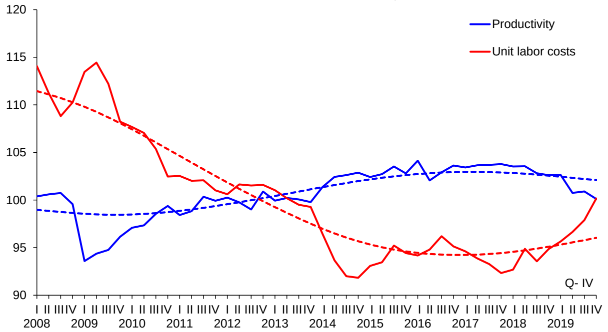
Chart 18
National Unemployment Rate and Urban Unemployment Rate

Percent, s. a.



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

Chart 19
Global Labor Productivity Index (IGPLE for its acronym in Spanish) and Unit Labor Costs 1/
Indexes 2013 = 100, a. e.



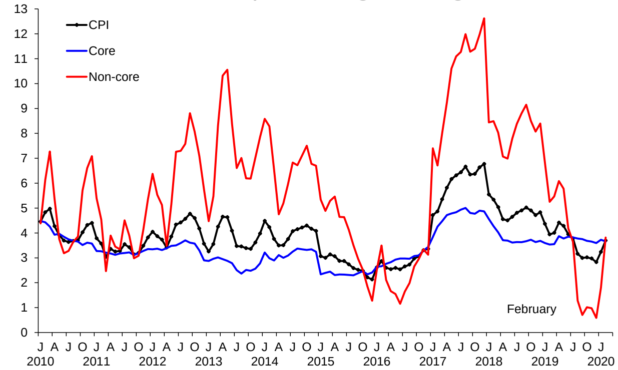
s. a. / Seasonally adjusted and trend series. The former is represented by a solid line and the latter by a dotted line. Trend series estimated by Banco de México.
1/ Productivity based on hours worked.
Source: IGPLE published by INEGI. Unit labor costs prepared by Banco de México with INEGI data.

In January 2020, domestic financing to the private sector continued showing a reduction in its growth rate. Within it, financing to private firms continued to decelerate, following the trend that has been observed since the second half of 2018. This trend is explained by the lower growth of bank credit and a lower domestic debt issuance. As to the household segment, mortgages exhibited lesser dynamism, whereas consumer credit continued growing at low rates. As for interest rates, those of firm financing decreased, in line with the reduction in the overnight interbank funding interest rate. For its part, mortgage rates decreased slightly in December 2019, after having remained stable since the second quarter of 2017. In the segment of consumer credit, interest rates on credit cards and personal loans stopped following the upward trend observed lately. Regarding portfolio quality, firm and mortgage delinquency rates remained at low levels, while those related to consumption did not register significant changes and remain at high levels.

A.2.3. Development of inflation and inflation outlook

Annual headline inflation increased from 3.24 to 3.70% between January and February 2020 (Chart 20 and Table 1). This behavior was due to a decline of 4 basis points in the incidence of core inflation and an increase of 50 basis points in that of non-core inflation.

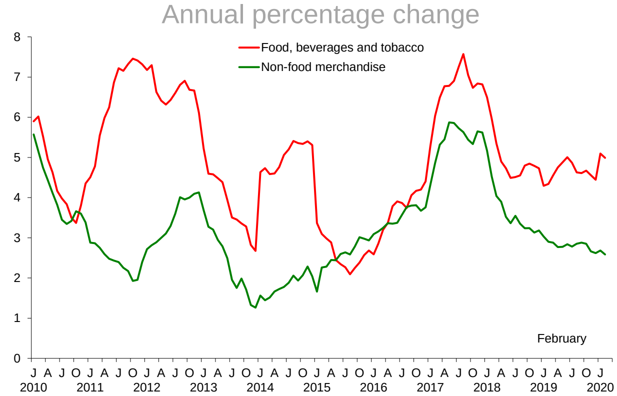
Chart 20
Consumer Price Index
Annual percentage change



Source: Banco de México and INEGI.

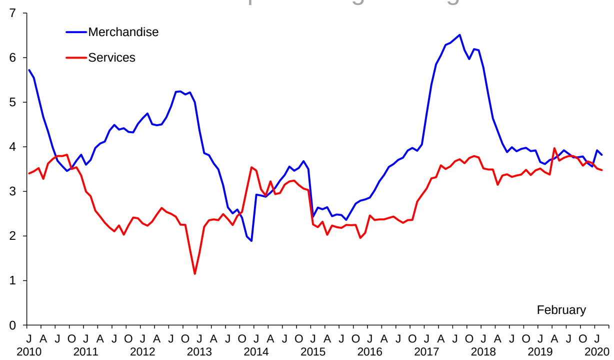
Annual core inflation declined from 3.73 to 3.66% between January and February 2020. In particular, the annual rate of change of food merchandise prices decreased from 5.10 to 4.99%, while that of non-food merchandise prices went down from 2.68 to 2.58% (Chart 21). For its part, the annual rate of change of services prices decreased marginally from 3.51 to 3.48% in the same months (Chart 22), which is mainly associated with the lower increases in tourist and food services prices vis-à-vis the previous year.

Chart 21
Merchandise Core Price Subindex
Annual percentage change



Source: Banco de México and INEGI.

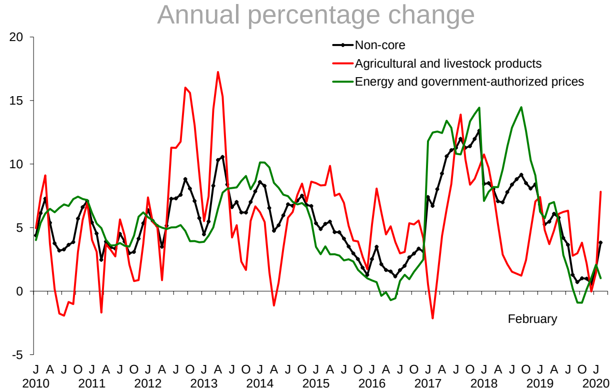
Chart 22
Merchandise and Services Core Price Subindex
Annual percentage change



Source: Banco de México and INEGI.

Annual non-core inflation increased from 1.81 to 3.81% between January and February 2020 (Chart 23 and Table 1). This was due to the increase in the annual rate of change of agricultural and livestock product prices, especially of fruit and vegetable prices. Said increase was partially offset by a reduction in the annual rates of change of gasoline and LP gas prices.

Chart 23
Non-core Price Subindex
Annual percentage change



Source: Banco de México and INEGI.

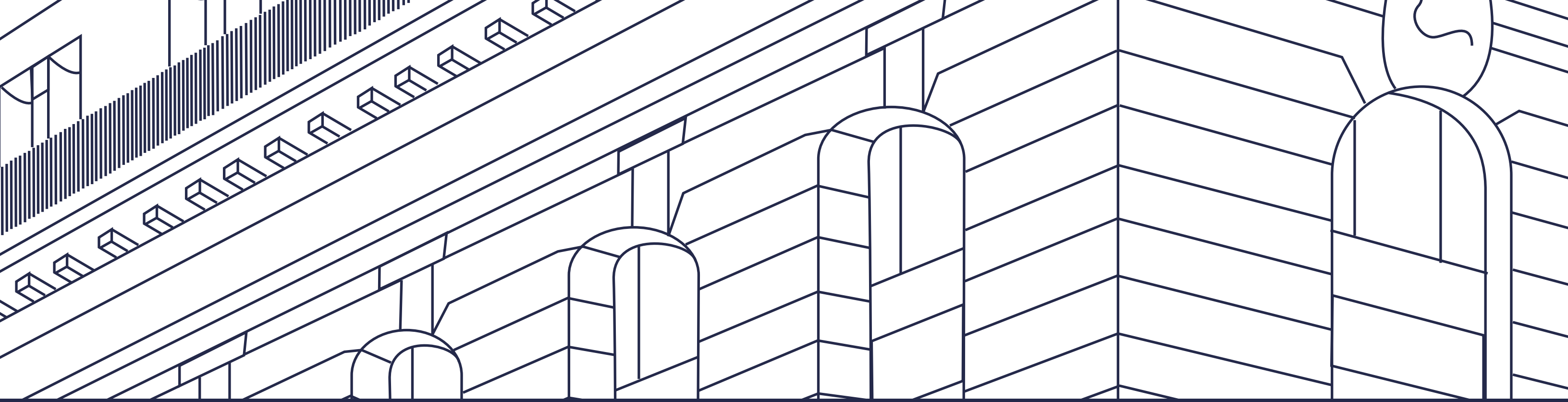
As for inflation expectations drawn from Banco de México's Survey of Private Sector Forecasters, short-, medium- and long-term headline inflation remained relatively stable between January and February, albeit above 3%. Those corresponding to core inflation registered slight mixed adjustments. Finally, long-term inflation expectations (average of 6 to 10 years) implied in long-term market instruments, as well as the inflation risk premium, decreased marginally in the same period, although both breakeven inflation and inflation risk have increased at the margin in a context of volatility.

The COVID-19 pandemic poses significant risks for inflation albeit with uncertain effects. The expected widening of the negative output gap together with the decline in international energy prices, may imply downward pressures on this indicator. Nevertheless, these could be offset by upward pressures on prices exerted by the depreciation of the peso. In this context, there is high uncertainty as to the magnitude and duration of the different demand and supply shocks, as well as to the size and persistence of the shocks to financial markets, so the effects on inflation in the short and medium term remain unclear. Thus, the uncertainty over the balance of risks for inflation has increased.

Table 1
Consumer Price Index and Components
Annual percentage change

Item	December 2019	January 2020	February 2020
CPI	**2.83**	**3.24**	**3.70**
Core	**3.59**	**3.73**	**3.66**
Merchandise	**3.56**	**3.92**	**3.82**
Food, beverages and tobacco	4.45	5.10	4.99
Non-food merchandise	2.62	2.68	2.58
Services	**3.64**	**3.51**	**3.48**
Housing	2.91	2.93	2.94
Education (tuitions)	4.73	4.69	4.55
Other services	4.05	3.78	3.72
Non-core	**0.59**	**1.81**	**3.81**
Agricultural and livestock products	**-0.03**	**1.44**	**7.82**
Fruits and vegetables	-5.40	-1.76	11.23
Livestock products	4.98	4.45	4.91
Energy and government-authorized prices	**1.04**	**2.08**	**1.01**
Energy products	-0.54	0.86	-0.54
Government-authorized prices	5.05	5.07	4.86

Source: INEGI.



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