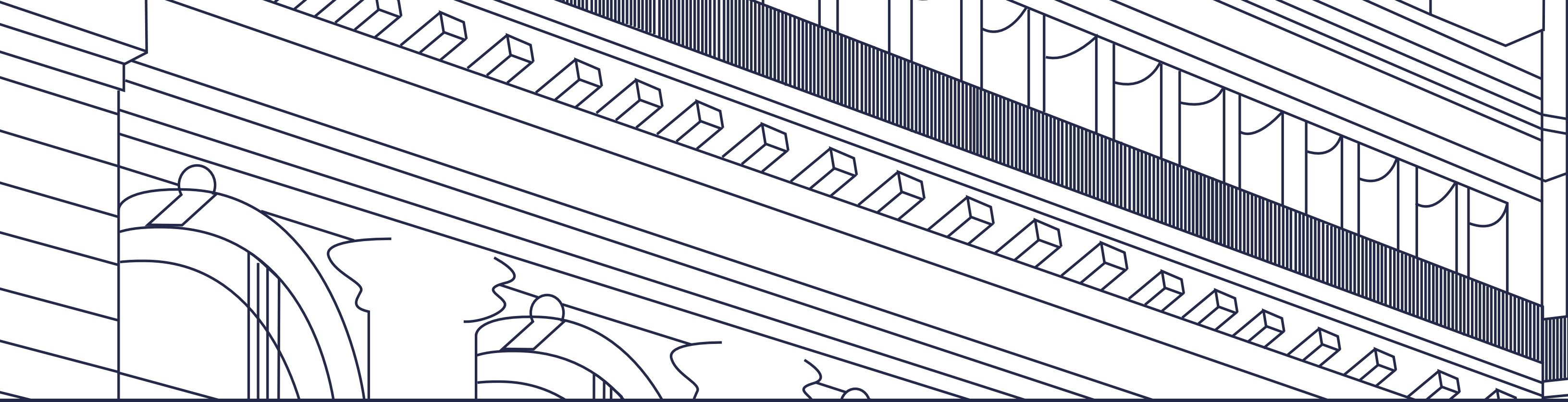

BANCO DE MÉXICO®

Minutes number 87

Meeting of Banco de México's Governing Board on the occasion of the monetary policy decision announced on September 30, 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: September 29, 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 Eduardo 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

The majority mentioned that global economic activity continued to recover, although at a slower pace and heterogeneously across countries and sectors, associated with vaccine availability, the evolution of the pandemic, and spending programs. They noted that the shortage of inputs has contributed to a deceleration of industrial and manufacturing production. One member stated that retail sales and purchasing managers' indices also show signs of moderation. He/she added that in several countries, output and employment gaps remain negative, particularly in emerging economies with a tighter fiscal and monetary space. **Another** member added that the global economy continues to be affected by the effects of the pandemic: i) the health challenge associated with infections and the vaccination process; ii) the heterogeneity in the recovery; iii) the differences among countries regarding the space available to incentivize spending; iv) the transition from an abrupt shutdown of activities to a vigorous expansion in a short period of time, which intensified the impact on the supply chains for goods' production and generated an irregular pace in the recovery of services; and v) a profound reallocation of spending, with increases in consumption of durable goods and reductions in services, which increased the asymmetry in production and price pressures faced by each sector.

One member stated that the revisions to growth expectations by international organizations point to a moderation for advanced and Asian economies, as well as to a marginal increase for Latin American economies. He/she added that the outlook continues to be subject to a high degree of uncertainty. He/she pointed out as factors of concern for global growth: i) the persistence of heterogeneity among sectors and economies; ii) the intensification in magnitude and duration of supply shocks; iii) the high demand due to the reopening and to the economic stimuli, and iv) the spread of the Delta variant. **Another** member noted that growth forecasts for the United States have been revised downwards for 2021.

All members mentioned that global inflation continued to increase due to pressures from higher commodity and energy prices, as well as production bottlenecks. Most members added the higher ocean freight costs and **some** members added spending programs and the marked reallocation of expenditure towards merchandise. Regarding this last point, **one** member noted that in the United States, the deflator for durable goods spending increased from -1.54% in February 2020 to 6.96% in July of this year. He/she added as factors that have pressured inflation, the lack of flexibility in production of goods and the unprecedented distortions in the labor market that have led to lower availability of labor, which could be associated with the perception of contagion risk and with the effects of transfers to households. **Another** member detailed that OECD estimates suggest that transportation costs from China to the United States and Europe add about 11 percentage points to these economies' merchandise import price inflation, and about 1.5 percentage points to overall inflation. However, **one** member added that some stabilization of inflationary dynamics has been observed recently, particularly in advanced economies and in some emerging Asian economies.

Another member noted that the difficulties faced on the production side do not correspond to typical supply shocks. He/she added that unprecedented stimuli spending has been channeled to the consumption of goods and services available under the pandemic, thus widening output and price differences among sectors. He/she argued that the lack of flexibility in the production of goods, the reallocation of spending towards merchandise, and an unprecedented fiscal support in advanced economies have reduced supply's capacity to absorb the growth of demand, generating an environment prone to multiple shocks and inflationary pressures. In this regard, he/she pointed out that inflationary pressures have been heterogeneous and greater in economies that are more integrated to global trade and that have implemented greater spending stimuli. He/she mentioned that the disruptions caused by the pandemic are very different from those observed in other crises, contributing to an environment of high uncertainty, which has made it difficult to identify their short- and medium-term effects.

One member considered that inflationary pressures can be foreseen to start subsiding once economic activity normalizes and the production of inputs increases. He/she pointed out that, in line with the above, the median of forecasts of the members of the Federal Open Market Committee (FOMC) anticipates inflation in the United States to be 2.2% at the end of 2022. He/she stated that the expectation of the transitory nature of inflationary pressures is also reflected in the implied trajectories for the future prices of wheat, corn and soybean, which anticipate deflations in 2022. **Another** member noted that several measures of inflation expectations in the United States, including those of business and consumers, have increased. He/she added that the 5-year breakeven inflation rate implicit in fixed-income markets in that country is 2.5%. **One** member argued that given the reopening of the economy, the higher inflation outlook and pressures on supply chains and on commodities and energy are not expected to revert soon, and uncertainty about their duration prevails. **Another** member said that while the effects of the shocks are expected to be predominantly transitory, the risks to price formation at the global level are on the upside, given the wide range of prices impacted and the magnitude of the price increases, and the extended time horizon over which they have affected inflation. **One** member added as upside risks that the potential approval of a new stimulus package in the United States reinforces demand, as well as a worsening of the energy crisis in China due to the shortage of coal and natural gas. However, he/she added that information from market instruments shows stable inflation expectations for longer terms.

The majority pointed out that the central banks of the main advanced economies have maintained their accommodative monetary stance, although some of them are already expecting to reduce it, while those of several emerging economies continue reducing it. One member specified that in their latest decisions central banks of advanced economies reaffirmed that the accommodative stances, with interest rates at historically low levels, will be maintained for a prolonged period. **Another** member mentioned that the main challenge for central banks has been to distinguish between changes in relative prices that are of a transitory nature and more persistent ones. He/she considered that in some economies high inflation is being observed along with macroeconomic imbalances, forcing their monetary authorities to act more aggressively. **Most members noted that the Federal Reserve indicated that it could start reducing its asset purchase program this year and that the program would end in mid-2022. One** member mentioned that while this process is expected to be orderly, which would avoid an episode similar to the so-called *Taper Tantrum*, it is important to have greater caution, as the latest forecasts imply a more rapid adjustment than previously anticipated. **Some** members noted that both markets and FOMC members expect the first increase in the federal funds rate to be in 2023. However, **one** member added that several FOMC members moved forward their expectations of an increase to 2022. On the other hand, he/she noted that, in contrast to the global trend of stimulus reduction, and derived from the possible default of China's real estate developer *Evergrande Group*, the People's Bank of China took measures to increase liquidity in that economy. **Another** member mentioned that despite the increase in inflation, most central banks in emerging economies continue with highly accommodative policy stances and negative real interest rates, which allows them to continue supporting economic activity. He/she added that Mexico stands out for having a positive ex-ante real interest rate, in contrast to what has been observed in other economies, which are also registering certain deviations of inflation from their targets.

One member highlighted the greater margin for monetary policy maneuver in the United States and other advanced economies. He/she explained that this is due to structural factors that have lowered inflation, potential growth, and the neutral rate. He/she added that these economies could be more patient in withdrawing the monetary stimulus, as in recent decades their price formation processes and inflation expectations have remained anchored at or below their target levels. On the other hand, he/she mentioned that small and open emerging economies are highly sensitive to inflationary pressures and global monetary and financial conditions. He/she pointed out that Mexico is facing significant external inflationary pressures and, will soon face the effects of greater global financial restrictions. He/she stated that those economies that complement their domestic savings with external sources must maintain a sound macroeconomic policy stance. He/she added that monetary policy should contribute to maintain inflation around its target, enabling an orderly adjustment of the economy, the exchange market and the yield curve, while avoiding capital outflows. **Another** member pointed out the importance of coordination between fiscal and monetary policies and considered that monetary policy's effectiveness to achieve the convergence of inflation to the target could be obstructed. He/she expressed that the processes of fiscal consolidation and normalization of interest rates can trigger different risks that could exert pressure on the dynamics of global inflation and international financial conditions, and thus it is likely that countries facing less fiscal pressure may achieve inflation convergence towards its targets with less effort than those in which the fiscal equilibrium has deteriorated significantly.

Most members stated that international financial markets exhibited a stable performance, and that, recently, interest rates increased, particularly in the United States and the US dollar appreciated in view of prospects of a reduction in the Federal Reserve's asset purchase program. One member noted that although markets have shown some volatility in recent days, the announcements on the reduction of asset purchases have been carried out without major disruptions in debt markets or in risk premia. **Some** members pointed out that in recent weeks some stock indices reached historic highs. **One** member stated that this is due to a highly accommodative policy stance at the global level, which implies vulnerabilities in case of a correction in assets' valuation.

Some members noted a mixed performance in emerging economies' financial markets. **One** member considered that they were favored by expectations that an accommodative monetary policy stance would be maintained in the United States. He/she noted that volatility in emerging market currencies decreased sharply, although it increased towards the end of the period. **Another** member added that emerging markets exhibited a negative bias due to higher risk aversion. **One** member mentioned that moderate capital inflows were observed, although they concentrated mainly in China.

Some members noted that adjustments in monetary conditions could lead to episodes of volatility in international financial markets. **One** member noted that this could imply a tightening in financial conditions, especially for emerging economies. **Another** member pointed out that the lack of an agreement to increase the debt ceiling in the United States would cause nervousness in financial markets and capital outflows from emerging economies to safe-haven assets. He/she added as a risk the possible default of *Evergrande Group*, since its relative importance would imply risks of contagion and systemic risks, which would translate into episodes of volatility at a global level and to a tightening of financing conditions. Meanwhile, **one** member considered that the highly accommodative monetary policy would continue to favor global financial conditions for some time.

Economic activity in Mexico

Most members mentioned that the Mexican economy continued to recover during the third quarter of the year, although stating that there are still marked differences across sectors and regions. One member added that the Central region, which has a higher concentration of services, was the most affected by the pandemic, while the Northern and North-Central regions, where manufacturing production is more prevalent, performed better. **Some** members highlighted that economic activity remains below pre-pandemic levels. **One** member stated that the latest data point to a deceleration in economic activity. He/she specified that, according to the Timely Indicator of Economic Activity (IOAE, for its acronym in Spanish), in August economic activity could have registered a level similar to that of May, indicating four months of stagnation.

On the demand side, most members agreed that consumption continued to recover, although **some** of them noted that it fell in June. **Some** members highlighted that consumption was supported by the good performance of remittances and the wage bill. **One** member pointed out that, during the first 7 months of the year, remittances increased by 23.5% as compared to the same period of 2020, and that in July the wage bill exceeded the levels registered in February 2020. **Another** member noted that timely indicators of purchases in commercial establishments suggest consumption has performed well. In turn, **some** members underlined the weakness of certain indicators related to consumption, such as consumer confidence and sales reported by the National Retailers Association of Mexico (ANTAD, for its Spanish acronym). **One** member pointed out that credit card and debit card expenditure remained stagnant. **Regarding investment, most members considered that it remains weak. Some** members emphasized that it remains below pre-pandemic levels. **One** member considered that investment continued recovering moderately. **Another** member pointed out that it showed stability in recent months. **One** member mentioned that investment is expected to follow an unfavorable trajectory.

Regarding the external sector, most members underlined the differentiated performance of exports and problems related to the supply of inputs. Some members highlighted the impact on automotive exports, while non-automotive exports continued recovering. **One** member stated that in August automotive exports were 16.76% below the levels registered in February 2020, while non-automotive manufacturing exports were 8.25% above the levels observed in the same period of 2020. **Another** member considered that, despite the aforementioned supply-related problems, exports have recovered considerably. However, **one** member mentioned that in August both oil and non-oil exports fell relative to the previous month. **Another** member highlighted that non-oil imports of intermediate goods and consumer goods are above the levels registered in late 2019, while capital imports are at lower levels.

On the supply side, most members underlined the heterogeneous recovery across different sectors. They underlined that manufacturing is still being affected negatively by the shortage of inputs, especially in sectors more integrated to global production chains, such as the automotive sector. They added that services continued to recover, albeit heterogeneously across sectors. One member mentioned that industrial production reactivated in July, due to a boost in manufacturing. However, he/she warned that the sector overall seems to have lost momentum since the beginning of the second quarter. **Another** member stated that the construction sector shows a lack of dynamism and noted that tertiary activities have performed better, although in recent months they have slightly decelerated. **One** member added that most components of this sector are still below their pre-pandemic levels. **Another** member stated that services continue recovering, with the negative impact centered on the sectors most exposed to contagion dynamics.

Most members highlighted that the labor market continues to recover. However, they noted that weak conditions still prevail. One member pointed out that labor participation has not returned to its pre-pandemic levels yet, that the urban unemployment rate is 5.5%, and that the underemployment rate is 13%, a level almost twice as high as in normal times. **Another** member stated that underemployment remains the buffer for the labor market. **One** member added that alternative unemployment increased slightly in July, and that it is currently above pre-pandemic levels. **Another** member pointed out that the unemployment rate has not decreased significantly since May and that it is still far from its pre-pandemic levels. He/she mentioned that the unemployment rate that includes the underemployed, the unemployed and the inactive who are available to work is at 26.3% of the extended PEA (Economically Active Population, for its Spanish acronym). He/she highlighted that formal IMSS-insured employment has continued to recover, and is currently at a level 192 thousand jobs lower than that observed in February 2020. **Some** members added that the recovery of the labor market is still unequal by gender. **One** member underlined that the reading of the labor market has become more complicated.

All members agreed that the economy maintains ample slack conditions, with marked differences across sectors. One member stated that, according to timely information, slack conditions continued to narrow during the third quarter, although they remain wide and heterogeneous across sectors. **Some** members mentioned that these are expected to continue narrowing. **One** member emphasized that there is a greater uncertainty in estimates of slack. He/she added that this derives from the pandemic-related effects on goods and services' production capacity, and from a deep reallocation of spending. **Another** member expressed that the Global Economic Activity Indicator (IGAE, for its Spanish acronym) has not yet surpassed its pre-pandemic level, and that aggregate activity remains 7.6% below its trend level according to the OECD. He/she stated that all of the above is evidence of the long road that the Mexican economy still has ahead to reach a full recovery. **One** member mentioned that the closure of activities and the decrease in certain firms' capacity might have affected markets' flexibility and competitiveness, as well as potential growth. These effects are hard to estimate given that, at the same time, digitalization and automation processes have accelerated and human-capital formation processes have been affected.

Most members highlighted that the Mexican economy is expected to continue recovering during the rest of the year and in 2022. One member stated that said prevision is based on advances in the vaccination process, the boost from external demand, and the recovery of domestic spending. **Another** member mentioned that market consensus maintains optimistic expectations which confirm a more robust recovery pattern than initially anticipated. **One** member mentioned that the third wave of infections, less mobility, stagnation of the IGAE and the decline in business opinion and consumer confidence indicators represent risks for the recovery, which is not yet fully established and is incomplete.

Inflation in Mexico

All members mentioned that global inflationary pressures and bottlenecks in production continue affecting headline and core inflation. Some members highlighted the influence of inflationary pressures in the United States. In this regard, **one** member underlined that such economy stands out for its high inflationary pressures. **Some** members pointed out that the above has affected food merchandise prices. **One** member highlighted the importance of these prices in the case of Mexico, given that the food component has a weight of close to 25% in headline inflation, while in other emerging economies it is merely 22%, and in advanced economies it is 14%. Nevertheless, he/she pointed out that international references suggest that some of these pressures have started to decline. **Another** member mentioned the disproportionate impact of food commodity prices on a reduced group of products relevant for the Consumer Price Index. He/she mentioned that the atypical inflation of just three key products: cooking oils, corn tortilla, and fresh milk, accounts for 50 basis points of the increase in core inflation in 2021. Nonetheless, he/she added that the international prices of the main production inputs of the latter have already started to decrease. **One** member mentioned that non-food merchandise inflation is also highly correlated with that of the United States, which generates a process of imported inflation which would explain the dynamics of higher inflation in the Northern and North-Central regions of Mexico. **Another** member pointed out that during 2020, the decline in world inflation levels did not occur in the same magnitude in Mexico. He/she stated that, despite the stability of the Mexican peso, the prices of goods and services that are susceptible to foreign exchange adjustments have increased constantly, which suggests the high sensitivity of these goods to other global costs in addition to exchange rate pressures.

Most members emphasized the increase in headline and core inflation in the first fortnight of September. One member indicated that unexpected increments have been observed since the previous monetary policy decision. He/she added that, this year so far, monthly headline inflation has been above analysts' expectations and only on two occasions core inflation was lower than anticipated. **Another** member highlighted that inflation rebounded consistently, coming close to 6%, despite economic activity remaining below pre-pandemic levels, the insufficient recovery of employment, and credit to the private sector continuing to contract. He/she added that the persistence of high inflation levels for a prolonged period can contaminate the price formation process and lead to a de-anchoring of expectations. **One** member underlined that headline inflation was affected by additional shocks, causing its trimmed mean indicator to be above 5%. He/she mentioned that, among emerging economies, Mexico has one of the highest levels of headline and core inflation relative to the headline inflation target, and that, in line with some estimates, recent inflationary dynamics are being pressured by both short-term and higher-persistence factors. He/she added that the frequency and the magnitude of fortnightly revisions have increased, particularly in merchandise prices. He/she noted that surveys among private sector businesses point to multiple significant effects on their productive processes, with possible implications on prices. Finally, he/she mentioned that the financial cost in real terms decreased for all agents and is below the costs expected at the beginning of the year. **Another** member considered that inflationary pressures have started to decrease at the margin. He/she stated that, over the last three fortnights, the monthly changes in headline inflation, services inflation, and non-core inflation have been in line with their historic average. He/she indicated that the only component with behavior deviating from its historic average is that of merchandise, which has been affected by disruptions in supply chains and by changes in consumption patterns. However, he/she considered that the magnitude of increments in this component is likely to have decreased.

Most members noted that core inflation has followed an upward trend, mainly due to an increase in the annual change in merchandise prices. Some members pointed out that core inflation has been above 4% for a prolonged period. **Some** members noted that the trimmed mean indicator of this component continues to increase. **One** member stated that the levels the core sub-index is registering are among the highest observed since April 2009. All components of this sub-index are under pressure as more than half of their monthly increments lie above 4% at an annualized rate. Meanwhile the trimmed mean indicator continues showing the same trend than the official figure, which has increased for 10 consecutive months, and already stands nearly at 5%. **One** member mentioned that supercore inflation is at 3.43%, which is similar to its pre-pandemic levels. **Another** member noted that, over the past five years, merchandise prices have faced constant pressures, which could not be contained during the pandemic despite an unprecedented negative output gap. **One** member added that different measures, that adjust this index for seasonality or that are obtained from a decomposition at different frequencies, suggest that the pressures affecting it are greater than those observed in other inflationary episodes. He/she stated that pressures on non-food merchandise prices show a high degree of dispersion, making it difficult to determine the average duration of these pressures. **Some** members mentioned the rise in services inflation in recent months, although **other** members noted that this component declined at the margin. **One** member considered that, notwithstanding the above, the services component continues to be an additional factor of inflationary pressures. **Another** member noted that the phenomenon of reversion to trend associated to the gradual reopening of the economy has led to an increase in the annual rate of inflation in the clothing and services components which had displayed price increases below their historical average in 2020. However, he/she stated that the annualized biennial rate, which eliminates the ups and downs that occurred in the previous two years, shows that the trend in these components is quite stable.

Some members mentioned that non-core inflation reached 8.86% in the first fortnight of September. **One** member emphasized that the evolution of this component has reflected two opposite movements: the effect of greater variations in agricultural and livestock product prices and the decline in LP gas inflation from June to date, as a result of the price cap policy. He/she considered that this contributes to an underestimation of inflation, since during this period the international references of LP gas continued to increase, and thus, in the absence of price caps, headline inflation would probably have been adjusted upwards. **Another** member stated that the recent behavior of the non-core sub-index is mainly explained by the increases in LP gas prices, since the price cap policy allows for an adjustment in consumer prices according to international references.

The majority of members pointed out that expectations for headline and core inflation for 2021 and 2022 increased again, while medium- and long-term inflation expectations have remained more stable, although the latter are at levels above the target. They highlighted that short-term expectations are well above the target. One member stated that expectations for the end of 2022 are at a level close to the average observed in other inflationary episodes. **Another** member attributed the stability of long-term expectations to the credibility of the central bank. **One** member considered the stability of these expectations to be consistent with the transitory nature of current inflationary pressures. As for inflation expectations derived from market instruments, he/she mentioned that those of 6 to 10 years are currently at 3.0%. On the other hand, **another** member added that the compensation for inflation and inflationary risk implicit in 10-year and 30-year bonds displays a cumulative increase during the year of 70 and 73 basis points, respectively. He/she considered it of concern that these are on an upward trend and warned that such behavior could mark the beginning of a process of de-anchoring of long-term expectations.

Most members noted that headline and core inflation forecasts were again revised upwards from those published in the April-June 2021 Quarterly Report. One member stated that this responds to the inflationary pressures that have arisen and to the reduction of slack. **Another** member pointed out that headline inflation is expected to converge to the target in the third quarter of 2023. He/she mentioned that the revised forecasts do not consider additional shocks or the possibility that the current ones may be prolonged. **One** member highlighted that the scenarios locate inflation at twice the target level. He/she estimated that headline inflation will be around 6.4% at the end of the year and that core inflation will be above 5% during the next nine months, reaching a maximum level of 5.6% in February 2022.

The majority of members pointed out that inflationary pressures are associated with shocks that are expected to be transitory. However, they noted the risk of a negative impact on the price formation process. One member mentioned that pressures have continued to worsen due to external and domestic factors, and thus their transitory nature seems to be less probable. He/she warned that the persistence of high inflation levels for a prolonged period could de-anchor medium- and long-term expectations. He/she said that if inflation remains high for a prolonged period, economic agents incorporate it into their expectations without distinguishing between transitory or permanent increases or between those coming from supply or demand shocks, so that inflationary pressures tend to become entrenched. **Another** member mentioned that in addition to supply shocks, inflation is also facing various structural factors that will limit the decline in prices in the coming months. He/she pointed out that inflationary pressures point to a structural and inertial problem of core inflation that can hardly be considered transitory. He/she added that the changes in relative prices originated by the new consumption patterns possibly will not be reversed in a long time, given that the upward adjustment in service prices is occurring at the same time that merchandise inflation remains high. **One** member mentioned that high inflation is the result of various transitory or exogenous factors: i) the increase in international commodity prices; ii) the reversion of prices to their trend in a group of goods and services, which should not be cause for concern for the central bank since it is the result of the process of closing and gradual reopening of the economy; and iii) the adjustment in the relative prices of some goods derived from changes in consumption patterns and disruptions in production processes. He/she stated that the change in consumption patterns is a one-time change, and warned that, in the case of disruptions in production processes, it is foreseen that these pressures are to begin receding as the normalization process advances. He/she added that in the first fortnight of September the joint effect of the atypical variations in merchandise prices and the reversion in services and clothing prices was 109 basis points, which reveals that a significant part of the increase in core inflation is transitory in nature. He/she considered that inflationary pressures have started to ease at the margin, which will result in a reduction of the annual inflation rate in the future.

Among the upward risks to inflation, most members mentioned external inflationary pressures. Some members added cost pressures and an exchange rate depreciation. **One** member mentioned also the risk of high persistence of core inflation and increases in agricultural and livestock product prices. **Another** member noted that higher inflationary pressures are expected as the reopening progresses and the output gap closes. **One** member noted that, although the deterioration in short-term inflation expectations is marginal, inflation has continued to rise and, although a further increase was already anticipated due to arithmetic effects, this dynamic represents a challenge if inflation expectations continue to be revised upwards. As for downside risks, **another** member pointed to the widening of the negative output gap, further social distancing measures, and an exchange rate appreciation. **Most members considered the balance of risks to inflation within the forecast horizon to be biased to the upside. One** member mentioned that this is due to the persistence of multiple supply shocks and the external boost to aggregate demand, and added that inflationary pressures are expected to continue for the next few months.

Macrofinancial environment

Most members considered that Mexican financial markets have exhibited a mixed performance since the previous monetary policy decision. They mentioned that the Mexican peso appreciated slightly, although in recent days, and in line with what has been observed internationally, it depreciated and its volatility increased. One member noted that the recent depreciation was due to the fact that the peso is one of the most sensitive currencies to interest rate adjustments, which has led to the currency reaching levels above 20.50 pesos per dollar. He/she added that a favorable adjustment could take place as volatility conditions normalize. **Most members mentioned that interest rates increased. One** member pointed out that the yield curve of government instruments rose, especially in the middle part. **Some** members pointed out that the stock market recently registered adjustments in a narrow range. **One** member added that the Mexican stock market recorded its highest level of the year during this period. **Another** member noted that trading conditions in both the fixed income and equity markets in Mexico had improved. He/she added that sovereign risk indicators deteriorated slightly. **One** member stated that Pemex's risk indicators are still among the highest of all oil companies worldwide. Regarding monetary aggregates, he/she emphasized the deceleration in their expansion rate, mainly explained by a lower growth of term deposits, since demand for liquid assets remains high, although **another** member considered that it is still below its level of 2020.

One member pointed out that fiscal discipline in Mexico is an anchor for macroeconomic stability, since there is currently no problem in this area that could exert pressure on sovereign risk or the exchange rate. **Another** member added that optimistic growth expectations are strengthened by a balanced fiscal package that, although it does not generate much momentum, it does not distort the decisions of economic agents.

Most members pointed out that credit to the private sector continued to perform poorly and highlighted the fall in financing to firms. One member stated that this segment has been the most affected, with a reduction of 9.7% in real terms. **Another** member mentioned that financing to Small- and Medium-sized Enterprises (SMEs) shows a contraction of 13% compared to pre-pandemic levels, with no signs of improvement. He/she argued that a contraction of credit is observed even in sectors that did not experience a recession. **Most members noted that consumer credit continued to decline** and **some** members indicated that mortgage lending has grown at a more moderate pace. **One** member pointed out that total financing continued to contract in real terms at an annual rate, albeit at a slower pace than in previous months. He/she added that foreign financing contracted more than domestic financing. **Some** members mentioned that delinquency rates have continued to decrease. **One** member pointed out that this, together with financial stability conditions, minimizes the possible harmful effect of higher interest rates on households and firms. He/she added that the decline in credit and investment responds to factors beyond monetary policy, such as economic slack and the environment of uncertainty.

Monetary policy

Most Governing Board members pointed out that due to the variety, magnitude, and the extended horizon over which the shocks have affected inflation, they may pose risks to the price formation process and to inflation expectations. In order to avoid such risks, they deemed necessary to reinforce the monetary policy stance by adjusting it to the trajectory required for inflation to converge to its 3% target within the forecast horizon. Therefore, they decided to increase the target for the overnight interbank interest rate by 25 basis points to 4.75%. They emphasized that for the next monetary policy decisions they will assess the factors that have an incidence on the foreseen trajectory for inflation and its expectations, in order for the policy rate to be consistent at all times with the orderly and sustained convergence of headline inflation to the 3% target within the time frame in which monetary policy operates, enabling an adequate adjustment of the economy and financial markets.

One member considered that given the transitory and exogenous nature of the inflationary process, a less accommodative monetary stance would be inefficient as it does not solve the problems that give rise to the current levels of inflation such as the increase in the prices of commodities and the problems in supply chains. In contrast, he/she considered that a higher rate would have a negative impact on a wide range of the economy's margins, such as consumption, investment, credit, public finances and domestic financial markets, among others. He/she argued that this would occur in the midst of a still incomplete recovery from one of the most severe crises on record. He/she added that the variables most sensitive to monetary policy, such as credit, consumption and investment, have deteriorated considerably. He/she pointed out that raising interest rates in the current juncture would also imply not taking advantage of the anchor of fiscal discipline on country risk and on the foreign exchange rate. He/she highlighted that in the absence of fiscal discipline, the central bank is obliged to provide such an anchor, but that the current fiscal policy should make room for a more accommodative monetary policy. He/she stated that interest rate increases reduce room for eventually reacting to a cycle of increases in the Federal Reserve's funds rate and that if Banco de México acts too soon in anticipation, it may be forced to bring the interest rate to levels that are too restrictive in order to avoid a deterioration of its relative stance. He/she stated that a continued upward adjustment in interest rates may be interpreted as a signal that observed inflation is of a relatively permanent nature. He/she considered that this may affect inflation expectations and the price formation process. He/she pointed out that the recent interest rate increases and the subsequent adjustments to short-term inflation expectations seem to confirm this. He/she stated that, from the first increase to date, short-term inflation expectations have only increased, so that the intended objective of the supposed reinforcement of monetary policy seems to have had very low effectiveness. He/she mentioned that it would be better to have a more effective communication policy that thoroughly explains the nature of the inflationary shock, instead of responding mechanically with interest rate increases, which do not manage to slow inflation down and may negatively affect inflation expectations and the price formation process. He/she expressed that, from his/her view, the idea that interest rate increases are necessary to reinforce the institution's credibility seems to underestimate the progress achieved in this realm.

Another member highlighted that with the aim of preventing inflation expectations from deteriorating, the recommendation has been to take prudent decisions that are predictable and well-communicated. He/she highlighted that it is important to differentiate between a reinforcement of monetary policy and a cycle of interest rate increases, given that the Mexican economy is in a better macroeconomic position than other similar economies, fiscal and monetary stimuli in Mexico were limited, and an ample slack has been maintained. He/she stated that reinforcing monetary policy allows to act preventively in light of expectations of less accommodative monetary conditions worldwide in the following months, at a time when inflation has increased again and in which its expectations for the next 12 months and for the end of next year have been marginally affected. He/she considered that expectations for the next 12 months registered the greater increase and may limit the effectiveness of the monetary policy reinforcement. He/she added that monetary policy's effectiveness is also achieved by effectively communicating the factors that are determining the evolution of prices. He/she pointed out that most of the current inflationary pressures are attributable to an unprecedented situation that will not continue indefinitely, but that these pressures represent a challenge to decision making. He/she estimated that, considering that the current asymmetric supply shock has favored some sectors and harmed others, a process of reallocation of resources in the economy, which monetary policy should facilitate, is expected. He/she warned that as a consequence of the pandemic, demand conditions in the loanable funds market have been significantly compressed to levels even below those of the 2008 crisis, which could suggest that the range in which the neutral interest rate is estimated may have adjusted downwards.

One member stated that an increase in the reference rate indicates that the Governing Board is worried about the level and trajectory of inflation and is acting decisively. He/she mentioned that decisive monetary policy actions are required, taking advantage of the spaces available to meet the central bank's primary mandate. He/she noted that recently inflation has been above expectations, leading to their steady deterioration, with levels above 6% for 2021 and with smaller increases for 2022. He/she pointed out that this has led to expectations of reference rate increases in the following months, which, in the current scenario, may be justified. He/she warned that if these increases do not materialize, it could be interpreted as a signal of complacency. He/she noted that it must be explained that inflationary shocks demand decisive actions and it must be warned that, if inflation continues to increase, the expansionary policy stance will continue to diminish. He/she stated that in this way credibility will be strengthened in order to maintain inflationary expectations anchored, which allows to comply with the central bank's primary mandate. He/she pointed out that expectations of a more robust recovery diminishes the need for a further stimulus. He/she added that financial conditions and the absolute and relative monetary policy stances allow to continue with an adjustment. Likewise, global monetary conditions also aim towards a relative monetary policy stance that is less lax. He/she stated that the improvement in trading conditions in money markets allows to raise interest rates without an undesired tightening of financial conditions. He/she considered that raising the reference rate will have a reduced effect on economic recovery, given the limited transmission of the credit channel. He/she mentioned that the causality of monetary policy on inflation via the expectations channel is not bidirectional, since a more restrictive policy stance helps to reduce inflationary pressures rather than the other way around. Furthermore, the increase in the interest rate sends a signal of greater commitment with the primary objective, while the inaction of monetary policy given the accumulation of inflationary shocks is a factor that generates a deterioration of expectations. For that reason, he/she pointed out that monetary policy must be proactive in face of the harmful effects of inflationary shocks, regardless of their nature or temporality. Thus, the increase in rates is a preventive and timely measure in view of transitory shocks that but which, when combined, have an indeterminate duration which may transcend the time-frame in which monetary policy operates. He/she added that this increase is a direct signal that that more inflation will not be tolerated, in order to avoid a greater deterioration of inflation expectations that would make it harder to maintain an environment of price stability. Finally, he/she pointed out that if the increase in prices were to continue, the expansionary monetary policy stance will have to be reduced until a neutral posture is achieved, or even one that is slightly restrictive, more consistent with the current inflationary gap and a much narrower negative output gap.

Another member highlighted the rise in inflation once again above expectations, and the subsequent upward adjustment of the expected trajectory in an environment of high uncertainty, pointing out that this situation implies renewed tensions in monetary policy implementation. He/she added that the increase in inflation has implied a significant loss of purchasing power for the population and that if inflation were to remain elevated for a prolonged period, it would be incorporated into agents' inflation expectations, which would tend to entrench inflationary pressures in the economy. He/she considered that any likely initial stage of a process of de-anchoring of long-term expectations necessarily requires timely action by this central bank. He/she mentioned that if a new adjustment were not implemented, the convergence of inflation to the target within the time frame in which monetary policy operates would be jeopardized. Additionally, he/she reflected that the appropriate pace for withdrawing the monetary stimulus must be evaluated, arguing that a greater effort should be made in normalizing monetary policy, in order to avoid a scenario of exchange rate depreciation and an acceleration in the pace of price increases. He/she pointed out that failure to do so would mean failing to comply with the primary mandate. He/she recalled that, between 2015 and 2017, it took an increase of 400 basis points and 20 months for core inflation to start declining, in the presence of new shocks. He/she highlighted that an increase in the rate would seek to prevent the further strengthening of second round effects in the price formation process. He/she stated that, for the time being, no additional risks have materialized but it is very likely that a more complex scenario will be observed, which, under a preventive approach, would require a more aggressive adjustment. He/she added that, in light of the above, it is essential to maintain a prudent approach in monetary policy that allows to implement adjustments in a timely and sufficient manner, and ensures an orderly and sustainable convergence of inflation to the target.

One member pointed out that headline and core inflation forecasts have been revised significantly upwards on numerous occasions throughout the year, in response to inflationary pressures and to a reduction in ample slack conditions. He/she added that this points to the need for a trajectory for the interest rate target that reduces the monetary stimulus. He/she added that, considering the simultaneity and magnitude of the shocks that have affected headline and core inflation, as well as the upward revision of their forecasts and that slack in the economy will close at a faster pace than previously expected, it is essential for Banco de México to reinforce its commitment to comply with its constitutional mandate of safeguarding the domestic currency's purchasing power. He/she argued that although shocks to headline and core inflation are expected to be mostly transitory in nature, there is a risk that price formation and inflation expectations may be contaminated due to: i) the broad range of prices affected; ii) the magnitude of price increases; iii) the extended horizon over which they have occurred; iv) the persistent reallocation of household spending; and v) greater uncertainty about the adjustment of the economy and prices in the face of an unprecedented scenario. He/she considered that tolerating high inflation levels, very much above the target, without reinforcing the monetary policy stance to levels consistent with a trajectory that fosters the convergence of inflation to the target within the forecast horizon, would contribute to deteriorate the price formation process and contaminate inflation expectations, which would in turn undermine Banco de México's credibility, with high costs for society.

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 and to inflation expectations. In order to avoid such risks, it was deemed necessary to reinforce the monetary policy stance by adjusting it to the trajectory required for inflation to converge to its 3% target within the forecast horizon. The Governing Board decided to increase the target for the overnight interbank interest rate by 25 basis points to 4.75%.

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

4. VOTING

Alejandro Díaz de León, Galia Borja, Irene Espinosa, and Jonathan Heath voted in favor of increasing the target for the overnight interbank interest rate by 25 basis points to 4.75%. Gerardo Esquivel voted in favor of leaving the target for the overnight interbank interest rate unchanged at 4.50%.

5. DISSENTING OPINIONS/ VOTES

Vote. Gerardo Esquivel

I believe that raising the interest rate in the current juncture is ineffective and inefficient. It is ineffective because a higher rate does not solve the factors that originate inflationary pressures: increases in international input prices and disruptions in supply chains. It is inefficient because the increase may affect the economy in several areas: consumption, investment, credit and public finances. The increase also reduces future room for the time when the Federal Reserve begins its normalization process. Acting too soon in anticipation of said process may imply that in the future the rate will have to be adjusted to a very restrictive level to avoid affecting the relative policy stance. Finally, the increase could also be counterproductive. Continued increases could be interpreted as signals that inflation is of a permanent nature. This could affect expectations and the price formation process. Since the first increase to date, short-term expectations have only risen and therefore the sought objective has not been met. Thus, the question arises as to whether a communication policy that explains the nature of the current inflationary shock clearly would be better than responding mechanically with continuous rate increases.

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

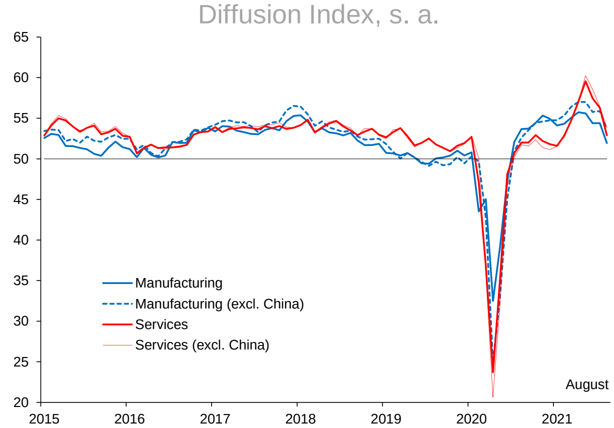
A.1.1. World economic activity

Available indicators suggest that world economic activity continued to recover during the third quarter of the year, although at a slower pace than as expected at mid-year. This recovery was driven by the expansion of the major advanced economies and of some emerging economies. Recovery continued to be heterogeneous across countries, reflecting differences in the availability of vaccines, the evolution of the pandemic, and stimulus spending. The dynamism of industrial production has diminished due to the intensification of bottlenecks, the re-imposition of certain restrictions on mobility in some Asian economies, and the shortage of inputs (Chart 1). Services have also shown a slower pace of recovery in recent months, despite the fact that the reopening process has continued in most economies. Global inflation continued to increase due to pressures on commodity prices, base effects, bottlenecks in production, spending support programs and the reallocation of spending towards merchandises. As such, in most of the main advanced and emerging economies, inflation was above their central banks' targets.

In this environment, the central banks of the major advanced economies have maintained their monetary stimulus, although those of Norway and Korea announced an increase in their interest rates and others already foresee a reduction of their monetary stimulus, while those of several emerging economies continue to diminish it. Financial markets remained fairly stable for most of the period since Mexico's last monetary policy decision, although in recent weeks an increase in volatility and lower risk appetite at a global level were observed. The above, in an environment in which there are also concerns regarding the spread of the Delta variant of the SARS-CoV-2 virus and the real estate sector in China, among other factors.

Among key global risks, those associated with the pandemic, inflationary pressures, and adjustments to monetary and financial conditions stand out. In particular, the emergence of new and more resistant variants of the SARS-CoV-2 virus, coupled with the slow vaccination process in some countries, may delay global economic recovery. Although some of the factors that have been driving global inflation are expected to be largely transitory, it cannot be ruled out that some of them, such as the disruptions in global supply chains, may last longer than anticipated, resulting in a greater persistence of inflation at high levels, which in a context of economic recovery could lead to a more rapid tightening of monetary policy.

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



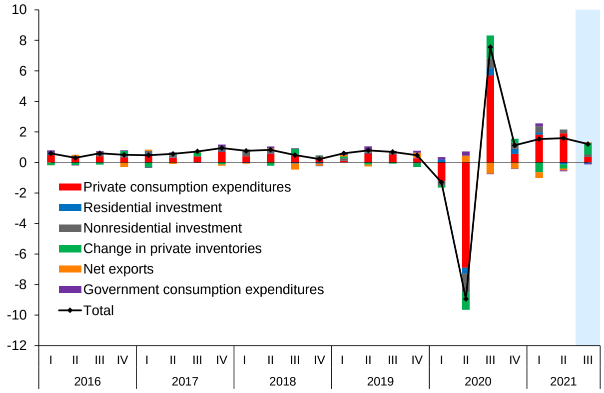
s. a. / Seasonally adjusted figures.
Source: IHS Markit.

In the United States, available indicators for the third quarter of the year suggest that, after registering a seasonally adjusted quarterly growth of 1.6% in the second quarter, economic activity continued to recover during the third quarter (Chart 2). However, the surge of COVID-19 cases and the intensification of bottlenecks have reduced the dynamism of this recovery.[1] Private consumption continued to be one of the drivers of economic activity, although it moderated in the face of the reduction of some stimuli such as unemployment subsidies, the rise in inflation, the surge of infections, and the persistent supply restrictions for some products, such as automobiles and electronic goods. Although new orders for capital goods from businesses point to a weakening of investment, available figures on

[1] Expressed as a quarterly annualized rate, US seasonally adjusted GDP grew at a rate of 6.6% during the second quarter of 2021.

business inventories suggest that these could contribute positively to growth in the third quarter of the year.

Chart 2
US Real GDP and Components
Quarterly percentage rate and contributions in percentage points, s. a.



s. a. / Seasonally adjusted figures.
Note: The shaded area refers to the Blue Chip forecasts for September 2021.
Source: Bureau of Economic Activity (BEA) and Blue Chip.

US industrial production continued to expand, although at a more moderate pace, registering a seasonally adjusted monthly growth of 0.4% in August, after having grown 0.8% in July. This moderation was largely due to the contraction in mining due to the impact of Hurricane Ida that affected oil and gas extraction in the Gulf of Mexico. Manufacturing activity expanded 0.2% in August, after having rebounded 1.6% in July due to the reopening of some automotive plants. The growth in August occurred despite the shutdown of petrochemical plants and refineries due to Hurricane Ida and the persistent shortage of semiconductors. Gas and electricity generation was driven by the greater demand for air conditioning due to unusually warm weather conditions. The Purchasing Managers' Index (PMI) of the manufacturing sector suggests that the gradual recovery of this sector may continue in the coming months.

The US labor market continued to recover during August, although at a slower pace than in previous months due to the impact of the higher levels of COVID-19 cases on some activities. The non-farm payroll registered an increase of 235,000 jobs in August, after the 1.1 million jobs registered in July. Employment increased in sectors such as professional, scientific and technical services, management of companies and enterprises, transportation and warehousing, and manufacturing, albeit in some cases at a slower pace than in previous months. In contrast, employment stagnated in art, entertainment and recreation services, as well as in accommodation, food and education, while contracting in other services such as in retail trade. Thus, the level of employment was still 5.7 million below pre-pandemic levels. The unemployment rate decreased from 5.4% in July to 5.2% in August. Job vacancy rates have remained at high levels, despite the expiration of additional unemployment insurance payments, which adds to uncertainty about the evolution of wage dynamics and labor participation.

In the euro area, available indicators suggest that economic activity during the third quarter of the year continued to recover at a strong pace, after having grown at a seasonally adjusted quarterly rate of 2.2% during the second quarter.[2] The dynamism of the economy has continued to be favored by the continued recovery of household consumption and business investment, reflecting the lifting of mobility restrictions, greater confidence, and favorable financial conditions. Industrial activity continued to expand, although its growth in the short term may continue to be limited due to bottlenecks in supply chains. The unemployment rate declined from 7.8% in June to 7.6% in July, while an increasing number of firms have highlighted labor shortages as a constraint to production. Purchasing Managers' Indices suggest that economic activity will continue to recover during the third quarter.

In the United Kingdom, available indicators suggest that economic activity continued to recover during the third quarter of 2021, after having grown at a seasonally adjusted quarterly rate of 4.8% during the previous one.[3] Economic activity has been supported by the lifting of restrictions associated with the COVID-19 pandemic, which has mainly favored art, entertainment and recreation services. However, retail sales deteriorated in July and August, partly reflecting disruptions in supply and retailers' difficulties in sourcing goods and services. The unemployment rate continued to diminish by falling from 4.7% in June to 4.6% in July, while there have been greater difficulties in filling job vacancies, particularly in the sectors of accommodation and food services, art, entertainment and recreation, and warehousing and transportation. The Purchasing Managers' Indices of the manufacturing and service sectors suggest that the UK economy will continue

[2] In annualized terms, euro area GDP registered a quarter-on-quarter seasonally adjusted variation of 9.2% during the second quarter of 2021.

[3] In annualized terms, the UK GDP variation during the second quarter of 2021 was 20.7%.

to recover at the end of the third quarter, although at a more moderate pace.

In Japan, available information suggests that, after having grown at a seasonally adjusted quarterly rate of 0.5% during the second quarter of the year, economic activity will continue to gradually recover in the third, despite the implementation of a new state of emergency as of July.[4] Economic activity has been driven by the demand for capital goods, while household consumption, particularly in services, has continued to be limited by the health measures. The unemployment rate decreased from 2.9% in June to 2.8% in July. Purchasing Managers' Indices indicate that manufacturing activity will grow at a moderate pace in the third quarter, while the services sector would continue to deteriorate, in line with the extension of the state of emergency to August and September in some regions of the country.

In the main emerging market economies, growth has been heterogeneous across regions, mainly depending on the evolution of the pandemic and the exposure of each country to the impact on global supply chains. In Latin America, economic activity in most countries has recovered during the third quarter. In emerging Asia, recovery has been heterogeneous. While some of the economies in that region that were strongly affected by the health crisis during the second quarter of the year have started to recover, others have slowed down due to the impact of the intensification of the effects on supply chains. In China, economic indicators on consumption, investment and industrial production have decelerated, in an environment in which some of the economic stimuli have started to be withdrawn, new restrictions have been imposed due to the COVID-19 pandemic, and the risk of a slowdown in the real estate sector has increased due to the regulatory changes implemented over the last year and the financial vulnerabilities of some of the main firms. In emerging Europe, available indicators overall suggest a relatively robust growth, partly reflecting the advance in the vaccination process and the normalization of activities.

International commodity prices exhibited a mixed behavior since Mexico’s previous monetary policy decision. In particular, during most of August, oil prices decreased due to a deterioration in the outlook for demand as a result of the spread of new variants of the SARS-CoV-2 virus in some of the main economies, particularly in Asia. This trend was later reversed after the disruptions in energy production and distribution due to the hurricanes that affected the US Gulf Coast, the lower crude oil inventories, and expectations of a recovery in oil demand in 2022. Natural and L.P. gas prices continued to increase, in an environment of a greater demand and supply restrictions associated with the shutdown of extraction plants and gas pipelines in some regions due to climatic factors, relatively low inventory levels, and lower exports by some of the main producers, especially Russia. In turn, the prices of most industrial metals have increased, although with episodes of volatility, as a result of supply restrictions associated with disruptions in global supply chains. However, in some cases, such as that of iron, prices have diminished due to the lower dynamism of industrial production in some countries, including China. Finally, the prices of most grains decreased due to higher production expectations in major producing countries, such as the United States and Canada, although there are still disruptions to exports in the United States due to disturbances in certain ports along the Gulf of Mexico.

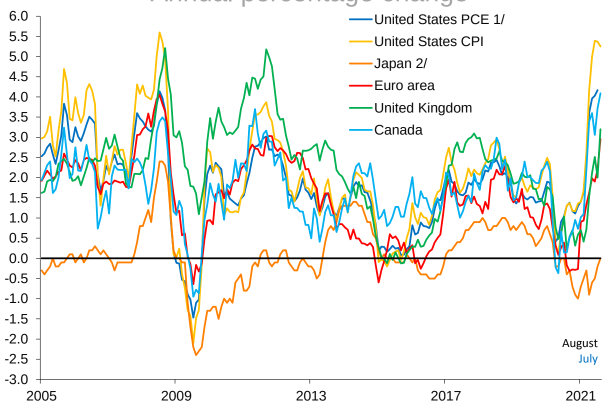
A.1.2. Monetary policy and international financial markets

Inflation continued to rise worldwide, pressured by commodity prices, base effects, bottlenecks in production chains, as well as spending programs and the reallocation of spending towards merchandises. The increase in headline inflation in most major advanced economies placed it above their central banks' targets, with the exception of Japan (Chart 3). In the United States, inflationary pressures were higher than in the rest of advanced economies. However, pressures in this country have moderated for some items, resulting in a decrease in consumer price index (CPI) inflation from 5.4% in July to 5.3% in August. In this context, short-term inflation expectations drawn from surveys continued to increase for most of these economies, while those for longer terms, drawn from financial instruments, also showed increases for economies such as the United Kingdom and the euro area.

[4] In annualized terms, Japan GDP grew at a quarter-on-quarter seasonally adjusted variation of 1.9% during the second quarter of 2021.

Chart 3
Selected Advance Economies: Headline Inflation

Annual percentage change



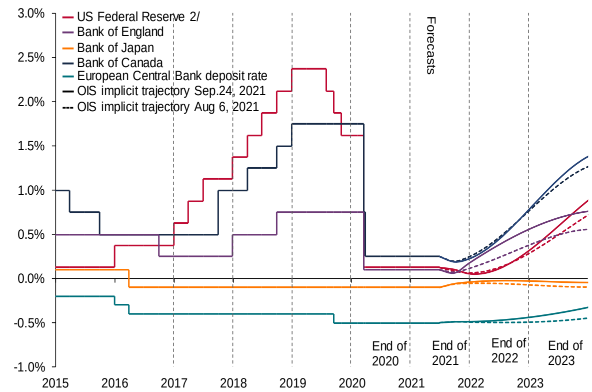
1/ The personal consumption expenditure deflator is used.
2/ Excludes fresh food. This series does not exclude the effect of the rise in consumption tax in May 2014 and October 2019, nor the effect of the free daycare and preschool program in October 2019.
Source: Bureau of Economic Analysis, Bureau of Labor Statistics, Eurostat, Bank of Japan, Statistics Canada, Office of National Statistics.

In the main emerging economies, headline inflation was above their central banks' targets in many cases. Although inflation has continued to rise in most of these economies, there was some moderation in certain countries of the Asian region as a result of the imposition of greater contention measures in light of the surge of COVID-19 cases that has weakened demand, as well as of idiosyncratic factors in some economies.

In this environment, the central banks of the major advanced economies left their interest rates unchanged at levels around zero, except for South Korea and Norway, which announced 25 basis-point rate increases. Most banks in these economies continued to use their balance sheets to preserve favorable financing conditions and to foster the convergence of inflation to their respective long-term targets, although the European Central Bank announced a moderate reduction in the pace of purchases under its Pandemic Emergency Purchase Program (PEPP), while leaving its total amount unchanged. Most central banks have reiterated that they will be patient in withdrawing their accommodative monetary stances until inflation reaches their targets in a sustained manner. However, given the progress in economic recovery and the risk of persistent inflationary pressures, some central banks are expected to reduce their monetary stimulus. In the period reported, the Federal Reserve pointed out that it considers that if progress towards its targets continues as anticipated, a moderation in the pace of its asset purchase program may soon be justified, and adjusted upwards its expectations about the trajectory of its reference interest rates. In this context, expectations drawn from financial instruments anticipate interest rate increases in some of the main advanced economies in 2022 and 2023 (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 in the main advanced economies, the following stand out:

i) In its September 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 stated that the economy has made progress towards these goals, and if such progress continues as anticipated, the Federal Open Market Committee (FOMC) considers that a moderation in the pace of asset purchases may soon be justified. In this regard, the Chairman of the Fed explained that, overall, FOMC members consider that, as long as the recovery remains on track, a gradual tapering process of asset purchases that concludes by the middle of next year is likely to be appropriate. It also indicated that the timing and pace of said tapering will not be intended to send a direct signal regarding the timing of an interest rate increase. In this context, the medians of the forecasts of FOMC's members published in September point to the following changes: a downward revision in growth expectations for 2021 and upward revisions for 2022 and 2023, as well as an increase in the expected unemployment rate for 2021. In turn, headline inflation expectations for this year were revised significantly to the upside, from 3.4 to 4.2%, and for 2022 from 2.1 to 2.2%, although inflation is expected to remain at this level during 2023 and decrease to 2.1% in 2024. Forecasts for core inflation were revised upward for 2021 and, to a lesser extent, for 2022 and 2023. As for the reference rate, the median of forecasts increased from 0.1 to 0.3% for 2022 and from 0.6 to 1.0% for 2023, while for 2024 it was 1.8%. This suggests expectations of between three and four interest rate increases by the end of 2023 and at least six in total by the end of 2024. Within the FOMC, nine of the 18 members anticipate the first increase to occur during 2022. The implied trajectory for the federal funds rate in financial instruments incorporates expectations of between two and three increases by the end of 2023, anticipating the first increase of 25 basis points to occur at the end of the first quarter of that year.

ii) In its September meeting, the European Central Bank (ECB) left its refinancing rate, key deposit facility rate and key lending facility rate unchanged at 0.0, -0.5 and -0.25%, respectively. It also reiterated that the Board expects these interest rates to remain at current or lower levels until inflation is observed to reach 2% during its forecast horizon, remain at that level in a sustained manner, and progress in core inflation is sufficiently advanced to be consistent with the stabilization of inflation at 2% over the medium term, which could imply a transitory period in which inflation is moderately above its target. The ECB maintained its Asset Purchase Program (APP) unchanged at €20 billion monthly. It noted that it considers that favorable financing conditions can be maintained with a moderately lower pace of net asset purchases under the Pandemic Emergency Purchase Program (PEPP) than in the two previous quarters, while leaving the total amount of €1,850 billion unchanged. In this regard, the ECB's President explained that this adjustment in the pace of purchases is a recalibration of its program rather than a withdrawal of stimulus (tapering).

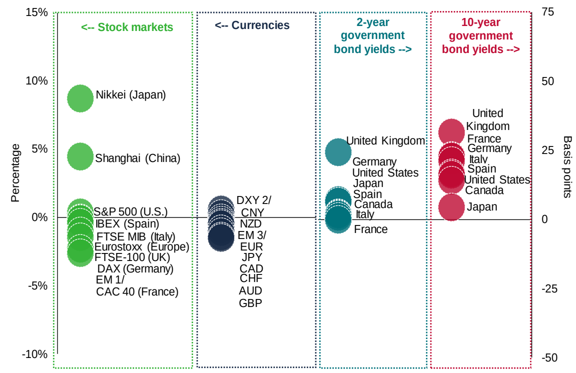
iii) In its September meeting, the Bank of Japan left unchanged its short-term policy rate at -0.1% and its long-term interest rate (indexed to its 10-year bond) at around 0%, as well as its asset purchase program. Said central bank ratified that, if necessary, it will not hesitate to take additional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

iv) In its September meeting, the Bank of England left unchanged its reference interest rate at 0.10% and its asset purchase program. It recalled that, in its August meeting it noted that, should the economy evolve in line with its central forecasts, a modest tightening of monetary policy during the forecast horizon would likely be necessary in order to be consistent with meeting the 2% inflation target on a sustainable basis over the medium term. In this regard, it indicated that some recent events seem to have strengthened the previous case, although a considerable level of uncertainty persists. Regarding its current asset purchase program, said central bank reiterated expectations that it will conclude at the end of 2021. In addition, its minutes mention that most Monetary Policy Committee's members agreed that any tightening of the initial monetary policy should be implemented by an increase in the reference interest rate, even if said tightening was appropriate before the end of the current asset purchase program.

The monetary authorities of emerging economies face different risks for price formation than those of advanced economies, as inflation and its expectations have not remained below their targets for prolonged periods of time. In particular, emerging economies that are more commercially integrated with advanced economies that have recovered more rapidly and have registered greater rises in inflation, in addition to domestic and idiosyncratic factors, face important risks as these increases may be greater and more persistent than anticipated. In this context, some central banks in this group of economies have continued reducing their monetary stimulus. In particular, during the reporting period, the central banks of Hungary, Chile, Brazil and Russia announced additional interest rate increases and the Bank of Peru increased its rate for the first time since the beginning of the pandemic by 25 basis points in August and another 50 basis points in September. After having raised its interest rate last March, Turkey's central bank announced a 100-basis point cut in its interest rate, following the increase announced last March.

In this environment, international financial markets have been relatively stable overall since the last monetary policy decision in Mexico (Chart 5), although in recent weeks there has been an increase in volatility and a lower risk appetite for global risk. In this context, since Mexico's previous monetary policy decision, the stock markets of the majority of the main advanced economies exhibited a relatively stable behavior during most of the period, with the positive performance of the Japanese market standing out due to expectations of a greater fiscal stimulus for this economy, among other factors. Nevertheless, in recent weeks, some stock indices registered moderate growth and greater volatility partly associated with uncertainty about the evolution of the pandemic, high inflation, the expectation of a reduction in the monetary stimulus, and concerns about China's real estate sector. Emerging markets, on the other hand, posted moderate gains in general (Chart 6). In foreign exchange markets, the dollar depreciated moderately against most of the currencies of advanced economies during the first part of the reporting period, while in subsequent weeks this movement was reversed. Emerging economies' currencies registered mixed adjustments in a narrow range, in some cases corresponding to depreciations. Long-term government bond interest rates in the main advanced economies rose, leading to a slight steepening of the yield curves. Long-term interest rates in emerging economies mostly showed increases. In this environment, since Mexico's previous monetary policy decision, moderate net capital inflows were recorded in most emerging economies, mainly in China, although capital outflows from some fixed-income markets have been recently observed.

Chart 5
Change in Selected Financial Indicators from August 6 to September 24, 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 since August 9, 2021
Percent, basis points

Region	Country	Currencies	Equity markets	2-year interest rates	10-year interest rates	CDS
Latin America	Mexico	-0.13%	0.40%	9	14	0
	Brazil	-1.91%	-7.91%	72	87	16
	Chile	-1.38%	3.15%	157	60	13
	Colombia	3.99%	6.50%	36	108	8
	Peru	0.00%	6.41%	183	-15	1
Emerging Europe	Russia	1.42%	6.29%	41	37	0
	Poland	-1.05%	2.43%	18	26	2
	Turkey	-2.01%	-2.97%	-36	-44	31
	Czech Republic	-0.66%	6.46%	46	31	3
	Hungary	-1.88%	3.57%	34	29	4
Asia	China	0.37%	2.52%	2	1	6
	Malaysia	0.97%	2.43%	7	21	-2
	India	0.57%	10.43%	-8	-1	-8
	Philippines	-1.20%	4.88%	15	33	-2
	Thailand	-0.27%	5.18%	12	32	0
	Indonesia	0.77%	-0.08%	-8	-11	3
Africa	South Africa	-1.95%	-6.36%	13	26	-1

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 that would lead to tighter global financial conditions, particularly affecting emerging economies that, in general, have less fiscal and monetary policy room to maneuver; ii) possible distortions in the valuation of some financial assets that could lead to a sudden correction in their prices; and; iii) high levels of private debt and the associated insolvency and default problems that could lead to contagion and to a tightening of financial conditions, particularly in emerging economies; and iv) an increase in public debt and the associated risk of unsustainable public finances. In addition, emerging economies could also face greater challenges in the medium term as their sources of financing become more limited, in a context of greater absorption of resources by advanced economies and because of China's participation in global investment indices.

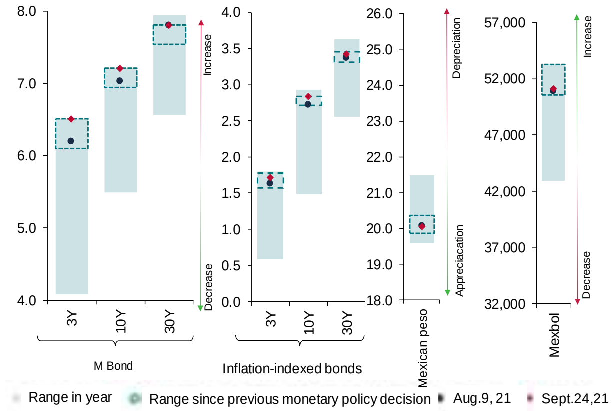
A.2. Current situation of the Mexican economy

A.2.1. Mexican markets

Since the previous monetary policy decision to date, financial asset prices in Mexico have exhibited a mixed behavior (Chart 7), in an environment in which the central banks of developed countries reiterated that the withdrawal of the monetary stimulus will be gradual and that monetary policy will remain accommodative for a prolonged period. In the last few days, a climate of greater risk aversion prevailed in light of the financial situation of a major Chinese real estate developer and a certain degree of caution due to the surge in COVID-19 cases worldwide. In this context, in some emerging economies, monetary policy is expected to be less accommodative due to the rebound in inflation and its expectations.

In the case of the Mexican peso, exchange rate volatility increased, and the peso fluctuated in a range between 19.86 and 20.37 pesos per dollar, ending the period with a depreciation of 0.13% (Chart 8). This occurred in a context in which both spot- and future trading conditions improved.

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



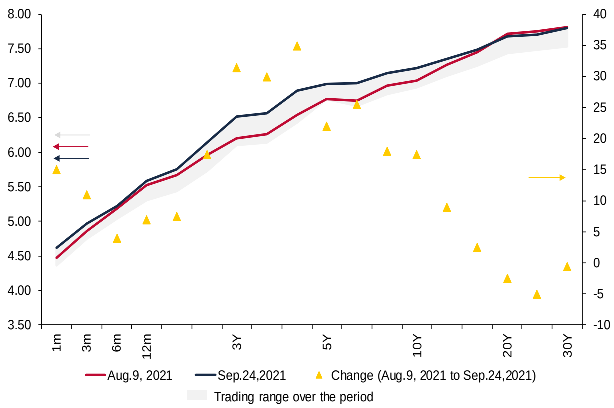
Source: Prepared by Banco de México.

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

Source: Prepared by Banco de México.

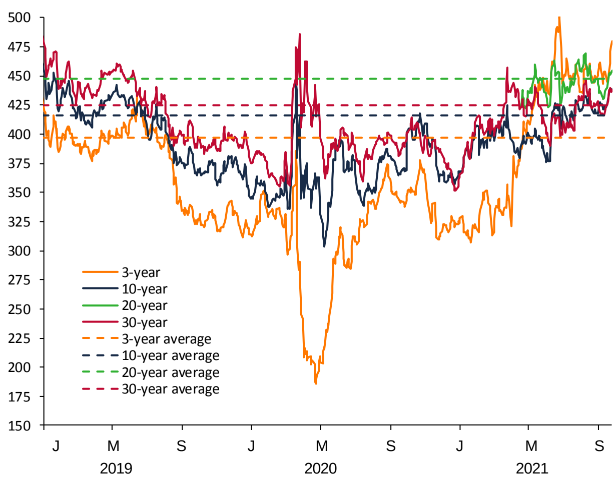
Interest rates of government securities exhibited a mixed behavior (Chart 9), with a flattening trend with movements between -7 and 35 basis points along the curve. The yield curve of real rate instruments showed similar dynamics, registering movements between -24 and 18 basis points across all maturities. In this context, with respect to the August monetary policy decision, compensation for inflation and inflation risk premia implicit in spreads between nominal and real rates of market instruments registered upward movements in 3- and 10-year maturities, while in 20- and 30-year maturities they decreased (Chart 10). These adjustments took place in an environment in which trading conditions in this market improved.

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



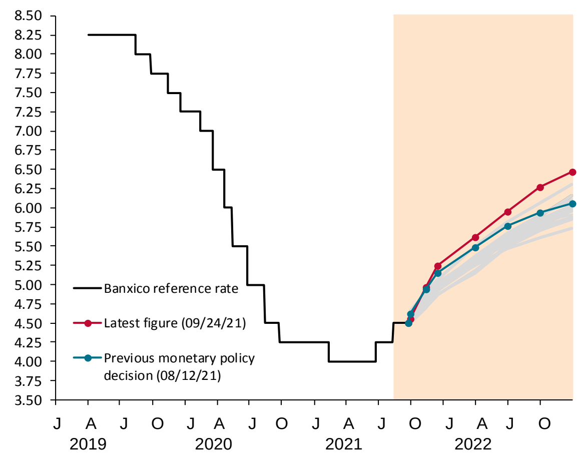
Source: PIP.

In line with the establishment of a swap mechanism between Banco de México and the Federal Reserve, an auction of financing in dollars was held on August 18 in which resources for an amount of 100 million dollars were allotted.

Regarding the measures initially announced by Banco de México on April 21, 2020, as set forth in its press release of February 25, 2021, the term of certain facilities will end on September 30 of this year.

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 September and November meetings (Chart 11). In a related manner, the median of the consensus of forecasters surveyed by Citibanamex anticipates the reference rate to be at 4.75% in the next monetary policy decision. For the end of 2021, market variables anticipate a target rate of 5.24%, 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



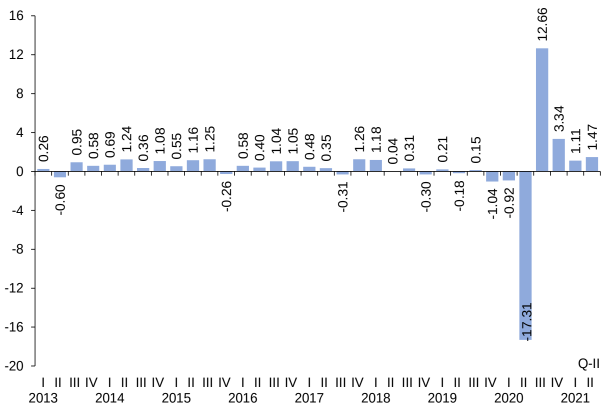
Source: Prepared by Banco de México with Bloomberg data.

A.2.2. Economic activity in Mexico

After having expanded in the second quarter of the year (Chart 12), economic activity continued to recover in the beginning of the third, although with marked differences across sectors and in a context of persistent uncertainty regarding the pandemic.

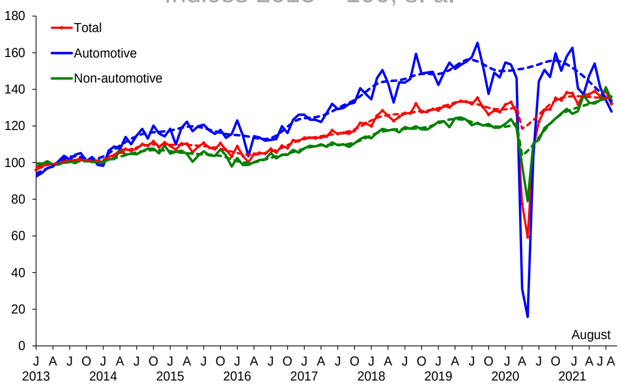
As for external demand, in August, non-automotive manufacturing exports contracted at the margin, thus reversing the growth observed in July, albeit remaining at relatively high levels (Chart 13). Automotive exports continued their downward trend, reflecting the effects of the ongoing global semiconductor shortage. By destination, in August, exports to the United States reversed the rebound observed in the previous month, while shipments to the rest of the world exhibited a negative performance.[5]

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



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

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

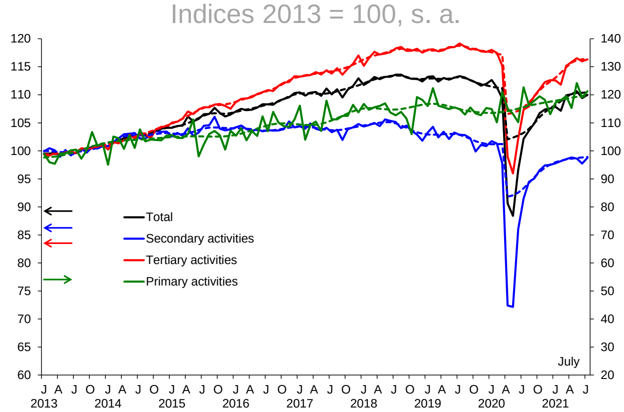


s. a. / Seasonally adjusted series and trend series based on data in nominal US dollars. The former is represented by a solid line and the latter by a dotted line.
Source: Prepared by Banco de México with data from the Tax Administration Service (SAT, for its Spanish acronym), the Ministry of the Economy (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, after having recovered gradually in previous months, in June private consumption halted its pace of recovery, remaining below the level reported in February 2020. Consumption of imported goods continued its upward trend and that of domestic goods fell for the second consecutive month, while consumption of services continued to recover gradually. Meanwhile, in June, gross fixed investment accentuated the weakness it has exhibited in recent months. Investment in machinery and equipment fell for the third consecutive month, although it remained above the level observed in February 2020, while investment in construction showed an incipient downward trend.

As for production, in July industrial activity reversed the declines of May and June (Chart 14). During that month, the performance of industrial activity was driven by the manufacturing sector excluding transportation equipment, as the latter continued to be affected by the shortage of certain inputs. Both construction and mining exhibited weakness (Chart 15). In July, tertiary activities performed heterogeneously across its subsectors. In particular, there were increases in leisure and other services; commerce; temporary accommodation and food and beverage preparation services; and educational and health services. On the other hand, financial and real estate services; transportation and mass media information services; and professional, corporate and business support services registered declines. It should be noted that the decline in the latter occurred in the context of the transition to the new regime of outsourcing.

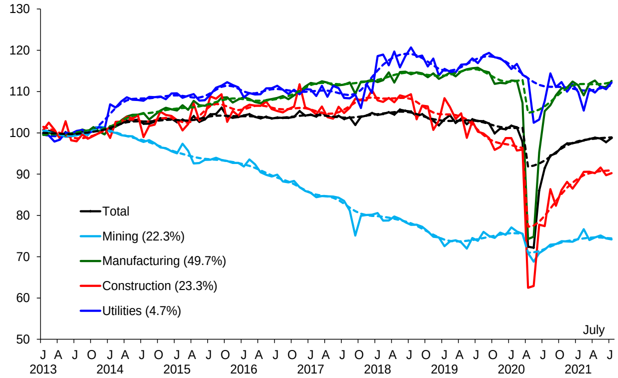
Chart 14
Global Indicator of Economic Activity
Indices 2013 = 100, s. a.



s. a. / Seasonally adjusted and trend series. The former is represented by a solid line and the latter by a dotted line.
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.

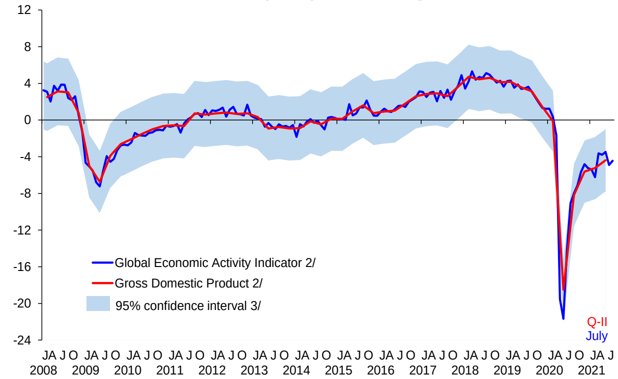
Chart 15
Industrial Activity [1/]
Indices 2013 = 100, s. a.



s. a. / Seasonally adjusted and trend series. The former is represented by a solid line and the latter by a dotted line.
1/ 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.

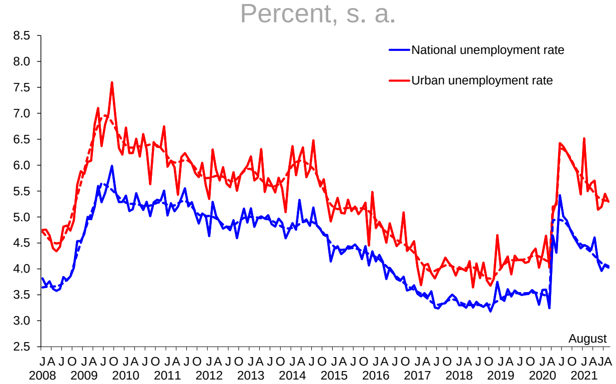
Regarding the economy's cyclical position, available information suggests that at the beginning of the third quarter of 2021 slack conditions for the economy as a whole remained wide (Chart 16) and with marked differences across sectors. In August, labor market indicators showed some weakness. In particular, the labor participation rate decreased at the margin and the employment to working-age population ratio remained at a similar level to that of the previous month, while the national unemployment rate was also similar to that of July and the urban unemployment rate decreased (Chart 17). In August, the number of new IMSS-insured jobs continued to recover, although it remained around 192 thousand jobs below pre-pandemic levels. Finally, in July, unit labor costs in the manufacturing sector were similar to those of previous months (Chart 18).

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



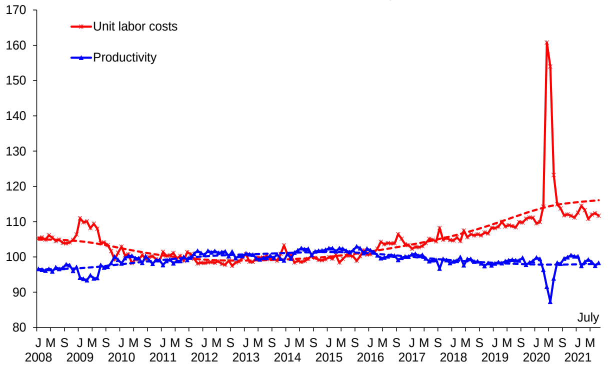
s. a. / Calculations based on seasonally adjusted figures.
1/ Output gap estimated with a tail-corrected Hodrick-Prescott filter; see Banco de México (2009), "Inflation Report, April-June 2009", p.74.
2/ GDP timely figures as of Q2 2021, and IGAE figures as of July 2021, in line with said timely figure.
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/
Indices 2013 = 100, s. a.



s. a. / Seasonally adjusted and trend series. The former is represented by a solid line and the latter by a dotted line.
1/ Productivity based on hours worked.
Source: Prepared by 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.

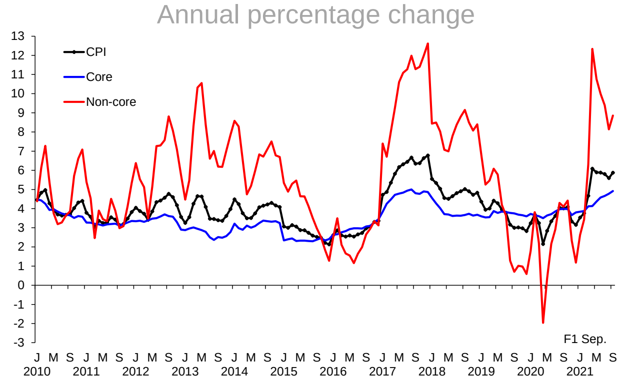
In July 2021, domestic financing to firms moderated its contraction in real terms at an annual rate. This is explained by a smaller reduction of bank lending to both large- and smaller-sized firms. It should be noted that the demand for corporate credit shows an incipient recovery at the margin, although it remains at low levels. Likewise, lending conditions for firms in general continued to be tight compared to the beginning of the pandemic, although they have not shown additional restrictions so far this year. Meanwhile, net corporate debt issuance in the domestic market continued to show low dynamism, extending the lackluster behavior that has been present since the first quarter of the year. In terms of credit to households, the housing portfolio continued to grow with dynamism. In turn, banks' current consumer loan portfolio reduced its contraction at an annual rate for the fourth consecutive month, mainly due to a greater dynamism, at the margin, of payroll loans. This, in a context characterized by a gradual recovery of household demand for credit and lending conditions that have not tightened further.

Interest rates of bank credit to firms have followed the dynamic of the bank funding rate. Intermediation margins in general decreased, nearing pre-pandemic levels. At the same time, mortgage interest rates remained at levels around their historic lows. In June, credit card interest rates were similar to those observed during the first quarter of the year, while personal credit rates fell slightly. Thus, consumer credit intermediation margins remained at levels higher than pre-pandemic ones. With respect to portfolio quality, the corporate loan delinquency rate declined in July and remained at low levels. The mortgage loan delinquency rate also declined, after having followed a moderate upward trend since November 2020, and also remains at low levels. In spite of having declined for the fifth consecutive month, consumer portfolio delinquency rates remain at high levels.

A.2.3. Development of inflation and inflation outlook

Between July and the first fortnight of September 2021, core inflation continued to increase, while non-core inflation decreased. Annual headline inflation remained at a high level, increasing from 5.81 to 5.87% between the abovementioned dates (Chart 19 and Table 1). The increase in core inflation reflects the fact that it continues to be influenced by pandemic-related shocks that have affected the supply chains and production processes of various goods and services. The decrease in non-core inflation was associated with lower energy inflation, as a result of the reduction in LP gas prices in August due to the introduction of the price cap policy.

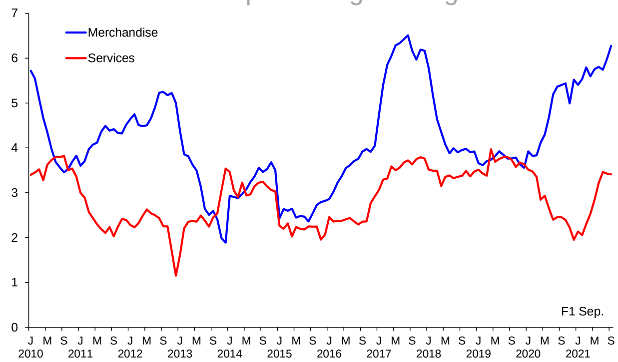
Chart 19
Consumer Price Index
Annual percentage change



Source: Banco de México and INEGI.

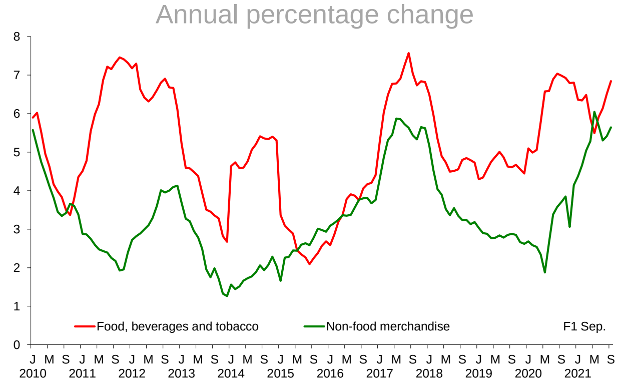
Annual core inflation increased from 4.66 to 4.92% between July and the first fortnight of September 2021. Within it, the annual variation of merchandise prices rose from 5.74 to 6.27%, reflecting the higher production costs that several productive processes face due to pandemic-related shocks (Chart 20). In particular, annual food merchandise inflation rose from 6.14 to 6.84% during this period, while non-food merchandise inflation increased from 5.30 to 5.64% (Chart 21). During the referred period, annual inflation of services remained relatively stable, registering levels of 3.46 and 3.41%, respectively. As for its components, annual inflation of services other than education and housing fell from 5.17 to 4.74% between those dates, while housing and education inflation increased, albeit from low levels, the former from 2.09 to 2.25% and the latter from 1.23 to 2.04%.

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



Source: Banco de México and INEGI.

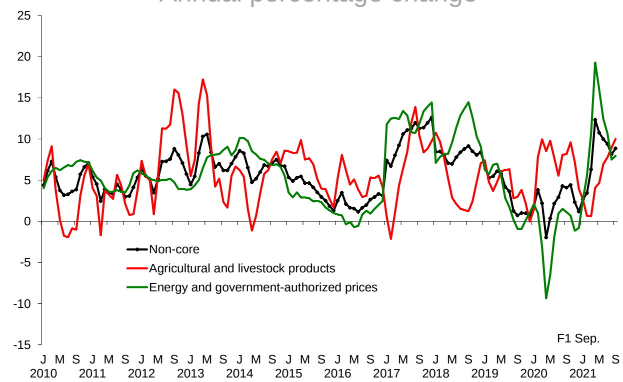
Chart 21
Merchandise Core Price Sub-index
Annual percentage change



Source: Banco de México and INEGI.

Between July and the first fortnight of September 2021, annual non-core inflation fell from 9.39 to 8.86% (Chart 22 and Table 1). This result was due to the decrease from 34.97 to 17.61% in the annual variation of LP gas prices, as a result of the aforementioned price cap policy. This was partially offset by the 7.77 to 10.01% increase in the annual inflation of agricultural and livestock products, mainly due to the higher annual variation of fruit and vegetable prices.

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



Source: Banco de México and INEGI.

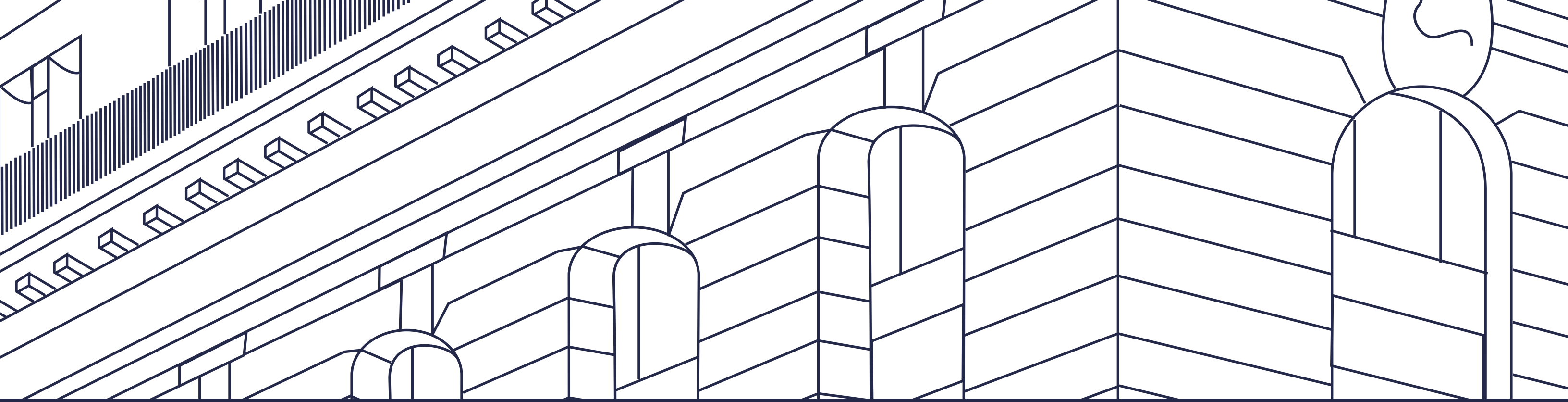
As for inflation expectations drawn from Banco de México's Survey among Private Sector Forecasters, between July and August, the median of expected headline inflation for the end of 2021 increased from 6.00 to 6.05%, while that corresponding to the core component went from 4.66 to 4.90%. Medians of expectations for the end of 2022 were adjusted from 3.67 to 3.75% for headline inflation and from 3.68 to 3.70% for core inflation. 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 registered a moderate average increase and remained at high levels, reflecting the behavior of both inflation expectations and the inflation risk premium.

Considering the nature of the shocks that have affected headline and core inflation, the corresponding forecasts were revised upwards compared to those previously released, and the larger increases correspond to the short term. Annual headline and core inflation projections are expected to decrease, particularly for one year and beyond, and to converge to the 3% target by the end of the forecast horizon. 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) a widening of the negative output gap; ii) greater 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	July 2021	August 2021	1st fortnight Sep. 2021
CPI	**5.81**	**5.59**	**5.87**
Core	**4.66**	**4.78**	**4.92**
Merchandise	**5.74**	**5.99**	**6.27**
Food, beverages and tobacco	6.14	6.51	6.84
Non-food merchandise	5.30	5.41	5.64
Services	**3.46**	**3.43**	**3.41**
Housing	2.09	2.17	2.25
Education (tuitions)	1.23	1.92	2.04
Other services	5.17	4.87	4.74
Non-core	**9.39**	**8.14**	**8.86**
Agricultural and livestock products	**7.77**	**8.95**	**10.01**
Fruits and vegetables	4.99	5.94	8.70
Livestock products	10.08	11.54	11.15
Energy and government-authorized prices	**10.67**	**7.50**	**7.95**
Energy products	14.41	10.07	10.77
Government-authorized prices	2.57	1.99	1.89

Source:INEGI.



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