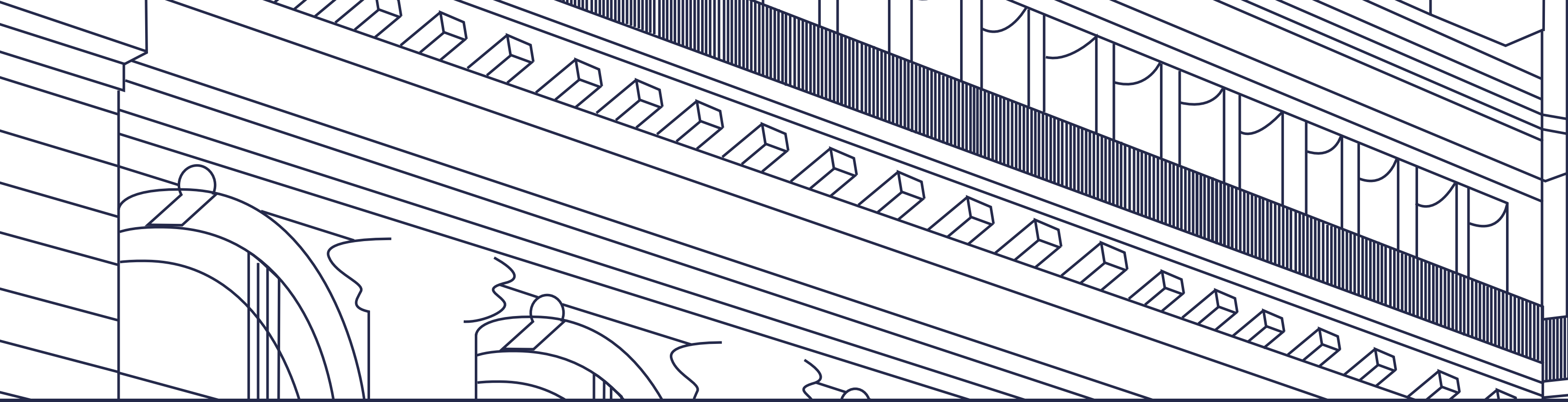

BANCO DE MÉXICO®

Minutes number 81

Meeting of Banco de México's Governing Board on the occasion of the monetary policy decision announced on December 17, 2020

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: December 16, 2020.

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

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

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

International environment

Most members mentioned that global economic activity has been recovering, although heterogeneously among countries and sectors. Some members noted that it is still below pre-pandemic levels. They pointed out that the differences in the recovery are partly associated with the implemented policies. In this regard, **one** member noted that consumption and investment have recovered more in economies that have implemented significant relief measures.

The majority of members highlighted the increase in COVID-19 infections in advanced economies. They noted that, in this context, growth forecasts for the next few quarters have been revised downwards. One member indicated that confidence indicators have deteriorated as a result of the implementation of new lockdown measures. **Another** member considered that the recovery has continued and that growth forecasts for 2020 and 2021 have improved compared to those of last June. He/she stated that advanced economies' forecasts have increased for the second half of 2021 in light of expectations that vaccination will allow for a greater control of the pandemic. **One** member noted that the slowdown in advanced economies will have a negative impact on global activity, with longer-lasting effects.

Most members highlighted the risks for global economic growth associated with the evolution of the pandemic and with vaccine production and distribution. One member mentioned that the start of the vaccination phase in the United Kingdom and the United States could help reactivate consumer confidence and support the recovery. **Another** member noted that while several vaccines are expected to complete their testing stages in the short term, it is not yet possible to dispel doubts about their effectiveness nor to rule out potential errors in their implementation. **Most members added as a risk that fiscal stimuli turn out to be insufficient to support the recovery. One** member stated that recent announcements and decisions by various authorities have contributed to diminish the perception of risks derived from an early withdrawal of relief measures. **Another** member highlighted the obstacles in the Brexit process, the unsustainability of public and corporate debts, as well as the possibility of a bubble in the prices of technology firms' equity. **Some** members stated that the balance of risks to global growth remains biased to the downside. **One** member considered that the environment for the recovery is uncertain, with a better outlook in the medium term.

The majority of members mentioned that inflation in advanced economies remains below their central banks' targets. One member stated that a recomposition of relative prices, with increases in those of certain merchandises and decreases in those of services, has been observed. He/she highlighted the marked volatility in energy prices in the face of changes in the outlook for economic recovery. He/she pointed out that in the United States food inflation has increased significantly and services inflation has decreased considerably. He/she added that in the euro area lower food inflation and the weakness in services prices have been reflected in headline and core inflation levels close to zero. He/she also noted that in Japan headline and core inflation are markedly negative. **Another** member pointed out that in some emerging economies upward pressures on inflation due to food price increases and exchange rate depreciations were observed. **One** member noted that the effects of lower global aggregate demand have been more significant in services as well as in some goods, such as clothing and footwear. He/she mentioned that global inflation forecasts remain low, although with a greater variability than a year ago.

All members mentioned that central banks of advanced economies reiterated their intention to maintain accommodative monetary policy stances for an extended period. Most members highlighted the possibility of further monetary stimuli. Some members stressed the Federal Reserve's decision to maintain its range for the federal funds rate at 0-0.25%. **One** member stated that given its new monetary policy strategy, it would take longer than before for this central bank to raise its interest rates. **Another** member noted that in its latest decision it committed to continue buying monthly Treasury bonds and mortgage-backed assets for an indefinite period, at the established minimum amounts. He/she added that the European Central Bank kept its reference rates unchanged and announced increases and extensions in its asset purchase programs and long-term refinancing facilities. **Most members noted that the fiscal authorities of several advanced economies also announced extensions to their relief programs. Some** members stated that the expectation of an additional fiscal stimulus package in the United States has gained strength.

Most members agreed that global financial markets have performed favorably, driven by progress in the development of vaccines against COVID-19. One member pointed out that the increase in commodity prices and the orderly resolution of the electoral process in the United States also contributed to the improved functioning of financial markets.

The majority of members highlighted the favorable performance of stock markets in the main economies, the depreciation of the US dollar against a broad basket of currencies and the lower risk aversion. One member stated that certain stock indexes have even reached record highs. He/she added that corporate bond spreads also declined. **Another** member explained that the lower risk aversion has favorable implications for less secure assets such as those from emerging economies. **One** member added that the extension of monetary stimuli has increased the valuations of financial assets. **Another** member considered that going forward markets are expected to continue to perform favorably with the progress in the vaccination process, which could be consolidated starting in the second quarter of 2021.

Most members mentioned that financial markets of emerging economies also performed positively, highlighting the increase in capital inflows. Some members referred to the increase in inflows to equity instruments. **One** member pointed out that this result contrasts with the situation observed in previous months. **Another** member added that, despite this increase, significant contractions continue to be registered in cumulative flows during the year. **One** member pointed out that capital inflows have had a positive impact on currency prices, stock market indexes and interest rates in emerging economies. **Another** member noted that the current environment has been favorable for assets from these economies, although there have been episodes of volatility.

The majority of members considered that international financial markets are subject to several risks, with those already mentioned for global activity standing out. One member added that neither external nor idiosyncratic risks can be ruled out, which, if materialized, could have a significant impact on emerging economies.

Economic activity in Mexico

All members highlighted that, after the recovery of the third quarter, economic activity in Mexico continued to improve at the beginning of the fourth. Most members indicated that activity remains below pre-pandemic levels and that the pace of recovery has moderated. One member added that it is difficult to make an accurate assessment of the evolution of activity during the fourth quarter, due to the limited information available and the uncertainty associated with the pandemic.

All members noted that external demand has shown greater dynamism. Most members pointed out that during October, exports, especially manufactures, exceeded pre-pandemic levels. One member stated that consumption of imported goods registered an annual variation of -19% in September and that imports of oil-related consumer goods contracted by 44% in October. **Some** members mentioned that the recovery in exports and the marked weakness in imports have led to a trade balance surplus.

Most members noted that consumption and investment continue to show a lackluster performance. Some members highlighted the 16% annual contraction in investment in September. **One** member pointed out that investment is the weakest component of aggregate demand, underlining the sluggishness of construction. **Another** member added that investment was already weak prior to the pandemic. He/she stated that the annual variation of private consumption was -11.4% in September and that of non-oil imports of consumer goods was -29.3% in October. He/she highlighted the strength of remittances, which are a determinant of consumption, and stated that from January to October they accumulate 33,564 million US dollars. **One** member mentioned that consumption of domestically produced goods has followed an upward trajectory since June, in contrast with the trajectory of consumption of imported goods. **Some** members emphasized the forecast of a slow recovery of consumption and investment. **One** member added that the vaccination phase will extend for a relatively long period and that it is subject to risks, and that for this reason it is difficult to anticipate a rapid rebound in consumption and investment. He/she mentioned that the situation is complicated by a complex external environment, potential obstacles to remittances in the coming months, the absence of fiscal support, and an unfavorable environment for investment.

On the supply side, most members highlighted the heterogeneity in the recovery of different sectors. They pointed out that manufacturing production has had the best performance, exhibiting levels close to those seen prior to the pandemic, while construction and services continue to show weakness. In that regard, **some** members noted that, after manufacturing production exhibited a significant annual contraction of 35.3% in April, this figure was 1.0% in October. They indicated that accommodation and food preparation services, transportation and information services, and recreation services have shown the greatest weakness. **One** member highlighted that industrial production fell at an annual rate of 29.4% in May and of only 3.1% in October. He/she added that in that month construction contracted 9.7% on an annual basis. **Another** member highlighted that the primary sector continued to grow.

The majority of members agreed that the labor market has continued to recover, although elements of weakness prevail. One member emphasized that the recovery has been slow, especially for women, and that pre-pandemic levels have not been reached yet. **Some** members highlighted the decline in the labor participation rate and the high levels of unemployment, underemployment and of the population not economically active but available to work. **One** member stated that the latter increased by 3 million between March and October of this year. **Another** member mentioned that between February and April formal and informal employment decreased by 12.5 million and that between May and October it increased by 9.7 million. **Some** members highlighted the increase in the rate of informal employment. **One** member pointed out that the informal sector of the labor market is the only one that records employment rates similar to those observed prior to the pandemic. He/she added that in October the number of people in formal employment was still 1.4 million lower than that recorded in March of this year.

Most members noted that the economic recovery will be gradual and prolonged. Some members highlighted the outlook for positive, albeit moderate, growth rates for 2021 and 2022. **One** member stated that, according to the most recent survey of private sector forecasters, growth expectations for 2020 remained at -9% and for 2021 they rose from 3.34% to 3.44%. **Another** member considered that economic activity could take several years to return to the level of the first quarter of 2019. He/she indicated that the vaccine does not change the outlook in the short term, since it is estimated that some groups could begin to be vaccinated until the middle of next year, so that the economic impact will continue for a considerable part of 2021. From a longer-term perspective, **some** members voiced concerns about the possible decline in potential growth. **One** member argued that potential growth will be affected by pre-pandemic developments in investment and total factor productivity, as well as by the impact of the health crisis on these variables. He/she added that for the period 2021-2030, the median of forecasters surveyed by Banco de México has recently set the expected average annual growth of the economy between 1.9 and 2%. He/she stated that, in the absence of policies to boost private investment and productivity, potential growth will be lower.

In view of the economic contraction and the expected recovery scenarios, most members agreed that ample slack conditions are foreseen throughout the time frame in which monetary policy operates. One member considered that given the impact on productive activity, the output gap will remain negative for a long period. **Another** member stated that slack conditions are anticipated to continue narrowing gradually. **One** member pointed out that the labor market continues to operate under ample slack conditions.

Most members mentioned that an environment of uncertainty and downward risks to economic activity persists. Some members warned that with the increase in the number of COVID-19 infections, additional social distancing measures may be implemented, which would affect the pace of recovery. **One** member mentioned that, although the vaccination campaign is about to begin, there is uncertainty about the process of acquiring and distributing vaccines, and about the latter's effectiveness. **Another** member emphasized that an improvement in the health situation and economic recovery, particularly in the United States, are key factors for the recovery of Mexico's economy. **One** member considered as risks to productive activity: i) volatility in financial markets, either due to reductions in risk appetite or idiosyncratic factors; ii) greater solvency problems of households and firms, and iii) an impact on public finances and its possible effect on the conditions of access to financial markets.

Inflation in Mexico

All members indicated that annual headline inflation fell between October and November due to a reduction in both its core and non-core components. One member noted that annual headline inflation in November was within its variability interval, with monthly inflation being at its lowest historical level for that month since 1970. **Another** member stated that headline inflation surprised in November by decreasing 76 basis points, from 4.09% in October to 3.33% in November. **Most members noted that inflation has suffered from the effects of the pandemic.**

All members emphasized the decline in core inflation between October and November, with the lower annual change in non-food merchandise prices standing out, mainly associated with the longer duration and greater intensity of discount sales during the "El Buen Fin" period. Some members added that the prices of services also decreased. **One** member considered that part of the success of "El Buen Fin" in managing to sustain a decline in prices for a long period has its origin in the weakness of aggregate demand, whose effect on prices materialized through this program. **Another** member pointed out that several factors could be influencing the decline in non-food merchandise prices. On the one hand, the weakness of demand could lead to a more persistent decline in prices. On the other hand, supply-related effects and a recomposition of spending towards merchandise would exert upward pressure on prices once the sales period ends.

Most members pointed out that the effect of "El Buen Fin" on prices is expected to be transitory. One member noted that the effect is likely to fade rapidly. **Another** member explained that compared to the second fortnight of October, the change in the prices of non-food merchandise, which were no longer on discount sale in the second half of November, shows that in about 80% of the cases the prices have already reached their original level or even a higher one. He/she emphasized that private sector analysts also anticipate a transitory effect, since, although their inflation expectations for 2020 were adjusted downwards, those for 2021 remained stable above the target. **One** member highlighted that food merchandise inflation remains at high levels, slightly below 7%. He/she pointed out that during the first half of December core inflation could be subject to additional pressures, which might make it reach levels near those registered in October. He/she stated that these adjustments might reflect the fact that towards the end of the year some supply-related pressures had been accumulated due to the effects of the pandemic, which had not been offset by the weakness of demand. He/she noted that this could be associated with the recomposition of household spending, which has intensified as a result of the pandemic, with higher spending on merchandise and lower spending on services. He/she argued that this is confirmed by the fact that annual merchandise inflation is much higher than that of services.

As for non-core inflation, **some** members mentioned that it fell, mainly due to the fall in the annual rates of change of fruits and vegetable and gasoline prices. **One** member pointed out that this component of inflation tends to be the most volatile and added that the annual rate of change of energy prices was negative.

Some members highlighted the importance of identifying whether the referred reduction in inflation will be transitory or more persistent. **One** member underlined that, despite the decline in headline inflation, core inflation was 3.66%, above the 3% target and close to its average since April 2018. **Another** member considered that the behavior of core inflation is not consistent with what is usually observed during the bottom stage of the business cycle, when all expenditure items are typically affected. He/she noted that, due to the nature of the pandemic and the social distancing measures, households have concentrated their expenditure mostly on merchandise and have significantly reduced their spending on services, which brings about additional uncertainty on the inflationary process.

Most members mentioned that headline inflation expectations for the end of 2020 were adjusted downwards and those for the medium and long terms remained stable at levels above the 3% target. One member pointed out that inflation expectations for the end of 2020 were adjusted significantly downwards to 3.5% in December. **Another** member stated that analysts expect inflation to end 2021 at 3.5%. **Some** members pointed out that the inflationary risk premium and inflation expectations drawn from market instruments also decreased in the last weeks. In this context, **one** member considered that inflation expectations remain anchored and under control.

Most members pointed out that the trajectories of both headline and core inflation for the next 12 to 24 months are expected to be around 3%. One member noted that this scenario assumes the gradual fading of supply pressures and greater effects of slack on headline and core inflation within the forecast horizon. **Some** members considered that headline inflation would end the year at levels below 3.5%. **Some** members highlighted that inflation forecasts indicate that the target would be attained in 2022. **One** member stated that the evolution of inflation in the following months will continue to be influenced by the impact of the pandemic on supply and demand, as well as by the behavior of the peso exchange rate, among other factors. **Another** member pointed out that a rise in inflation is anticipated mainly associated with a comparison base effect that would prevail until April 2021, while inflation would maintain its convergence to the 3% target during the second half of 2021. **One** member argued that fundamental inflation determinants, such as the exchange rate appreciation, the weakness of demand and low energy prices, exhibit a behavior that tends to favor price stability. He/she mentioned that the recent international events have dissipated factors of uncertainty and improved the balance of risks around the inflation forecast.

As for upward risks to inflation, most members highlighted possible episodes of exchange rate depreciation. One member mentioned that considering the historical trend of the exchange rate, there is a risk of a further depreciation of the peso, which would imply delaying the convergence of inflation to the target. **Another** member emphasized that a relatively stable evolution of the peso exchange rate, at levels similar to the current one, may be unfeasible given that the peso exchange rate may be affected by several factors, including a deterioration of the health situation, the election process next year, the challenges for public finances, the evolution of the sovereign rating, the high liquidity of the peso in international financial markets under a volatile environment, and the recent draft proposal of reforms to Banco de México’s Law. **Some** members added the risk posed by wage increases. **One** member argued that the adjustment to the minimum wage may be of such a magnitude as to complicate the convergence of inflation to the target during the time frame in which monetary policy operates. **Another** member added the risk of aggressive wage increases in 2021 possibly contributing to a deterioration of inflation expectations. He/she also noted the persistence of core inflation, despite the slack conditions. **One** member highlighted the risk of core inflation pressures stemming from the recomposition of spending towards merchandise, as well as several cost-related pressures on firms. **Another** member considered that, although core inflation still remains at relatively high levels, this should not be overestimated as this indicator is still reflecting the price dynamics of the most severe phase of the pandemic, when food and other merchandise prices increased significantly. He/she noted that the performance of this indicator can be expected to be more favorable once these price increases are undone, which would contribute to reduce headline and core inflation levels.

As for downward risks to inflation, **some** members highlighted an exchange rate appreciation and a greater than expected effect of the negative output gap. **One** member added greater social distancing measures or persistence in the decline in prices due to “El Buen Fin”, as well as lower inflationary pressures worldwide. **Another** member stated that recent international events have improved the balance of risks for inflation, as factors of uncertainty about the behavior of the exchange rate have dissipated.

Some members considered that the balance of risks around the projected trajectory of inflation remains uncertain. **One** of them noted that this is associated with the unprecedented shocks that have affected the economy this year and the opposing effects they have had on inflation. **Another** member pointed out that, although the current scenario is subject to both downward and upward risks, the balance is biased to the upside.

Macrofinancial environment

Most members noted that financial markets showed a favorable behavior partly due to greater risk appetite in international markets. One member highlighted the soundness of Mexico's macroeconomic fundamentals.

The majority of members mentioned that the stock market registered gains and noted that the Mexican peso appreciated. One member added that the peso has significantly reversed the depreciation it presented at the beginning of the pandemic. **Another** member pointed out that, although trading conditions have improved, they have still not returned to those observed prior to the pandemic. He/she added that, recently episodes of peso volatility, associated with the discussion regarding the reform to Banco de México's Law, were observed.

Most members noted that short-term interest rates exhibited moderate adjustments and long-term interest rates decreased. They mentioned that sovereign risk premia have shown reductions and are now at levels similar to those prior to the pandemic. One member added that long-term risk premia still remain above the levels observed one year ago. **Some** members pointed out that outflows in government securities have slowed and that foreign investor inflows have already been registered. **One** member noted that despite the above, accumulated outflows during the year amount to USD 18 billion (excluding USD 7 billion from Pemex's repo operations), which is the highest level recorded since at least 2013. He/she added that appetite for domestic instruments remains low. **Another** member warned that risk appetite in global financial markets remains fragile and prone to capital outflows.

The majority of members stated that risks to financial markets persist and further episodes of volatility cannot be ruled out, although **one** member mentioned that the balance of risks for financial markets has recently improved. **The majority considered that the proposed reform to Banco de México's Law may represent a risk for financial markets. Some** members added that it may exert pressure on the peso exchange rate.

Some members noted that the state of public finances is a risk factor. **One** member mentioned that the shortfall in budget revenues continued to widen due to lower tax and oil revenues. He/she added that the use of resources from the Budget Revenue Stabilization Fund (FEIP, for its acronym in Spanish) and the repurchase operation carried out by Pemex in November, reported as revenues, have allowed the fiscal balance to register a greater surplus than programmed. However, he/she argued that this does not reflect the risks of public finances adequately. He/she added that the resources of the FEIP will have been spent in 2021, which will exert more pressure on programmable spending. He/she noted that the fiscal balance could deteriorate in the event of increased spending pressures associated with the continuation of the pandemic and the materialization of a downgrade of sovereign credit ratings. **Another** member noted that some rating agencies affirmed the investment grade of the sovereign debt without changing its outlook, which reduces the possibility of the country losing its credit rating in the short term. He/she noted that the expected debt-to-GDP ratio for Mexico in the following years is below that of emerging countries with better credit ratings, and that a lower debt service in the future may set Mexico apart from other countries and increase the attractiveness of domestic assets. He/she added that fiscal discipline and responsibility are important in preserving macroeconomic fundamentals.

Some members expressed concerns about Pemex's financial situation. They mentioned that the possibility of this company requiring additional support may affect public finances. **One** member pointed out that the fall in its sales has led to an increase in its indebtedness with suppliers and to a contraction in investment. He/she added that Pemex accumulates significant under-spending in investment, which could affect future crude oil production in a context where it has registered figures below those expected. He/she stated that the cost of hedging against Pemex's default risk is higher than that for other oil companies with similar credit ratings, which reflects markets' perception about the risks stemming from the state-owned company's financial situation.

Most members mentioned that the evolution of financing to firms and consumers remains a cause of concern. Some members highlighted the reduction in credit to consumers and small- and medium-sized firms. **One** member noted that consumer credit via credit cards registered a real annual contraction of 12.5% in October, while credit to small- and medium-sized firms showed an annual fall of 6.3% in the same month, although its most recent monthly variation was slightly positive after having declined for seven consecutive months. **Another** member pointed out that financing to firms and consumers continued to fall for the fifth consecutive month. **Some** members noted that the contraction of credit in Mexico contrasts with that observed in other economies, with **one** member highlighting the cases of both advanced and emerging economies. **Another** member attributed this situation to the implementation of fiscal stimuli programs in several countries, while **one** member emphasized the lack of government guarantees for bank credit. **Another** member stated that the evolution of credit is determined by supply and demand factors. He/she pointed out that the level of commercial banks' deposits tends to boost the supply of credit, while business confidence influences demand. He/she added that, while it cannot be ruled out that demand factors play a part in the current situation, evidence from Banco de México's Survey on General Conditions and Standards in the Banking Credit Market (*EnBan,* for its acronym in Spanish) indicates that credit lines offered by commercial banks' have decreased and, thus, supply factors contributing to the contraction of credit cannot be minimized.

One member considered that public policies that incentivize the supply and demand of credit should be strengthened. He/she added that development banks must intensify their efforts, not only by expanding the credit they offer, but also by providing guarantees to debtors. He/she noted that these measures should aim at promoting investment and consumption, particularly of durable goods. He/she highlighted that it is necessary to maintain a responsible flexibilization that adjusts to the severity of the current situation, both to avoid imbalances and to promote greater credit flows.

Regarding financial stability, **another** member mentioned that, although the banking system maintains high capital levels, the continuation of the health emergency and the slow economic recovery may deteriorate its capitalization. He/she added that it is therefore important to monitor all warning signs, particularly regarding the deterioration of the credit portfolio. In this regard, he/she noted that the past-due portfolio increased in October, particularly in the credit card segment, due to the expiration in September of the special accounting criteria.

Some members highlighted that the current environment is not conducive to private investment. **One** member added that the outlook of uncertainty and economic expectations are conditions that do not incentivize investment. **Another** member mentioned the lack of fiscal support. **One** member argued that, in face of a complex environment, a sound and sustainable macroeconomic stance that promotes confidence and contributes to an orderly adjustment of financial markets and of the economy overall is essential. He/she emphasized the importance of maintaining sustainable public finances, a low and stable inflation, and a sound and well-capitalized financial system.

As to the recent initiative to amend Banco de México Law regarding the acquisition of foreign currency cash, most members agreed that it is positive that Congress, and in particular the Chamber of Deputies, decided to open a space for reflection regarding the proposal, with the objective of contributing to the process of analysis to find the best options for the solution of the issues and challenges raised. They highlighted that it is fundamental that the solution reached preserves Banco de México's autonomy and that it does not affect its operation. They pointed out that the risk that the Central Bank's balance sheet may become contaminated with resources of illicit origin must be avoided, as it would jeopardize the availability of international reserves and access to external financing sources, which could lead to macroeconomic and financial instability. One member mentioned that Banco de México has pointed out that it agrees with the benefits pursued by this proposal in regards to improving the circulation of foreign currency that enters our country as a result of legal activities. However, he/she underlined that efforts in this direction must preserve the constitutional autonomy granted to Banco de México and avoid jeopardizing its operation and the availability of international reserves. He/she argued that if the actions adopted in this regard address the above-mentioned risks, this would avoid introducing a considerable and unnecessary factor of uncertainty in Banco de México's functions and in the financial system's operations. **Another** member mentioned the comments by a rating agency stating that in case the proposal were approved in its actual terms, it would affect the Central Bank's autonomy along with the macroeconomic stability of the country. He/she added that this constitutes a risk for the Central Bank and for the national financial system.

Monetary Policy

Considering the impact on inflation, economic activity and financial markets, the inflation outlook and the uncertainty surrounding it, as well as the convenience of consolidating a downward trajectory of headline and core inflation towards the 3% target, most members agreed to maintain the target for the overnight interbank interest rate at 4.25%. Two members voted for lowering the target to 4.00%. **Most members agreed that the decision to leave the policy rate unchanged constitutes a pause which provides the necessary room to confirm the convergence of the inflation trajectory to its target.**

One member mentioned that, considering the pandemic-related supply, demand and financial shocks, monetary policy must contribute to maintain inflation at low levels and around its target, foster an orderly functioning of financial markets, financial system stability, and contribute to a sustained economic recovery. He/she noted that, to achieve these goals it is important that the yield curve follows an orderly behavior, given that the aggregate demand components respond to the different segments of the curve. He/she argued that an orderly and sustainable downward adjustment in this curve has benefits, especially considering the pandemic-related impacts, and contributes to a better response of aggregate demand and the financial system. He/she considered that, especially in emerging economies, medium- and long-term interest rates include various risk premia and that inflation must remain low and stable to lower inflationary risk premia throughout the yield curve. He/she stressed that for small open emerging economies, which need to complement their domestic savings with external sources of financing, it is important to maintain a stable macroeconomic environment, both to attract and to retain capital, and to have the financial conditions required for an orderly adjustment of the economy. In this regard, he/she highlighted that so far this year short- and long-term interest rates in Mexico have adjusted downwards significantly as compared to other emerging economies, which, despite having lower short-term interest rates, have been subject to pressures on long-term ones. He/she added that pandemic-related factors have made it more difficult to maintain low and stable risk premia in emerging economies, given that a deep economic contraction, lower public revenue, growing spending and capital outflow pressures were observed simultaneously. He/she pointed out that it is necessary to avoid taking measures that might jeopardize macroeconomic stability and soundness. In this context, he/she referred to the proposal seeking to modify Banco de México's Law which has been recently approved by the Mexican Senate. Finally, he/she considered that leaving the policy rate unchanged would allow to better identify the challenges and trade-offs faced by monetary policy, in an environment in which headline and core inflation have been pressured by opposing factors and have exhibited considerable volatility in their most recent figures, despite the sharp economic weakness. In addition, this room for maneuver would provide greater clarity over other significant risk factors that are affecting the Mexican economy.

Another member expressed that further extending the pause in the monetary easing cycle would allow to assess, based on incoming information, monetary policy's margin of maneuver and reinforce the credibility of the Central Bank's commitment to its primary mandate. He/she argued that extending the pause would allow to confirm if inflation, mainly its core component, has started a downward trend or whether November's data were atypical. He/she stated that the balance of risks for inflation remains uncertain and recalled that core inflation's resistance to decline has been observed for a long period, and that thus it is prudent to not anticipate conclusions, which could be counterproductive. He/she added that high risks that could generate volatility persist. He/she underlined that domestic risks have gained more relevance and could exert pressure on the exchange rate, which would further stress the monetary policy stance. In particular, regarding the proposal to amend Banco de México's Law, he/she mentioned that allowing more time to analyze the challenges associated with inflows of foreign currency cash to the country was a positive decision. He/she pointed out that, although there are risks associated with this legislative process, it is key to address said challenges without jeopardizing the Central Bank's autonomy, which has been a cornerstone of Mexico's macroeconomic stability and the main strength behind the country's credit profile. In addition, he/she emphasized that the weakening of public finances, Pemex's fragile situation, and the deterioration of the business environment worsen the concerns regarding country risk, and that the electoral process in 2021 could also lead to more volatility. For this reason, he/she stated that insofar as the exchange rate risk persists, a prudent monetary policy approach as the one followed should be maintained, in order to assess if there is a margin for a greater stimulus. Finally, he/she considered that the monetary policy statement should clearly communicate that the current monetary policy decision seeks to guarantee the downward trend of inflation to its target in the time frame in which monetary policy operates, and that a prudent and responsible monetary policy implementation is the best way to confirm the Central Bank's commitment to price stability.

One member pointed out that the decision in November to make a pause in monetary policy implementation had the objective of obtaining greater clarity regarding the future trajectory of inflation. He/she considered that the time elapsed has not been sufficient to achieve the above. First, he/she pointed out that there are no signs of a sustained reduction of inflationary pressures. Second, he/she added that upwards risks to inflation have intensified and that the most important one stems from the proposed reform to Banco de México's Law. He/she pointed out that recent experience shows its potential repercussions on the exchange rate, and that statistical exercises indicate that even moderate exchange rate depreciations can make inflation deviate from its target considerably. He/she stated that although the recent decision to provide a space for dialogue is welcome, the risks associated with the proposal would continue insofar as this initiative is not defined. In this context, he/she considered that a message of monetary policy easing would contradict the Central Bank's reasoning on the issue and, thus, would be detrimental for the institution. To the above he/she added the possible impact of an adjustment in the minimum wage on prices. Third, he/she underlined the risk of new volatility episodes in global financial markets, as well as risks derived from idiosyncratic factors, among which he/she highlighted the challenges to public finances, due in part to the possible need to provide additional support to Pemex, in view of the continuous deterioration of its financial situation. Fourth, he/she mentioned that the date of inflation's convergence to the target continues to be postponed, and that both analysts' inflation expectations and their incompatibility with the adjustments in the reference rate anticipated by many of them highlight the credibility challenges faced by the Central Bank. Regarding the future trajectory of the reference rate, he/she argued that the prevailing uncertainty does not allow for the provision of accurate forward guidance. He/she warned that messages of such nature, or others that give the impression that monetary policy is focused on goals different from inflation, such as stimulating growth, would generate confusion in the markets and would accentuate the credibility challenges. In this regard, he/she underlined the importance of pointing out that monetary policy will be implemented in a prudent manner, with pragmatism and flexibility, based on incoming information in each meeting, with the goal of attaining the convergence of inflation to its target within the period of monetary policy influence.

Another member pointed out that the recent decline in inflation, the favorable evolution of its determinants and the improvement in the balance of risks provide additional room to continue with the monetary easing cycle. He/she claimed that the need for a greater easing is attributed to a number of factors. First, credit to households and firms continues contracting. An additional monetary easing would allow businesses to reduce financing costs and to improve credit granting conditions, which have recently deteriorated. He/she stated that, despite the low level of development of the financial system, when credit fluctuations are very pronounced, such as in the current juncture, their impact on aggregate activity is significant despite the fact that only a fraction of the economy operates with bank credit. Second, he/she mentioned that the ex-ante real interest rate in Mexico is still high as compared to other emerging economies. He/she pointed out that in many countries this rate has become negative, while in Mexico it remains positive. He/she added that although some countries which have lowered their policy rates more than Mexico, as is the case of Brazil and South Africa, show high long-term rates, this derives from the fact that their sovereign risk is higher than Mexico's. Other countries with lower sovereign risk, such as Chile, Peru and, to a lesser extent, Colombia, have managed to cut their short-term interest rates, while maintaining long-term rates at low levels. He/she noted that the current level of sovereign risk in Mexico provides an opportunity to continue easing monetary policy and to affect the entire yield curve. Third, he/she mentioned that the macroeconomic outlook in Mexico is characterized by the typical symptoms of economies conducting a very tight monetary policy. As the first symptom, he/she underlined the poor performance of demand components that are more sensitive to interest rates, such as consumption with credit cards and investment. As an additional symptom, he/she mentioned the contrast between the dynamism of the external sector, which does not directly respond to the domestic interest rate, and the less dynamic performance of the domestic economy, which does depend on said rate. He/she considered that the current account surplus is also associated with a tight monetary policy, which encourages saving and discourages investment. He/she warned that, maintaining the real interest rate high, in a context of weak aggregate demand, incurs the risk of falling into a long and deep recession, and that it can even affect potential growth. Finally, he/she considered that the cycle of reductions cannot end and that it is urgent to restart it once there are opportunities, as in the case of the current juncture, that allow the provision of support to the economy without jeopardizing the Central Bank's primary objective of price stability.

One member considered that since the last policy decision inflation has performed favorably, the Mexican peso has appreciated and sovereign risk, measured with Credit Default Swaps (CDS), has decreased to pre-pandemic levels. He/she mentioned that meanwhile, economic activity continues exhibiting a clear bias to the downside, to such a degree that a historic surplus of 6.7% of GDP was recorded in the current account in the third quarter. He/she cautioned that the vaccine against COVID-19 will not prevent the scenario of a weak recovery in the short term. He/she added that, in view of fiscal austerity, monetary policy is the only countercyclical instrument. He/she emphasized that, based on the monetary policy stance, there is still room to adopt a more expansionary effort, given that the neutral rate is lower considering the sharp fall of economic activity. He/she added that, if the impacts that limit investment are not addressed, irreversible structural damage will be done to future generations. Given the expectation of a fragile, difficult and prolonged economic recovery, it is necessary to adopt, as practically in the rest of the world, a highly accommodative stance, and to point out that it will remain so for a long period. As a consequence, he/she stated that the Central Bank must continue with the cycle of lowering the reference rate, and with the complementary measures that have accompanied said cycle. He/she mentioned that given the described outlook and considering the lag with which monetary policy operates, it is imperative to lower the reference rate. He/she added that, during the 2009 financial crisis, real interest rates remained very low, and even negative, which made the monetary stimulus compatible with a relative price stability. He/she noted that a lower real interest rate than that adopted at that time is necessary, given that the impact of the ongoing crisis on economic activity is much greater and the recovery is anticipated to be slower. He/she stated that temporary deviations of inflation, when following a foreseen trajectory, should not lead to an overreaction, given that upward pandemic-related distortions in inflation would need to dissipate over the following months. He/she emphasized that the level of interest rates should strengthen financing, without compromising financial stability. He/she noted that a low level of interest rates reduces the risk of default for variable-rate loans, which represent a significant fraction of credit granted to firms and improves renegotiation conditions of debtors. Likewise, it increases asset valuation, improving the balance sheet of financial institutions and businesses' guarantees to obtain loans. He/she underlined that one of the messages of the past Financial Stability Report is that a recovery of economic activity and employment contributes to reduce the rate of default on credits, and that for this reason, monetary stimulus to the economy is currently compatible with financial stability. He/she indicated that a pause in the monetary easing cycle, when there is room to extend it, self-limits the monetary stimulus needed for the economic recovery. Consequently, it is necessary to continue lowering interest rates to strengthen the signal of the Central Bank's commitment. Considering the lag with which monetary policy operates, it is not appropriate to have expectations that the easing will stop for some time, but, on the contrary, that it will continue and will be maintained in the medium term until the economy shows a sustained improvement. In this way, households and businesses can mitigate the current uncertainty with the prevalence of lower costs of financing. He/she concluded that the final stage of the downward cycle depends on the moment when economic activity begins to significantly respond to the monetary stimulus. Similarly, the pace of the monetary easing cycle will have to consider the evolution of the risks to the inflationary outlook. He/she considered that currently it is possible to continue with the easing cycle, given that inflation is estimated to converge to its target and that multiple risks, both domestic and external, have been thoroughly assessed so as to be addressed efficiently. He/she stated that, at the present moment this opportunity should be taken to continue with a monetary stimulus consistent with price stability, given that any imbalance in the future could limit Banco de México's room for maneuver.

3. MONETARY POLICY DECISION

The risks for inflation, economic activity and financial markets pose major challenges for monetary policy and for the economy in general. Considering the mentioned forecasts for inflation, the uncertainty that surrounds them, as well as the convenience of consolidating a downward path for headline and core inflation towards the 3% target, with the presence of all its members, Banco de México's Governing Board decided by majority to maintain the target for the overnight interbank interest rate at 4.25%. Two members voted for lowering the rate to 4.00%. This pause provides the necessary room to confirm that the trajectory of inflation converges to the target.

Looking ahead, monetary policy implementation will depend on the evolution of the factors that have an incidence on headline and core inflation, on their foreseen trajectories within the forecast horizon, and on their expectations.

The Governing Board will take the necessary actions on the basis of incoming information in order for the policy rate to be consistent with the orderly and sustained convergence of headline inflation to Banco de México's target within the time frame in which monetary policy operates. In addition, it is imperative to safeguard the institutional framework, strengthen the macroeconomic fundamentals and adopt the necessary actions on both monetary and fiscal policy fronts, to enable a better adjustment of domestic financial markets and of the economy as a whole.

4. VOTING

Alejandro Díaz de León-Carrillo, Irene Espinosa-Cantellano and Javier Eduardo Guzmán-Calafell voted in favor of maintaining the target for the overnight interbank interest rate at 4.25%.

Gerardo Esquivel-Hernández and Jonathan Ernest Heath-Constable voted in favor of lowering the target for the overnight interbank interest rate to 4.00%.

5. VIEWPOINTS / DISSENTING VOTES

Vote. Gerardo Esquivel-Hernández

In November, annual inflation fell by 76 basis points in comparison with October (from 4.09 to 3.33%). Although this might be partially due to transitory factors, private sector forecasters anticipate annual inflation will end 2020 at 3.4%, an expectation that is certainly more favorable than that at the time of the previous monetary decision (3.95%). Looking ahead, inflation expectations remain stable, while the Central Bank's forecasts estimate inflation will near the target starting in the third quarter of 2021. Although core inflation remains relatively high, this is due to factors associated with the first stage of the lockdown, which are expected to fade by the second half of 2021. Considering the amount of slack in the economy, the high appreciation of the peso, the decline in country-risk perception, and forecasts on energy prices, no inflationary pressures are foreseen in the short term. For all of the above, and given that economic reactivation is expected to take place at a relatively slow pace, and that both consumption and domestic investment remain weak, I believe that it would have been more prudent on this occasion to resume the easing cycle and lower the interest rate target by 25 basis points.

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Vote. Jonathan Ernest Heath-Constable

My vote for a 25 basis-point reduction is a reiteration of my voting and viewpoint in the past monetary policy decision. The fundamental reason for my vote is that we face a fragile, difficult and prolonged recovery after a sharp fall in economic activity and its resultant negative impact on the labor market. In the last month, inflation has fallen considerably, the peso has significantly appreciated, and risk perception is close to levels observed prior to the onset of the pandemic. In addition, the inflation rate for the end of the year is anticipated to be very close to the Central Bank's point target, with it being imminent that many states will go back into lockdown due to an increase in the pandemic's levels of contagion. For this reason, I believe it is erroneous to continue with this pause, and to miss this window of opportunity to implement a more accommodative monetary policy, consistent with the economic crisis that we face and with the room to maneuver provided by the inflation outlook. To think that in this favorable context we need to pause to have more clarity on the risk factors does not adequately take into consideration the magnitude of the current crisis

ANNEX

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

A.1. External conditions

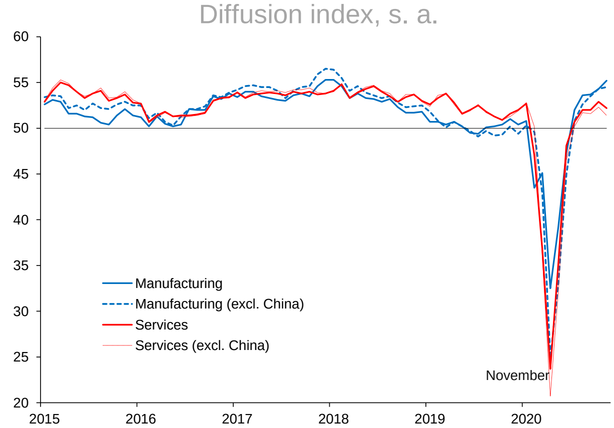
A.1.1. World economic activity

Available information for the fourth quarter suggests that world economic activity has continued to recover gradually, driven by the reopening of various productive activities and by household and business support programs. However, this recovery has taken place at a more moderate pace since July and in a more heterogeneous manner among countries and sectors (Chart 1). Regardless of the greater optimism generated by the approval, production and distribution of vaccines, the implementation of new lockdown measures due to the resurgence of COVID-19 cases in several countries has started to be reflected in mobility and household and business confidence indicators of some major advanced economies. The effects of this second wave of infections have varied depending on the evolution of the pandemic and on lockdown measures implemented in each country. Thus, the performance of economies still differs among sectors, with services being more affected than the industrial sector due to the new mobility restrictions. The behavior of inflation has also continued to be heterogeneous among countries, depending on both the magnitude and direction of the shocks stemming from the pandemic as well as on the idiosyncratic features in each country. In the main advanced economies inflation remained below their respective central banks' targets, while its behavior in most emerging economies continued to be heterogeneous.

In this environment, the main central banks kept their policy interest rates at historically low levels, continued to use their balance sheets to promote a proper functioning of financial markets and reiterated their intention to maintain an accommodative monetary policy stance for an extended period. Some of the main advanced economies announced new fiscal stimuli packages, while in other cases the negotiation processes have been extended. The monetary, financial and fiscal measures implemented in advanced economies, along with the progress in the development of vaccines to fight COVID-19 and expectations of a new fiscal stimuli package in the United States, favored a positive behavior of international financial markets.

In this context, the forecasts of private sector analysts and multilateral organizations continue to anticipate a strong contraction of the world economy in 2020 and a gradual recovery in 2021. However, higher-frequency forecasts among analysts point to a slight downward revision of estimated growth for the fourth quarter of 2020 and the first quarter of 2021, particularly in those countries that have implemented new lockdown measures in response to the upsurge of COVID-19 infections. In turn, progress in the approval, production and distribution of vaccines has been reflected in an upward revision of forecasters' expectations for the second half of 2021. These forecasts continue to be subject to a high degree of uncertainty associated with the evolution of the pandemic, the production and distribution of vaccines, the sufficiency of fiscal stimuli to support economic recovery, the possible intensification of social conflicts, and other tensions worldwide.

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



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

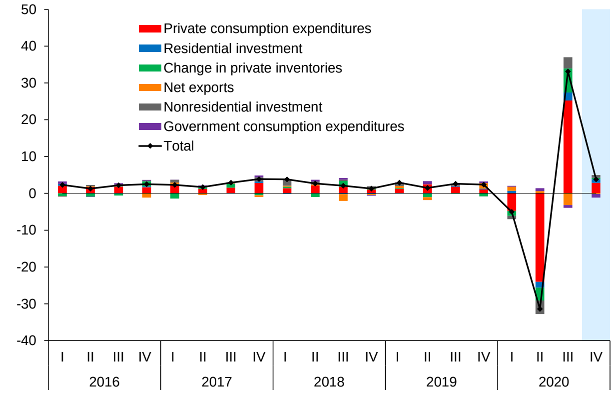
In the United States, available indicators suggest that the recovery of economic activity continued at the beginning of the fourth quarter, although at a more moderate pace, after registering a seasonally adjusted quarterly growth of 7.4% during the third quarter (Chart 2).[1] In particular, the rise in capital goods orders during October points to a continued recovery of investment in equipment, while the increase in housing starts and sales indicate a new rise in residential investment. Nevertheless, retail sales have decreased and consumer confidence indicators have moderated, reflecting the implementation of new lockdown measures. In this regard, there is certain uncertainty about the outlook for the US economy associated with the evolution of the pandemic, the possible imposition of additional social distancing measures, and the lack of consensus to approve a new fiscal stimuli package.

After having slightly contracted in September, US industrial production increased in October and November at an average monthly rate of 0.7%, reflecting an expansion in manufacturing activity. In turn, mining recovered in November, after having contracted in October due to a weather-related fall in oil and gas production. Electricity and gas generation contracted in November declined due to the unusually warm weather. As for Purchasing Managers' Indices of the manufacturing sector, they remained at high levels, suggesting continuous growth in this sector.

As to the US labor market, the unemployment rate continued to decrease from 6.9% in October to 6.7% in November, although this was mainly the result of a fall in the labor force. The pace of job creation in the non-farm sector moderated further, decreasing from 610,000 new jobs in October to 245,000 in November due to the imposition of new lockdown measures in some regions. Likewise, initial claims of unemployment remained at high levels.

In the euro area, some available data to the fourth quarter, such as consumer confidence indices, suggest a moderation in the pace of recovery of economic activity due to the re-imposition of social distancing measures in some countries. Likewise, the PMI of the services sector deteriorated sharply in November, remaining at contractionary levels. After several months of negotiations, the European leaders reached an agreement on the next long-term budget and a stimulus package for a total of €1.8 trillion.

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



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

In the United Kingdom, GDP grew at a seasonally adjusted quarterly rate of 15.5% in the third quarter, after having contracted 19.8% during the second. This behavior was driven by the lower dynamism of private consumption, business investment and, to a lower extent, public spending, in a context of easing lockdown measures. Some more timely indicators, such as retail sales, continued to recover in October, albeit at a slower pace. PMIs continued to deteriorate in November, suggesting a moderation of economic activity during the fourth quarter due to the increase of COVID-19 cases and the imposition of new social distancing measures. As to the labor market, the unemployment rate rose from 4.5% in August to 4.9% in October. Regarding negotiations of the trade agreement between the United Kingdom and the European Union, uncertainty persists as to the possibility that said agreement is reached before December 31, 2020.

In Japan, after having contracted for three consecutive quarters, GDP grew at a seasonally adjusted quarterly rate of 5.3% during the third quarter of the year. This result reflected the good performance of private consumption, which was driven by stimulus measures, along with the increase in net exports and public spending. Available consumption and investment indicators to the fourth quarter of the year, suggest that the recovery of economic activity continued in October and November, driven by the extension of some stimulus measures. However, the upsurge in COVID-19 infections and the reestablishment of certain restrictions may moderate the dynamism of

[1] In seasonally adjusted annualized terms, US GDP growth was 33.1% during the third quarter of the year.

economic activity in December. As to the labor market, the unemployment rate increased from 3.0% in September to 3.1% in October.

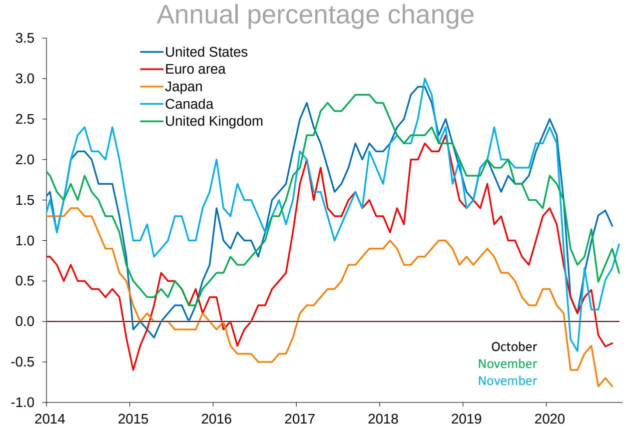
In emerging economies, the performance of economic activity has been heterogeneous, depending on the evolution of the pandemic, the extent and duration of the measures to contain it, the relative importance of the most affected economic sectors, and the stimulus measures implemented. In China, industrial production indicators, fixed investment and retail sales, continued to recover in October and November. The above mentioned, along with available information on foreign trade and PMIs for November, suggest that the economic recovery will continue during the fourth quarter of the year. As to Latin American economies, although some timely indicators to the fourth quarter point to certain recovery of economic activity in most of the region, the resurgence of COVID-19 cases and the imposition of new mobility restrictions in some countries suggest that the economic recovery may slow down.

International prices of commodities overall registered an upward behavior since México's previous monetary policy decision. In particular, oil prices were driven by progress in the development of vaccines against COVID-19, expectations that a new fiscal stimuli package is approved in the United States, and the agreement between the Organization of Petroleum Exporting Countries (OPEC) and other producers to increase oil production only by 500,000 barrels per day (bpd) for next year, which would bring total production cuts to around 7.2 million bpd in January 2021. Industrial metal prices maintained their upward trend due to the continued recovery of industrial production worldwide. Finally, grain prices exhibited a high volatility due to the changing weather conditions in the United States and Canada, registering a decrease in recent weeks after having increased in November.

A.1.2. Monetary policy and international financial markets

Inflation worldwide has been subject to various supply and demand shocks stemming from the evolution of the pandemic and the measures implemented to contain it. In this context, in recent months inflation has shown a heterogeneous behavior among countries, depending on both the magnitude and direction of shocks, as well as the idiosyncratic factors in each country. Thus, in the main advanced economies inflation continues to be below their respective central banks' targets (Chart 3). In this context, inflation expectations drawn from surveys on these economies have shown a greater dispersion and a certain reduction since the beginning of the pandemic, in general being below the levels registered at the beginning of the year. Expectations drawn from financial instruments somewhat recovered due to the reopening of economic activity, after having decreased significantly at the beginning of the pandemic. In emerging economies, inflation has fallen in some countries as a result of the effects of the pandemic on economic activity and the downward pressures on the prices of some services. Other countries have continued to be subject to upward pressures stemming largely from increases in food prices and the depreciation of their currencies.

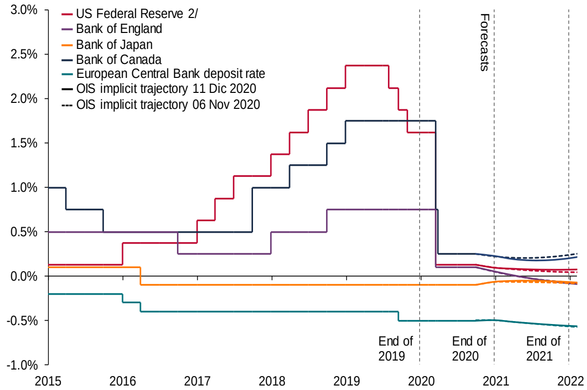
Chart 3
Selected Advanced Economies: Headline Inflation
Annual percentage change



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

Thus, the main central banks of advanced economies maintained their reference interest rates at historically low levels, continued to promote the orderly functioning of financial markets by using their balance sheets, and reiterated their intention to maintain an accommodative monetary policy stance for an extended period. In this regard, expectations drawn from market instruments continue to anticipate that these central banks will maintain highly accommodative monetary policy stances (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 the effective overnight reference rate.
** In the case of the US observed reference rate, the average interest rate of the federal funds target range is used (0.0% - 0.25%).
Source: Prepared by Banco de México with Bloomberg data.

Among the monetary policy decisions, the following stand out:

i) In its November meeting, the Federal Reserve left unchanged its range for the federal funds rate at 0%-0.25% and reiterated that it expects that it will be appropriate to maintain this range until labor market conditions have reached levels consistent with its maximum employment estimate and inflation has increased to 2% and is heading moderately to exceed the 2% target for some time. It also pointed out that it will continue to increase its holdings of Treasury bonds by at least USD 80 billion monthly and of agency mortgage-backed securities by at least USD 40 billion monthly until substantial progress has been made towards its maximum employment and price stability targets. Likewise, prior to its December meeting, it announced the extension until March 2021 of several lending facilities that were set to expire in the last days of 2020. This extension applies to the Commercial Paper Funding Facility, the Primary Dealer Credit Facility, the Money Market Mutual Fund Liquidity Facility and the Paycheck Protection Program Liquidity Facility. In this context, the medians of forecasts of the Federal Open Market Committee (FOMC) suggest that the reference rate will remain unchanged until 2023. Likewise, both market variables, as well as the analysts' consensus incorporate the expectations that the Fed will maintain its reference rate unchanged during 2020 and 2021.

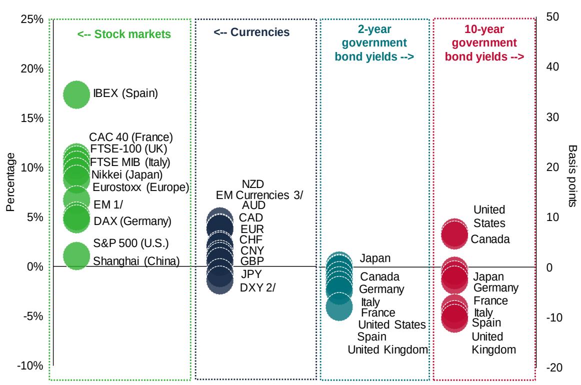
ii) In its December meeting, the European Central Bank (ECB) left its policy rates unchanged, maintaining its refinancing rate, key deposit facility rate and key lending facility rate at 0.0, -0.5 and -0.25%, respectively. It reiterated that these interest rates are expected to remain at or below their current levels until inflation forecasts converge strongly to a level sufficiently close but below the 2% inflation target, and that this convergence has been consistently reflected in core inflation dynamics. It also announced several measures to preserve favorable financial conditions during the pandemic. It increased the pandemic emergency purchase program (PEPP) by €500 billion to a total of €1,850 billion, extending its horizon until March 2022. It also extended the reinvestment of principal payments from maturing securities purchased under the PEPP until at least the end of 2023. Likewise, the ECB announced adjustments to the conditions of the third series of targeted longer-term refinancing operations (TLTRO III), extending to June 2022 the favorable financing conditions and conducting three additional operations between June and December 2021. In the same regard, it decided to offer four additional pandemic emergency longer-term refinancing operations (PELTROs) in 2021, and extended to June 2022 the duration of the set of collateral easing measures. The ECB also extended to March 2022 the swap lines and repo facilities for both the Eurosystem's central banks and those outside the euro area. The Governing Council pointed out that it is ready to adjust its instruments as appropriate to ensure that inflation moves to its target in a sustained manner, in line with its commitment to symmetry.

iii) In its December meeting, the Bank of Canada left its reference rate unchanged at 0.25%, reiterating that it will keep its reference interest rate at levels close to zero until the slack has been reduced, so that the 2% inflation target is reached in a sustained manner, which it expects to be achieved until 2023. It also kept its asset purchase program unchanged and announced that said program will continue until recovery is clearly underway and that it will adjust it as necessary to enable inflation to return to the target in a sustained manner.

Since Banco de México's previous monetary policy decision, most central banks of emerging economies left their reference interest rates unchanged, except for Turkey, which increased it, and the Philippines and Indonesia, which lowered them. Likewise, some central banks maintained several measures to provide credit, supply liquidity and foster the proper functioning of financial markets.

In the context of world economic activity described above, global financial markets exhibited a positive performance and less volatility. This was mostly due to the progress in the development of a vaccine against COVID-19 and the expectations of a new fiscal stimuli package in the United States, although the number of COVID-19 infections and the associated lockdown measures continued to increase in several countries. The financial assets of advanced economies thus exhibited positive adjustments and the main stock market indexes registered gains (Chart 5). In foreign exchange markets, the US dollar depreciated slightly against most developed countries' currencies and the interest rates of long-term government bonds exhibited relative stability. Emerging economies registered net capital inflows, both to fixed-income and equity assets. Their stock markets exhibited gains, while their currencies remained relatively stable in general, although with a slight depreciation bias (Chart 6).

Chart 5
Change in Selected Financial Indicators from November 6 to December 11, 2020
Percent, basis points



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

Chart 6
Emerging Economies: Financial Assets Performance from November 9 to December 11, 2020
Percent, basis points

Region	Country	Currencies	Equity markets	Interest rates 2Y	Interest rates 10Y	CDS
Latin America	Mexico	1.11%	9.73%	1	-33	3
	Brazil	5.66%	10.46%	-25	-41	-14
	Chile	3.07%	4.59%	12	25	-2
	Colombia	5.84%	12.42%	10	-2	0
Emerging Europe	Russia	4.19%	9.63%	22	19	0
	Poland	3.44%	8.64%	6	9	-2
	Turkey	3.12%	11.10%	-10	-5	-72
	Czech Republic	3.10%	8.13%	17	8	-2
	Hungary	3.80%	12.27%	-2	11	-3
Asia	Malaysia	1.44%	10.51%	13	7	1
	India	0.67%	8.22%	24	23	-7
	Philippines	0.14%	8.38%	-8	2	-1
	Thailand	1.82%	15.30%	-9	9	-3
	Indonesia	-0.11%	10.87%	-46	-34	-9
Africa	South Africa	1.65%	3.50%	52	10	-20

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

Looking ahead, the behavior of financial markets will depend on several factors, such as the evolution of the pandemic, the production and distribution of a vaccine, and the sufficiency of fiscal stimuli implemented to support the recovery of economic activity. Other additional risk factors include the high levels of public and private borrowing; an increase in the number of bankruptcies in the sectors most affected by the pandemic; geopolitical and social conflicts in different regions of the world; and the possible exit of the United Kingdom from the European Union without a trade agreement, among others.

A.2. Current situation of the Mexican economy

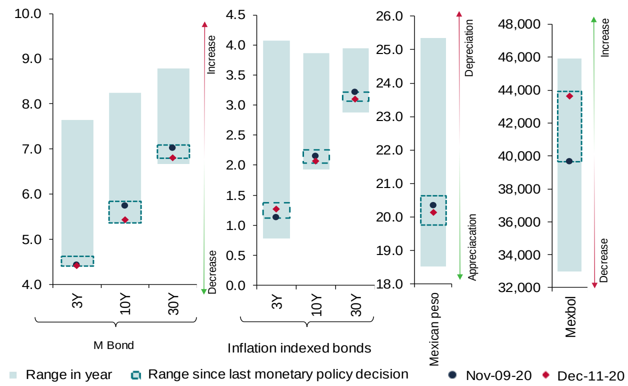
A.2.1. Mexican markets

Since Banco de Mexico's previous monetary policy decision to date, the prices of financial assets in Mexico exhibited a positive bias, in line with that observed in other emerging economies (Chart 7). This occurred in an environment of lower volatility, after the US election results, where expectations that developed countries' central banks will maintain an accommodative monetary policy stance for an extended period persist, and where a resurgence of COVID-19 cases in different regions was also observed. Despite the aforementioned, positive news regarding the effectiveness and distribution of vaccines and expectations about additional fiscal stimuli in the United States provided additional support to risk assets.

The Mexican peso traded in a range between 19.77 and 20.63 pesos per dollar, ending the period with an appreciation of 1.11% (Chart 8). This occurred in a context where both spot and forward trading conditions improved vis-à-vis the period of the previous monetary policy decision, although they remain deteriorated with respect to the levels prior to the pandemic.

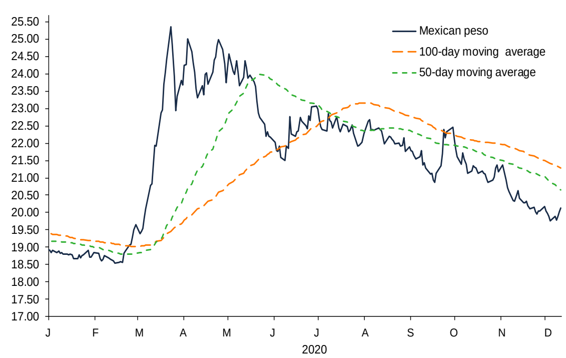
In this regard, in line with the swap line mechanism between Banco de México and the Federal Reserve established on March 19, on December 7 the Exchange Commission instructed Banco de México to renew maturities for a total of USD 3 billion, where the allocated amount totaled USD 1.13 billion.

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



Source: Prepared by Banco de México.

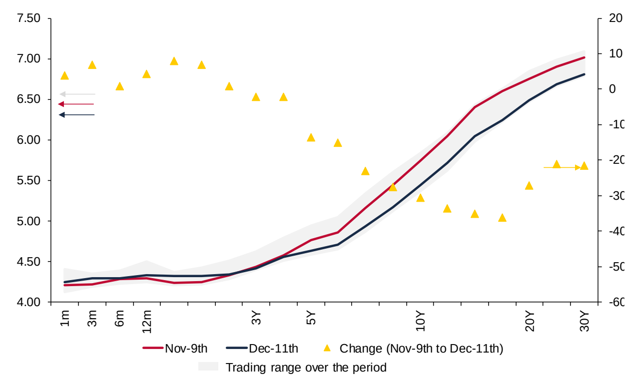
Chart 8
Mexican Peso Exchange Rate with Moving Averages
MXN/USD



Source: Prepared by Banco de México.

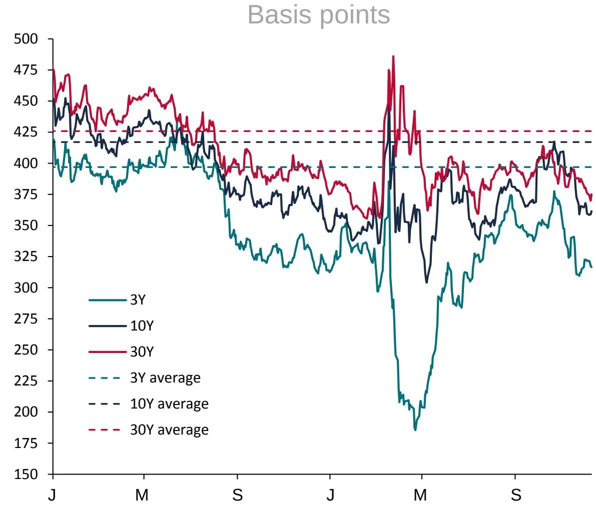
Interest rates of government securities exhibited moderate adjustments differentiated by term. In this regard, limited increases were observed for those in the short end of the yield curve, while significant reductions were observed in the medium and long-term nodes (Chart 9), which led to a reduction of the 3 year - 30 year spread. The yield curve of real-rate instruments exhibited a similar dynamic to that of nominal rates. In this context, breakeven inflation and inflation risk premia implicit in the spreads between nominal and real market instrument rates exhibited reductions vis-à-vis the monetary policy decision of November (Chart 10). It is worth noting that such adjustments took place in an environment where trading conditions improved with respect to the period of the previous monetary policy decision.

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



Source: PIP.

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

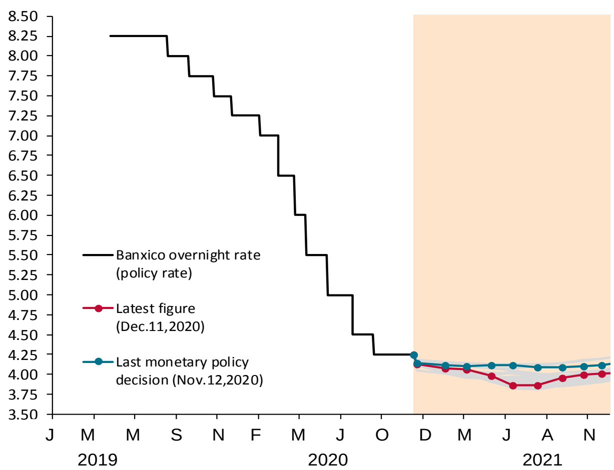


Source: PIP.

As to the measures announced by Banco de México in April, the first call for a collateralized financing facility for commercial banks with corporate loans to be channeled to micro, small- and medium-sized enterprises was published on December 4. This facility is for up to MXN $100 billion.

As to expectations regarding the path of the monetary policy target rate, information implied by the Interbank Equilibrium Interest Rate (TIIE, for its acronym in Spanish) swap curve discounts with a 52% probability that the target rate will remain unchanged for the monetary policy decision of December (Chart 11). Likewise, private sector forecasters surveyed by Citibanamex are also expecting that the reference interest rate will remain at 4.25%. For the end of 2020, market variables and the median of surveyed forecasters anticipate a level of 4.25%. Finally, for the end of 2021, market variables are anticipating a target level of 4.01%, while the median of private sector forecasters surveyed anticipates a level of 4.00%.

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



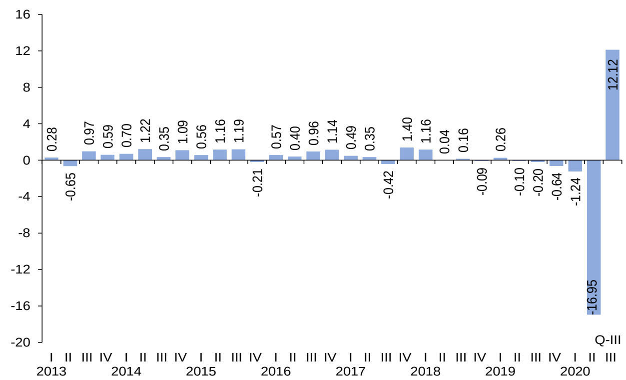
Source: Prepared by Banco de México with Bloomberg data.

A.2.2. Economic activity in Mexico

During the third quarter, economic activity began to recover from the severe impact of the COVID-19 pandemic during the second quarter (Chart 12). This behavior reflected a recovery of external demand, the reopening of several activities, and greater population mobility. Although information is limited, some available indicators suggest that after the recovery of the third quarter productive activity continued to improve at the beginning of the fourth quarter, although it still remains below the levels prior to the pandemic.

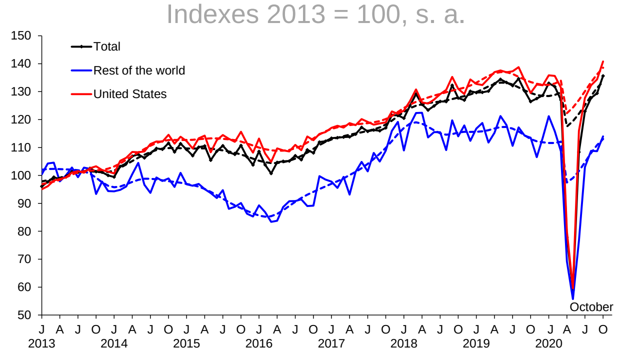
As for external demand, at the beginning of the fourth quarter exports continued to recover due to the favorable performance of both automotive exports and the rest of manufacturing exports, particularly to the United States.[2] Thus, exports reached levels above those registered prior to the health emergency (Chart 13).

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
Indexes 2013 = 100, s. a.



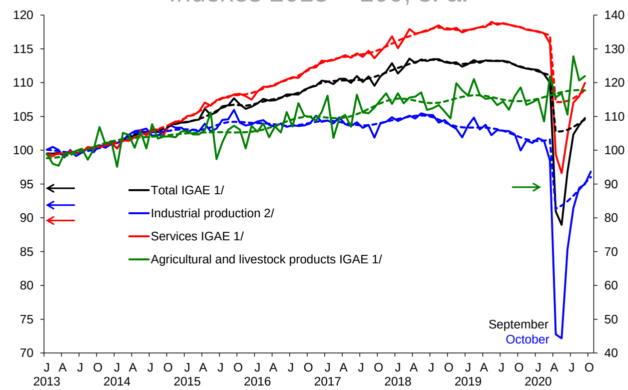
s. a. / Seasonally adjusted series and trend series based on data in nominal US dollars. The former is represented by a solid line and the latter by a dotted line.
Source: Prepared by Banco de México with data from the Tax Administration Service (SAT, for its Spanish acronym), the Ministry of the Economy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

[2] 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 Spanish acronym), given that the latter represents the value added, measured in constant pesos.

According to its monthly indicator, private consumption continued to recover gradually in September, although it remains below the levels prior to the health emergency. This behavior reflected a slow reactivation of consumption of both domestic goods and services, while the item of imported goods and services slowed the progress achieved in previous months. Timely indicators suggest that this indicator had continued to improve at the beginning of the fourth quarter. In particular, in October and November the slight improvement in sales of light vehicles continued, while the National Association of Self-Service and Department Stores (*ANTAD*, for its acronym in Spanish) sales continued performing positively. It is worth noting that *ANTAD* sales were influenced by the *El Buen Fin* 2020 sales campaign, which lasted longer than on previous occasions. In September, gross fixed investment reversed partially the recovery it had exhibited between June and August and remained at levels well below those registered prior to the health emergency. Within this indicator, the rebound in construction observed in August was partially reversed, while the pace of recovery of investment in machinery and equipment slowed down markedly in August and September vis-à-vis the observed in June and July. Related indicators, such as capital imports, suggest that investment may slightly improve at the beginning of the fourth quarter.

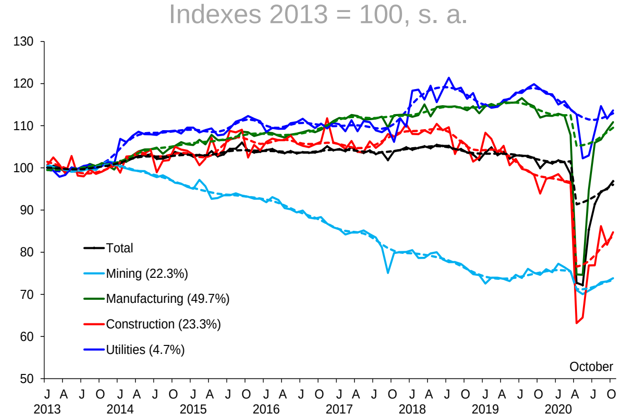
As for production, at the end of the third quarter and beginning of the fourth, productive activity continued to exhibit a gradual recovery (Chart 14). In particular, in September, most tertiary activities continued to recover, although with a significant heterogeneity as to their performance. Accommodation and food services; transportation, warehousing and information; and arts, entertainment, recreation and other services registered increases. In contrast, educational, health care and social assistance services slightly decreased. In October, industrial activity continued to improve, although it has still not regained its pre-pandemic level (Chart 15). Within it, manufacturing and mining continued to reactivate, although the latter followed a more moderate pace, while construction remains at low levels, despite the improvement observed during the month.

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



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

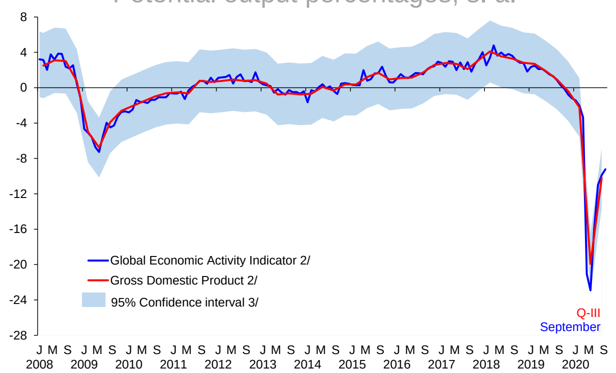
Chart 15
Industrial Activity Indicators [1/]
Indexes 2013 = 100, s. a.



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

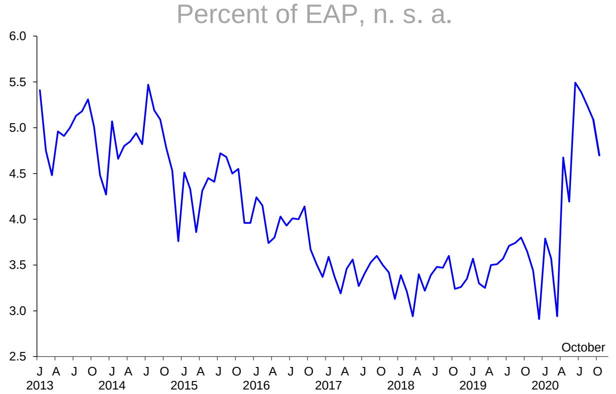
As to the economy's cyclical position, as a result of the gradual reactivation of productive activity and greater population mobility, the considerable widening of slack conditions observed in previous months reversed steadily throughout the third quarter (Chart 16). Slack conditions are anticipated to have remained significantly wide during the fourth quarter. According to the results of INEGI's latest National Survey on Occupation and Employment (*ENOE*, for its Spanish acronym), several labor market indicators continued to show a moderate improvement in October. In particular, labor participation continued to increase, while the underemployment rate decreased once again. In turn, both the national and urban unemployment rates continued to decrease at the margin, although they remain above the levels prior to the health contingency (Chart 17). The creation of IMSS-insured jobs continued to recover moderately, remaining in November at a level still below that reported in February. Finally, as a reflection of the recovery of production and hours worked, in September unit labor costs in the manufacturing sector accumulated five consecutive monthly reductions, remaining at levels slightly higher than those prior to the COVID-19 pandemic (Chart 18).

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



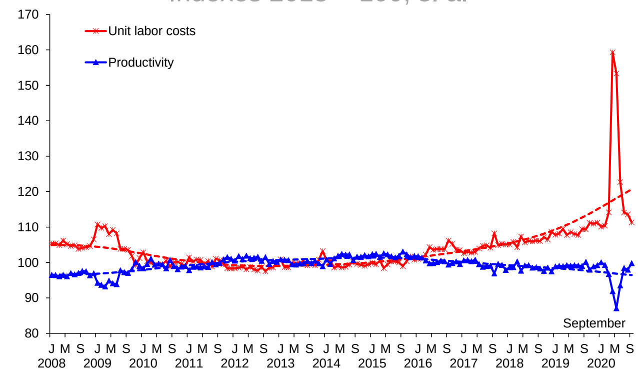
s. a. / Calculations based on seasonally adjusted figures.
1/ Output gap estimated with a tail-corrected Hodrick-Prescott filter; see Banco de México (2009), "Inflation Report (April-June 2009)", p.74.
2/ GDP figure as of the third quarter of 2020; IGAE figure as of September 2020.
3/ Output gap confidence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

Chart 17
National Unemployment Rate
Percent of EAP, n. s. a.



n. s. a. / Not seasonally adjusted (original series).
Source: Prepared by Banco de México with data from ENOE, ETOE (from April to June 2020) and ENOE new edition (ENOE[N]) from July 2020 to date.

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



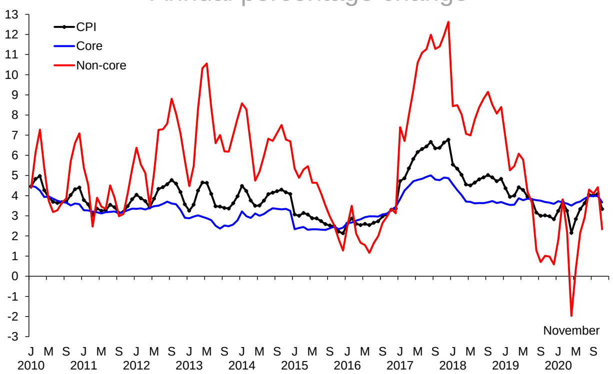
s. a. / Seasonally adjusted and trend series. The former is represented by a solid line and the latter by a dotted line.
1/ Productivity based on hours worked.
Source: Prepared by Banco de México with seasonally adjusted data of the Monthly Manufacturing Industry Survey and industrial activity indicators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

In October, domestic financing to firms contracted at an annual rate for the fifth consecutive month, extending the loss of dynamism that has been observed since May. This was mainly due to the reduction in bank lending to large firms, which have moderated their demand for this type of financing vis-à-vis what was observed at the beginning of the pandemic. In the domestic corporate market, the recovery in debt issuance continued in October, after the low levels of activity exhibited during the second quarter. Bank lending to smaller firms contracted further at an annual rate. As for credit to households, housing portfolio issuance continued to increase, although it remains below the levels observed prior to the pandemic. Consumer credit continued to contract. As to interest rates of bank credit to private firms, they decreased in October, while the margins of intermediation remained relatively stable. In October, interest rates of mortgages continued to decrease for the ninth consecutive month, while those of credit cards showed in August levels similar to those of June. As for portfolio quality, corporate and mortgage loan delinquency rates remained low, while those for consumption remained at high levels and even increased at the margin, after having decreased in previous months.

A.2.3. Development of inflation and inflation outlook

Annual headline inflation fell from 4.09 to 3.33% between October and November 2020. This reduction is explained by the lower levels of core inflation, which were considerably influenced by the effects of *El Buen Fin*, as well as by a significant reduction of non-core inflation (Chart 19 and Table **1**).

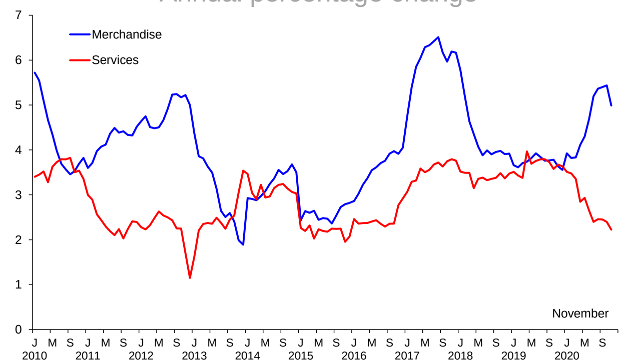
Chart 19
Consumer Price Index
Annual percentage change



Source: Prepared by Banco de México with INEGI data.

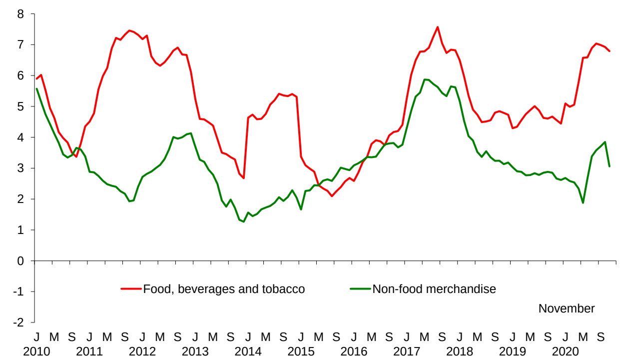
As for annual core inflation, it fell from 3.98 to 3.66% between October and November. Within it, inflation of merchandise prices decreased from 5.44 to 4.99% in that period (Chart 20 and Table 1). This result is largely associated with the sharp reduction of inflation of non-food merchandise prices from 3.85 to 3.06%, which was mainly due to the *El Buen Fin* discount sales. In 2020, this sales period lasted longer and registered greater intensity of discount sales, particularly in clothing, furniture, domestic appliances and entertainment devices. Inflation of food merchandise and services prices also decreased during the same period, although more moderately (Chart 21), from 6.93 to 6.79% and from 2.40 to 2.22%, respectively. In particular, inflation of services prices continues to reflect the effects associated with the measures to contain the COVID-19 pandemic, which have led to a reduction in the demand for several services, although the decline in prices during the above mentioned period was mainly due to the lower annual variations of tourist services prices.

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



Source: Prepared by Banco de México with INEGI data.

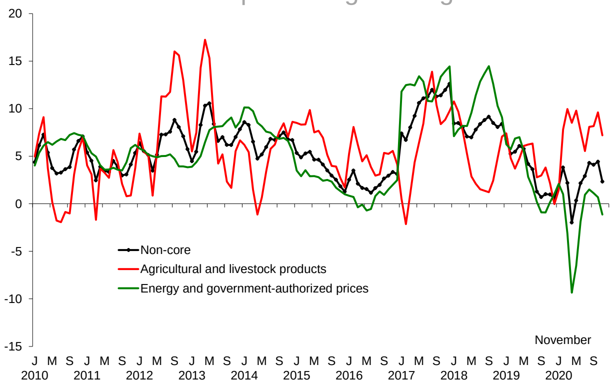
Chart 21
Merchandise Core Price Sub-index
Annual percentage change



Source: Prepared by Banco de México with INEGI data.

Between October and November, annual non-core inflation decreased from 4.42 to 2.33% (Chart 22 and Table **1**). This reduction is associated with the lower annual inflation of both energy and agricultural and livestock product prices. In particular, the annual inflation of energy prices fell from -0.71 to -3.05% during the same months, reflecting mostly the lower annual variation of gasoline prices. The annual inflation of agricultural and livestock product prices decreased from 9.61 to 7.20% during the same months, with the lower annual variations of fruit and vegetable prices standing out.

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



Source: Prepared by Banco de México with INEGI data.

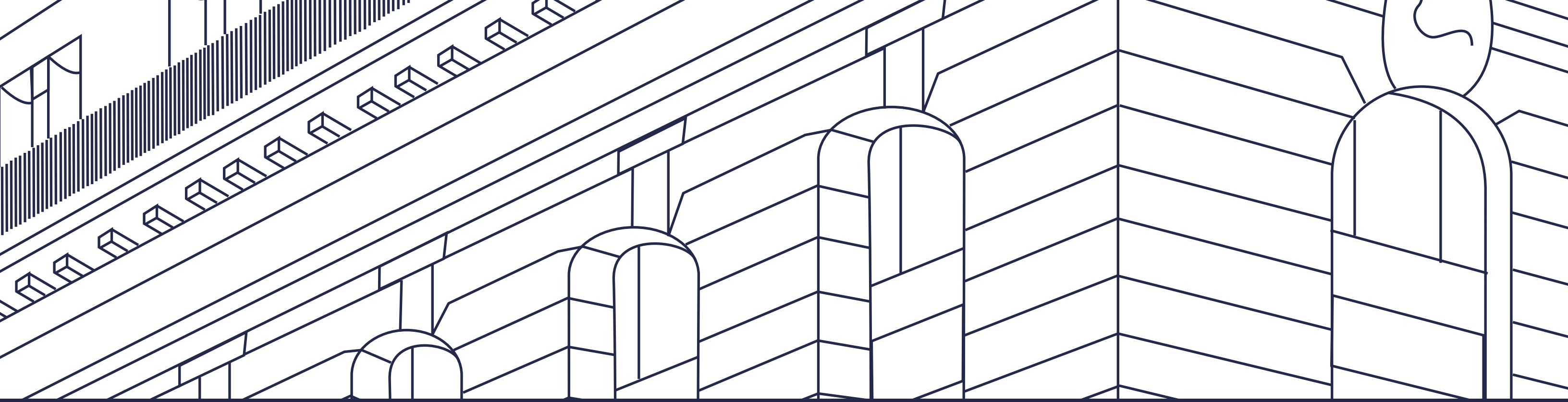
As for inflation expectations drawn from Banco de México's Survey of Private Sector Forecasters, between October and November, the medians for headline and core inflation at the end of 2020 decreased from 3.95 to 3.64% and from 3.92 to 3.78%, respectively. As to the medians for headline and core inflation for the end of 2021, they increased slightly from 3.58 to 3.60% and from 3.50 to 3.53%, respectively. The median for medium- and long-term expectations for both headline and core inflation remained at around 3.50%. Finally, breakeven inflation and inflation risk decreased since the last monetary policy decision.

The evolution of inflation is subject to short- and medium-term risks, among which the following stand out. To the downside: i) a greater-than-expected effect due to the negative output gap, greater social distancing measures or some persistence in the reduction in prices due to the *El Buen Fin* sales period; ii) lower inflationary pressures worldwide; and, iii) additional foreign exchange appreciation. To the upside: i) core inflation pressures generated by the recomposition of spending towards merchandise; ii) episodes of foreign exchange depreciation; and, iii) various cost-related pressures for firms. The balance of risks for the projected trajectory of inflation described above is uncertain.

Table 1
Consumer Price Index and Components
Annual percentage change

Item	September 2020	October 2020	November 2020
CPI	**4.01**	**4.09**	**3.33**
Core	**3.99**	**3.98**	**3.66**
Merchandise	**5.40**	**5.44**	**4.99**
Food, beverages and tobacco	6.99	6.93	6.79
Non-food merchandise	3.71	3.85	3.06
Services	**2.45**	**2.40**	**2.22**
Housing	2.20	2.12	2.09
Education (tuitions)	2.16	2.11	2.11
Other services	2.75	2.71	2.37
Non-core	**4.10**	**4.42**	**2.33**
Agricultural and livestock products	**8.16**	**9.61**	**7.20**
Fruits and vegetables	12.76	16.24	9.50
Livestock products	4.49	4.29	5.32
Energy and government-authorized prices	**1.11**	**0.68**	**-1.13**
Energy products	-0.39	-0.71	-3.05
Government-authorized prices	4.47	3.88	3.46

Source:INEGI.



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