BANCO DE MÉXICO®

Minutes number 79

Meeting of Banco de México's Governing Board on the occasion of the monetary policy decision announced on September 24, 2020

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FOREWARNING
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1. PLACE, DATE, AND PARTICIPANTS

1.1. Place: Meeting held by virtual means.

1.2. Date of Governing Board meeting: September 23, 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. Some members noted that in various advanced economies the recovery has been greater than expected. In this regard, **one** member highlighted the cases of the United States and, to a lower extent, the euro area.

The majority of members stated that the economic performance has been heterogeneous across economies and sectors, and that economic activity is still far from pre-pandemic levels. Some members pointed out that the heterogeneity in pandemic contention measures and stimulus policies has influenced the differentiated recovery across economies. **One** member added that the dynamics of the COVID-19 pandemic, the relative importance of the most affected sectors, the labor market flexibility, the strength of the macro-economy and public finances, as well as the adjustment and soundness of the financial system have also influenced these developments. **Another** member noted that, in aggregate terms, there was a greater dynamism of investment, production, and foreign trade, as well as a significant increase in private consumption. **One** member stated that the reopening of various sectors enabled a mild recovery of industrial production in advanced and emerging economies, while the recent behavior of consumption has responded to the stimulus measures adopted. He/she highlighted the cases of the United States and the euro area, where comparing the latest figures available with those at the end of 2019, consumption even increased. **Another** member emphasized the case of China, where industrial and capital goods' production, as well as exports, exceeded pre-pandemic levels. Regarding the labor markets, he/she noted that various countries exhibited a favorable performance, although the euro area and Japan registered a significant reduction of hours worked.

In this context of global economic recovery, most members pointed out that economic activity forecasts for 2020 have been adjusted upwards, while those for 2021 have been revised downwards. They mentioned that the world economy is subject to several risks, including those associated with the pandemic. Some members underlined the resurgence of infections in various countries. **One** member considered the possibility that lockdown measures could be extended or reestablished. He/she added that, although it is unlikely that these new measures would be as strict as in the early stages of the pandemic, they would imply significant costs for economic activity.

Another member noted that although the reopening of activities may prompt a turning point in economies, recovery in the medium term will be associated with the permanent effects of the pandemic on the most affected sectors, as well as with the strength and support of consumption and investment, and the dynamics of external demand. **One** member argued that economic policy actions will continue to be a key determinant of the trajectory of the world economy in the short, medium and long terms. He/she stated that the stimulus provided by central banks has been reinforced. As for fiscal policy, he/she pointed out that the materialization of continuing support may face greater restrictions due to the absence of room for maneuver and to political factors. He/she added that trade policy will be crucial for the international flows of goods and services and the reconfiguration of global value chains.

Most members mentioned that inflation in advanced economies remains below their central banks' targets. The abovementioned despite the increase in food merchandise inflation and the rebound of energy prices. One member pointed out that inflation in these economies has remained low due to the fall in aggregate demand. **Another** member stated that the monetary authorities of these countries anticipate that headline and core inflation will remain below their targets for an extended period. **Some** members underlined that in a large number of emerging economies inflation is also below target as a result of the impact on services and the weakness of demand. In this regard, **one** member stated that, despite the greater slack, in some emerging economies, increases in energy and food merchandise prices, as well as the exchange-rate depreciation, have led to positive deviations vis-à-vis their inflation targets.

Most members mentioned that the monetary authorities of advanced economies are expected to maintain accommodative stances for an extended period. Some members highlighted the asset purchase programs implemented by these authorities. **Regarding the Federal Reserve, the majority of members mentioned that in its September decision it maintained the range for the federal funds rate at 0-0.25%. Some** members noted that its projections indicate that the rate will remain in such range at least until the end of 2023. **The majority of members highlighted the announcement of a new monetary policy strategy that will maintain monetary stimulus until inflation is moderately above its 2% target. The majority also emphasized that this adjustment is due to the limitations faced by monetary policy to influence aggregate demand when the target rate is at the zero lower bound and inflation expectations remain persistently below the target. One** member recalled how the impossibility of having a sufficiently low real interest rate during the financial crisis of 2008-09 led to a slower-than-desirable recovery of the US economy. He/she argued that the restriction on real interest rates was due to a combination of low inflation and a zero lower bound on the federal funds rate. In this regard, he/she stated that introducing the possibility of inflation remaining above 2% for some time would allow for a greater reduction of real interest rates, and thus the Federal Reserve anticipates that it could now be able to provide a greater stimulus to the economy.

Some members added that the Federal Reserve also adopted a new definition of the full employment target, which will be used asymmetrically and respond only when employment is below maximum levels. **One** member pointed out that these adjustments are relevant due to the importance of the US dollar as a reserve currency and its role as a reference for investments in international financial markets, particularly in Mexico. He/she mentioned that, on the one hand, this strategy would delay interest rate increases until inflation is consolidated at levels above its target, thus decreasing expectations of short-term interest rates, and argued that this contributed to a depreciation of the US dollar after the strategy's announcement, which deepened after September's monetary policy decision. On the other hand, he/she considered that this new strategy introduces greater uncertainty about the future behavior of inflation, which may lead to higher inflation risk premia. In this regard, he/she noted that long-term interest rates increased slightly after the announcement.

Some members pointed out that other central banks are also considering adjusting their monetary policy frameworks. **Some** members mentioned that the Bank of England is evaluating the possibility of adopting negative interest rates. **One** member added that most central banks of emerging economies have also privileged fostering accommodative financial conditions by setting low real interest rates to strengthen the flow of credit. He/she mentioned that ten out of 14 emerging countries analyzed have a negative ex-ante real interest rate. He/she added that even countries with an inflation level above their targets have cut their real interest rate to levels close to zero or below, while in Mexico the ex-ante real interest rate remains at positive levels. He/she noted that expectations for the average reference interest rate in emerging economies for the end of 2020 are below 3%.

Most members agreed that global financial markets have shown a positive behavior in the last weeks, reflecting the effects of the measures implemented in advanced economies. One member added that the improvement in economic figures has also driven this behavior. **Some** members highlighted the generalized weakening of the US dollar against a broad group of currencies. **One** member underlined the narrow and mixed adjustments of interest rates and the steepening of the yield curve in the United States due to expectations of greater levels of inflation in the long term.

As for financial markets of emerging economies, **some** members highlighted that in an environment of lower risk aversion, there were capital flows to fixed-income assets. However, **one** member added that flows to equity assets continued to register negative balances, partly due to the recent adjustments to growth expectations of emerging economies. **Another** emphasized that markets have exhibited some improvement in recent weeks and added that, despite showing some volatility, various emerging market currencies have appreciated against the US dollar and risk premia have diminished. Nevertheless, he/she mentioned that financial conditions observed at the beginning of the year, in terms of risk premia and value of emerging market currencies against the US dollar, have not been attained yet. **One** member added that in an environment subject to risks, there were recent episodes of volatility, in which the exchange rates of emerging economies' currencies lost some of the ground gained during previous weeks. He/she added that these economies have faced lower commodity prices and negative impacts on other revenues, which led to downgrades and negative outlooks on sovereign ratings.

Most members considered that international financial markets are subject to several risks. In addition to those associated with the pandemic, they mentioned: i) the US election process; ii) the escalation of trade tensions; iii) political and geopolitical conflicts, and iv) a possible adjustment of the prices of some higher risk assets, such as the stocks of technology sector firms. In this context, **one** member mentioned that given these risks, although the external environment seems to be favorable, it is still a fragile equilibrium. **Another** member argued that emerging economies are particularly exposed due to their dependency on external financial conditions and to the idiosyncratic risks they face. **One** member added that the environment of economic weakness, uncertainty about the pandemic, lower public revenues and pressures on government spending, imply considerable challenges for emerging economies overall. He/she also highlighted that, in these economies, public sector's borrowing requirements have increased considerably and that they could face greater restrictions in domestic and international financial markets.

Economic activity in Mexico

All members highlighted that, after a deep contraction in April and May, economic activity in Mexico began to recover in June and July. One member noted that during the second quarter of 2020, GDP registered an annual fall of 18.7% using seasonally adjusted data, while **another** member added that it decreased 17.1% with respect to the first quarter of this year.

As for the supply side, most members highlighted the heterogeneity in the pace of recovery of different sectors. They pointed out that the industrial sector has exhibited the best performance, driven by manufactures, particularly automotive, while, in contrast, services continue to show weakness. One member explained that industrial production fell at an annual rate of 11.6% in July, a smaller decline than the 30.1% contraction registered in April. He/she added that construction has shown a slower recovery and contracted at an annual rate of 23.7% in July. He/she stated that services remain weak, particularly those related to accommodation, which contracted at an annual rate of 28.6% in June, and arts, entertainment and recreation and food services, which fell 68.8%. **Another** member mentioned that the tertiary sector is expected to recover at a slower pace than the secondary sector as long as all activities are not fully reopened.

As for the demand side, most members agreed that its recovery has been driven by the external sector. Some members underlined that exports started to increase in June. **One** member stated that, compared to December 2019, exports rose from 60.4% in April to 92.1% in July. **Another** member stated that exports are expected to be the driving force behind demand.

Most members highlighted that consumption and investment remain sluggish. One member added that the behavior of imports, consumption and investment points to a slow recovery of domestic demand. **Another** member highlighted the sharp fall in consumption in April and its recovery in June and July, although he/she underlined that it continues to be far below the level observed at the end of 2019, which contrasts with the recovery of this aggregate in some advanced economies that have implemented economic relief programs. **One** member pointed out that, in August, several consumption indicators registered levels close to those prior to the pandemic, while other indicators, such as credit card purchases or domestic car sales, remain deteriorated. **Another** member mentioned that remittances, which are a determinant of consumption, continue increasing, although with heterogeneity among sender and receiver states. **One** member highlighted that investment has not shown signs of recovery and that its weakness can be seen in the figures of the second quarter and in the timely indicators of construction and capital goods imports. **Another** member underlined that investment is facing the effects associated with the pandemic and that, as a result, in April it contracted at an annual rate of 38.2%, and in June it registered a level 25.2% lower than that of the previous year, as well as an environment unfavorable for investment, as stands out in the results drawn from business opinion surveys.

All members underlined the large impact on the labor market, although **one** of them highlighted that said market has started to normalize gradually. **Most members pointed out that the underemployment rate, unemployment rate and the rate of workers who are not part of the labor force but who are available to work, remain at high levels. Some** members pointed out that the unemployment rate rose from 2.9% in March to 5.4% in July. **One** member noted that, following the outflow of over 12 million workers from the labor force, as of July 7.2 million workers had rejoined the labor force. **Another** member underlined that, although the labor participation rate has recovered to a level of 55%, it is below the average level of the last 6 years, of approximately 59%. He/she added that it could take several years to return to the employment levels observed prior to the pandemic. **One** member added that almost 6 million jobs were lost between March and July, with and extended unemployment rate of 22.1% in July. As a result, the labor gap has reached historically high levels, with 23.3 million people in need of full-time jobs. **Another** member noted that, despite the improvement, 5.4 million workers left the labor force between March and July and added that the jobs created after May have been mainly in the informal sector. **One** member indicated that, as a consequence of the above and of the increase of underemployment, a loss of job quality is observed, with individuals who have returned to their jobs but are now earning lower wages. He/she added that there are differentiated effects by gender, which will require particular attention. **Some** members stated that formal employment, measured through the number of IMSS-insured workers, contracted by over one million during the first seven months of the year. **Some** members highlighted that formal employment showed a slight recovery in August.

Most members emphasized that the economic recovery will be difficult and prolonged, and added that it is subject to uncertainty. One member pointed out that a 10% contraction is anticipated in 2020 and emphasized that the magnitude of the recovery over the next months is key to determine how long it will take to return to the levels of economic activity observed during the third quarter of 2018, in order to end the recovery phase and start an expansion phase. He/she estimated that the recovery phase might last from two to six years, or even up to a decade if per capita GDP is considered. **Another** member underlined that, given the difficulty to forecast a central scenario for economic growth, Banco de México has maintained three scenarios with different recovery trajectories, depending on the evolution of the pandemic and the performance of advanced economies and domestic demand, all of which continue to be subject to a high degree of uncertainty. **One** member pointed out that, based on the most recent surveys, private sector analysts already estimate the Mexican economy's long-term growth to be below 2%.

Most members agreed that wide slack conditions are anticipated throughout the horizon in which monetary policy operates. The majority highlighted that there are downward risks to economic activity and underlined the implications for productive activity derived from the evolution of the pandemic. One member mentioned a high probability of a second wave of infections in the short term, mainly associated with the easing of lockdown measures, a situation that could become more complicated in view of the beginning of the influenza season. He/she added that, even with a vaccine available, a recovery that relatively quickly offsets the contraction registered in 2020 is unlikely to occur. This, due to the fact that an imbalance in the determinants of GDP growth is foreseen to persist during 2021. He/she stated that a higher-than-expected growth of the US economy and of world trade, combined with the USMCA, should stimulate exports. Nevertheless, he/she warned that consumption will recover more slowly due to the high levels of unemployment, fears of virus contagion, and the absence of sufficient fiscal support. He/she pointed out that the latter factor and an unfavorable business climate would limit the recovery of private investment. In addition to the above described risks to growth, **another** member added the following: i) that the negative effects on goods and services' production and on businesses and households' revenues continue; ii) that additional episodes of risk aversion in financial markets are observed; iii) pressures on public revenue, which could affect the sovereign risk outlook and the conditions of access to financial markets, and iv) solvency problems of households and businesses affected by the pandemic.

Inflation in Mexico

All members pointed out that in August, headline inflation ended above 4%. Most members highlighted that, with this, it exceeded the upper limit of the variability interval around the 3% target. One member stated that in that month inflation registered its highest level since May 2019. **Another** member added that it has increased over the last four months, as compared to the downward trend observed in numerous advanced and emerging economies.

Most members considered that inflation has continued to be affected by the pandemic, which has implied supply and demand shocks, thus contributing to a recomposition in relative prices. One member mentioned that these adjustments took place in the context of a marked weakness of demand. He/she highlighted that seasonally adjusted monthly changes of the items that registered upward shocks in recent months have started to show variations closer to their average of the last ten years. **Another** member argued that supply and demand shocks, and the behavior of the exchange rate, are reflected in both the divergent evolution of merchandise and services' prices and in the contrasting price increases of different items of the CPI basket. He/she noted that slightly more than a half of said basket registers annualized monthly price increases higher than 4% and close to a third annualized monthly price increases below 2%. He/she pointed out that headline inflation has remained high and above the expected level as certain upward risks to the core component have materialized. **One** member mentioned that inflation of services and of energy prices are below their respective historical average levels, while prices of food merchandise and agricultural and livestock products register cumulative inflations above said levels, although the most recent data suggests these have somewhat moderated or stabilized.

Delving into the core component, all members mentioned that services inflation remains low and merchandise inflation has increased. One member pointed out that services prices have been affected by a lower demand caused by social distancing measures and by lower private spending. **Another** member stated that services inflation is below the target level, although this has not offset the upward pressures in merchandise prices. **One** member noted that the lower services inflation has moderated, which, in addition to the increases in merchandise inflation, has led to upward pressures on core inflation. **Some** members stated that food merchandise prices have been pressured by supply chain disruptions, changes in the consumption basket, and the concentration of spending on these goods. **One** member added that changes in the excise tax (special tax on production and services, also known as IEPS) on soft drinks and tobacco have also affected said prices. **Another** member highlighted that pressures stemming from merchandise prices have become generalized, given that, although food prices register higher annual increases, non-food prices are contributing to a larger extent to the acceleration of inflation.

As for non-core inflation, most members underlined the increase in energy prices. One member added that the evolution of these prices reflects the impact of reductions in supply and the recent recovery of world economic activity. **Some** members noted the increase in agricultural and livestock prices.

Some members mentioned that headline inflation expectations for the end of 2020, and to a lower extent for 2021, have increased. **One** member considered that this suggests that the less favorable outlook has started to extend to the following year. **Another** member noted that expectations for the end of 2021 are far above those of the Central Bank and added that short-term core inflation expectations have also continued to increase. **Some** members added that medium- and long-term expectations remained stable at levels above the 3% target. In this regard, **one** member highlighted that the dispersion around 3.5% has practically disappeared, which indicates a stronger entrenchment of long-term expectations at levels above the target. **Another** member considered that despite the recent increase in observed inflation, inflation expectations for both the medium-term and for the end of 2021 have remained stable, while those for the next 12 months have decreased after having increased at the beginning of the pandemic, although they remain above the 3% target. He/she added that the average of one to 10 years of annual inflation expectations implicit in market instruments was of around 3% in September, which suggests that the recent price increases are considered as transitory and have not contaminated inflation expectations.

All members pointed out that inflation is anticipated to converge to the target in the horizon in which monetary policy operates. One member noted that, in the expected scenario, inflation is estimated to show in the short term the effects of some recent price adjustments. He/she pointed out that in the 12-to-24 month forecast horizon, headline and core inflation are anticipated to be around 3%. **Another** member considered that, looking forward, prices will remain contained by both a depressed demand and low energy prices. He/she stated that some sectors that exhibited increases in sales and in prices, due to a recomposition in spending, have already started to be affected by the decrease in aggregate demand. **One** member estimated that, due to their nature, both supply shocks and other upward pressures on certain products derived from the pandemic should fade off or, at least, be mitigated, once the health problem is resolved, while economic weakness will most probably persist for a longer period. In this context, **some** members argued that the effect of the contraction of demand on prices should prevail, thus contributing to the convergence of inflation to its target.

One member mentioned that supply and demand pressures on inflation are foreseen to continue until the first half of 2021, to later decelerate and reach the target by the end of that year. He/she pointed out that core inflation is still subject to pressures derived from increases in energy prices, the exchange rate and wages. He/she pointed out that the food merchandise subcomponent has been particularly under pressures stemming from tax adjustments, supply chain disruptions, and changes in consumption baskets. Nevertheless, he/she stated that these are expected to be transitory. **Another** member mentioned that both headline inflation and its components continue on an upward trend, despite the wide slack and the exchange rate appreciation. He/she noted that, while inflation is still anticipated to converge to 3% during the fourth quarter of 2021, the foreseen trajectory has been adjusted upwards for the entire forecast horizon.

As to the balance of risks for inflation, **some** members highlighted the risk of additional episodes of exchange rate depreciation. **One** of them stated that this is particularly relevant in an environment characterized by numerous domestic and external challenges. In addition to the above, he/she underlined that the inflation scenario also faces different risks stemming from the recent performance of inflation and the relative impact of supply and demand shocks. **Another** member stated that further impacts from the supply side cannot be ruled out. **One** member mentioned the persistence of core inflation, highlighting that it has averaged 3.7% over the last 30 months, and that it is expected to continue until March 2021. He/she added that although the trajectory of non-core inflation is difficult to anticipate, it could reverse to its historic mean of around 6%, causing a deviation from the baseline scenario. He/she also underlined the risk of inflation expectations de-anchoring, since inflation has remained above the target for an extended period, although he/she stated that analysts agree that said deviation is transitory. He/she added the risk associated with the impact of the wage policy and expectations of a considerable increase in 2021. He/she pointed out that, since 2018, unit labor costs have increased and productivity has declined, which implies that profit margins have decreased and/or a partial or a total pass-through effect to prices has taken place. In this context, **some** members considered that the balance of risks for the foreseen inflation trajectory remains uncertain. **One** member indicated that, despite the above, upward risks have increased. Meanwhile, **another** member considered that risks are balanced and that he/she does not identify factors that could significantly affect the foreseen trajectory for inflation in the Central Bank forecasts. He/she considered that this implies that inflation will return to its target within the time frame in which monetary policy operates.

Macrofinancial environment

Regarding financial markets, most members highlighted the appreciation of the Mexican peso, although it has recently been subject to episodes of volatility. Some members mentioned that the Mexican peso has been one of the currencies that has appreciated the most among emerging countries' currencies. **One** member stated that although the negative balance of the net currency position stopped widening, the cumulative annual flow to fixed-income instruments remains negative by more than USD 14 billion.

Most members pointed out that moderate inflows of foreign capital have been observed. Some members added that sovereign risk has improved, although it remains above its level at the beginning of the year. **One** member stated that it has recently increased marginally. **Some** members noted that interest rates on government securities exhibited limited and mixed adjustments. **One** member mentioned that the stock market fell, in line with the global trend.

In this context, **some** members mentioned that trading conditions remain deteriorated. However, **one** member noted the improvement in the conditions of the fixed-income market and stated that financial markets will continue to improve as the recovery advances, although episodes of volatility are not ruled out. **Another** member highlighted that the risk of episodes of turbulence caused by domestic or external factors remains latent, as shown by the recent experience with the exchange rate.

Most members pointed out that the situation of public finances is a risk factor. In this regard, **one** member stated that between 2019 and 2020, Public Sector Borrowing Requirements will increase from 2.3 to 4.7%, while their historical balance will do so from 44.8 to 54.7% as a percentage of GDP. **Some** members noted that the economic package for 2021 represents a continuation of the policy of the previous two years, with an emphasis on an austere management of public finances and on channeling spending to the current administration's priority programs. **Another** member highlighted the modest increase proposed for health spending and the cuts in public investment to its lowest level in 20 years. He/she emphasized that resource allocation and social profitability of the projects to be financed will compromise the country's growth potential even further.

Some members highlighted the risk that the depletion of the stabilization funds' resources implies for 2021. They argued that several assumptions of the economic package might not materialize, emphasizing those related to the evolution of oil production and economic activity. **One** member stated that the oil revenue target assumes a production of 1.8 million barrels per day, compared to the 1.6 million currently produced. He/she pointed out that the extension of lockdown measures due to insufficient control of the health crisis has had a greater-than-expected impact on economic activity, exerting an additional pressure on public finances. **Another** member pointed out the need to consider redirecting government spending and to permanently strengthen public revenues.

Most members expressed their concern about Pemex's situation. Some members highlighted the possibility that the state firm requires additional fiscal support. **One** member considered that this, together with a materialization of a downgrade in the state oil company's or the sovereign's ratings, as well as pressures on spending originated by the extension of the pandemic, could negatively affect public finances. **Another** member emphasized that public finances face challenges due to the absence of a long-term solution to Pemex's problems.

Some members mentioned that the impact of the pandemic continued to affect financing to firms and households. **One** member pointed out that the growth of credit granted by commercial banks to firms continues registering negative figures at an annual rate. He/she indicated that the decline in credit is a worrisome particularly in the case of smaller firms, for which it fell at an annual rate of -5.4% in July. He/she added that the spread between the rate that these firms face and the risk-free interest rate continued to increase, which implies that the cost of credit is not decreasing at the same rate as the reference rate, thus making it difficult to restore credit flows. **Another** member noted that although there was a tightening in bank financing conditions, the adjustments have moderated recently. He/she pointed out that the deterioration of delinquency rates of consumer and firm credit has eased.

Most members highlighted that there is an unfavorable environment for private investment. One member mentioned that ongoing sit-in protests, takeovers of rail infrastructure and toll booths, the re-emergence of fuel theft, and increased insecurity discourage the private investment needed for sustained economic growth. **Another** member pointed out that the lack of sufficient fiscal support will increase the risk of long-term damage to the productive capacity, especially in the case of small- and medium-sized firms. He/she noted that this environment, combined with unfavorable business conditions, will limit the recovery of investment. **One** member stated that a policy adverse to private investment will further compromise potential growth.

Another member argued that in face of such a complex environment, a solid and sustainable macroeconomic policy stance that contributes to an orderly adjustment of financial markets and of the economy as a whole is required. This within a framework that maintains the sustainability of public finances, a low and stable inflation, and a solid and well-capitalized financial system.

Monetary policy

Taking the referred risks for inflation, economic activity and financial markets into account, major challenges arise for monetary policy and for the economy in general, and based on the foreseen scenarios for inflation and considering the room for maneuver that on balance these provide to monetary policy, all members agreed to lower the target for the overnight interbank interest rate by 25 basis points to a level of 4.25%. All members considered that monetary policy implementation will depend on the evolution of the factors that have an incidence on the outlook for inflation and its expectations, including the effects that the pandemic might have on both of them.

One member mentioned that among the challenges faced by monetary policy under the current complex environment, the significant supply and demand shocks which affect economic activity and inflation, as well as the fragility prevailing in global financial markets and risk appetite, which are subject to episodes of volatility and capital outflows, stand out. He/she highlighted that inflation has continued to suffer the effects of the pandemic and has increased in recent months. Although he/she recalled that headline and core inflation are expected to be on target in the horizon in which monetary policy operates, he/she emphasized that risk factors to inflation persist. He/she added that in order to consolidate an orderly adjustment of the national economy and maintain low and stable inflation, the well-functioning of domestic financial markets is required. Considering the above, he/she highlighted monetary policy's limited room for maneuver, and that in the future the available room will depend on the evolution of the factors that influence inflation forecasts.

Another member pointed out that at the beginning of the pandemic, monetary policy faced unprecedented challenges, since the possible impact of this shock on the economy, its duration, depth, scope and risks were unknown. He/she added that currently there is valuable, available information that should be considered for the monetary policy decision, although high uncertainty persists. He/she mentioned that, although a favorable evolution of financial markets has been observed, price dynamics, the evolution of inflation expectations, as well as the persistence of uncertainty worldwide and of idiosyncratic risk factors indicate that prudence and caution should be reinforced when conducting monetary policy. He/she considered that with the referred reduction of 25 basis points, the space for monetary easing has probably been exhausted, which will allow for inducing the trajectory of inflation and its expectations to its 3% target in the horizon in which monetary policy operates. Finally, he/she highlighted that the monetary policy announcement has to communicate that the trajectory and current levels of inflation have reduced the margin of maneuver for future target rate cuts and that future decisions will depend on the deviations that are observed in the trajectory of inflation to the 3% target.

One member pointed out that given the uncertainty about the impact of the pandemic on the economy, there is no clear information about how the main macroeconomic aggregates will behave during monetary policy's period of influence. He/she noted that the statistical exercises conducted suggest that the convergence of inflation to the target is feasible during the second half of 2021, even with a further reduction to the monetary policy rate. However, he/she emphasized that upward risks to inflation have increased. In this regard, he/she underlined that in recent weeks inflation reached levels above Central Bank's expectations and the target, which has resulted in a certain increase in the forecasts for coming months. On the other hand, he/she added that adjustments to the reference rate since August 2019 have decreased or even reversed the comparable interest rate spread relative to other emerging economies, posing challenges to an economy highly exposed to capital movements and with a very liquid currency in international markets. He/she pointed out that this is happening in a context where inflation expectations for both the second half of 2021 and the long term have not converged to the target. He/she added that the latter is combined with other sources of uncertainty in addition to those associated with the pandemic, such as, among others, the US presidential elections, the challenges for Pemex and for public finances in Mexico, the risks to the sovereign's rating which could even affect the investment grade, a wage policy for 2021 still to be defined, and an important electoral process in Mexico in that year. He/she considered that, under these circumstances, the implementation of a monetary policy that is even more prudent than in previous months, is necessary. He/she pointed out that this implies not only slowing down the pace of monetary policy easing, but also acknowledging that the margins of maneuver for additional easing have probably already been exhausted, which underlines the convenience of beginning a pause after this decision, although he/she recognized that this will depend on the evolution of inflation and its expectations.

Another member considered that the referred reduction of 25 basis points would benefit the Mexican economy without putting price stability at risk. He/she mentioned that the cycle of monetary easing should slow down, but that there is space to continue, since from various perspectives, in his/her opinion, the monetary easing is still insufficient. Comparing the current situation with the 2009 crisis, he/she pointed out that GDP fell -6.5% in the first nine months of 2009, while in the first six months of 2020, it did so by -10.1%. He/she added that inflation and its expectations are currently behaving more favorably than eleven years ago. He/she highlighted that inflation expectations for the next 12 months are at 3.58%; while in 2009 they were well above 4% and even exceeded 5% at some point. He/she added that the persistence of monthly inflation has been reduced to less than half the level of 2009, thus contributing to prevent expectations from being contaminated. Thus, he/she considered that these elements allow for a policy easing at least equivalent to that of 2009, when monetary easing took the real interest rate even to negative levels. He/she argued that making a pause in the current cycle of easing would imply ignoring Banco de México's achievements and would deprive the economy of an additional impulse, which might be highly beneficial and very necessary in the current conditions. In this regard, he/she pointed out that several studies show that monetary policy's credit channel operates in Mexico. He/she said that an accommodative monetary policy can reduce credit costs, thus contributing to its flow to households and firms. He/she referred to different, credit-related areas of demand that remain depressed, such as credit card purchases, domestic car sales, and investment. He/she considered that, for this reason, monetary policy is still insufficient and might yet play a significant role in the economic recovery process. He/she added that the negative economic effects associated with a very high real interest rate are documented in the literature. In this regard, he/she referred to the case of the United States during the global financial crisis and the recent change in the monetary policy strategy of the Federal Reserve. On the other hand, he/she argued that although inflation in Mexico is higher than in other emerging economies, the key variable is the real ex-ante interest rate, which depends on inflation expectations and not on observed inflation. He/she pointed out that the expected inflation in Mexico has not changed significantly and is well anchored, so that real ex-ante rates are positive, which could eventually be incompatible with a sustained recovery. He/she considered that it would not be convenient to send a signal that the cycle of monetary easing has ended. He/she pointed out that the current conditions of the Mexican economy could be aligned with what other central banks are doing and contribute to the recovery process, without jeopardizing the priority objective of price stability.

One member considered that monetary easing should continue given the depressed economic activity that faces a difficult, fragile and potentially long recovery. However, he/she pointed out that it is advisable to adjust its speed and focus carefully on the performance of economic indicators in the following months. In his/her opinion, this adjustment is due to four factors. First, he/she mentioned the described inflationary outlook. In this regard, he/she highlighted that the increase in current inflation may not be temporary and that several shocks may shift inflation away from its expected trajectory. Second, he/she mentioned that the room for maneuver offered by the absolute and relative monetary policy stances is starting to narrow. Regarding the absolute policy stance, he/she noted that the temporary increase in inflation has partially offset the room for maneuver offered by the economic slowdown. As to the relative stance, he/she mentioned that there is room for maneuver due to both the expectation that the Federal Reserve will keep interest rates low for a prolonged period and the containment of risk aversion worldwide. However, he/she considered that Mexico's interest rate spread is not so high when considering exchange rate volatility, so each additional reduction must be done with caution. He/she noted that with increased risk appetite and the marked foreign exchange rate appreciation observed in the last weeks, the interest rate spread is likely to become more relevant. He/she added that portfolio outflows seem to have stopped, although we are still far from regaining the investment flows lost due to the shocks of the pandemic. Third, he/she noted that maintaining the current pace of easing could be interpreted as the price stability objective taking second stage. He/she added that the cut to the policy rate has a limited impact, as the credit channel is inefficient due to limited credit depth and low financial inclusion. In contrast, he/she considered that the expectations channel has shown a greater effectiveness. In this regard, strengthening the central bank's credibility regarding its commitment to contain the price increases is fundamental. Fourth, he/she referred to the idiosyncratic risks related to public finances and uncertainty for investment, among others mentioned above. Finally, he/she highlighted the importance of never disregarding the inflationary concerns and preventing the loss of purchasing power from further eroding households, which currently face a significant decline in their income.

Most members noted that the extraordinary measures adopted by the Central Institute have mitigated the impact of the crisis on the financial system. The majority highlighted the importance of recently extending these measures until February 28, 2021, for the well-functioning of financial markets, given the challenges that continue to be faced. Additionally, **some** members pointed out the need to monitor the restructuring of credit portfolios subject to the special accounting criteria, in view of their expiration, as this could have implications for financial stability, and highlighted the risks to the payment capacity of the households and firms most affected by the pandemic. **One** member also underlined the potential challenges for the financial system as the crisis begins to be reflected more evidently in the solvency of some firms.

3. MONETARY POLICY DECISION

Taking into account the referred risks for inflation, economic activity and financial markets, major challenges arise for monetary policy and for the economy in general. Based on the foreseen scenarios for inflation and considering the room for maneuver, although narrow, that on balance these provide to monetary policy, with the presence of all members, Banco de México's Governing Board decided unanimously to lower the target for the overnight interbank interest rate by 25 basis points to a level of 4.25%. Monetary policy implementation will depend on the evolution of the factors that have an incidence on the outlook for inflation and its expectations, including the effects that the pandemic might have on both of them.

The Governing Board will take the necessary actions on the basis of incoming information and considering the large impact on productive activity as well as the evolution of the financial shock that we are currently facing. The latter 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. Perseverance in strengthening the macroeconomic fundamentals and adopting the necessary actions regarding both monetary and fiscal policies will contribute to a better adjustment of domestic financial markets and of the economy as a whole.

4. VOTING

Alejandro Díaz de León-Carrillo, Irene Espinosa-Cantellano, Gerardo Esquivel-Hernández, Javier Eduardo Guzmán-Calafell and Jonathan Ernest Heath-Constable voted in favor of lowering the target for the overnight interbank interest rate by 25 basis points to a level of 4.25%.

ANNEX

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

A.1. External conditions

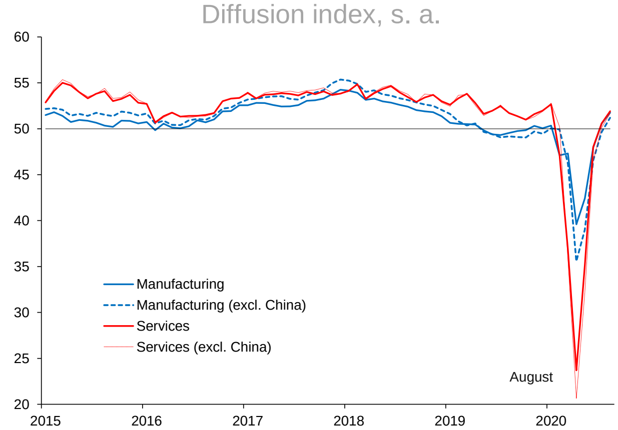
A.1.1. World economic activity

Available information indicates that the recovery of world economic activity that began in May and June continued during July and August, although at a more moderate pace and with a high heterogeneity among countries. This recovery has been driven by a greater dynamism of private consumption, a slight reactivation of investment, and a greater volume of foreign trade, the latter pushing a higher growth of manufacturing activity. In addition, higher frequency indicators, such as the purchasing managers' and mobility indexes, continue to show a gradual improvement (Chart 1). In most advanced economies headline and core inflation have recently increased, due mainly to the rebound of energy and goods' prices, in a context of gradual reopening of economic activity. However, headline inflation remains below their central banks' targets. In emerging economies inflation has exhibited a more heterogeneous behavior.

In this context, monetary and fiscal authorities have continued to implement stimulus measures to mitigate the adverse effects of the pandemic on the economy. In particular, in addition to keeping interest rates at historically low levels and continuing to use their balance sheets to promote an orderly functioning of financial markets, the major central banks have emphasized their commitment to maintain accommodative monetary policy stances for a prolonged period until they attain their inflation targets. The monetary, fiscal and financial stimulus measures implemented in advanced economies, along with the gradual recovery of their economic activity and certain progress in the development of a vaccine against COVID-19, favored a relative stability in financial markets during the period immediately after Mexico's latest monetary policy decision. However, in recent weeks there have been periods of volatility associated with a combination of factors, including the uncertainty about the approval of an additional package of fiscal support measures in the United States, pauses in the development of the COVID-19 vaccine, an increase in the number of infections in several countries, concerns about the valuation of certain financial assets, and the possibility of the United Kingdom leaving the European Union without a trade agreement.

In this environment, the forecasts of multilateral organizations and analysts for world economic growth in 2020 have been revised to the upside due to the materialization of a lower than expected contraction during the second quarter, particularly in advanced economies. In turn, growth expectations for 2021 were revised slightly to the downside due to the lower economic contraction expected in 2020 and the expectation that social distancing will continue during that year. It is worth noting that these forecasts are subject to a high degree of uncertainty. The number of infections in the United States and Latin America remains high and it has increased once again in several European and Asian countries, which may lead to the adoption of new lockdown measures that may limit the recovery of economic activity.

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



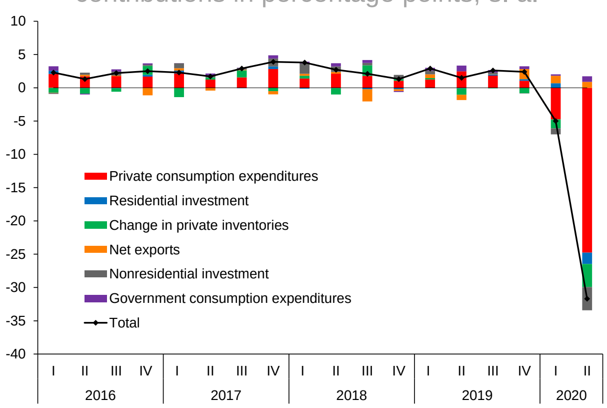
s. a. / Seasonally adjusted figures.
Source: Markit.

In the United States, available information suggests economic activity rebounded during the third quarter of 2020, after having contracted at a seasonally adjusted annualized rate of 31.7% during the second quarter (Chart 2). This recovery would be driven by spending in private consumption, which would in turn respond to the fiscal stimuli and reopening of the economy as well as to residential investment in light of the low level of mortgage interest rates. Other indicators, such as capital goods' orders and exports have shown a more moderate recovery. Higher frequency indicators, such as purchasing managers' and mobility indexes, are consistent with the rebound exhibited by economic activity during the third quarter.

During July and August, US industrial production recovered at a slower pace, growing at an average monthly rate of 1.8% during these months, after having grown 6.1% in June. This trend reflected some deceleration in manufacturing, and the stagnation of mining activity as a result of the negative impact of Hurricane Laura during August.

US employment continued to recover in July and August, partly due to the return to work of employees that had been temporarily dismissed. In particular, the unemployment rate has continued trending downwards, registering 8.4% in August, after having reached 14.7% in April. Nevertheless, it still remains above pre-pandemic levels. Between May and August, 10.6 million of the more than 22 million jobs that were lost between March and April in the non-farm sector have been recovered. The level of initial claims of unemployment insurance continued to decrease, although it still remains high.

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 Euro area, available indicators also point to a gradual recovery of economic activity during the third quarter. Particularly, in the major economies of the region, retail sales continued to recover in July, although at a more moderate pace, after having significantly rebounded in May and June. This recovery was driven by greater mobility and improved consumer confidence. Industrial production continued to grow in July, with improvements in all of its items. The purchasing managers' indexes suggest that economic activity moderated its pace of recovery in August, particularly in the services sector. In this context, the unemployment rate increased only slightly, from 7.7% in June to 7.9% in July, largely as a result of the implementation of several job retention schemes, as well as a lower labor force participation in several countries of the region.

In the United Kingdom, available information to July suggests a recovery of economic activity, mainly driven by the growth of manufacturing and construction, while the services sector has recovered at a more moderate pace, and still remains below pre-pandemic levels despite the lifting of mobility restrictions and the reopening of shopping centers. The purchasing managers' indexes continued to improve in August, while the services sector registered a greater rebound during that month. In this context, the unemployment rate rose from 3.9% in June to 4.1% in July, while the number of partially employed workers remained high.

In Japan, available indicators point to a gradual recovery of economic activity during the third quarter of the year. In particular, after having strongly rebounded in June, domestic consumption grew moderately in July due to the increase in the number of COVID-19 infections. Industrial production and new orders rebounded in July and the purchasing managers' index in the manufacturing sector continued to improve in August, although it still remains in contractionary levels. In this context, the unemployment rate remained at low levels, partly as a result of job retention schemes, increasing from 2.8% in June to 2.9% during July.

In emerging economies, economic conditions have varied considerably depending on the spread of the pandemic, the effectiveness of the measures to contain it, and the economic stimuli implemented. In China, indicators of economic activity in August suggest that the recovery would extend to the third quarter of the year, driven by industrial activity, exports, consumption, and investment. In emerging economies of Eastern Europe and Asia, available indicators to July and August, mainly those related with industrial production and foreign trade, suggest a gradual recovery in the Czech Republic, Hungary, Poland, Russia, India, Malaysia and the Philippines, among others. Finally, in most Latin American economies economic activity has remained weak.

Since Mexico's previous monetary decision, the international prices of commodities have registered a mixed behavior. Oil prices continued to increase in August, supported by the perception of compliance with production cuts by the Organization of Petroleum Exporting Countries (OPEC) and other producers and fears about the hurricanes in the Gulf of Mexico. Later, at the beginning of September, oil prices decreased due to the resurgence of COVID-19 infections in several countries, which increased the uncertainty about the pace of recovery of the world economy, although in recent dates they rose once again in light of the statements by the OPEC regarding the strong measures it will take against the countries that fail to comply with the agreed production cuts. Industrial metal prices have continued to trend upwards due to the restart of industrial production, while those of gold, after having reached historically high levels in August, fell slightly as a result of a greater risk appetite. Finally, grain prices were driven up by the gradual recovery of their demand, as well as unfavorable weather conditions, especially in the United States.

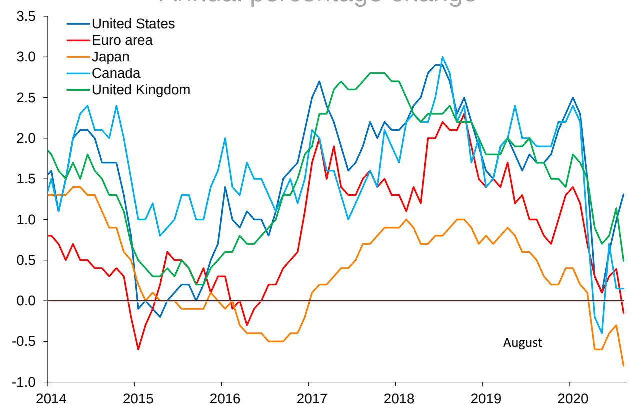
A.1.2. Monetary policy and international financial markets

In most advanced economies, headline inflation has increased recently due mainly to the increase in energy prices, although it remains below their respective central banks' targets (Chart 3). Core inflation also rose, largely reflecting the increase in goods prices, while services prices overall remain weak. In this context, inflation expectations drawn from financial instruments have increased recently for major advanced economies, although in general they remain at low levels.

In emerging economies, headline and core inflation showed a more mixed behavior, reflecting a combination of factors. Although the weakening of economic activity and the decline in some services prices generated downward pressures on inflation in most countries, various economies were subject to upward pressures generated by increases in food and energy prices and by the depreciation of their currencies.

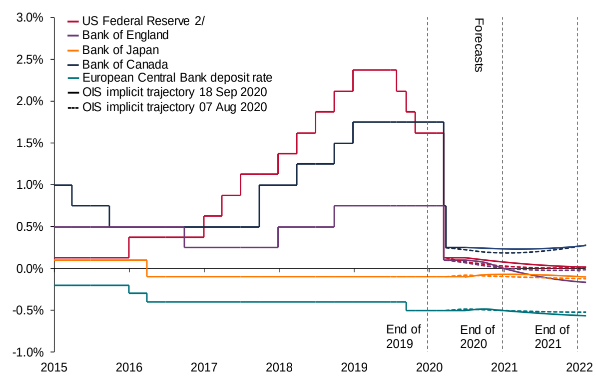
In this context, the main central banks, in addition to maintaining their reference interest rates at historically low levels and continuing to use their balance sheets to foster an orderly functioning of financial markets, emphasized their commitment to maintain highly accommodative monetary policy stances for an extended period by adjusting their future guidance regarding their interest rates or asset purchase programs or by suggesting the possible adoption of new monetary policy instruments to attain their inflation targets. Looking ahead, expectations drawn from market instruments continue to anticipate that central banks will maintain highly accommodative monetary policies (Chart 4).

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.

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



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

Among the monetary policy decisions in this period, the following stand out:

i) The Federal Reserve announced in August adjustments to its monetary policy strategy, adopting a flexible average inflation target. Among the most significant adjustments, the Federal Open Market Committee (FOMC) emphasized that maximum employment is considered a broad and inclusive objective and informed that its decisions will seek to eliminate the "employment deficit vis-à-vis its full employment level". In addition, it pointed out that it will seek to achieve a 2% average inflation over time. Thus, in its September meeting, the Federal Reserve left unchanged its range for the federal funds rate at 0%-0.25% and adjusted its statement to adapt it to the modifications in its monetary policy strategy. In this regard, the Fed noted that it expects that maintaining the current range for its reference interest rate will be appropriate until labor market conditions have reached levels consistent with its full employment estimate and inflation has increased to 2% and is heading to moderately exceed the 2% target for some time. In this context, the medians of FOMC forecasts suggest that the federal funds rate will remain unchanged until 2023. Likewise, both market variables and the consensus of forecasters incorporate that this central bank will maintain its reference rate unchanged during 2020 and 2021.

ii) In its September meeting, the European Central Bank (ECB) left its policy rates unchanged, maintaining its refinancing rate, key deposit facility rate and key lending facility rate at 0.0, -0.5 and -0.25%, respectively. It reiterated that these interest rates will remain at or below their current levels until inflation forecasts converge to a level sufficiently close but below the 2% inflation target, and that this convergence has been consistently reflected in core inflation dynamics. It also kept its asset purchase program unchanged and mentioned that it will continue with the Pandemic Emergency Purchase Program (PEPP) until the end of June 2021 or until the Committee considers that the crisis phase has ended. In a press conference, the President of the ECB pointed out that the Monetary Policy Committee acknowledged that the recent appreciation of the euro has exerted downward pressure on inflation, that the central bank does not have a mandate on the exchange rate level and that, although the balance of risks for growth is biased to the downside, it considers that deflationary risks have decreased since June.

iii) In its September meeting, the Bank of Japan left its short-term policy interest rate unchanged at -0.1% and its long-term interest rate (indexed to its 10-year bond) at around 0%, and reiterated that it will continue its asset purchase program. It pointed out that economic activity in Japan has recovered gradually, although it continues in a severe situation due to the impact of COVID-19. It noted that economic activity will probably continue to improve as demand increases, with the support of accommodative financial conditions and economic stimulus measures by the government, although the pace of recovery is expected to be moderate as long as the effects of the pandemic persist. It will continue to support financing of firms and financial market stability. This institution reiterated that it will not hesitate to take additional measures if necessary and that it expects interest rates to remain at or below their current levels.

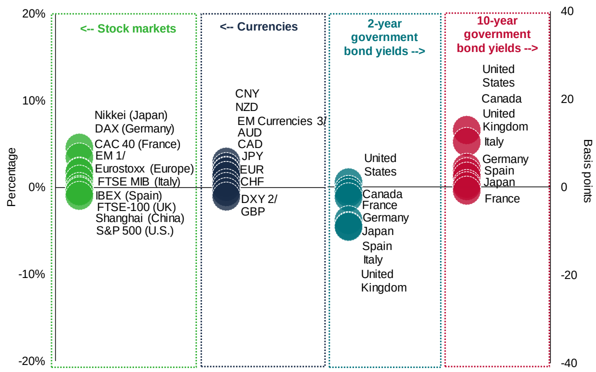
iv) The Bank of England kept its reference interest rate unchanged at 0.10% in its September meeting and the amount of its asset purchase program at £745 billion. It reiterated that it will continue to closely monitor the situation, standing ready to adjust its monetary policy in order to comply with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

v) In its September 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. Although it stated that it will continue its large-scale asset purchase program at the current rhythm and until economic recovery is clearly underway, it is worth highlighting that, in its latest meeting, this central bank mentioned that such program will be gauged to provide the necessary monetary stimulus. As for its short-term liquidity programs, it pointed out that their use has decreased due to the proper functioning of financial markets.

Since Banco de México's previous monetary policy decision, most central banks of emerging economies left their reference interest rates unchanged, while some banks maintain various measures to ensure the supply of liquidity, provide credit, and foster the well-functioning of financial markets.

International financial markets showed a relatively stable behavior during the period after Mexico's latest monetary policy decision, driven by the gradual recovery of economic activity, the fiscal, monetary and financial stimulus measures adopted in advanced economies, and certain progress in the development of a vaccine against COVID-19. Nevertheless, due to the combination of factors that have influenced investors' sentiment, there have been episodes of greater volatility in recent weeks. As a result, financial markets registered a mixed behavior by type of asset and region. In particular, financial assets showed mixed adjustments with episodes of high volatility in advanced economies. In particular, stock markets exhibited slight gains and a volatile behavior (Chart 5). The case of the United States stands out since, after its stock indexes reached maximum levels, such gains reversed recently, in a context of stock market losses in the technological sector, lack of progress in the approval of an additional fiscal stimulus package, uncertainty regarding the development of a vaccine against COVID-19, and in light of the possible implementation of new lockdown measures in response to the resurgence of coronavirus infections in various countries. Most currencies of advanced economies exhibited limited adjustments, with a trend towards appreciation against the US dollar, although the pound sterling depreciated and exhibited higher volatility in recent weeks, in an environment of greater uncertainty about the United Kingdom's exit agreement from the European Union. Finally, interest rates of long-term government bonds exhibited mixed adjustments, with the steepening of the US yield curve standing out. Emerging economies registered net capital inflows, mainly to fixed-income assets, while their stock markets registered slight losses and their foreign exchange markets exhibited less volatility in general (Chart 6).

Chart 5
Change in Selected Financial Indicators from August 7 to September 18, 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 August 7 to September 21, 2020
Percent, basis points

Region	Country	Currencies	Equity markets	Interest rates 2Y	Interest rates 10Y	CDS
Latin America	Mexico	4.60%	-6.54%	-3	-2	11
	Brazil	0.44%	-5.63%	69	96	13
	Chile	1.80%	-8.65%	9	10	1
	Colombia	-0.46%	4.85%	-24	-7	21
Emerging Europe	Russia	-3.27%	-3.66%	31	37	27
	Poland	-2.04%	-6.35%	0	6	3
	Turkey	-4.77%	2.49%	79	-39	-16
	Czech Republic	-3.27%	-5.00%	-8	-6	3
	Hungary	-4.80%	-10.37%	28	44	-3
Asia	Malaysia	1.57%	-4.99%	18	11	-2
	India	2.05%	-0.02%	36	37	28
	Philippines	1.37%	1.08%	25	15	0
	Thailand	-0.25%	-3.72%	-30	16	1
	Indonesia	-0.51%	-2.81%	-54	4	-8
Africa	South Africa	4.85%	-6.06%	7	10	0

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, new episodes of risk aversion in financial markets cannot be ruled out, which will depend largely on the evolution of the pandemic, the development, approval and distribution process of a vaccine and the capacity of governments to contain new waves of infections and mitigate the negative impact on economic activity. Along with the above there is the persistence of other risk factors that may lead to new episodes of global financial conditions tightening, including the perception of overvaluation of certain financial assets, a new escalation of trade and political tensions between the United States and some of its trade partners, a worsening of geopolitical and social conflicts in different world regions, the US election process, and the end of economic relief programs that had been implemented to face the pandemic, among others.

A.2. Current situation of the Mexican economy

A.2.1. Mexican markets

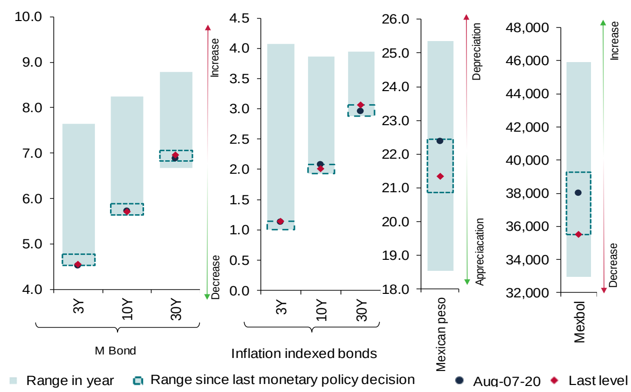
Since Banco de Mexico's previous monetary policy decision to date, the prices of financial assets in Mexico exhibited a mixed behavior by asset class (Chart 7). This occurred in an environment where uncertainty about the effects of the pandemic and caution by investors towards risky assets persists.

In the case of the Mexican peso, it appreciated slightly, although it has recently been subject to episodes of high volatility. In particular, it traded in a range between 20.87 and 22.44 pesos per US dollar and ended the period with an appreciation of 4.60% (Chart 8). This occurred in a context where both spot and forward trading conditions stabilized, although still above those observed prior to the pandemic.

In this regard, in line with the swap mechanism established between Banco de México and the US Federal Reserve on March 19 this year, in September the Foreign Exchange Commission instructed Banco de México to renew maturing positions and provide additional liquidity in US dollars for a total of USD 7.5 billion.

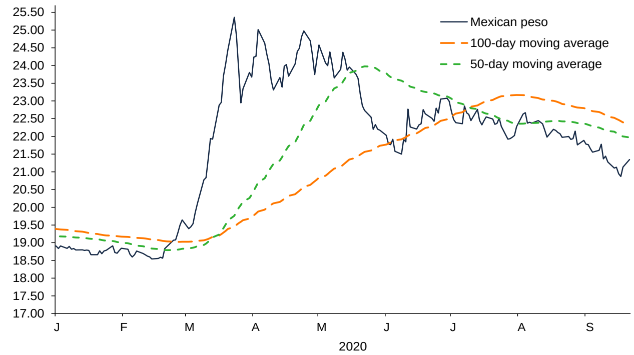
As to the measures announced by Banco de México on April 21, on September 15, the central bank announced the extension of their validity to February 28, 2021, as well as a redistribution of amounts among facilities for government securities repurchase agreements and temporary collateral exchange for a total of 50 billion pesos.

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



Source: Prepared by Banco de México.

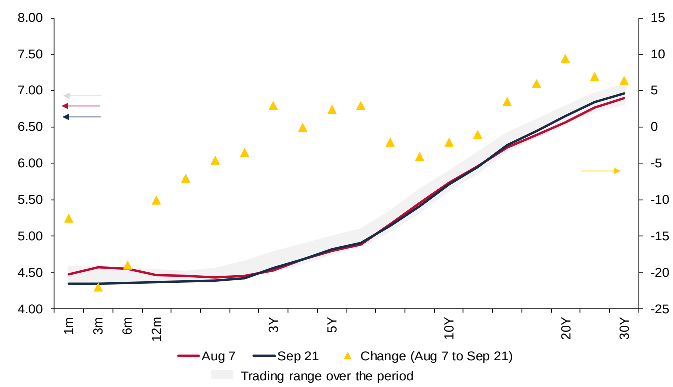
Chart 8
Mexican Peso Exchange Rate with Moving Averages
MXN/USD



Source: Prepared by Banco de México.

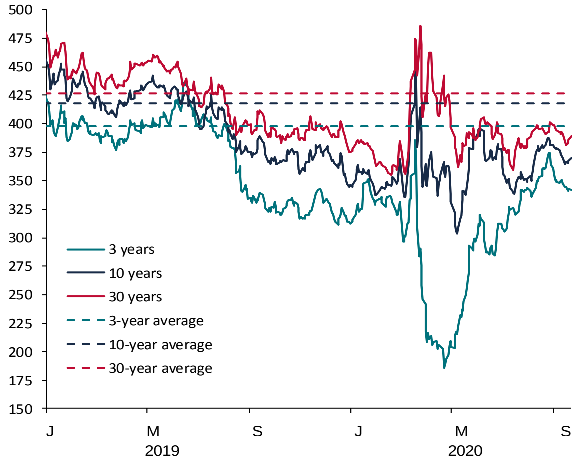
Nominal government bond yields decreased for shorter terms and exhibited minor adjustments for longer terms (Chart 9). Likewise, the yield curve of real-rate instruments registered mixed adjustments at the short-term nodes, while longer-term instruments showed a slight upward correction. In this context, breakeven inflation and inflationary risk premia implicit in the spreads between nominal and real instruments exhibited moderate adjustments (Chart 10). It is worth noting that said adjustments occurred in a context where trading conditions have improved in the last sessions, after having deteriorated during most of the period due to the summer seasonality.

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.

Finally, as to expectations regarding the path of the monetary policy target rate, information implied by the Interbank Equilibrium Interest Rate (TIIE, for its acronym in Spanish) swap curve discounts with a 60% probability a 25-basis point cut for the monetary policy decision of September (Chart 11). Private sector forecasters surveyed by Citibanamex are also expecting a 25-basis point cut. For the end of 2020, market variables are anticipating a target level of around 4.00%, while the median of surveyed forecasters expects a level of 4.25%.

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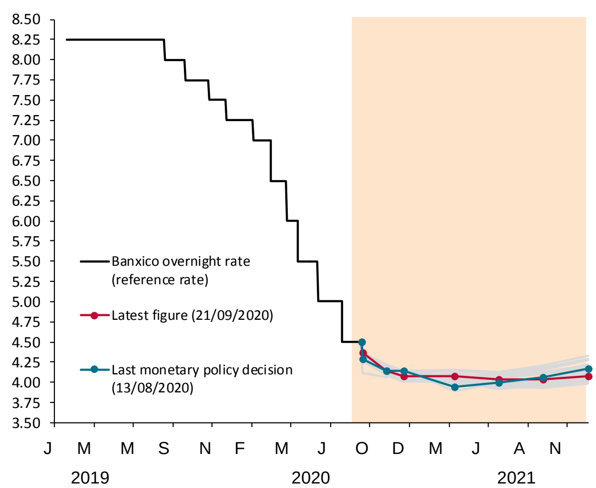
Chart 11
Banxico's Overnight Interbank Rate Implied in TIIE IRS Curve
Percent



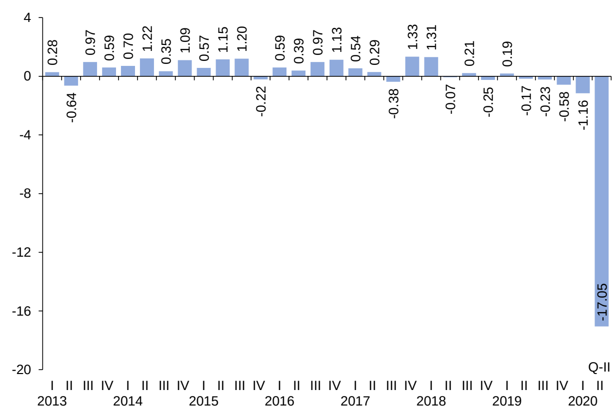
Source: Prepared by Banco de México with Bloomberg data.

A.2.2. Economic activity in Mexico

During the second quarter of 2020, as a result of the effects of the pandemic and the actions implemented to contain it, particularly in April and May, Mexico's GDP exhibited the highest seasonally adjusted quarterly contraction in the history of this indicator (Chart 12). Notwithstanding the above, in a context of easing of measures implemented to face the health crisis, greater population mobility, and improvement of external demand, economic activity began to recover in June and July, although an environment of uncertainty and downward risks persists.

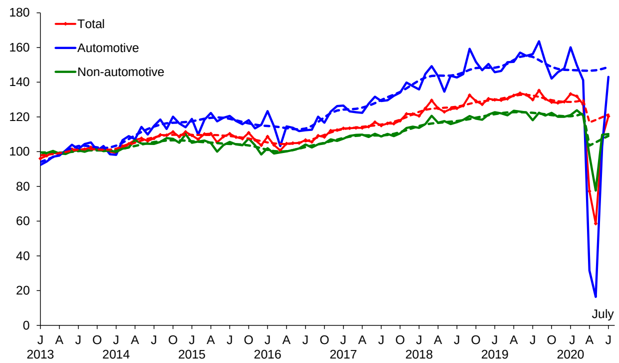
As for external demand, after having recovered in June, manufacturing exports once again expanded in July. This reflected both the continued reactivation of several productive sectors, as well as the gradual recovery of external demand, particularly in the United States. By type of good, this monthly improvement was mainly explained by the increase in automotive exports, while the rest of manufacturing exports slowed down (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.

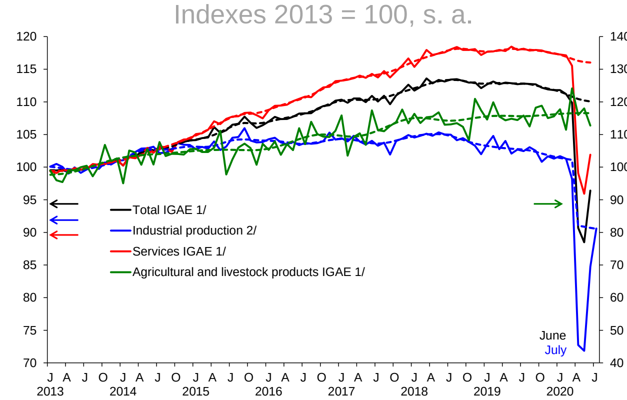


s. a. / Seasonally adjusted series and trend series based on data in nominal US dollars. The former is represented by a solid line and the latter by a dotted line.
Source: Prepared by Banco de México with data from the Tax Administration Service (SAT, for its Spanish acronym), the Ministry of the Economy (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).

According to its monthly indicator, in June private consumption showed a slight recovery associated with increases in all of its components. Timely information suggests that at the beginning of the third quarter this indicator continued to recover gradually. In particular, National Association of Self-Service and Department Stores (*ANTAD*, for its acronym in Spanish) and light vehicle sales grew moderately both in July and August. In June, gross fixed investment increased slightly, although it remains at levels well below those at the beginning of the year. Within this indicator, both investment spending on construction and machinery and equipment recovered slightly. Indicators related to this aggregate, such as capital imports, suggest that investment continued recovering gradually at the beginning of the third quarter.

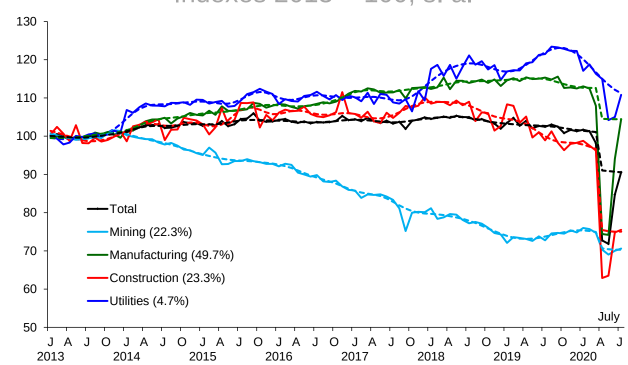
As for production, industrial activity continued to recover in July, after its reactivation in June (Chart 14). Within this indicator, manufacturing continued to exhibit a relatively high dynamism (Chart 15). In contrast, construction performed weakly and mining continued to slow down, despite the conclusion in July of the scheduled cutback in crude oil production as part of Mexico's commitments to OPEC. Tertiary activities recovered slightly in June, although their reactivation has been gradual, moderate and mixed among subsectors. Progress was observed mainly in retail and wholesale trade; transportation, warehousing and information; and accommodation and food services, although the latter remain at particularly low levels. In contrast, decreases were observed in finance, real estate, management of companies and enterprises, and administrative and support services.

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 June 2020.
2/ Figures as of July 2020 from the Monthly Industrial Activity Indicator.
Source: Mexico's National Accounts System (SCNM, for its acronym in Spanish), INEGI.

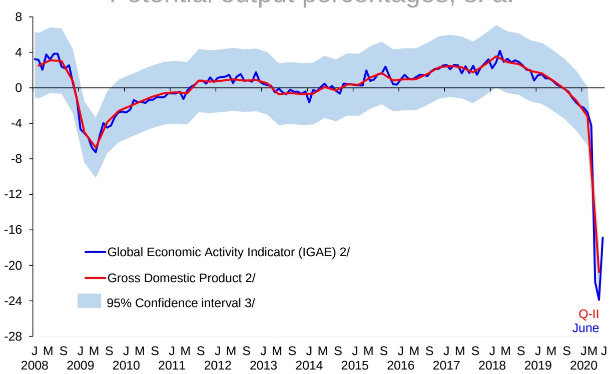
Chart 15
Industrial Activity [1/]
Indexes 2013 = 100, s. a.



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

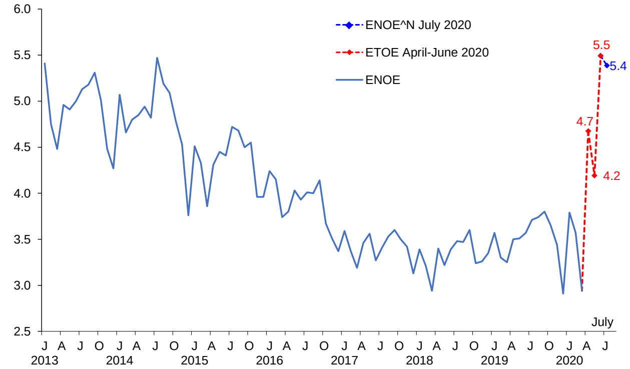
As to the economy's cyclical position, although the significant widening of slack conditions in the second quarter is anticipated to reverse partially during the third, ample slack conditions are expected to prevail (Chart 16). According to the results of INEGI's Telephone Survey on Occupation and Employment (*ETOE*, for its Spanish acronym), several labor market indicators continued to improve slightly in July, although at a more moderate pace than in June and showing weakness in regards to formal employment. Labor participation increased slightly, while the employed population also rose, reflecting higher levels of informal employment, given that formal employment decreased at the margin. After having grown in the previous months, the unemployment rate registered a slight monthly decrease (Chart 17). The creation of IMSS-insured jobs exhibited a moderate recovery in August, although jobs related to services for firms, individuals and home cleaning continued to decrease. Finally, as a reflection of the recovery of production and of hours worked, largely as a result of the gradual reactivation of manufacturing, after having increased significantly in April, unit labor costs in this sector accumulated three consecutive monthly falls (May to July) although they still remain above pre-pandemic levels (Chart 18).

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



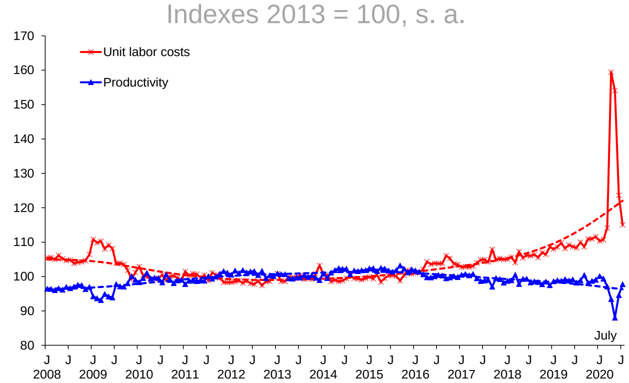
s. a. / Calculations based on seasonally adjusted figures.
1/ Output gap estimated with a tail-corrected Hodrick-Prescott filter; see Banco de México (2009), "Inflation Report (April-June 2009)", p.74.
2/ GDP figure as of the second quarter of 2020; IGAE figure as of June 2020.
3/ Output gap confidence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

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



n. s. a. / Not seasonally adjusted (original series).
Source: Prepared by Banco de México with data from ENOE up to March 2020 and from the ETOE from April to June 2020.

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



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

In July, for the second consecutive month, domestic financing to firms contracted at an annual rate, thus reverting the increase that had been observed in April. Indeed, although in March and April the growth rate of bank lending to large firms increased, it has reversed since May. The domestic market for corporate debt showed a slight recovery in August, after exhibiting a low level of activity for four consecutive months. Meanwhile, bank lending to smaller firms contracted further at an annual rate, although it stabilized slightly in July. As for credit to households, it contracted once more in July, mainly as a result of a reduction in consumer credit, as well as a slowdown in mortgages. Regarding interest rates of bank credit to private firms, in July they declined, in line with the reduction of banks' overnight funding rate. However, the margins of intermediation of interest rates of new loans to firms increased slightly, although less than in previous months. In June, interest rates of mortgages continued at levels below those registered at the beginning of the year, while those of credit cards remained slightly below the levels of February and April. Regarding portfolio quality, corporate and mortgage loan delinquency rates remained low, while those for consumption credits continue at high levels, although they appear to have stabilized after the deterioration observed since March.

In line with the measures announced by Banco de México to promote an orderly functioning of financial markets, strengthen the credit channels, and provide liquidity for the sound development of the financial system, the start of the facility to provide resources to banking institutions to channel credit to micro, small- and medium-sized firms and individuals affected by the pandemic stands out. In August, five credit institutions signed agreements to use this facility.

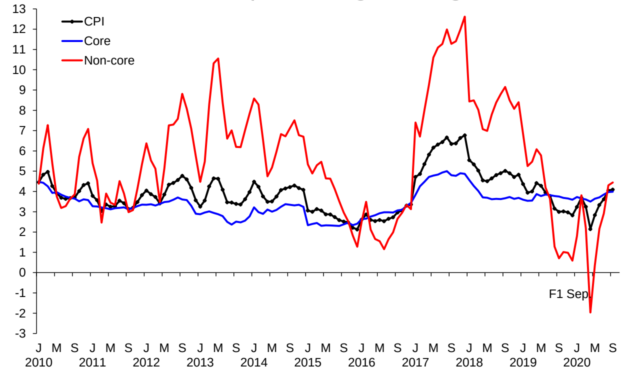
A.2.3. Development of inflation and inflation outlook

Annual headline inflation rose from 3.62 to 4.10% between July and the first fortnight of September 2020. This behavior was associated with an increase of 37 and 11 basis points in the incidence of its non-core and core components, respectively (Chart 19 and Table 1).

Annual core inflation rose from 3.85 to 3.99% between July and the first fortnight of September 2020. Within it, the annual inflation of merchandise prices increased from 5.19 to 5.36% during the same period (Chart 20), as a result of the greater annual rates of change of both food and non-food merchandise prices (Chart 21). The annual inflation of services rose from 2.40 to 2.50% during the same period, due to the greater price increases in services other than housing and education.

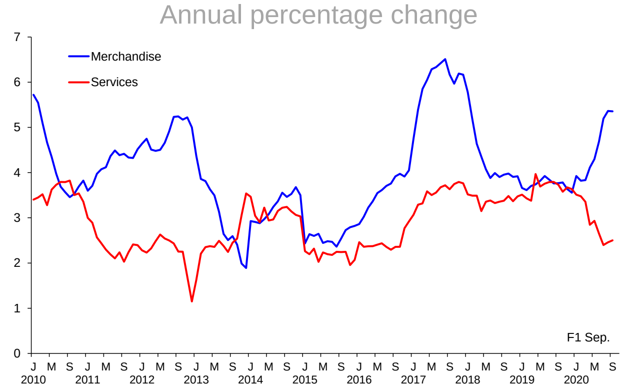
Annual non-core inflation increased from 2.92 to 4.44% between July and the first fortnight of September 2020 (Chart 22 and Table 1). In this regard, the annual inflation of agricultural and livestock product prices rose from 5.55 to 8.39% between July and the first fortnight of September 2020. The annual rates of change of energy prices increased from -0.41 to 0.20% during the same period.

Chart 19
Consumer Price Index
Annual percentage change



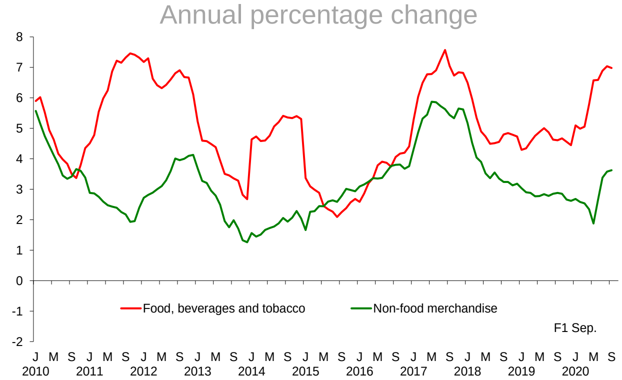
Source: Prepared by Banco de México with data from INEGI.

Chart 20
Merchandise and Services Core Price Subindex
Annual percentage change



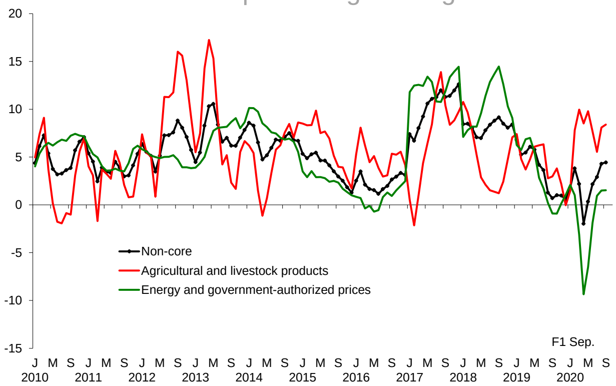
Source: Prepared by Banco de México with data from INEGI.

Chart 21
Merchandise Core Price Subindex
Annual percentage change



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

Chart 22
Non-core Price Subindex
Annual percentage change



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

As for inflation expectations drawn from Banco de México's Survey of Private Sector Forecasters, between July and August the medians for headline and core inflation for the end of 2020 increased from 3.61 to 3.82% and from 3.73 to 3.92%, respectively.

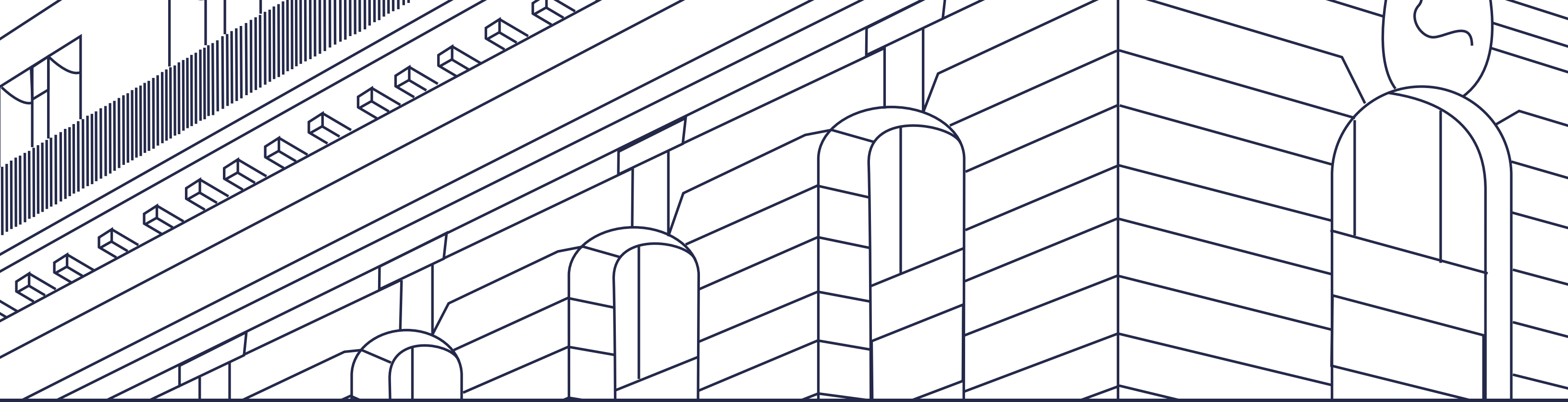
The medians of medium- and long-term expectations for headline and core inflation remained at around 3.50%. Finally, breakeven inflation and inflation risk decreased since the last monetary policy decision, although this indicator exhibited volatility.

These forecasts are subject to considerable risks in the short and medium terms. To the downside: i) a greater than expected impact of the widening of the negative output gap; ii) downward inflationary pressures worldwide; and, iii) social distancing measures reducing the demand for certain services. To the upside: i) additional episodes of foreign exchange depreciation; ii) a high persistence of core inflation; and iii) logistical problems and higher costs associated with the sanitary measures. The balance of risks for the projected trajectory of inflation remains uncertain.

Table 1
Consumer Price Index and Components
Annual percentage change

Item	July 2020	August 2020	1st fortnight Sep. 2020
CPI	**3.62**	**4.05**	**4.10**
Core	**3.85**	**3.97**	**3.99**
Merchandise	**5.19**	**5.36**	**5.36**
Food, beverages and tobacco	6.89	7.04	6.98
Non-food merchandise	3.38	3.58	3.62
Services	**2.40**	**2.46**	**2.50**
Housing	2.38	2.28	2.21
Education (tuitions)	4.31	3.11	2.17
Other services	2.02	2.47	2.83
Non-core	**2.92**	**4.30**	**4.44**
Agricultural and livestock products	**5.55**	**8.09**	**8.39**
Fruits and vegetables	8.43	13.12	13.35
Livestock products	3.26	4.10	4.43
Energy and government-authorized prices	**0.95**	**1.50**	**1.53**
Energy products	-0.41	0.27	0.20
Government-authorized prices	4.01	4.25	4.51

Source:INEGI.



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