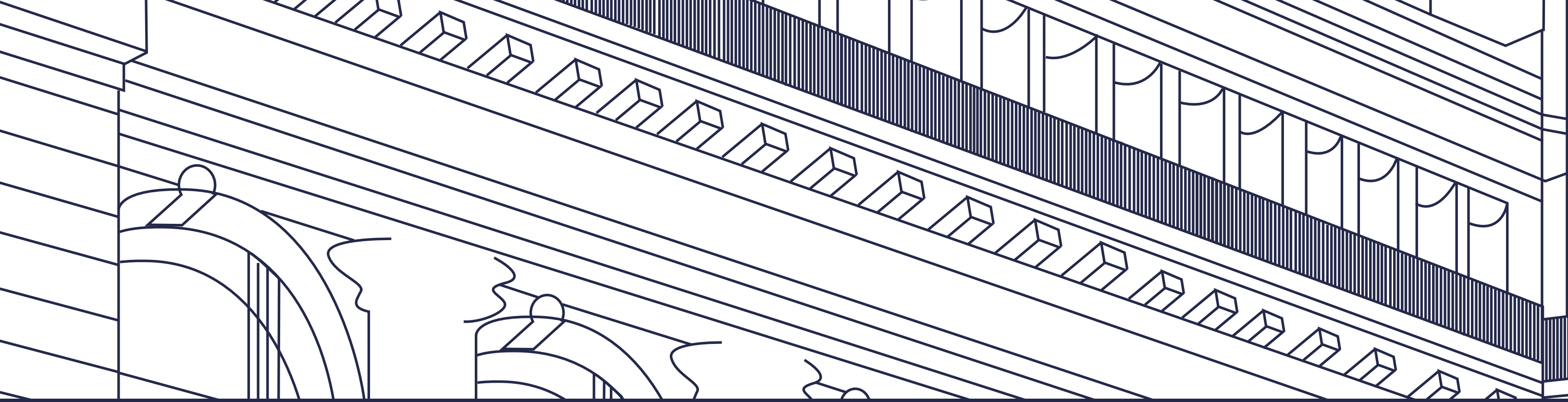

BANCO DE MÉXICO®

Minutes number 83

Meeting of Banco de México's Governing Board on the occasion of the monetary policy decision announced on March 25, 2021

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FOREWARNING
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1. PLACE, DATE, AND PARTICIPANTS

1.1. Place: Meeting held by virtual means.

1.2. Date of Governing Board meeting: March 24, 2021.

1.3. Participants:
Alejandro Díaz de León-Carrillo, Governor.
Galia Borja-Gómez, Deputy Governor.
Irene Espinosa-Cantellano, Deputy Governor.
Gerardo Esquivel-Hernández, 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

All members agreed that global economic activity continued to recover heterogeneously across countries and sectors. Some members attributed the recovery to the loosening of lockdown measures, the vaccination process, and to the fiscal and monetary stimuli. **One** member added that those economies with the most support, mainly the advanced ones, will reach pre-pandemic activity levels in a shorter time period.

Most members highlighted the improvement in global growth forecasts. Some members mentioned the upward revision of OECD forecasts for 2021 and 2022, to 5.6 and 4.0%, respectively. In the case of the U.S., **some** members underlined that the OECD forecast for 2021 was revised from 3.2 to 6.5%. **One** member noted that, in contrast, the economies of the euro area, the United Kingdom and Japan have observed a relatively weaker recovery.

Most members considered that expectations of a more vigorous recovery in the U.S. are associated with the approval of the significant fiscal stimulus and with progress in the vaccination process. One member stated that the output gap in that economy is foreseen to be positive before the year ends and that it will remain positive during the next two years. **Another** member considered that the fiscal package approval has significantly affected the global economic outlook. **Some** members pointed out, as risks to the world economy, the evolution of the pandemic and possible delays in the vaccination programs.

Most members noted that commodity prices rose. They highlighted that oil prices exhibited significant increases and volatility. One member added that increases in those prices have moderated in view of the OPEC's decision to maintain its supply of crude oil.

Most members pointed out that global inflation rose mainly due to the increase in energy prices, highlighting that, in advanced economies inflation remains at levels below their central bank targets. One member added that this also reflected the impact of temporary factors and the end of subsidies and tax cuts that had been implemented in some countries in response to the pandemic. **Some** members mentioned that in most emerging economies inflation has risen recently. **One** member considered that the exchange rate depreciation contributed to the above. **Another** member pointed out that in some of these economies inflation remains close to or even below the targets of their respective central banks.

Most members stated that global inflation expectations have been revised upwards, particularly in the U.S., in light of a greater fiscal stimulus and an outlook for a more vigorous recovery. Some members noted that compensation for inflation and inflation risk in the medium term has increased. **One** member stated that, in the U.S., inflation risk premia rose by 50 basis points this year so far and that five-year, five-year forward inflation expectations reached 2.4%. **Another** member pointed out that fixed-income assets have begun to incorporate the higher inflation expectations. **Some** members added that the fiscal stimulus is foreseen to enable higher growth without exerting significant pressure on prices. **One** member considered that this assumes a small slope in the Phillips curve. **Another** member recalled that inflation in said country has been persistently low in recent years, and that thus it is still to be seen if, on this occasion, the economic recovery will have a sustained effect on prices.

Most members mentioned that the central banks of advanced economies reiterated their intention to maintain accommodative monetary policy stances. They underlined that the Federal Reserve anticipates it will maintain an accommodative policy stance for an extended period and that said central bank considers inflationary pressures in 2021 to be transitory, and that for this reason, an increase in the federal funds rate will not be necessary until 2023. One member emphasized that such central bank maintained the range for its reference rate and its asset purchase program for USD 120 billion, although inflation pressures seem to be demand-related. In this regard, **another** member indicated that a first element of uncertainty over the Federal Reserve's monetary policy stance refers precisely to the asset purchase program, which was designed for an environment of weak demand, and that it is currently in a juncture of increased public debt issuances and high uncertainty in the mid- and long-end of the yield curve. He/she noted that an eventual announcement of a downward adjustment in asset purchases could have a significant impact on markets. **One** member added that a greater tightening in financial conditions, stemming from a possible reversal of the monetary stimulus, in a context of historic levels of both public and private debt, could pose a risk to global financial stability. **Another** member pointed out that the interest rate trajectory implied by market instruments indicates that the reference rate will start to increase in 2022, which differs from the Federal Reserve's forecast. He/she added that this discrepancy, as well as the volatility observed in global markets, could be due to a lack of understanding or confidence in the implementation of the new monetary policy framework. In this regard, he/she noted the highly accommodative nature of monetary policy as a result of the change in long-term targets announced by the Federal Reserve last August. He/she mentioned that, on the one side, the maximum employment goal is more ambitious than before since it is now defined as broad-based and inclusive. He/she pointed out that said central bank has acknowledged that the benefits of the economic recovery reach the most disadvantaged only after several years of sustained growth. He/she stated that, on the other hand, the price stability goal is more lax than before given that after inflation has remained below 2% for a certain period, now it will be allowed to be slightly above 2% for a certain time. He/she concluded that the latter implies that monetary policy must remain accommodative for a longer period than what the past framework implied. He/she underlined that it would be foreseeable that the discrepancy in the trajectory of interest rates fades away insofar as the Federal Reserve communicates its signals clearly and consistently.

Most members observed that some emerging economies' central banks have begun to implement a less accomodative monetary policy and have even increased their reference rates. One member said that, in some cases, these actions were unexpected, and took place in a context of inflationary pressures. **Another** member pointed out that most central banks of these economies maintain highly accommodative monetary policy stances. He/she stressed that although it is true that some central banks of these countries have recently raised their reference rates, the idiosyncratic character of these decisions needs to be highlighted, and therefore no simplistic extrapolations of these episodes should be made.

All members highlighted the large fiscal stimulus recently approved in the United States. Most of them observed that such stimulus equals approximately three times the US output gap in 2020. One member pointed out that it represents over 9% of 2020 GDP and it adds to the already expected deficit for 2021 of around 10.35% of GDP. He/she noted that a package of additional spending in infrastructure is currently being evaluated in the United States. He/she noted that it is not clear how much of the large transfers that will increase households' disposable income will be spent, and in which time-frame. He/she highlighted that in some advanced economies transfers of this type have been saved in greater magnitude than initially foreseen, which increases the uncertainty concerning the temporality of fiscal spending's impact on aggregate demand and its effect on inflation. **Another** member mentioned that while some specialists argue that this program would cause an economic overheating and a de-anchoring of inflation expectations, others consider that it would not generate a persistent increase in inflation above its target nor an early tightening in financial conditions. He/she stated that in any case the approval of the stimulus has had a significant effect on the world economic outlook and on international financial markets. **One** member stated that, for emerging economies, this environment implies higher levels of external demand and therefore higher growth –driven by the boost generated by a more vigorous growth in the U.S. – but also tighter financial conditions.

All members agreed that global financial markets exhibited volatility and that medium- and long-term interest rates increased in the United States, in view of the approval of a large fiscal stimulus and prospects of higher growth. Most members pointed that an adjustment in portfolios has been observed. Some members stated that, in general, tighter global financial conditions have been observed, with increases in all terms of the yield curves. **One** member added that volatility in financial markets is also due to various factors, such as: i) the pandemic-related shock, whose origin is not associated to the economic or financial cycle; ii) the outlook of a heterogeneous global recovery across countries, with significant differences in their yield curves and with possible exchange rate adjustments and adjustments in the external accounts; and iii) the modification of the Federal Reserve's monetary policy strategy, which implies that there is no available information to anticipate or extrapolate the Federal Reserve's possible actions or the implementation of its new strategy.

Most members mentioned that the US dollar appreciated and that stock markets in advanced economies registered moderate gains. Some members pointed out the positive effect of higher growth prospects. **One** member mentioned that the technology sector was the exception because of a possible overvaluation of its assets. **Another** member stated that risk asset prices have increased in general due to excess liquidity, which implies a latent risk of adjustments in their prices.

Some members noted a less favorable environment for financial markets in emerging economies, which incorporates the expectation of tighter global financial conditions. **Most members stated that negative capital flows were registered, particularly to fixed-income assets. One** member mentioned that inflows to equity assets continue, mainly towards the Asian region. **Most members highlighted the recomposition of capital flows towards the Chinese economy, due to the incorporation of their debt instruments in global bond indices. Some** members pointed out that, given the interest rate levels in China and the low exchange rate risk in its instruments, the remaining emerging economies face greater challenges to attract capital flows. **One** member added that the increase in medium- and long-term interest rates in the United States also implies greater difficulties to attract and retain capital, exchange rate adjustments, and upward pressures on yield curves. He/she also mentioned in addition to such challenges the idiosyncratic effects of the pandemic on the macroeconomic soundness and the recovery outlook of emerging economies. **Another** member pointed out that a slight increase in the country risk indicators of these economies was also observed.

Some members identified possible inflation surprises as a risk for financial markets. In this regard, **one** member highlighted the case of the United States. **Another** member referred to the possibility of the monetary stimulus reverting in different economies and expects the environment of uncertainty to prevail until the effects of the fiscal stimulus on inflation and on interest rates are clearer. **One** member pointed out that global financial markets will continue to benefit from the economic recovery prospects. He/she added that the possibility of a reversion in long-term interest rates should not be discarded, in case market expectations start to align with the Federal Reserves' messages, although there could be additional episodes of volatility as long as some degree of uncertainty or mistrust regarding the future trajectory of interest rates persists.

Economic activity in Mexico

All members highlighted that domestic economic activity decelerated in January and February. Most members stated that the deceleration was due to the intensification of the pandemic, the implementation of new mobility restrictions, as well as supply disruptions of certain inputs. They underlined that some timely indicators point to a contraction during the first quarter of 2021. One member stated that the Timely Indicator of Economic Activity suggests an annual variation of-4% in the Global Indicator of Economic Activity (IGAE, for its Spanish acronym) in February. **Another** member mentioned that the economic recovery is still in a critical situation.

Regarding demand, most members agreed that the recovery has been driven mostly by the external sector. One member highlighted that in January manufacturing exports surpassed their pre-pandemic levels. In this regard, he/she stressed that external demand is expected to continue contributing significantly to the economic recovery in Mexico. He/she considered this to be the case, given the upward revisions to US industrial production forecasts for 2021. He/she added that the recovery of exports and the weakness of imports have contributed to a large trade surplus. **Nevertheless, most members noted that exports decelerated in January. Some** members underlined that the fall in Mexican exports was mainly due to a global shortage of key inputs.

Most members mentioned that investment and consumption remain lackluster. One member pointed out that in the last months both components have decelerated in response to the additional distancing measures implemented, and highlighted that investment has been significantly affected. **Some** members added that investment and its components remain below pre-pandemic levels, **one** member noted that both domestic machinery and equipment, and construction remain the most affected sectors. **Some** members added that capital imports, construction and sales of heavy vehicles remain weak. As for consumption, **one** member underlined that total sales reported by the National Association of Self-Service and Department Stores (ANTAD, for its Spanish acronym), domestic retail sales of light vehicles and weekly spending via credit and debit cards increased moderately, and are still at levels below those recorded prior to the pandemic. **Another** member considered that job losses and the deterioration of consumer confidence suggest that consumption will continue to recover at a slow pace, despite the dynamism of remittances. **One** member highlighted that remittances continue supporting both consumption of over 1.7 million households and the economic recovery.

Regarding supply, all members underlined the loss of dynamism in production at the beginning of the year. They pointed out that this was mostly due to the mobility restrictions implemented in some states and to the temporary interruption in the supply of some industrial inputs. Most members highlighted that the manufacturing sector, particularly the automotive industry, was affected by the shortage of semiconductors. One member recalled the disruptions to the supply of natural gas and of electric power in Mexico, which derived from climatic events in the south of the U.S. in mid-February.

Most members pointed out that a gradual and heterogeneous recovery across sectors and regions is expected. One member underlined that the recovery has been differentiated and that the economic subsectors, which continue registering a contraction of over 5% in their monthly activity as compared to their pre-pandemic levels, account for around 26% of GDP. He/she added that, within the industry, manufacturing has led the recovery, while construction registers activity levels that are over 10% lower than those registered in early 2020. He/she added that services have exhibited an even more differentiated behavior, in which those provided in person continue to be significantly affected.

Most members noted that the recovery of the labor market has lost strength and that some indicators have deteriorated at the margin. One member mentioned that the national labor participation rate stagnated in January due to a lower urban participation rate. **Another** member pointed out that, although up to February of this year 9.7 out of the 12.5 million jobs lost between February and April 2020 were regained, said recovery has lost dynamism. He/she added that in February IMSS-insured jobs were 3.28% below the figure registered during the same month of 2020. **One** member mentioned that estimates of urban unemployment were above 6.5% in January, and that the broadest unemployment measure, which includes the unemployed population, the underemployed population and the population available to work, increased by 900 thousand people between December and January. **Some** members expressed their concern about the deterioration of the labor market being greater for women, which has widened the gender gap. **One** member indicated that differences between age groups have also increased.

Most members highlighted the increase in growth expectations for the Mexican economy in 2021. They mentioned that this is mainly due to a greater boost from external demand and to prospects of progress in the vaccination process. One member added the better-than-expected performance of economic activity during the second half of 2020 and higher levels of activity associated with the expenditure for the electoral process of June 2021. **Another** member emphasized that, starting from February 15, Mexico began the national vaccination campaign among the senior citizens. **Some** members pointed out that, as mobility restrictions ease and greater progress is attained in the vaccination process, the pace of recovery is expected to accelerate in the second half of the year. **The majority of members highlighted that in the last weeks various sources have revised growth expectations for 2021 upwards. One** member considered it feasible for the economy to grow over 5% in 2021 despite weak investment. He/she also underlined that said growth will not be sustainable or lasting in the absence of a significant recovery of productive investment in the medium and long terms.

The majority of members pointed out that productive activity continues to operate under ample slack conditions. One member stated that these slack conditions are shown by diferent indicators, which reflect a considerable underutilization of available resources in the economy. He/she mentioned that the output gap remained close to 7% and that the labor underemployment rate lied at 15%, close to twice the figure observed in normal times. **Another** member mentioned that available information suggests that slack conditions will remain significantly wide during the first quarter of 2021. **Most members stated that ample slack conditions are anticipated throughout the forecast horizon. One** member mentioned that the amount of slack might decrease as the economic recovery becomes more vigorous. **Another** member added that slack conditions will be very different across sectors.

Some members highlighted that the balance of risks for economic activity is biased to the downside. **One** member underlined that, although this bias has diminished due to an improved economic outlook, challenges stemming from the weakness of demand and the labor market, as well as from the evolution of the pandemic, persist. **Another** member highlighted that despite the improvement in the expected recovery, the following risks stand out: i) an upsurge in COVID-19 cases or delays in the vaccination program; ii) negative effects of input shortages on production; iii) volatility in financial markets; iv) deterioration of credit portfolio quality; v) lower public revenues, impacts on sovereign risk and on the conditions of access to financial markets; and vi) uncertainty affecting investment.

Inflation in Mexico

All members mentioned the increase in annual headline inflation. Some members noted that this increase was higher than expected. **One** member pointed out that it was above the market consensus and even above the highest expectations drawn from the latest survey. He/she explained that the prices of goods and services which are more sensitive to pressures generated by energy prices and the exchange rate, are the ones increasing the most. **Another** member pointed out that the pandemic has implied changes in relative prices, with upward pressures on merchandise inflation and downward pressures on services inflation. He/she added that in addition there are pressures on the prices of certain raw materials, mainly those that are energy-related. He/she stated that all of the above reflects the shocks to which inflation has been subject. **One** member noted that although the level of inflation during the first fortnight of March was above the interval established by Banco de México, this should not be interpreted as a generalized increase in prices. He/she detailed that the proportion of goods and services with significant monthly variations below their historical averages is close to 50% and that the percentage is higher if the components of core inflation are the only ones considered. He/she stated that this has not translated into lower inflation because the intensive component of increases in certain prices has prevailed over the extensive component of decline in inflation of most prices.

Most members pointed out that core inflation increased during the first fortnight of March, with **some** members highlighting the upward trend of the non-food merchandise component. **One** member mentioned that this was mainly due to the increases in the prices of furniture and household appliances, clothing and footwear, entertainment material, and vehicles and car accessories. He/she added that the food merchandise component remained high. **Some** members highlighted the slowdown in services inflation and stated that the lower inflation of educational services partly offset the pressures in merchandise prices. **One** member noted the end of the downward trend in services inflation that had been observed since January. He/she highlighted that its increase reflected the rise in telecommunication and transportation services prices. He/she highlighted that housing and education prices continued registering lower increases, thus suggesting the prevalence of weakness in the domestic market. **Another** member pointed out that super core inflation remains at 3.17%.

The majority of members mentioned that annual non-core inflation rose significantly during the first fortnight of March, due to the increase in energy prices. One member highlighted the faster increase in domestic gas prices. **Another** member underlined the increase in agricultural and livestock product prices, mainly in those of livestock.

Some members pointed out that headline inflation expectations for the end of 2021 increased and that those for the medium and long terms remained stable at levels above the 3% target. **One** member highlighted that those for the end of 2021 ended near the upper limit of the variability interval of Banco de

México's target. **Some** members mentioned that the inflationary risk premium has increased at the margin. **One** member noted that annual inflation expectations drawn from market instruments remained anchored at levels close to 3% for the 1-10 year average. **Another** member noted that while these expectations remain below 3.2%, they have increased at the margin, and so has the inflationary risk premium. **One** member pointed out that breakeven inflation rates increased marginally for the 10- and 30-year nodes, while those for the 3-year term remained at 3.34%, still below their historic average figures.

All members mentioned that headline inflation is expected to increase in the next months. The majority pointed out that headline inflation will be temporarily affected by the arithmetic effects associated with last year's fall in energy prices. They stated that headline and core inflation are still expected to converge to the 3% target as of the second quarter of 2022. Some members noted that the projected short-term trajectories for inflation are slightly higher than those published in the Quarterly Report October-December 2020. **Some** members mentioned that higher increases in energy prices are expected due to the reactivation of the world economy. **One** member stated that higher annual core inflation levels are expected due to a more depreciated trajectory for the exchange rate and to the indirect effects of the increase in energy prices. **Another** member mentioned that both headline and core inflation are expected to begin declining as of July and lie closer to the target during the entire second half of 2021.

As for upward risks for inflation, most members mentioned possible episodes of exchange rate depreciation. Some members added greater pressures on energy price benchmarks. **Some** members pointed out greater inflationary pressures worldwide and tensions in core inflation due to the recomposition of spending towards merchandise. **One** member noted the uncertainty regarding the expected reduction in core inflation as of May, given the persistence it has shown for several years. He/she mentioned the risk of possible increases and volatility in commodity prices in world markets and in tourist services domestically. He/she added that slack conditions could be insufficient to offset the effects of supply shocks on inflation. **Another** member considered that the low services inflation will cease to offset merchandise inflation as activities start to reopen in the country. As for downward risks, **some** members highlighted the slack conditions in the economy, greater social distancing measures, and possible events of foreign exchange appreciation.

Some members pointed out that the balance of risks for inflation is biased to the upside. **One** member pointed out that such bias is observed in the short term. **Another** member added that this occurs despite the amount of slack in the economy, since it is foreseeable that core inflation pressures will continue due to the recomposition of spending derived from the pandemic, and that the low levels of services inflation stops offsetting the high levels of merchandise inflation as activities begin to reopen. He/she also mentioned that more episodes of foreign exchange depreciation can be expected due to external and domestic factors and to a higher level of inflation worldwide. **One** member considered that the balance has deteriorated at the margin. **Another** member highlighted that none of the inflation determinants have deteriorated significantly to the point of expecting upward pressures on prices given that: i) ample slack conditions persist; ii) the peso exchange rate has withstood episodes of volatility and has depreciated only moderately; and iii) despite the increases in international oil prices, their impact on domestic prices is expected to be partially mitigated by the federal government's pricing policy. **One** member noted that both the global financial environment and the increase and volatility in international energy price benchmarks could represent inflationary pressures that are difficult to foresee.

Macrofinancial environment

Regarding domestic financial markets, all members mentioned that the Mexican peso depreciated. Most members noted that its behavior has been volatile. One member considered that this is due to volatility in the long-term US Treasury bond market and that exchange rate tensions could be reinforced by downgrades of the sovereign and/or Pemex ratings, the election process to be held in June, and domestic policies that generate uncertainty.

Regarding the stock market, most members highlighted that the IPC stock market index registered gains. One member stated that this was due to the improvement in the growth outlook, which allowed this indicator to register a gain of 8%, one of the highest among emerging economy stock markets.

All members highlighted the increases in medium- and long-term interest rates. Most

members noted that these were due to the rise in international interest rates generated by the expected impact of the US fiscal package. Some members pointed out that the long end of Mexico's yield curve has increased between 80 and 100 basis points. **One** member mentioned that short-term rates increased up to 20 basis points, resulting in a significant steepening of the yield curve. He/she noted that domestic markets have shown a deterioration in trading conditions and an increase in volatility, in line with developments in international markets. **Another** member highlighted the possibility that, given a greater convergence between market expectations in the United States and the Federal Reserve's actions and messages, a reduction in medium- and long-term interest rates could be observed, and even an appreciation of the Mexican peso.

Most members pointed out that the sovereign risk premium increased due to a rise in global risk aversion. One member mentioned the impact of idiosyncratic factors. **Another** member stated that, despite the recent increase in the sovereign risk premium, it remains low, similar to pre-pandemic levels. He/she noted that this could be associated with the fiscal discipline in Mexico. **Some** members mentioned that a reduction in foreign holdings of government bonds was observed. **Some** members stated that Mexico has been affected by a recomposition of capital flows. In this context, they emphasized that it is important to monitor the effects of the integration of the Chinese financial market into international markets. **One** member noted that, despite equity market inflows, there was a net decrease in this position. **Another** member considered that, looking ahead, domestic financial markets could benefit from the favorable growth outlook.

Most members mentioned that financing to the private sector contracted for the eighth consecutive month. Some members noted that this contraction was observed for both large and smaller firms, although **one** member stated that demand for credit from SMEs has increased moderately. He/she noted that this contraction confirms the expectation of a tightening in credit approval for the first quarter of 2021 that was observed in Banco de México's Survey on General Conditions and Standards in the Banking Credit Market (EnBan, for its Spanish acronym). In this context, **another** member mentioned that the decrease in financing to the private sector occurred due to both less debt issuance and lower bank lending, in an environment of tight lending conditions, despite the reduction in interest rates. **One** member pointed out that business loans contracted at a real annual rate of 5% in January, while loans to SMEs decreased 8.2%. He/she warned that this differs from what has been observed in other economies, both advanced and emerging, where credit to firms has continued to expand, driven, among other factors, by real interest rates lower than those prevailing in Mexico. **Some** members noted that there was a high demand for liquidity from firms and households. **One** member pointed out that this was due to precautionary motives and lower opportunity costs of holding low or zero-yield assets.

Another member warned that the risks for financial stability have increased. **Some** members noted that firms and households register higher delinquency rates. **One** member added that this was observed even though most loans are established at variable rates and are benefitted by an accommodative monetary policy stance. He/she stated that low interest rates tend to reduce the profitability of financial institutions, especially smaller ones, which, along with the aforementioned increase in delinquency rates and the regulatory requirements, can reduce the room for maneuver to expand credit supply. This, in a context where an excess of global liquidity has increased world investors' risk taking, which has affected both valuation and risk of financial institutions' market portfolios. **Another** member noted that, although bank credit interest rates have followed the dynamics of the funding rate, intermediation margins continue to be at levels higher than those observed prior to the pandemic.

One member warned about the Federal Government's recently announced additional support for Pemex, for an amount equivalent to 1% of GDP, through a lower tax burden, greater capitalization and debt amortization. He/she considered that, although this support will not affect the public sector's budget deficit, it will imply issuing debt in an environment of higher interest rates. He/she added that in the next years Pemex will face increasing maturities that will be difficult to meet without a structural plan. In this context, he/she mentioned that it is foreseeable that this company will continue to require the support of the Federal Government and exert pressure on public finances. **Another** member pointed out that fiscal discipline has distinguished Mexico from other countries that have resorted to greater indebtedness. He/she mentioned that it seems increasingly unlikely that the sovereign debt will lose its investment grade rating in the next few years.

Some members considered that macroeconomic fundamentals need to be strengthened to generate confidence and promote an orderly adjustment of the Mexican economy. **One** member pointed out that idiosyncratic risks continue to increase, with repercussions on the macroeconomic, institutional and rule of law framework. He/she highlighted the financial situation of Pemex and its implications for the sovereign debt rating, as well as the uncertainty related to the Electricity Sector Law. He/she stated that the latter has generated a significant number of legal proceedings that have so far resulted in more than 20 definitive suspensions. He/she stated that in addition to the negative effects for private investors, this could lead to actions by several countries, which would imply an environment of greater uncertainty, lack of confidence and volatility.

Monetary policy

Considering the abovementioned inflation forecasts, the risks they are subject to, as well as the need to consolidate a downward trajectory for headline and core inflation to the 3% target, all members agreed to maintain the target for the overnight interbank interest rate at 4.00%.

All members highlighted that monetary policy must ensure the anchoring of inflation expectations, and that headline and core inflation follow a downward trend. They pointed out the importance of inflation converging to its target within the time frame in which monetary policy operates. Most members mentioned that this pause in the easing cycle does not mean that said cycle has ended, and that looking ahead they will be aware in case the conditions allow for continuing it. They stated that although monetary policy might contribute to the recovery, it must do so without jeopardizing price stability. Furthermore, all members highlighted that monetary policy implementation faces risks associated, mainly, with the recent evolution of financial markets, and mentioned the importance of applying a prudent and cautious approach. Finally, they pointed out that, looking ahead, monetary policy implementation will depend on the evolution of the factors that have an incidence on inflation, on its foreseen trajectories within the forecast horizon, and on its expectations.

One member stated that emerging economies continue to be affected by pandemic-related shocks and that now they are also facing the effects of the US fiscal stimulus. He/she noted that said stimulus will increase the demand for exports, thereby supporting the recovery, but will also exert pressure on global interest rates and increase the risks of abrupt adjustments in financial markets. He/she pointed out that in small and open emerging economies, which need to complement their domestic savings with external financing sources, it is even more important to maintain a stable macroeconomic environment that attracts capital and fosters an orderly adjustment in the economy. In this regard, he/she considered that monetary policy should contribute to maintain inflation low and around its target, containing increases in risk premia and medium- and long-term interest rates, as well as exchange rate adjustments. He/she noted that the pandemic has implied a significant economic contraction and major changes in relative prices. This, in a context of an exchange rate depreciation, pressures on fiscal revenues, challenges regarding the sovereign credit rating, and recent increases in external interest rates. He/she pointed out that in addition to the above, the prices of some commodities, mainly energy-related, have increased. He/she mentioned that in view of the challenges described above, monetary policy must foster an orderly adjustment of relative prices and prevent an impact on price formation and inflation expectations, in order to maintain low inflation on a sustained basis. He/she added that the risks to which domestic financial markets and inflation are subject to have increased. He/she highlighted that the latest information shows a greater persistence of inflationary pressures on core inflation. Although it is foreseen that such pressures will be transitory, it is necessary to maintain a prudent monetary policy stance that leads to a decreasing trajectory for headline and core inflation towards the 3% target.

Another member pointed out that headline inflation is expected to rebound during the second quarter of the year, due to two factors that will generate an increase in the non-core component. He/she pointed out that one factor is the arithmetic effect related to a low annual comparison base and the other has to do with the increases in energy prices that are already taking place due to the reactivation of the world. He/she stated that, in principle, both factors are generated by supply shocks that are transitory and that give rise to changes in relative prices or to first-round adjustments in inflation. On the other hand, he/she mentioned that since the last meeting, greater volatility in financial markets and a reversion of capital flows have been observed. He/she considered it prudent to make a pause in the monetary easing cycle and pointed out that this should not be considered as the end of such cycle, but rather a pause that will allow to validate expectations of a downward trajectory of the core component. He/she highlighted the need to evaluate the presence of second-round effects that affect inflation expectations, the effects of the fiscal stimulus in the United States, the conditions in which international financial markets operate, and the slack conditions. He/she underlined that on previous occasions the conditions were appropriate to act concurrently with the easing cycle, but that now it was necessary to monitor the available information carefully to evaluate whether there is another opportunity to support the economic recovery without jeopardizing price stability and without compromising the anchoring of medium- and long-term inflation expectations.

One member underlined that in the case of Mexico there is statistically significant evidence that the rise in long-term interest rates in the United States increases sovereign risk indicators, which in turn affects the exchange rate. He/she stated that the recent evolution of international financial markets suggests acting prudently, and therefore the monetary policy decision should consider the probability of a more depreciated exchange rate, in order to anticipate more objectively the trajectory of inflation's convergence to the target within the forecast horizon. He/she added that said decision should take into account the beginning of the normalization of reference rates in emerging economies and the fact that despite the amount of slack, the balance of risks for inflation is biased to the upside. He/she added that the tightening in financial conditions and a low margin of fiscal support reduce the room for maneuver for monetary policy. Given the complex environment, he/she considered it essential that monetary policy is conducted prudently and cautiously, in order to promote an orderly adjustment of financial markets and the sustained convergence of inflation to the 3% target.

Another member stated that, since the last decision, the window of opportunity for further monetary easing has closed. This, as a result of serious doubts about the forecasted trajectory of inflation's convergence to the target, especially in the short term; the possibility of further external financial shocks; the stability of the financial system; the evolution of the pandemic and the vaccination campaign; and the limits faced by a low reference rate. He/she acknowledged that, while it has been confirmed that the economic recovery remains fragile and needs as much monetary support as possible, there are considerations that imply a pause in monetary easing. He/she pointed out an increase in inflation, a steepening of the yield curve, a greater depreciation of the Mexican peso, an increase in risk aversion, certain impacts on macro-financial stability, and the possibility of more external shocks of a financial nature. He/she noted that this scenario is largely the result of the approval of the fiscal package in the United States. He/she highlighted that in order to be able to maintain low rates to support the economic recovery, the existing room for maneuver should be managed with caution, as we are near the lower limit of the reference rate. Thus, the accommodative cycle should resume only when the circumstances allow for it and better opportunities are present again. He/she pointed out that the highly volatile external circumstances have reduced the room for maneuver of the relative monetary policy stance. On the other hand, the space offered by the absolute policy stance can be reduced due to higher inflation rates and to an increase in the short-term neutral rate. He/she warned that Banco de México's sphere of action is limited by domestic and external economic-financial aspects that evolve rapidly and in directions difficult to detect. In particular, economic policy faces many unknowns that will have to be resolved. He/she stated that the dilemma for monetary policy is that the economy is in recession with a temporary increase in inflation and a core component that is not decreasing. Consequently, he/she considered that given the extraordinary conditions of the pandemic and the lag with which monetary policy operates, it is time to cautiously assess monetary policy's room for maneuver in order to avoid in the future a position of vulnerability that may affect the credibility of the Central Bank, as well as the anchoring of inflationary expectations. He/she emphasized that monetary support should continue, especially in the absence of fiscal support, which implies that monetary policy continues being the only available tool, even when this is not ideal. He/she therefore stated the need for a monetary support such as domestic and external financial conditions allow. He/she pointed out that this pause does not mean that monetary easing has ended, but that windows of opportunity should be carefully determined to continue supporting the economic recovery while reinforcing Banco de México's commitment to monetary stability.

One member mentioned that a pause will allow for strengthening the message of the Central Institute's commitment to price stability at a time of various concerns due to both domestic and external factors. Looking ahead, he/she considered that there is still room for additional interest rate cuts, which, if they materialize, could contribute to the recovery of the Mexican economy without jeopardizing the price stability objective. He/she pointed out that Mexico, unlike other countries, has maintained solid macroeconomic fundamentals that could allow implementing an accommodative policy stance for a prolonged time, without the need to anticipate the adjustments the Federal Reserve will eventually make. He/she mentioned that fiscal discipline has contributed to reduce domestic absorption and, therefore, to improve the current account, which in turn contributes to reduce pressures on the exchange rate. He/she also stated that fiscal discipline relieves pressure on the sovereign risk premium and prevents capital outflows related to concerns about default. He/she highlighted that the origin of the recent episode of volatility in global markets is the prospect of a rapid economic recovery of our most important trading partner, so that the current situation does not essentially imply a negative shock. He/she mentioned that, from his/her point of view, most of the volatility stems from the inadequate perception of the role that central banks will play in the recovery process, which he/she considered will be resolved if the Federal Reserve remains clear and consistent in its policy messages and actions, as it has been doing so far. He/she considered that additional interest rate cuts would be beneficial for several reasons: i) the economy will continue to operate with an ample amount of slack for an extended period; ii) an unfavorable performance is observed in those areas where monetary policy has a direct impact, such as credit to households and firms, consumption and investment; iii) the current account surplus reflects that the monetary policy stance is still restrictive for the current economic conditions; and iv) Mexico's real interest rate continues to be above that observed in most emerging economies. He/she expressed that there could be a window of opportunity to continue with the monetary easing process as long as the rest of the macroeconomic policies continue being a factor of stability and price anchoring, and once the current uncertainty in financial markets is resolved.

3. MONETARY POLICY DECISION

In a highly uncertain environment, the risks for inflation, economic activity and financial markets pose major challenges for monetary policy. It is necessary to enable an orderly adjustment of financial conditions and a change in relative prices, without affecting price formation and inflation expectations. Considering the abovementioned inflation forecasts, the risks they are subject to, as well as the need to consolidate a downward trajectory for headline and core inflation to the 3% target, with the presence of all its members, the Governing Board decided unanimously to maintain the target for the overnight interbank interest rate at 4.00%. Looking ahead, monetary policy implementation will depend on the evolution of the factors that have an incidence on inflation, on its foreseen trajectories within the forecast horizon, and on its expectations.

The Governing Board will take the necessary actions based on incoming information in order for the policy rate to be consistent with the orderly and sustained convergence of headline inflation to the 3% target within the time frame in which monetary policy operates. It is necessary 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, Galia Borja-Gómez, Irene Espinosa-Cantellano, Gerardo Esquivel-Hernández and Jonathan Ernest Heath-Constable voted in favor of maintaining the target for the overnight interbank interest rate at 4.00%.

ANNEX

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

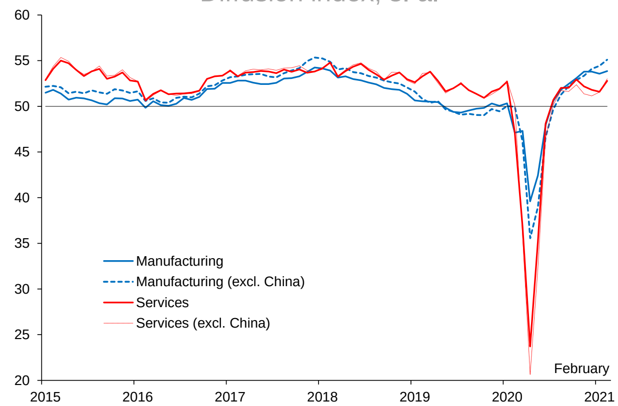
A.1. External conditions

A.1.1. World economic activity

The world economy continued to recover at the beginning of 2021, although heterogeneously across countries and sectors. This reflected, among other factors, the lockdown measures implemented in several countries in response to the upsurge in COVID-19 cases at the end of 2020 and the beginning of 2021, the economic policy measures adopted, as well as differences in the sectoral structure of economies (Chart 1). Thus, while economic activity in the United States has continued to recover at a vigorous pace, the euro area, the United Kingdom and Japan have exhibited a relatively weaker growth. Leading and higher frequency indicators suggest that world economic activity could strengthen in response to the easing of lockdown measures, progress in the vaccination process, and the fiscal stimuli approved for this year in various major economies. However, risks for this recovery persist, such as those associated with the evolution of the pandemic, delays in vaccination programs and a greater tightening of global financial conditions.

In the main advanced economies, headline inflation and its expectations recently registered increases, reflecting the rise in energy prices, as well as the effects of some transitory factors and the end of subsidies and tax cuts implemented in some countries in response to the impact of the pandemic. Nevertheless, inflation remains below their central banks' targets. In this environment, the authorities have maintained an accommodative monetary policy stance and, in some cases, have extended their fiscal stimuli to mitigate the adverse effects of the pandemic. In this context, financial markets registered volatility and increases in interest rates of medium- and long-term government bonds, particularly in the United States.

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

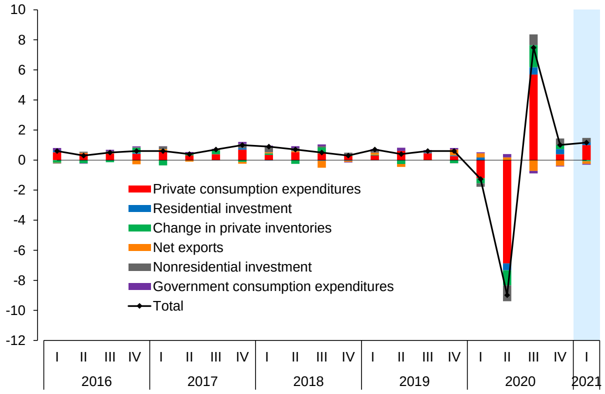


s. a. / Seasonally adjusted figures.
Source: Markit.

In the United States, available indicators suggest that economic activity continued to recover at a vigorous pace at the beginning of the first quarter of 2021, driven by the fiscal package approved last December, by progress in containing the pandemic and in the vaccination process, and by the approval of a new large fiscal stimulus program. Looking ahead, private consumption and investment are expected to continue to be supported by the monetary and fiscal stimuli as well as the continuing recovery of consumer and business confidence (Chart 2).

US industrial production continued to recover in January 2021, registering a monthly growth of 1.1%, which reflected the continued expansion of mining and manufacturing activity. However, in February, it registered a monthly contraction of 2.2% due to frosts in several regions of the country that led to weakness in mining activity and in some manufacturing industries, and due to a shortage of supplies for the automotive industry. Some leading indicators, such as the Purchasing Managers' Index (PMI) of the manufacturing sector, suggest that activity in this sector might resume its growth rate in the short term.

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



s. a. / Seasonally adjusted figures.
Source: Bureau of Economic Analysis (BEA) and Blue Chip (March 2021).

After having contracted in December 2020 due to the reimposition of social distancing measures, the US labor market exhibited an improvement in January and February 2021. The unemployment rate decreased from 6.3% in January to 6.2% in February. The non-farm payroll increased by 379,000 new jobs in February, reflecting improvements in the items of accommodation and food services and arts, entertainment and recreation, which had been strongly affected by the lockdown measures. Despite the partial recovery at the margin, employment is still 9.5 million below pre-pandemic levels.

In mid-March 2021, a new $1.9 trillion fiscal support package was approved in the United States to face the health, economic and social impact of the COVID-19 pandemic. This package includes, among other measures, support for workers and families through direct financial assistance, the extension of supplemental unemployment insurance payments, the expansion of fiscal credits, and support for the payment of rent, mortgages and energy services. Supports for small firms and state and local governments, several health care and COVID-19 response measures, as well as others focused on education and transportation were also approved.

In the euro area, some available and higher frequency indicators suggest that social distancing measures and a slower vaccination process than in other advanced economies have continued to affect economic activity so that a weak recovery is expected during the first quarter of 2021, after having contracted at a seasonally adjusted quarterly rate of 0.7% during the fourth quarter of 2020.[1] The Purchasing Managers' Index of the manufacturing sector, however, registered a strong rebound in February. The unemployment rate remained unchanged at 8.1% between December and January. Looking ahead, the recent reimposition of lockdown measures may extend the weakness of some economies in this region.

In the United Kingdom, after having grown 16.1% during the third quarter of 2020, GDP grew at a seasonally adjusted quarterly rate of 1.0% during the fourth.[2] This moderate growth reflected the imposition of new lockdown measures in most parts of the country since November. Available indicators to the first quarter of 2021 suggest a weakening of the economy, mainly in services, due to the aforementioned measures. In addition, international trade figures have started to reflect the negative impact of the greater trade barriers resulting from the United Kingdom's exit from the European Union. In this environment, the unemployment rate decreased from 5.1% in the three months ending in December 2020 to 5.0% in the three months ending in January 2021.

In Japan, after having grown 5.3% during the third quarter of 2020, GDP grew at a seasonally adjusted quarterly rate of 3.0% during the fourth.[3] The growth in activity was driven by business investment and net exports and, to a lesser extent, by private consumption. However, some indicators available to the first quarter of 2021, such as retail sales and machinery orders, point to a slower recovery of the economy. As for production, industrial activity continued to be driven by higher global demand. Regarding the labor market, the unemployment rate decreased moderately, from 3.0% in December to 2.9% in January.

In emerging economies, available indicators suggest that economic growth has been heterogeneous during the first part of 2021. In China and in the rest of Asian emerging economies, timely indicators show that they continued to expand at the beginning of 2021, although at a slower pace than in the fourth quarter of 2020. Particularly in China, the loss of dynamism seems to be associated with a more moderate growth of consumption and investment

[1] In seasonally adjusted annualized terms, euro area GDP was -2.6% during the fourth quarter of the year.
[2] In seasonally adjusted annualized terms, UK GDP grew 81.9% during the third quarter of the year and 4.0% during the fourth.
[3] In seasonally adjusted annualized terms, Japan GDP grew 22.8% during the third quarter of the year and 11.7% during the fourth.

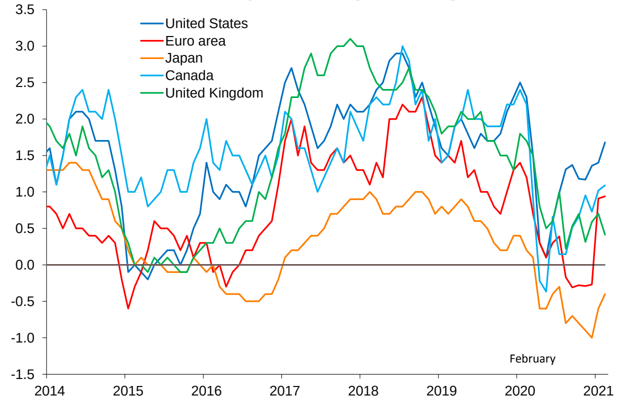
due to the gradual withdrawal of certain stimuli policies. In contrast, exports have continued to expand at a high pace, favoring the performance of industrial activity. In Eastern Europe and Latin America, economic performance has been more heterogeneous, as Chile and Russia would appear to have continued expanding at a moderate rate, while others, such as Hungary and Brazil, may have registered a contraction as a result of the intensification of the COVID-19 health crisis.

Since México's previous monetary policy decision, international commodity prices overall increased, although in some cases registering volatility. Oil prices were driven by several factors. One was the suspension of US oil production due to the strong frosts that occurred in February. Another was the agreement between OPEC members and other producers to continue cutting oil production until April, and Saudi Arabia's decision to maintain its voluntary cut of 1 million barrels daily. Expectations of higher world growth given the approval of new fiscal stimuli in some of the major economies was also a factor. Industrial metal prices increased during February due to the recovery of global industrial activity and the optimism generated by the eventual approval of a new fiscal stimulus package in the United States. However, in March, prices have declined due to concerns about a more moderate pace of recovery of China's economic activity. Finally, grain prices remained relatively stable throughout the period, even though unfavorable weather conditions have affected crops, especially in the United States and South America.

A.1.2. Monetary policy and international financial markets

In the main advanced economies, headline inflation increased recently (Chart 3), reflecting the rise in energy prices as well as the effects of some temporary factors and the end of subsidies and tax cuts implemented in some countries in response to the pandemic. Nevertheless, headline inflation remains below their central banks' targets. Inflation expectations for some of these economies have risen. This has been more evident in the United States.

Chart 3
Selected Advanced Economies: Headline Inflation
Annual percentage change

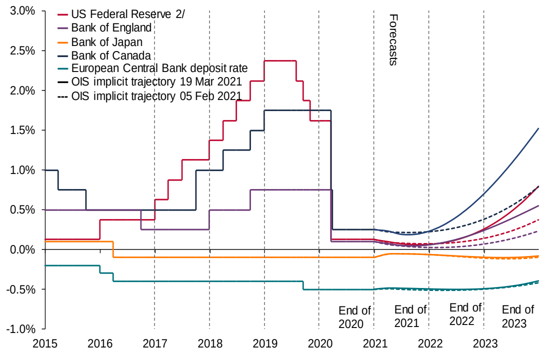


Source: Bureau of Labor Statistics, Eurostat, Bank of Japan, Statistics Canada, Office of National Statistics.

In emerging economies, headline inflation has continued to show a heterogeneous behavior, although it has recently increased in a large number of them. On the one hand, in economies such as Brazil, Russia and Turkey, headline inflation has continued to rise, reflecting increases in food and energy prices, as well as the effects of the depreciation of their currencies. On the other hand, in countries such as Chile, Indonesia and Peru, headline inflation has decreased at the margin.

The central banks of the major advanced economies maintained their reference interest rates at historically low levels. They also continued to use their balance sheets, with adjustments in the pace of asset purchases in some cases, to preserve favorable financing conditions and, thus, support the provision of credit, boost economic activity and seek the convergence of inflation to their respective long-term targets. They also reiterated that they will maintain accommodative monetary policy stances until inflation reaches their targets in a sustained manner. In this context, expectations drawn from market instruments continue to anticipate that these central banks will maintain highly accommodative monetary policy stances, although they are starting to incorporate expectations of a moderate rise of interest rates by some central banks in a longer horizon. In particular, in the case of the United States, during the past weeks there was an increase in the trajectory implied by financial instruments for the federal funds rate in the next years, which was associated with the approval of a large fiscal stimulus package and expectations of higher growth in this country (Chart 4).

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



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

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

i) In its March meeting, the Federal Reserve left its range for the federal funds rate unchanged at 0-0.25% and reiterated that it will be appropriate to maintain it until labor market conditions have reached levels consistent with its maximum employment estimate and inflation has increased to 2% and is on track to moderately exceed this target for some time. It also stated that it will maintain the current pace of its asset purchase program at least until substantial progress has been made towards its maximum employment and price stability goals. In this context, the medians of forecasts by the Federal Open Market Committee (FOMC) published in March reflect expectations of greater growth and higher inflation for this year, although the increase in inflation is expected to be transitory. As to the reference rate, the median of forecasts suggests that it will remain unchanged until at least 2023, although the number of members expecting upward adjustments during 2022 increased from one to four and the number of those expecting said adjustments during 2023 increased from five to seven. The Chairman of the Fed's Board of Governors pointed out that a transitory increase in inflation above 2%, such as that foreseen for this year, would not meet the conditions established for adjusting the interest rate.

ii) In its March meeting, the European Central Bank maintained 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 robustly 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 maintained its asset purchase programs unchanged, although it pointed out that purchases under the pandemic emergency purchase program (PEPP) are expected to be made at a significantly higher pace during the first months of the year, due to the recent sharp increase in long-term interest rates. Thus, this central bank pointed out that purchases will be made in a flexible manner according to market conditions and to avoid an unexpected tightening of financial conditions.

iii) In its March 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%. It also published the findings of the review of its monetary policy framework, based on which, it pointed out that, in order to reach its inflation target, it will continue the monetary easing in a sustained manner and it will provide fast and effective answers. In this regard, it announced a series of actions, among which the following stand out: a new interest rate scheme to promote lending, the widening of the range of 10-year Japanese government bond (JGB) yield fluctuations to +/- 0.25% from the target level, and the introduction of fixed-rate purchase operations for consecutive days to set an upper limit on interest rates when necessary. Said central bank also pointed out that it will continue to purchase exchange-traded funds (ETFs) and Japan real estate investment trusts (J-REITs) as necessary, with upper limits of about 12 trillion yen and about 180 billion yen per year, respectively, even after the COVID-19 pandemic subsides. In his press conference, the Chairman of said central bank ruled out that the announced measures are the prelude to the end of several years of a highly accommodative monetary policy.

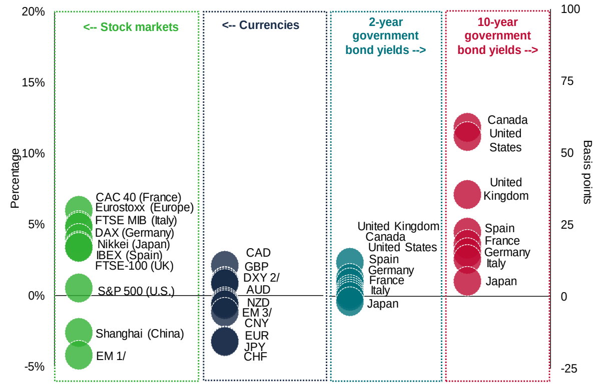
iv) In its March meeting, the Bank of England kept its reference interest rate unchanged at 0.10%, the amount of its asset purchase at £875 billion, and the stock of sterling non-financial investment-grade corporate bond purchases at £20 billion. In the minutes of said meeting, the Monetary Policy Committee noted that news on economic activity in the short term have been positive, although it is not clear to what extent they may modify the medium-term outlook, as it remains uncertain. The Committee reiterated that it has no intention to tighten its monetary policy stance at least until there is clear evidence that significant progress is being made in eliminating the excess slack in the use of productive capacity and in achieving a 2% inflation target in a sustained manner.

Since Banco de México's previous monetary policy decision, most central banks of the main emerging economies left their reference interest rates unchanged, except for Indonesia, which lowered it, and Brazil, Turkey and Russia, which increased them. Likewise, the central banks of these economies decided to maintain measures to provide credit, supply liquidity and foster the well-functioning of financial markets.

In the context of world economic activity described above, international financial markets registered volatility and increases in long-term interest rates of advanced and emerging economies. These episodes were mainly associated with the significant increase of medium- and long-term interest rates in the United States due to the approval of a large fiscal stimulus and expectations of higher growth. Concerns about the high valuations of some financial assets, especially in the technology sector, led to some episodes of losses in the stock markets of some of the main advanced and emerging economies during the period since Mexico's last monetary policy decision. In foreign exchange markets, the US dollar strengthened against most of the currencies of both advanced and emerging economies (Chart 5). In this environment, since Mexico's last monetary policy decision, most emerging economies registered capital outflows of fixed income assets, while inflows to equity assets continued, mainly in the Asian region (Chart 6).

In addition to the aforementioned risks to world growth, there are other risks to international financial markets' stability. One of them is a higher-than-anticipated increase in inflation that might be reflected in a significant rise in interest rates, particularly in the United States, which could lead to tighter financial conditions worldwide. There are still concerns associated with the high valuations of certain financial assets, which may lead to a sharp adjustment of their prices. The abovementioned factors may intensify the problems of business insolvency and bankruptcies, as well as the vulnerabilities associated with the high levels of public and private borrowing accumulated in recent years.

Chart 5
Change in Selected Financial Indicators from February 5 to March 19, 2021
Percent, basis points



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

Chart 6
Selected Emerging Economies: Financial Assets Performance from February 8, 2021
Percent, basis points

Region	Country	Currencies	Equity markets	Interest rates 2Y	Interest rates 10Y	CDS
Latin America	Mexico	-2.92%	6.40%	38	104	26
	Brazil	-3.47%	-2.90%	130	93	55
	Chile	2.32%	7.99%	6	66	13
	Colombia	0.27%	-4.25%	13	111	29
Emerging Europe	Russia	-0.48%	1.19%	92	84	27
	Poland	-3.90%	0.96%	-8	22	5
	Turkey	-12.24%	-9.84%	149	106	15
	Czech Republic	-2.60%	2.34%	73	49	2
	Hungary	-3.47%	-0.39%	40	32	5
Asia	China	-0.91%	-2.52%	-2	-1	4
	Malaysia	-1.20%	2.76%	18	66	6
	India	0.81%	-3.07%	16	14	15
	Philippines	-1.09%	-8.96%	73	153	7
	Thailand	-2.96%	3.29%	0	55	2
	Indonesia	-2.86%	1.49%	57	56	11
Africa	South Africa	0.70%	1.31%	75	82	18

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

A.2. Current situation of the Mexican economy

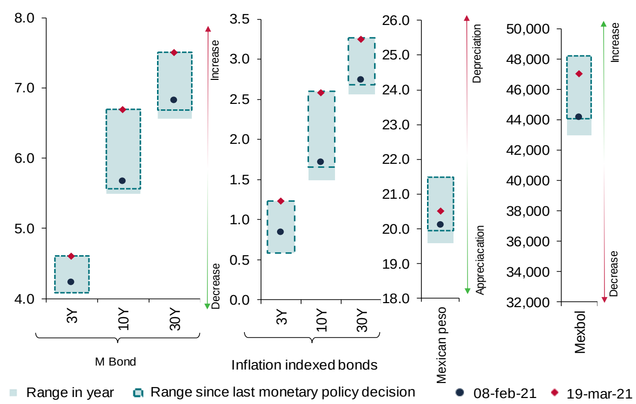
A.2.1. Mexican markets

Since Banco de México's previous monetary policy decision to date, the prices of financial assets in Mexico showed a negatively biased behavior (Chart 7). This occurred in an environment in which markets incorporated expectations of a faster recovery in some developed countries and an incipient increase of inflation and its expectations.

As to the Mexican peso, it fluctuated in a range between 19.95 and 21.49 pesos per dollar, ending the period with a depreciation of 1.77% (Chart 8). This occurred in a context in which both spot and forward trading conditions remained deteriorated.

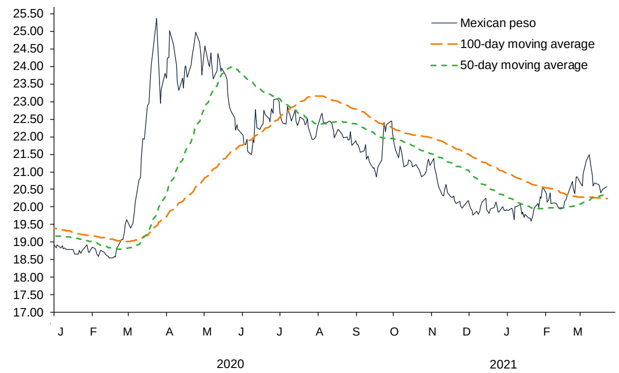
In line with the swap mechanism established between Banco de México and the Federal Reserve on March 19, 2020, on March 1, 2021, the Foreign Exchange Commission instructed Banco de México to renew maturities for a total of USD 1.5 billion, for which the amount allocated was USD 400 million.

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



Source: Prepared by Banco de México.

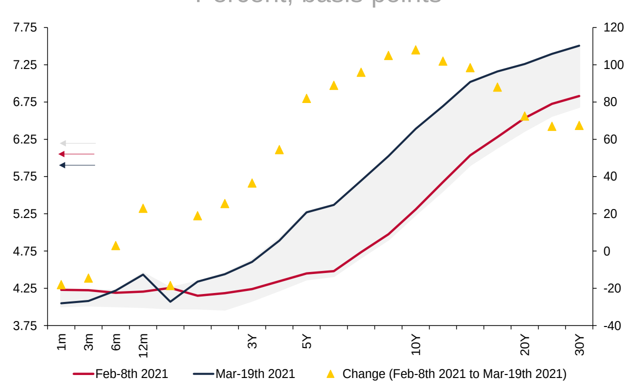
Chart 8
Mexican Peso Exchange Rate with Moving Averages
MXN/USD



Source: Prepared by Banco de México.

Interest rates of government securities exhibited negative adjustments (Chart 9), with increases of up to 103 basis points in the medium- and long-term part of the yield curve. As a result, the 3 year – 30 year spread increased by 34 basis points. The yield curve of real rate instruments also exhibited a negative dynamic, albeit of a lower magnitude than that observed in nominal rates. In this context, breakeven inflation and inflation risk premia implicit in the spreads between nominal and real market instruments registered mixed adjustments as compared to February's monetary policy decision, with increases in the 10- and 30-year nodes (Chart 10). Such adjustments took place in an environment where trading conditions deteriorated considerably with respect to those observed in the period of the previous monetary policy decision.

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



Source: PIP.

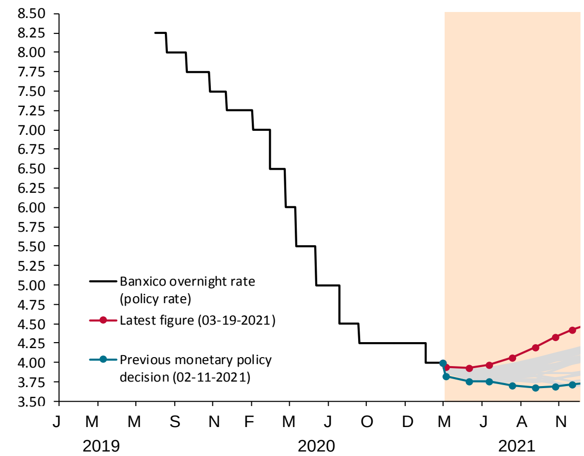
Chart 10
Breakeven Inflation and Inflation Risk Implicit in Government Securities' Interest Rate Curves
Basis points

Source: PIP.

Regarding the measures announced by Banco de México on April 21, several adjustments to said measures were announced on February 25. In particular, the extension until September 30, 2021 of the extraordinary liquidity provision measures, of the measures for the provision of resources for credit institutions to channel credit to micro, small- and medium-sized firms and individuals affected by the pandemic, and of the financing facility to multiple banking institutions guaranteed with bank credit assets for the financing of micro, small- and medium-sized enterprises. As to the instruments for conducting monetary policy and promoting the orderly functioning of the money, debt and foreign exchange markets in Mexico, Banco de México announced that it will consider the possibility of using them whenever it deems necessary to comply with its objectives of ensuring the stability of the peso's purchasing power, promoting the healthy development of the financial system, and fostering the well-functioning of payment systems.

As to expectations regarding the trajectory of the monetary policy rate, information implied by the Interbank Equilibrium Interest Rate swaps curve (TIIE, for its Spanish acronym) discounts with a 24% probability that the target rate will decrease by 25 basis points for the monetary decision of March (Chart 11). In a related manner, the median of the consensus of forecasters surveyed by Citibanamex expect the reference interest rate to lie at 3.75%. For the end of 2021, market variables anticipate a level of 4.42% for the target rate, while the median of the aforementioned survey among forecasters lies at 3.75%.

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



Source: Prepared by Banco de México with Bloomberg data.

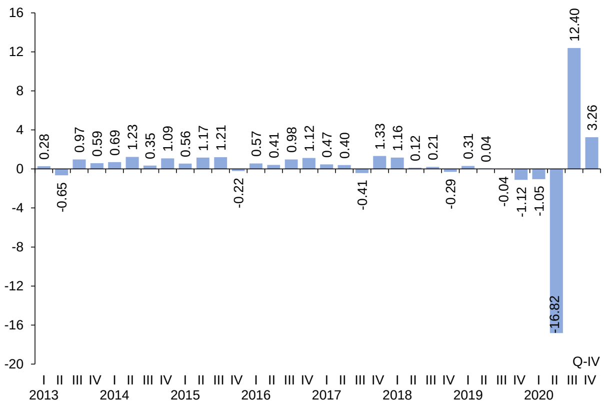
A.2.2. Economic activity in Mexico

During the fourth quarter of 2020, economic activity continued to recover, although at a more moderate rate than in the third (Chart 12). Available indicators for the first quarter of 2021 suggest that the weakness observed at the end of 2020 persisted through January and February, partly reflecting the upsurge of the pandemic, new restrictions implemented in different states –although these have been easing as the number of cases has decreased gradually– as well as some temporary disruptions to the automotive supply chain and to the supply of natural gas in February.

As for external demand, after having recovered significantly during the second half of 2020, exports slightly decelerated in January 2021. This performance was associated with a decline in non-automotive exports, as automotive exports grew (Chart 13).[4]

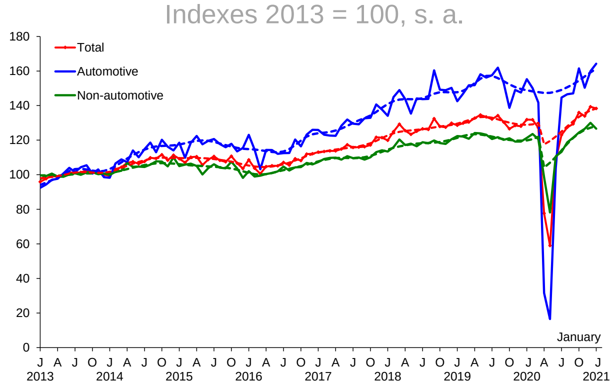
[4] Refers to the value of merchandise exports in current US dollars. This value differs from that reported for goods exports by Mexico's System of National Accounts (SCNM, for its acronym in Spanish), given that the latter represents the value added, measured in constant pesos.

Chart 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.

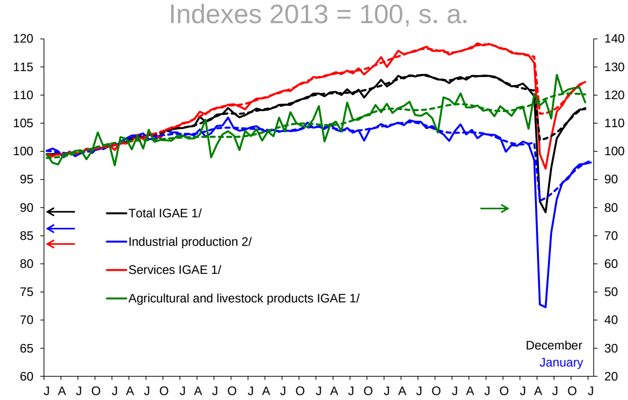


s. a. / Seasonally adjusted series and trend series based on data in nominal US dollars. The former is represented by a solid line and the latter by a dotted line.
Source: Prepared by Banco de México with data from the Tax Administration Service (SAT, for its Spanish acronym), the Ministry of the Economy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

According to its monthly indicator, in December 2020 private consumption slowed the moderate recovery exhibited between June and November, partly reflecting the rebound in the upsurge of COVID-19 cases in the country and the new measures to contain it. Timely indicators suggest that private consumption continued to show some weakness at the beginning of 2021. In particular, in January, sales reported by the National Association of Self-Service and Department Stores (ANTAD, for its Spanish acronym) showed a sharp contraction once again, although it reversed in February. During the first two months of the year, light vehicle sales grew at a moderate pace, remaining at low levels. In December 2021, gross fixed investment partially reversed the increase observed in previous months and remained well below its pre-pandemic levels. Within this indicator, the slow recovery of both investment in construction and spending on machinery and equipment was halted.

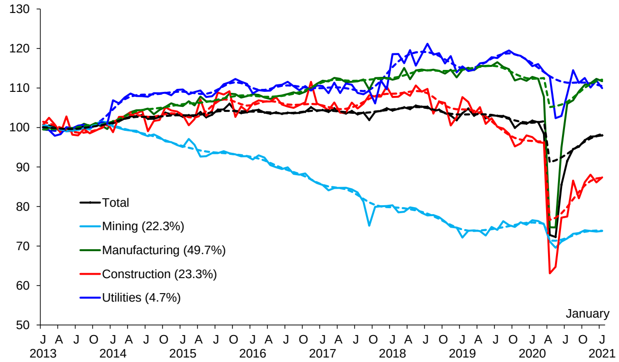
As for production, in December 2020 and January 2021 the pace of growth of productive activity slowed down (Chart 14). In particular, although tertiary activities continued to recover in December 2020, they did it at a slower pace than in previous months and heterogeneously across sectors. Wholesale and retail sales; transportation, warehousing and information services; professional, scientific and technical services; management of companies and enterprises; and accommodation and food services contributed to the growth of this sector. In contrast, finance and insurance; public administration; arts, entertainment and recreation, as well as other services (except public administration) had negative contributions. The low dynamism of industrial activity in January 2021 reflected the fall in manufacturing, which was largely associated with the contraction of transportation equipment. The latter can be explained partly by the initial effect of the global shortage of semiconductors that extended into February and the beginning of March. In turn, construction maintained a slow reactivation trend, with levels far below those observed prior to the health emergency, while mining remained weak (Chart 15).

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.
Source: Mexico's System of National Accounts (SCNM, for its Spanish acronym), INEGI.

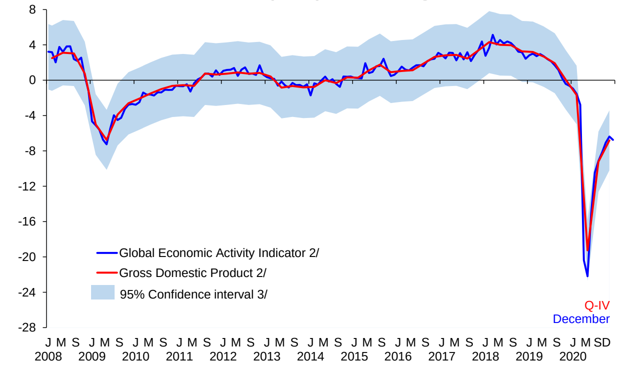
Chart 15
Industrial Activity Indicators [1/]
Indexes 2013 = 100, s. a.



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 parenthesis correspond to their share in the total in 2013.
Source: Mexico's System of National Accounts (SCNM, for its Spanish acronym), INEGI.

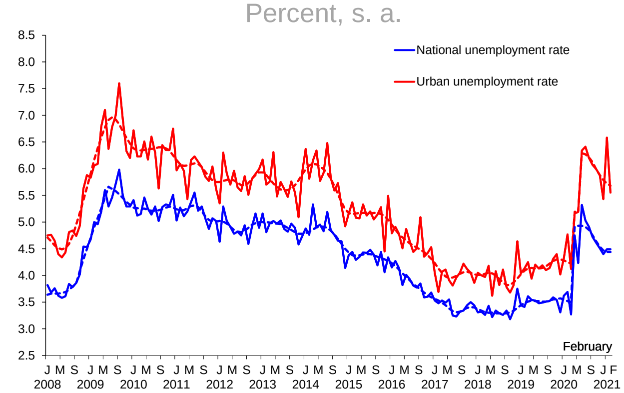
As to the economy's cyclical position, slack conditions remained considerably wide at the end of 2020 (Chart 16) and are anticipated to continue registering similar levels at the beginning of 2021. Some labor market indicators showed some improvement in February 2021. In particular, both the national and urban unemployment rates decreased at the margin (Chart 17), in a context in which the Economically Active Population (EAP) and employed population grew with respect to previous months. In addition, the underemployment rate decreased in its monthly comparison, although it remained well above its level of March 2020. Similarly, the creation of IMSS-insured jobs continued to exhibit some recovery in February, although it grew at a slower pace than in the last months of 2020. Finally, at the beginning of 2021, unit labor costs in the manufacturing sector showed a slight increase, thus remaining above the level registered prior to the health emergency (Chart 18).

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



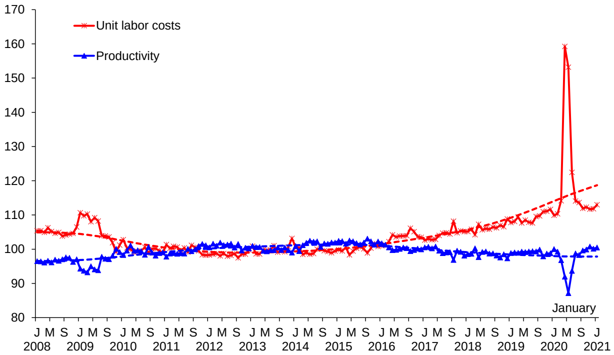
s. a. / Calculations based on seasonally adjusted figures.
1/ Output gap estimated with a tail-corrected Hodrick-Prescott filter; see Banco de México (2009), "Inflation Report, April-June 2009", p.74.
2/ GDP figures as of the fourth quarter of 2020. IGAE figures as of December 2020.
3/ Output gap confidence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

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



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

Chart 18
Productivity and Unit Labor Cost 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 teh Montly Manufacturing Industry Survey and industrial activity indicators of Mexico's System of National Accounts (*Sistema de Cuentas Nacionales de México*,SCNM, INEGI.

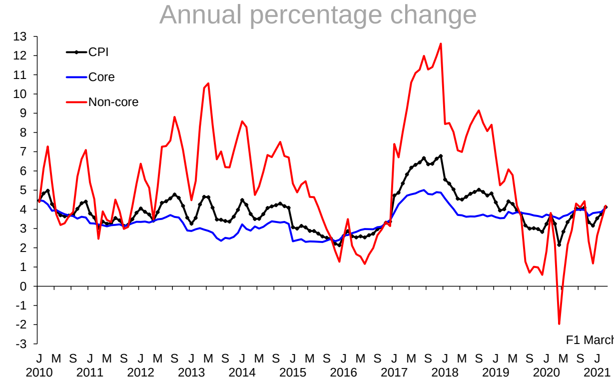
In January 2021, domestic financing to firms contracted at an annual rate for eight consecutive months, extending the loss of dynamism that has been observed since May 2020. This was partly due to a reduction in bank lending both to smaller firms –segment that decreased in annual terms since the first quarter of 2019–, and to large firms –segment that during the fourth quarter of the year continued to show weakness in the demand for this type of financing vis-à-vis the level observed at the beginning of the pandemic–. Lending conditions remained tight for the two segments of firms as compared to the beginning of the pandemic. Corporate debt issuance continued to show a lower dynamism vis-à-vis the third quarter of 2020. As to credit to households, the housing portfolio exhibited positive annual variations once again, driven by significant increases in mortgage loan issuance, reaching in December 2020 higher levels than those registered prior to the pandemic. Performing bank credit portfolio for consumption continued contracting in all segments in a context in which credit granting conditions to households remain tight.

Interest rates of bank credit to firms have generally followed the dynamics of the bank funding rate. Similarly, while the margins of intermediation remain at levels above those observed prior to the pandemic, at the margin these have shown an incipient trend to decrease. In December 2020, interest rates of mortgages were at levels around their historical lows, while those of credit cards decreased. As to portfolio quality, corporate and mortgage loan delinquency rates showed an incipient increase, despite remaining at low levels, while those for consumption remained at high levels and increased for the fourth consecutive month, after having declined during the previous months.

A.2.3. Development of inflation and inflation outlook

Between January and the first fortnight of March 2021, annual headline inflation increased from 3.54 to 4.12% (Chart 19 and Table 1). The core and non-core components contributed 18 and 40 basis points, respectively, to the increase of annual headline inflation. Core inflation rose mainly due to the higher levels of non-food merchandise inflation. Non-core inflation rose in response to the evolution of energy prices.

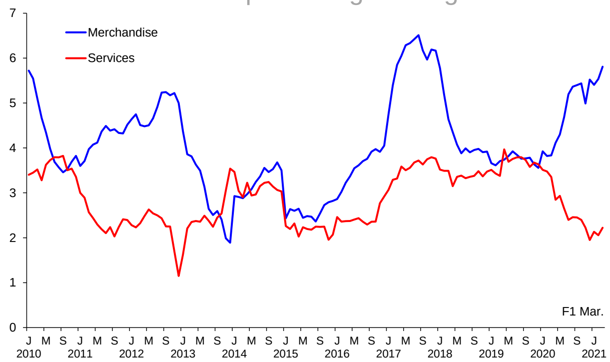
Chart 19
Consumer Price Index
Annual percentage change



Source: Prepared by Banco de México and INEGI data.

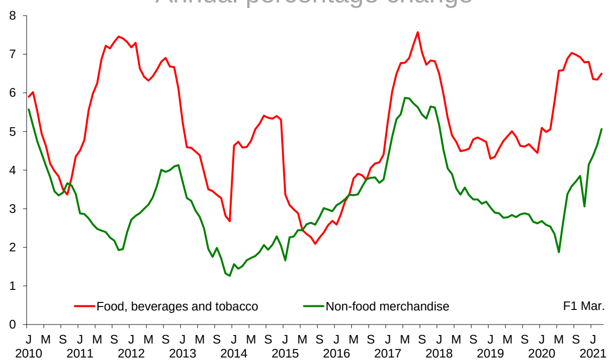
Annual core inflation registered levels of 3.84 and 4.09% in January and in the first fortnight of March 2021, respectively. Within it, annual inflation of merchandise prices rose from 5.41 to 5.81% during the same period (Chart 20 and Table 1). This increase is explained by the higher levels of inflation that non-food merchandise continued to show, moving from 4.37 to 5.06%, while inflation of food merchandise prices rose from 6.36 to 6.50% (Chart 21). The annual inflation of services prices increased from 2.13% to 2.22% during the same period, although its components showed a heterogeneous behavior. On the one hand, inflation of services other than education and housing rose from low levels, due mainly to increases in the annual price variation of tourism services. On the other hand, education and housing continued to exhibit lower inflation levels, due to the COVID-19 pandemic.

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



Source: Banco de México and INEGI.

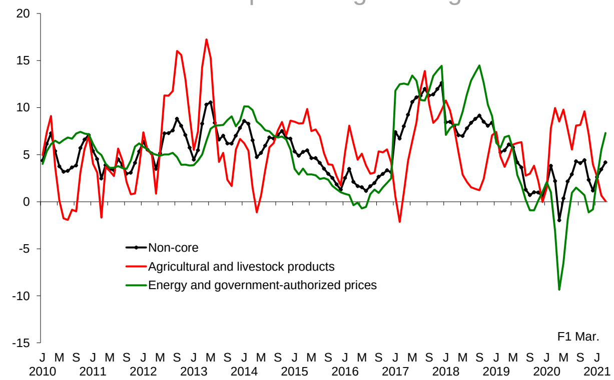
Chart 21
Merchandise Core Price Sub-index
Annual percentage change



Source: Banco de México and INEGI.

Between January and the first fortnight of March 2021, annual non-core inflation rose from 2.63 to 4.19% (Chart 22 and Table 1), a result that is mainly associated with the increase in energy price inflation, which rose from 2.66 to 9.45%, driven by the higher annual variations in gasoline and domestic L.P. gas prices. In contrast, the annual inflation of livestock and agricultural products decreased from 2.64 to 0.07% during the same period, with the reduction in fruits and vegetables inflation standing out, while inflation of livestock products maintained an upward trend.

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



Source: Banco de México and INEGI.

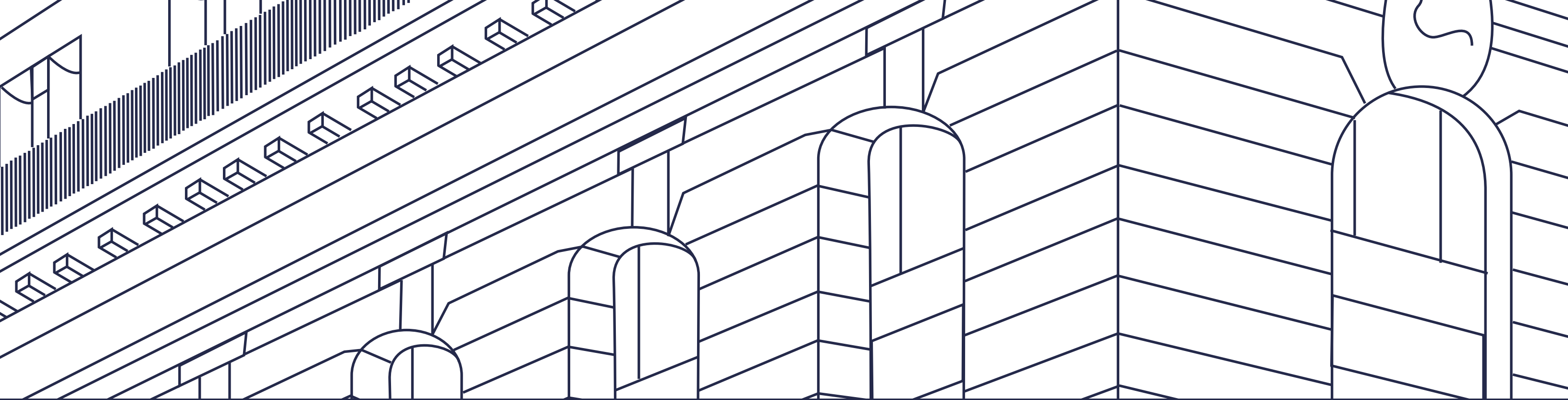
As for inflation expectations drawn from Banco de México's Survey of Private Sector Forecasters, between January and February, the median for headline inflation for the end of 2021 increased from 3.66 to 3.90%, while that for core inflation rose from 3.57 to 3.58%. The medians for headline and core inflation expectations for the medium and long terms remained around 3.50%. Finally, breakeven inflation and inflation risk increased slightly since the previous monetary policy decision.

The anticipated paths for headline and core inflation in the short term are slightly above those foreseen in the last Quarterly Report, although they are still expected to converge to the 3% target as of the second quarter of 2022. Over the next months, headline inflation will be temporarily affected by the arithmetic effects generated by last year's fall in energy prices. These forecasts are subject to risks. On the upside: i) a recomposition of spending towards merchandise or cost-related pressures; ii) episodes of exchange rate depreciation; and iii) external inflationary pressures. On the downside: i) effects stemming from the negative output gap; ii) greater social distancing measures; and iii) foreign exchange appreciation.

Table 1
Consumer Price Index and Components
Annual percentage change

Item	January 2021	February 2021	1st fortnight March 2021
CPI	**3.54**	**3.76**	**4.12**
Core	**3.84**	**3.87**	**4.09**
Merchandise	**5.41**	**5.54**	**5.81**
Food, beverages and tobacco	6.36	6.34	6.50
Non-food merchandise	4.37	4.66	5.06
Services	**2.13**	**2.06**	**2.22**
Housing	1.94	1.85	1.81
Education (tuitions)	1.59	1.16	1.12
Other services	2.42	2.44	2.83
Non-core	**2.63**	**3.43**	**4.19**
Agricultural and livestock products	**2.64**	**0.66**	**0.07**
Fruits and vegetables	-3.89	-8.57	-10.39
Livestock products	8.42	9.01	9.68
Energy and government-authorized prices	**2.62**	**5.50**	**7.30**
Energy products	2.66	6.83	9.45
Government-authorized prices	2.54	2.38	2.27

Source:INEGI.



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