BANCO DE MÉXICO®

Minutes number 80

Meeting of Banco de México's Governing Board on the occasion of the monetary policy decision announced on November 12, 2020

This document is provided for the reader's convenience only. The translation from the official Spanish version was made by Banco de México's staff. Discrepancies may possibly arise between the original document in Spanish and its English translation. For this reason, the original Minutes in Spanish are the only official document.

FOREWARNING
This document is provided for the reader's convenience only. The translation from the official Spanish version was made by Banco de México's staff. Discrepancies may arise between the original document in Spanish and its English translation. For this reason, the original Spanish version is the only official document.

1. PLACE, DATE, AND PARTICIPANTS

1.1 Place: Meeting held by virtual means.

1.2. Date of Governing Board meeting: November 11, 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** noted that it still remains at levels below those prior to the pandemic and that the recovery has been heterogeneous among countries and sectors. **One** member pointed out that in the short term the reopening of activities led to an increase in production and, in the medium term, the recovery is associated to the evolution of aggregate demand. He/she stated that differences in economic recovery among countries are due to: (i) the rate of COVID-19 infections and the measures adopted to contain it; (ii) the relative importance of the most affected services; (iii) the characteristics of both the labor market and the informal sector; (iv) the strength of the macroeconomy and of the financial system, and (v) the magnitude of employment and income support programs. In this regard, he/she noted that economies with significant relief measures have shown a greater-than-expected recovery. In this respect, **some** members mentioned that consumption and investment have recovered in certain advanced economies. **One** of them added that the latest indicators, such as the purchasing managers' indexes, are in expansionary territory and trending upwards. In this context, **some** members pointed out that global growth forecasts for 2020 have been adjusted upwards.

The majority of members highlighted the resurgence of COVID-19 infections in several countries, mainly European, and the reestablishment of measures to contain it in these countries. One member pointed out that, as a result, the recovery is losing strength, as suggested by the latest data. **Another** member stated that while the new measures are less strict than those adopted at the beginning of the pandemic, their effects are foreseen to hinder the economic recovery. **In this context, most members highlighted the risks to global economic growth associated with the pandemic, especially those related to the dynamics of infections and the establishment of additional social distancing measures. Some** members considered that such measures may be less disruptive, as more information is available about which are the most effective public health actions. Nevertheless, **some** highlighted the risk that distancing measures could be maintained for an extended period and that their effect may be substantial. **Most members also considered the risk that fiscal stimuli could prove insufficient to support the recovery. One** member added the unsustainability of public and corporate debt, the potential post-electoral tensions in the United States, and the lack of definition of the terms by which the United Kingdom may leave the European Union. **Some** members expressed that the balance of risks for global growth is negative.

Most members mentioned that inflation in advanced economies remains below their central banks' targets. **One** member stated that these institutions expect the above to continue for a prolonged period. **Some** members highlighted that a recomposition of relative prices, with increases in those of certain merchandises and reductions in those of services, has been observed. **One** member added that energy prices exerted a downward impact on inflation at the beginning of the pandemic, but that this impact has recently moderated. He/she noted that in the United States inflation of food products has increased, which has been largely offset by decreased pressures in services prices. He/she added that in the euro area the increase in food prices has been smaller, which, together with the weakness in services prices, has led headline and core inflation to levels close to zero. **Most members underlined that in a large number of emerging economies inflation rates have decreased,** and **one** member noted that they are below their targets. In contrast, **some** members pointed out that in Mexico inflation has increased. **One** member mentioned that this is partly due to the fact that the weight factors used in Mexico give more importance to those components that have had larger increases. **Another** member pointed out that in some emerging economies inflation was subject to upward pressures due to exchange rate depreciations and increases in energy and food prices.

Most members mentioned that the central banks of advanced economies reiterated that they will maintain accommodative monetary policy stances for an extended period. They highlighted the Federal Reserve's decision to maintain its range for the federal funds rate at 0%-0.25% until its inflation and employment targets are met. One member stated that given its new monetary policy strategy, it would take longer than before for this central bank to raise its interest rate. **Another** member added that both private sector forecasters and market variables suggest that the federal funds rate will remain unchanged during 2020 and 2021.

Most members highlighted the possibility that central banks of advanced economies increase their monetary stimuli. One member mentioned that the Federal Reserve is assessing the possibility of extending the terms of its lending facilities. **Another** member added that the Bank of Canada will focus its asset purchases on longer-term bonds, with the aim of having a more direct influence in the rates relevant for households' and firms' financing. **One** member stated that fiscal authorities in some advanced economies have also announced extensions to their relief programs. **Another** member noted that Federal Reserve board members pointed out that it may be necessary to increase the fiscal stimulus. **One** member noted that the margin available to implement macroeconomic and financial policies to stimulate the economy could be exhausted. He/she explained that this possibility is low for major advanced economies, particularly regarding monetary policy, while in emerging economies both upward inflationary pressures resulting from exchange rate effects or supply shocks, as well as doubts about the sustainability of their public finances, could lead to a premature withdrawal of stimuli.

The majority of members noted that global financial markets exhibited volatility, although it has decreased recently due to the results of the US election and favorable news about the development of a vaccine. One member expressed that markets were closely attentive to the US electoral process, the extension of the relief measures, the tax policy outlook and the type of leadership in that country. **Some** members emphasized the better performance of US stock markets and the narrow adjustments of interest rates. However, **one** member added that in view of the deterioration of growth expectations, the prices of commodities, particularly of crude oil, suffered declines, although most recently there was a moderation of these declines. **Another** member added that the performance of financial markets is expected to continue improving and the gaps of economic activity to continue narrowing by the end of the year.

Some members stated that emerging economies' financial markets exhibited a positive behavior. They noted that inflows to fixed-income and equity instruments continued, although **one** member added that inflows to equity instruments registered only small changes. **Another** member noted that the currencies of emerging economies appreciated, their stock markets registered gains, their risk premia decreased and their interest rates exhibited mixed, albeit narrow, adjustments.

Most members considered that international financial markets are subject to risks, with those already mentioned for global activity standing out. **One** member added idiosyncratic risks, especially in emerging economies. He/she added that if they were to materialize, there would be potentially disorderly adjustments resulting from abrupt changes in market sentiment. He/she noted that this would particularly affect emerging economies, as capital flows to these countries and their asset prices have still not returned to their pre-pandemic levels.

Economic activity in Mexico

All members pointed out that timely information suggests that, after a deep contraction in the second quarter, economic activity showed a recovery in the third one. Most members highlighted that the GDP flash estimate points to a seasonally adjusted growth rate of 12% during the third quarter relative to the previous one, driven by external demand and the reopening of activities. Some members noted that economic activity remains below pre-pandemic levels. **One** member noted that between January and September 2020 GDP was nearly 10% lower than during the same period of 2019, while **another** member emphasized that it decreased 8.6% at an annual rate during the third quarter of 2020. He/she added that in monthly terms, the greatest contraction was observed in April and to a lesser extent in May, while in June and July there was a significant recovery that moderated in August and that is expected to remain moderate in September.

On the supply side, most members highlighted the heterogeneity in the recovery of different sectors. Some members pointed out that the industrial sector, driven by manufacturing, has shown the best performance, while services continue to show weakness. **One** member outlined that industrial production fell at an annual rate of 29.4% in May and of 7.5% in September. He/she added that, in contrast, accommodation and food; transportation, information, and arts, entertainment and recreation services contracted at an annual rate of 53.4, 20.8 and 21.8% in August, respectively. **Another** member mentioned that tourism faces the most complex situation and that tourist sector businessmen estimate that the recovery could be achieved only until 2022.

On the demand side, all members underlined that external demand has shown greater dynamism. The majority of members highlighted that in September exports reached levels close to those observed before the pandemic. Some members highlighted the trade balance surplus. **Most members noted that consumption, investment and imports continue showing a lackluster performance. One** member emphasized the weakness in the consumption of services and of durable goods. **Another** member stated that private consumption in August was 13.08% lower than in the previous year. He/she added that non-oil imports of consumer goods registered an annual contraction of 25.5% in September. He/she mentioned that remittances, which are a determinant of consumption, have continued to grow. He/she pointed out that in August investment registered an annual contraction of 16.64% as a result of the impact of the pandemic and an environment that is not conducive to investment.

Most members noted that the labor market has started to recover, although it continues to show a considerable deterioration. They highlighted the reduction in the labor participation rate and increases in unemployment and underemployment. One member pointed out that in September, the labor participation rate was below 56%, the unemployment rate was 4.73%, and the underemployment rate was above 15%. He/she added that is outside of the labor force but available for work remains above 10%, as compared to 6% before the pandemic. **Another** member pointed out that while unemployment did not increase as much as in other crises, it continues to be disguised by the number of people that have left the labor market. **One** member pointed out that by the end of the year the extended unemployment rate could be close to 20%.

One member noted that formal and informal employment decreased by 12.5 million persons between February and April. He/she stated that it has gradually recovered since those months and that in September it was 4.6 million below the level registered in February. **Another** member mentioned that, despite this improvement, the decline is considerable with respect to what was observed prior to the pandemic. As for the creation of IMSS-insured jobs, **one** member mentioned that, after registering negative growth rates between March and July, positive ones were observed in August and September, which were close to their historical averages. **Another** member stated that the recovery in employment is explained almost entirely by the increase in informality. **Some** members agreed that the adjustment in the labor market has affected women to a greater extent, with **one** member adding that this also applies to young people.

Most members noted that the economic recovery will be gradual and prolonged. One member mentioned that, given the weakness of some aggregate demand components, it is foreseeable that the recovery will begin to slow down once the effects of the reopening of activities fade. **Another** member pointed out that the recovery will be difficult and thus could be extended until mid-2024. **Some** members noted that growth expectations for 2020 were revised slightly upwards. **One** member added that this was due to a stronger than expected rebound in the third quarter. He/she explained that according to the most recent surveys of private sector forecasters, growth expectations for 2020 changed from -9.8 to -9.3%, while they remained at 3.2% for 2021. **Another** member mentioned that the GDP flash estimate for the third quarter points to a trajectory of economic activity during 2020 close to the less pessimistic scenario published in the Quarterly Report April-June 2020. **One** member added that he/she expects a GDP fall of 9.0% in 2020.

In view of the economic contraction and the expected recovery scenarios, most members emphasized that wide slack conditions are foreseen in the horizon in which monetary policy operates. One member specified that, although the output gap will remain negative, the anticipated trajectory of economic activity implies a lower level of slack throughout the horizon in which monetary policy operates. **Another** member argued that, based on the GDP flash estimate for the third quarter, the negative output gap has started to decrease, although it still exhibits wide slack. He/she added that, in light of the current magnitude of the gap, in 2021 it is expected to remain negative even under optimistic growth scenarios. He/she considered that it is difficult to estimate the output gap in the two-year horizon in which monetary policy has an effect, given the environment of uncertainty and the possibility that the potential growth of the economy is below the estimated figure. He/she indicated that it has most probably been affected by both weak investment and the absence of sufficient efforts to boost productivity since before the emergence of the pandemic, along with the effects of the latter on both physical and human capital stocks and on total factor productivity.

Most members mentioned that an environment of uncertainty and downside risks to economic activity persists, especially risks related to a new outbreak of the pandemic. Some members warned about the possibility of new distancing measures being implemented. **One** member referred to states of Mexico that have once again adopted stricter lockdown measures —similarly to what has been observed in some European countries— and that consequently the economic outlook depends significantly on the virus' trajectory. He/she stated that a resurgence of the virus could not only delay the economic recovery even more, which implies collateral damage to employment, but that additionally the pandemic represents a sizeable risk for the productive outlook in the medium term, which could cause structural damage to the economy. **Another** member pointed out the uncertain economic environment for 2020 and 2021. He/she stated that, despite promising news on the possibility of having a vaccine, there is still no certainty over when the vaccine or an effective treatment to the virus would be available, or over how long it would take to produce and distribute said vaccine, once it is available, in order for a relevant economic impact to be observed. Among risks for growth, **some** members highlighted the impact on public finances and its possible consequences on the conditions of access to financial markets. They indicated that other external risks of an economic, political and geopolitical nature should be added to the above. **One** of them added those of idiosyncratic nature that the country faces. **Another** member highlighted episodes of risk aversion, trade tensions, and solvency problems of households and businesses.

Inflation in Mexico

Most members mentioned that annual headline inflation increased between September and October and that it is above the 3% target. One member underlined that inflation in October was at its highest level in 17 months and that its evolution has exceeded Banco de México's projections.

Most members considered that inflation has continued to be affected by the pandemic, which has implied supply and demand shocks, as well as an exchange rate depreciation, which has led to changes in relative prices. Some members noted on the one hand the logistical and supply-related problems, and on the other the reallocation of consumers' spending. **One** member stated that increases in prices caused by the closure of establishments and by logistical problems are beyond the traditional domain of monetary policy. **Another** member pointed out that the decline in aggregate demand and the fall in energy prices have favored price reductions. **One** member mentioned that the decline in demand has still not been reflected thoroughly on inflation.

Regarding core inflation, most members highlighted the increase in the annual rate of change of merchandise prices, especially food merchandise, and reductions in that of services prices. One indicated that the decline in the prices of services has not compensated the price increases in those of merchandise, mainly food merchandise that are still at levels near 7%. **Another** member considered worrisome that in October, this component was practically at the upper limit of the variability interval of the inflation target for the third consecutive month. **One** member underlined that core inflation slightly decelerated during the second fortnight of October, showing an increase of only 7 basis points with respect to the previous fortnight. He/she mentioned that processed food prices, which had increased considerably in March and April, showed signs of stabilizing, even registering a slight deflation during the second fortnight of October with respect to the previous fortnight. **Some** highlighted that in October the annual change of services prices was 2.4%. **One** member pointed out that the lower annual rate of change in services prices reflects a lower demand generated by the social distancing measures. **Another** member mentioned that in the short term the negative output gap's influence on inflation has been insufficient, given that fundamental core inflation has not decreased significantly.

Most members expressed that non-core inflation increased, highlighting the rise in the annual rate of change of fruit and vegetable prices. One member noted that agricultural and livestock products' prices unexpectedly rose at a faster rate in October, which explains why inflation was above the variability interval during said month. **Another** member pointed out that the less favorable dynamics in energy prices also drove non-core inflation upwards.

Most members considered that there are signs of stabilization in some components of inflation. One member pointed out that this is due to the recent evolution of food merchandise, services and energy prices. **Another** member stated that the pressures on prices associated with value chain disruptions, input costs, energy prices and the exchange rate are starting to be contained. For this reason, an important decline in annual headline inflation is anticipated for November with respect to October. He/she added that distortions caused by the lockdown have made the reading of inflation difficult given that CPI's fixed weights have become obsolete. He/she mentioned that the consumption pattern has changed, as the purchase of foods has increased and spending on transportation, apparel, recreation and tourism has decreased. In turn, the prices of the former group have increased more, while those of the latter group have increased less or even decreased, and thus households' cost of living has increased more than is indicated by inflation. He/she considered that this goes beyond monetary policy's usual domain.

Some members stated that headline inflation expectations for the end of 2020 increased, while medium- and long-term expectations remained stable at levels above 3%. **One** member added that expectations for the end of 2021 rose as well. **Another** member noted that the latter still exceed the central bank's projections by a relatively ample margin. **One** member noted that analysts will likely adjust their inflation expectations downwards for the end of the year, given that the impact on certain prices apparently has started to recede. **Another** member specified that private sector forecasters' inflation expectations for the end of 2021 are at 3.5% and for the next 12 months have remained stable and below the level registered at the beginning of the pandemic. He/she added that expectations implicit in market instruments are at 3.2% for the average of one to five years. He/she considered that all of the above implies that inflation expectations have not been contaminated significantly by the recently observed inflation levels. Meanwhile, **one** member added that the 10-year inflation risk premium implicit in market instruments is still increasing.

Most members considered that the recent behavior of headline and core inflation implies a slight increase in the foreseen trajectories within forecast horizon, although those for the next 12 to 24 months are anticipated to be around 3%. One member noted that this scenario considers a gradual fading of supply-related pressures and greater effects of economic slack on headline and core inflation within the forecast horizon.

Some members pointed out that the convergence of inflation to the 3% target during the second half of 2021, as had been anticipated, is not the most feasible scenario. **One** member stated that headline and core inflation will probably remain relatively high over the next months and that it will be until mid-2021 when they will decrease considerably, as a result of both the direct and indirect impact of the fading of the base effect generated by the fall in oil prices during the second quarter of 2020. **Another** member underlined that despite a more appreciated exchange rate and the lower gasoline prices, expectations for headline and core inflation were adjusted to the upside throughout the forecast horizon, delaying the convergence to the target from the fourth quarter of 2021 to the first quarter of 2022. He/she pointed out that the higher prices of merchandise and agricultural and livestock products contributed to the above.

Meanwhile, **some** members considered that inflation lies on the foreseen path to reach the target, although a transitory increase is expected during the second quarter of 2021. **One** member pointed out that this rebound in inflation is associated with a low comparison base. He/she mentioned that the decreasing trajectory is based on the expected or observed evolution of different determinants, highlighting that: i) energy prices remain relatively stable; ii) the exchange rate has appreciated significantly for seven consecutive months, thus reverting a sizeable fraction of the initial shock of the pandemic, and iii) the economy continues operating with a large amount of slack. **Another** member indicated that, despite current pressures, inflation is expected to decrease significantly during the second quarter of 2021 and the target is expected to be attained by the end of that year. He/she highlighted that there are signs of a moderation in the growth of prices that had increased the most.

As for downward risks to inflation, most members highlighted the economic slack. One member added the possibility of lower inflationary pressures at a global level and a new outbreak of the virus lowering the demand for goods and services. **Another** member considered that, in general, inflation pressures observed so far are transitory and/or associated with supply-related factors. **One** member noted that the recent appreciation of the Mexican peso suggests lower pressures on prices in the following months. He/she added that the current nil fiscal pressure on inflation is positive. He/she mentioned that no new taxes or extraordinary increases in government-authorized prices have been registered, especially in energy prices, and thus non-core inflation could have a downward influence on inflation.

Among upward risks, **some** members highlighted possible episodes of exchange rate depreciation. **One** member considered the behavior of the exchange rate as one of the main risks to inflation in the following months, as would be expected of such a liquid emerging economy currency as the Mexican peso. He/she added that the outcome of the US presidential elections and the recent news on the development of a vaccine have attenuated the considerable risks faced by inflation, although they have not eradicated them. **Some** members added that upwards pressures caused by the pandemic might continue. **One** member added the implications of a complex international context and domestic factors, such as the situation of public finances, the minimum wage increase for 2021, and the electoral process in Mexico in the following year. He/she considered that the wide output gap will prevail over the previous ones, but that the most recent forecasts suggest that the convergence of inflation to the target will take longer than foreseen. **Another** member underlined the risk of volatility in the financial markets, although he/she stated that it seems to be limited. **Some** members pointed out the persistence of core inflation at high levels. **One** member added that this phenomenon, observed since 2018, has worsened as a result of the pandemic through the food merchandise component, without the wide slack conditions having offset the upward pressures. He/she considered that the balance of risks to inflation has deteriorated. **Another** member noted that the balance of risks associated to the new foreseen trajectory for inflation is uncertain.

Macrofinancial environment

Most members noted that financial markets exhibited a favorable behavior. One member stated that significant fluctuations were observed, caused mainly by the US elections and by the expectations about the availability of a vaccine against COVID-19.

Most members highlighted that, in said context, the Mexican peso exhibited volatility and an appreciation. One member added that trading conditions in the foreign exchange market have recently improved. **Another** member mentioned that the Mexican peso has been one of the emerging-economy currencies that has appreciated the most and added that, at the end of October, the negative balance of the net foreign-exchange position declined, reaching its lowest level since March.

Most members pointed out that interest rates exhibited mixed and narrow adjustments. One member mentioned that short-term government bond rates registered marginal adjustments, while long-term ones increased. **Another** member underlined that the latter registered fluctuations. **Some** members underlined the decline in sovereign risk and the increase in the stock market. **One** member indicated that outflows in government securities were registered, although smaller than those observed in March and April.

Some members mentioned that risks to financial markets persist and that new volatility episodes that could exert pressure on the exchange rate cannot be ruled out. **One** member highlighted the risks associated with the weakening of public finances, Pemex's fragile situation, uncertainty about domestic policies, and possible non-compliance with the USMCA, as well as the 2021 electoral process. **Another** member stated that the decline in risk aversion depends on the world economic recovery, the possible economic stimuli, and the development of the vaccine. He/she pointed out that delays on these fronts would raise risk premia and financial volatility, and would exert pressure on the exchange rate.

One member highlighted the challenges that are confronted given a large economic contraction, lower public revenues, spending pressures, as well as a deterioration of the terms of trade and lower revenues from abroad which has affected sovereign credit ratings and their perspectives. Moreover, public sector borrowing requirements have increased recently, in an environment in which uncertainty persists regarding domestic and external financing sources.

Another member pointed out that from 2019 to 2020 the Public Sector Borrowing Requirements are projected to increase from 2.3 to 4.7% and that their historical balance will increase from 44.8 to 54.9% as a percentage of GDP. He/she mentioned that the fiscal balance could deteriorate further due to additional spending pressures generated by the lengthening of the pandemic. **One** member noted that the outlook for public finances for 2021 is complicated given the possibility of tax and oil revenues being lower than projected. He/she added that the latter, in an environment of depletion of resources from the stabilization funds and an unfavorable growth outlook, is one of the main risks for the sovereign rating and the economy, both in 2021 and in the medium and long terms. In this context, he/she emphasized the need for a fiscal reform. **Another** member stated that the risks associated with the outlook for public finances should not be overstated. He/she considered that a manageable deficit, even with small deviations with respect to the projections for 2021, and low public debt are consistent with macroeconomic balance. He/she stated that while assumptions of the economic package for 2021 may be optimistic, it is possible to keep the fiscal accounts in order. **One** member argued that considering the magnitude of the economic shock, public finances have performed relatively well. He/she added that the strong appreciation of the exchange rate from March to date has its origin in that the macroeconomic fundamentals of the country have remained solid, among which the observed commitment to fiscal discipline must be included.

Some members expressed concern about Pemex's situation. They added that this constitutes a risk for the sovereign rating and highlighted the possibility that the state company may require additional fiscal support, which could affect public finances. **One** member noted that in the event of a downgrade in the sovereign and/or Pemex's ratings, the fiscal balance could deteriorate further. **Another** member stated that the possibility of an additional downgrade in Pemex's rating has already been incorporated by the markets, so this event must be properly assessed.

Most members stated that the impact of the pandemic continued affecting the financing of firms. One member noted that financing conditions remain tight, although they have improved compared to those observed during the beginning of the health crisis. **Another** member pointed out that domestic and external financing sources continued to increase during the third quarter. **Nevertheless, most members highlighted the contraction in bank credit. Some** members mentioned that this has mainly affected small- and medium-sized enterprises. **One** member pointed out that in September credit to these firms registered an annual contraction of -6.3%. He/she added that credit from commercial banks to firms and households remains weak, without clear signs of improvement. He/she stated that this situation is gravely affecting households. He/she mentioned that financing through credit cards declined at an annual rate of -11.5% and that other types of credit, such as payroll, personal and auto loans have also been declining. **Some** members pointed out that the credit contraction is due to low demand. **One** member mentioned the lack of firms' confidence, legal uncertainty, and an adverse environment for investment. He/she stated that financial institutions have a perception of higher credit risk. **Another** member added that this is also due to banks' tighter conditions and the absence of sufficient government guarantees. **One** member stated that the contraction is associated with supply factors and relatively high active rates. He/she emphasized the tightening of credit conditions for all sectors, which registered the most serious deterioration on record in the second quarter of 2020. He/she argued that this deterioration is largely explained by the reduction in credit lines offered. **Some** members noted that this decrease in bank credit is not due to a liquidity problem, considering the liquidity available to banks and the actions taken by the Central Bank in this matter.

Some members argued that it is imperative for commercial banks and the government to stimulate credit through guarantee programs. **One** member noted that the availability of credit depends not only on central bank actions, but on the alternatives offered by banks. He/she stated that it is imperative for commercial banks to also do their part in the process of economic reactivation, and pointed out that the argument about an insufficient demand for credit is not credible. **Another** member mentioned that the economic recovery will be more difficult without an adequate expansion of bank credit. **One** member pointed out that although banks have solid capital and liquidity levels, the deterioration in their loan portfolio is still latent. He/she argued that the National Banking and Securities Commission (CNBV, for its acronym in Spanish) should encourage financial intermediaries to restructure credits of solvent clients that have liquidity problems and seek to minimize delinquency rates. He/she stated that the CNBV should expand even more, although prudently, the existing facilities so that institutions have additional reserves, increase their regulatory capital, and reduce their capital requirements due to credit risk. **Another** member highlighted that in view of the expiration of the special accounting criteria, it is important to monitor the stress indicators in the financial system.

Monetary policy

Taking into account the effects on inflation, economic activity and financial markets, as well as the projections for inflation and the convenience of consolidating a downward path for headline and core inflation towards the 3% target, the majority of members agreed to maintain the target for the overnight interbank interest rate at 4.25%. One member voted for lowering the policy rate to a level of 4.00%. **All members agreed that the decision to keep the reference rate unchanged constitutes a pause, in order to confirm a trajectory for inflation that converges to the target. Some** members mentioned that this pause should not be considered as the end of the monetary relaxation cycle. **Looking ahead, all pointed out that monetary policy decisions will depend on the information available, particularly on the evolution of the factors that have an incidence on inflation.**

One member stated that monetary policy faces, on the one hand, major supply and demand shocks that affect economic activity and inflation and, on the other hand, uncertainty in global financial markets and fragility in risk appetite and capital flows. He/she added that in order to have an orderly adjustment of the national economy and maintain low and stable inflation, financial markets must function properly. He/she noted that the effects of monetary policy throughout the yield curve must be identified, since the components of aggregate demand respond to the different segments of the curve. He/she mentioned that in view of the economic contraction and its effects on inflation, it is desirable that the entire curve presents an orderly and sustainable downward adjustment. He/she added that medium and long-term interest rates include risk premia associated with various factors and that monetary policy should seek to ensure that the medium- and long-term inflationary risk premia are low and contained. He/she considered necessary for inflation expectations to be kept around their target in a sustained manner, which reduces inflationary risk premia throughout the yield curve. He/she stated that this is important when evaluating monetary policy responses among emerging economies, since they generally need to complement their domestic savings with external sources of financing, and that their risk premia are relevant for this purpose. In this regard, he/she mentioned that a solid and resilient macroeconomic framework is required, capable of withstanding adverse scenarios and allowing for lower financing costs along the yield curve.

He/she also emphasized that in light of the effects of the pandemic, the yield curve in Mexico has adjusted downwards in an orderly and sustained manner. He/she pointed out that when comparing the behavior of said curve among emerging economies, it stands out that short and long term interest rates in Mexico have decreased considerably. He/she pointed out that while short-term rates are lower in other emerging economies, in some of them long-term rates have decreased less or even increased. He/she noted that the challenge of maintaining low and stable risk premia has been complicated by the pandemic. He/she considered that given the challenges and disjunctives that monetary policy has confronted, in an environment in which headline and core inflation have been subject to pressures, despite the substantial weakness of economic activity, a pause would grant space to confirm the downward trajectory of headline and core inflation to the 3% target.

Another member argued that monetary policy faces a complex scenario due to conflicting effects: the largest fall in GDP in ninety years contrasts with rising inflation that exceeds forecasts and inflation expectations above the target. He/she added the presence of various risks that could pressure the exchange rate and impose greater stress on the monetary policy stance. He/she stated that in light of the complex environment, it is time to make a pause in the cycle of monetary easing and that this is a consistent, prudent and cautious decision given the significant global and domestic uncertainty. He/she considered that such decision will reinforce the credibility about the central banks' commitment to its primary mandate and will send an unequivocal message of prudence.

The same member pointed out that currently the ex-ante real interest rate is at an accommodative level and that the interest rate spread with respect to the Federal Reserve has reached a level below the one recorded during the 2009 crisis. The aforementioned in spite of greater domestic risks stemming from a more deteriorated fiscal position. Regarding the possibility that a cut to the policy rate is relevant for the reactivation of credit, he/she emphasized that recent data suggests that the interest rate channel has little influence on financing. He/she argued that actions in the sphere of monetary policy have been comprehensive and timely, but the impact on investment, credit and consumption has been limited, since these rely more on confidence and legal certainty. He/she added that this argument is reinforced when considering that the relevant interest rates for investment and consumption of durable goods are the medium and long term ones, which are currently at levels lower than during the recession of 2009. On the other hand, he/she stated that given the high sensitivity of capital flows in Mexico, it is imperative to maintain a cautious monitoring and to calibrate monetary policy, in order to avoid increasing the country's financial vulnerabilities, in an uncertain international environment and with a high country risk. Finally, he/she considered that the monetary policy statement must communicate that the decision seeks to guarantee the downward path of inflation to the target in the horizon in which monetary policy operates and that the prudent and responsible implementation of monetary policy is the best way to ratify the Central Bank's commitment to price stability.

One member argued that the monetary policy implemented in recent months has made a significant reduction in the reference rate compatible with an approach based on prudence. He/she noted that a de-anchoring of long-term inflation expectations has been avoided despite the shocks faced; the interest rate spread comparable with other emerging economies has been narrowed or inverted without exerting excessive pressures on the exchange rate, and long-term interest rates have remained at levels below those observed in several economies with lower reference rates. He/she mentioned that despite these efforts and the sharp economic contraction, mainly as a result of the shocks stemming from the pandemic, the inflationary situation remains difficult. He/she emphasized that in addition to inflation being above target, consideration must be given to the prolonged period in which core inflation has remained high, the persistence of short- and long-term expectations above the target, the risks to inflation in the coming months, as well as the fact that in the face of inflation data frequently exceeding forecasts during the year, the possibility of inflation converging to the target within the previously forecasted period seems to fade. He/she mentioned that many analysts anticipate that inflation for 2021 and in the long term will be above the target while also expecting that there will be cuts to the policy rate, which suggests doubts about the credibility of the commitment of the Central Bank to the target. He/she stated that, for all the above reasons, it is necessary to continue acting with prudence, which implies keeping the reference rate unchanged. He/she indicated that this represents the scenario to which information derived from market-based instruments assigns the highest probability. Finally, he/she considered that the duration of this pause will depend on the behavior of inflation and its expectations and forecasts, and that in an environment of so much uncertainty, flexibility in the implementation of monetary policy will be needed in order to ensure the convergence of inflation to the target.

Another member argued that, from different perspectives, monetary easing is still insufficient and that a pause should in no way be interpreted as the end of the easing cycle. He/she noted that the ex-ante real interest rate is still high in relation to that observed during the 2009 crisis, when the slack was lower than the current one and inflation expectations were higher. He/she added that said rate is also high in relation to that observed in the rest of the emerging economies. He/she mentioned that while in most economies real rates close to zero or negative were reached several months ago, in Mexico they are still in positive territory. He/she noted that monetary policy still has room to contribute to improve financing conditions without jeopardizing other aspects of the economy. He/she highlighted that interest rates faced by firms tend to decrease with monetary policy easing. He/she argued that the demand components typically associated with credit, such as investment, purchases of durable goods and purchases with credit cards, are those that have exhibited the weakest recovery. He/she emphasized that monetary easing should continue when inflationary pressures begin to ease and as long as the negative output gap continues. Otherwise, there may be costly implications during the recovery process and permanent effects on production and social welfare levels.

One member argued that an even lower rate is needed to help the recovery process. He/she added that inflation lies on the foreseen trajectory and that the output gap will remain very negative for a long period, which gives room to continue with the current cycle of easing as most countries have done. He/she noted that the ex-ante real interest rate is still positive and that there is a margin before reaching a level of zero or negative. He/she noted that, given the difficulty of implementing a greater fiscal stimulus, a more expansionary monetary policy is needed and that it should be signaled that it will remain so for a long time. He/she also emphasized that the monetary stimulus must continue to be complemented with measures to increase liquidity, to address the functioning of the payments system, and to strengthen the financing channels for micro-, small- and medium-sized firms. With regards to the absolute policy stance, he/she noted that low economic activity and reduced risk aversion open space for further easing, although the temporary increase in inflation could reduce this margin for a few months. He/she argued that, in relative terms, the global monetary easing and the lower risk aversion allow for maintaining an accommodative policy stance. He/she stated that the end point of the easing cycle is uncertain, as it depends on inflation remaining on the expected path towards the target, the output gap being negative and the recovery continuing. He/she underlined that if on this occasion the monetary policy decision is not to modify the target rate, this has to be considered as a pause and not as the end point of the expansionary cycle, in order to leave the door open to a more expansionary stance as has been recommended by some international financial authorities. He/she noted that Mexico's inflationary gap is positive, in contrast to the negative gaps in most emerging economies, so future decisions should incorporate the evolution of economic indicators. In addition, he/she pointed out that caution should be maintained in order to avoid affecting exchange rate stability and the financial system.

3. MONETARY POLICY DECISION

The risks for inflation, economic activity and financial markets pose major challenges for monetary policy and for the economy in general. Considering the mentioned forecasts for inflation and the convenience of consolidating a downward path for headline and core inflation towards the 3% target, with the presence of all its members, Banco de México’s Governing Board decided by majority to maintain the target for the overnight interbank interest rate at 4.25%. One member voted for lowering the policy rate to a level of 4.00%. This pause provides the necessary room to confirm that the trajectory of inflation converges to the target. Looking ahead, monetary policy implementation will depend on the evolution of the factors that have an incidence on headline and core inflation, on their foreseen trajectories within the forecast horizon, and on their expectations.

The Governing Board will take the necessary actions on the basis of incoming information in order for the policy rate to be consistent with the orderly and sustained convergence of headline inflation to Banco de México’s target within the time frame in which monetary policy operates. 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 and Javier Eduardo Guzmán-Calafell voted in favor of maintaining the target for the overnight interbank interest rate at 4.25%.

Jonathan Ernest Heath-Constable voted for lowering the target for the overnight interbank interest rate by 25 basis points to a level of 4.00%.

5. VIEWPOINTS / DISSENTING VOTES

Vote. Jonathan Ernest Heath-Constable

My vote is for lowering the policy rate by 25 basis points to 4.0% and continue the downward cycle as far as possible. The main problem we face is the significant fall in economic activity, its impact on the labor market and expectations of a weak, difficult and prolonged recovery. Given the magnitude of the economic collapse, we should not overreact to inflation being temporarily one tenth of a percentage point above the variability range of its target. Given the difficulty in implementing greater fiscal stimuli, more is required from monetary policy; an even lower policy rate is needed to aid in the recovery process. If not addressed appropriately, the economy might suffer practically irreversible structural damages. The greatest possible support is therefore required, shifting from a current slightly expansionary monetary policy stance to a highly accommodative stance, and communicating that it will remain as such for a long period. Not even a pause in the policy stance is acceptable when a sensitive decline in inflation is expected in November as a result of the fall in energy and in fruit and vegetable prices, and of the discounts in many goods during the *Buen Fin* sale.

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

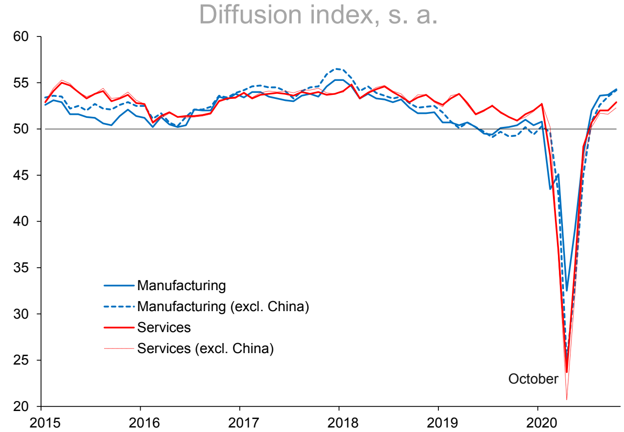
A.1.1. World economic activity

Available information suggests that the recovery of world economic activity that began in May with the gradual reopening of production activities has been heterogeneous among countries and sectors, and, recently, has taken place at a slower pace than that observed between May and June (Chart 1). Thus, the global economy remains at levels of economic activity below those prior to the pandemic. The risk that economic recovery is hindered by new lockdown measures, such as those implemented as of October in some European countries in light of the resurgence of COVID-19 cases in several countries, also persists. The COVID-19 pandemic and the measures implemented to contain it have significantly affected the evolution of inflation worldwide. Thus, although in advanced countries and in most emerging market economies downward inflationary pressures have prevailed over upward pressures, inflation has shown a mixed behavior across countries. This has depended on the various shocks faced by countries and on several idiosyncratic factors, such as the differentiated effects on specific sectors, the policy responses, and the effects on different currencies. In this environment, in the major advanced economies inflation remained below their respective central banks' targets, while in emerging economies the behavior of inflation has been more heterogeneous.

In this context, the central banks and fiscal authorities of systemically important economies have maintained several stimulus measures to mitigate the impact of the pandemic on the economy. In particular, the main central banks kept their reference interest rates at historically low levels, continued to use their balance sheets to foster a proper functioning of financial markets, and reiterated their commitment to maintaining highly accommodative monetary policy stances for an extended period. Nevertheless, since September, global financial markets have shown higher volatility, albeit not as high as that observed at the beginning of the pandemic. The uncertainty related to the approval of a new fiscal relief package in the United States and the possible effects of the electoral process, the resurgence of COVID-19 cases, the resumption of lockdown measures in several countries, as well as concerns regarding the valuation of certain financial assets, and the possible exit of the United Kingdom from the European Union without a trade agreement, have contributed to the greater volatility.

In this environment, the forecasts of analysts and multilateral organizations continue to anticipate a strong contraction of the world economy in 2020, although recently they have been revised to the upside due to a lower slowdown than what had been expected for the second quarter, particularly in advanced economies. Expectations of a gradual recovery in 2021 were also revised slightly to the downside due to the lower than expected contraction in 2020 and the expectation that social distancing will continue during the next year. These forecasts are subject to a high degree of uncertainty, given that the pace of recovery will be influenced by the still uncertain evolution of the demand components in several countries and economic sectors.

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



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

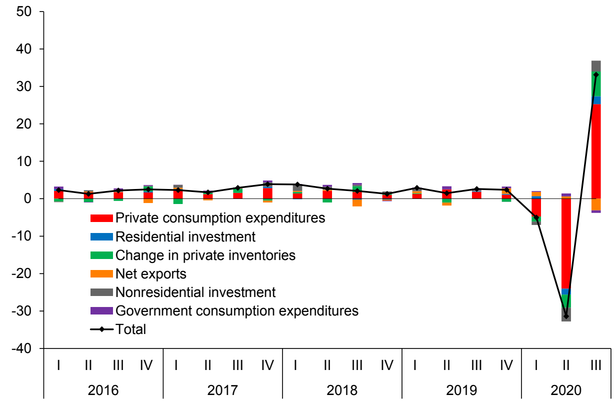
In the United States, GDP grew at a seasonally adjusted annualized quarterly rate of 33.1% during the third quarter, after having contracted 31.4% in the second (Chart 2). These results indicate that this indicator still remains below its pre-pandemic level. This recovery was driven by a strong growth of private consumption and investment in real estate and equipment, which were supported by the fiscal stimuli and favorable financial conditions. In contrast, the items that contributed negatively to GDP include public spending, as some fiscal stimuli started to decrease, and net exports, due to the greater dynamism of imports.

In September, US industrial production contracted at a monthly rate of 0.6%, remaining still below the levels prior to the pandemic. This fall reflected a contraction in electricity generation, which is explained by a lower demand for air conditioning, after an unusually warm summer season and, to a lower degree, a decrease in the manufacturing sector stemming from a lower production of computers, electronic equipment, and motor vehicles. The mining sector increased driven by greater oil/gas drilling and extraction. In this context, available indicators to October, such as the Purchasing Managers' Index (PMI) of the manufacturing sector, suggest a moderate recovery of this sector.

US employment continued to recover in September and October, largely due to the return to work of employees that had been temporarily laid off. The unemployment rate continued to decrease from 8.4% in August to 6.9% in October, although it remains at levels far above those observed prior to the pandemic and the number of employees that lost their jobs involuntarily and are not expecting to recover it in the short term remains high. As to the non-farm sector, although between May and October 12.1 million of over 22 million jobs lost during March and April have been recovered, the pace of recovery has moderated.

In the euro area, after the strong contraction during the first and second quarters of 2020, economic activity increased at an annualized quarterly rate of 61.1% during the third quarter, although it still remains below pre-pandemic levels. In particular, retail sales recovered slightly in August, driven by the greater mobility and consumer confidence, although recently both factors have decreased due to the resurgence of COVID-19 cases in some countries. Leading indicators, such as PMIs, confidence indexes and other high-frequency indicators, point to a significant moderation in the pace of recovery of economic activity, mainly in the services sector. The unemployment rate increased at a moderate pace, by rising from 8.1% in July to 8.3% in September.

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



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

In the United Kingdom, available indicators suggest a rebound of economic activity during the third quarter, driven mainly by the growth of manufacturing and construction, while the recovery of the services sector has been more moderate. Retail sales continued to recover in September, standing above the levels prior to the pandemic. Although PMIs continue to lie above 50, they registered a decline in September and October, which suggests a moderation in economic activity during the fourth quarter. It is worth noting that, despite the progress in the negotiation of the trade agreement between the United Kingdom and European Union, uncertainty persists as to the possibility that said agreement is actually reached before December 31, 2020.

In Japan, available indicators suggest a gradual recovery of economic activity during the third quarter of the year. On the one hand, retail sales exhibited certain stability, while consumer confidence increased in recent months, although it still remains below pre-pandemic levels. On the other hand, industrial production rebounded in September, driven by exports and the gradual recovery of domestic demand. Purchasing Managers' Indexes for October continue to exhibit contraction. As for the labor market, the unemployment rate increased slightly from 2.9% in July to 3.0% in September.

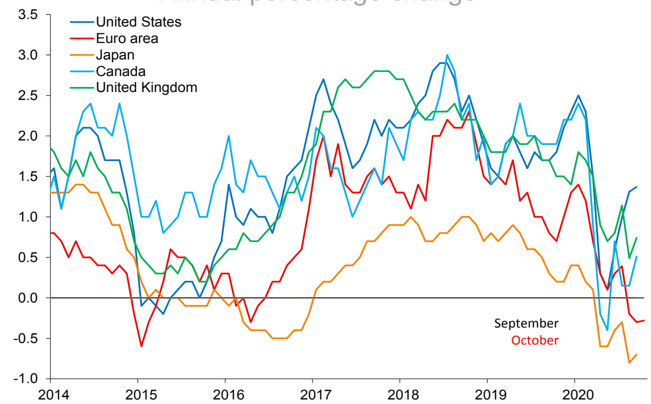
In emerging economies, economic conditions continue to vary depending on the spread of the pandemic, the effectiveness of measures to contain it, and the economic stimuli implemented. In China, the economy continued to recover during the third quarter of the year, with GDP growing at an annual rate of 4.9%, after the 3.2% rate registered in the second quarter. This has reflected the drive of investment and exports, which has fostered the expansion of industrial production. The recovery of the services and consumption sectors continues to fall behind. As for Latin American economies, aggregate demand and production indicators suggest that economic recovery has taken place at a slower pace than in other regions and has moderated in some countries.

Since Mexico's previous monetary decision, the international prices of commodities have registered a mixed behavior. In particular, oil prices have exhibited volatility since September given the uncertainty about the approval of a new fiscal package in the United States, the possible reduction in fuel demand due to the resurgence of COVID-19 cases in several countries, and the impact on production of hurricanes in the Gulf of Mexico. Industrial metal prices have continued to trend upwards due to the sustained recovery of industrial production worldwide and the strong demand for metals from China. Finally, grain prices were driven up by the strong demand for these goods, as well as by the unfavorable climate conditions for certain crops, particularly in the United States.

A.1.2. Monetary policy and international financial markets

The pandemic and the measures implemented to contain it have had a significant impact on the evolution of inflation worldwide. The weakness of economic activity exerted, in general, considerable downward pressures on service prices. The prices of some goods, such as foods, increased due to a greater demand and supply-related effects. Thus, although in both advanced and most emerging market countries, downward pressures have prevailed over upward pressures, the effects have been heterogeneous depending on the magnitude of the shocks and on idiosyncratic factors such as the differentiated effects across sectors and the policy response, including subsidies and tax cuts, among others. Therefore, in the main advanced economies, inflation continues to be below their targets (Chart 3). In this context, despite having increased in general, inflation expectations drawn from financial instruments for the main advanced economies remain at low levels. In emerging economies, the weakening of economic activity and the fall in the prices of certain services affected by the pandemic contributed to a decline in inflation in many of them, while in other countries there were upward pressures generated by increases in energy and food merchandise prices, as well as by the depreciation of their currencies.

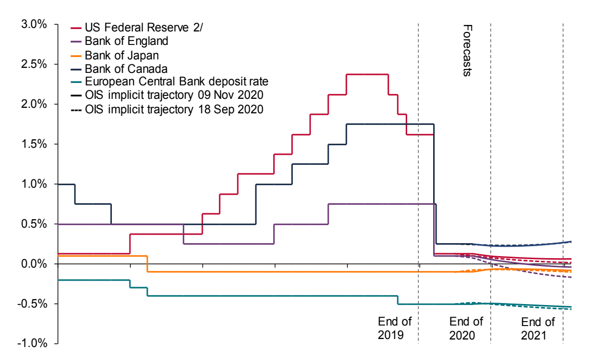
Chart 3
Selected Advanced Economies: Headline Inflation
Annual percentage change



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

In this context, the main central banks of advanced economies, in addition to keeping their reference interest rates at historically low levels and continuing to use their balance sheets to foster an orderly functioning of financial markets, reiterated their commitment to maintain highly accommodative policy stances for an extended period, given the considerable effects of the pandemic on aggregate demand. Expectations drawn from market instruments continue to anticipate that these central banks will maintain highly accommodative monetary policy stances (Chart 4).

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



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) In its November meeting, the Federal Reserve left unchanged its range for the federal funds rate at 0%-0.25% and asset purchase program. It reiterated that it expects that it will be appropriate to maintain this range until the labor market conditions have reached levels consistent with its maximum employment estimate and inflation has increased to 2% and is heading moderately to exceed the 2% target for some time. Likewise, prior to its November meeting, it announced adjustments to the terms of its Main Street Lending Program, reducing the minimum amount of loans and adjusting their fees to foster the provision of smaller loans, thus reorienting support towards smaller firms. In this context, market variables incorporate that the Fed will maintain its reference rate unchanged during 2020 and 2021.

ii) In its October meeting, the European Central Bank (ECB) left its policy rates unchanged, maintaining its refinancing rate, key deposit facility rate and key lending facility rate at 0.0, -0.5 and -0.25%, respectively. It reiterated that these interest rates are expected to remain at or below their current levels until inflation forecasts converge 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 stated that, in the current environment where the balance of risks is biased to the downside, its Governing Council will evaluate the pandemic dynamics, the expectations for launching COVID-19 vaccines and the evolution of the exchange rate. In particular, it pointed out that the new forecasts that will be available in December and an assessment of the balance of risks, will allow to recalibrate its monetary policy instruments as necessary to support economic recovery and offset the negative impact of the pandemic on the trajectory of inflation. The ECB noted that these measures will foster the sustained convergence of inflation to its target, in line with its commitment to a symmetric inflation target.

iii) In its October 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 also pointed out that it will continue to support the financing of firms and financial market stability with the special program to support financing in response to the COVID-19 pandemic, a widespread provision of yen liquidity, and purchases of exchange-traded and property funds. 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.

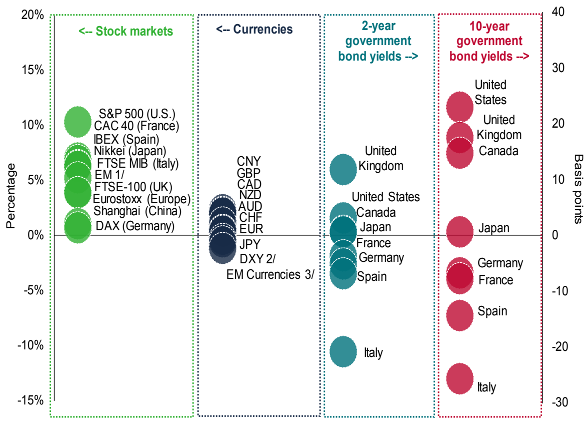
iv) The Bank of England kept its reference interest rate unchanged at 0.10% and the amount of its asset purchase program in its latest meetings. Nevertheless, in its November meeting it added another £150 billion to its asset purchase program, for a total value of £875 billion. It reiterated that it will continue to closely monitor the situation and pointed out that, if inflation expectations weaken, the Monetary Policy Committee will be ready to take any additional action to comply with its mandate. This central bank also pointed out that the Committee does not intend to tighten its monetary policy stance until there is clear evidence that significant progress has been made in eliminating the excess slack in the use of productive capacity and in moving towards its 2% inflation target in a sustainable manner.

v) In its October meeting, the Bank of Canada left its reference rate unchanged at 0.25%, reiterating that it will keep its reference interest rate at levels close to zero until the slack has been reduced, so that the 2% inflation target is reached in a sustained manner, which it expects to be achieved at least until 2023. It also announced a recalibration of its asset purchase program towards purchasing longer-term bonds and gradually reducing the total amount to at least CAD 4 billion weekly. The Board considered that, with these adjustments, it is providing at least as much monetary stimulus as before and reiterated that the program will continue until economic recovery is clearly underway.

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

In the context of world economic activity described above, international financial markets exhibited a volatile behavior since Mexico's latest monetary policy decision, although said volatility was more limited than during March and April. This was due to several factors, such as the uncertainty associated with the approval of an additional stimulus package in the United States and the possible effects of the US electoral process; an increase in COVID-19 cases in various countries; the announcement of new social distancing measures; the concerns about the valuation of some financial assets; and the possibility that the United Kingdom's exit agreement from the European Union is not reached. In advanced economies, financial assets exhibited episodes of high volatility. In particular, stock market indexes registered gains in the last week, driven mainly by the results of the US electoral process and progress in the development of a vaccine against COVID-19. The US dollar depreciated slightly against most developed countries' currencies. Finally, interest rates of long-term government bonds exhibited mixed adjustments by region, with a continued decrease of rates in the euro area and a slight steepening of the US yield curve standing out (Chart 5). Emerging economies registered net capital inflows, mainly to fixed-income assets. Their stock markets exhibited episodes of higher volatility and mixed adjustments by region, while their currencies exhibited a depreciation bias in general (Chart 6).

Chart 5
Change in Selected Financial Indicators from September 18 to November 9, 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 September 21 to November 9, 2020
Percent, basis points

Region	Country	Currencies	Equity markets	Interest rates 2Y	Interest rates 10Y	CDS
Latin America	Mexico	4.71%	11.64%	-12	5	-56
	Brazil	0.64%	6.73%	59	-24	-61
	Chile	2.26%	7.81%	-3	15	-18
	Colombia	3.69%	1.35%	-17	-22	-54
Emerging Europe	Russia	-0.21%	4.33%	-17	-22	-44
	Poland	0.71%	4.91%	6	21	-9
	Turkey	-5.78%	13.29%	74	88	-104
	Czech Republic	2.63%	3.66%	10	36	-6
	Hungary	1.22%	13.35%	-7	-17	-19
Asia	Malaysia	0.34%	1.66%	-16	14	-14
	India	-1.02%	12.00%	-32	-45	-45
	Philippines	0.48%	13.14%	-48	-18	-15
	Thailand	2.07%	0.84%	-1	-4	-2
	Indonesia	4.32%	7.13%	-8	-47	-29
Africa	South Africa	8.38%	7.48%	-36	-35	-86

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 possible adoption of new measures to contain it in more countries, the sufficiency of fiscal stimuli implemented to support the recovery, and on the processes of development and distribution of a vaccine. Along with the above there is the persistence of other risk factors, such as the high levels of private borrowing, the greater number of bankruptcies in the sectors most affected by the pandemic, trade tensions, a worsening of geopolitical and social conflicts in different regions of the world, a greater uncertainty about the possible effects of the US electoral process, and the possible exit of the United Kingdom from the European Union without a trade agreement, among others.

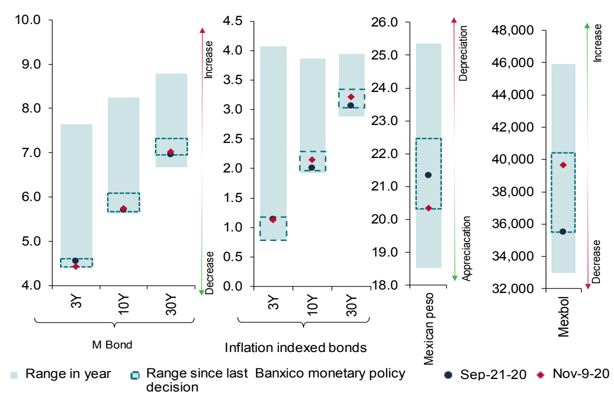
A.2. Current situation of the Mexican economy

A.2.1. Mexican markets

Since Banco de Mexico's previous monetary policy decision to date, the prices of financial assets in Mexico exhibited a positive bias, in line with that observed in other emerging economies (Chart 7). This occurred in an environment where uncertainty persists about the effects of the pandemic on the global economy and the resurgence of COVID-19 cases in some regions, and where caution by investors towards risky assets spread due to the uncertainty about the results of the US election. However, the preliminary results of the electoral process, along with positive news regarding vaccines and effective treatments against COVID-19, provided additional support to emerging countries' assets.

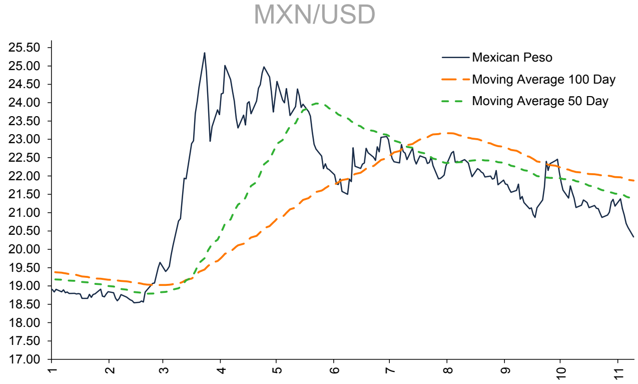
The Mexican peso stood out among emerging economies' currencies with the best performance, trading with volatility in a range between 20.32 and 22.46 pesos per US dollar and ending the period with an appreciation of 4.71% (Chart 8). This occurred in a context where both spot and forward trading conditions exhibited a marginal improvement vis-à-vis the period of the previous monetary policy decision, although they remain deteriorated with respect to the levels prior to the pandemic.

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



Source: Prepared by Banco de México.

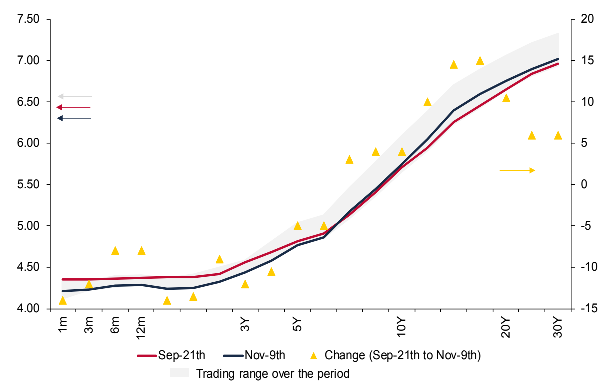
Chart 8
Mexican Peso Exchange Rate with Moving Averages
MXN/USD



Source: Prepared by Banco de México.

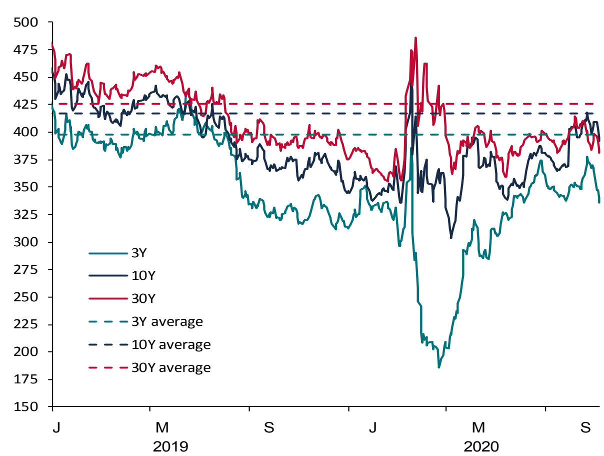
Interest rates of government securities exhibited moderate adjustments that were differentiated by term. In this regard, reductions were observed for those in the short end of the yield curve and increases in the longer end, (Chart 9), which led to an increase of the 3 year-30 year spread to levels not seen since the beginning of the pandemic. The yield curve of real-rate instruments also exhibited dynamics similar to that of nominal rates. In this context, breakeven inflation and inflation risk premia implicit in the spreads between nominal and real market instrument rates exhibited mixed adjustments since the September monetary policy decision (Chart 10). It is worth noting that such dynamics took place in a context where trading conditions exhibited a marginal deterioration vis-à-vis the period of the previous monetary policy decision.

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



Source: PIP.

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

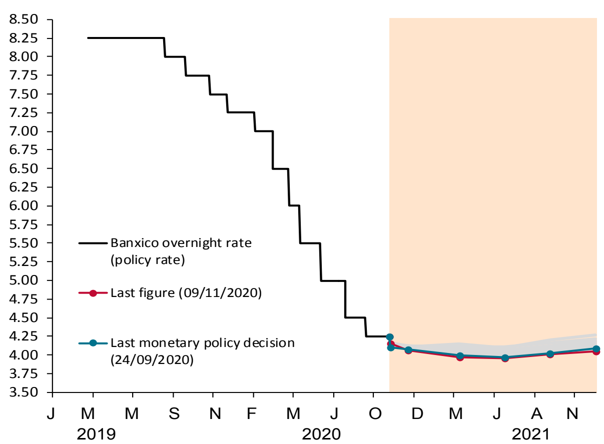


Source: PIP.

As to the measures announced by Banco de México in April, the first transaction of the temporary collateralized financing facility took place on October 21. This facility has been instrumented on three occasions and reports that 3.99 billion pesos of the total amount of 50 billion pesos available have been used.

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 39% probability a 25-basis point cut for the monetary policy decision of November (Chart 11). Private sector forecasters surveyed by Citibanamex are also expecting a 25-basis point cut. For the end of 2020, market variables anticipate a target level of 4.07%, while the median of surveyed forecasters expects a level of 4.00%. Finally, for the end of 2021, market variables are anticipating a target level of 4.05%, while the median of private sector forecasters surveyed anticipates a level of 4.00%.

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



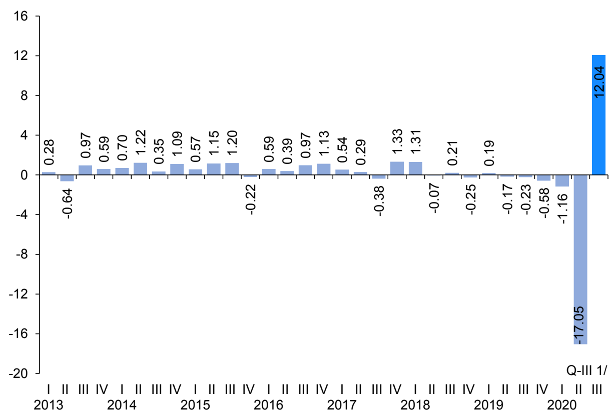
Source: Prepared by Banco de México with Bloomberg data.

A.2.2. Economic activity in Mexico

According to the GDP flash estimate published by INEGI, after having contracted sharply during the second quarter, Mexico's economic activity recovered slightly in the third quarter, although it remained below the levels prior to the health emergency, in an environment of uncertainty and downside risks (Chart 12). This behavior was driven by the relatively strong recovery of external demand since the end of the previous quarter and the more moderate reactivation of domestic demand, associated with the easing of measures implemented since the end of May in response to the health contingency.

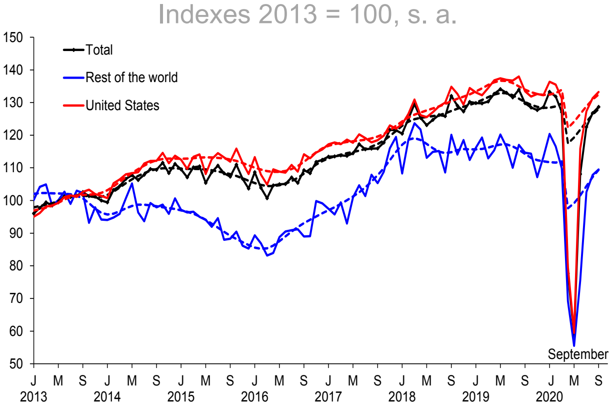
As for external demand, after having been strongly impacted by the pandemic between March and May, exports started to recover as of June, reflecting the rebound of certain economic activities previously considered as non-essential by the health authorities and the gradual reactivation of external demand. This recovery resulted from both the dynamism of automotive exports, as well as the rest of manufacturing exports, particularly those to the United States (Chart 13).

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



s. a. / Seasonally adjusted figures.
1/ The figure for the third quarter of 2020 refers to the quarterly GDP flash estimate published by INEGI.
Source: Mexico's System of National Accounts (SCNM, for its Spanish acronym), INEGI.

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

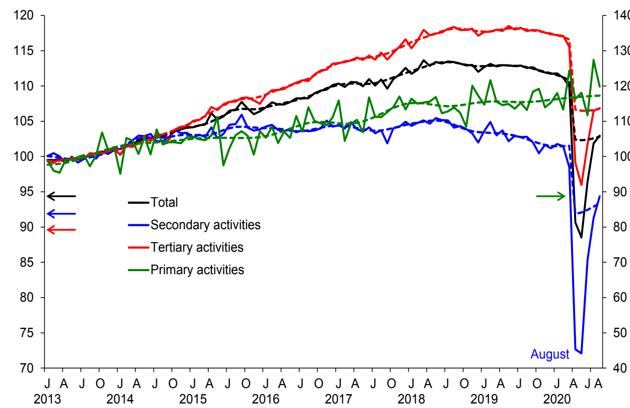


s. a. / Seasonally adjusted series and trend series based on data in nominal US dollars. The former is represented by a solid line and the latter by a dotted line.
Source: Prepared by Banco de México with data from the Tax Administration Service (SAT, for its Spanish acronym), the Ministry of the Economy (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 July and August private consumption continued to recover moderately, although it still remains below the levels of February and decelerated at the margin. This result reflected the increases in consumption of both goods and services. Timely indicators suggest that private consumption has continued to recover during the rest of the third quarter and the beginning of the fourth. In particular, National Association of Self-Service and Department Stores (*ANTAD*, for its acronym in Spanish) sales reached in September levels similar to those observed before the health crisis, while sales of light vehicles also grew significantly during the July – October period. In July and August, gross fixed investment also continued to recover, although it remains at levels well below those at the beginning of the health crisis. Within this indicator, machinery and equipment continued to recover, although it exhibited a sharp deceleration in August, while construction remains at particularly low levels despite the rebound in August. Timely indicators related to this component, such as capital imports, suggest that investment would have continued to recover moderately at the end of the third quarter.

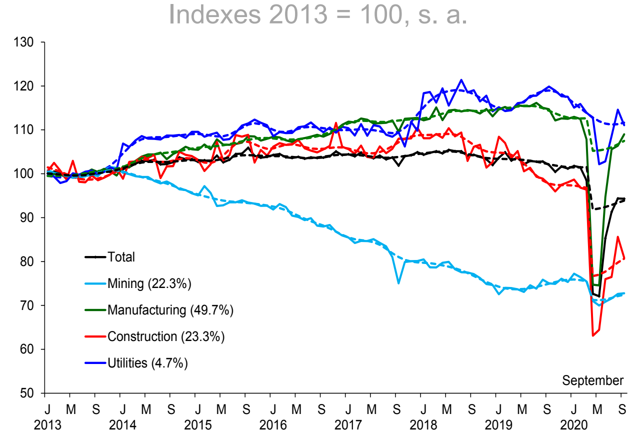
As for production, throughout the third quarter, secondary activities reversed partially the strong contraction observed during the second quarter, although they lost some dynamism in September (Chart 14). In particular, manufacturing recovered for the fourth consecutive month, growing at a slightly faster rate at the margin, while mining continued to exhibit lackluster growth (Chart 15). In contrast, construction decreased considerably in September, partially reversing the rebound shown in the previous month. Tertiary activities recovered at a more moderate pace and in a heterogeneous manner among its sectors. Increases were observed in accommodation and food services; wholesale trade; education and health; and transportation, warehousing and information. In contrast, decreases were observed in arts, entertainment, recreation and other services; finance and insurance; real estate, rental and leasing; public administration; retail trade; administrative and support services; and in management of companies and enterprises.

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 National Accounts System (SCNM, for its acronym in Spanish), INEGI.

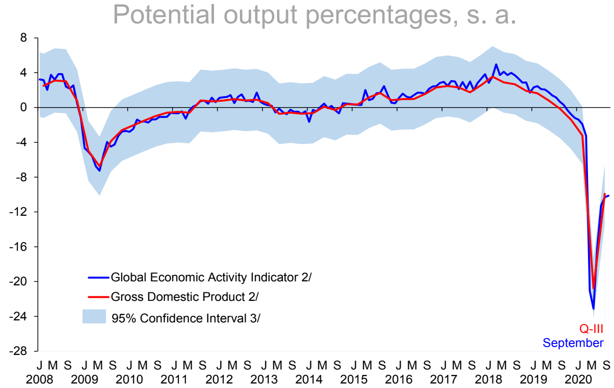
Chart 15
Industrial Activity [1/]
Indexes 2013 = 100, s. a.



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.

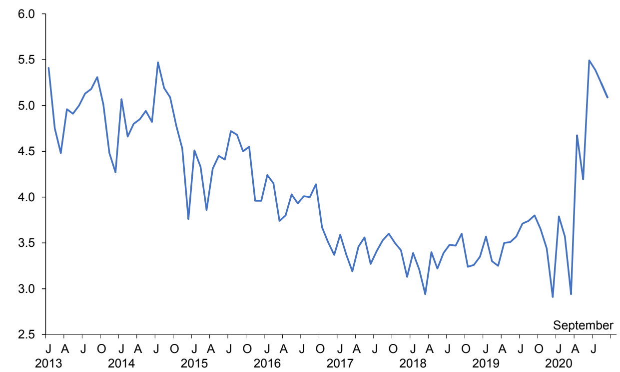
As to the economy's cyclical position, due to the gradual reactivation of production activities and greater population mobility, the considerable widening of slack observed in April and May has been partially reversed since June, although it is still foreseen to remain at ample levels (Chart 16). According to the results of INEGI's latest National Survey on Occupation and Employment (*ENOE*, for its Spanish acronym), several labor market indicators continued to improve moderately in September. In particular, labor participation increased with respect to August, while the underemployment rate continued to decrease as compared to the previous month, which may be associated partly with an increase in hours worked and the return to work of certain temporary employees. The national unemployment rate also decreased as compared to August, although it remains at levels above those prior to the health contingency (Chart 17). The creation of IMSS-insured jobs has rebounded slightly after the impact of the pandemic, although at a moderate pace. Finally, as a reflection of the recovery of production and hours worked, unit labor costs in the manufacturing sector accumulated four monthly consecutive reductions in August, although they still continue to be above pre-pandemic levels (Chart 18).

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



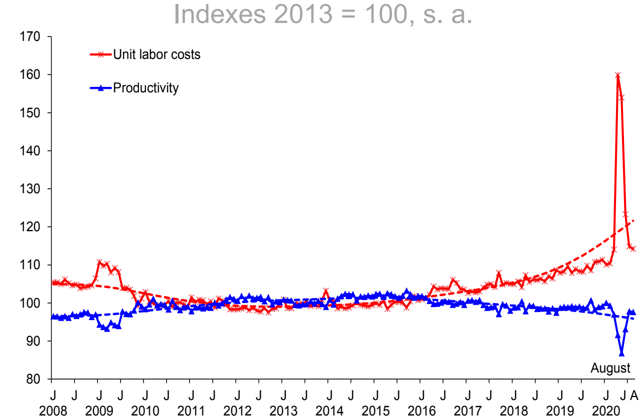
s. a. / Calculations based on seasonally adjusted figures.
1/ Output gap estimated with a tail-corrected Hodrick-Prescott filter; see Banco de México (2009), "Inflation Report (April-June 2009)", p.74.
2/ GDP figure as of the second quarter of 2020; IGAE figure as of June 2020.
3/ Output gap confidence 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) and ENOE new edition (ENOE[N]) from July to September 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.

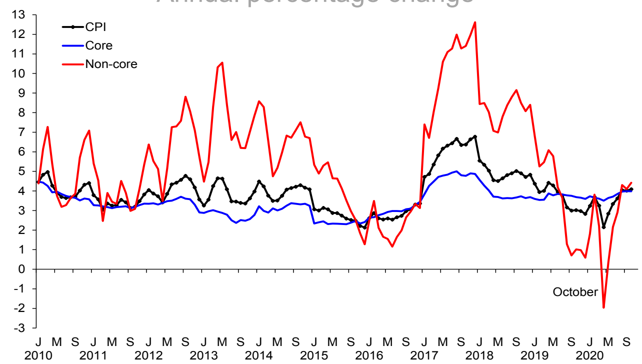
In September, domestic financing to firms contracted at an annual rate for the fourth consecutive month, thus increasing the loss of dynamism that has been observed since May. This was mainly due to the reduction in bank lending to large firms, which have had a more moderate demand for this type of financing vis-à-vis at the beginning of the pandemic. In the domestic corporate debt market, the rebound of debt issuance continued in September, after low levels of activity during the second quarter. Bank lending to smaller firms contracted further at an annual rate. As for credit to households, housing portfolio issuance increased, although it remains below that at the beginning of the pandemic. Consumer credit continued to contract, although an increase of credit cards and durable goods consumption was observed at the margin. Interest rates of bank credit to private firms decreased in September, in line with the reduction in banks' overnight funding rate, while the margins of intermediation of interest rates of lending to firms remained relatively stable. In August, interest rates of mortgages continued to decrease for the seventh consecutive month, while those of credit cards showed levels similar to those of June. As for portfolio quality, corporate and mortgage loan delinquency rates remained low, while those for consumption credit have been decreasing since July, although they are still at high levels.

In September, the additional measures implemented by Banco de México to promote the sound development of the financial system were extended to February 28, 2021. As for the facility to provide resources to banking institutions to channel credit to micro, small- and medium-sized firms and individuals affected by the pandemic, up to October fourteen credit institutions had signed agreements to use this facility.

A.2.3. Development of inflation and inflation outlook

Annual headline inflation rose from 4.01 to 4.09% between September and October 2020 (Chart 19 and Table 1). The adjustment at the margin reflected an increase in non-core inflation, with a rise in the annual rate of change of fruit and vegetable prices standing out.

Chart 19
Consumer Price Index
Annual percentage change

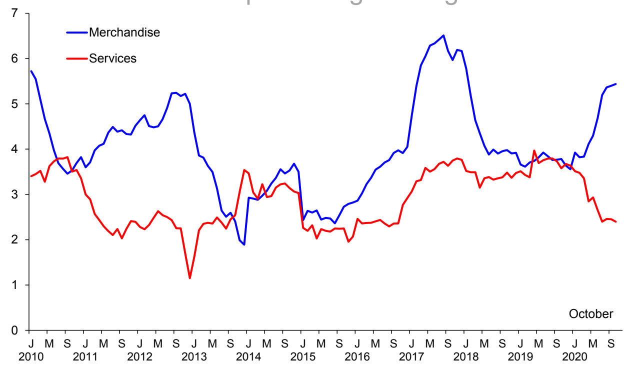


Source: Banco de México e INEGI.

In September and October, annual core inflation was 3.99 and 3.98%, respectively. The effects associated with the COVID-19 pandemic have influenced it in such a way that it has undergone a recomposition, characterized by upward pressures in the prices of merchandise and downward pressures in service prices. In those months, annual merchandise inflation was 5.40 and 5.44%, respectively (Chart 20 and Table 1). Within it, after having increased significantly, the annual variations of food merchandise prices remained stable during the reference period, while those of non-food merchandise prices increased slightly (Chart 21). For its part, the annual inflation of service prices stood at 2.45 to 2.40% during the same periods. In particular, the rates of change of housing and education prices decreased, while those of other services, such as air transportation and tourism increased.

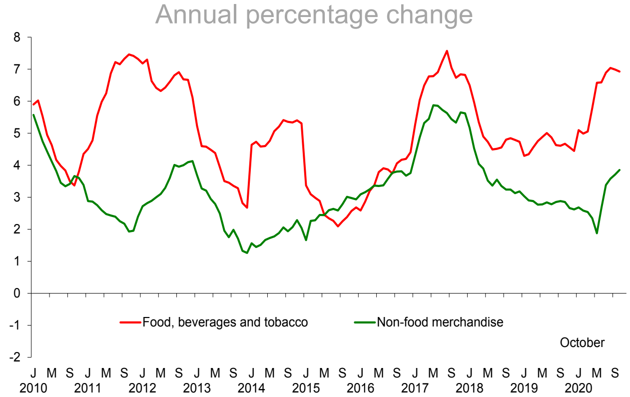
Annual non-core inflation rose from 4.10 to 4.42% between September and October (Chart 22 and Table 1), a result which was associated largely to the higher inflation of agricultural and livestock product prices, which increased from 8.16 to 9.61%, with the high rates of change of fruit and vegetable prices standing out. The annual inflation of energy prices, on the other hand, were at rates of -0.39 and -0.71% in those months.

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



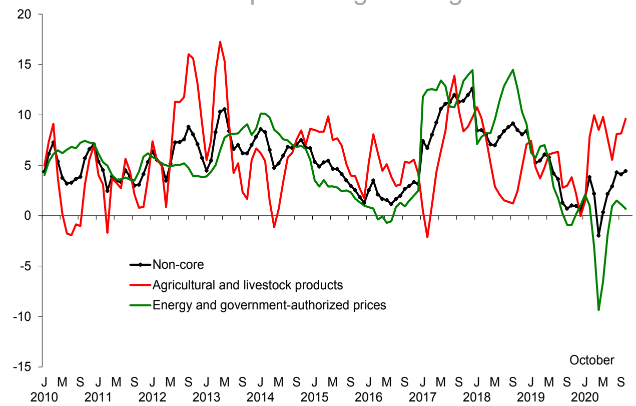
Source: Prepared by Banco de México with data from INEGI.

Chart 21
Merchandise Core Price Sub-index
Annual percentage change



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

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



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

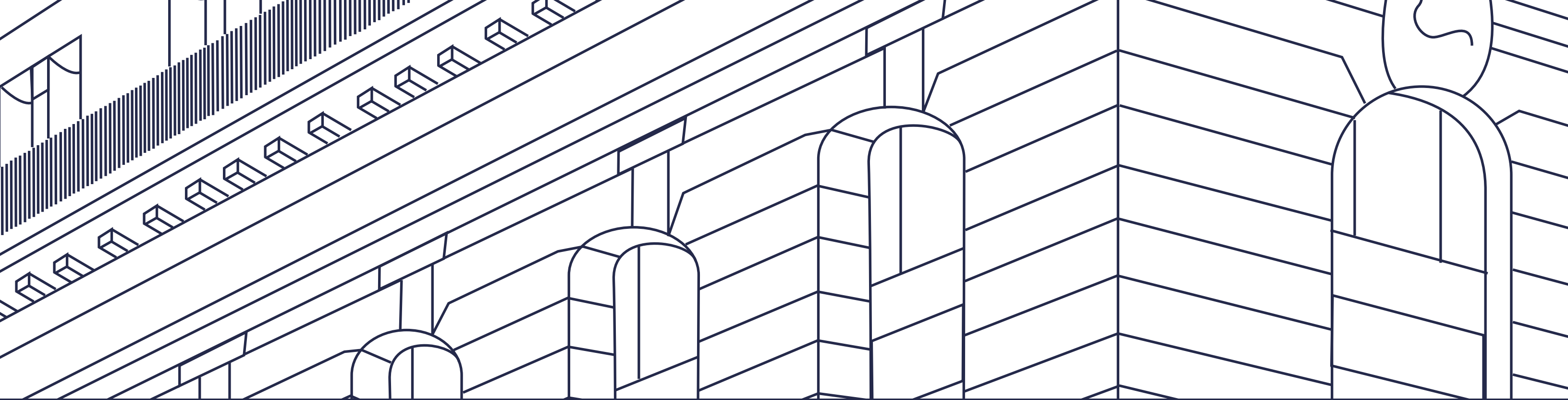
As for inflation expectations drawn from Banco de México's Survey of Private Sector Forecasters, between August and October the median for headline inflation for the end of 2020 rose from 3.82 to 3.95%, while that of core inflation continued at 3.92%. The medians of for medium- and long-term expectations for both headline and core inflation remained at around 3.50%. Finally, breakeven inflation and inflation risk increased since the last monetary policy decision, in an environment of volatility.

The evolution of inflation is subject to short- and medium-term risks. To the downside: i) a greater-than-expected effect due to the negative output gap; ii) lower inflationary pressures worldwide; and, iii) greater social distancing measures that lower the demand for goods and services. To the upside: i) episodes of foreign exchange depreciation; ii) persistence of core inflation at high levels; and, iii) logistical problems and higher costs associated with the health measures. The balance of risks for the projected trajectory of inflation described above is thus uncertain.

Table 1
Consumer Price Index and Components
Annual percentage change

Item	August 2020	September 2020	October 2020
CPI	**4.05**	**4.01**	**4.09**
Core	**3.97**	**3.99**	**3.98**
Merchandise	**5.36**	**5.40**	**5.44**
Food, beverages and tobacco	7.04	6.99	6.93
Non-food merchandise	3.58	3.71	3.85
Services	**2.46**	**2.45**	**2.40**
Housing	2.28	2.20	2.12
Education (tuitions)	3.11	2.16	2.11
Other services	2.47	2.75	2.71
Non-core	**4.30**	**4.10**	**4.42**
Agricultural and livestock products	**8.09**	**8.16**	**9.61**
Fruits and vegetables	13.12	12.76	16.24
Livestock products	4.10	4.49	4.29
Energy and government-authorized prices	**1.50**	**1.11**	**0.68**
Energy products	0.27	-0.39	-0.71
Government-authorized prices	4.25	4.47	3.88

Source::INEGI.



BANCO DE MÉXICO®

Document published on November 26, 2020