BANCO DE MÉXICO®

Minutes number 88

Meeting of Banco de México's Governing Board on the occasion of the monetary policy decision announced on November 11, 2021

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FOREWARNING
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1. PLACE, DATE, AND PARTICIPANTS

1.1. Place: Meeting held by virtual means.

1.2. Date of Governing Board meeting: November 10, 2021.

1.3. Participants:

Alejandro Díaz de León, Governor.
Galia Borja, Deputy Governor.
Irene Espinosa, Deputy Governor.
Gerardo Esquivel, Deputy Governor.
Jonathan Heath, Deputy Governor.
Rogelio Eduardo Ramírez, Secretary of Finance and Public Credit.
Gabriel Yorio, Undersecretary of Finance and Public Credit.
Elías Villanueva, Secretary of the Governing Board.

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

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

International environment

The majority mentioned that global economic activity continued to recover during the third quarter, although at a slower pace and heterogeneously across countries, associated with the evolution of the pandemic and with spending programs. Some members pointed out that the recent increase in the number of infections negatively affected economic activity in several economies. In this regard, **one** member noted the lower job creation. **Another** member pointed out the slower recovery of the services sector. He/she delved into the shortage of inputs slowing down production in certain sectors, which is uncommon during an early upward stage of the economic cycle. He/she added that this can be observed in the longer delivery times of manufacturing products and in the increase in ocean freight costs.

Most members highlighted the downward revision in global growth forecasts. Some members underlined the heterogeneity of those revisions across regions and countries. They noted the upward adjustments for 2021 for the euro area and Latin America, and the downward adjustments for the United States, Japan, the United Kingdom and some emerging economies in Asia. **One** member pointed out that, according to the International Monetary Fund, advanced economies are expected to recover the growth trajectory exhibited prior to the pandemic, while emerging economies, with the exception of China, are foreseen to continue growing below pre-pandemic forecasts, even until 2024. **Some** members pointed out that there is concern about the economic recovery. **One** member considered that, given the persistence of negative effects, there are still doubts about the velocity of the recovery. He/she added that the heterogeneity across the growth outlooks is a cause for concern. **Another** member emphasized that the adjustment in the outlook indicates fragility in the recovery and suggests risks to the economic activity.

Among global risks, most members mentioned those associated with the pandemic, inflationary pressures, and adjustments in monetary and financial conditions. Some members pointed out the imbalances between supply and demand, as a result of the reopening of economies, economic stimuli programs, the change in consumption patterns, and the disruption in global supply chains. **One** member noted that the atypical nature of the recovery is causing frictions, which have detonated risks to growth and inflation.

Another member highlighted the role of the pandemic in inflationary pressures, which can be divided in two stages. First: i) unprecedented shocks with forecast errors in economic activity and inflation; ii) the abrupt shutdown of activities prompted businesses to lower their costs, inventories, investment and their workforce; iii) social impact and political tensions, which contributed to the implementation of large spending stimuli in advanced economies; iv) a reallocation of household expenditure from services towards merchandise; and v) a profound impact in the labor market. Second, i) a faster recovery and a considerable increase in fiscal support programs in the United States, generating bottlenecks and pressures on world trade and on durable goods' prices; ii) the recovery of the services' sector as a result of vaccine availability; iii) limitations in production; and iv) a high leverage after a long period of historically low interest rates, which, in addition to fiscal expansion, poses challenges to financial stability. As to the lack of flexibility in production, he/she pointed out that the impact on supply chains, the lack of investment in hydrocarbons due to the energy transition, and the end of the negative effect on manufacturing prices that had been observed with China's increasing participation in world trade. As to the labor market, he/she mentioned that the pandemic accelerated the outflow of certain workers from the labor force and generated lower participation in others. Similarly, it produced a change in relative wages as a result of risks of contagion. He/she expressed that, considering all of the above, world inflation dynamics responds both to the direct impact on production and to pressures due to the reallocation of spending and to spending programs.

Most members mentioned that world inflation continued to be pressured by bottlenecks in production, the reallocation of spending towards merchandise, the rise in food and energy prices, the reopening of certain services, and by imbalances between supply and demand. One member added the impact of stimulus spending, the increase in ocean freight costs, and pressures on consumer durables. He/she emphasized the high annual change of the US producer price index, which registered 8.6% in September and October, and the pressures on consumer durables, for which inflation reached 6.96% in August 2021, as compared to -1.54% in February 2020. He/she also highlighted that said economy stands out for having had the largest spending stimulus programs implemented and for registering the highest inflation pressures in a broad range of products, as well as the highest levels of CPI inflation since 1990 (6.2%). He/she pointed out that these have contributed to raise inflation expectations of business and consumers, as well as expectations implicit in fixed-income markets. **Another** member stated that spot and future prices of different commodities continued increasing significantly. **One** member pointed out that the increase in international commodity prices is also due to climate-related factors. He/she added that the origin of all these factors is directly linked to the pandemic, and thus their effects will not last forever. **Another** member noted that in most economies, with a few exceptions, such as Japan, inflation is above the respective central bank targets.

Most members mentioned that the adverse effects of global inflationary pressures are expected to be mainly transitory. One member added that there is no consensus on this matter. **Some** members pointed out that pressures are anticipated to dissipate by the end of next year, depending on progress towards containing the pandemic. **One** member noted that some pressures, such as those on international prices of food and industrial inputs, have already started to dissipate. **The majority highlighted that the horizon in which the pressures could affect inflation is uncertain and the risk of them affecting the price formation process. One** member stated that it would be reflected in higher inflation expectations and in an earlier-than-anticipated or a faster withdrawal of monetary stimuli. He/she added that information from surveys in advanced economies suggests an increase in short-term expectations, while expectations drawn from longer-term financial instruments show moderate increases. **Another** member highlighted the magnitude of inflationary pressures and the broad range of products being affected. He/she added that the deterioration in the inflation outlook and the challenge it implies have been acknowledged by all central banks and that most of them have taken measures to address the issue.

Most members pointed out that the central banks in the main advanced economies have maintained accommodative policy stances. Some members noted that in these economies financial markets anticipate increases in interest rates in 2022. **One** member considered that the continuing stimulus in a significant number of central banks implies to some extent the recognition that increases in interest rates are not useful in solving supply problems, which are leading to the current levels inflation, and that they could indeed have a negative impact on the recovery. **Another** member noted that some central banks have already started to reduce their asset-purchase programs. **One** member mentioned that monetary conditions have started to become less accommodative. **Another** member highlighted that, despite the plans to gradually withdraw stimuli, there is still uncertainty over the duration of inflation pressures and the adjustment of markets.

All members indicated that the Federal Reserve announced the reduction in its asset-purchase program. Some members noted that said institution also stated that the conditions to increase the federal funds rate have not yet been met. **One** member added that the Federal Reserve has made it clear that the start of the reduction in its asset purchases does not imply an imminent increase in rates. He/she added that this central bank stated that it would remain patient in view of the inflationary pressures, which it expects to be transitory, and given the evolution of the economic recovery, which is still incomplete. **The majority pointed out that markets anticipate the first interest rate increase in 2022. One** member pointed out that markets anticipate the first rate increase to take place in the last quarter of 2022. He/she stated that market expectations are consistent with expectations of the members of the Federal Open Market Committee (FOMC), thus both foresee that the monetary stimulus will continue being significant for a long time. **Another** member underlined that, although FOMC expectations still point to an increase in interest rates in 2023, those drawn from financial instruments indicate that it could occur in 2022. **Some** members pointed out that Federal Reserve communications have mitigated the risk of a monetary policy surprise.

One member argued that the larger monetary space in the United States and in other advanced economies, where inflation and inflation expectations had been below their targets for many years, allows them to be more patient, although they face the risk of undermining their credibility if it is perceived that they tolerate high levels of inflation. On the other hand, he/she mentioned that, in emerging economies, and in Mexico in particular, price formation can become rapidly contaminated by the shocks that have affected inflation. He/she also pointed out that open emerging economies are highly exposed to global pressures and that those that are highly integrated to international financial markets will be affected to a larger extent by tighter monetary and financial conditions.

Most members stated that the central banks of emerging economies continue reducing their monetary stimulus. Some members noted that higher increases in reference rates have been observed in economies with macroeconomic imbalances. **One** member mentioned that the central banks of emerging economies have reacted heterogeneously, although the majority of them have maintained accommodative monetary policy stances and negative ex-ante real rates. He/she mentioned that although some central banks have reacted to inflationary pressures with more significant interest rate increases, he/she clarified that these are countries that implemented highly expansionary fiscal policies and which now require more conservative monetary policies. **Another** member pointed out that only in those cases where inflation has taken place along with various macroeconomic imbalances, and there has been a higher elasticity of inflation expectations to the shocks from the pandemic, it has been necessary to remove the stimuli implemented last year. Additionally, he/she pointed out that, according to certain estimates, this has been the case among Latin American economies, where about one third of the inflation variance would be explained by idiosyncratic factors, and an additional one-third, by inflation expectations.

Some members mentioned that, since the last monetary policy meeting, international financial markets exhibited some volatility. **Some** pointed out that interest rates, especially short-term ones, increased. **One** member noted that this reflects to some extent the recent inflationary pressures. He/she considered that foreign exchange and stock markets registered a mixed behavior and moderate variations in asset prices. **Some** members highlighted that markets benefitted from the Federal Reserve's announcement. In this regard, **one** member pointed out that long-term interest rates in advanced and emerging economies decreased despite the beginning of the reduction in the Federal Reserve's asset-purchase program. He/she mentioned that short-term interest rates also moved downwards, although in a differentiated manner, given the varied expectations of the trajectory of each economy's monetary policy. He/she added that, toward the end of the period, some volatility was registered after the release of unfavorable inflation figures in the United States.

Another member stated that, in emerging economies, financial markets exhibited a mixed performance, with a negative bias due to higher risk aversion. He/she added that considerable capital outflows from fixed-income markets were registered, while capital inflows to equity assets continued. **One** member added that, following the Federal Reserve announcement, most emerging market currencies appreciated against the US dollar. **Some** members mentioned that, looking ahead, these economies will face risks derived from tighter global financial conditions, a possible reallocation of investment portfolios, and from idiosyncratic factors.

Economic Activity in Mexico

All members mentioned that preliminary information indicates that the Mexican economy contracted during the third quarter and that sectors continue evolving heterogeneously. They highlighted that the contraction was due to the increase in the number of infections, to persistent disruptions in supply chains, and to the effect of the new labor outsourcing regulation on services. One member pointed out that, with respect to the previous quarter, GDP contracted

0.2% during the third quarter, when it was expected to grow 0.8%. **Another** member stated that, even without accounting for the effect of the labor outsourcing reform, the economy is facing a significant deceleration. Meanwhile, **one** member stated that the weakness of economic activity shows the fragility of the recovery, which is still far from complete.

On the supply side, all members highlighted the contraction of services during the third quarter, partly reflecting the new regulation on labor outsourcing. Some pointed out that the new regulation implied a fall in professional services. **One** member added that the latter represent about 9% of tertiary activities. **On the other hand, most mentioned that industrial production has continued to recover, although heterogeneously among its components. They mentioned that non-automotive manufacturing has performed better, while automotive manufacturing has suffered from the shortage of inputs. One** member pointed out that the technical shutdowns, due to the lack of inputs, affected negatively the production and export of light vehicles throughout the whole year, and recently that of heavy vehicles. He/she added that, from a longer-term perspective, industrial production has begun to stabilize at low levels.

On the demand side, all members highlighted the weakness of consumption and of automotive exports. Some members noted that, in contrast, non-automotive exports continued to recover. **One** member pointed out that, in September, automotive exports were 12% below their February 2020 levels, while non-automotive exports were 12% above. **Another** member highlighted that, in August, consumption registered three consecutive month-to-month contractions. **One** member noted that consumption of durable and semi-durable goods has been the most affected. **Another** member highlighted that leading indicators, such as credit card spending, retail sales and light vehicle purchases, show lack of dynamism. He/she added that, in contrast, ANTAD sales and consumer confidence increased at the margin. **Some** members noted that remittances and the wage bill have increased. **Regarding investment, most mentioned that it has recovered slightly since July. One** member pointed out that this was supported by construction. **Another** member mentioned that investment has remained virtually stagnant over the past six months and is 15% below its maximum level reached in 2018.

Most members acknowledged that while the labor market continues to recover, labor market conditions are still weak. One member pointed out that formal employment has already recovered to the level observed in January 2020. **Another** member noted that the unemployment rate has been declining. **One** member stated that the underemployment rate remains stagnant at levels that almost double those observed in normal times and shows no signs of improvement. **Some** members mentioned that the rate that includes underemployed, unemployed and inactive people available for work increased in September. **One** member pointed out that it represented 26.6% of the extended Economically Active Population (PEA, for its acronym in Spanish) while **another** member mentioned that it is above pre-pandemic levels. **One** member highlighted that the recovery of the labor market continues to be uneven in terms of gender.

All members agreed that slack conditions persist in the economy. Some members noted that during the third quarter of the year, the output gap even widened at the margin. **One** member pointed out that the Global Indicator of Economic Activity (IGAE, for its acronym in Spanish) is 5% below its maximum level. **Another** member mentioned that, considering the GDP flash estimate for the third quarter, the economy is about 2.5 percentage points below its pre-pandemic levels. **Some** members noted that economic activity has deviated about 10% from the trend that it would have followed in the absence of the pandemic. **Looking ahead, most members mentioned that slack conditions are expected, with marked differences across sectors. One** member said that, in view of the expected economic recovery, a reduction in slack conditions is anticipated.

Some members indicated that economic activity is expected to resume its recovery starting in the fourth quarter. **One** member stated that this will be driven by external demand and the recovery of domestic spending. He/she pointed out that the latter would be supported by advances in the vaccination program, the increase in the wage bill, and remittances. However, he/she highlighted that the GDP flash estimate for the third quarter will imply a downward revision of growth estimates for the entire year. **Another** member mentioned that, due to Mexico's insertion in global value chains, the terms of trade have started to be affected, particularly regarding non-automotive non-oil exports, which poses an external restriction to economic growth. He/she added that the speed of the economic recovery will probably begin to normalize towards the historical growth rate average. He/she estimated that, if the economy grows at its average level of the last 15 years, it would not be possible to reach the level of activity that would have otherwise been registered in the absence of COVID-19 before 2025. **Some** members pointed out that the environment for economic activity remains uncertain. **One** member stated that the balance of risks to growth has deteriorated and is biased to the downside.

Inflation in Mexico

All members mentioned that world and domestic inflationary pressures continue affecting headline and core inflation. The majority stated that, so far this year, inflation has been affected by disruptions in production chains, generalized increases in commodity and food prices, as well as changing consumption patterns. One member pointed out that, regarding external pressures, the challenge is to understand the magnitude of the disruptions in production chains and production costs, given the expectation that inflation will be less transitory and more difficult to revert. Regarding internal pressures, he/she pointed out that the contamination of these shocks onto the price formation process must be monitored. **Another** member added the effect of the reversion to the trend in the prices of some goods and services. **Most members indicated that, due to the deep economic integration with the United States, the higher levels of inflation in that country have contributed to the rebound in inflation in Mexico. One** member highlighted that this has particularly affected food commodity prices. He/she considered this to be relevant, since in Mexico the food component has a high weight in the consumption basket, which extends its effect on headline and core inflation.

Some members indicated that inflationary pressures have recently been observed in a variety of goods and services and no longer appear to be reflecting only transitory changes in relative prices. **One** member stated that a phenomenon of generalized and sustained increases is being faced, since the prices in most major components have increased significantly. He/she pointed out that annualized monthly increases were observed in more than 50% of the major class items comprising headline inflation. **Another** member mentioned that, in October, more than 75% of the major class items registered a monthly annualized inflation rate above 3%, while a year ago this percentage was around 50%. **One** member pointed out that 54% of the major class items of the headline inflation component register an annual variation above 4%, and, of these, 91% register a variation of more than 5%. He/she added that something similar is observed in the case of the core inflation component, and even to a greater extent among merchandise prices.

Most members noted that headline inflation in October registered a high annual variation, mainly explained by an increase in the core component. Some members noted the high level of the inflation gap. **One** member added that this is one of the largest within emerging economies. **Another** member underlined that annual inflation reached the highest level in almost four years, above analysts' and Banco de México's forecasts. **One** member stated that it is very important to distinguish between annual figures which incorporate information of accumulated shocks in the past, from figures at the margin, which provide information on the most recent dynamics. In this regard, he/she considered that pressures at the margin on general and core inflation decreased between August and September, while in October some pressure was registered once more due to the decrease in the number of infections and the reactivation of spending. **Another** member indicated that monthly inflation in October was above expectations and registered the highest level for an October month since 1998. **One** member pointed out that from March to date, monthly inflation growth has been significantly above historical averages. He/she added that this sustained increase in inflation is taking place in the face of an incomplete, fragile and difficult recovery. He/she highlighted that the widening of the negative output gap and the ample slack conditions have not been able to offset inflationary pressures caused by the continuation of so many shocks. **Another** member noted that the trimmed mean indicator for headline inflation is 5.22% and that the one for core inflation is 4.69%. He/she highlighted that, in October, the producer price index registered an annual variation of 8.6%.

Most members pointed out that core inflation was affected significantly by the higher pressures on merchandise prices. One member highlighted that core inflation has increased for 11 consecutive months. He/she mentioned that annual merchandise inflation was the highest since 2009, when there were exchange rate depreciations of up to 26.9% annually. **Another** member noted that recently, food merchandise inflation rose to levels close to 8% and non-food merchandise inflation close to 7%. **One** member indicated that pressures on food merchandise prices have started to ease, in line with the stability observed in international food commodity prices. He/she added that non-food merchandise continues to be under pressure at the margin, consistent with supply constraints and changing consumption patterns. **Most members mentioned the recent increase in services inflation. One** member expressed that service prices have continued with a reversal-to-trend process, which responds to a decline in the number of infections. He/she added that annualized two-year services inflation remained at 3%, and thus there does not seem to be a new shock or an additional source of pressure in this component. **Another** member highlighted that inflation of services other than education and housing is above 5%. He/she stated that, despite the slack conditions in the economy, supercore inflation shows a strong upward trend.

Some members mentioned that non-core inflation has also been subject to pressures. **One** member noted that the biggest inflation surprises with respect to Banco de México's forecasts have concentrated in this component, mainly on the side of energy and some livestock products. **Another** member pointed out that energy prices remained stable at the margin, while certain pressures were registered in the agricultural and livestock products' component, although he/she considered that these tend to be corrected in a relatively short period of time.

Most members noted that expectations for headline and core inflation for 2021, for the next 12 months, and for the end of 2022, increased again, while longer-term inflation expectations have remained stable at levels above 3%. One member pointed out that expectations for 2022 are very close to the upper limit of the variability interval. He/she added that while expectations for 2023 and beyond have not deteriorated, it cannot be assumed that the divergence between short- and long-term expectations will be maintained, given the continuation of the current bubble and the difficulty in fighting it. **Another** member argued that the increasing inflation levels observed at least during the last 11 months have led to second-round effects, and they are contaminating short-term expectations and have begun to affect medium-term expectations. **One** member pointed out that inflation expectations drawn from market instruments for the short term have deteriorated. **Another** member said that inflation expectations for the next 6-10 years have continued to be anchored around 3%. **Some** mentioned that implied expectations in medium- and long-term bonds have increased. **One** member indicated that compensation for inflation and inflationary risk implied by 10-year bonds accumulated an increase of more than 100 basis points during the year, while the inflation risk premium was above the observed peak in January 2017.

Most members pointed out that forecasts for headline and core inflation were revised upward, in particular for the short term. Some members mentioned that this was due to additional inflationary pressures. **One** member said that high levels of inflation are expected in November as a result of last year's low base effects, the result, among other things, of a longer-lasting discount program in 2020. **Some** members noted that headline inflation at the end of this year would reach its highest level in 20 years. They added that core inflation could be around 6%. **One** member noted that this last figure would be the highest one since the fourth quarter of 2001. **Another** member stated that headline and core inflation are expected to decline further in a year. He/she added that the speed of inflation convergence has shown to be uncertain and that inflation expectations will be key in shaping this trend. **One** member noted that, although the negative output gap will prevail through most of 2022, it is not expected to offset the price pressures. He/she added that, although fiscal pressure in Mexico is lower than in other countries, it will also not mitigate any supply- and external-related pressures on domestic prices.

Most members highlighted that the shocks that have affected inflation are mainly transitory. One member stated that these should begin to fade as health control measures advance. He/she added that while it has been difficult to estimate the duration and severity of the shocks, they are expected to decline by the second half of 2022. He/she added that medium- and long-term expectations remain anchored, consistent with the transitory nature of the pressures. He/she indicated that there are signs that some components of inflation have started to ease. **Another** member noted that at the beginning of the year, the pressures were associated with base effects, changes in consumption patterns, and with an adjustment in relative prices that resulted from a supply shock which had the characteristic of being asymmetric. He/she added that in the middle of the year, the economic reopening, the recovery of the prices of several services, the renewed tensions in energy prices, and the persistence in merchandise inflation also played a role. He/she pointed out that in September there were additional increases in food merchandise prices due to a higher imported inflation, which affected headline and core inflation given the importance of food items in the consumption basket. Thus, the number of shocks increased during the second half of the year, mainly due to supply effects that are not permanent. **One**

member considered that although there is the argument that current pressures are basically due to supply shocks that will revert as the global supply chains operations normalize, said argument does not take into account that those pressures are also due to an expansion of demand generated by the stimuli implemented worldwide and to a reallocation of spending that might have more permanent effects. He/she added that, without the intervention of monetary authorities, the interaction of these two phenomena may result in an inflation with an equilibrium level above the one that it had before the pandemic. **Another** member mentioned that the debate over the temporary nature of inflation pressures is irrelevant given that, unlike the energy price shock in 2017, the current inflationary episode is the result of an accumulation of ongoing shocks that began before the pandemic and whose effects will transcend the pandemic. For this reason, he/she noted that the discussion should center on the duration and persistence of high inflation. **One** member pointed out that although the effects of inflationary pressures are expected to be transitory, considerable risks to price formation prevail worldwide, with a possible impact on inflation in Mexico, due to the persistent uncertainty about the duration of the shocks. This, in addition to the fact that such pressures have affected the prices of a wide range of products significantly.

Among upward risks to inflation, most members highlighted external inflationary pressures, cost-related pressures, and the increase in agricultural and livestock product prices, as well as in energy prices. Some members added the persistence of high core inflation and an exchange rate depreciation. **Some** members mentioned the risk of a deterioration in medium- and long-term inflation expectations. **One** member added wage increases in the United States as external inflationary pressures. He/she highlighted the risk of less slack and a readjustment in the relative prices of services as a consequence of the economic reopening. **Another** member mentioned that the probability of inflationary pressures in Mexico and worldwide being more persistent than anticipated has increased. Among downward risks, **some** members pointed out the widening of the negative output gap, further social distancing measures, and an appreciation of the exchange rate. **Most members considered that the balance of risks to inflation within the forecast horizon deteriorated with respect to the last decision and that it is biased to the upside.**

Macrofinancial environment

Most members noted that the peso exchange rate exhibited volatility and depreciated slightly. One member stated that this was due to increased risk aversion. However, he/she added that better trading conditions were observed in the foreign exchange market. **Another** member considered that financial markets were favored by the Federal Reserve's most recent decision. **The majority of members stated that short-term interest rates increased and longer-term interest rates were influenced by external conditions. They mentioned that a flattening of the yield curve was observed. Some** members stated that this was due to expectations of further increases in the reference rate. **One** member pointed out that, if monetary normalization in the United States begins earlier than expected, there could be episodes of volatility that could generate exchange rate pressures or wider spreads in the yield curve with respect to external government interest rates. **Most members noted that the Mexican stock market registered gains. Some** members stated that sovereign risk indicators remained practically unchanged. **One** member pointed out that those of Pemex decreased, in line with those of other oil companies in the world, although they are still among the highest worldwide.

Some members noted Mexico's better macroeconomic fundamentals compared to other similar economies, and highlighted the country's fiscal discipline. **One** member noted that the proposed fiscal package for 2022 maintains a responsible fiscal balance. However, he/she added that public finances may be affected if weak investment persists due to the deterioration of the business climate, the effects of legislative initiatives, such as the one that seeks to reorganize the electricity sector, or the possible need to allocate additional budgetary resources to Pemex. He/she indicated that it is essential to address the factors that affect investment decisions necessary to generate inclusive and sustained growth.

The majority of members noted that the weak performance of financing to the private sector continues. Some members highlighted the fall in consumer and business lending. **One** member stated that credit continues contracting due to factors beyond monetary policy, such as investors' reluctance to invest. **Another** member pointed out that financing to Small- and Medium-sized Enterprises (SMEs) remains about 12% below pre-pandemic levels and with negative annual growth rates. **One** member added that only mortgage lending continued to grow and that adjusted delinquency rates for consumer, housing and business loans continued to decline. **Some** members noted that domestic sources of financing were above pre-pandemic levels. **Some** members stated that the external sources of financing have become negative. **One** member pointed out that financing conditions are the tightest on record and that, while demand for credit is expected to recover, it remains below the levels seen even during the global financial crisis. **Another** member mentioned the recent increase in interest rates, especially for loans to smaller-size firms.

Monetary policy

The majority of members considers the shocks that have increased inflation to be mainly transitory. Nevertheless, the horizon in which they could affect it is unknown, and they have involved a wide range of products, while being of considerable magnitude. This poses greater risks to the price formation process and to inflation expectations. For this reason, it was deemed necessary to continue reinforcing the monetary policy stance, adjusting it to the trajectory required for inflation to converge to its 3% target within the forecast horizon. The majority thus decided to increase the target for the overnight interbank interest rate by 25 basis points to 5%. Most members highlighted that, for the next monetary policy decisions, they will assess thoroughly the behavior of inflationary pressures as well as of all factors that have an incidence on the foreseen trajectory for inflation and its expectations. The latter, in order to adopt a policy rate that is consistent at all times with the trajectory needed to facilitate the orderly and sustained convergence of headline inflation to the 3% target within the time frame in which monetary policy operates as well as an adequate adjustment of the economy and financial markets.

One member stated that continuing increases in the reference rate will not stop pressures stemming from changes in consumption patterns or supply restrictions from taking place. He/she stated that the latter could even worsen due to the impact of higher rates on credit, business creation and, therefore, on the productive plant, which in the end would lead to a higher inflation instead of a lower one. He/she added that such rate increases have a negative impact on consumption, investment, credit, public finances and financial markets, making them not only ineffective, but also inefficient. He/she added that, given the fragility of the economic recovery, further monetary tightening could affect people's wellbeing. He/she expressed that the objective sought with the rate increases has not been achieved, since from June to date, inflation expectations for the end of the year and for 2022 have not ceased to increase. He/she mentioned that, in the face of an unprecedented economic context, it is important not to act in a mechanical manner, but rather to be more reflective and cautious. He/she pointed out that, as in Mexico, inflation in many economies has exceeded the forecasts of their central banks, but most of them have continued to grant monetary stimulus, acknowledging the inability of the tools available to combat the current pressures. He/she highlighted that the origin of inflation in Mexico is the same as in other countries, but that Mexico stands out for its fiscal discipline, which has relieved pressures on the sovereign risk premium and the exchange rate. He/she argued that this should allow Banco de México to implement a less restrictive monetary policy than other emerging economies, which has not been the case. He/she stated that global market conditions and the continuation of accommodative policy stances in the main central banks have opened a space for patience. In light of the outlook that the Federal Reserve will not begin its normalization process before the second half of 2022, he/she considered that anticipating said normalization would reduce any future space for possible interest rate adjustments, which could lead to an unnecessarily restrictive position in the near future. He/she considered that communication with the public should play a more important role in explaining in detail the factors that give rise to inflation.

Another member pointed out that it is necessary to act decisively and responsibly, and thus monetary policy actions must be gradual, not only in terms of magnitude but also of timing. He/she argued that this will allow monetary policy to be conducted more effectively given the unprecedented circumstances, and will help to maintain expectations anchored, by driving the reference rate through a gradual trajectory that will allow it to comply with the central bank's priority mandate, within the horizon in which monetary policy operates. He/she pointed out that the inflationary pressures related to the pandemic have continued, and that although they cannot last indefinitely, they have shown to be more persistent. Nevertheless, he/she stated that there are elements that allow for acting with prudence and caution, particularly that the national economy, compared to other similar economies, has better macroeconomic balances, a solid international reserve position, more stable fiscal balances, and a higher ex-ante real interest rate. He/she also added that, given the collapse of demand conditions for loanable funds and the relative stability of the economy's total sources of financing, the estimated range for the neutral interest rate may have decreased. He/she stated that although there is significant uncertainty in its estimation, especially in the current unprecedented environment, the stated circumstances may suggest this decline. He/she pointed out that communication must continue to be used as a tool that, if implemented adequately, will help prevent market overreactions to monetary policy decisions, given the prevailing high uncertainty about the magnitude and persistence of the effects of the pandemic on the economy. He/she explained that inflation expectations have shown to be more sensitive to the changes in narrative that has accompanied the decisions, than to the rate increases, so that mechanical monetary policy responses may not have the same implications as in previous cycles. Taking all of the above into consideration, he/she underlined that, on this occasion, he/she considers it necessary to continue reinforcing monetary policy.

One member mentioned that it is necessary to analyze whether a gradual approach is adequate, considering its lagged impact and its effects on inflation through the expectations channel. He/she highlighted that the discussion should focus on the persistence of high inflation, particularly of core inflation, in order to determine if convergence to the target will require a greater monetary policy tightening, both in terms of magnitude and timing. He/she pointed out that not acting in the face of a significant increase in inflation puts the anchoring of expectations and credibility at risk, which would not only make more difficult the attainment of the target, but also entail the enlargement of negative effects of shocks. For this reason, any increase in inflation must be matched with proportional adjustments in the monetary policy stance. He/she stated that the margins available to go beyond monetary neutrality must be analyzed and the boundary between the neutral and restrictive range of the reference rate must be calibrated. He/she argued that the relative monetary policy stance will gain more relevance in decision making, because the sources of external financing have become negative and capital flows are more sensitive to interest rate spreads. He/she highlighted that the pace of monetary adjustment must be transmitted effectively along the yield curve so that inflation expectations converge to the target but avoiding overreactions in financial markets. He/she stated that an eventual increase in the speed of adjustment must be of a determined duration to rule out an aggressive and prolonged cycle, which, in view of the expected adjustments in the Federal Reserve's reference rate next year, could lead to an overly restrictive policy stance in face of a weak economic recovery. He/she emphasized that clear, transparent and timely communication about the purpose of monetary policy actions generates greater credibility, strengthens monetary policy pass-through mechanisms, and increases their effectiveness. He/she mentioned that since the forecasted trajectory for inflation convergence requires maintaining a cycle of interest rate increases, forward guidance must be more explicit about said adjustments. For this reason, the convenience of publishing with each monetary policy announcement the foreseen path for the reference rate which is consistent with the board’s inflation forecast for the following eight quarters, as many central banks do. He/she added that, although less complete, another option would be to communicate the average of the reference rate for the analysis horizon. Lastly, he/she emphasized that, given the current scenario, communication on its own does not work, since the basis for a credible regime is a firm response, preventive and consistent in the face of inflationary pressures.

Another member considered that, given the evolution of inflation and its expectations, and the possibility of a greater persistence of inflationary pressures, the central bank must act in a clear and decisive manner, in order to contain any impact on the price formation process that may lead to the de-anchoring of medium- and long-term expectations. He/she expressed that central banks should avoid adapting higher inflation expectations by wrongly extending the monetary stimulus. He/she argued that failure to act now may lead to inflation reaching a higher equilibrium level than before. He/she pointed out that the main challenge is to assess the appropriate pace for withdrawing the monetary stimulus to ensure the convergence of inflation to the 3% target and maintain expectations anchored. He/she argued that, based on available information and the foreseen trajectory for inflation, the monetary stimulus should be cut by 50 basis points. However, he/she pointed out that accelerating the pace in an environment of high uncertainty may have undesirable effects on markets. He/she noted that, given the high level of uncertainty, maintaining a gradual approach such as the one implemented, allows adjustments to be made in a timely and prudent manner in order to ensure an orderly convergence to the inflation target. However, he/she acknowledged that, although the strategy implemented is gradual, it also increases the risk of having to make a larger discrete adjustment in future monetary policy decisions. He/she stated that the monetary policy stance is consistent with an ex-ante real interest rate of around 1.5%, in accommodative territory and below the estimated neutral interest rate of 2.6%. He/she highlighted that this offers room to make the necessary and sufficient adjustments. As to the monetary policy statement, he/she pointed out that it should stress the additional shocks and the reasons for the deterioration in the balance of risks for inflation, as well as point out that the purpose of the decision is to prevent second-round effects from strengthening. He/she argued that this will allow Banco de México to be in a better position to face additional risks in a flexible manner.

One member stated that the pandemic has implied a unique challenge for economic activity and inflation. Inflation has faced multiple shocks in 2021, and has become a global and domestic challenge. He/she highlighted that headline and core inflation forecasts have increased significantly on several occasions throughout the year, and once again on this occasion, in response to additional inflationary pressures. He/she argued that the above points to the need to continue adopting a trajectory for the interest rate target that strengthens the monetary policy stance. He/she added that, considering the simultaneity and magnitude of the shocks that have affected headline and core inflation and the high levels they have reached, as well as the uncertainty of the horizon over which they may affect inflation, the monetary policy stance must continue to be reinforced, adjusting it to the trajectory required for inflation to converge to its 3% target within the forecast horizon. He/she expressed that this strategy of monetary policy response is necessary to keep inflation expectations anchored, induce orderly conditions in the foreign exchange market, and contain risk premia in fixed-income instruments. He/she added that Mexico faces important external inflationary pressures and the oncoming effects of greater global financial restrictions. He/she pointed out that those economies, such as Mexico, that complement their domestic savings with external sources must maintain a solid macroeconomic stance. In this regard, he/she considered that monetary policy should contribute to maintain inflation around its target, promoting an orderly adjustment of the economy, the foreign exchange market and the yield curve, and avoiding capital outflows. He/she argued that tolerating high inflation levels well above the target without further reinforcing the monetary policy stance would affect price formation and lead to a significant deterioration of domestic financial markets, further complicating and increasing the cost of inflation convergence to its target, and jeopardizing the hard-earned credibility. Finally, given the complex outlook for inflation, he/she emphasized that Banco de México must reinforce its commitment to comply with its constitutional mandate of preserving the domestic currency's purchasing power.

3. MONETARY POLICY DECISION

The shocks that have increased inflation are largely considered to be transitory. Nevertheless, the horizon in which they could affect it is unknown, and they have involved a wide range of products, while being of considerable magnitude. This poses greater risks to the price formation process and to inflation expectations. For this reason, it was deemed necessary to continue reinforcing the monetary policy stance, adjusting it to the trajectory required for inflation to converge to its 3% target within the forecast horizon. The Governing Board decided to increase the target for the overnight interbank interest rate by 25 basis points to 5%.

For the next monetary policy decisions, the Governing Board will assess thoroughly the behavior of inflationary pressures as well as of all factors that have an incidence on the foreseen trajectory for inflation and its expectations. The latter, in order to adopt a policy rate that is consistent at all times with the trajectory needed to facilitate the orderly and sustained convergence of headline inflation to the 3% target within the time frame in which monetary policy operates as well as an adequate adjustment of the economy and financial markets.

4. VOTING

Alejandro Díaz de León, Galia Borja, Irene Espinosa, and Jonathan Heath voted in favor of increasing the target for the overnight interbank interest rate by 25 basis points to 5.00%. Gerardo Esquivel voted in favor of leaving the target for the overnight interbank interest rate unchanged at 4.75%.

5. DISSENTING OPINIONS/ VOTES

Vote. Gerardo Esquivel

The current unprecedented economic context calls for a non-mechanical response. Many central banks are facing inflationary pressures, but most have opted for maintaining the monetary stimulus, acknowledging the inability to fight them with the available tools. Due to its global nature, the inflationary process is similar in different economies. However, Mexico differs from other countries in the sense that it has maintained fiscal discipline, which relieves pressure on the exchange rate and the sovereign risk premium. This macroeconomic balance gives us a room that other emerging economies lack and which has not been used. Moreover, the Federal Reserve's monetary policy stance will remain accommodative for a long period. Thus, acting too soon in regards to our own normalization process may reduce future room for maneuver and lead to an unnecessarily restrictive policy stance in the near future. In addition to being ineffective and inefficient, interest rate increases may also be counterproductive. From June to date, short-term inflation expectations have not ceased to be revised upwards, so the goal pursued with interest rate increases has not been achieved.

ANNEX

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

A.1. External conditions

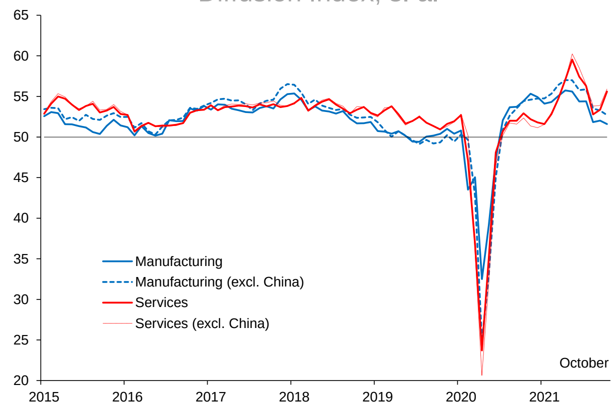
A.1.1. World economic activity

World economic activity continued to recover during the third quarter of this year, although at a slower pace and heterogeneously across countries due to the evolution of the pandemic and spending programs. Global industrial production and international trade moderated significantly after having reached historically high levels in previous months, with contractions in some sectors affected by the aggravation of bottlenecks in global supply chains. The services sector also experienced a moderation in its pace of recovery during most of the quarter (Chart 1) due to the increase in COVID-19 cases, although in October it exhibited a more dynamic performance. Global inflation continued increasing due to pressures originated by bottlenecks in production, stimulus spending and the reallocation of spending towards merchandise, the rise in food and energy prices, and the reopening of certain services. In most of the main economies, both advanced and emerging, inflation was above their central banks' targets.

In this context, most central banks in the main advanced economies started to show signs of a gradual reduction in monetary stimulus. In emerging economies, a large number of monetary authorities have reduced monetary stimulus by raising their policy interest rates. In this environment, financial markets, in general, performed favorably, albeit with some volatility in government bond interest rates.

Among key global risks, those associated with the pandemic, inflationary pressures, and adjustments in monetary and financial conditions stand out. The possibility that supply chain disruptions could last longer than expected also stands out. Likewise, although some of the factors that have driven global inflation are expected to be largely transitory, it cannot be ruled out that some of them, such as production bottlenecks, could result in a more persistent behavior of inflation at elevated levels, which, in an environment of recovery, could lead to a more accelerated tightening of monetary policy and generate new episodes of volatility in financial markets.

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



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

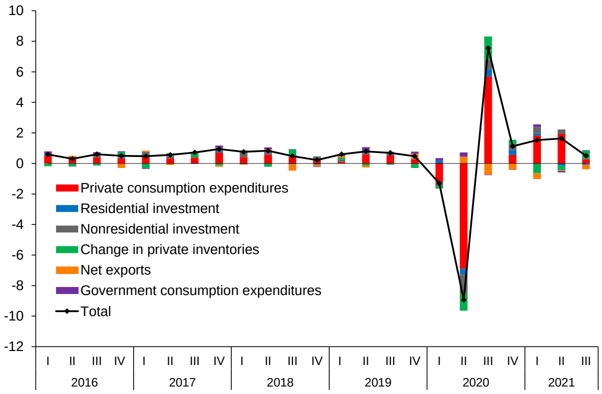
In the United States, economic activity moderated its dynamism during the third quarter of 2021, growing 0.5% at a quarterly and seasonally adjusted rate, after having registered a growth of 1.6% in the previous quarter (Chart 2).[1] This occurred in the context of a reduction of certain fiscal stimuli, such as additional unemployment insurance payments, an increase in the number of COVID-19 cases, particularly during the first half of the quarter, and multiple bottlenecks in the production and trade of goods. This was reflected in a moderation of private consumption and in a negative contribution of net exports. Inventory accumulation and business investment were major contributors to growth during the third quarter of the year.

US industrial production contracted at a monthly rate of 1.3% in September, after having grown 0.1% in August. This reflected a generalized decline in its main sectors. In particular, manufacturing activity contracted as a result of the continued impact on automotive production due to the shortage of semiconductors. Meanwhile, the fall in gas and electricity generation was due to the normalization of

[1] Expressed as a quarterly annualized rate, US seasonally adjusted GDP grew at a rate of 6.7% during the second quarter and 2.0% in the third quarter of 2021.

demand for air conditioning, following the rebound generated by warmer-than-usual weather conditions during August. The Purchasing Managers' Index (PMI) of the manufacturing sector suggests that the gradual recovery of this sector will continue to be affected by the persistence of bottlenecks.

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



s. a. / Seasonally adjusted figures.
Source: *BEA.*

The US labor market continued to recover during October. In particular, employment generation in the private sector showed a rebound, following the normalization of some services that had been affected by the increase in COVID-19 infections during the previous months. The non-farm payroll increased by 531 thousand jobs in October, after having grown by 314 thousand jobs in September. The recovery in employment was particularly strong in sectors such as leisure and hospitality, professional and business services, transportation and warehousing, and manufacturing. The level of employment was still 4.2 million below pre-pandemic levels. The unemployment rate declined from 4.8% in September to 4.6% in October.

In the euro area, despite the impact on production chains and the rebound in the number of infections, economic activity accelerated during the third quarter of 2021, growing 2.2% at a quarterly and seasonally adjusted rate, after having grown 2.1% in the second quarter.[2] This increase reflected a generalized growth in the region's economies. Available indicators suggest that economic activity was driven by domestic sales. Regarding the labor market, the unemployment rate decreased from 7.5% in August to 7.4% in September. Meanwhile, Purchasing Managers' Indices suggest that the pace of economic recovery will continue to be affected by the disruptions in global supply chains caused by the pandemic.

In the United Kingdom, available indicators point to a sustained recovery of economic activity during the third quarter of 2021, albeit at a slower pace than that observed during the second quarter, when a seasonally adjusted quarterly rate of 5.5% was recorded.[3] This moderation reflected the rebound in the number of COVID-19 infections, the negative effect of supply shortages and the increase in natural gas prices on economic activity. As for the labor market, the unemployment rate decreased from 4.6% in July to 4.5% in August. Purchasing Managers' Indices suggest that the recovery in manufacturing and services activity will be gradual.

In Japan, available information suggests that economic activity slowed down as a state of emergency was declared for most of the third quarter due to the worsening pandemic.[4] Production and exports, mainly of automobiles, continued to be affected during the period by the persistence of bottlenecks and the shortage of semiconductors. The unemployment rate remained unchanged in August at 2.8%. Purchasing Managers' Indices suggest that activity in the services sector would accelerate at the beginning of the fourth quarter of the year in line with the lifting of the state of emergency, while manufacturing activity would continue to recover gradually.

In the main emerging market economies, growth has been heterogeneous across regions and countries, depending on the evolution of the pandemic and the exposure of each country to the impact on global supply chains. In Latin America, indicators reflect a recovery of economic activity in most countries that can be associated with the gradual normalization of productive activities. In Emerging Asia, economic activity has exhibited a mixed behavior. In China, timely indicators point to a slowdown in activity mainly due to the gradual withdrawal of some economic stimulus measures and the imposition of renewed restrictions due to the presence of COVID-19 in some regions. In Emerging Europe, available indicators suggest robust GDP growth in most

[2] In annualized terms, euro area GDP registered a quarter-on-quarter seasonally adjusted variation of 8.7% during the second quarter and 9.1% during the third quarter of 2021.

[3] In annualized terms, the UK GDP quarterly seasonally adjusted variation during the second quarter of 2021 was 23.9%.

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

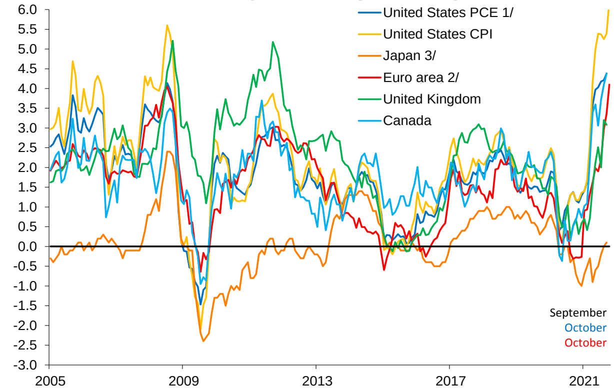
economies, in light of advances in the vaccination processes and the normalization of activities.

International commodity prices have generally risen since Mexico's previous monetary policy decision. Oil prices reached their highest level in more than seven years, driven by higher global demand, in an environment of supply restrictions due to crude oil production cuts by members of the Organization of the Petroleum Exporting Countries (OPEC) and other oil producers. Natural gas prices increased during most of the period analyzed due to a strong increase in demand and low inventory levels that in turn resulted from lower-than-expected production due to unplanned shutdowns at natural gas exporting plants in several countries, a higher demand from Asia and Latin America, and lower investment in the sector; the latter driven in part by greater incentives to promote the use of renewable energy. However, gas prices have recently declined due to higher exports by major producers such as Russia. Prices of industrial metals generally trended upward given concerns that production of these metals will be affected by high fuel prices, while disruptions in global supply and transportation chains caused a moderation in industrial production and exerted downward pressures on the price of some metals, such as iron ore. The prices of most grains followed an upward trend due to crop damage caused by heavy rains in the major producing regions.

A.1.2. Monetary policy and international financial markets

World inflation continued increasing, albeit heterogeneously across countries, due to pressures originated by bottlenecks in production, stimulus spending and the reallocation of spending towards merchandise, the rise in food and energy prices, and the reopening of certain services. The increase in headline inflation in most of the major advanced economies continued to place it above their central banks' targets, with the exception of Japan (Chart 3). In this context, short-term inflation expectations drawn from surveys continued increasing in most advanced economies, while longer-term inflation expectations drawn from financial instruments registered more moderate increases.

Chart 3
Selected Advanced Economies: Headline Inflation
Annual percentage change



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

In most of the main emerging economies, inflation continued increasing as a result of the same factors that affected inflation in advanced economies. In some cases, such as Brazil, Peru and Chile, exchange rate depreciation also played a role. In most of these economies, except for some in the Asian region, inflation remained above their central banks' targets. Although it is expected that the factors that have led to higher inflation will be transitory, a scenario of greater inflation persistence cannot be ruled out.

In this environment, the US Federal Reserve announced a reduction in its asset-purchase program; the European Central Bank announced a moderate reduction in the pace of purchases under its Pandemic Emergency Purchase Program (PEPP), although the total amount of the program remained unchanged; and the Bank of Canada decided to end its asset purchase program and begin the reinvestment phase in which it will purchase assets only to maintain its holdings of government bonds constant. On the other hand, the central bank of New Zealand announced the first increase since the beginning of the pandemic of 25 basis points to its interest rate and the central bank of Australia concluded its yield curve control policy. Other central banks in advanced economies are expected to begin withdrawing their monetary stimulus (Chart 4).

Among the recent monetary policy decisions in the main advanced economies, the following stand out:

i) In its November meeting, the US Federal Reserve left its target range for the federal funds rate unchanged at 0-0.25% and reiterated that it will be appropriate to maintain that range until labor market conditions have reached levels consistent with its estimate of maximum employment and inflation is at 2% and is on track to moderately exceed that level for some time. Given the economy's further substantial progress towards its targets, the Federal Open Market Committee (FOMC) decided to start tapering the monthly pace of net asset purchases beginning in November. Net purchases of Treasury securities will be reduced by USD10 billion and agency mortgage-backed securities by USD5 billion in November and by an equal amount in December. The Committee indicated that similar cuts are likely to be appropriate going forward, although it is prepared to adjust them if changes in the economic outlook warrant it. In this regard, the Chairman of said institution stated that the above would imply that the net increases in its securities holdings would end by the middle of next year. He also indicated that the decision to reduce its asset purchases does not imply any direct guidance regarding its interest rate policy. He noted that the timing of interest rate hikes will depend on the economy's trajectory, indicating that he considers they can be patient in this regard. In this context, the trajectory of the federal funds rate implied by financial instruments incorporates the expectation of a first increase of 25 basis points in the third quarter of 2022.

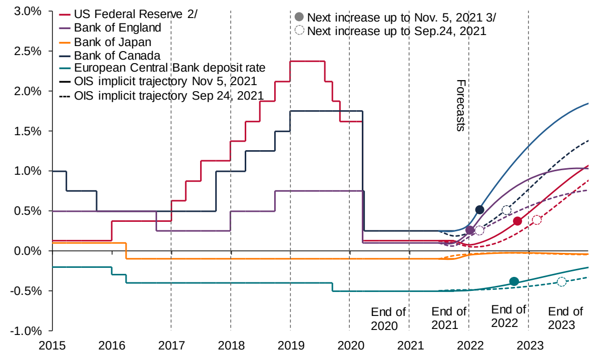
ii) At its October meeting, the European Central Bank (ECB) left its refinancing rate, key deposit facility rate and key lending facility rate unchanged at 0.0, -0.5 and 0.25%, respectively. It also reiterated that the ECB board expects these interest rates to remain at current or lower levels until: i) inflation reaches the 2% target over the forecast horizon; ii) inflation remains at that level for a sustained period of time; and iii) the central bank considers that progress in core inflation is sufficiently advanced to be consistent with the stabilization of inflation at 2% in the medium term. It reiterated that this could imply a transitory period in which inflation is moderately above its target. Regarding its Asset Purchase Program (APP), it was left unchanged at €20 billion net per month. On the other hand, regarding its Pandemic Emergency Purchase Program (PEPP), it insisted that it considers that favorable financing conditions can be maintained with a moderately lower pace of purchases than in the second and third quarters of this year, keeping the total amount unchanged at €1.85 trillion. In this regard, the president of said institution reiterated that the adjustment in the pace of purchases is a recalibration of its Program and not a withdrawal of stimulus (tapering). She also indicated that the conditions required for an interest rate increase are not currently being met and will not be met in the near future. Expectations drawn from financial instruments anticipate a first interest rate increase of 10 basis points in the third quarter of 2022.

iii) At its October meeting, the Bank of Japan maintained the reference rate unchanged at -0.1% and the 10-year rate target at around 0%, as well as its asset purchase program. It restated that, if necessary, it will not hesitate to take additional easing measures and that it expects interest rates to remain at their current levels or even lower. In addition, it reiterated that it will continue to support corporate financing and stability in financial markets.

iv) In its November meeting, the Bank of England left its reference interest rate unchanged at 0.10%. It stated that, should the economy, particularly the labor market, evolve in line with its central forecasts, an interest rate increase will be necessary in the coming months in order for inflation to return sustainably to its 2% inflation target. It kept its current government bond purchase program unchanged and reiterated the expectation that it will conclude by the end of 2021. Expectations drawn from financial instruments anticipate a first interest rate increase of 15 basis points in the first quarter of 2022.

In emerging economies, given the increase in inflation and the additional risks to price formation, as compared to advanced economies, a large number of central banks continue reducing their monetary stimulus. Thus, since the last monetary policy decision in Mexico, the central banks of Brazil, Colombia, Peru, Chile, the Czech Republic, Poland, Hungary, and Russia, among others, raised their interest rates. In contrast, Turkey's central bank announced a further decrease in its reference interest rate.

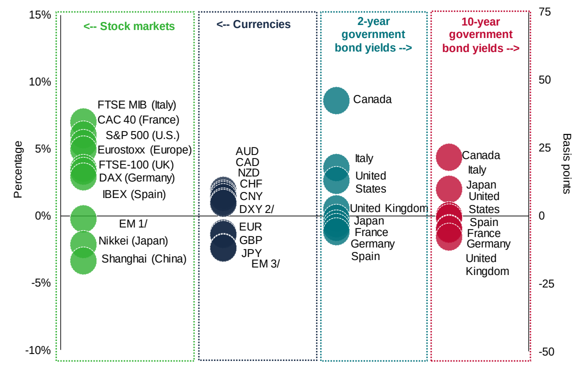
Chart 4
Reference Rates and Trajectories Implied in OIS Curves[1/]
Percent



1/ OIS: Fixed floating interest rate swap where the fixed interest rate is associated to the effective overnight reference rate.
2/ For the observed reference rate of the U.S. the average interest rate of the target range of the federal funds rate (0.0% - 0.25%) is used.
3/ A first increase of 25bps is assumed for the US Federal Reserve and the Bank of Canada, 15 bps for the Bank of England and 10 bps for the European Central Bank and the Bank of Japan.
Source: Banco de México with data from Bloomberg.

In this environment, since the last monetary policy decision in Mexico, the stock markets of most of the main advanced economies performed favorably, mainly driven by a positive balance in the corporate financial statements of the different regions, in some cases reaching new all-time highs. (Chart 5). Similarly, most emerging economy markets recorded moderate gains (Chart 6). In foreign exchange markets, the US dollar showed moderate changes against most of the currencies of advanced economies. Likewise, emerging economies' currencies registered moderate mixed fluctuations, with some depreciations, such as, for example, the Turkish lira. With respect to government bond interest rates in the main advanced economies, there was a significant increase in the short-term rates of some of these economies due to expectations of monetary policy rate increases. Similarly, long-term rates increased during the first half of October and subsequently decreased. For their part, long-term interest rates in emerging economies rose for the most part. In this environment, in general, moderate net capital inflows towards equity assets in most emerging economies, and outflows from fixed-income markets were observed during the period.

Chart 5
Change in Selected Financial Indicators from September 24 to November 5, 2021
Percent, basis points



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

Chart 6
Selected Emerging Economies: Financial Assets Performance since September 27, 2021
Percent, basis points

Region	Country	Currencies	Equity markets	2-year Interest rates	10-year Interest rates	CDS
Latin America	Mexico	-1.46%	0.74%	103	3	1
	Brazil	-3.67%	-7.71%	264	73	36
	Chile	-1.75%	0.84%	95	101	-8
	Colombia	-0.92%	3.21%	101	32	6
	Peru	2.72%	9.47%	61	-60	-18
Emerging Europe	Russia	1.62%	2.92%	127	89	-7
	Poland	-0.98%	6.28%	209	84	2
	Turkey	-10.45%	14.57%	-42	79	-37
	Czech Republic	-0.29%	4.93%	136	65	2
	Hungary	-1.49%	6.32%	39	75	-1
Asia	China	0.95%	-2.35%	-5	2	9
	Malaysia	0.79%	0.15%	23	9	8
	India	-0.25%	0.78%	35	9	-1
	Philippines	1.61%	6.32%	44	43	12
	Thailand	1.36%	0.38%	13	8	-2
	Indonesia	-0.04%	8.33%	1	-16	3
Africa	South Africa	-0.35%	5.49%	21	26	-21

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

Looking ahead, several risks to the stability of international financial markets persist, which are related to the evolution of economic activity and inflationary pressures, a disorderly or earlier-than-anticipated withdrawal of monetary stimuli resulting in new episodes of volatility and tighter global financial conditions, distortions in the valuation of financial assets, high levels of private and public sector debt that could lead to default or contagion problems, and difficulties in reaching agreements regarding the US debt ceiling, among other factors.

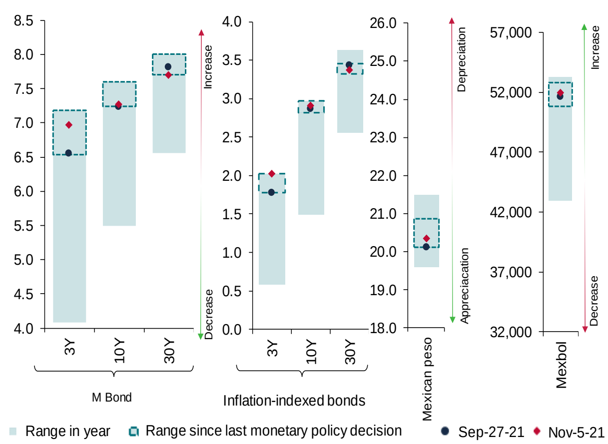
A.2. Current situation of the Mexican economy

A.2.1. Mexican markets

Since the previous monetary policy decision to date, financial asset prices in Mexico have exhibited a mixed behavior (Chart 7). The peso exchange rate exhibited volatility and depreciated slightly, short-term interest rates increased, and long-term ones were influenced by external conditions.

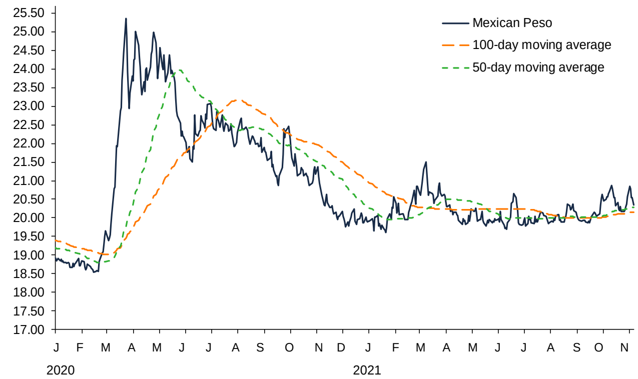
In particular, the Mexican peso fluctuated in a range of 76 cents, between 20.11 and 20.87 pesos per dollar, ending the period with a depreciation of 1.46% (Chart 8). This occurred in a context in which both spot- and future trading conditions improved slightly with respect to the previous period.

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



Source: Prepared by Banco de México.

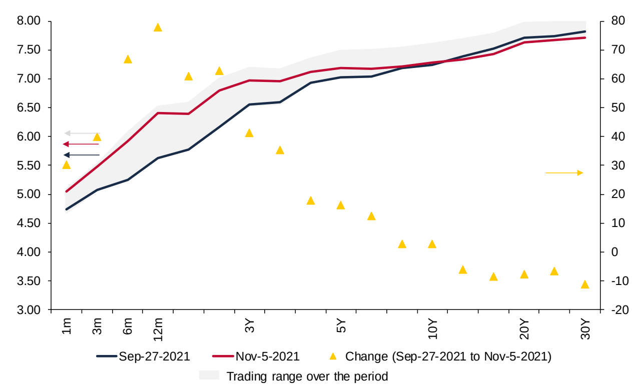
Chart 8
Mexican Peso Exchange Rate with Moving Averages
MXN/USD



Source: Prepared by Banco de México.

Interest rates of government securities exhibited a flattening dynamic (Chart 9), increasing up to 68 basis points in those of shorter terms, while long-term ones decreased up to 11 basis points. The yield curve of real rate instruments showed a similar dynamic, registering movements between -12 and 32 basis points across all maturities. In this context, compensation for inflation and inflationary risk implicit in spreads between nominal and real rates of market instruments showed increases for short terms and decreases in long ones, remaining at levels above 400 basis points in general (Chart 10). These adjustments took place in an environment in which trading conditions showed some improvement during the period covering the monetary policy decision.

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



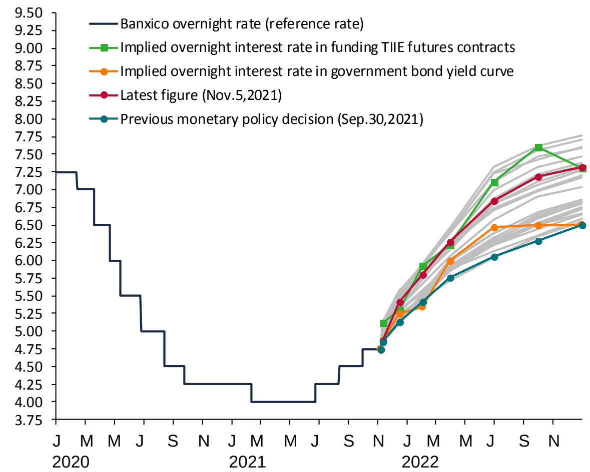
Note: The chart does not include bonds maturing in December 2021 and June 2022. CETES with similar maturities are considered.
Source: PIP.

Chart 10
Compensation for Inflation and Inflationary Risk Implicit in Government Securities' Interest Rate
Basis points

Source: PIP.

Regarding expectations for the trajectory of the monetary policy reference rate, information implied by the Interbank Equilibrium Interest Rate (TIIE, for its Spanish acronym) swap curve incorporates an increase of around 12 basis points for the November meeting, a reference rate of 5.42% for the end of 2021, and of close to 7.32% for the end of 2022 (Chart 11). Rates implicit in the curve of government securities incorporate a level of the target rate close to 5.25% for the end of 2021 and of 6.50% for the end of 2022. Finally, most forecasters surveyed by Citibanamex anticipate the reference rate to increase by 25 basis points to 5.00% in the November decision, while they expect it to reach 5.25% for the end of 2021 and 6.00% for the end of 2022.

Chart 11
Banco de Mexico Overnight Interbank Rate Implied in the TIIE IRS Curve
Percent



Source: Prepared by Banco de México with Bloomberg data.

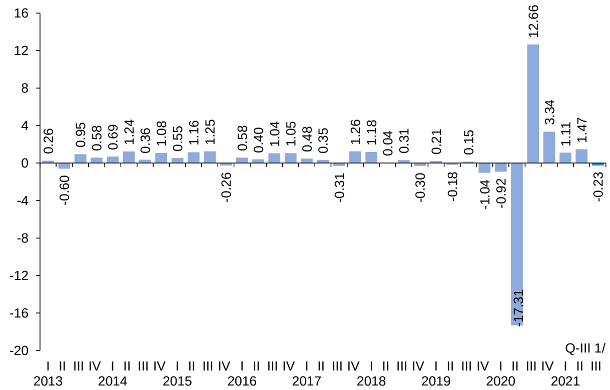
A.2.2. Economic activity in Mexico

According to INEGI's GDP flash estimate, economic activity contracted during the third quarter of 2021, with a differentiated behavior among sectors of economic activity (Chart 12). This occurred in a context of an intensification of the pandemic, continued disruptions in global supply chains, and a strong reduction of spending in business support services due to the transition towards the new outsourcing regime.

As for external demand, the value of non-automotive manufacturing exports increased during the third quarter, with respect to the previous quarter, while automotive exports fell sharply, reflecting the effects of the persistent disruptions in the supply of semiconductors on the sector (Chart 13).[5] By destination, manufacturing exports to the United States increased slightly, while those to the rest of the world contracted significantly.

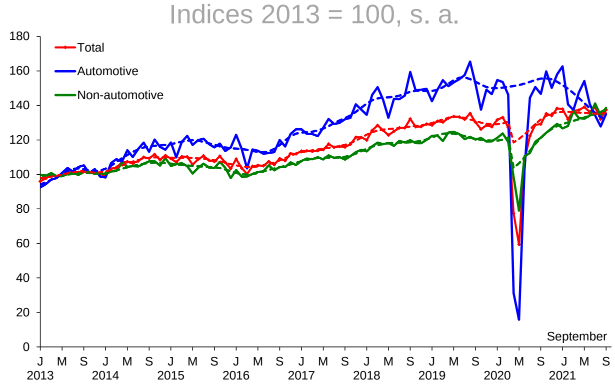
[5] Refers to the value of merchandise exports in US dollars. This value differs from that reported for goods exports by Mexico's System of National Accounts (SCNM, for its acronym in Spanish), given that the latter represents the value-added measured in constant pesos.

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



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

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



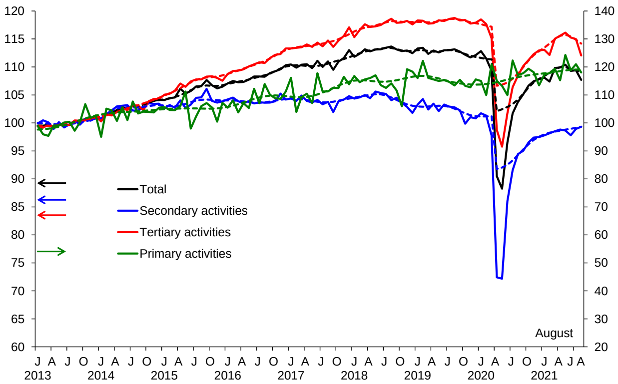
s. a. / Seasonally adjusted series and trend series based on data in nominal US dollars. The former is represented by a solid line and the latter by a dotted line.
Source: Prepared by Banco de México with data from the Tax Administration Service (SAT, for its Spanish acronym), the Ministry of the Economy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

According to its monthly indicator, in August private consumption followed a downward trajectory, remaining below the level reported in February 2020. Within it, consumption of goods of imported origin has been declining for three months, while both consumption of goods of national origin and of services registered a weak performance. In August, gross fixed investment continued to reactivate, although it remained below the level prior to the health emergency. The component of spending in investment in construction rebounded, while that in machinery and equipment partially reversed the expansion registered in July, although it remained above the level reported in February 2020.

As for production, according to timely information, industrial activity improved slightly during the third quarter, after having performed weakly during the second (Chart 14). This performance of industrial activity was mainly due to the dynamism of manufacturing excluding equipment and, to a lesser extent, to the slight reactivation of construction (Chart 15). In contrast, the transportation equipment sector remained weak due to the continued shortage of semiconductors, while mining remained stagnant. Services diminished, in a context in which a differentiated behavior continued among its subsectors in light of the intensification of the pandemic and the transition to the new regime outsourcing regime. Particularly, in July-August, professional, corporate and business support services; transportation and mass media information services; educational and health services; and public administration services registered negative contributions to growth. In contrast, commerce, leisure and other services, as well as temporary accommodation and food and beverage preparation services, contributed positively.

Chart 14
Global Indicator of Economic Activity

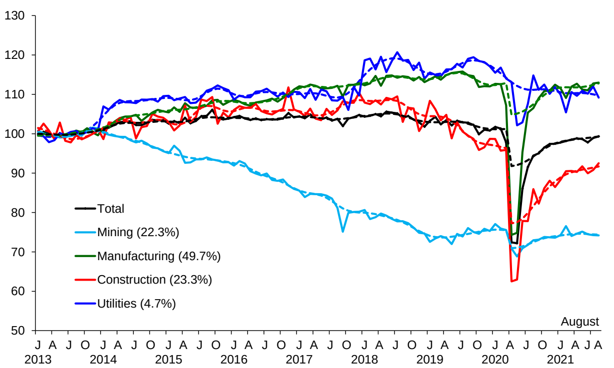
Indices 2013 = 100, s. a.



s. a. / Seasonally adjusted and trend series. The former is represented by a solid line and the latter by a dotted line.
Source: Mexico's System of National Accounts (SCNM, for its Spanish acronym), INEGI.

Chart 15
Industrial Activity[1/]

Indices 2013 = 100, s. a.

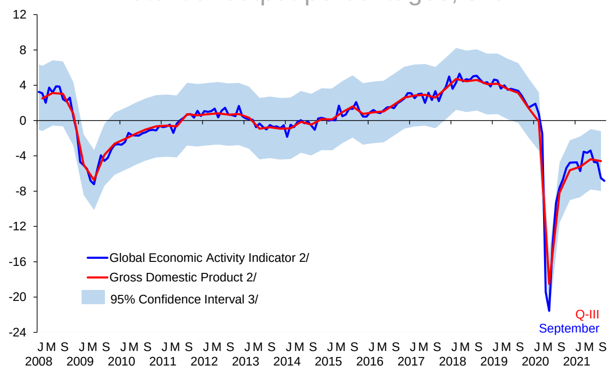


s. a. / Seasonally adjusted and trend series. The former is represented by a solid line and the latter by a dotted line.
1/ Figures in parenthesis correspond to their share in the total in 2013.
Source: Mexico's System of National Accounts (SCNM, for its Spanish acronym), INEGI.

Regarding the economy's cyclical position, slack conditions for the economy as a whole are expected to have remained wide at the beginning of the third quarter (Chart 16), with marked differences across sectors. The negative output gap is anticipated to have slightly widened vis-à-vis the previous quarter, in line with the performance of economic activity during the period. In September, labor market indicators exhibited a mixed behavior. In particular, the labor participation rate and the employment-to-working-age population ratio decreased for the second consecutive month, while both national and urban unemployment rates decreased at the margin (Chart 17). In September, the creation of IMSS-insured jobs continued to recover, although it remains 18,000 jobs below its pre-pandemic levels. Finally, in August, unit labor costs in the manufacturing sector registered their second consecutive monthly reduction and remained slightly below the level reported in February 2020 (Chart 18).

Chart 16
Output Gap Estimates [1/]
Excluding Oil Industry [4/]

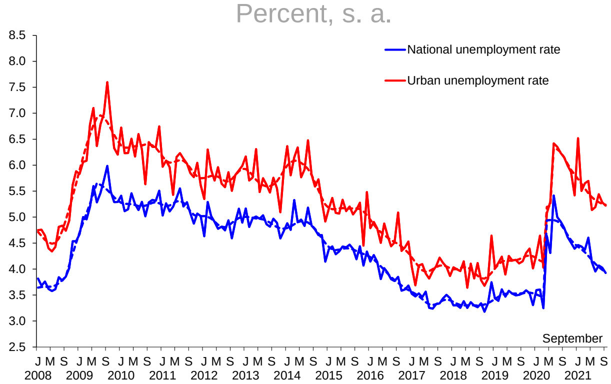
Potential output percentages, s. a.



s. a. / Calculations based on seasonally adjusted figures.
1/ Output gap estimated with a tail-corrected Hodrick-Prescott filter; see Banco de México (2009), "Inflation Report, April-June 2009", p.74.
2/ GDP timely figures as of Q2 2021, and IGAE figures as of September 2021, in line with said timely figure.
3/ Output gap confidence interval calculated with a method of unobserved components.
4/ Excludes both oil and gas extraction, support services for mining, and petroleum and coal products' manufacturing. Source: Prepared by Banco de México with INEGI data.

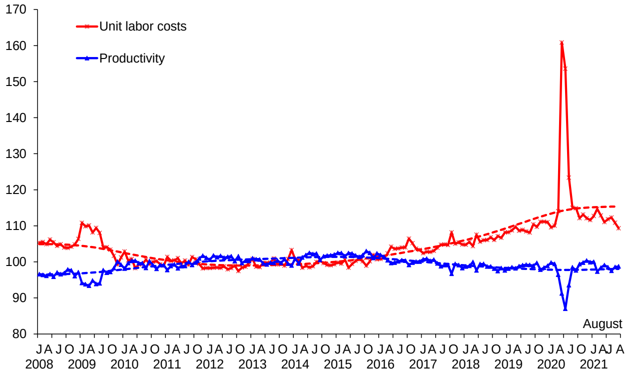
Chart 17
National and Urban Unemployment Rates

Percent, s. a.



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

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



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

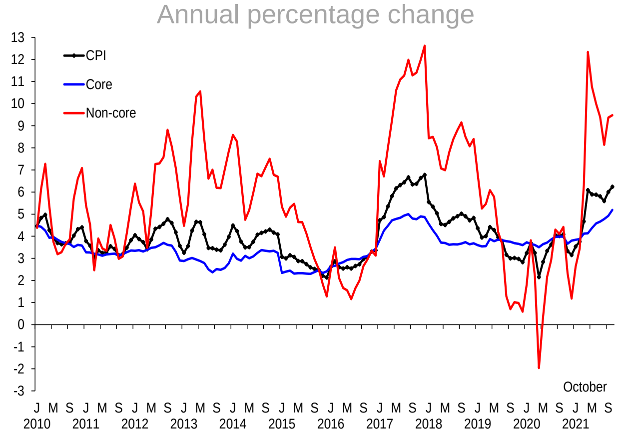
In September 2021, domestic financing to firms moderated its contraction in real terms at an annual rate for the second consecutive quarter. This is explained by a smaller reduction in bank credit to both large- and smaller-sized firms. The demand for corporate credit continued to recover, although it remained at low levels. Lending conditions to firms have remained stable throughout the year, thus remaining tight. Net corporate debt issuance in the domestic market rebounded in September, after the low activity in this market registered as of the first quarter of the year. In terms of credit to households, the housing portfolio continued to exhibit a positive real annual variation, regaining a greater dynamism during the reference quarter. In turn, banks' current consumer loan portfolio reduced its contraction at an annual rate for the sixth consecutive month, with the dynamism of payroll loans standing out. This, in a context characterized by a gradual recovery of household demand for credit. As for lending conditions, mortgages remained stable, while, in the case of consumer portfolio, those for credit cards and payroll loans have eased, and, for the rest of the segments, they remained tight.

Interest rates of bank credit to firms have followed the dynamic of the bank funding rate. Intermediation margins rebounded slightly as compared to the end of the second quarter, standing at higher levels, although nearing pre-pandemic levels. In turn, mortgage interest rates remained at levels around their historic lows. In August, credit card and personal credit interest rates were similar to those observed during the first quarter of the year. Thus, consumer credit intermediation margins remained at levels higher than pre-pandemic ones. With respect to portfolio quality, in September the corporate loan delinquency rate remained stable and at low levels. The mortgage loan delinquency rate decreased and remains at low levels. Finally, consumer portfolio delinquency rates remained at high levels, although they declined for the seventh consecutive month.

A.2.3. Development of inflation and inflation outlook

Between September and October 2021, annual headline inflation increased from 6.00% to 6.24% (Chart 19 and Table 1). This result was driven by the continued increase of core inflation, associated with cost-related pressures, the reallocation of spending, and the effects of the reopening of several activities, as well as the increase in non-core inflation associated with the higher annual variation of energy prices during that period.

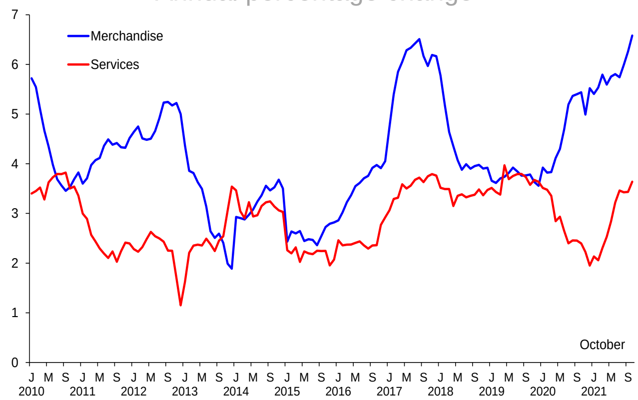
Chart 19
Consumer Price Index
Annual percentage change



Source: Banco de México and INEGI.

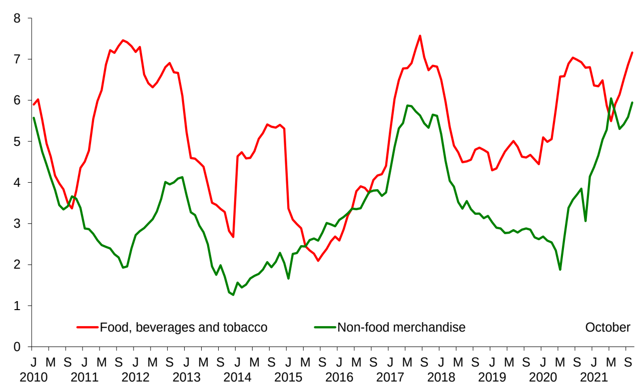
Annual core inflation rose from 4.92% to 5.19% between September and October 2021, accumulating eleven consecutive months of increases. Within it, annual merchandise and services inflation rose during this period (Chart 20). The former went from 6.26% to 6.58%, driven by the disruptions that continue to be observed in production and supply chains, bottlenecks, and the resulting higher production costs. The above is taking place in a context of global supply and demand imbalances and the reallocation of spending towards merchandise. In particular, annual food merchandise inflation increased from 6.87 to 7.16%, while non-food merchandise inflation rose from 5.59 to 5.94% (Chart 21). As for services, annual inflation increased from 3.43 to 3.64% in the referred period, mainly due to the increase from 4.78 to 5.11% in the annual variation of services prices other than education and housing, especially tourism, food and beverage preparation, and art, entertainment and recreation services. The gradual reopening of these sectors may have contributed to this behavior.

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



Source: Banco de México and INEGI.

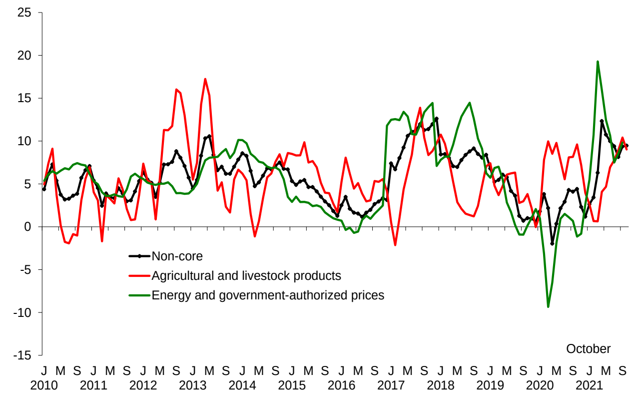
Chart 21
Merchandise Core Price Sub-index
Annual percentage change



Source: Banco de México and INEGI.

Between September and October 2021, annual non-core inflation went from 9.37 to 9.47% (Chart 22 and Table 1). This result reflected the increase from 11.69 to 13.44% in the annual inflation of energy, with the increase from 20.63 to 27.10% in the annual variation of the LP gas price standing out, which was influenced by rises in its international references. This was partially offset by the decrease from 10.41 to 9.02% in the annual inflation of livestock and agricultural products that is associated in turn with the lower annual variation of fruit and vegetable prices.

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



Source: Banco de México and INEGI.

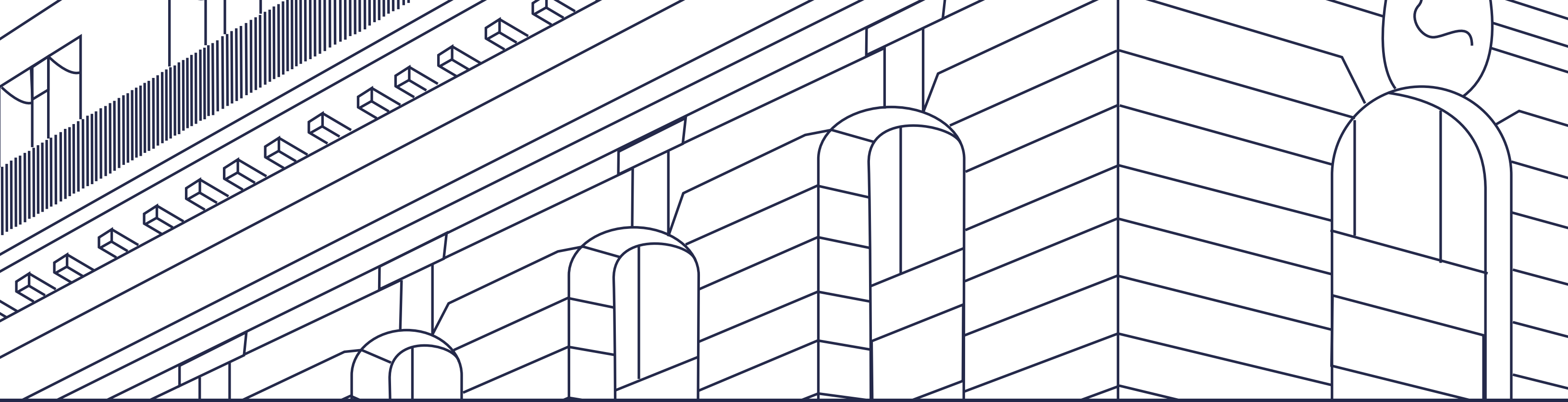
As for inflation expectations drawn from Banco de México's Survey among Private Sector Forecasters, between August and October, the median of expected headline inflation for the end of 2021 increased from 6.05 to 6.63%, while that corresponding to the core component went from 4.90 to 5.30%. Median expectations for the end of 2022 were adjusted from 3.75 to 3.84% for headline inflation and from 3.70 to 3.83% for core inflation. The medians of headline and core inflation expectations for the medium term were adjusted upwards from 3.51 to 3.60% and from 3.50 to 3.56%, respectively. Long-term inflation expectations remained at around 3.50%. Finally, the breakeven inflation rate increased and remained at high levels, reflecting the behavior of both inflation expectations and the inflation risk premium, although the rise in the latter stands out.

Headline and core inflation forecasts were revised upwards, especially shorter-term ones. Their annual variations are expected to decrease, particularly for one year and beyond, and converge to the 3% target by the end of the forecast horizon. These projections are subject to risks. On the upside: i) external inflationary pressures; ii) cost-related pressures; iii) core inflation persistence; iv) exchange rate depreciation; and v) increases in agricultural and livestock product prices and in energy prices. On the downside: i) a widening of the negative output gap; ii) social distancing measures; and iii) exchange rate appreciation. The balance of risks for the trajectory of inflation within the forecast horizon deteriorated and remains biased to the upside.

Table 1
Consumer Price Index and Components
Annual percentage change

Item	August 2021	September 2021	October 2021
CPI	**5.59**	**6.00**	**6.24**
Core	**4.78**	**4.92**	**5.19**
Merchandise	**5.99**	**6.26**	**6.58**
Food, beverages and tobacco	6.51	6.87	7.16
Non-food merchandise	5.41	5.59	5.94
Services	**3.43**	**3.43**	**3.64**
Housing	2.17	2.26	2.37
Education (tuitions)	1.92	2.04	2.09
Other services	4.87	4.78	5.11
Non-core	**8.14**	**9.37**	**9.47**
Agricultural and livestock products	**8.95**	**10.41**	**9.02**
Fruits and vegetables	5.94	9.38	5.72
Livestock products	11.54	11.29	11.98
Energy and government-authorized prices	**7.50**	**8.55**	**9.82**
Energy products	10.07	11.69	13.44
Government-authorized prices	1.99	1.86	1.88

Source:INEGI.



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