



Quarterly Report

January– March 2020

May 27, 2020



BANCO DE MÉXICO

Economic and Financial Environment

- Since the end of February, the economic and financial environment has become significantly adverse and even more complex due to **the challenges and risks associated with the COVID-19 pandemic.**
- As the pandemic began to spread to a larger number of countries and **lockdown and social distancing measures** were adopted to contain the virus, **world economic activity and international financial markets** have been **significantly affected.**
- **A global economic crisis, unprecedented in several decades,** has started to materialize due to several characteristics such as **having a sanitary rather than an economic cycle or financial origin, and the abrupt nature of its impact on the real sector and how it has rapidly spread worldwide.**
- **This has had, and is expected to continue having,** important repercussions on **financial markets, productive activity, and the inflation process in Mexico.**

In the present juncture, the Mexican economy faces a combination of different simultaneous shocks of considerable magnitude.

Three main channels of transmission are identified:

Supply Shock

- The measures to contain the virus spread such as **shutdowns of manufacturing production and the suspension of several services**, have led to a **decline in supply**.
- ✓ *These events have put at risk the functioning of global value chains and the supply of inputs for domestic production.*

Demand Shock

- Given **the global spread of the pandemic**, the Mexican economy faces **lower external demand**.
- Also, **social distancing measures and firms and households' lower incomes** are leading to a **contraction of domestic demand**.

Financial Shock

- **Higher risk aversion** in international financial markets and **falling oil prices** contributed to:
 - Major **tightening of external financing and capital outflows**.
 - Higher **interest rates and risk premia**.
 - A **significant depreciation of the Mexican peso**.

Outline

1 External conditions

2 Current situation of the Mexican economy

3 Inflation

4 Monetary policy

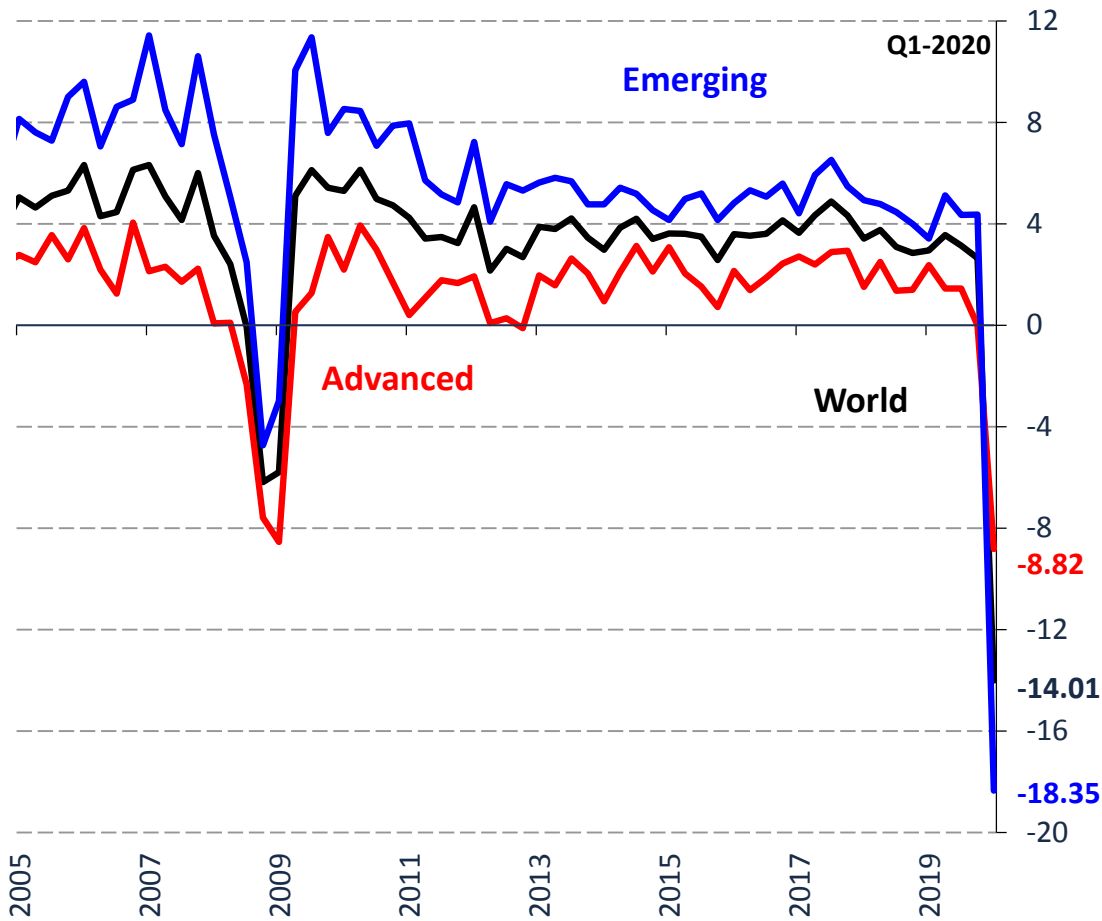
5 Forecasts and final remarks

Available information indicates that global economic activity has been significantly affected, falling sharply in Q1-2020. A greater contraction is expected in Q2-2020.

World Economy

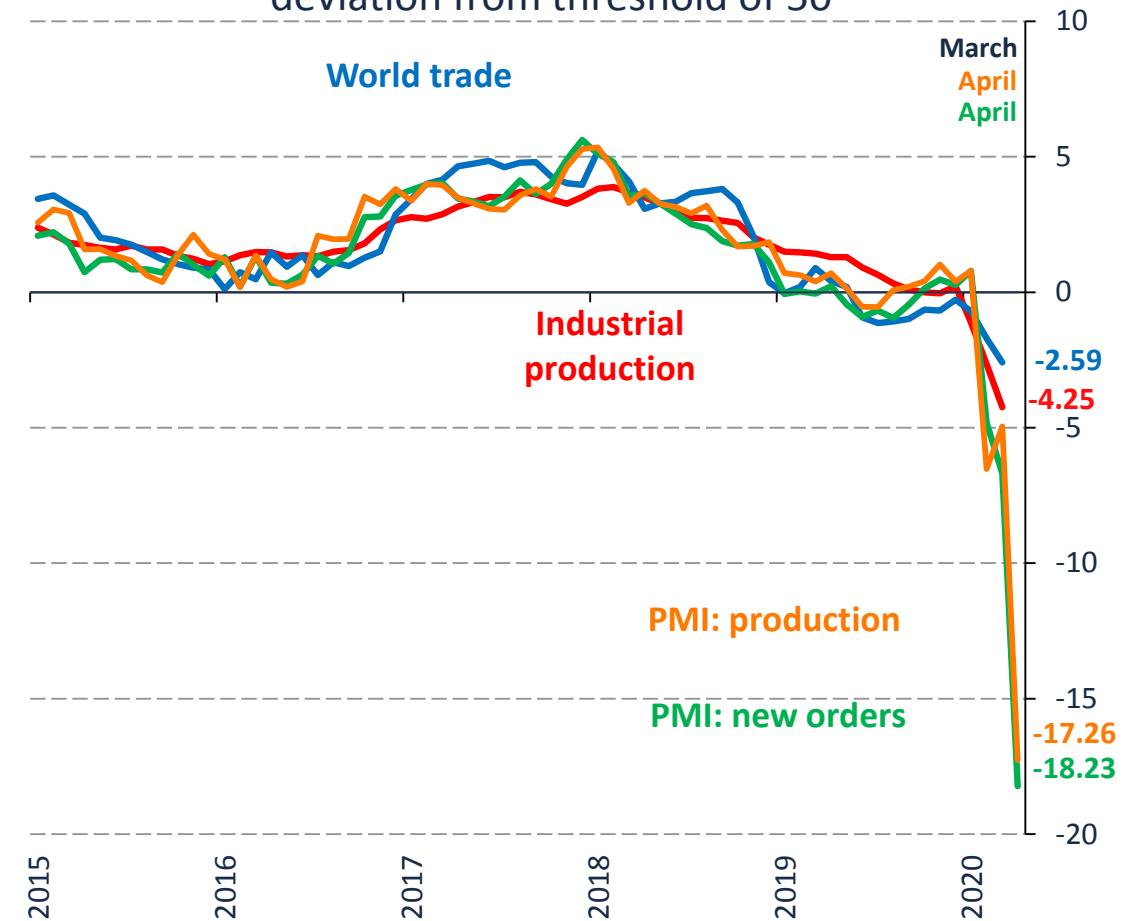
GDP Growth

Quarterly annualized % change, s. a.



Activity Indicators

Annual % change of 3-month moving average and deviation from threshold of 50



s. a. / Seasonally adjusted figures. Note: Estimations were used for Q1-2020 calculations. The sample of countries used for the calculations represents 85.6% of world GDP measured by purchasing power parity. Source: Prepared by Banco de México with data from Haver Analytics, J.P. Morgan and International Monetary Fund (IMF).

Source: CPB Netherlands and Markit.

This has led to unprecedented revisions of economic expectations. These forecasts are subject to a high degree of uncertainty given that the duration/depth of the health crisis' impact on global activity is still unknown.

World Economy

GDP Growth Forecasts for 2020 and 2021

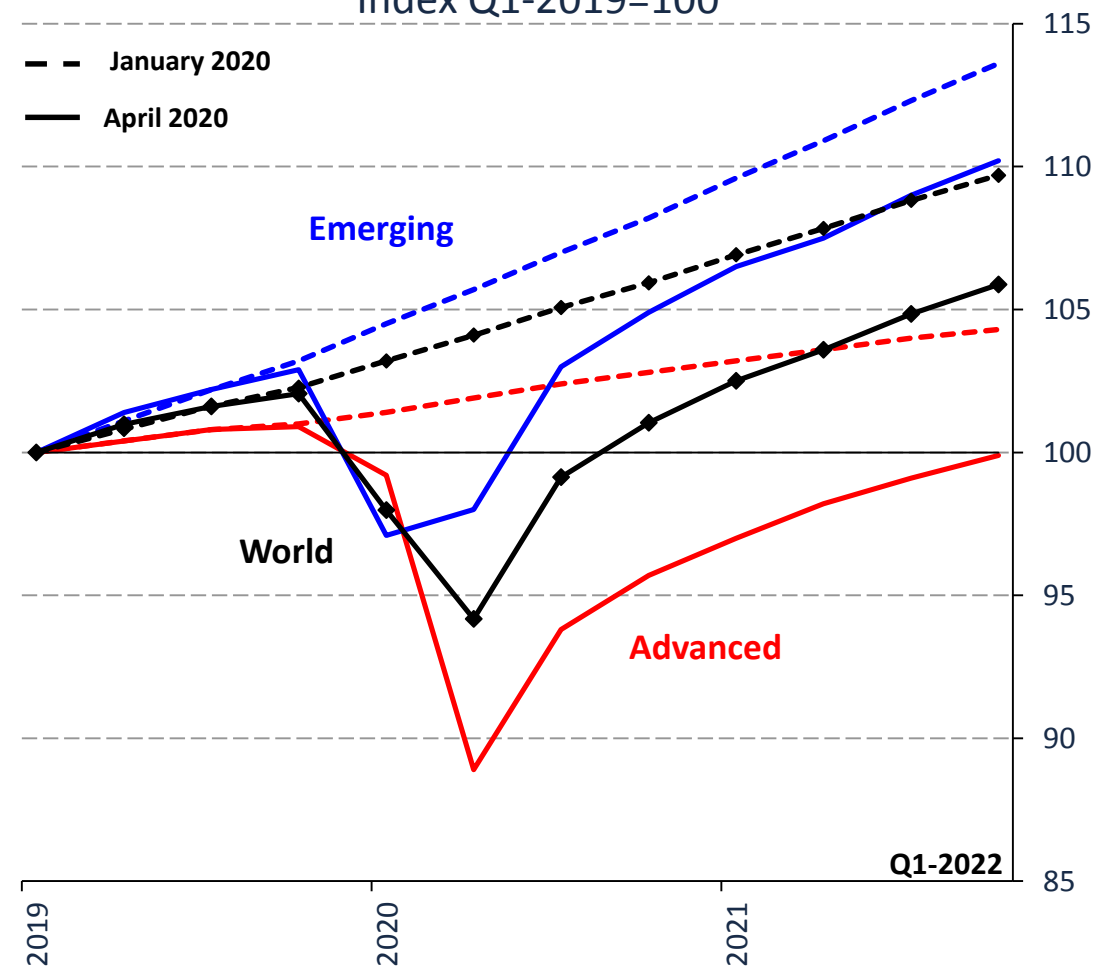
Annual % change

	WEO Forecasts April 2020		Change from January 2020	
	2020	2021	2020	2021
World	-3.0	5.8	-6.3	2.4
Advanced	-6.1	4.5	-7.7	2.9
United States	-5.9	4.7	-7.9	3.0
Euro area	-7.5	4.7	-8.8	3.3
Japan	-5.2	3.0	-5.9	2.5
United Kingdom	-6.5	4.0	-7.9	2.5
Emerging	-1.0	6.6	-5.4	2.0

Source: International Monetary Fund (IMF), World Economic Outlook April and January 2020.

Gross Domestic Product

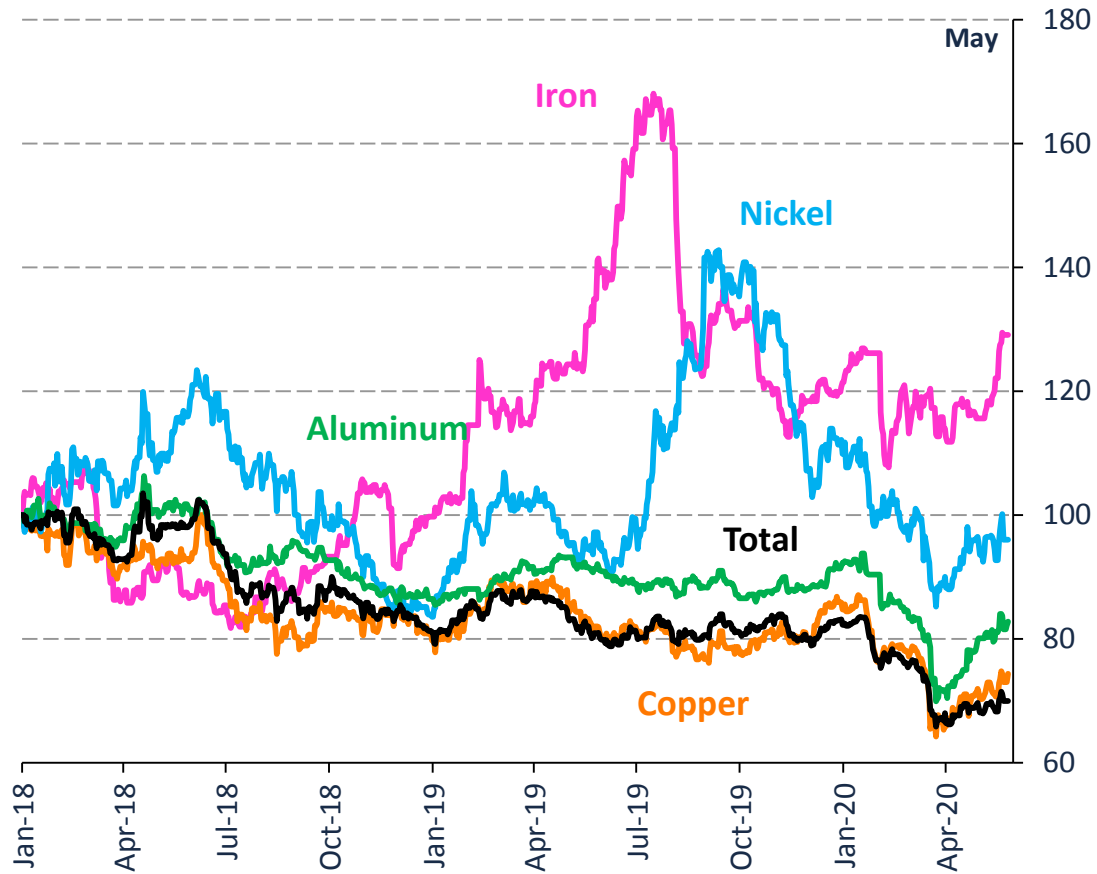
Index Q1-2019=100



Source: International Monetary Fund (IMF), World Economic Outlook April and January 2020.

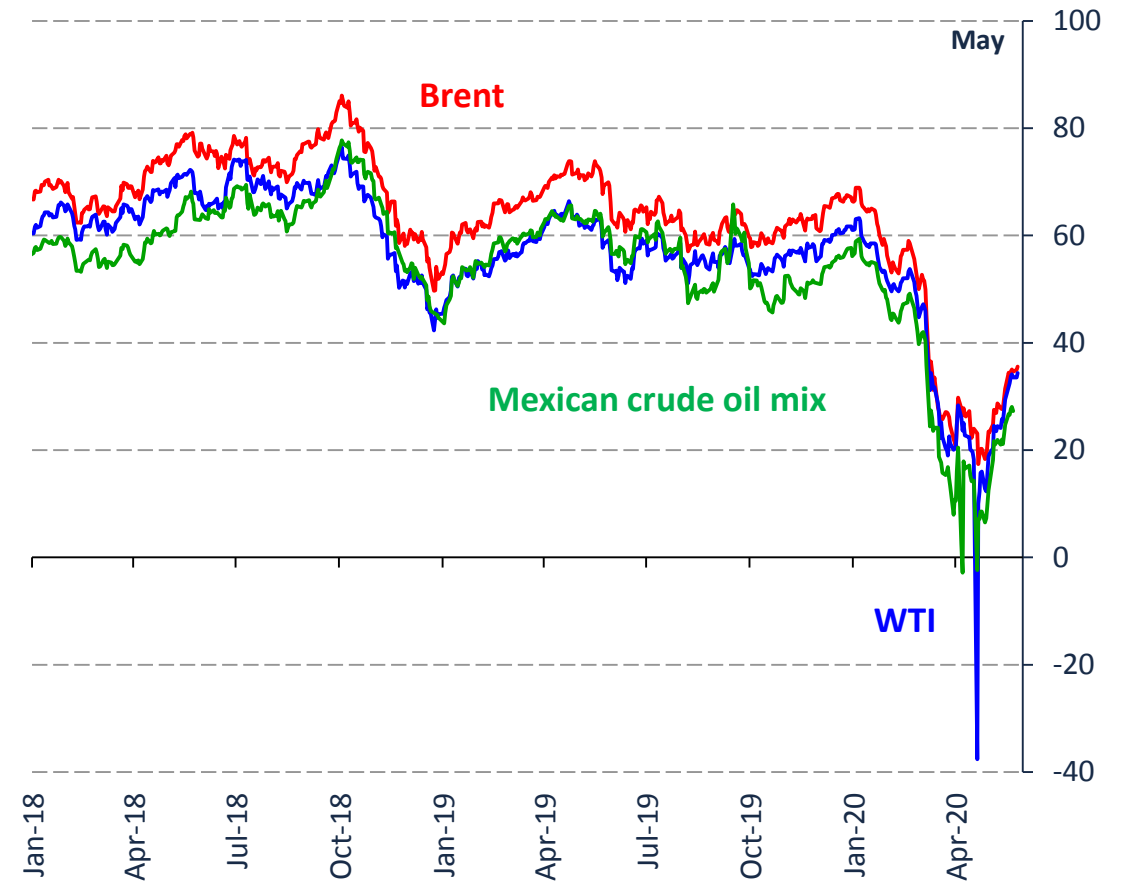
The sharp decline in global demand has led to a sharp fall in commodity prices, especially of crude oil, which remain low despite the agreement on production cuts among major producing countries and some recent production increases.

Selected Industrial Metals Prices ^{1/}
Index 01-Jan-2018=100



^{1/} This index is an indicator of 24 commodities. In particular the industrial metals component follows the prices of aluminum, copper, nickel, zinc and lead.
Source: Bloomberg.

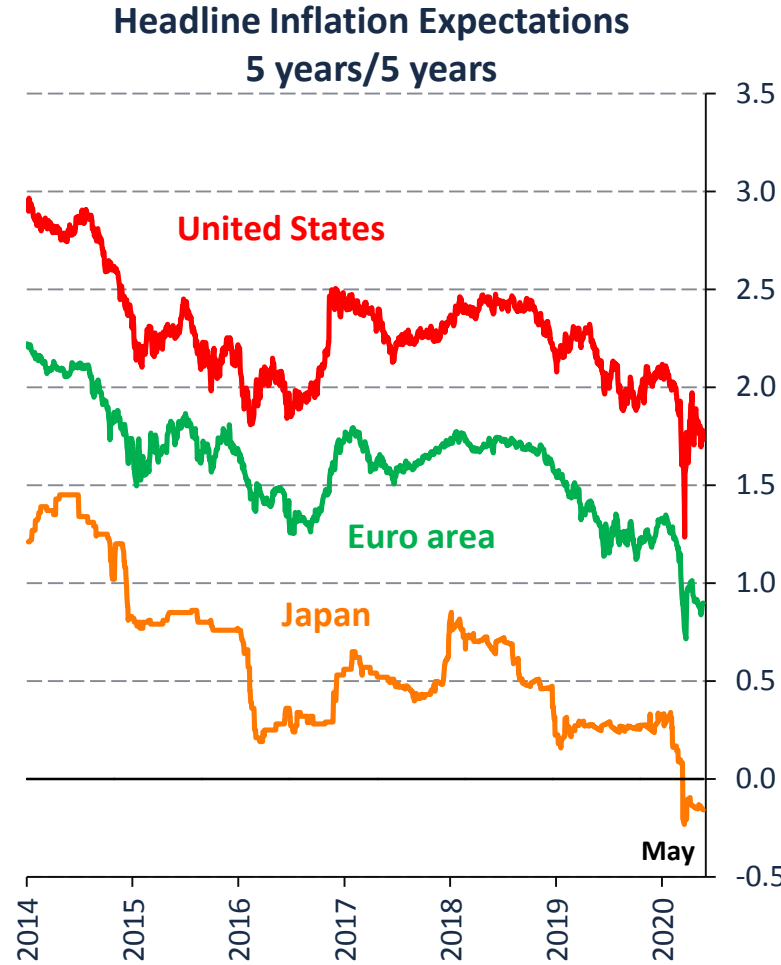
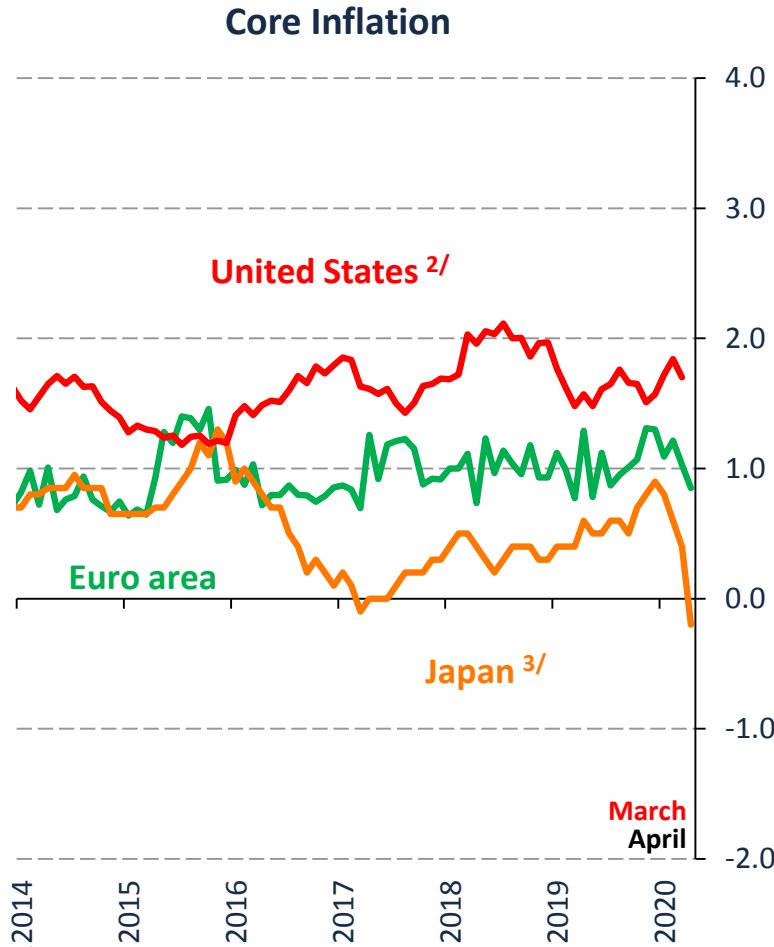
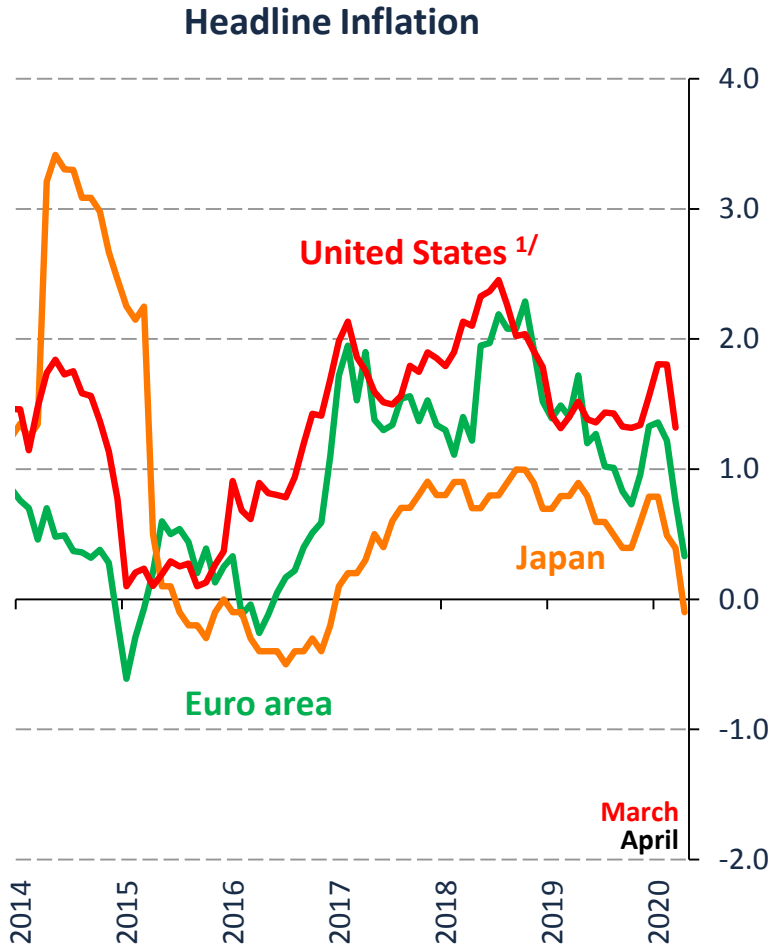
International Crude Oil Prices
US dollars per barrel



Source: Bloomberg.

In this context, in most advanced economies headline inflation has decreased, remaining below the targets of their respective central banks. Meanwhile, inflation expectations drawn from financial instruments declined considerably.

Advanced Economies Annual % change



1/ Refers to the Personal Consumption Expenditure Price Index (PCE).
Source: Haver Analytics.

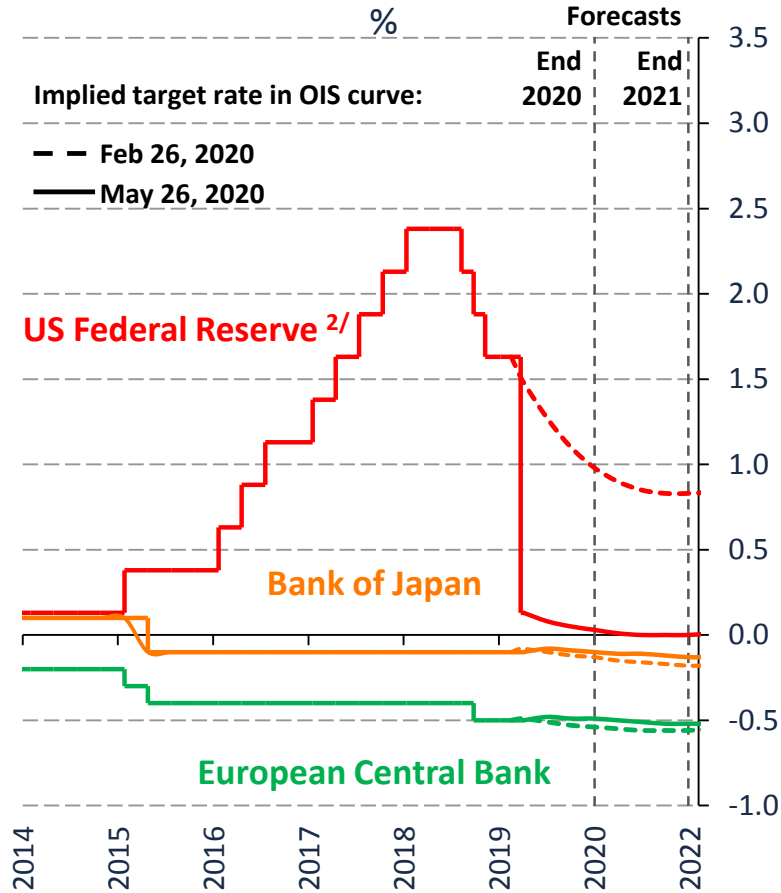
2/ Refers to the Personal Consumption Expenditure Price Index that excludes food and energy (PCE).
3/ Excludes energy and fresh food and the direct effect of the consumption tax increase. Source: Haver Analytics.

Source: JP Morgan.

Numerous central banks have significantly lowered their interest rates and implemented other extraordinary measures to promote the well-functioning of their financial systems. Thus, government bond yields in advanced economies decreased.

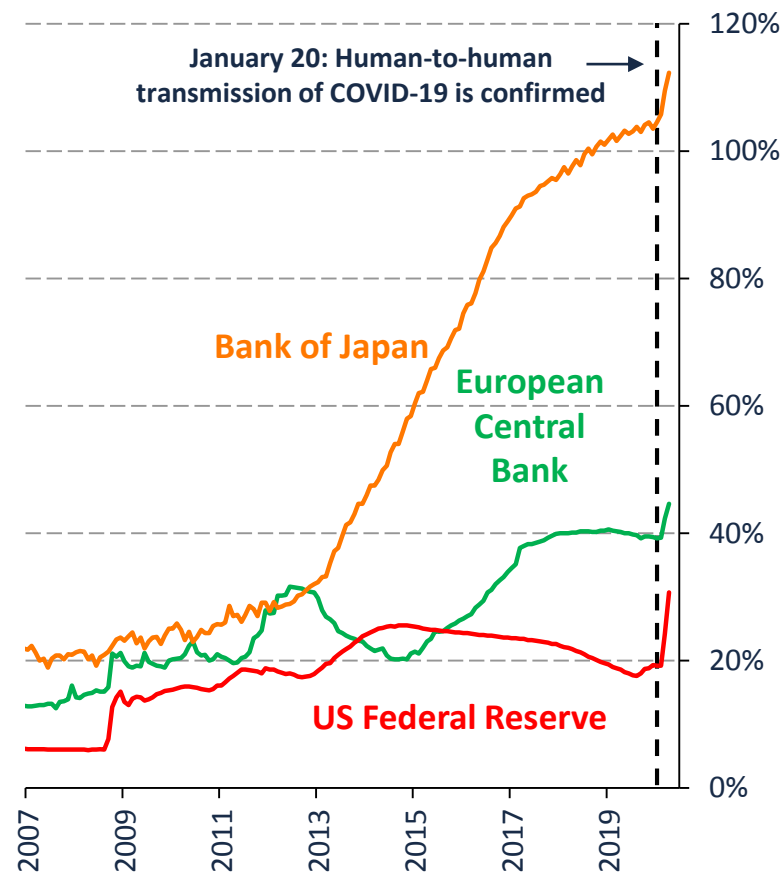
Advanced Economies

Reference Rates and Implied Trajectories in OIS Curves ^{1/}



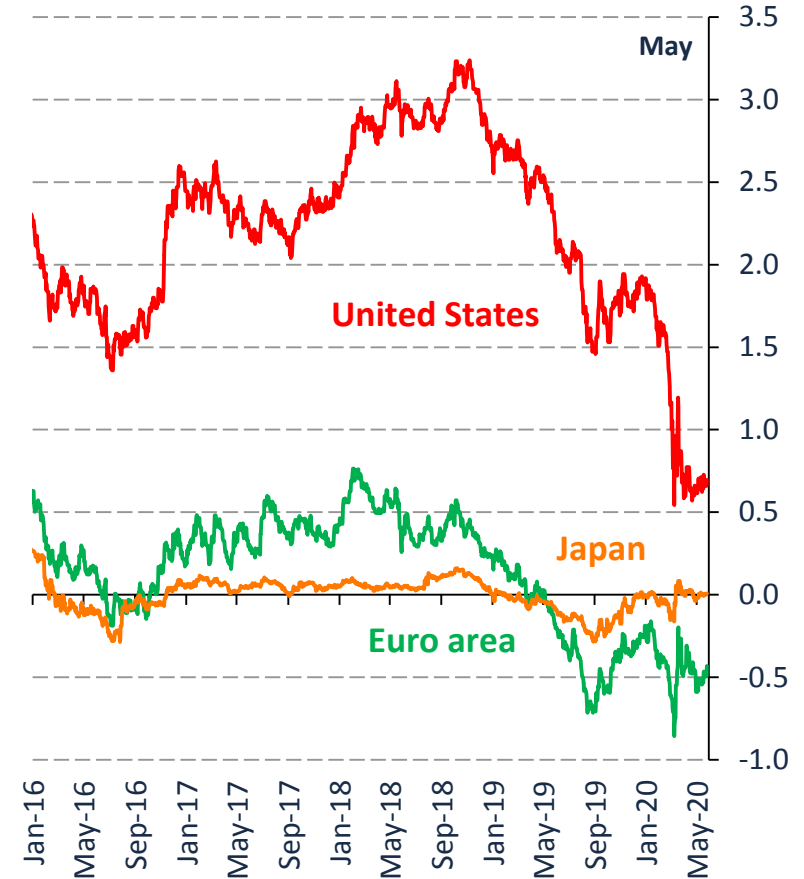
^{1/}OIS: Fixed-for-floating swap where the fixed interest rate is the overnight effective reference rate. ^{2/} Data for the observed federal funds rate corresponds to the average between the lower and upper bounds of the target range (0.0% - 0.25%). Source: Prepared by Banco de México with data from Bloomberg.

Balance Sheet of the Main Central Banks % of GDP



Source: Bloomberg.

10-year Government Bonds Interest Rates %



Source: Bloomberg.

Additionally, many countries have implemented policy actions of a monetary, exchange rate and financial nature. Likewise, they have implemented fiscal stimulus measures aimed at mitigating the adverse effects on employment and on households and firms' income.

Response Measures to COVID-19

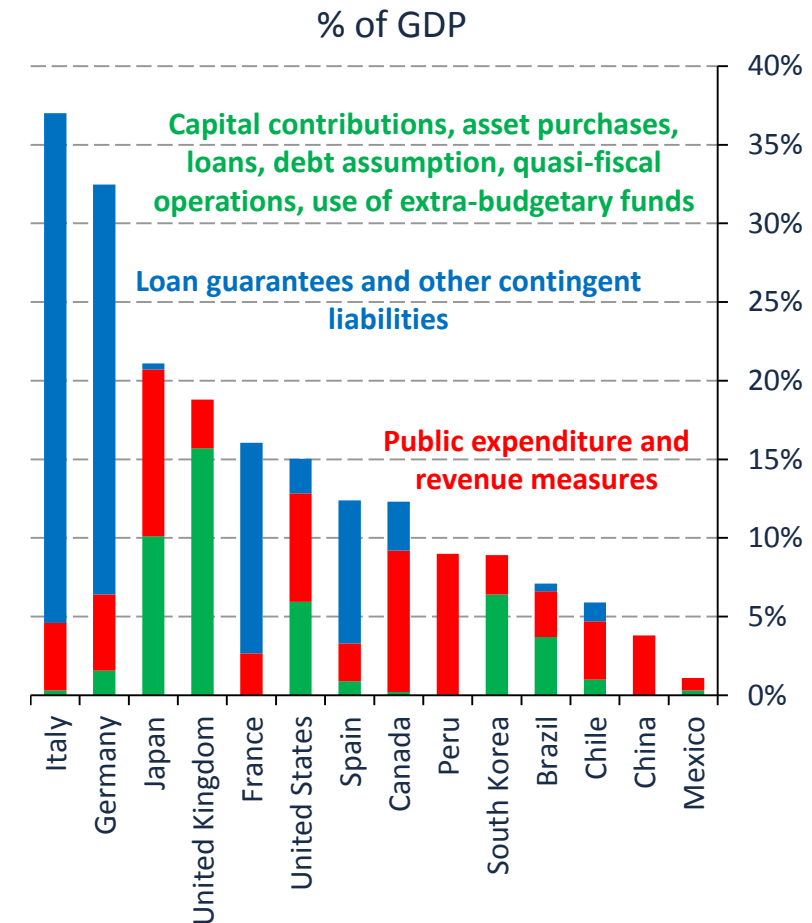
Monetary and FX

	Advanced										Emerging				
	GR	CA	SK	SP	USA	FR	IT	JP	UK	EA	BR	CL	CH	MX	PE
Reductions of monetary policy rates		●	●		●				●		●	●	●	●	●
Expansion of asset purchase programs	●	●	●	●	●	●	●	●	●	●	●				
Reducing reserve requirements					●						● ^{1/}	●	●	●	●
FX swaps with foreign central banks	●	●	●	●	●	●	●	●	●	●	●		●		●
FX interventions											●	●	●	●	●
Creation or expansion of windows for secured loans	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●
Schemes to provide liquidity for financial assets ^{2/}					●		●	●					●	●	●

Financial

	Advanced										Emerging				
	GR	CA	SK	SP	USA	FR	IT	JP	UK	EA	BR	CL	CH	MX	PE
Regulatory flexibility for carry-over of payments or restructuring of appropriations			●		●				●		●	●	●	●	●
Extension for regulatory compliance	●	●	● ^{3/}	●	●	●	●		●	● ^{4/}	●	●	●	●	●
Adjustments to liquidity requirements															
Reduction of countercyclical capital supplement	●	●				●			●						
Allowance for use of liquidity or capital supplements	●	●	●	●	●	●	●	●	●	●	●		●		●
Recommendations or restrictions to avoid shareholder reward mechanisms	●			●		●	●		●	●	●		●		●

Fiscal (as of May 21, 2020)



Note: Advanced countries: Germany (GR), Canada (CA), South Korea (SK), Spain (SP), United States (USA), France (FR), Italy (IT), Japan (JP), United Kingdom (UK), and euro area (EA); emerging countries: Brazil (BR), Chile (CL), China (CH), Mexico (MX), Peru (PE). 1/ The measure consists not in reducing reserve requirements, but in expanding the eligible currencies to constitute the reserve requirement of the obligations of financing for the banking sector guaranteed with credits or with high credit quality assets backed by credit. 2/ The measure consists of financing for the banking sector guaranteed with credits or with high credit quality assets backed by credit. 3/ The measure does not grant an extension but eliminates sanctions to those banks that do not deliver their financial statements or reports on time. 4/ Includes two measures. That implemented by: i) the European Banking Authority in the form of a recommendation to member countries, and by ii) the European Central Bank, which applies to banks under its jurisdiction.

Source: Prepared by Banco de México with data from central banks, official government websites, and the International Monetary Fund (IMF), "IMF Policy Tracker".

Source: Prepared by Banco de México with data from International Monetary Fund (IMF), "Fiscal Monitor" May 2020 and "IMF Policy Tracker" as of May 21, 2020.

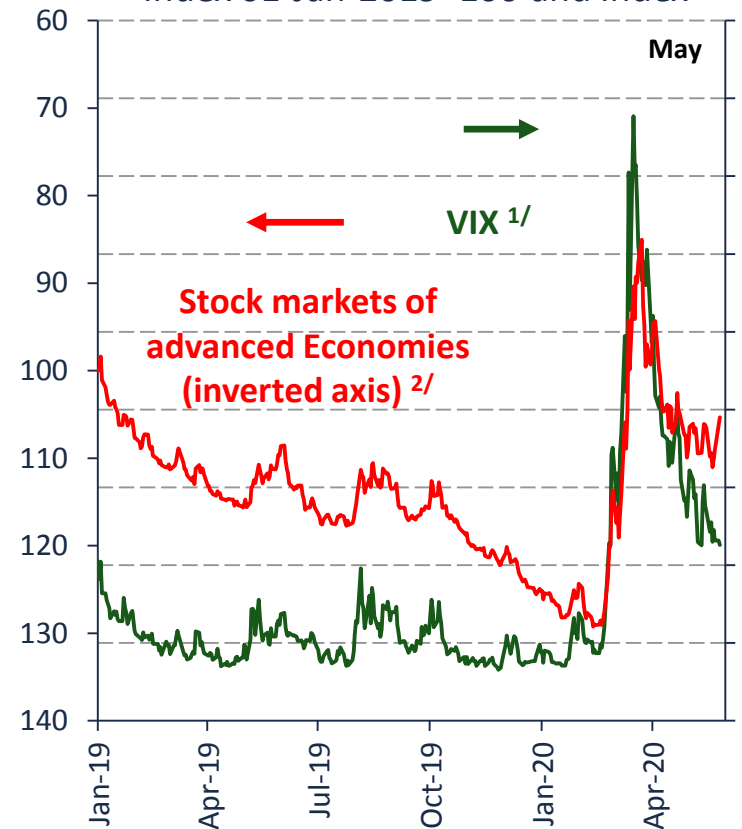
The evolution of the COVID-19 pandemic and concerns about its impact on global economic activity led to a significant deterioration of global financial conditions towards the end of February. However, the measures taken by advanced economies have contributed to a more stable performance of international financial markets since April.

Global Risk Appetite Index
Index



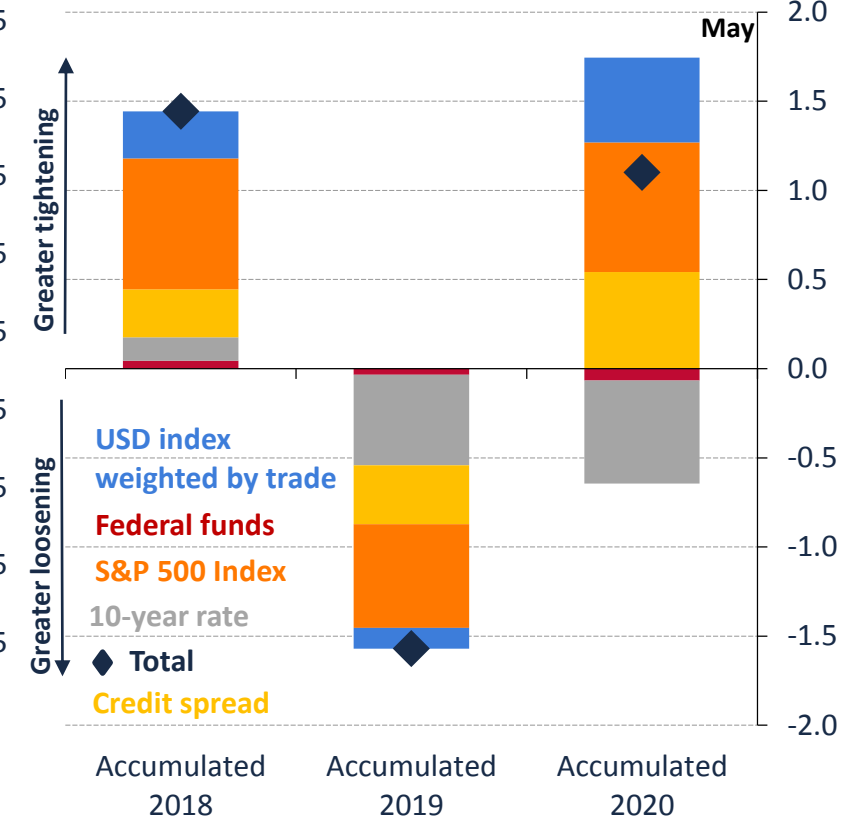
Note: The risk appetite index compares several financial assets, taking into account that in periods of high appetite for riskier assets, such as equities of advanced and emerging economies, these tend to register high returns, while safe assets, such as government bonds of the United States, the euro area and Japan, tend to present negative returns. On the other hand, during periods of low risk appetite, the opposite occurs. In this context, the index value refers to the coefficient of a regression of the daily yield of 64 assets based on their volatility.
Source: Credit Suisse.

Stock Markets of Advanced Economies and VIX
Index 01-Jan-2019=100 and Index



1/ The VIX index is a weighted indicator that measures implied volatility in the options' market for S&P 500.
2/ Includes Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, Holland, New Zealand, Norway, Portugal, Singapore, Sweden, Switzerland, the United Kingdom and the United States.
Source: Bloomberg.

United States: Changes in the Financial Conditions Index by Component^{3/}
Units



3/ The financial conditions index is constructed based on the effect of five variables on economic activity: the reference interest rate, the 10-year government bond, the spread of the bonds with investment grade on the government debt bond with equivalent maturity, the ratio of the stock index with average earnings of 10-year equities and the trade weighted exchange rate.
Source: Banco de México with Bloomberg data.

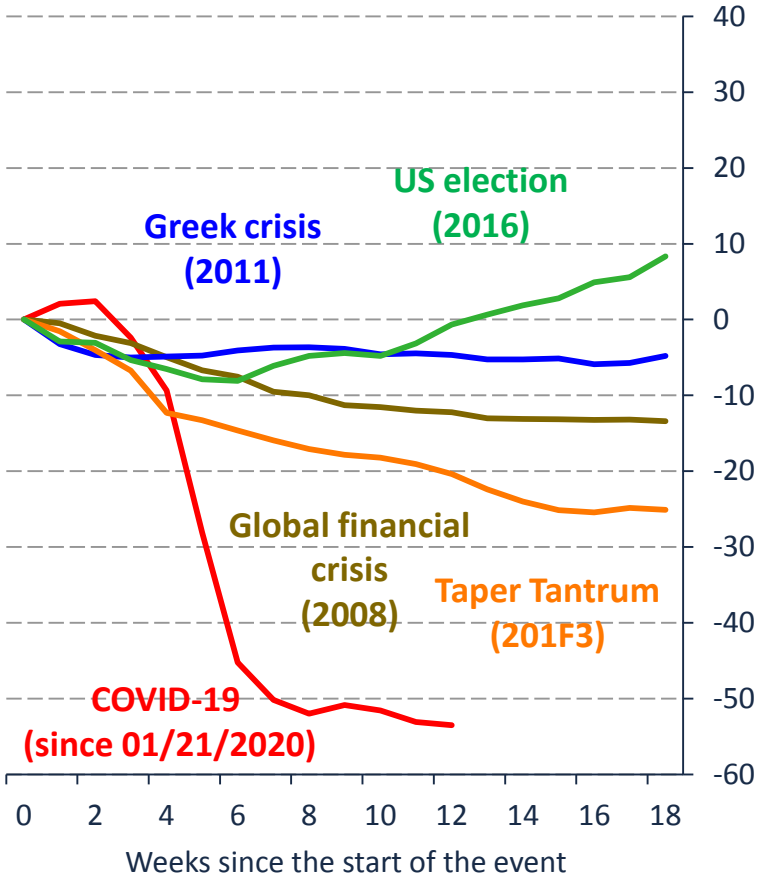
In this environment, there was a recomposition of portfolios towards lower risk assets and to a significant contraction in the holdings of emerging economies' assets, especially in fixed-income instruments. This led to a depreciation of the currencies of these economies and to a high volatility in their FX markets.

Emerging Economies

Accumulated Flows After Selected Episodes

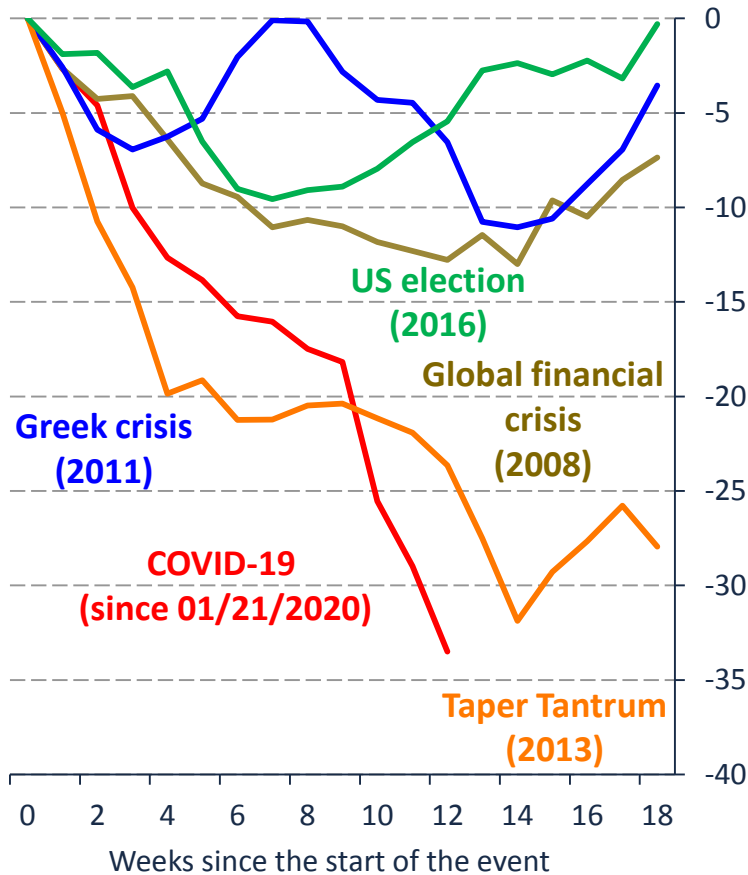
Billion dollars

Fixed Income



Source: Emerging Portfolio Fund Research (EPFR).

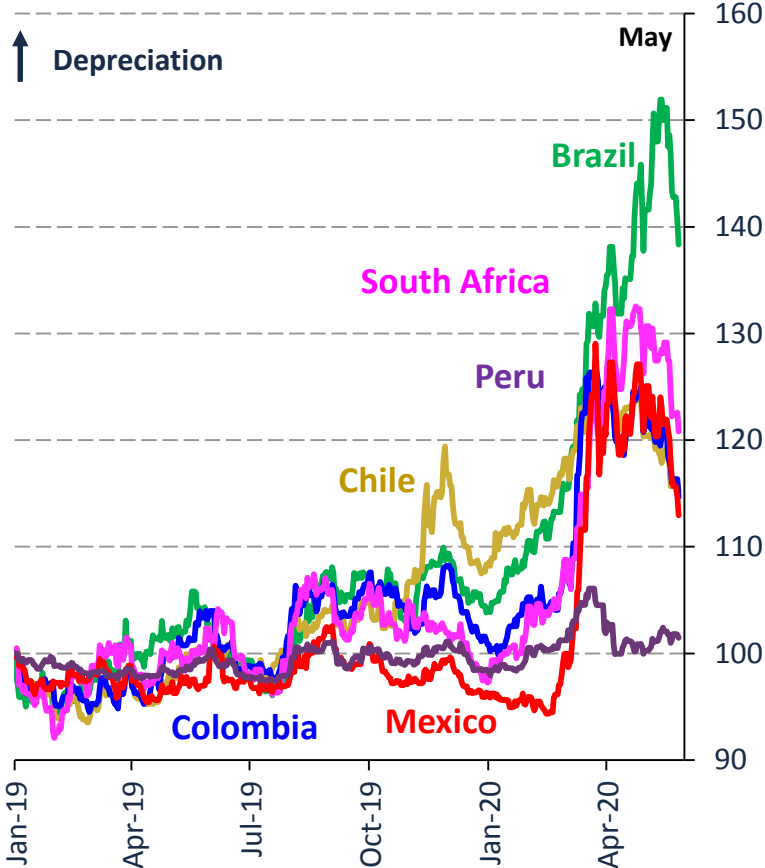
Equity



Source: Emerging Portfolio Fund Research (EPFR).

Nominal Exchange Rate against USD

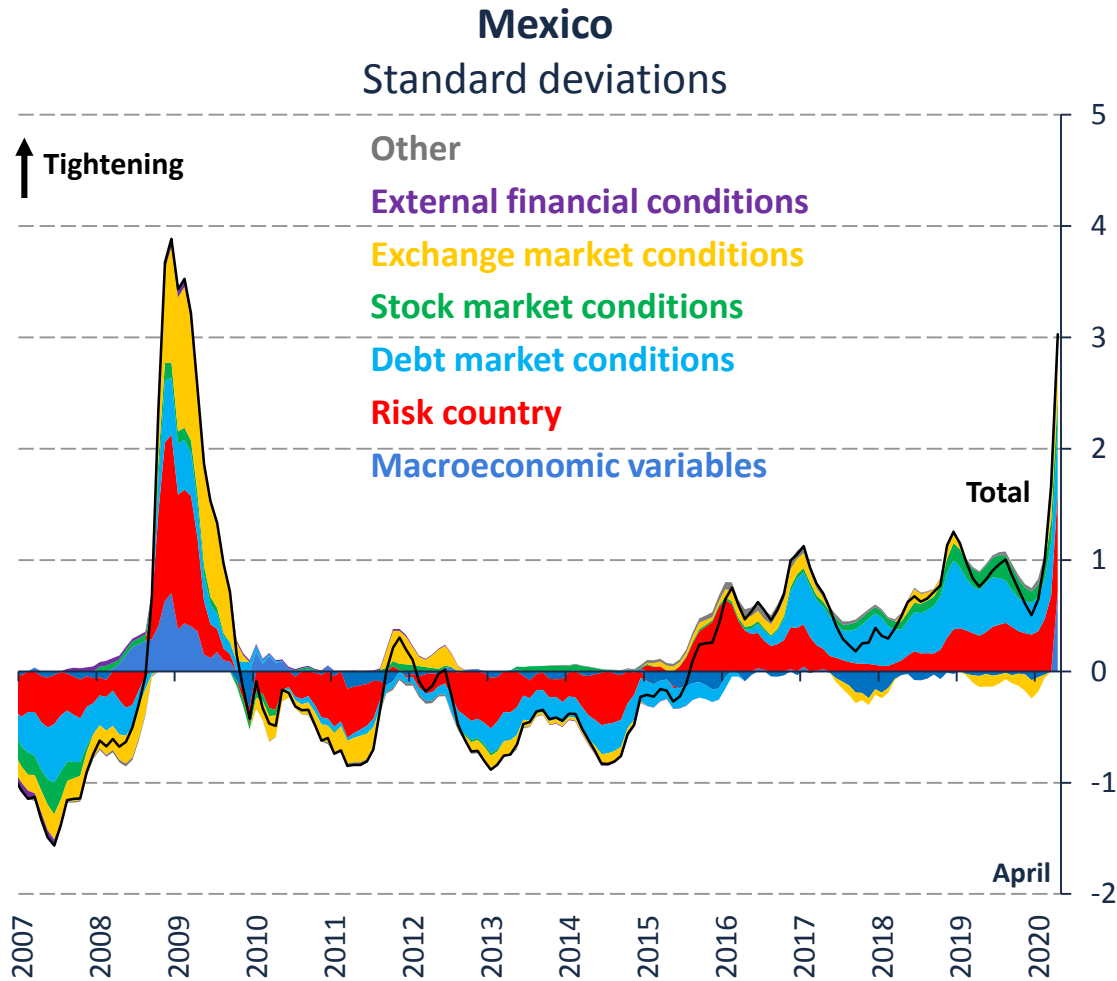
Index Jan-01-2019=100



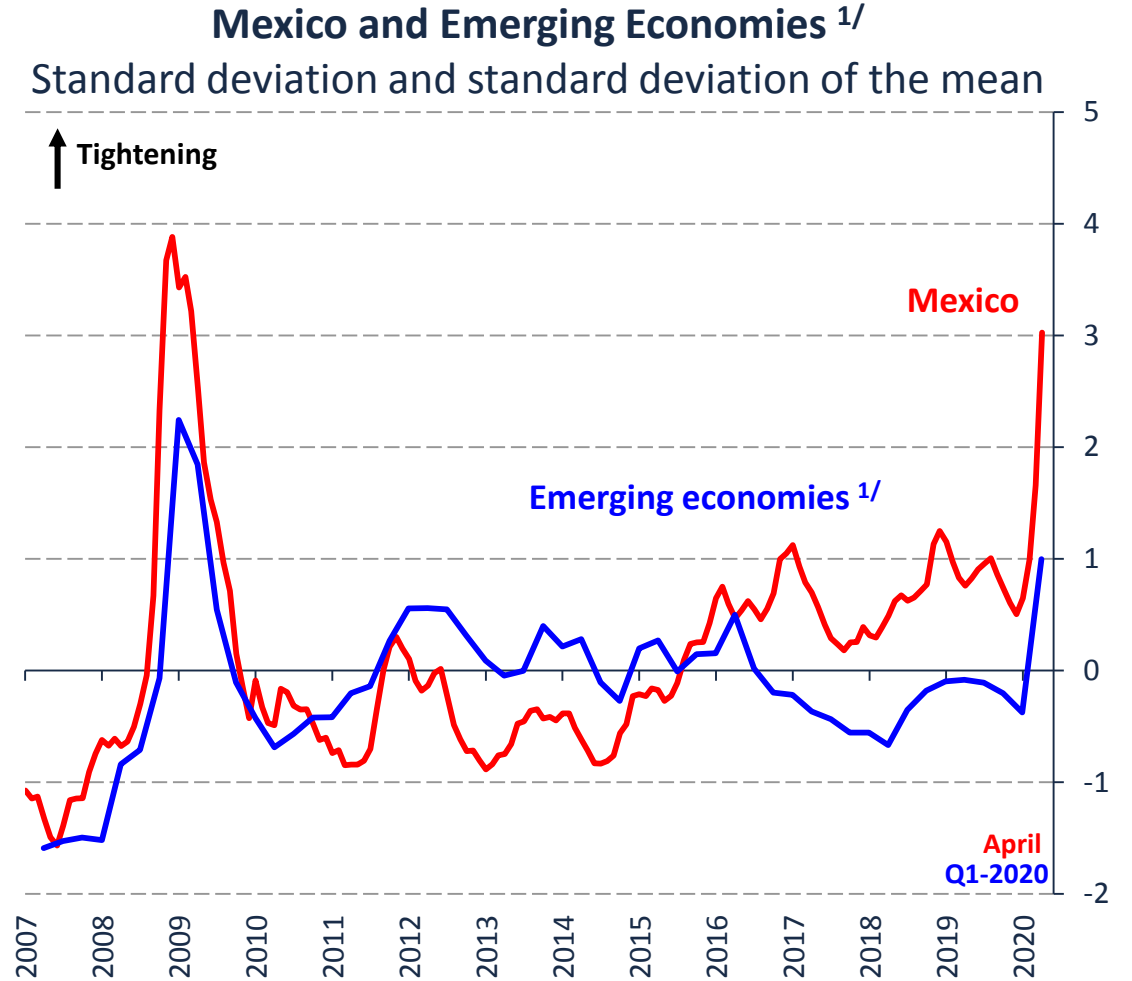
Source: Bloomberg.

In emerging economies, central banks confront a complex trade-off since lower policy rates would support the economic recovery, while they could also include larger portfolio adjustments, deteriorating financial conditions.

Financial Conditions Index



Source: Estimated by Banco de México with data from Bloomberg, Banco de México, BMV and INEGI



^{1/} Excluding China.

Source: Global Financial Stability Report, April 2020, International Monetary Fund and adjustments by Banco de México with data from Bloomberg, Banco de México, BMV and INEGI

Outline

1 External conditions

2 Current situation of the Mexican economy

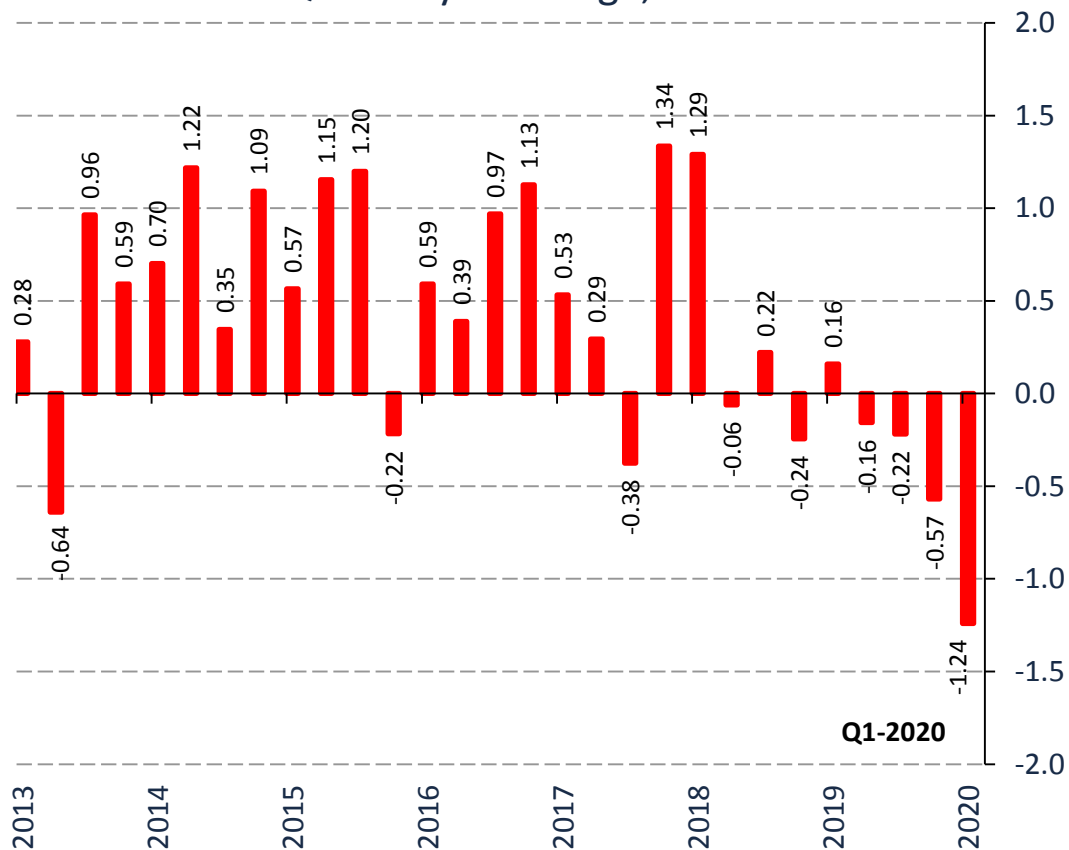
3 Inflation

4 Monetary policy

5 Forecasts and final remarks

After continuing to exhibit weakness at the beginning of 2020, in March, economic activity began to be strongly affected by social distancing measures, as well as by certain disruptions in global value chains and lower external demand. Thus, in Q1-2020, GDP contracted significantly quarter-to-quarter.

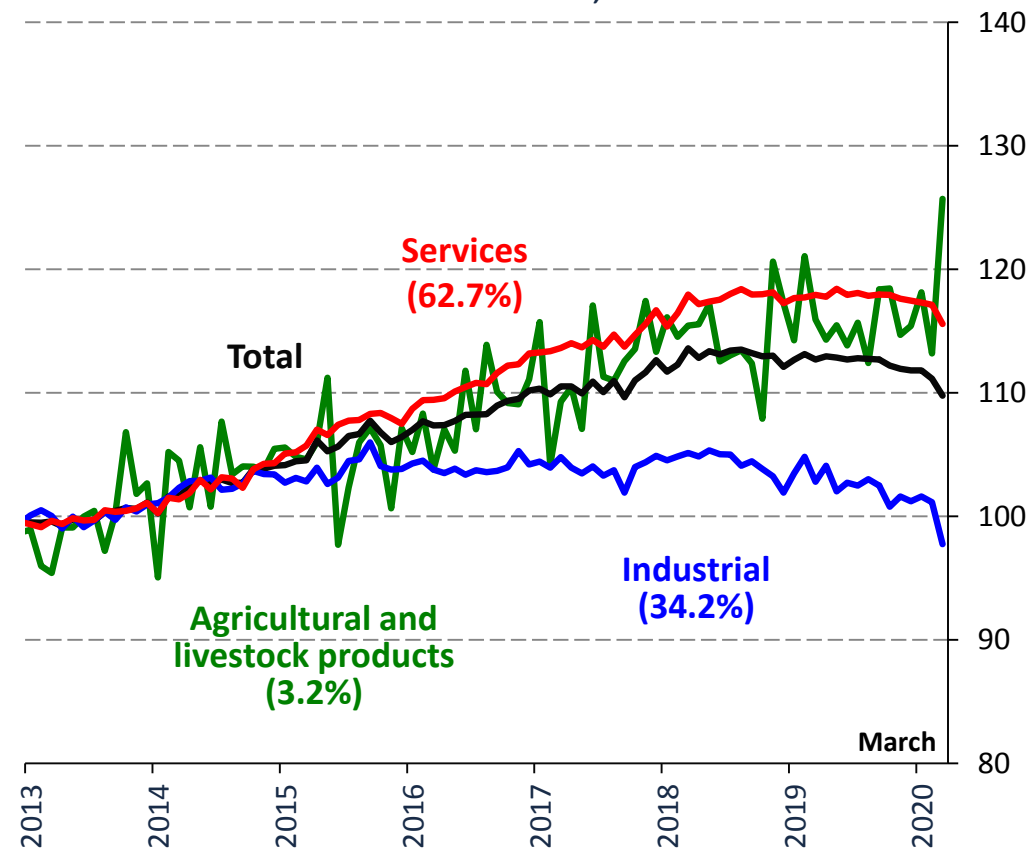
Gross Domestic Product
Quarterly % change, s. a.



s. a./ Seasonally adjusted figures

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

Global Index of Economic Activity
Index 2013=100, s. a.

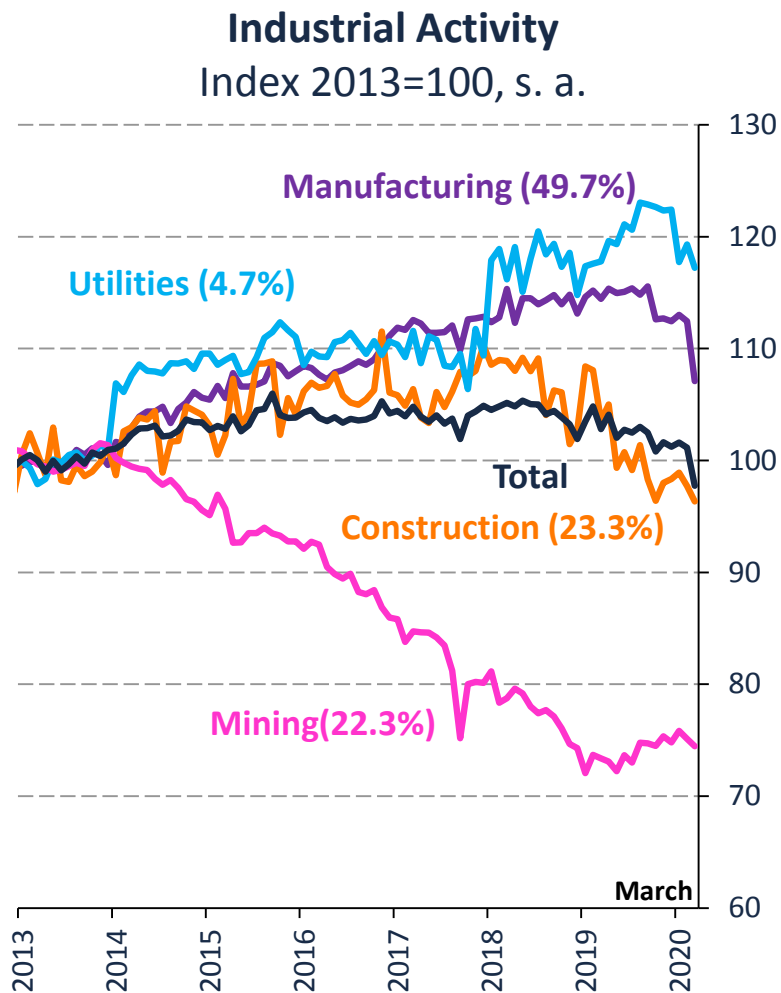


s. a./ Seasonally adjusted figures

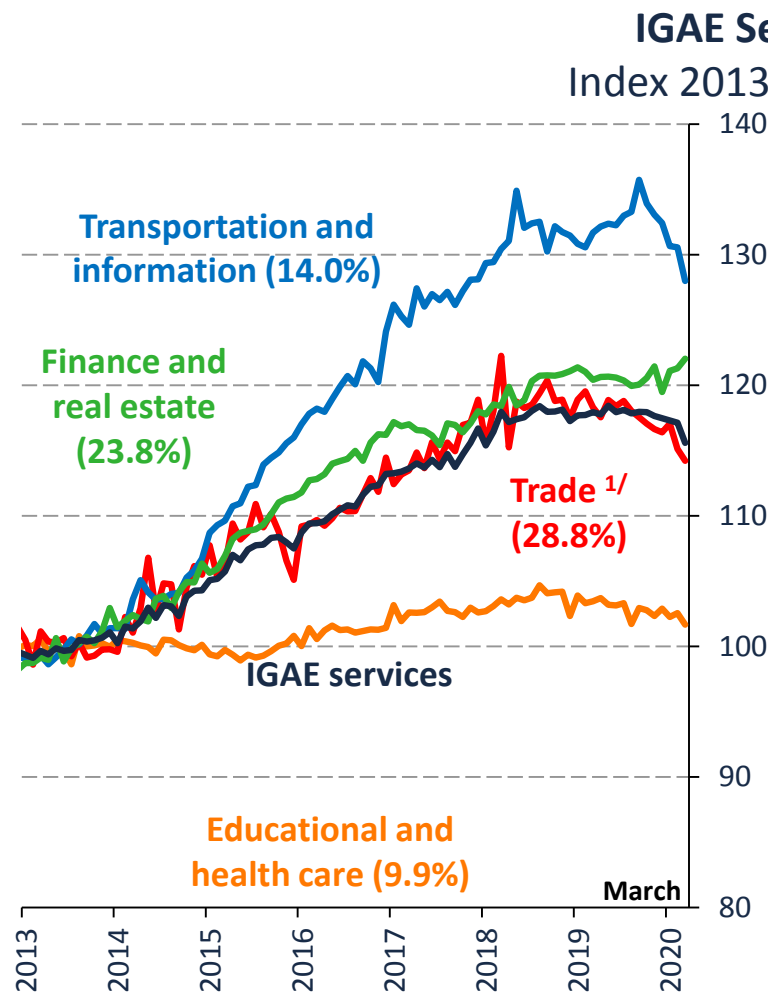
Note: Figures in parentheses represent their share in 2013. The sum of the components may not add up due to rounding.

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

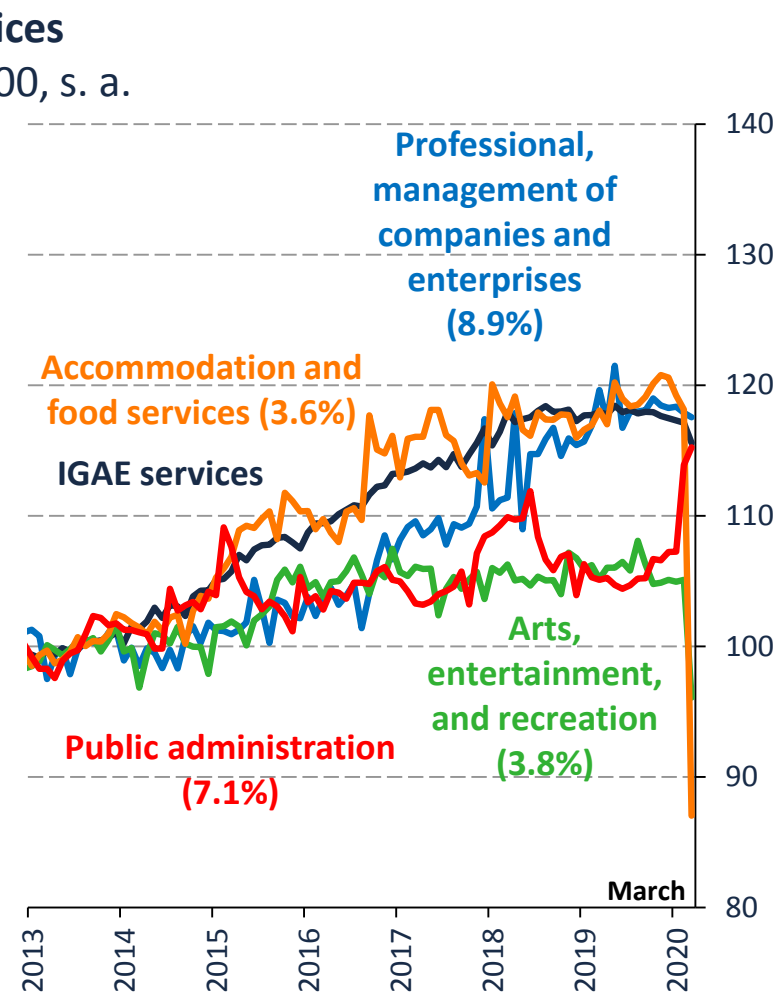
In March, the negative trajectory of both industrial production and services intensified significantly.



s. a. / Seasonally adjusted figures.
 Note: Figures in parentheses represent their share in 2013.
 Source: Monthly Indicator of Industrial Activity, Mexico's National Accounts System (SCNM, for its acronym in Spanish), INEGI.



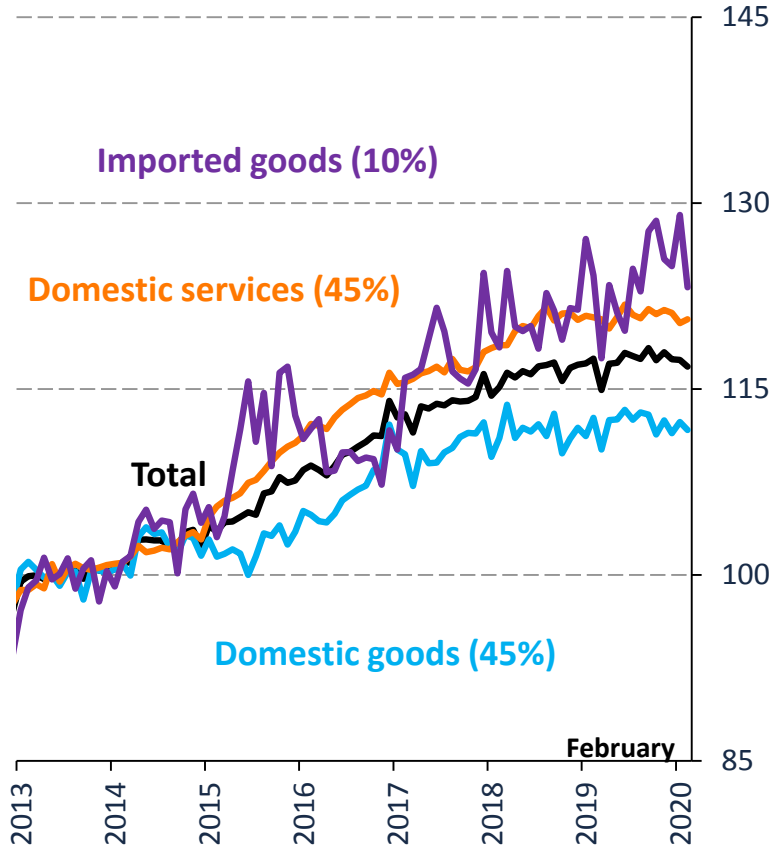
s. a. / Seasonally adjusted figures.
 Note: Figures in parentheses represent their share in 2013.
 1/ Includes both wholesale and retail trade.
 Source: Mexico's National Accounts System (SCNM, for its acronym in Spanish), INEGI.



s. a. / Seasonally adjusted figures.
 Note: Figures in parentheses represent their share in 2013.
 Source: Mexico's National Accounts System (SCNM, for its acronym in Spanish), INEGI.

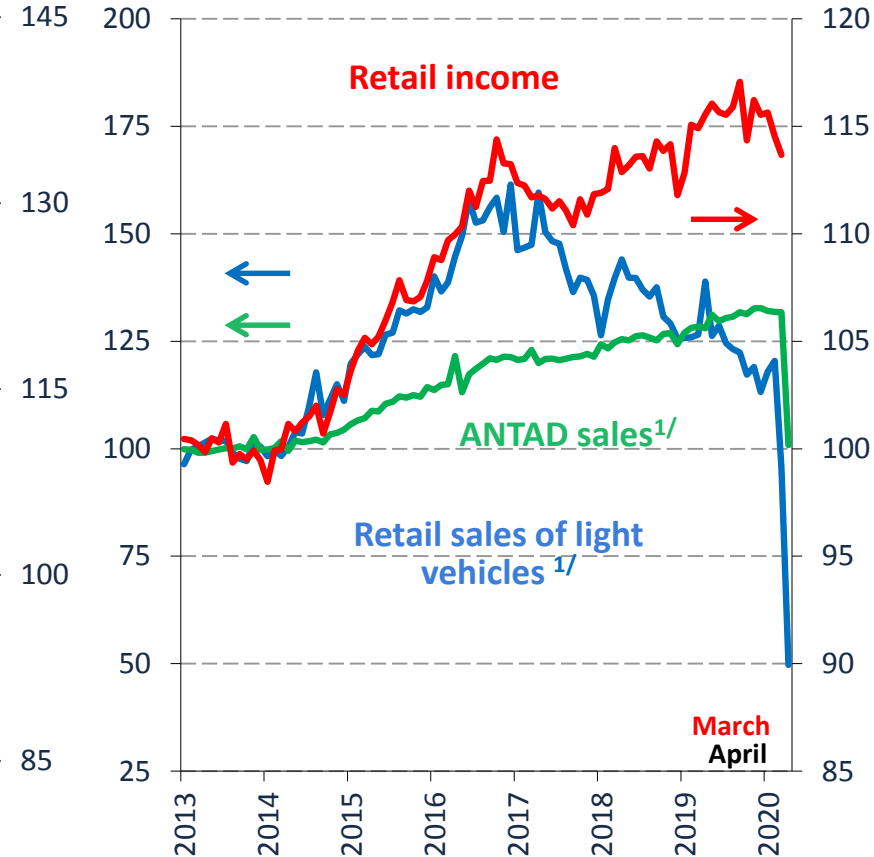
In the first two months of 2020, private consumption followed an incipient negative trajectory. By the end of the first quarter of 2020, and especially during the second quarter, private consumption, particularly services consumption, is anticipated to be significantly affected.

Private Consumption
Index 2013=100, s. a.



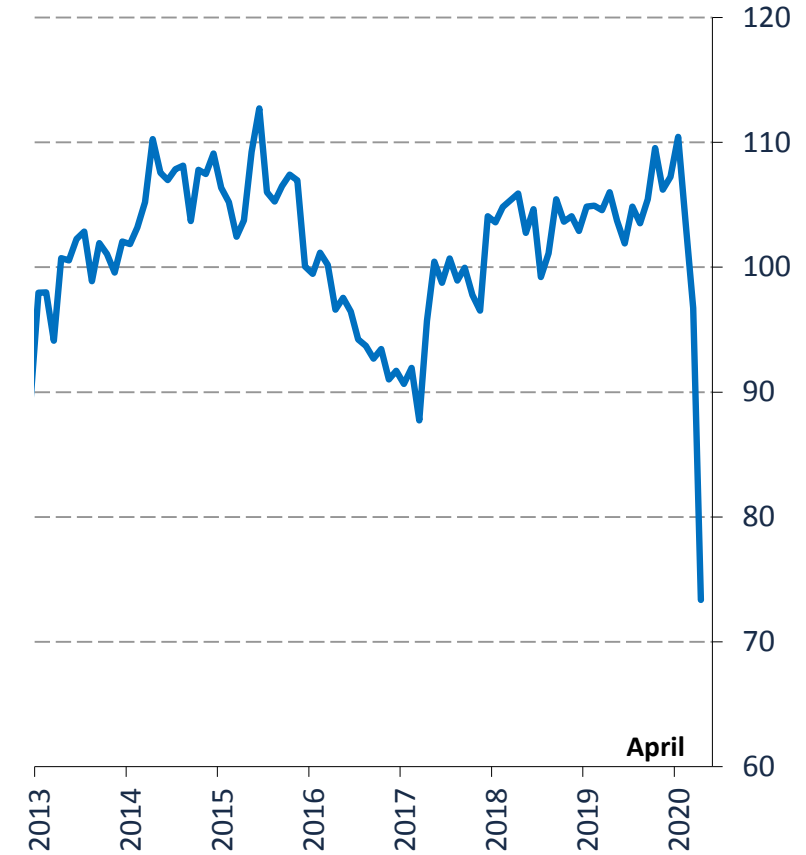
s. a. / Seasonally adjusted figures.
Note: Figures in parentheses represent their share in 2013.
Source: Mexico's National Accounts System (SCNM, for its acronym in Spanish), INEGI.

Domestic Retail Sales of Light Vehicles, ANTAD
Sales in Real Terms and Income in Retail Establishments
Index 2013=100, s. a.



s. a. / Seasonally adjusted figures.
1/ Seasonal adjustment of ANTAD's actual sales and domestic retail sales of light vehicles by Banco de México. Source: Prepared by Banco de México with data from the National Association of Self-Service and Department Stores (ANTAD for its acronym in Spanish), the Monthly Survey on Commercial Companies (EMEC, for its acronym in Spanish), INEGI, and the Administrative Registry of the Automotive Industry of Light Vehicles, INEGI.

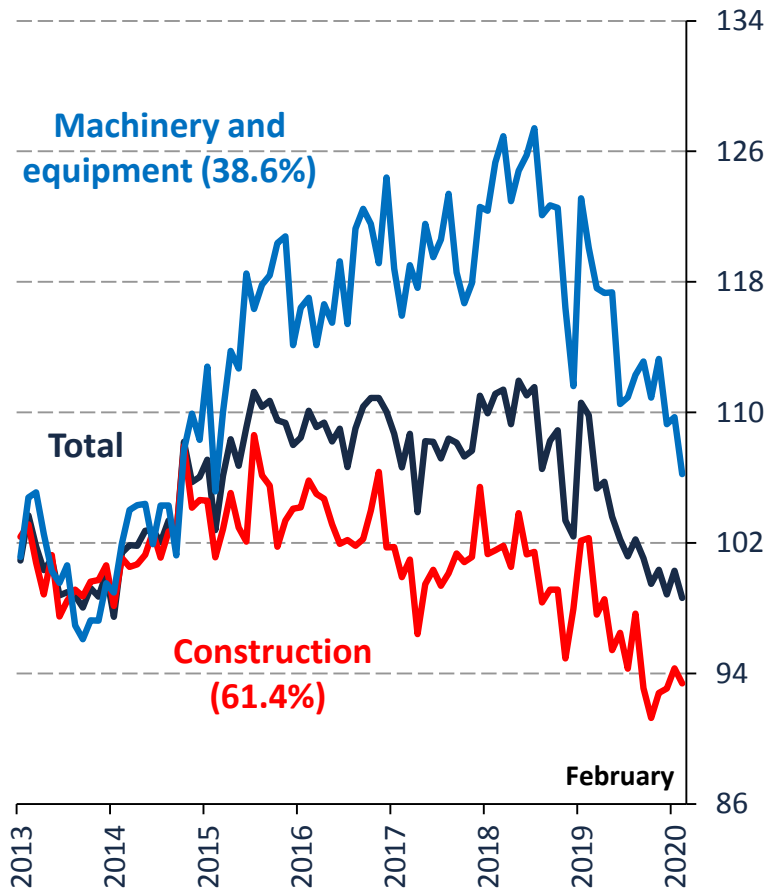
Imports of Non-oil Non-automotive Consumer Goods^{2/}
Index 2013=100, s. a.



s. a. / Seasonally adjusted figures.
2/ Current dollar figures.
Source: Prepared by Banco de México with data from PMI Comercio Internacional, S.A. de C.V., SAT, SE, Banco de México and INEGI. Commercial Balance of Goods of Mexico. SNIEG. Information of National Interest.

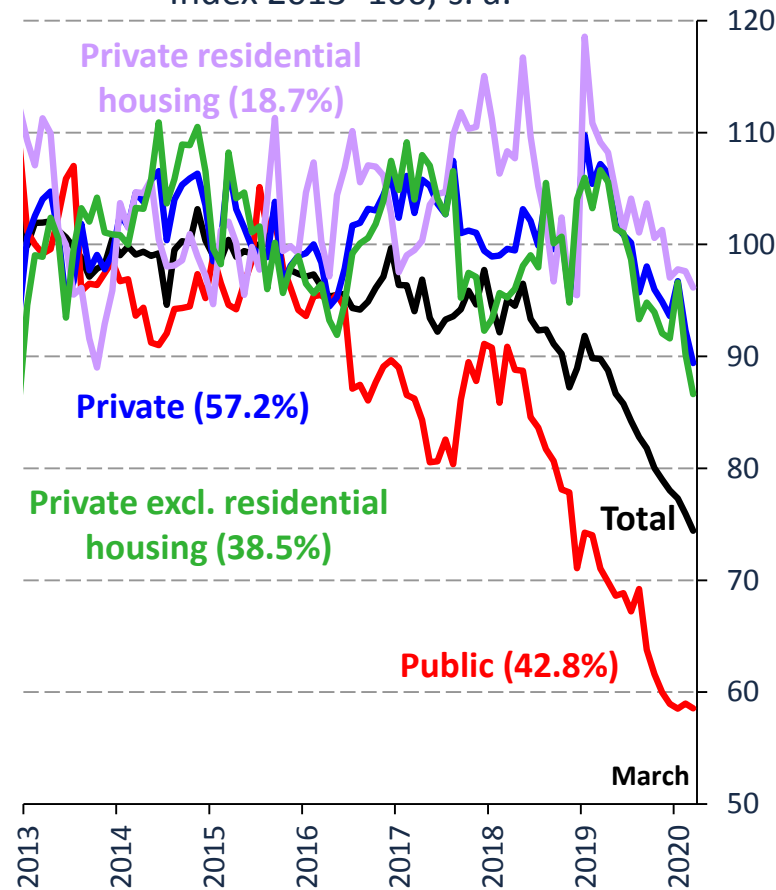
Until the first two months of 2020, gross fixed investment had been following a downward path, reaching particularly low levels. In March and April, capital goods imports fell significantly, anticipating a further deterioration of investment.

Investment
Index 2013=100, s. a.



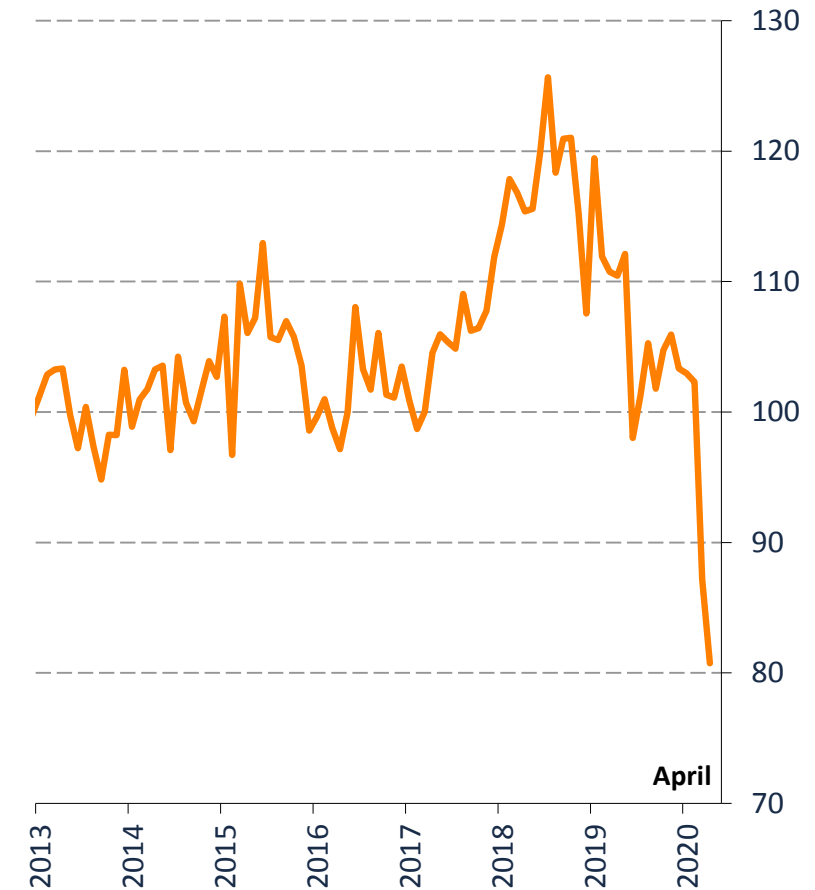
s. a. / Seasonally adjusted figures.
Note: Figures in parentheses represent their share in total in 2013.
Source: Mexico's National Accounts System (SCNM, for its acronym in Spanish), INEGI.

Real Value of Construction Output by Sector^{1/}
Index 2013=100, s. a.



s. a. / Seasonally adjusted figures.
Note: Figures in parentheses represent their share in total in 2018.
1/ Seasonally adjusted by Banco de México, except for the total series.
Source: Prepared by Banco de México with data from ENEC, INEGI.

Imports of Capital Goods^{2/}
Index 2013=100, s. a.



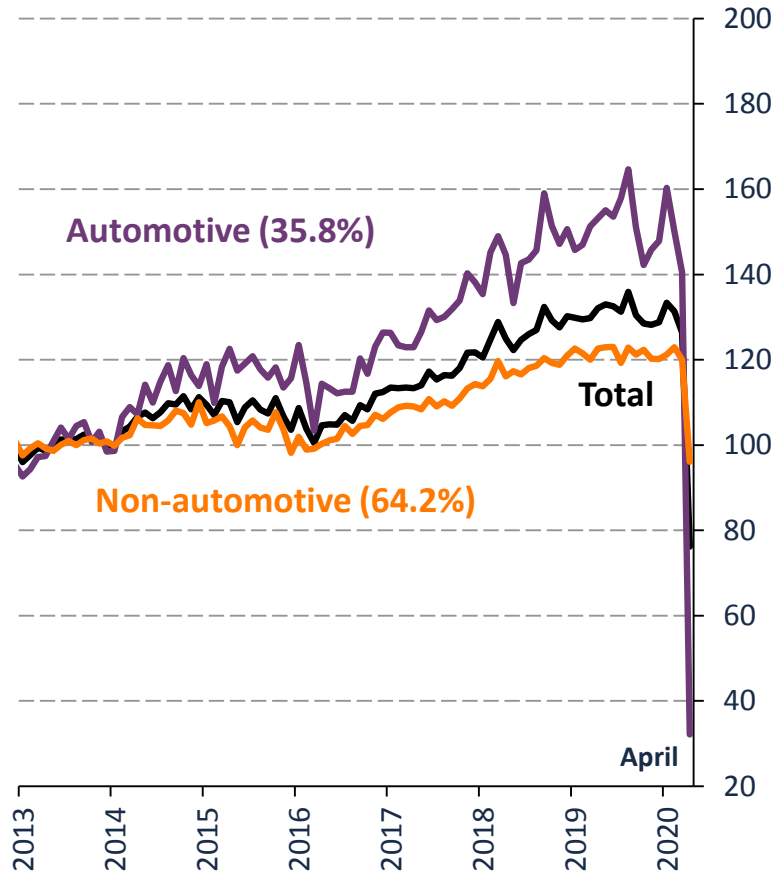
s. a. / Seasonally adjusted figures.
2/ current dollar figures.
Source: Prepared by Banco de México with data from PMI Comercio Internacional, S.A. de C.V., SAT, SE, Banco de México and INEGI. Commercial Balance of Goods of Mexico. SNIEG Information of National interest.

At the end of Q1-2020, foreign trade of goods began to resent the effects of the global pandemic, through the fall in manufacturing exports. This contraction deepened significantly in April.

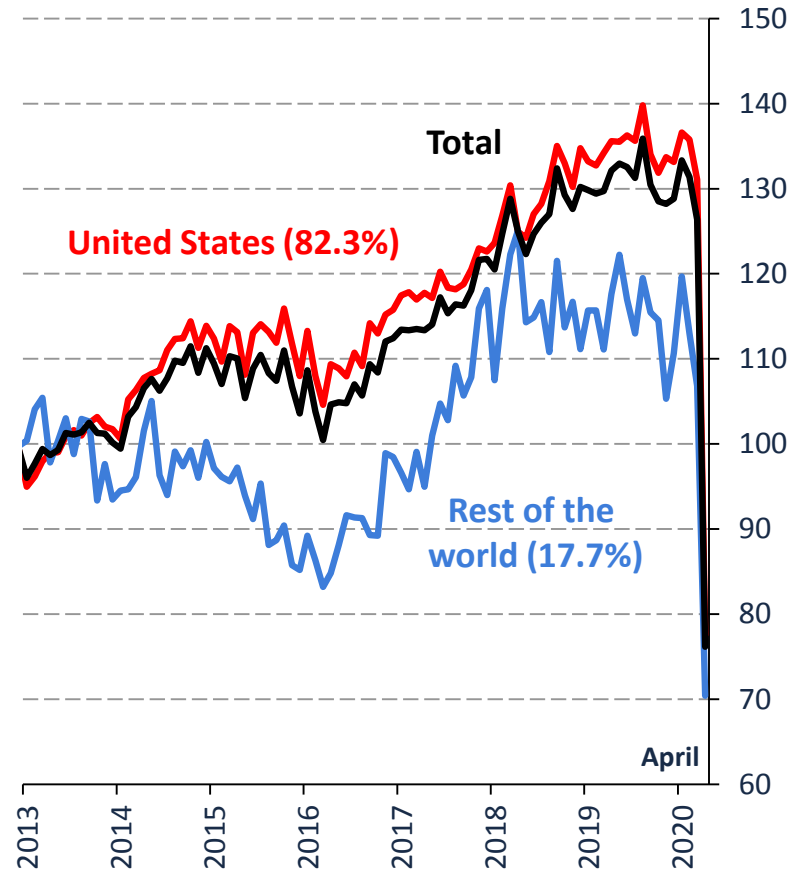
Manufacturing Exports

Index 2013=100, s. a.

Automotive and Non-automotive

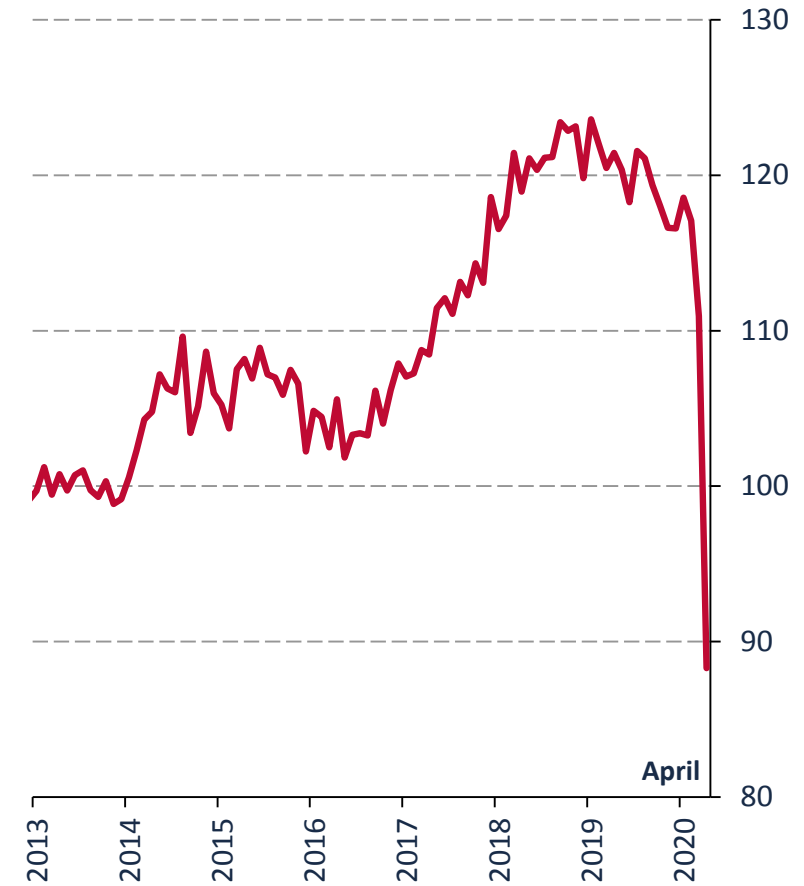


By Destination



Non-Oil Imports ^{1/}

Index 2013=100, s. a.



s. a. / Seasonally adjusted figures.

Note: Figures in parentheses represent their share in total in 2018.

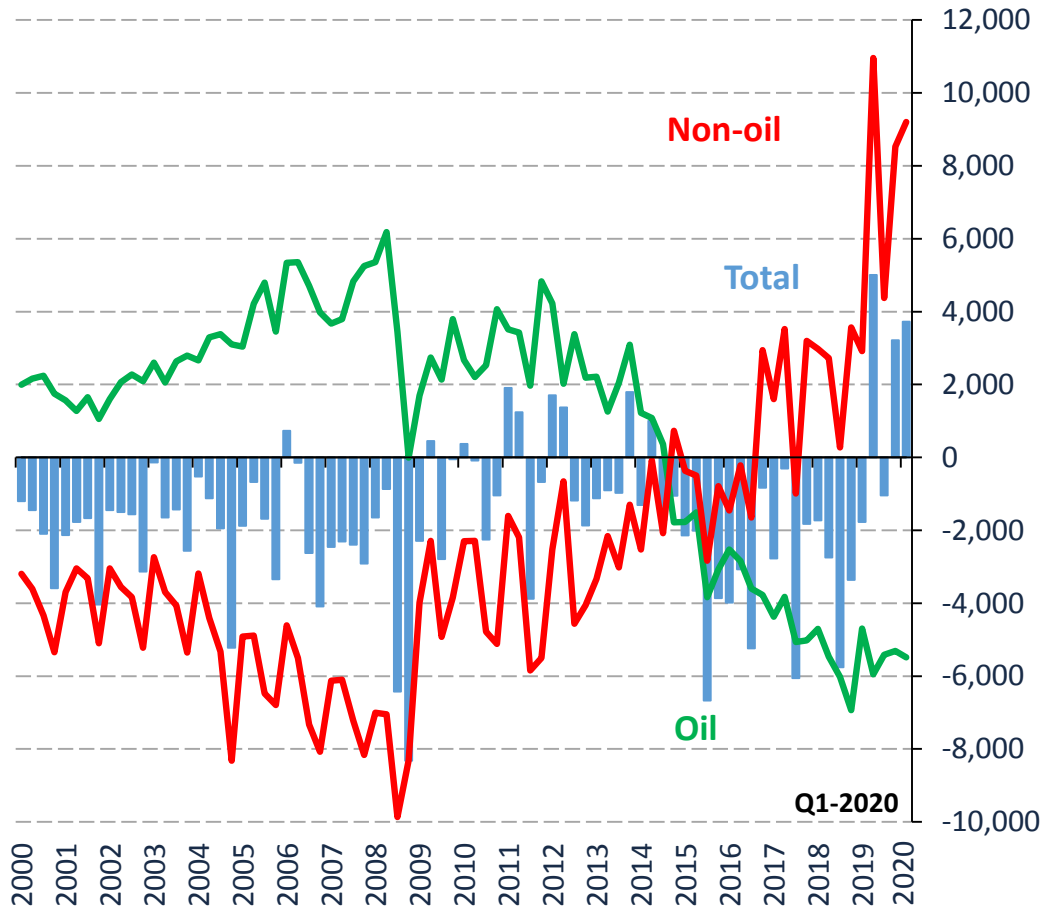
Source: Prepared by Banco de México with data from PMI Comercio Internacional, S.A. de C.V., SAT, SE, Banco de México, INEGI. Commercial Balance of Goods of Mexico. SNIEG. Information of National Interest.

s. a. / Seasonally adjusted figures. 1/ Figures in current US dollars.

Source: Prepared by Banco de México with data from PMI Comercio Internacional, S.A. de C.V., SAT, SE, Banco de México, INEGI. Commercial Balance of Goods of Mexico. SNIEG. Information of National Interest.

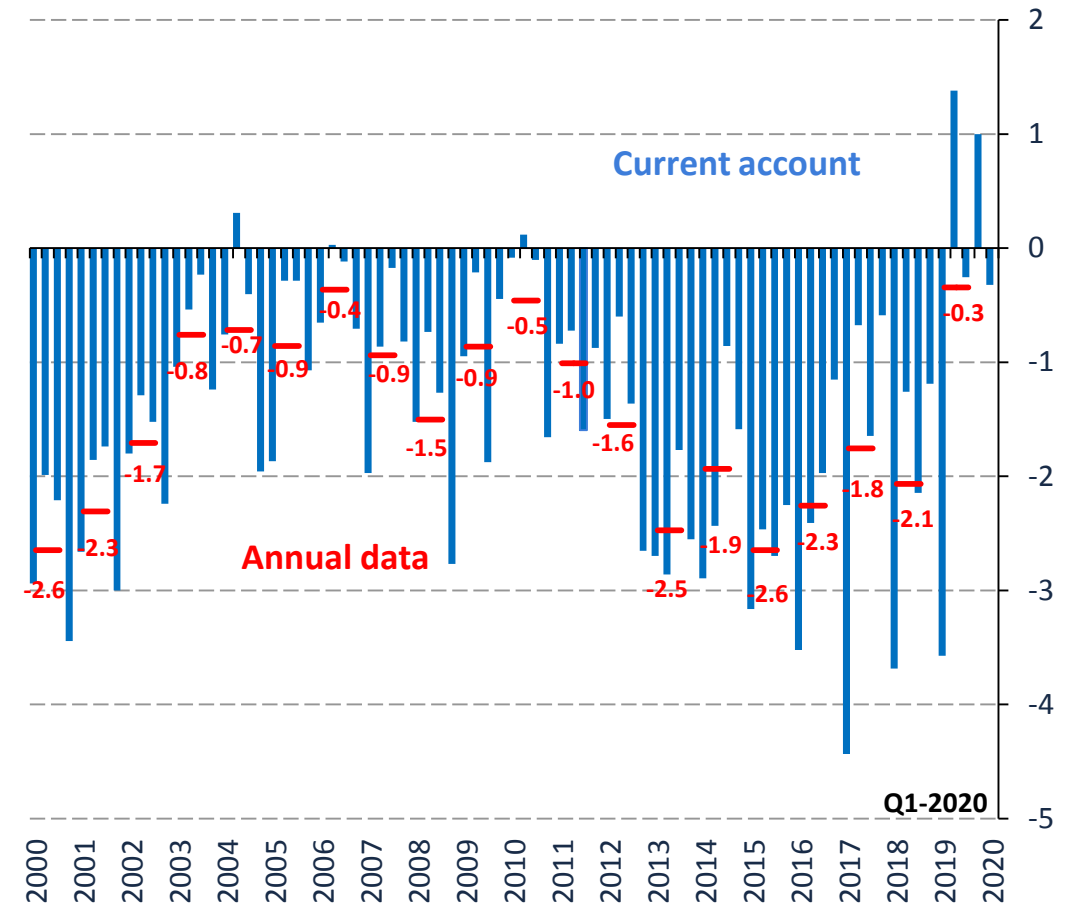
In Q1-2020 the current account deficit was below that reported during the same quarter of 2019. This result mainly reflected a significant annual increase in the non-oil trade balance surplus and a lower deficit in primary income. Nevertheless, the deterioration of various foreign revenues could affect its balance in the future.

Trade Balance
USD million



Source: SAT, SE, Banco de México, INEGI. Mexico's Merchandise Trade Balance. SNIEG. Information of national interest.

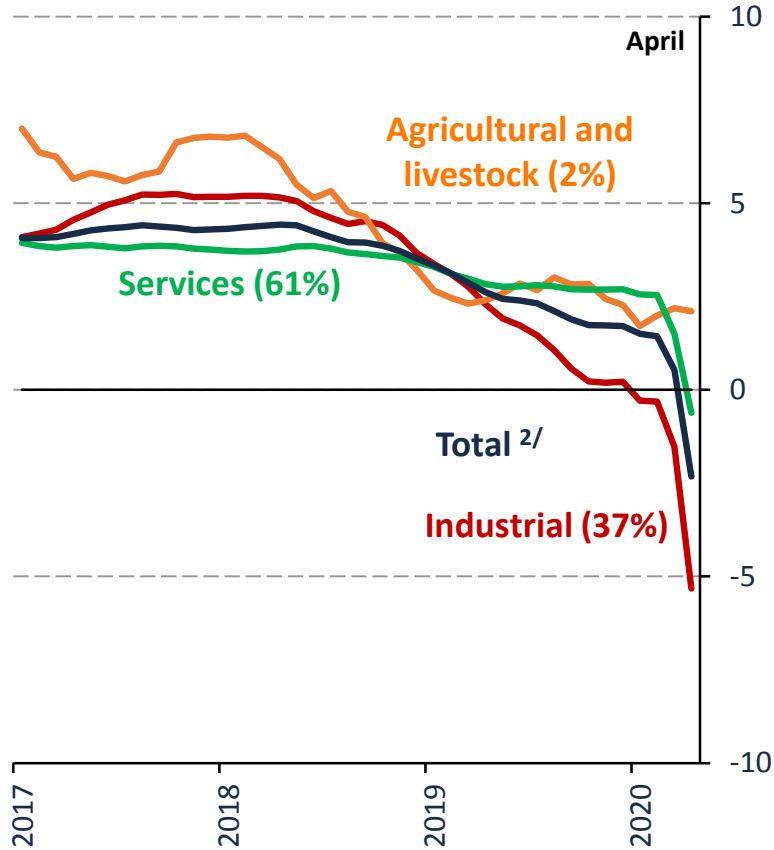
Current Account
% of GDP



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

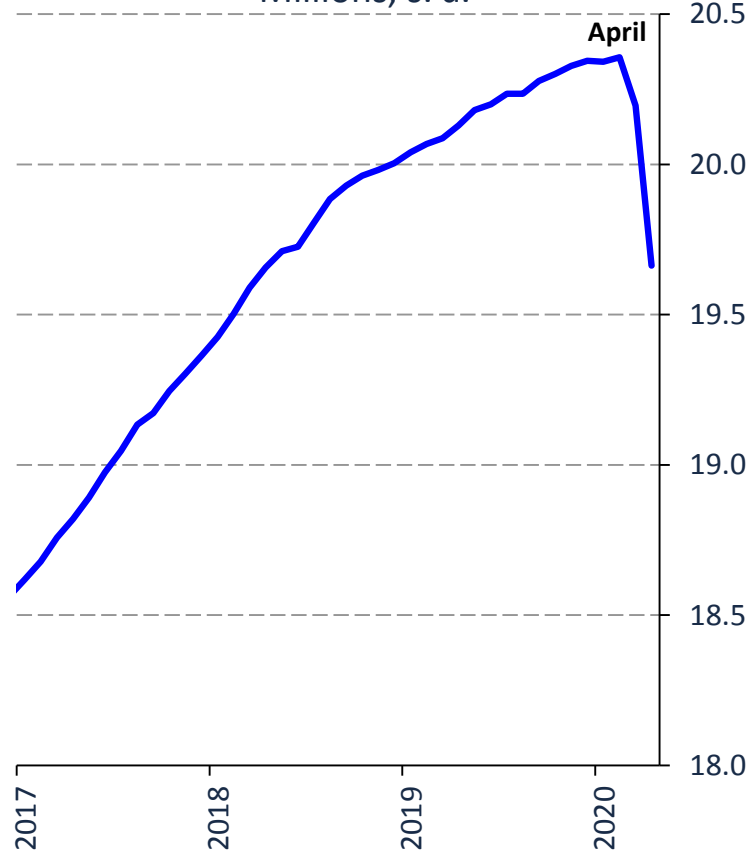
After remaining weak in the first two months of 2020, the creation of new IMSS-insured jobs fell to unprecedented levels. In Q1-2020, the national unemployment rate was at levels similar to those observed on average in 2019, while the urban unemployment rate remained on an upward trend.

IMSS-insured Jobs ^{1/}
Annual % change, s. a., m.a.



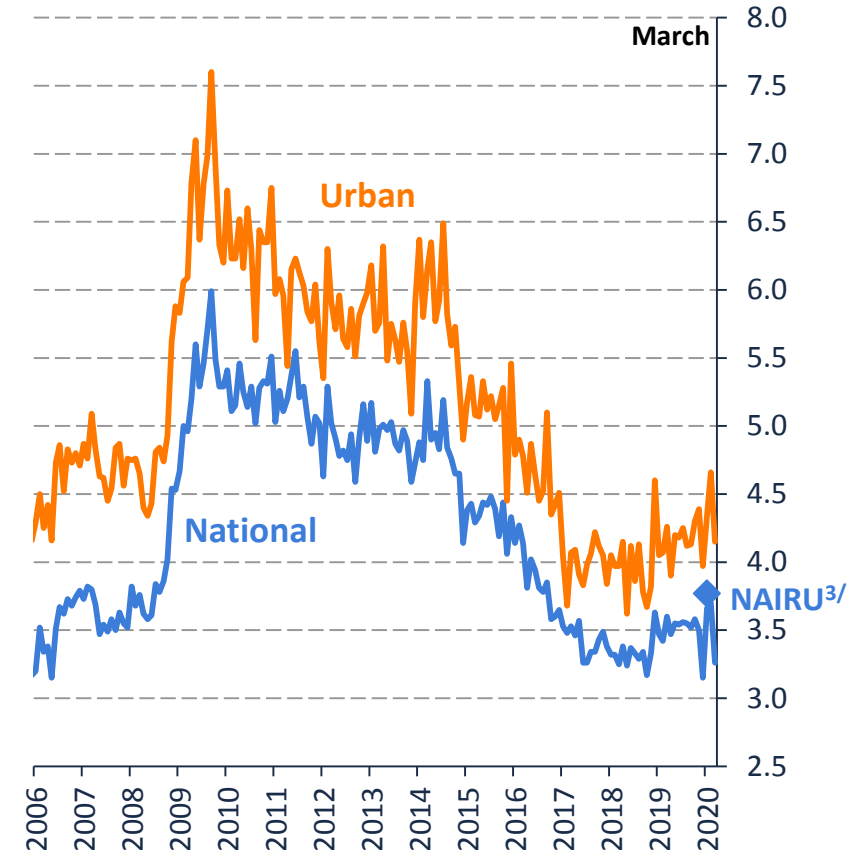
s. a./ Seasonally adjusted figures. m.a./ 3-month moving average until December 2019.
1/ The percentages in parentheses correspond to the share in the total as of February 2020.
2/ Refers to permanent and temporary urban workers.
Source: IMSS open data.

IMSS-insured Jobs: Permanent and Temporary in Urban Areas
Millions, s. a.



s. a./ Seasonally adjusted figures.
Source: Prepared by Banco de México with data from the IMSS.

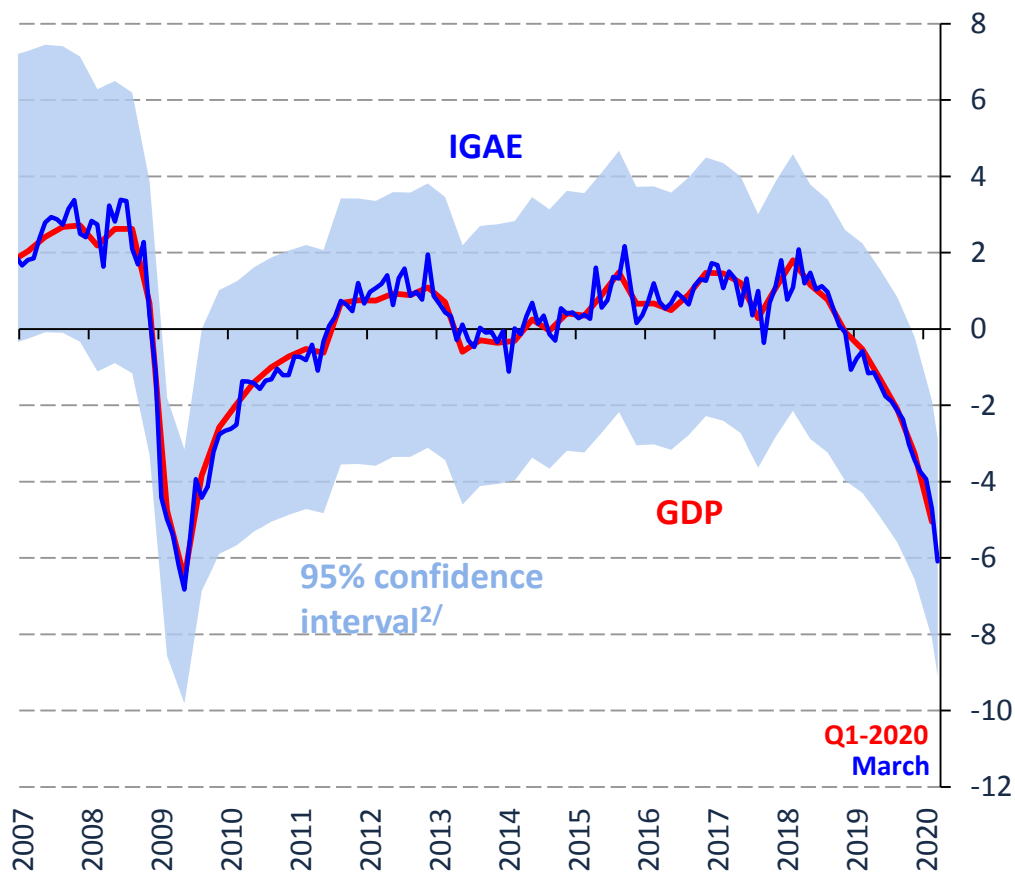
National and Urban Unemployment Rates
%, s. a.



s. a./ Seasonally adjusted figures.
3/ The NAIRU that is presented is associated with the National Unemployment Rate.
Source: Prepared by Banco de México with data from IMSS and INEGI (SCNM and ENOE).

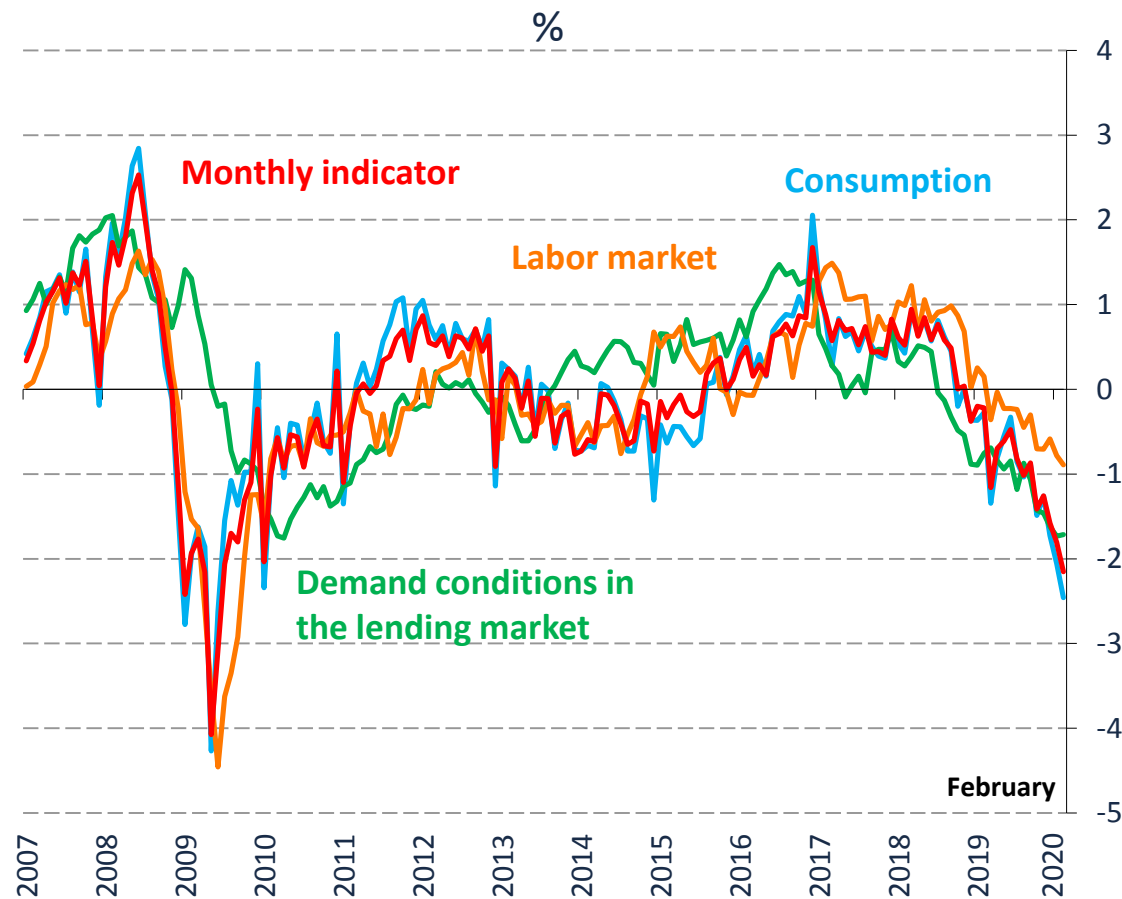
Slack conditions widened considerably as a result of the persistent weakness exhibited by economic activity in early 2020 coupled with the effects of the spread of COVID-19 on economic activity. Said conditions are expected to continue widening significantly during the second quarter.

Output Gap Estimate ^{1/}
% of potential output, s. a.



s. a. / Seasonally adjusted data.
 1/ Output gap estimated with a tail-corrected Hodrick-Prescott filter; see “Inflation Report April – June 2009”, Banco de México, p. 74.
 2/ Output gap confidence interval calculated with a method of unobserved components.
 Source: Prepared by Banco de México with data from INEGI and Banco de México.

Monthly Slack Indicators: Main Component by Indicators Frequency ^{3/}
%



3/ Main Indicators constructed using CCM methodology; see Banco de México (2018), “Quarterly Report, October-December 2017”, p.47. Monthly slack indicators are constructed with the main component of sets of series which includes 11 indicators. Slack indicators of consumption, economic activity, aggregate demand, labor market and demand conditions in the lending market are based on the first main component of sets of series which includes 6, 4, 3 and 6 indicators, respectively.
 Source: Prepared by Banco de México with data from INEGI and Banco de México.

Outline

1 External conditions

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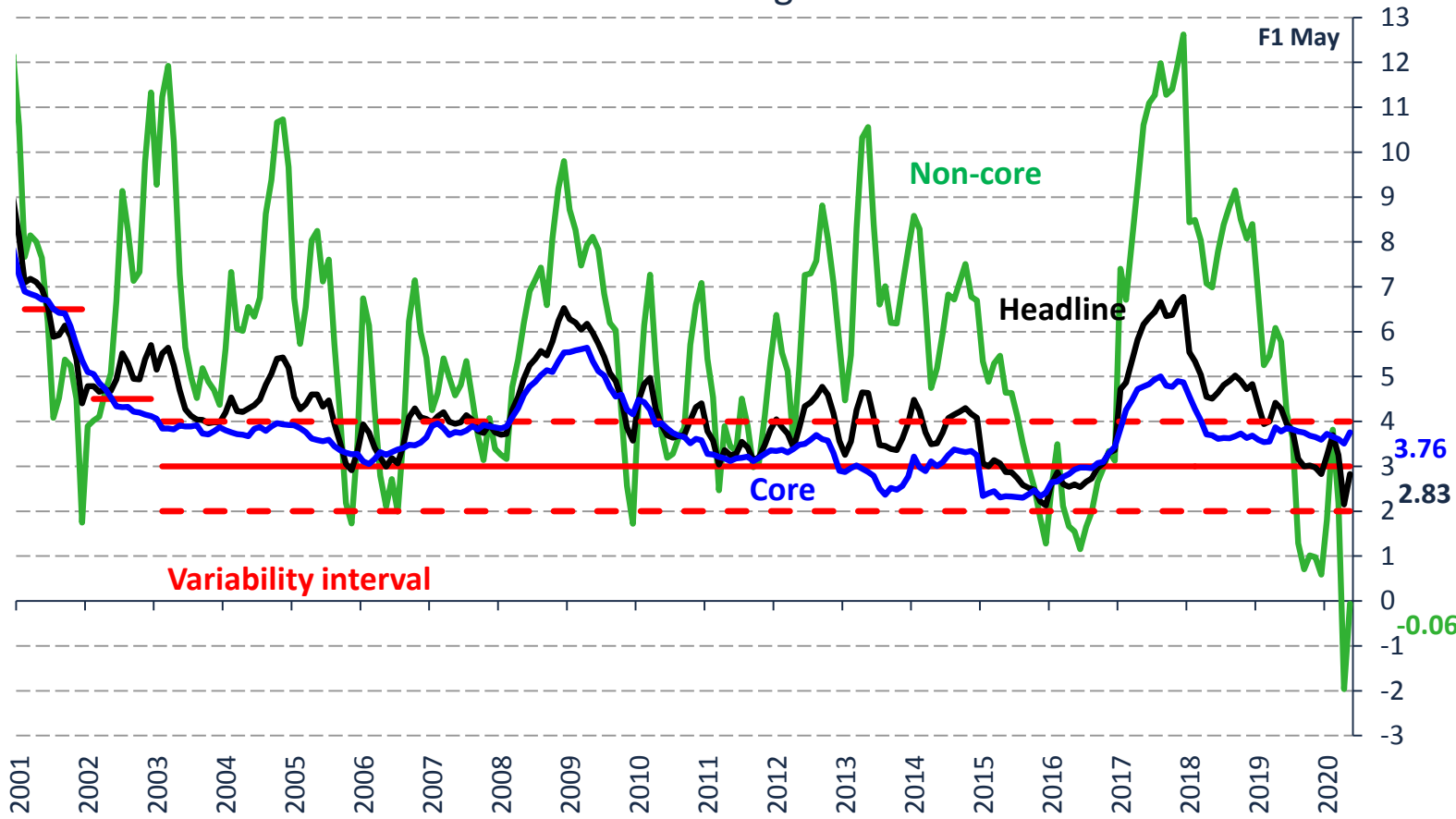
4 Monetary policy

5 Forecasts and final remarks

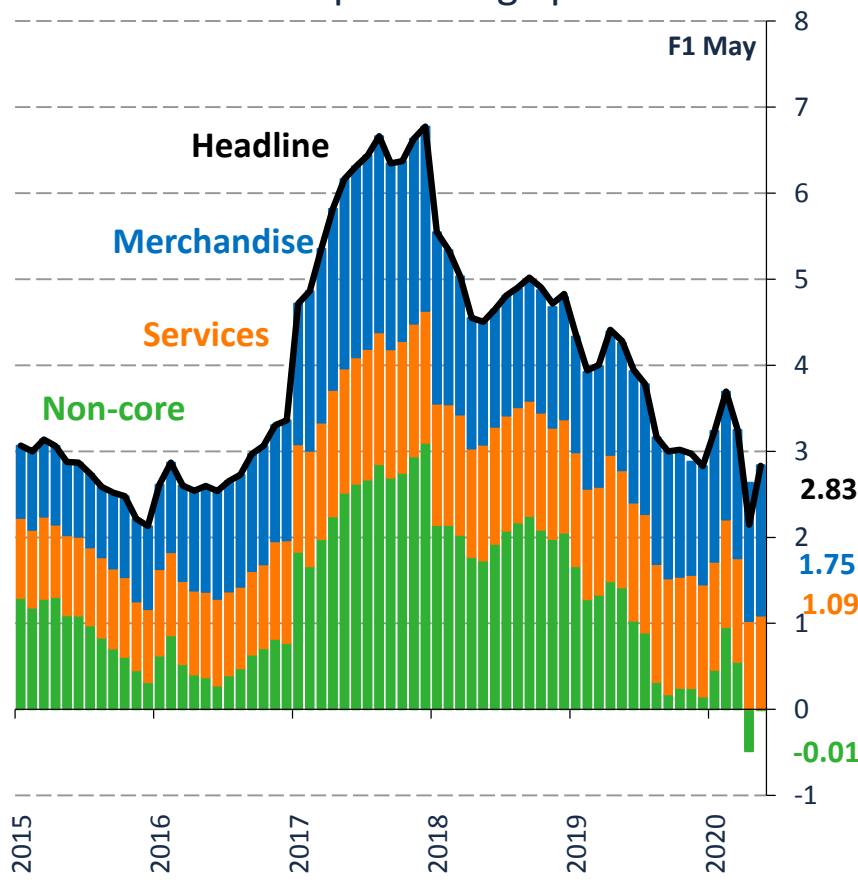
The effects of the pandemic can be seen in the recent evolution of inflation. Significant falls in gasoline prices exerted downward pressure on non-core inflation, although in F1-May these prices somewhat reverted. Core inflation, on the other hand, seems to be affected by changes in the relative demand for different goods and services. In that context, in F1-May annual headline inflation laid at 2.83% and core inflation at 3.76%.

Consumer Price Index

Annual % change ^{1/}



Incidences in percentage points ^{2/}

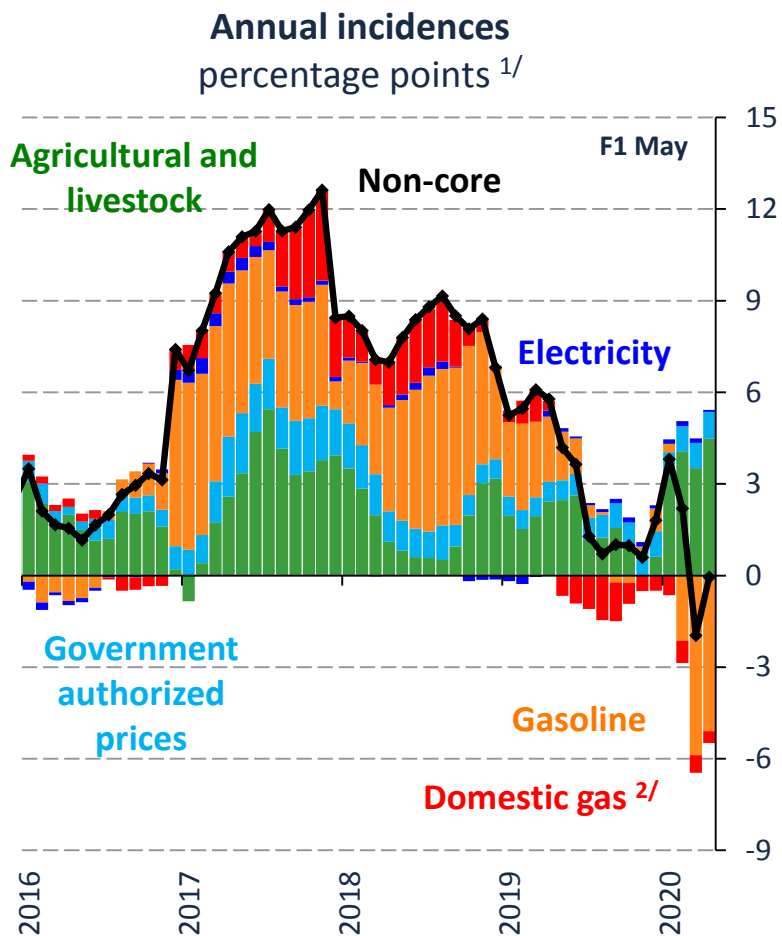


1/ Since 2003, a permanent inflation target of 3%, with a variability interval of +/-1%, was established for headline inflation. Source: Banco de México and INEGI.

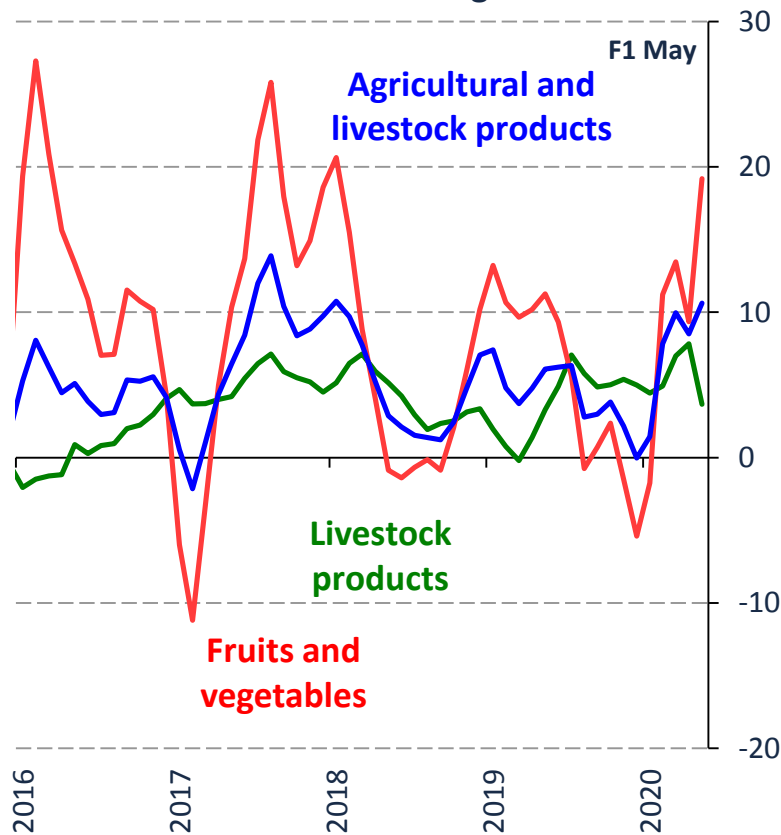
2/ The sum of inflation's components may not add up due to rounding. Source: Prepared by Banco de México with data from INEGI.

Non-core inflation grew at a higher rate in January and February, and subsequently, as a result of significant reductions in international energy references, it fell to -1.96% in April. In F1-May, it lay at -0.06%.

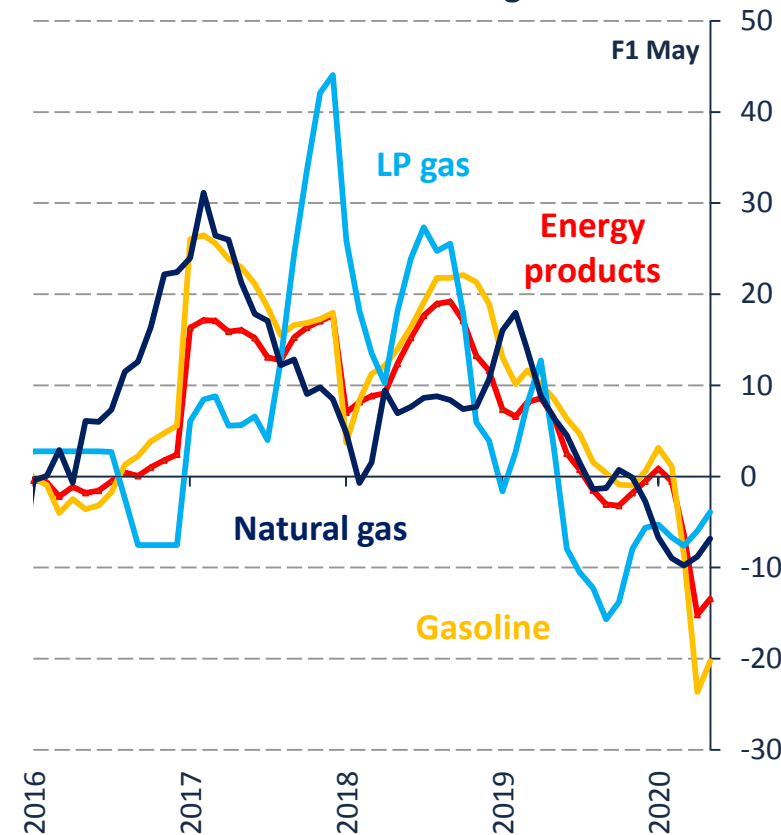
Non-core Price Subindex



Agricultural and Livestock Products
Annual % change



Selected Energy Price Indexes
Annual % change



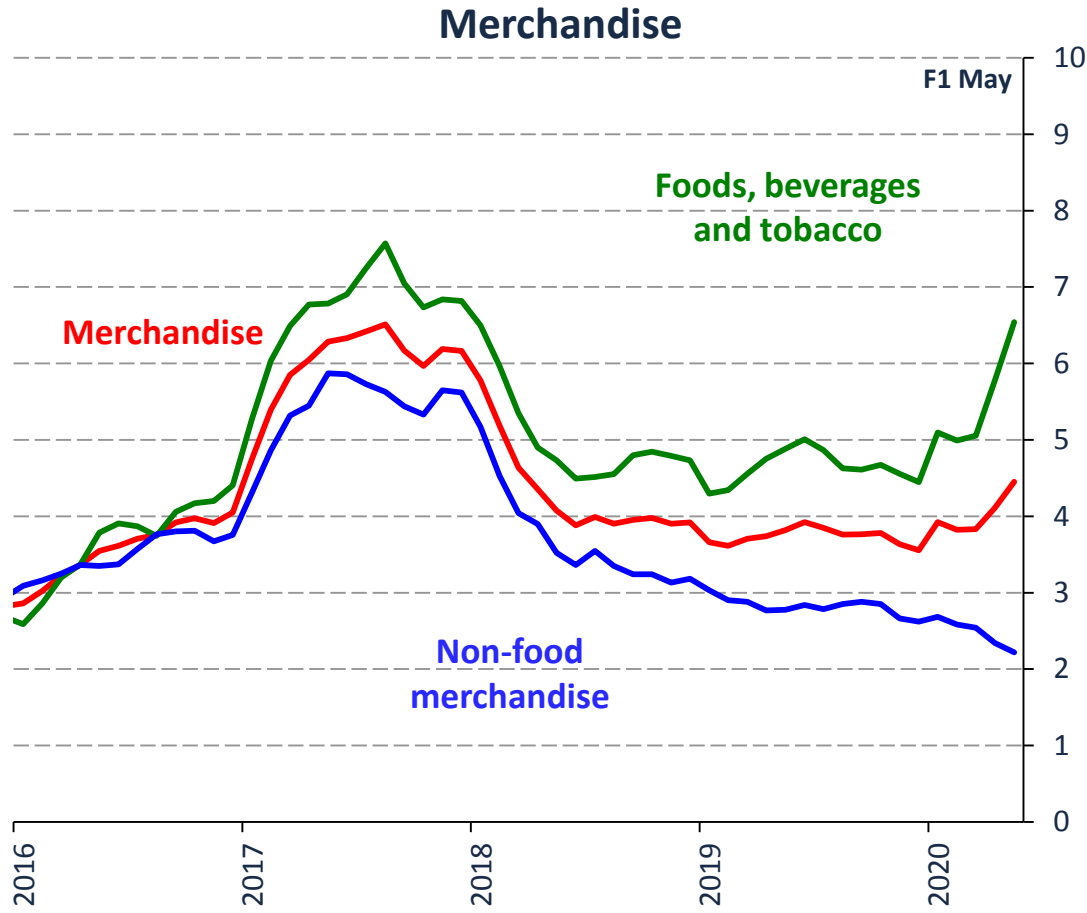
1/ In certain cases, the sum of inflation's components may not add up due to rounding. 2/ Includes LP gas and natural gas.
Source: Calculated by Banco de México with data from INEGI.

Source: Banco de México and INEGI.

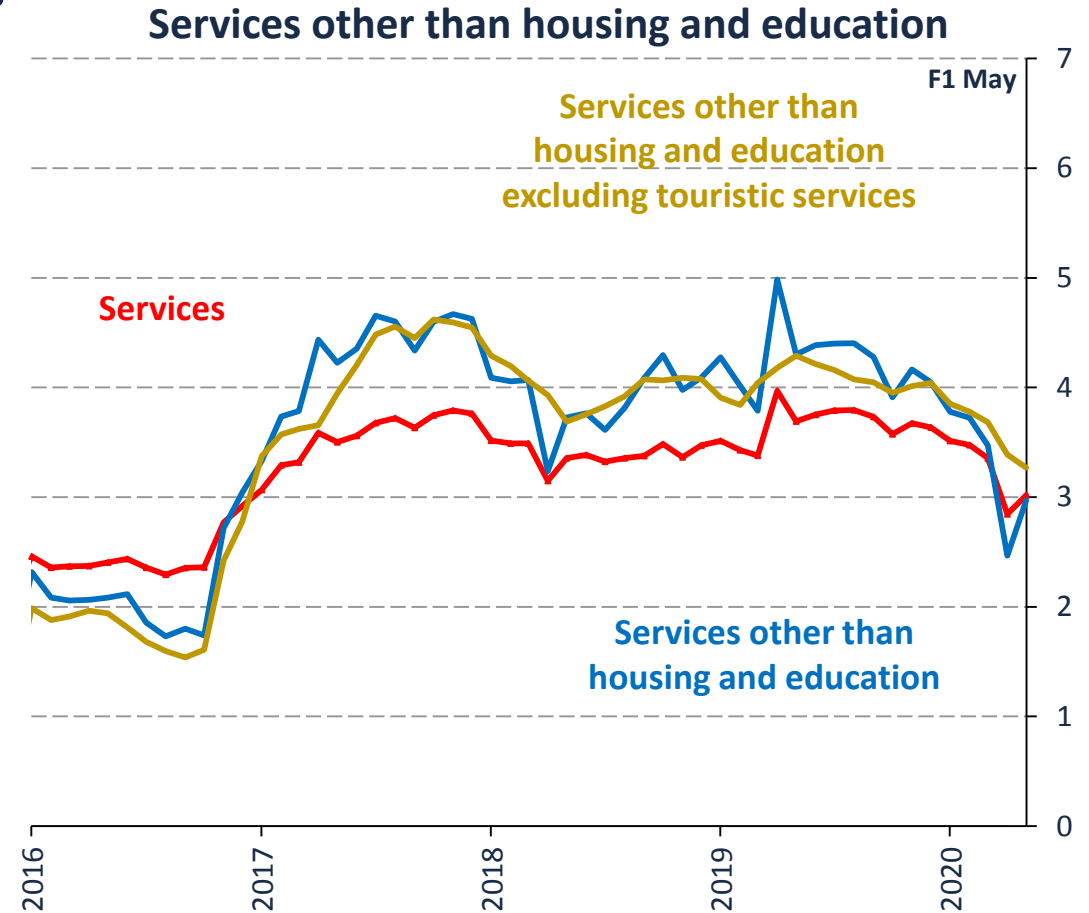
Source: Banco de México and INEGI.

Social distancing measures have led to a decline in services prices, particularly of tourism, although this is also evident in other line items such as food prices. In contrast, the prices of certain goods have been subject to upward pressures, which may have increased their demand as a result of the health crisis. Among these are food, medicines and household products.

Core Price Subindex Annual % change



Source: Banco de México and INEGI.



Source: Banco de México and INEGI.

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The shocks stemming from the pandemic are significantly affecting, in a simultaneous way, economic activity, financial conditions, and the inflation process in Mexico, which implies that the outlook for monetary policy is complicated.

February

25 bp reduction
to 7.0%

- ✓ The following were considered:
 - *The levels of headline inflation, the slack conditions in the economy, and the behavior of both external and domestic yield curves.*

March

(Moved forward)
50 bp reduction
to 6.5%

- ✓ Taking into account the risks for inflation, economic activity and financial markets derived from the COVID-19 pandemic, which pose significant challenges for monetary policy and the economy in general. Given the foreseen impact and considering the impact that on balance these grant monetary policy.

April

(Unscheduled decision)
50 bp reduction
to 6.0%

- ✓ In its March and April meetings, the Governing Board decided to implement additional measures to foster an orderly behavior of financial markets, strengthen the credit channels in the economy, and provide liquidity for the sound development of the financial system.

May

50bp reduction
to 5.5%

The additional measures announced in March and April were for four purposes:

A To provide liquidity and reestablish trading conditions in the money market

- I. **Reducing the Monetary Regulation Deposit (DRM, for its acronym in Spanish)** by 50 billion pesos.
- II. **Adjusting the Ordinary Additional Liquidity Facility (FLAO, for its acronym in Spanish)** interest rate.
- III. **Increasing liquidity** during trading hours.
- IV. **Extending the securities eligible** for the FLAO, and for foreign exchange hedging program operations and USD credit operations.
- V. **Extending the counterparts eligible** for the FLAO.
- VI. Implementing a **government securities term repurchase window**.

B To promote an orderly behavior in the government and corporate securities markets

- I. **Strengthening the Government Debt Market Makers Program**.
- II. Implementing a **temporary securities swap window**.
- III. Implementing **swaps of government securities**.
- IV. Implementing a **Corporate Securities Repurchase Facility (FRTC, for its acronym in Spanish)**.

C To strengthen the channels of credit provision

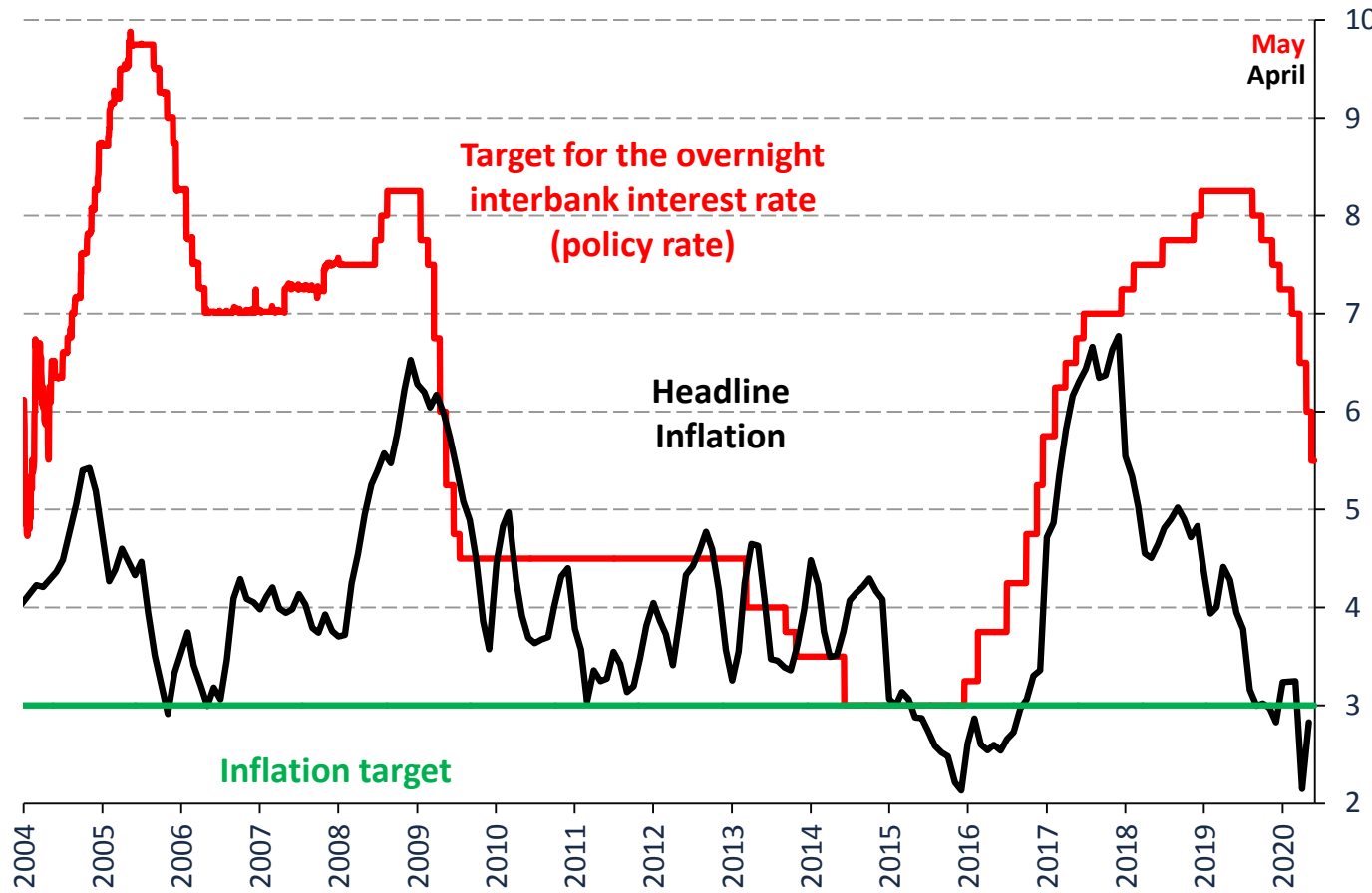
- I. Providing **resources to channel credit to micro, small- and medium-sized firms** as well as to **individuals** affected by the pandemic.
- II. Implementing a **collateralized financing facility** for commercial banks with corporate loans, to finance micro, small- and medium-size firms.

D To promote an orderly behavior in the foreign exchange market

- I. **Strengthening the USD foreign exchange hedges program** payable in pesos.
- II. Carrying out **USD auctions** through the **temporary US dollar swap line** with the US Federal Reserve.
- III. Establishing **foreign exchange hedges** settled by differences in US dollars **with non-resident counterparts**.

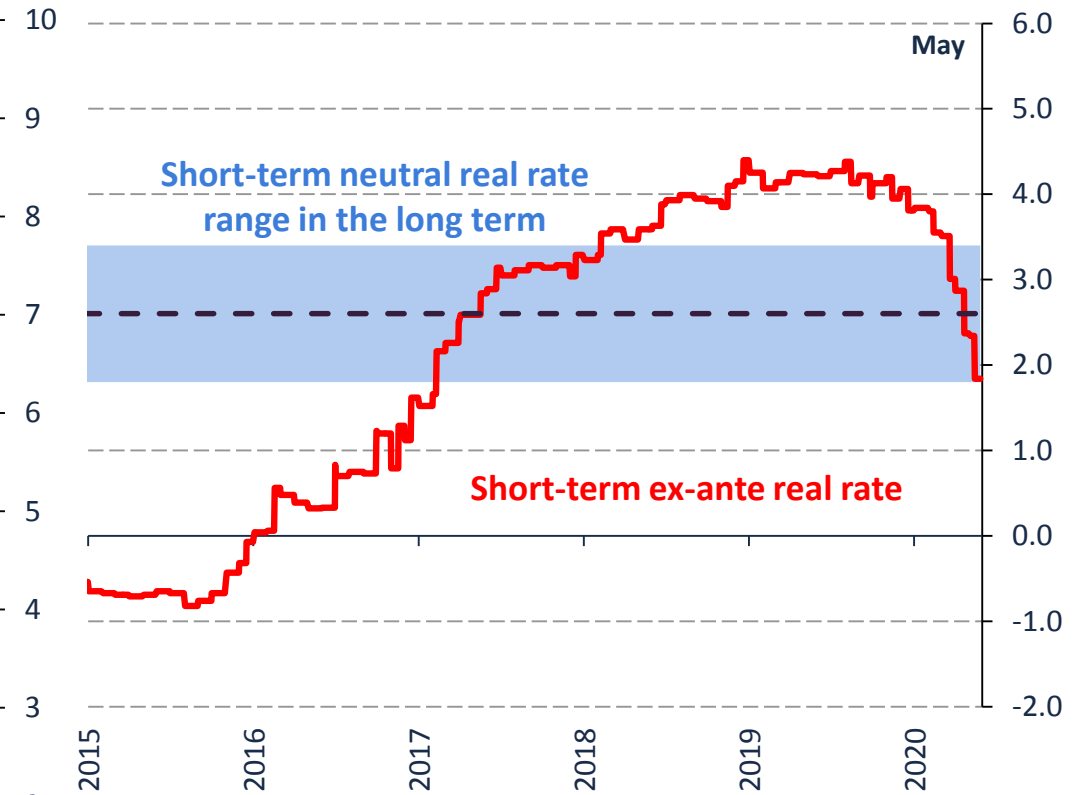
Considering the implemented monetary policy actions (reduction of 175 basis points in the year), the target for the overnight interbank funding rate (policy rate) is currently at 5.5%.

Monetary Policy Rate and Consumer Price Index ^{1/}
% and annual % change



^{1/}The data shown up to January 20, 2008 corresponds to the overnight interbank interest rate (policy rate). Source: Banco de México and INEGI.

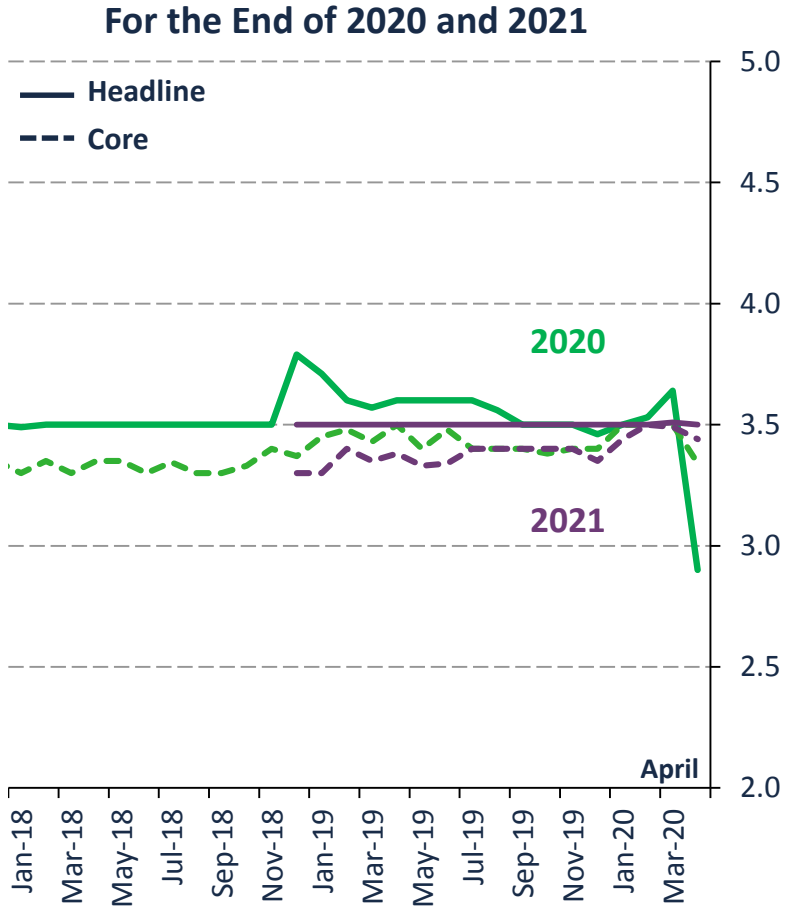
Short-term Ex-ante Real Rate and Estimated Range for the Short-term Neutral Real Rate in the Long Term ^{2/}
%



^{2/}The short-term ex-ante real rate is constructed using the Target for the Overnight Interbank Interest Rate and 12-month inflation expectations from Banco de México's Survey. The dotted line corresponds to the midpoint of the range for the short-term neutral real rate in the long term, which is now between 1.8 and 3.4%. Source: Banxico

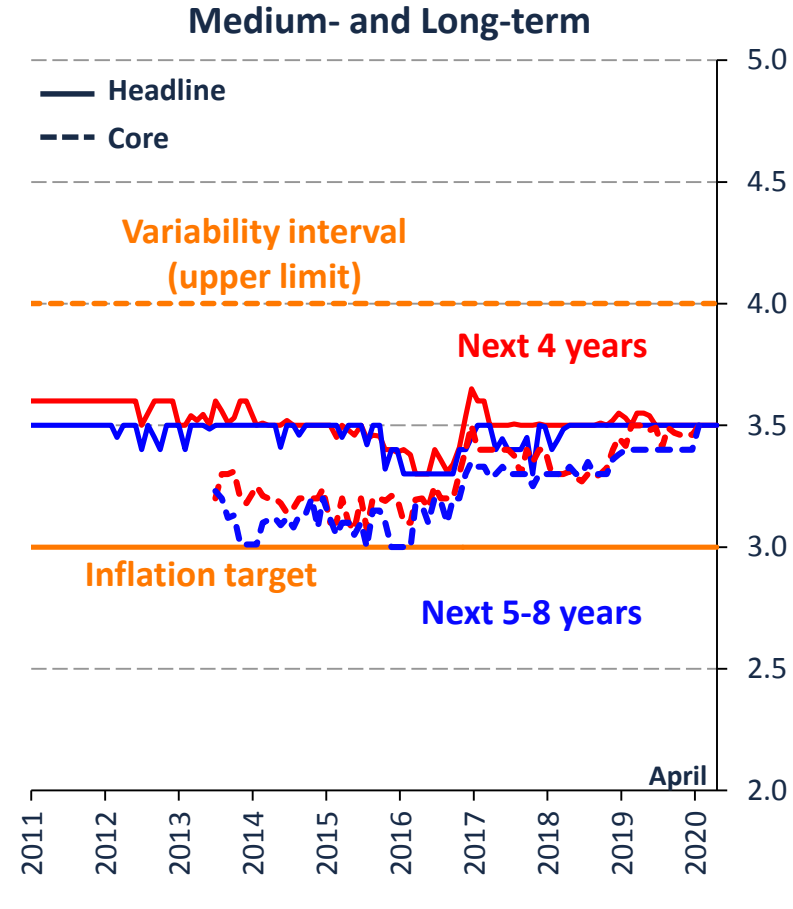
Headline inflation expectations for the end of this year were adjusted significantly downward in April. Expectations for the end of 2021, as well as for the medium and long terms, remained relatively stable. Breakeven inflation implied in market instruments has been decreasing.

Inflation Expectations Median, %



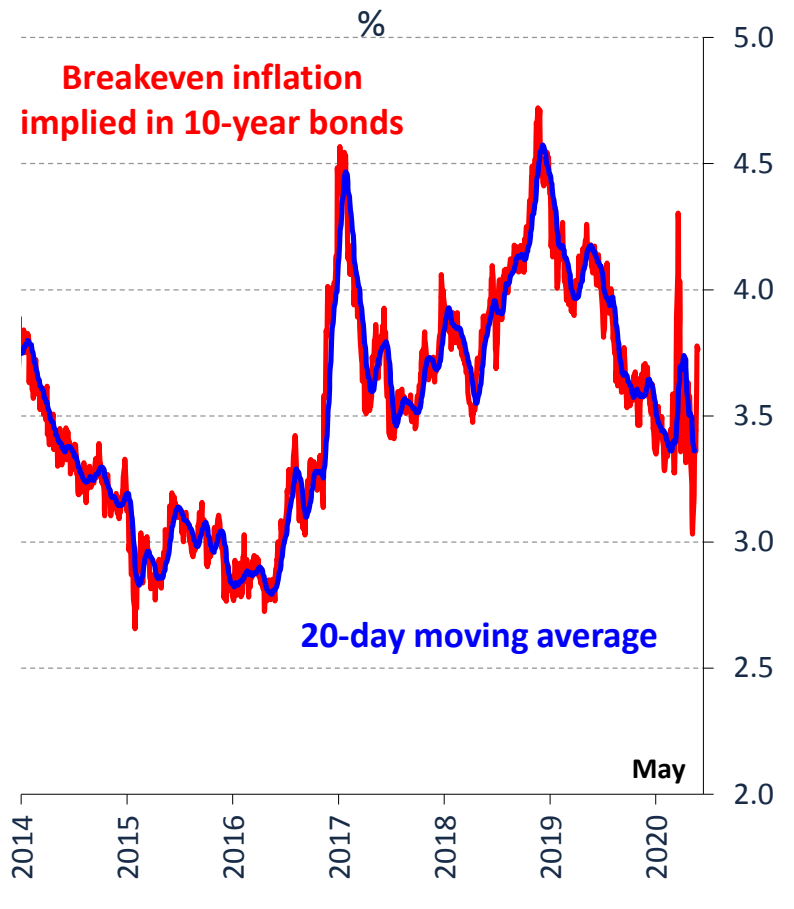
Source: Banco de México's Survey of Private Sector Forecasters.

Inflation Expectations Medium- and Long-term



Source: Banco de México's Survey of Private Sector Forecasters.

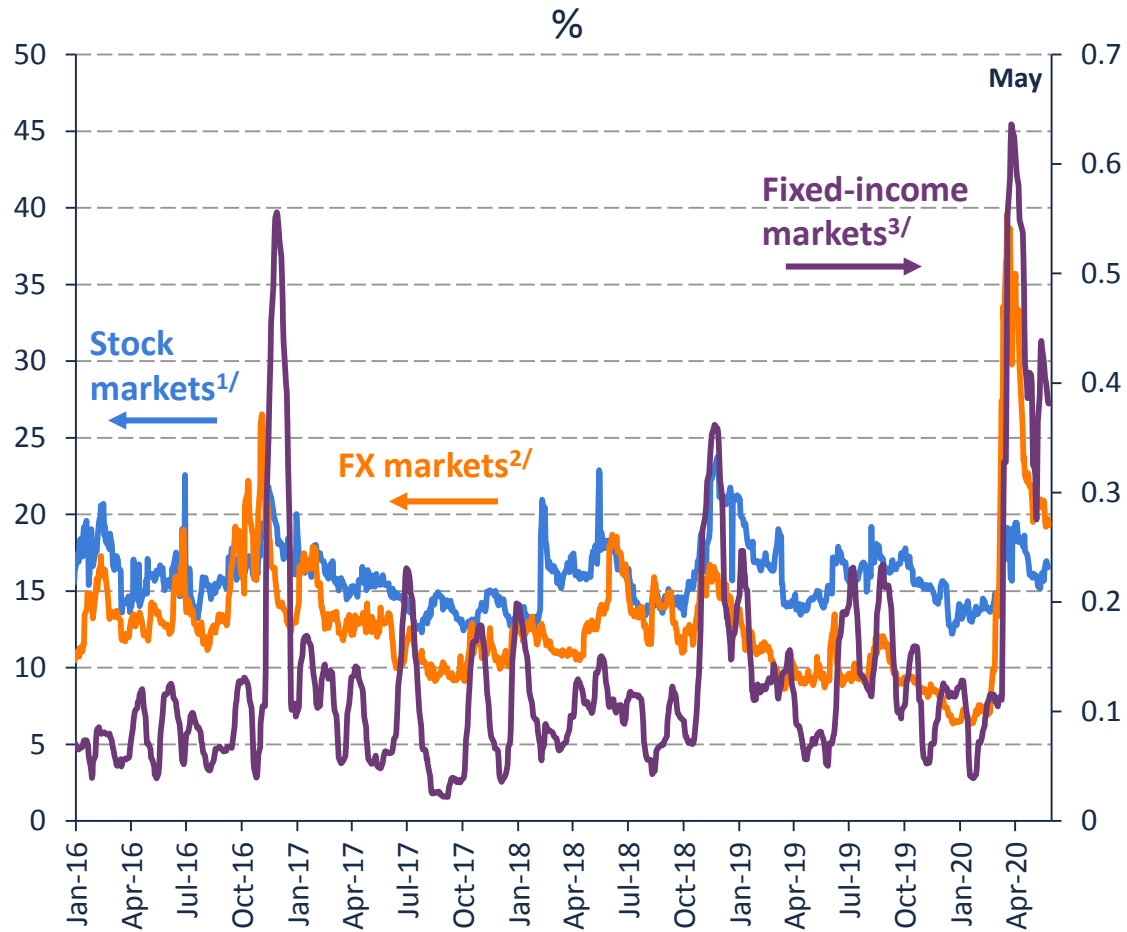
Breakeven Inflation and Inflation Risk Implied in Bonds



Note: Breakeven Inflation and Inflation risk is calculated as the difference between nominal and real long-term interest rates.
Source: Estimated by Banco de México's with Valmer and PiP data.

The improved performance of international financial markets, together with the monetary policy actions implemented in Mexico, resulted in a better performance of domestic markets, although volatility remains high.

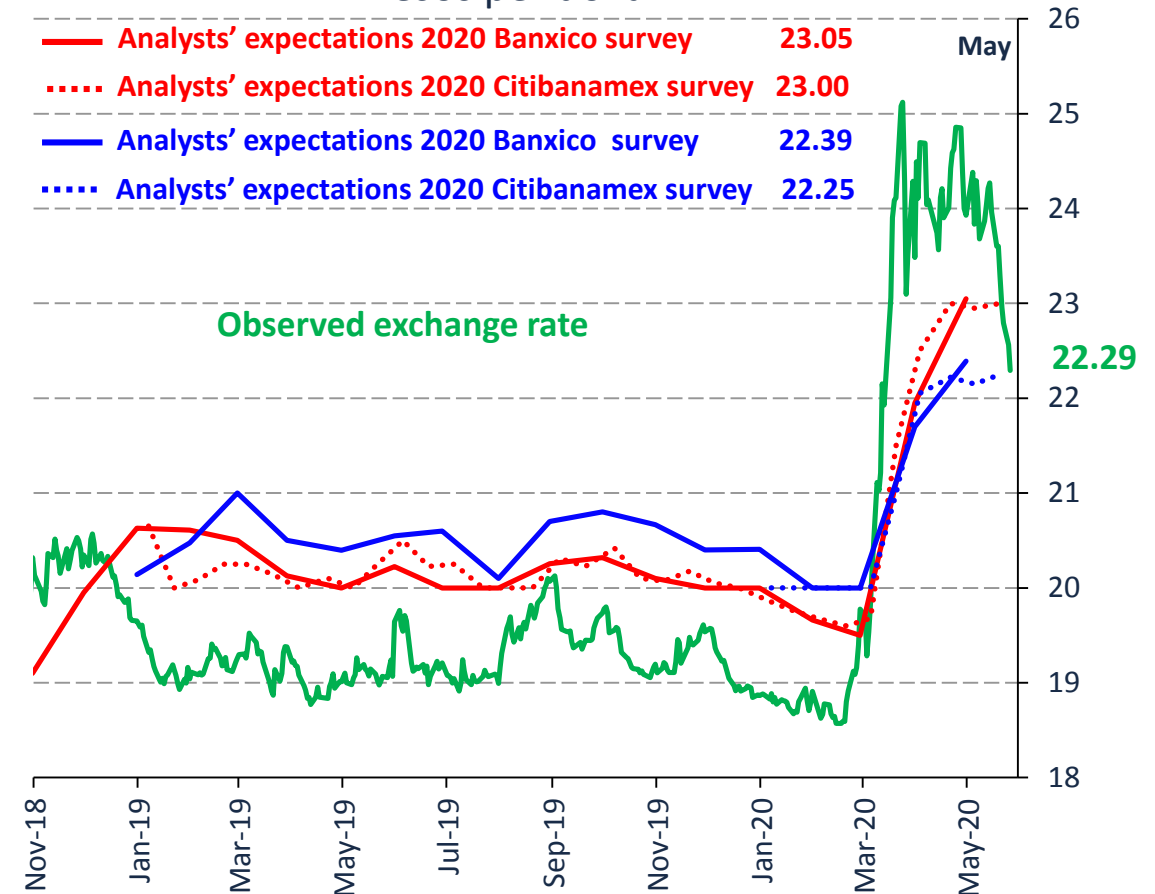
Volatility in Mexican Financial Markets



1/ Refers to the volatility index of S&P of the Mexican Stock Exchange.
 2/ Refers to volatility implied in 1-month Mexican peso options.
 3/ Refers to a standard deviation of a 30-day moving window of 10-year interest rates in Mexico.
 Source: Bloomberg and Proveedor Integral de Precios (PiP).

Nominal Exchange Rate ^{4/}

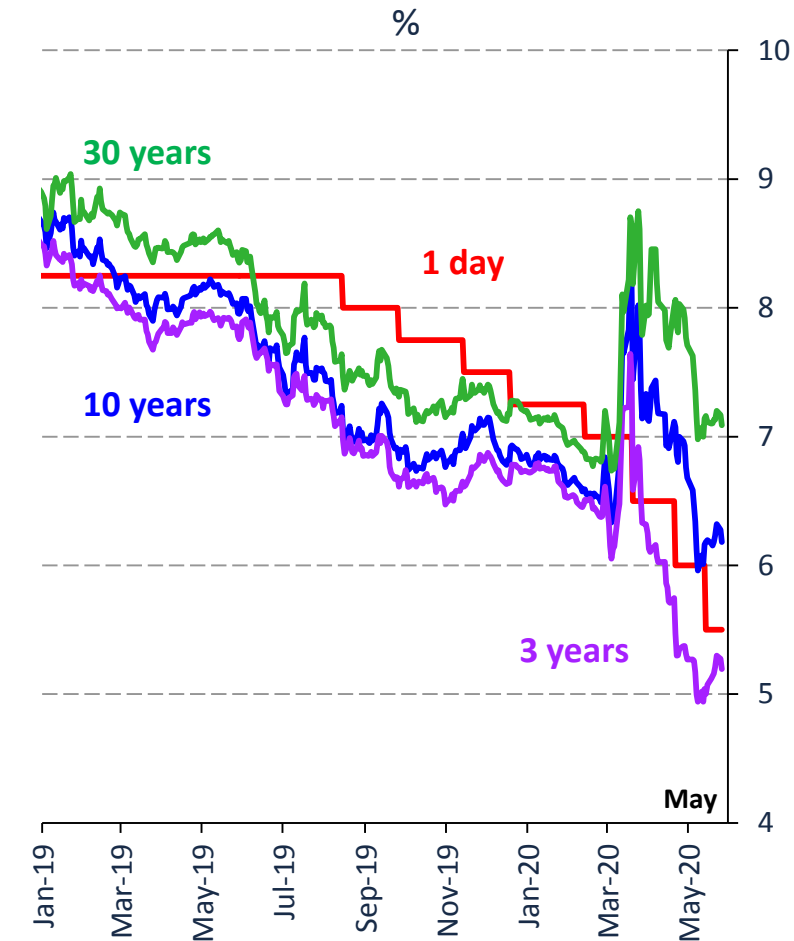
Pesos per dollar



4/ Observed exchange rate refers to the daily FIX exchange rate. Figures aside analysts' expectations correspond to the medians of Banco de México's survey for April and the Citibanamex survey for May 20, 2020.
 Source: Banco de México and Citibanamex.

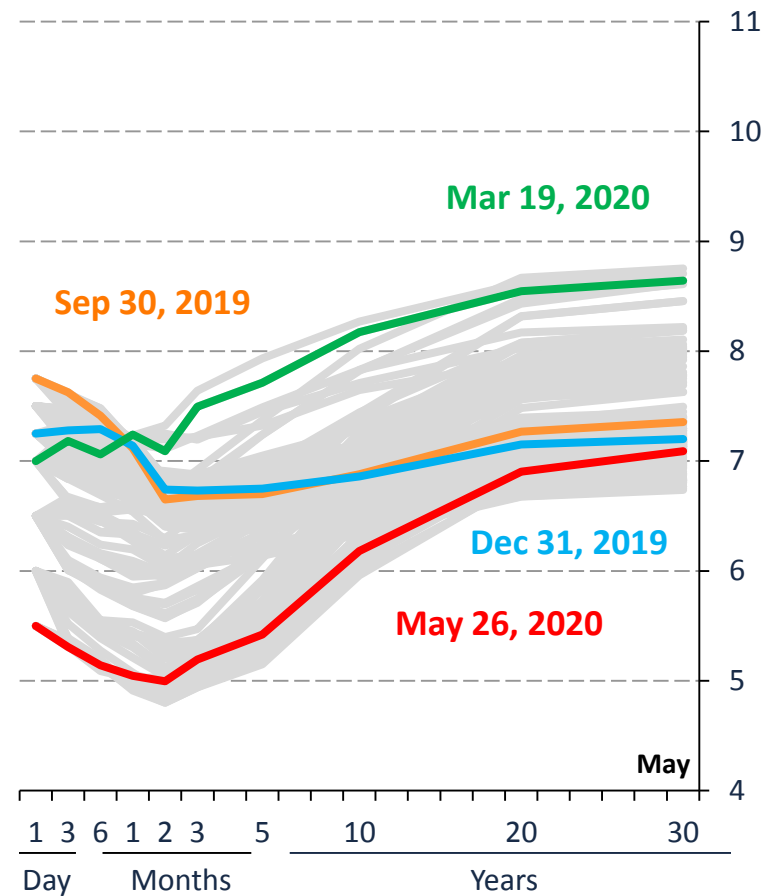
At the end of February and in March, the yield curve increased in all its terms, although more for longer-term ones. Subsequently, interest rates were adjusted downwards, short- and medium-term ones to a larger extent.

Target for the Overnight Interbank Interest Rate and Government Bond Yields



Source: Proveedor Integral de Precios (PiP).

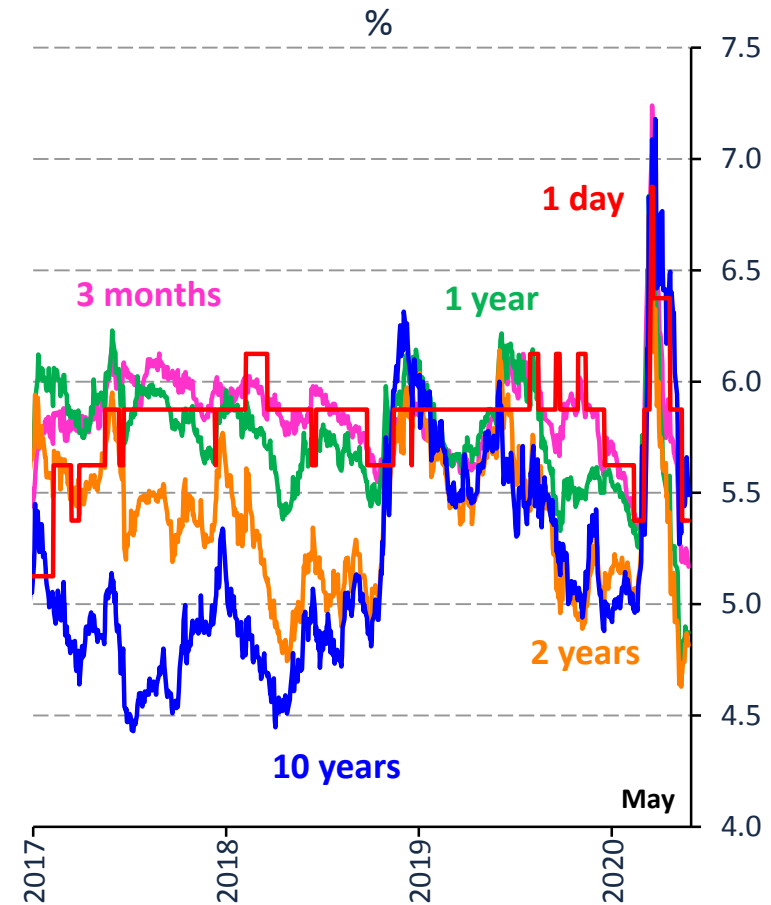
Yield Curve of Mexico



Note: The gray lines refer to the daily yield curves since September 30, 2019.

Source: Proveedor Integral de Precios (PiP).

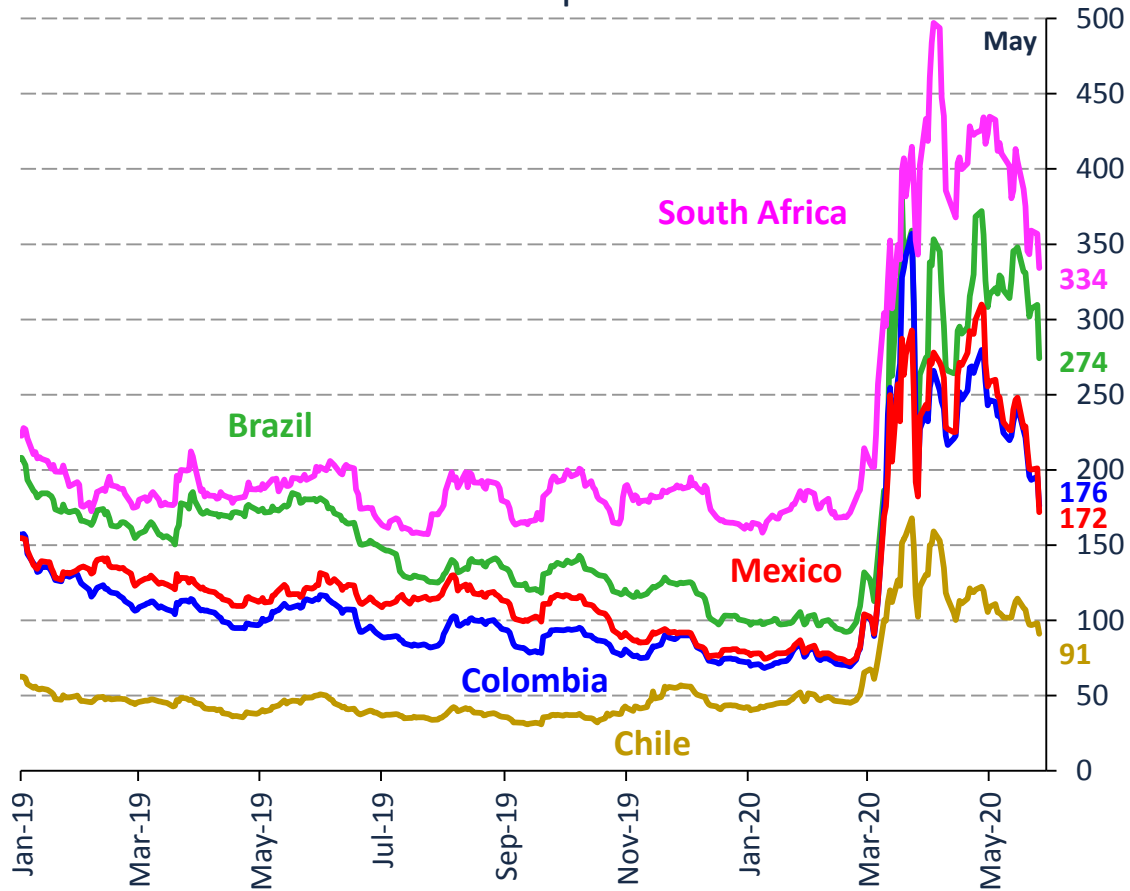
Interest Rate Spreads between Mexico and the United States ^{1/}



^{1/} For the US federal funds target rate, the average of the interval considered by the US Federal Reserve is taken into account.
Source: Proveedor Integral de Precios (PiP).

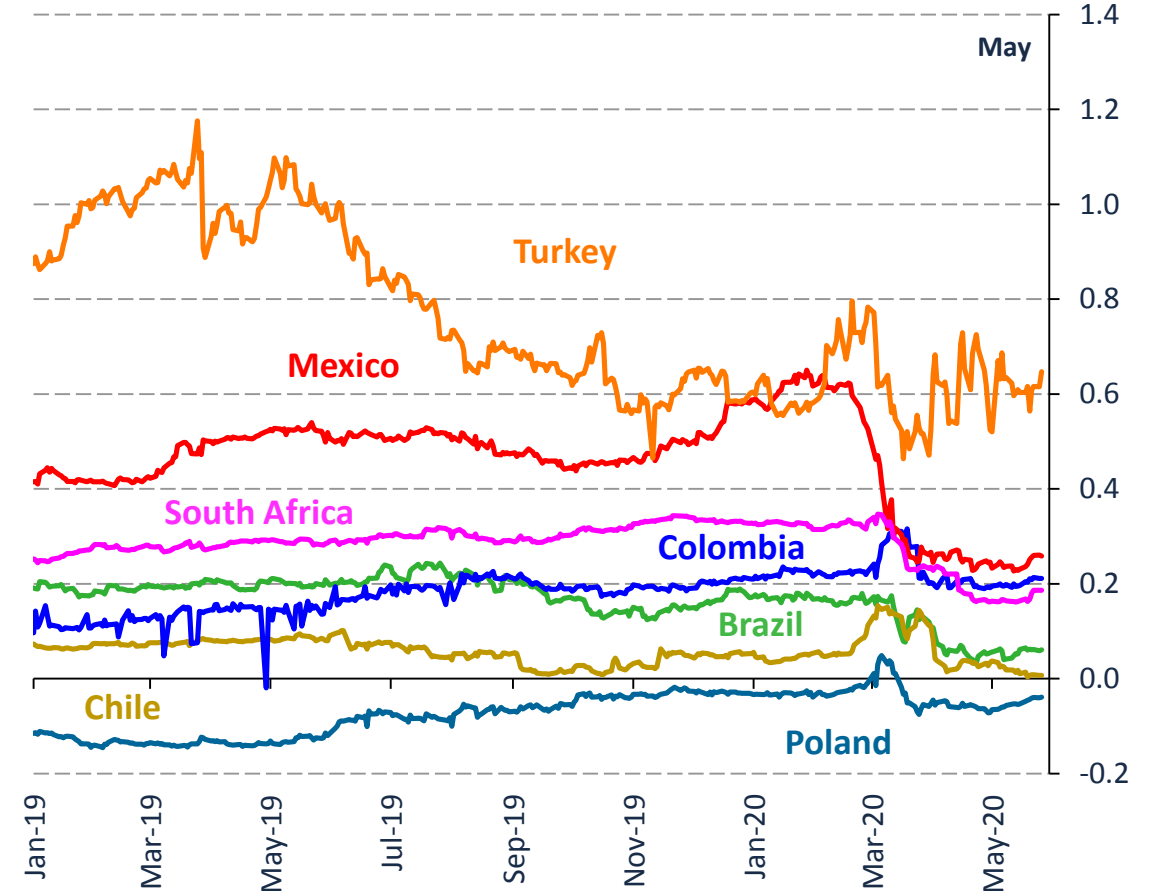
Market indicators measuring sovereign credit risk in Mexico increased as in other emerging economies, although they were higher than in those of economies with comparable credit ratings. Volatility-adjusted spreads (in Mexican pesos) between Mexico and United States interest rates have been adjusting downwards.

Market Indicators that Measure the Domestic Sovereign Credit Risk¹
Base points



^{1/} Refers to 5-year Credit Default Swaps (CDS).
Source: Bloomberg.

Volatility-adjusted Spreads between US 1-year Interest Rates and those of Emerging Economies
Index



Note: Estimates calculated with the spread implied in 1-year foreign exchange forwards, adjusted for the implied volatility in the same term. Source: Prepared by Banco de México with data from Bloomberg.

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Economic Activity Forecasts

- The fact that the COVID-19 pandemic is still underway both globally and domestically **generates a high level of uncertainty for any forecast for economic activity:**
 - ✓ *Uncertainty regarding the duration and severity of the lockdown measures.*
 - ✓ *In light of an eventual easing or lifting of lockdown measures, there is the risk of second-round spreads.*
 - ✓ *The timing as to when there could be an effective treatment or vaccine is still uncertain.*

➤ ***Given such uncertainty, a forecast baseline scenario for economic activity like the one usually published by Banco de México in its quarterly reports might suggest a higher level of precision to what the current conditions of available information allow for attaining.***

➤ ***Constructing various scenarios on the possible behavior of productive activity, based on different assumptions on the depth and duration of the consequences of the pandemic, might provide a better outlook of GDP for 2020 and 2021 (several central banks have adopted a similar strategy).***

Economic Activity Forecasts

GDP Growth Scenarios %

Report		2020	2021
Previous		0.5 to 1.5	1.1 to 2.1
Current Report	V-shaped	-4.6	4.0
	Deep V-shaped	-8.8	4.1
	Deep U-shaped	-8.3	-0.5

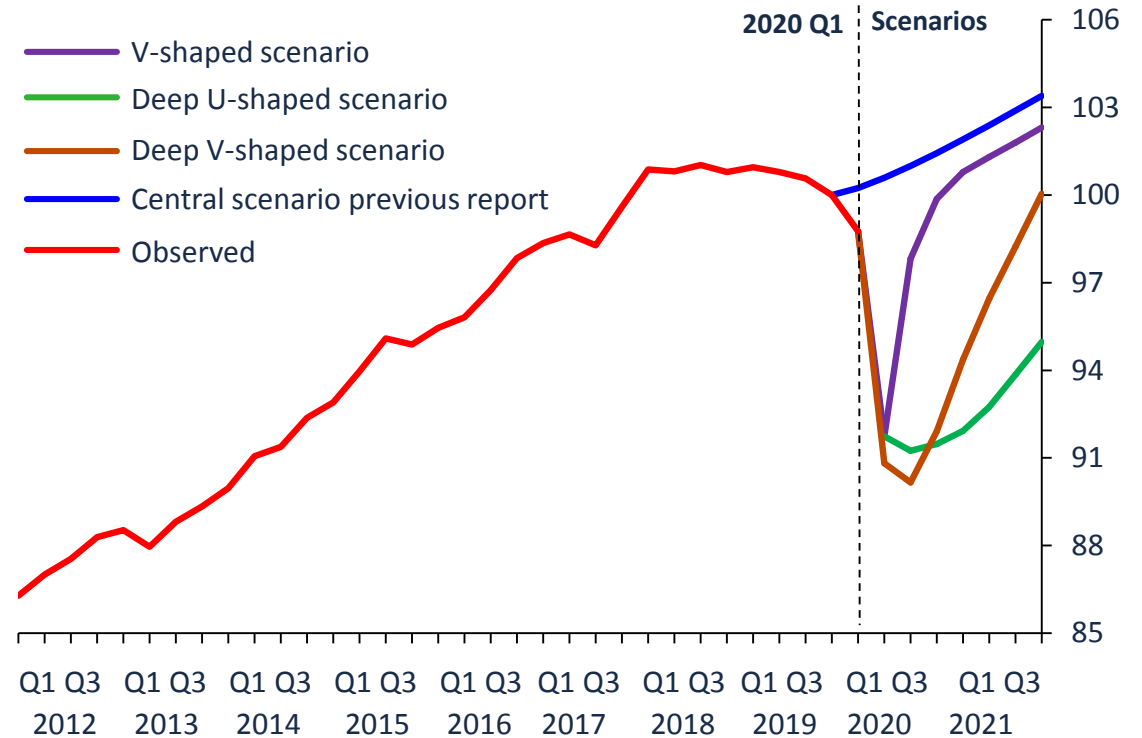
Increase in Number of IMSS-insured Jobs Thousands

Report	2020	2021
Previous	440 a 540	470 a 570
Current	-1,400 a -800	-200 a 400

Current Account Deficit % of GDP

Report	2020	2021
Previous	-0.9	-1.5
Current	-1.5 a -0.3	-1.8 a -0.5

Estimates of Mexico's GDP Base indices Q4-2019 = 100, s. a.



s. a. / Seasonally adjusted series.

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

Risks for Growth

To the downside:

- ↓ That social distancing measures are extended or become more strict.
- ↓ Additional bouts of volatility in international financial markets.
- ↓ That the support measures adopted are not effective.
- ↓ That the pandemic' effects on the economy are more permanent.
- ↓ Additional downgrades in sovereign and Pemex debt credit ratings.
- ↓ Greater weakness of aggregate demand components.

To the upside:

- ↑ Effective lockdown measures to contain the spread of COVID-19.
- ↑ That the stimuli provided are effective in countering the effects of the pandemic and in supporting economic recovery.
- ↑ That the entry into force of the T-MEC leads to higher than expected investment.

Inflation Forecasts

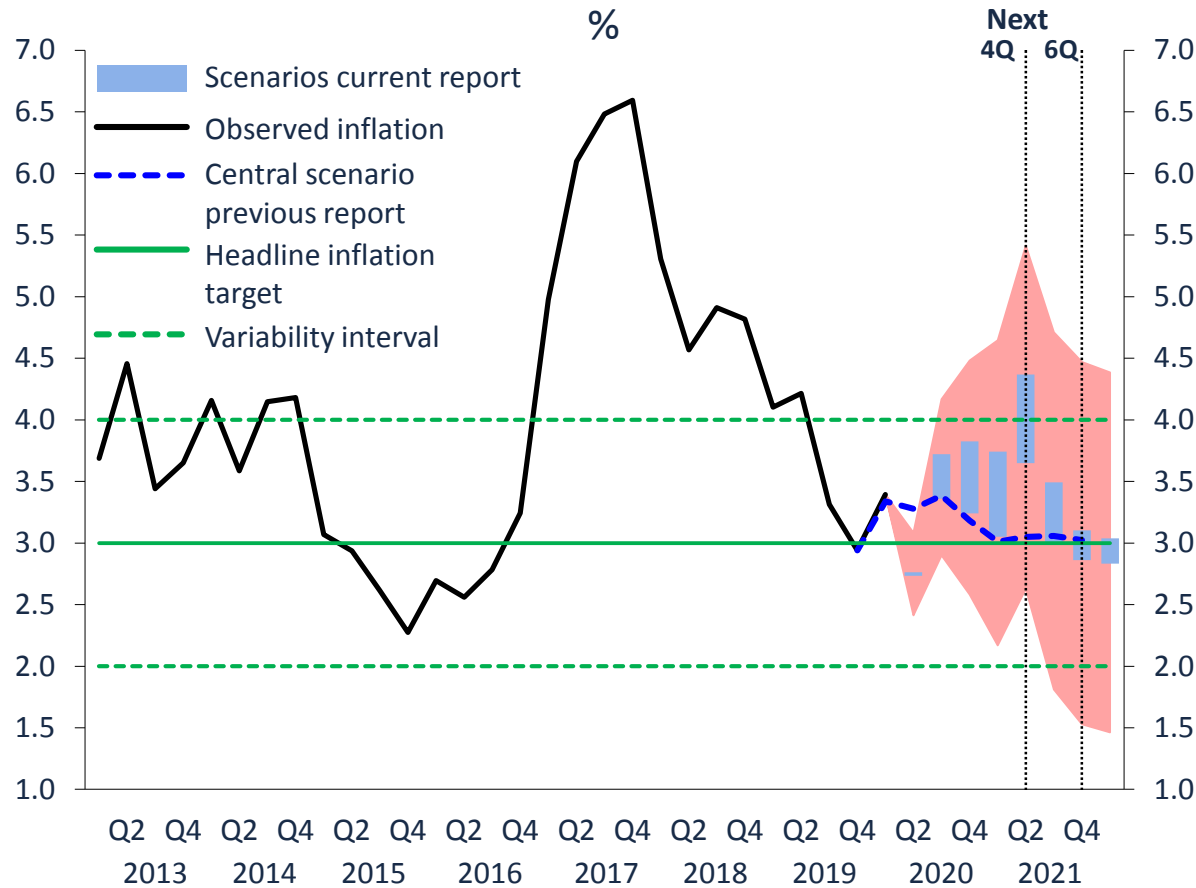
The uncertainty generated by the COVID-19 pandemic on the behavior of different economic and financial variables implies that the magnitude and duration of the shocks affecting inflation is also uncertain.

- Based on the trajectories of the macroeconomic variables resulting from the different scenarios described in the economic growth section, *paths for inflation* for the forecast horizon were elaborated. Said trajectories *reflect the downward and upward pressures that inflation would face under different scenarios*.
- Said pressures are:
 - ✓ *To the downside, the significant widening of the negative output gap, which differs in magnitude and depth among scenarios, as well as the fall in energy prices.*
 - ✓ *To the upside, the depreciation of the foreign exchange rate, which also differs among scenarios, and possible disruptions to the production and distribution chains of several goods and services.*
- Said pressures tend to counteract among themselves in different directions.
- Although the trajectories for inflation reveal higher uncertainty than those published in previous inflation reports, they also *show a lower dispersion than that for economic activity scenarios*.

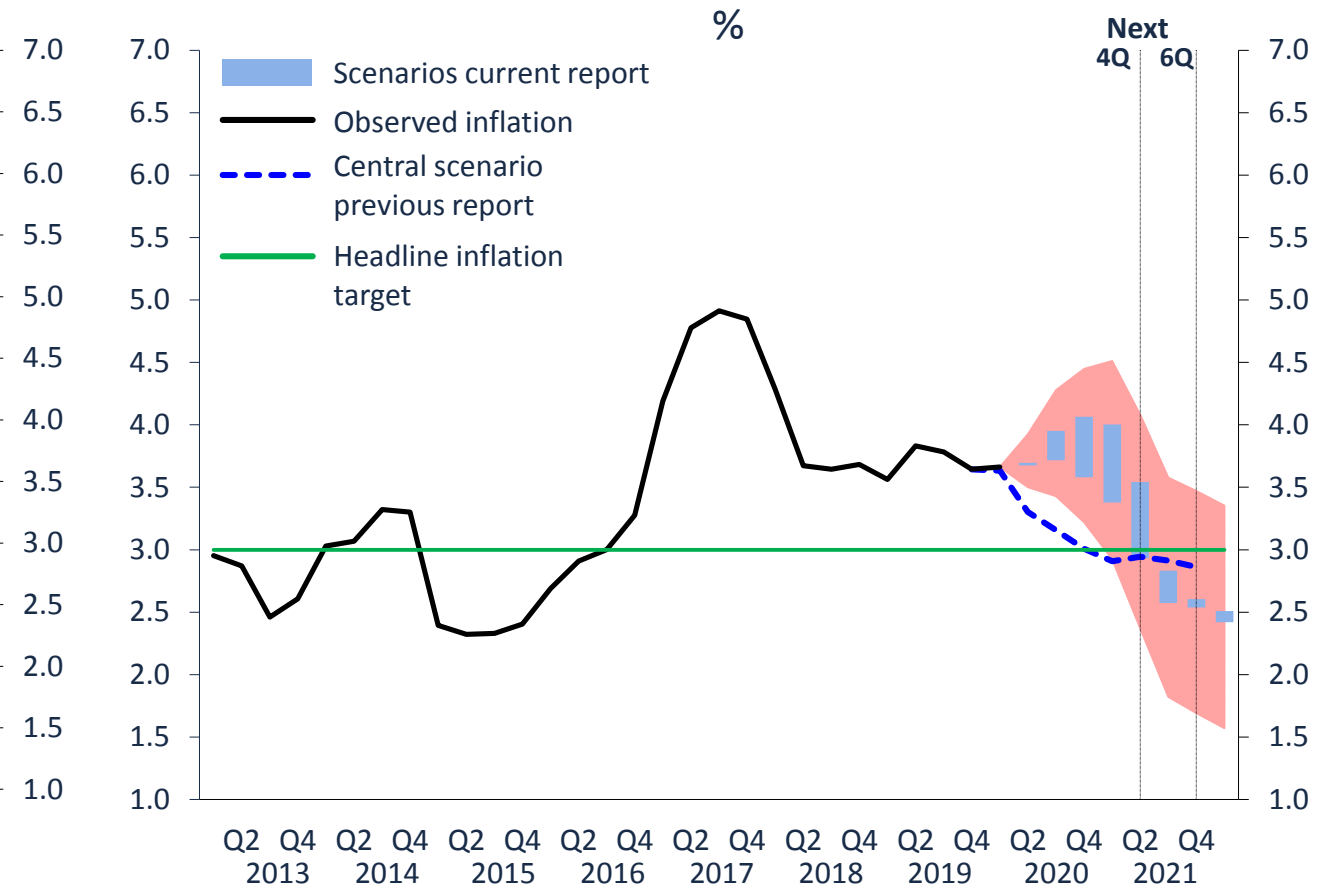
- **Annual headline inflation** is expected to lay within Banco de México's variability interval during the larger part of the forecast horizon, and to locate around the inflation target by the end of said horizon.
- **Core inflation** is expected to be higher than previously anticipated up to H1-2021 due to its high persistence, the foreign exchange rate depreciation, and pressures due to the lockdown measures, while for H2-2021 it is expected to be below 3% due to the effects of the greater economic slack.

Fan Charts^{1/}

Annual Headline Inflation



Annual Core Inflation



^{1/} Quarterly average of annual headline and core inflation. **Note:** Blue bars are presented to indicate the minimum and maximum levels that inflation would reach in the estimated scenarios for each quarter. Uncertainty can be represented by the shaded area in red. The next four and six quarters are shown as of the first quarter of 2020, that is, the second and fourth quarter of 2021, respectively; periods in which the monetary policy transmission channels fully operate. Source: Banco de México e INEGI.

Inflation Forecasts

- From the inflation forecasts resulting from the three scenarios, the **minimum** and **maximum** level that inflation would reach in each of the quarterly estimates of the forecast horizon was obtained, for **both headline and core inflation**.
- If inflation locates **at the center** of these intervals, the following **trajectories** would be observed:

**Headline Inflation
Estimated Trajectories**

	2020				2021				2022
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
Current ^{1/}	3.4	2.7	3.5	3.5	3.4	4.0	3.2	3.0	2.9
Previous ^{2/}	3.3	3.3	3.4	3.2	3.0	3.0	3.1	3.0	

**Core Inflation
Estimated Trajectories**

	2020				2021				2022
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
Current ^{1/}	3.7	3.7	3.8	3.8	3.7	3.2	2.7	2.6	2.5
Previous ^{2/}	3.6	3.3	3.2	3.0	2.9	2.9	2.9	2.9	

1/ Forecasts since May 2020. 2/ Forecasts since February 2019. Source::Prepared by Banco de México with data from INEGI.

Risks to Inflation Outlook within the Forecast Horizon

The balance of risks for inflation remains uncertain

Downward risks

- ↓ Greater slackness and a lower demand for certain goods and services than the expected.
- ↓ Downward pressures on all types of imported goods and inputs in response to the global slack conditions.
- ↓ Falls in energy prices intensifying or becoming permanent.
- ↓ That the appreciation of the exchange rate continues.

Upward risks

- ↑ Greater demand for certain goods due to the health contingency.
- ↑ Greater or more persistent depreciation of the exchange rate.
- ↑ Disruptions in the production chains.
- ↑ Cost pressures associated with the pandemic.

Considering the magnitude of the shocks that are currently being faced, there could be **nonlinearities** or **additional effects** that might **exert greater pressures** on inflation, **both to downside and to the upside.**

Final Remarks

- **Banco de México will take the necessary actions** based on incoming information and considering the strong impact on production activity, as well as on the evolution of the financial shock faced by the economy, in such a way that **the policy rate is consistent with the orderly and sustained convergence of headline inflation to its target** in the time frame in which monetary policy operates.
- In the current juncture, Banco de México is particularly attentive **to promoting the sound development of the financial system** and fostering the **well-functioning of the payments system**.
- Thus, additional measures have been taken to promote the orderly behavior of financial markets, strengthen the provision of credit and to supply liquidity, strictly complying with the legal framework and in coordination with other financial authorities.
- Perseverance in **strengthening the macroeconomic fundamentals and adopting the necessary actions, regarding both monetary and fiscal policies**, will contribute to a better adjustment of domestic financial markets and of the economy as a whole.
- **The microeconomic functioning of the economy needs to be strengthened and domestic economic uncertainty must be reduced** in order to improve the country's business climate perception.

Annex – Boxes

- 1 Measures implemented in various economies to tackle the COVID-19 pandemic
- 2 Ex-ante estimation of COVID-19 pandemic's impact on economic activity in Mexico
- 3 Formal employment in the face of the COVID-19 pandemic
- 4 Impact of monetary policy easing on firms' financing costs
- 5 Product varieties available online on supermarkets websites in the context of the COVID-19 pandemic
- 6 Recent revisions to the sovereign and Pemex credit ratings
- 7 Economic policies considered in Mexico to confront the adverse outlook generated by the COVID-19 pandemic



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