BANCO DE MÉXICO

Executive Summary

Quarterly Report January – March 2020

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Summary

During the period covered by this Report, Banco de México has conducted monetary policy in an environment of high uncertainty and significant shocks. Since the end of February this year, the global economic and financial environment has become significantly adverse and more complex. This is due to the challenges and risks associated with the COVID-19 pandemic. As the outbreak expanded to a larger number of countries, including Mexico, and lockdown and social distancing measures have been implemented to contain the virus propagation, both the world economic activity and international financial markets have observed negative effects of utmost importance. Given the magnitude of these effects and their uncertain duration, a global economic crisis has started to materialize. This crisis is unprecedented in the last decades due to its characteristics, such as having its origin in a health emergency rather than in an economic or financial cycle, as well as its sudden impact on the real sector and its rapid global spread. This has had, and is expected to continue having, significant repercussions on financial markets, on productive activity, and on the inflationary process in Mexico.

The COVID-19 pandemic has affected the world economic activity considerably. This has led to unprecedented revisions of economic expectations, which include a strong contraction of productive activity in 2020. This, in turn, has contributed to a sharp fall in commodity prices, especially of crude oil, which, in view of an anticipated lower demand and the lack of storage capacity, have decreased significantly despite the agreement achieved among oil producing countries to reduce oil supply. The fall in energy prices and a lower demand due to the pandemic have resulted in a decline in headline inflation in most economies, in some cases remaining below their respective central banks' targets. All of the above led numerous central banks to lower interest rates significantly and to implement other extraordinary measures to foster the well-functioning of their financial systems. Likewise, numerous countries have implemented fiscal stimulus measures to mitigate the adverse effects on employment and on households and firms' income. Furthermore, the effects of the pandemic have also led to a significant deterioration of global financial conditions, causing a recomposition of investors' portfolios towards lower-risk assets, and to the largest contraction on record in the holdings of emerging economies' assets, especially of fixed-income instruments. The actions taken by advanced economies to provide liquidity and to restore financing have contributed to a more stable behavior of international financial markets. Nevertheless, global financial conditions will remain dependent on the outlook for the effects of the pandemic.

> Different countries have implemented extraordinary economic measures to mitigate the negative consequences of the pandemic on households' income, to protect jobs, and to contain the propagation of the negative effects across the real and financial sectors. These measures, which include fiscal, monetary, foreign exchange and financial sector policies, are described in the analytical box *Measures Implemented in Various Economies to Tackle the COVID-19 Pandemic*. To overcome the crisis, all available public policy instruments should be used in a decisive and coordinated manner. For emerging economies, the challenge is greater since, besides the health emergency, the economic contraction and the tightening of financial conditions, these economies have also been affected by an increase in risk aversion, the fall in commodity prices and, in some cases, by credit rating downgrades. This has posed serious dilemmas for these economies, limiting their policy response as compared to the main advanced economies.

As a result of this complex juncture, the Mexican economy is currently facing a combination of different shocks that are simultaneous and of considerable magnitude, generated by the COVID-19 pandemic and by the actions implemented to prevent its spread. In general, three main transmission channels can be distinguished:

i. Supply-related shock. Measures aimed at containing the virus spread, such as shutdowns in manufacturing production and in different services, among others, have resulted in a fall in supply. Indeed, these effects have jeopardized the functioning of global value chains and the provision of inputs for domestic production.

ii. Demand-related shock. As a result of the global spread of the pandemic, the Mexican economy is facing a lower external demand. Likewise, social distancing measures implemented in Mexico, the fear of contagion among the population, and lower levels of income of firms and households are leading to a contraction of domestic demand.

iii. Financial shock. Given the considerable increase in risk aversion in international financial markets and the fall in crude oil prices, the Mexican economy has faced a financial shock that brought about a considerable tightening of external financing and capital outflows, significant increases in interest rates and risk premia, along with a significant depreciation of the peso exchange rate.

Delving into the effects of the financial shock on domestic markets, in late February 2020 the foreign exchange market exhibited a deterioration in trading conditions and a considerable increase in its volatility. The Mexican peso depreciated significantly against the US dollar. Meanwhile, interest rates along the yield curve in Mexico and risk premia increased importantly. Nevertheless, over the last weeks, Mexican financial markets have performed better, registering lower yields on government securities for all terms, while the peso exchange rate traded in a narrower range. Although domestic financial markets improved slightly, important risks to their evolution persist. Also, three agencies have downgraded both the sovereign and Pemex credit ratings, while two of them revised the latter to below investment grade.

The box *Recent Revisions to the Sovereign and Pemex Credit Ratings* presents a detailed recount of the downgrades to Mexico's sovereign and Pemex credit ratings by the main rating agencies during the first four months of 2020. This analytical box is an update of those presented in the Quarterly Reports of July-September 2018 and of April-June 2019, as well as in the Financial Stability Report of June 2019.

Furthermore, the referred shocks have already had repercussions on productive activity and inflation in Mexico. Indeed, although since the beginning of 2020 and prior to the COVID-19 spread economic activity had remained stagnant for several quarters, in March production was affected by the major weakening of the global economy and the disruption of global value chains, as well as by the measures adopted to contain the spread of the pandemic in the country, which led to a substantial fall in output during the first quarter of the year. Moreover, the aforementioned impacts are expected to be greater in the second quarter, leading to a significant contraction of the main aggregate demand components and, thus, to sharp falls in employment.

Among the main effects of the pandemic on inflation, energy prices decreased considerably in March and even more in April, as a consequence of the sharp fall in international references. This has exerted significant downward pressures on non-core inflation, although more recently international energy references have recovered, thus reversing part of the previous decrease. Additionally, social distancing and reduced mobility measures have led to a decline in the prices of certain services. Nevertheless, this has been offset by pressures on certain goods' prices, such as food, medicine, and household goods, which may have increased their demand as a result of the health crisis or which might be facing a supply-related shocks. In this way, after having decreased slightly throughout the year, in the first fortnight of May core inflation rose to 3.76%, while headline inflation lay at 2.83%.

Regarding monetary policy decisions, in its February 2020 meeting, Banco de México cut the policy rate by 25 basis points to a level of 7.0%, upon considering the levels of headline inflation, its outlook for the time frame in which monetary policy operates, the wider slack conditions of the economy, and the performance of external and domestic yield curves. Subsequently, considering the above mentioned risks for inflation, economic activity and financial markets caused by the COVID-19 pandemic, which pose important challenges for monetary policy and the economy in general, the Governing Board moved forward its monetary policy decision from March 26 to March 20. The Governing Board also made an unscheduled monetary policy decision on April 21. On both occasions, it cut the reference rate by 50 basis points. Later on, in light of the expected impacts of the pandemic on inflation, productive activity and financial markets, and considering the room for maneuver that, on balance, these impacts grant to monetary policy, in its decision of May 14, the Governing Board once again cut the reference rate by 50 basis points. The overnight interbank interest rate is thus currently at 5.5%.

The box *Impact of Monetary Policy Easing on Firms' Financing Costs* estimates that the reduction of Banco de México's reference rate has led to a moderation in the financial burden of private firms holding credits granted by commercial banks. Although this moderation has had a positive effect on the financial position of said firms, the relief has varied, being greater for large firms.

The March and April decisions were accompanied by the announcement of additional measures by Banco de México to foster an orderly functioning of financial markets, strengthen the provision of credit, and to supply liquidity for the sound development of the financial system. In like manner, in accordance with the decisions by the Foreign Exchange Commission, Banco de México implemented measures to improve the functioning of the foreign exchange market. These measures may be grouped in four:

A. *To provide liquidity and reestablish trading conditions in the money market*, measures that include: i) reducing the Monetary Regulation Deposit (DRM, for its acronym in Spanish) by MXN 50 billion (equivalent to reducing the reserves' requirement); ii) decreasing the interest rate of the Ordinary Additional Liquidity Facility (FLAO, for its acronym in Spanish) to 1.1%; iii) increasing liquidity during trading hours in the money market, which allows to closely monitor the banking overnight interest rate; iv) extending the securities eligible for the Ordinary Additional Liquidity Facility (FLAO, for its acronym in Spanish), foreign exchange hedging program operations, and USD credit operations, which allows counterparties to trade corporate securities as collateral; v) extending the counterparts eligible for the FLAO, which warrants development banks access to this facility; and vi) opening a temporary securities swap window, which implies providing resources for up to MXN 100 billion.

B. *To foster an orderly functioning of the government and corporate securities market,* which includes the following measures: i) strengthening the Government Debt Market Makers Program; ii) opening a government securities term repurchase window, which implies providing resources for up to MXN 100 billion; iii) swaps of government securities, which implies providing resources for up to MXN 100 billion; and iv) opening of a Corporate Securities Repurchase Facility (FRTC, for its acronym in Spanish), which implies providing resources for up to MXN 100 billion.

C. *To strengthen the provision of credit in the economy*, measures which include: i) providing resources to banking institutions to channel credit to micro, small-, and medium-size enterprises and individuals affected by the COVID-19 pandemic, which implies resources for up to MXN 250 billion; and ii) a collateralized financing facility for commercial banks with corporate loans, to finance micro, small- and medium-size enterprises, which implies resources for up to MXN 100 billion.

D. *To foster an orderly functioning of the foreign exchange market, attending the guidelines of the Foreign Exchange Commission,* which includes the following measures: i) extending the foreign exchange hedging program settled in domestic currency, from USD 20 billion to 30 billion, ii) US dollar auctions financed by the temporary US dollar liquidity arrangement (swap line) with the US Federal Reserve; and iii) foreign exchange hedges settled by differences in US dollars with nonresident counterparts.

Altogether, the measures described in domestic currency support the functioning of the financial system for up to MXN 800 billion, amounting to 3.3% of GDP.

In this regard, the box *Economic Policies Considered in Mexico to Confront the Negative Outlook Generated by the COVID-19 Pandemic* describes three sets of measures implemented in the country: i) the above mentioned Banco de México measures to foster the orderly functioning of financial and credit markets; ii) the fiscal and public spending measures by the Federal Government to offset the negative impact on the population's health and on economic activity; and, iii) financial and credit impulse measures, implemented by the National Banking and Securities Commission (CNBV), the National Insurance and Bonding Commission (CNSF), and development banks to temporarily relieve debtors' financial burden.

Banco de México's expected macroeconomic outlook is the following:

GDP growth: The COVID-19 pandemic has caused a global health emergency that has been simultaneously accompanied by supply, demand and financial shocks. The fact that the evolution of the pandemic is still underway at both the global and domestic levels creates a high degree of uncertainty for any forecast of economic activity in Mexico. In particular, the duration and the depth of the pandemic, both in Mexico and in other countries, is still uncertain. This implies uncertainty regarding the duration and severity of the lockdown and social distancing measures that will need to be put in place and maintained. Even in case of an eventual easing or lifting of many lockdown measures, there are risks of additional outbreaks and it is unknown when an effective treatment or vaccine will be available. All of the above affects the timing and pace at which a recovery and a normalization of domestic economic activity can be expected, which would also be affected by the pace of recovery of other economies.[1]

In view of said uncertainty, a baseline scenario of economic activity forecasts, such as the one usually presented by Banco de México in its Quarterly Reports, could suggest an accuracy level higher than the one that the current environment or the available information allow to attain. Furthermore, since the economic impact derives from the dynamic of the pandemic, there are no elements that allow to generate a probabilistic forecast such as the ones that are usually presented. In this regard, constructing different scenarios on the possible evolution of productive activity, based on different assumptions of the depth and duration of the consequences of the pandemic, could provide a better perspective of GDP in 2020 and 2021. Indeed, scenarios such as the ones presented in Box 2 of this Report allow to have references for the possible trajectories of economic activity.[2]

The box *Ex Ante Estimation of the COVID-19 pandemic's Impact on Economic Activity in Mexico* presents estimates of possible negative impacts on GDP arising from the pandemic, based on an input-output matrix approach and under different sectoral assumptions of the degree and duration of the impact. Given the high uncertainty prevailing regarding the evolution of the pandemic and its impact on the economy, this exercise represents scenarios that show a possible order of magnitude of the impact on GDP that could be expected under the described assumptions and do not constitute point forecasts for the level of economic activity for 2020.

The results obtained for the scenarios considered in the Box represent a marginal impact on GDP observed under different assumptions as to the effects associated with the health emergency. Thus, starting from the midpoint of the 0.5 and 1.5% range expected in the previous Quarterly Report for growth in 2020, prior to the health emergency, and considering additional information on the economy's performance, the scenarios suggest the following GDP growth rates for 2020 and 2021 (Chart 1):

In the type V impact scenario, the economic damage caused by both the weakness of external demand resulting from the pandemic and the lower levels of production in different economic sectors in compliance with the social distancing measures concentrates in the first half of the year. Subsequently, a relatively rapid economic activity recovery is assumed, which persists throughout early 2021, with the growth rate of economic activity normalizing during the remaining time horizon. This

[1] According to analysts surveyed by Blue Chip in May 2020, US industrial production is expected to vary by -8.7 and 3.2% in 2020 and 2021, figures that compare to the 0.4 and 1.5% rates presented in the previous Report.

[2] The approach favoring the construction of alternative scenarios over presenting a central baseline scenario under the current situation has been adopted by the central banks of countries such as Canada, Sweden, New Zealand and England, in response to the high degree of prevailing uncertainty.

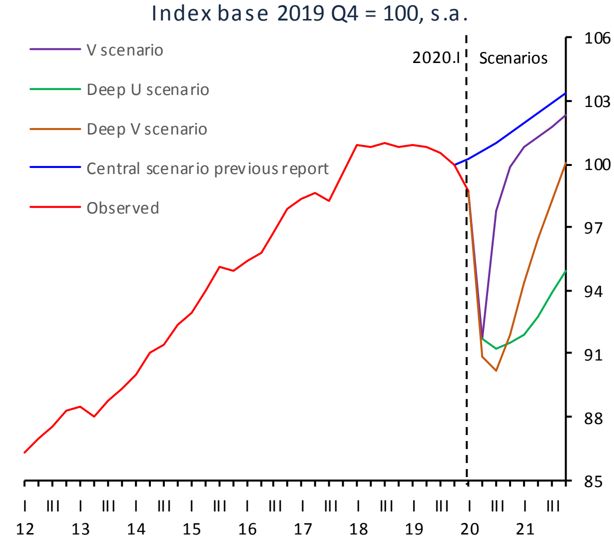
would result in a GDP contraction of -4.6% in 2020 and in GDP growth of 4% in 2021.

In the type deep V impact scenario, the negative effects on economic activity are stronger and extend to the third quarter of the year, to later present a recovery by the end of the year and during 2021. Under the assumptions of this scenario, described in Box 2, GDP would fall to -8.8% in 2020 and would grow 4.1% in 2021.

Finally, in the type deep U impact scenario, the weakness of economic activity caused by the shock in the first half of 2020 extends during the rest of the year, followed by a slow recovery in 2021. This would lead to a fall in GDP of -8.3% in 2020 and to an additional decline of -0.5% in 2021.

Note that the maximum difference among these scenarios is over 4 percentage points both in 2020 and in 2021. This represents the deep uncertainty faced by the economy and the different possible trajectories for GDP. This contrasts with the ranges of no more than one percentage point that are usually presented in Quarterly Reports. As more information is available on the dynamics of the pandemic and its effects on economic activity, it will be possible to determine the type of the scenario that is materializing.

Chart 1
GDP Estimates
Index base 2019 Q4 = 100, s.a.

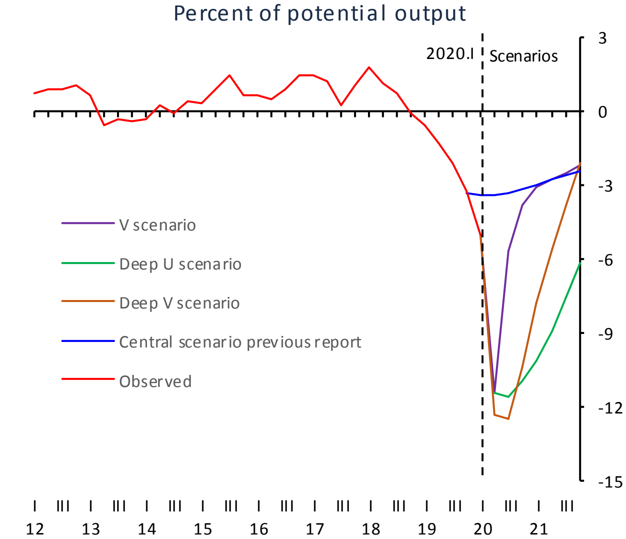


s.a. Seasonally adjusted figures.
Source: Banco de México with data from INEGI.

It must be emphasized that the risk of economic activity being among said scenarios or following trajectories above or under those set in the scenarios prevails. To the upside, there is the possibility that economic activity does not only normalize, but also that part of the consumption deferred during the social distancing phase recovers in such a way that economic activity grows more vigorously. To the downside, the intensity and, specifically, the duration of the effects could be greater than those assumed in the deep impact scenarios, which could generate an even greater negative impact on economic activity.

As for the economy's cyclical position, slack conditions are expected to have widened significantly during the first half of the year and are estimated to remain considerably more relaxed throughout the forecast horizon under any of the scenarios than previously estimated (Chart 2).

Chart 2
Output Gap Estimates, s.a.
Percent of potential output



s.a. Seasonally adjusted.
Source: Banco de México.

Employment: Uncertainty regarding the growth outlook implies, in turn, uncertainty over the forecast for the number of new IMSS-insured jobs. Based on the described scenarios, a broad range of possible results is presented for this indicator. For 2020, a negative variation of between 1,400 and 800 thousand new jobs might be observed, while, for 2021, the variation may fall between -200 and 400 thousand.

The shocks stemming from the impact of the COVID-19 pandemic have put the Mexican labor market under a high level of stress. The box *Formal*

Employment in the Face of the COVID-19 Pandemic analyzes the recent dynamics of IMSS-insured jobs and finds that the significant destruction of formal jobs registered in March and April was concentrated in those sectors of economic activity that were more exposed to the suspension of non-essential activities imposed by the health emergency and in activities that imply a higher degree of physical interaction.

Current account: Uncertainty as to the evolution of international trade and economic activity both at the domestic and global levels, along with exchange rate volatility and possible disruptions in global value chains, also lead to widespread uncertainty over the trade flows and other items of the current account. Thus, just like with other forecasts included in this Report, a broad range of possibilities for the current account balance is presented. In particular, the weakness of the global economy could lead to lower income from remittances, a lower balance of international travel and a lower external demand for Mexican goods, which could contribute to a higher current account deficit. Nevertheless, this could be offset, on the one hand, by a more depreciated exchange rate, which would mainly favor merchandise exports, and, on the other hand, by downward adjustments in Mexico's imports derived from both the expected fall in domestic demand and a higher level of the exchange rate. Thus, the trade balance for 2020 can be expected to lie between -4.8 and 4.6 billion dollars (-0.5 and 0.5% of GDP) while the current account balance can be estimated to be between -15.1 and -3.1 billion US dollars (-1.5 and -0.3% of GDP). For 2021, the trade balance could be between -7.2 and 4.5 billion US dollars (-0.6 and 0.5% of GDP) and the current account balance between -20.5 and -4.6 billion US dollars (-1.8 and -0.5% of GDP).

Risks for growth: In an environment of significant uncertainty and where all scenarios include deep effects on economic activity, the multiple risks that are faced should be emphasized. Among downward risks within the forecast horizon, the following stand out:

i. That, in order to avoid further contagion, social distancing measures persist or stricter measures are implemented, leading to a greater or more prolonged paralysis of economic activity, both at the global and domestic levels.

ii. That additional bouts of volatility are observed in international financial markets due to higher risk aversion or a loss of investors' confidence, depending on the evolution of the COVID-19 outbreak worldwide, or due to other events, such as the electoral process in the United States or other geopolitical factors, affecting the financing flows available for emerging economies.

iii. That the support measures adopted both at the domestic and global levels are ineffective or lack sufficient reach to avoid longer lasting adjustments in the productive apparatus, as a result of, for example, firms' bankruptcy or hysteresis in unemployment.

iv. That the aftermath of the pandemic on economic activity is more permanent if, for instance, it implies disruptions to global value chains or more protectionist stances from different countries. In particular, in a context of presidential elections in the United States, the differences that persist between this country and some of its main trade partners may escalate in light of the prevailing health emergency environment.

v. That additional downgrades of the sovereign and of Pemex's credit ratings are observed, which may further affect the access to financial markets.

vi. That the weakness that aggregate demand components had been exhibiting, even prior to the pandemic, persists. In particular, that the environment of domestic uncertainty that has affected investment persists, leading to a further postponement of investment plans, or that consumers cut their spending in a precautionary manner.

Among upward risks to growth within the forecast horizon, the following stand out:

i. That the lockdown and social distancing measures are more effective than expected in containing the spread of COVID-19 and avoiding a saturation in the health system, thus building confidence in the economy and raising expectations of a strong economic rebound.

ii. That the stimuli that have been granted internationally and domestically are effective to protect employment and the productive apparatus, to preserve global value chains, to reduce systemic risks, to restore consumer and investor confidence, and, overall, to offset the aftermath of the pandemic and to support the economic recovery. That all these factors lead to lower-than-expected effects and, consequently, that the world economy recovers at a faster and vigorous pace.

iii. That the upcoming entry into effect of the USMCA fosters greater-than-expected investments.

Inflation: The uncertainty resulting from the COVID-19 pandemic regarding the behavior of different economic and financial variables implies that the magnitude and duration of the shocks that affect inflation is also uncertain. In this context, on the basis of the trajectory of the macroeconomic variables resulting from the different scenarios described in the section of economic growth, inflation paths were constructed for the forecast horizon. Such paths reflect the downward and upward pressures that inflation would face in the different scenarios. Among the pressures to the downside, the most outstanding are the significant widening of the negative output gap, which differs in its magnitude and depth between scenarios, as well as the fall in energy product prices during the first months of the year. To the upside, the most outstanding are the depreciation of the peso exchange rate, which could also differ between scenarios, and possible disruptions to production and distribution chains of certain goods and services. Pressures in different directions tend to offset each other. Thus, although the inflation paths reveal a higher level of uncertainty than that published in previous Quarterly Reports, they show a lower dispersion than those of productive activity scenarios.

As for inflation expectations resulting from the three scenarios, Charts 3a and 3b use blue bars to indicate the minimum and maximum levels that headline and core inflation, respectively, could reach in the estimates for each quarter in the forecast horizon. If inflation were to lay at the midpoint of these bars, the resulting path would be the one reported in Table 1. The uncertainty surrounding such path can be represented with the red shaded area of Charts 3a and 3b. The red area corresponds to the areas of the fan chart usually presented; however, on this occasion, the different probability ranges are not set, given that in the present juncture it is difficult to determine the effect of the different shocks on inflation.[3] In particular, some of the inflationary pressures move in opposite directions and could be of greater magnitude and duration than as expected in those scenarios. There could also be nonlinearities. For these reasons, the balance of risks for inflation remains uncertain.

All scenarios anticipate that core inflation, which has increased according to timely information, will remain above that forecasted in the previous Quarterly Report until the first quarter of 2021. This is because it is anticipated to continue showing high persistence in the short term and also because of the influence of the peso exchange rate depreciation, in addition to possible effects on prices due to certain social distancing measures. Nonetheless, towards the second half of 2021, the effects of the wider economic slack are expected to lead to lower than previously expected levels of core inflation, so that it lies below 3%.

As for headline inflation, in the different scenarios it is estimated that after the considerable decline expected for the second quarter of 2020 vis-a-vis that published in the past Quarterly Report, due to the strong fall in energy product prices, it increases from mid-2020 up to mid-2021. This is due to: i) the rise in non-core inflation, in response to the recently registered increases in some agricultural prices, together with the expected steady decrease in the negative contribution of energy product prices, which in the first half of 2021 would pressure inflation upwards as a result of the arithmetic effect of a low base of comparison; and, ii) to a lower extent, as mentioned above, to the higher levels of core inflation. Later, in light of the decline of core inflation as a reflection of the greater economic slack, and as

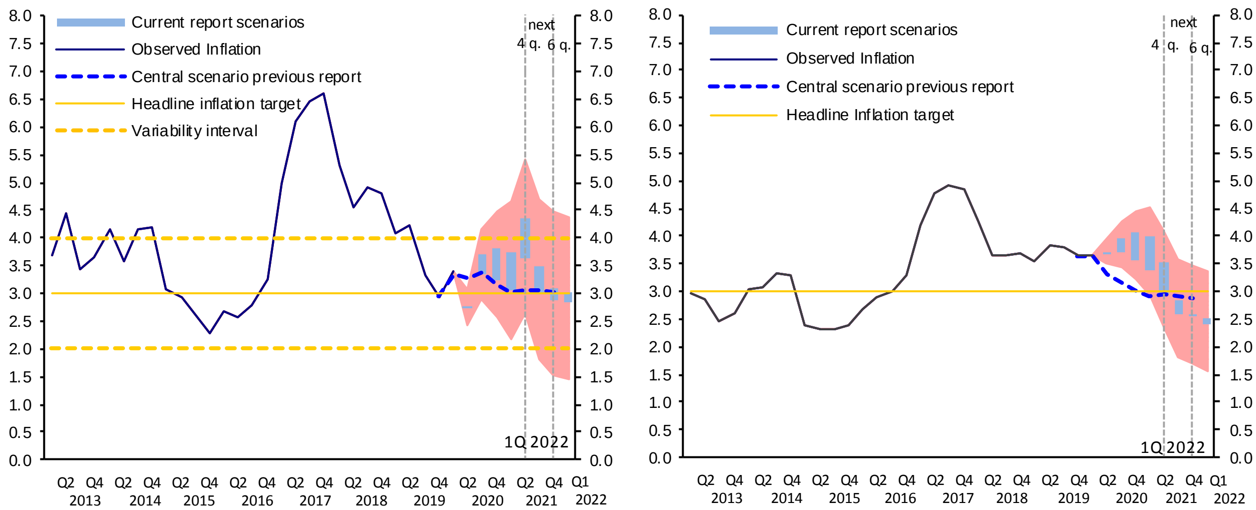
[3] For accuracy, the red shaded area in the fan charts is estimated only for the inflation trajectory where inflation would lie in the midpoint of the blue bars, which in turn represent the minimum and maximum levels that inflation would reach in each quarter across the three estimated scenarios.

the arithmetic effect of the comparison base of non-core inflation dissipates, headline inflation would decrease in larger magnitude by the end of 2021 and beginning of 2022 in the three scenarios. Thus, annual headline inflation is expected to lie within Banco de Mexico's variability interval during most of the forecast horizon, and around the inflation target towards the end of said horizon.

Chart 3

a) Fan Chart: Annual Headline Inflation 1/
Percent

b) Fan Chart: Annual Core Inflation 1/
Percent



1/ Quarterly average of annual inflation. The next four and six quarters from 2Q 2020 are highlighted with dotted vertical lines; they correspond to the second and fourth quarters of 2021 respectively, time frame in which the monetary policy transmission channel operates thoroughly. Projections for inflation were estimated based on the evolution of macroeconomic variables in the three scenarios described in this Report. Blue bars indicate the minimum and maximum for inflation accross scenarios on the forecast horizon.The red area corresponds to the fan chart area usually presented for inflation projections, and in this case is estimated for the inflation path reported on Table 1, where inflation lays at an equidistant point to such quarterly minima and maxima.
Source: Banco de México with data from INEGI.

Table 1
Headline and Core Inflation Forecasts
Annual change in percent

	2020				2021				2022
	I	II	III	IV	I	II	III	IV	I
CPI									
Current report 1/	3.4	2.7	3.5	3.5	3.4	4.0	3.2	3.0	2.9
Previous report 2/	3.3	3.3	3.4	3.2	3.0	3.0	3.1	3.0	
Core									
Current report 1/	3.7	3.7	3.8	3.8	3.7	3.2	2.7	2.6	2.5
Previous report 2/	3.6	3.3	3.2	3.0	2.9	2.9	2.9	2.9	

1/ Forecast from May 2020. Projections for inflation were estimated based on the evolution of macroeconomic variables in the three scenarios described in this Report. The minimum and maximum for inflation between scenarios was estimated for each quarter on the forecast horizon. This Table reports the path that inflation would follow if it were to lay in the forecast horizon at an equidistant point to such maxima and minima.

2/ Forecast from February 2020.

Source: Banco de México with data from INEGI.

The box *Product Varieties Available Online on Supermarkets Websites in the Context of the COVID19 Pandemic* presents evidence on how the number of product varieties available in the website of three supermarkets was gradually reduced in the third week of March and, right after Phase 2 of the health emergency in Mexico began, it fell sharply for certain goods. This decline would appear to have been influenced by a higher relative demand for such goods, in the context of the lockdown following the COVID-19 pandemic.

Delving into the various risks that affect inflation and pose significant challenges and difficulties for monetary policy, the following stand out:

To the downside:

i. That the effects of the widening of the negative output gap and of a lower demand for certain goods and services in light of social distancing measures or concerns about contagion are greater than expected.

ii. Downward pressures on the prices of all types of imported merchandise and inputs in response to the global slack conditions.

iii. That the fall in energy product prices intensifies or becomes more permanent.

iv. That the exchange rate appreciation observed in recent days continues, so that the exchange rate sets below the levels anticipated.

To the upside:

i. That the relative demand for certain goods increases in the context of the health emergency, exerting pressures on prices.

ii. That there is a greater or more persistent depreciation of the peso exchange rate.

iii. That disruptions to production and distribution chains continue, exerting pressures not only on merchandise prices, but on food prices as well.

iv. That cost pressures arise when implementing measures seeking workers and consumers' safety.

There could also be nonlinearities or effects additional to the usual ones that indicate that inflation might have different responses to those observed in less extreme circumstances due to the shocks that are being faced. Indeed, the exchange rate pass-through could be lower given the sharp fall in economic activity. Slack could have a more immediate effect vis-a-vis the delay with which its effects on prices usually take place. The overall weakness worldwide could lead to falls in the prices of different inputs or finished goods worldwide, which would also be reflected in downward pressures on prices in Mexico. In contrast, the depreciation of the peso exchange rate could be perceived as permanent, leading to a greater pass-through. The pressures that the pandemic could have on public finances may give rise to increases in risk premia, exerting even greater pressure on the exchange rate. Likewise, given the uncertainty and restriction of the provision of goods, price setters could decide not to lower their prices despite the economic slack.

The COVID-19 pandemic, with its impact on the population's health and its effects on economic activity, inflation, and financial markets, poses significant challenges never seen before for Mexico and for society overall. The present situation therefore requires a policy response that is timely, decisive, and coordinated among the different Mexican authorities in order to preserve the population's well-being.

In this complex and uncertain economic and financial environment, Banco de México will take the necessary actions based on incoming information and considering the strong impact on productive activity, as well as the evolution of the financial shock that we are facing, in such a way as to allow the policy rate to be in line with the orderly and sustained convergence of inflation to its target, within the timeframe in which monetary policy operates. By focusing on fulfilling its constitutional mandate, Banco de México can significantly contribute to maintain confidence, limit the spread of the financial shocks stemming from the pandemic, and facilitate transactions among economic agents in an efficient, safe and expedite manner, achieving a more orderly adjustment in light of the current circumstances. In the present situation, Banco de México remains particularly vigilant to promoting the sound development of the financial system and fostering the well-functioning of the payments system. The central bank has been taking additional measures to promote the orderly behavior of financial markets, strengthen the credit provision channels, and provide liquidity, strictly abiding by the legal framework and in coordination with other financial authorities.

In order to attain an expedite recovery of economic activity once the health contingency is resolved, and to restore the population's well-being, avoiding more permanent effects, solid macroeconomic fundamentals and the stability of the financial system must be maintained, and the necessary monetary and fiscal actions need to be adopted. Nevertheless, since macroeconomic stability, although necessary, is not sufficient by itself to trigger greater economic growth, the structural and institutional problems that have contributed to the low levels of investment and have prevented the country from increasing its productivity must be corrected. The health emergency should not only prevent the country from losing sight of these pending tasks, but should make them even more compelling. In particular, it is essential to conduct policies that strengthen the rule of law; tackle insecurity, corruption, and impunity; and ensure legal certainty, the fulfillment of the legal framework and the respect for property rights. It is also fundamental to strengthen the microeconomic functioning of the economy and to reduce domestic economic uncertainty to improve the business climate perception in the country. This will allow to attract investment and to trigger flexibility in the allocation of resources, both of which are necessary to face the COVID-19 crisis in the short term and the readjustments in the functioning of the economy in the medium term. This will allow to attain a more dynamic economic growth that brings along more and better-paid jobs and well-being for the population.

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