BANCO DE MÉXICO

Executive Summary

Quarterly Report July – September 2020

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Summary

During 2020, the COVID-19 pandemic implied shocks that had a widespread impact on all countries, with repercussions on economic activity, inflation, and global financial conditions. After a deep worldwide economic contraction in the second quarter, economic activity began to recover during the third quarter, mainly due to the reopening of different production activities. This recovery has been partial and there is still a high degree of uncertainty over its pace during the following quarters, which will depend, among other factors, on the evolution of the pandemic and the performance of different sectors and various components of aggregate demand. Following the episode of high global risk aversion in March and April, financial markets showed an improvement. However, they are still subject to bouts of volatility, albeit more limited, and considerable risks remain. This juncture poses significant risks to the Mexican economy, its recovery, the evolution of the labor market, and to maintaining both macroeconomic and financial-system stability. In this complex environment, Banco de México has sought to conduct monetary policy in a timely and prudent manner, seeking to maintain the domestic currency's purchasing power. In addition, a number of measures consistent with the goal of promoting a sound development of the financial system and an orderly functioning of payment systems have been adopted.

Delving into the international environment that Mexico has faced during the period analyzed in this Report, available information suggests that the recovery of world economic activity has been heterogeneous across countries, and, recently, it has been at a lower rate than the one observed between May and June. The global economy is, thus, still far from reaching the economic activity levels registered prior to the pandemic, and there is a risk that the recovery could be hampered by new lockdown measures. This has been recently observed in different countries, including the United States (U.S.) and some in European countries, in view of the resurgence of infections. In this context, the growth forecasts of multilateral organizations still anticipate a strong GDP contraction for 2020, although these projections have been revised upwards during the period covered by this Report, due to the fact that the contraction in the second quarter was lower than anticipated. Expectations for 2021 still foresee a gradual recovery, albeit slightly lower than previously foreseen. These forecasts are subject to a high degree of uncertainty, and depend upon the evolution of demand components in different countries and economic sectors. In this context, the balance of risks to world economic growth remains negative. Meanwhile, during the reported period, headline and core inflations in most advanced economies increased slightly, although they remain at low levels, below the targets of their respective central banks.

In response to this environment, monetary and fiscal authorities have adopted stimulus measures to mitigate the adverse effects of the pandemic on the economy. The main central banks have used their balance sheets to foster the well-functioning of financial markets and have kept interest rates at historically low levels, highlighting their commitment to maintain an accommodative stance for monetary policy for a long period of time until a sustained inflation increase is observed.

The box *The US Federal Reserve New Monetary Policy Strategy* describes the recent changes in the Federal Reserve monetary policy strategy. The box analyzes the challenges for its implementation, mainly in an environment in which inflation expectations have remained persistently below the 2% target. It also argues that the changes adopted by the Federal Reserve are not necessarily applicable to other economies, such as emerging-market economies, which face different conditions than those prevailing in the U.S.

Most emerging market economies registered inflation rates below their targets and the central banks of several of these economies continued to reduce their policy rates during the period under analysis.

The box *Use of Balance Sheets and Liquidity Provision Programs in the Central Banks of Emerging-Market Economies* describes the measures adopted by the central banks in emerging-market economies, which have implied the use of their balance sheets. A distinction is made between the traditional measures of liquidity provision, such as repos, and asset-purchase programs. The risks associated with the latter, and their differences regarding non-conventional measures in advanced economies, are analyzed. It is noted that the adoption of different measures is a function of the specific conditions of every economy. Finally, the case of Mexico is described, along with its policy response in view of the worsening of trading conditions in different financial markets.

Different economies have maintained or expanded their fiscal relief measures to address the pandemic. The International Monetary Fund estimates that these measures amounted to approximately 12% of world GDP by mid-September. In the case of advanced economies, stimulus measures, including additional spending, tax cuts, and granting of loans and guarantees, have reached 20% of GDP, while in emerging-market economies, these measures represent, on average, around 6% of GDP.

The box *Fiscal Response to the COVID-19 Pandemic* describes how, in view of the economic crisis brought about by the COVID-19 pandemic, monetary and fiscal authorities in different countries have implemented unprecedented stimulus measures. According to IMF estimates, the exceptional fiscal stimuli have amounted to around 12% of world GDP, a large part of which has been implemented by advanced economies and some larger emerging-market economies. The fiscal response has varied across countries as to its size and its characteristics, depending on each economy's structural conditions and fiscal characteristics. In this regard, this box briefly describes the magnitude of the fiscal response and the various types of measures implemented in different countries.

During most of the third quarter, international financial markets continued performing favorably, fueled by a gradual recovery of world economic activity and monetary, fiscal, and financial stimuli implemented in systemically important economies, as well as by expectations of progress in developing a vaccine against COVID-19. Nonetheless, as of mid-September, episodes of volatility were observed, although they were more limited as compared to those registered in March and April. This took place in light of a lower probability of approval of a new fiscal stimulus package in the U.S., the electoral process in that country, as well as a new wave of infections in different countries, among other factors.

Along with the evolution of the pandemic, additional risk factors include the high levels of indebtedness in both the public and private sectors, a higher number of business bankruptcies in the sectors most affected by the pandemic, a new escalation of trade tensions, an intensification of geopolitical and social conflicts in different regions of the world, a possible exit of the United Kingdom from the European Union without reaching a trade agreement, the insufficiency and/or the early withdrawal of stimulus and economic relief measures to tackle the pandemic, and the risk of greater natural disasters caused by environmental factors.

The box *Evolution of Sovereign Risk in Emerging-Market Economies* describes the recent performance of credit default swaps (CDS) in emerging-market economies and analyzes the determinants of said indicators. The results obtained through a panel-data model suggest that public indebtedness, the fiscal balance and the growth rate affect its value. Additionally, using a principal component analysis, it is observed that, between December and May 2020, the change of these indicators was dominated by a common component, but, starting from June on, there is a considerable degree of differentiation among economies. Moreover, through a vector autoregressive model for Mexico, it is found that the reduction in sovereign risk premia starting from May 2020 has responded to both a lower global risk aversion and idiosyncratic factors.

As for the Mexican economy, after a strong contraction in April and May due to the COVID-19 pandemic and the measures adopted to address it, since June economic activity has recovered fueled by the resumption of productive activities in different sectors and a reactivation of demand, especially external demand. Nevertheless, it remains below the levels observed prior to the pandemic and strong uncertainty persists regarding the future evolution of the economy, given that the pandemic continues, restrictions on the operation of different activities remain, the most lasting effects of the health emergence are still unknown, and the risk of resurgence, which would imply greater containment measures, is still present. In addition, looking forward, just like in other countries, the recovery will depend on the evolution of different components of aggregate demand and the challenges faced by each productive sector.

For most of the third quarter of 2020, Mexican financial markets performed favorably. Although they were subject to episodes of volatility starting from mid-September, these have been more limited than those registered in March and April. Thus, during the second half of September, the Mexican peso depreciated, and longer-term interest rates and risk premia increased. These changes were related to the volatility registered in international financial markets, which has moderated recently. By the end of the period under analysis, longer-term interest rates declined, and the Mexican peso appreciated. Going forward, new episodes of risk aversion and volatility cannot be ruled out, which will depend on the evolution of the pandemic, and on other idiosyncratic and external risk factors.

The box *Evolution of the Yield Curve in Emerging-Market Economies* analyzes the performance of the yield curve in Mexico and compares it to other emerging-market economies (EMEs). The first two principal components are related to the level and the slope of the curve. The former summarizes the information contained along the curve on financing conditions for the economy, while the latter contains information on risk premia. The results show that, with respect to other EMEs, in 2020 the yield curve in Mexico has observed an orderly and significant adjustment to the downside, which has allowed a reduction of financing costs in the economy and risk premia.

Inflation in Mexico increased during the third quarter of 2020 with respect to the previous one. After having registered a particularly low level of 2.15% in April, annual headline inflation exhibited an average of 2.77% in the second quarter, 3.90% in the third quarter, and 3.43% in the first fortnight of November. The upward trajectory of headline inflation during the third quarter was caused by both the evolution of the core component and a considerable increase in non-core inflation. Within the core component, upwards pressures on merchandise prices were observed, which were greater than the downward pressures on services prices. This recomposition within core inflation reflected the effects of the pandemic on households' consumption patterns, as well as the effects of supply shocks, and the exchange rate depreciation. However, since August, some of the shocks that had exerted upward pressures on core inflation have moderated, while in the first fortnight of November, core inflation significantly decreased, influenced by the sales season known as *El Buen Fin*.

The box *Effects of the COVID-19 Pandemic on Core Inflation's Components* shows that, during the months of the health crisis, the evolution of merchandise and services prices in Mexico has been atypical with respect to previous years, given the observed shocks. Based on econometric models' estimations, there is evidence of the presence of shocks on inflation that are potentially attributable to the pandemic, beyond what could be attributed to the performance of the usual determinants.

The performance of non-core inflation has been largely determined by the evolution of energy prices, which, in turn, reflected the dynamics of their international references. In this respect, after historically low energy prices contributed to annual non-core inflation registering a negative level in April, as these prices were recovering, non-core inflation was pressured via this channel until August. Subsequently, annual changes of energy prices decreased, but were offset by increases in agricultural and livestock product prices, until, in the first fortnight of November, both of these declined, generating an important reduction in non-core inflation.

The evolution of inflation has been subject to various shocks of diverse intensities and with effects in different directions, thus presenting considerable challenges and trade-offs for the conduct of monetary policy. These shocks have affected inflation during the months of the health contingency, and it will be important to be vigilant of their consequences going forward.

The box *Impact of the COVID-19 Pandemic on Consumer Price Dynamics in the U.S. and Mexico* shows that, although the COVID-19 pandemic has significantly affected economic activity both on the demand and supply side, contributing to a strong growth contraction, its effects on price dynamics are, a priori, ambiguous. Due to the simultaneous nature of these shocks, it is insufficient to only analyze the adjustments in the aggregate price index in order to identify the contributions of supply and demand factors. The objective of this box is to identify and quantify these contributions on the dynamics of inflation observed during the pandemic in Mexico and the U.S. at a sectoral level. The results suggest differences between Mexico and the U.S. in the evolution of the contribution of said factors to inflation, particularly regarding its persistence. However, there are coincidences in the impacts on sectors in both countries.

Regarding monetary policy decisions, Banco de México's Governing Board cut its reference rate by 75 basis points during the period covered by this Report. In particular, in its August decision, the reference rate was lowered by 50 basis points, and in the September decision by an additional 25 basis points, placing it at 4.25%, while in the November 12th decision it was left unchanged. In these meetings, the Governing Board considered that challenges stemming from the pandemic for monetary policy included both the significant impact on economic activity and the financial shock and its effects on inflation. In the August and September decisions, the Governing Board considered the foreseen scenarios and the room that, on balance, these provide to monetary policy. In the September monetary policy statement, the Governing Board stated that said room is limited. Meanwhile, in the statement of the decision of November 12th, it stressed that the recent performance of headline and core inflation, and the factors that affect them, imply a slight increase in the projected trajectories in the forecast horizon, although those corresponding to the next 12 to 24 months are expected to be around 3%. In said decision, the Governing Board considered these previsions and the benefit from consolidating the downward trajectory for headline and core inflation to the 3% target. The Governing Board noted that this pause grants the necessary space to confirm the convergence of the inflation trajectory to the target. The Governing Board stressed that, in the future, the monetary policy implementation will depend on the evolution of the factors that affect both headline and core inflation, on their estimated trajectories in the forecast horizon, and on their expectations.

The Governing Board will take the actions deemed necessary on the basis of incoming information in order for the reference rate to be consistent with the orderly and sustained convergence of headline inflation towards Banco de México's target within the horizon in which monetary policy operates. Perseverance in strengthening the macroeconomic fundamentals and adopting the necessary actions regarding both monetary and fiscal policies will contribute to a better adjustment of domestic financial markets and of the economy as a whole.

Regarding the macroeconomic scenario estimated by Banco de México, the following stands out:

GDP growth: Although the available information indicates that the Mexican economy has been recovering gradually from the distress observed during the second quarter, driven by the progressive opening of several activities and the greater mobility of the population, it still remains at levels below those prior to the health emergency. In addition, there is an environment of high uncertainty associated with both the global and domestic evolution of the pandemic, while restrictions to activity in different sectors continue. In particular, additional COVID-19 outbreaks in various economies and the absence of an effective treatment or available vaccine have extended the duration of the health crisis with respect to initial estimates.

In the two previous Quarterly Reports, three illustrative scenarios were presented to provide a comprehensive outlook of the possible behavior of GDP in 2020 and 2021. These scenarios were prepared considering that the shocks faced by the economy made it difficult to produce a traditional forecast because said shocks did not stem from a regular economic cycle but from a pandemic that caused significant confinement actions and closure of non-essential activities, as well as a marked uncertainty about both the evolution of the health emergency itself and its short- and medium-term effects on the economy. Given the greater information currently available on the magnitude of the initial adverse impact and the recovery phase set in motion by the reopening of various activities and the reactivation of the global economy, this Report presents a single central baseline scenario, in substitution of the aforementioned illustrative scenarios. However, the current juncture still involves a high degree of uncertainty regarding the future evolution of economic activity, both domestically and globally. Thus, the baseline scenario is presented together with a wider interval, in order to account for the high degree of uncertainty surrounding it.

The baseline scenario assumes a gradual recovery, taking place at a moderate pace throughout the forecast horizon, and converging to an inertial growth by 2022. Such a trajectory would reflect the gradual recovery of the global economy, the caution of consumers and investors due to the environment of marked uncertainty derived from the evolution of the pandemic and its effects on the economy, and heterogeneity across sectors in their pace of reactivation and in easing the restrictions they still face, as well as challenges to the recovery of aggregate demand, particularly due to the weakness of the domestic component and the gradual recovery expected for the labor market. According to these forecasts, GDP growth for 2020, 2021 and 2022 would be -8.9, 3.3 and 2.6%, respectively (Chart 1; the trajectories of the scenarios of the previous Report are included as a reference).

As mentioned above, given the high uncertainty regarding the performance of the economy, particularly in 2021, the baseline scenario presents a wide interval, whose limits are based on the following considerations:

a) The upper limit assumes a faster recovery than in the baseline scenario in the initial part of the forecast horizon. This is driven by a greater reactivation of several economic sectors and the labor market in general, as well as a greater push from external demand. It also assumes that throughout 2021 the recovery pace will moderate to converge to an inertial growth by 2022. Under this trajectory, GDP forecasts for 2020, 2021, and 2022 would be -8.7, 5.3 and 2.7%, respectively.

b) The lower limit assumes that there will be additional adversities, either as a result of the expiration of fiscal stimulus packages in various countries, or a worsening of the pandemic in Mexico, or in other countries, which would lead to the resumption of restrictions on activity in several sectors and to a decrease in economic activity between the end of 2020 and the beginning of 2021, a subsequent moderate recovery during the rest of 2021, and, finally, the convergence to an inertial growth by 2022. Under this trajectory, GDP forecasts for 2020, 2021 and 2022 are -9.3, 0.6 and 3.8%, respectively.

Attention might be drawn to the fact that the GDP annual percentage growth rate included in the baseline scenario for 2022 is lower than the rates obtained from the trajectories of the interval's limits. However, this is due to the arithmetic effects resulting from the different comparison levels that stem from the trajectories of GDP for 2021, given that, as it can be seen in Chart 1, the level of economic activity in the lower limit lies below that of the baseline scenario at all times, which, in turn, lies below that of the upper limit.

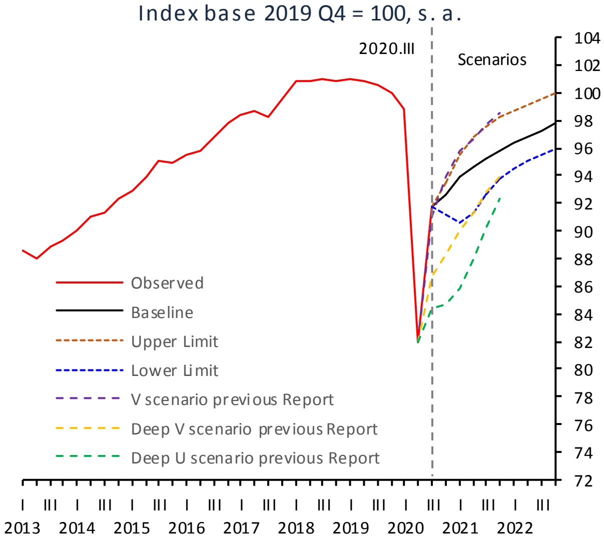
The duration and future evolution of the pandemic, as well as its effects on the economy, are still uncertain and the timing for an effective treatment or vaccine becoming available is still unknown. These factors will continue to affect the pace of normalization of economic activity. In addition, the performance of the economy is subject to upward and downward adjustments, given that, in the future, the dynamics of economic growth will respond less to the reopening of various activities and more to the behavior of the demand components and of productive sectors, which will likely be differentiated. It is worth noting that, under the baseline scenario, economic activity would not regain the pre-pandemic levels observed at the end of 2019 within the described forecast horizon, given that, under an inertial growth, these levels would be reached by the end of 2023. However, if GDP forecasts in the upper limit were met, said levels could be reached by the end of 2022.

As to the economy's cyclical position, slack conditions are expected to remain significantly eased throughout the entire forecast horizon, although narrowing gradually (Chart 2; the trajectories of the scenarios of the previous Report are included as a reference).

Employment: Although a high degree of uncertainty prevails regarding the evolution of the number of IMSS-insured jobs, based on the forecasts presented and on the updated information about the evolution of this indicator, it is expected to show a negative variation of between 850 and 700 thousand jobs for 2020, and a positive variation of between 150 and 500 thousand jobs, and of between 300 and 500 thousand jobs for 2021 and 2022, respectively.

The Box *Recent Dynamics of IMSS-Insured Jobs* shows that that the evolution of this employment was affected during the health emergency both by a greater destruction, as well as by less creation, of jobs by employers relative to what had been observed prior to the pandemic. It is also found that the net drop in employment was associated to a greater extent with less dynamism in hiring.

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

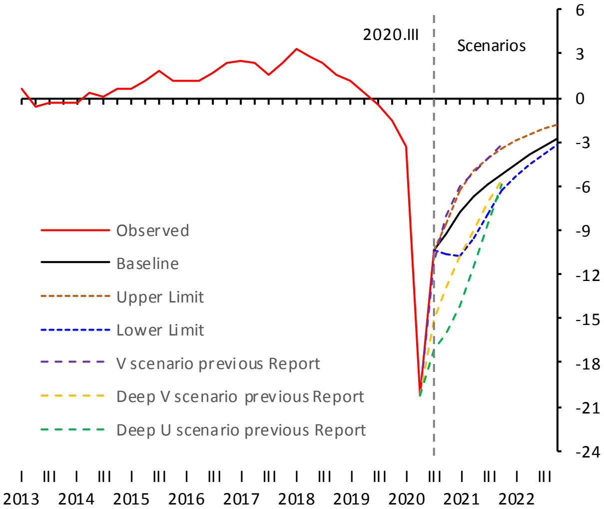


s. a. Seasonally adjusted figures.

Note: GDP growth in Q3 2020 considers the flash estimate released by INEGI; therefore, in the present Report the forecast begins in Q4 2020. The scenarios included in the previous Report began in Q3 2020.

Source: INEGI and Banco de México.

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



s. a. Seasonally adjusted figures.

Note: GDP growth in Q3 2020 considers the flash estimate released by INEGI; therefore, in the present Report the forecast begins in Q4 2020. The scenarios included in the previous Report began in Q3 2020.

Source: Banco de México.

Current Account: In line with the latest information and activity forecasts described above, for 2020 a trade balance of between USD 27.1 and 30.3 billion (2.6 and 2.9% of GDP), and a current account balance of between USD 20.3 and 24.3 billion (1.9 and 2.3% of GDP) are foreseen. For 2021, a trade balance of between USD 1.0 and 9.2 billion (0.1 and 0.8% of GDP), and a current account balance of between USD -9.4 and 1.9 billion (-0.8 and 0.2% of GDP) are expected. For 2022, a trade balance of between USD -5.0 and 0.0 billion (-0.4 and 0.0% of GDP), and a current account balance of between USD -12.5 and -4.4 billion (-1.0 and -0.4% of GDP) are anticipated.

Risks for growth: The risks to the baseline scenario are considered to be biased downwards. This is due to the environment of high uncertainty that persists regarding the evolution of the pandemic worldwide, in a context where some countries have tightened restrictions on several activities and where the scope of the fiscal stimulus packages that could be maintained or implemented in major economies is unknown, in addition to the domestic challenges faced due to the weakness of domestic demand and the labor market. It is worth noting that many of these risks could mutually reinforce each other. In particular, among the risks to the downside the following stand out:

i. That social distancing measures are extended, or stricter measures are taken domestically and globally, leading to a greater or longer impact on economic activity.

ii. That additional episodes of volatility in financial markets are observed, affecting the financing flows to emerging-market economies, due to a greater risk aversion or a loss of investor confidence depending on the evolution of COVID-19 outbreaks worldwide, or as a result of other factors such as geopolitical or international trade conflicts.

iii. That the relief measures adopted both domestically and internationally are insufficient to prevent greater effects on the productive apparatus, such as business bankruptcies or hysteresis in unemployment.

iv. That the negative effects of pandemic on the economy are more permanent.

v. That there are additional downgrades of both the sovereign and Pemex's credit ratings, which could affect the access to financial markets.

vi. That the domestic environment of uncertainty that has affected investment persists, leading to a further delay of investment plans, or that consumers reduce their spending in a precautionary manner.

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

i. That the pandemic fades in the short term, due to new treatments or the introduction of an effective vaccine, boosting confidence in the economy, and expectations of a strong recovery.

ii. That the stimuli granted internationally and domestically contributes to protect employment, and the productive apparatus, to preserve global value chains, to diminish systemic risks, to restore consumer and investor confidence and, overall, to offset the aftermath of the pandemic and support the recovery of the global economy.

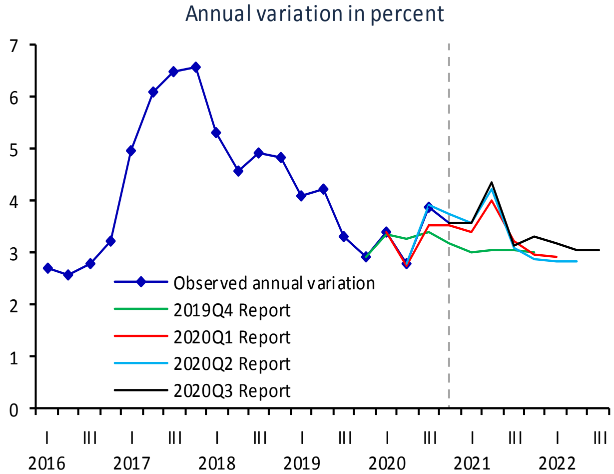
iii. That the recent entry into force of the USMCA fosters greater-than-expected investment.

Inflation: In the two previous Quarterly Reports, paths were constructed for the possible development of inflation consistent with the three scenarios considered for economic activity. Based on these paths, the Reports presented the trajectory that inflation would follow in an intermediate scenario, i.e., at the midpoint of the range resulting from the scenarios considered. Although the evolution of the pandemic and its effects on economic activity continue to generate uncertainty about the trajectory that inflation could follow, this Report, in line with the inclusion of a baseline scenario for economic activity, presents also a baseline scenario for inflation, as reported prior to the pandemic, but underscoring the prevalence of high uncertainty.

In this context, with respect to the intermediate scenario for annual headline inflation that was reported in the previous Report, the forecast for this variable in the baseline scenario in this Report shows, in the short term, a downward revision due to the expected path of non-core inflation. Afterwards, the forecast is adjusted to the upside due to slightly higher trajectories than those anticipated for both core and non-core inflation. However, the rise that annual headline inflation has presented is still expected to be transitory, so that in forecast horizon of 12 to 24 months it will be around 3% (Table 1, Charts 3 and 4).

The adjustment in the trajectory of annual headline inflation can be explained, regarding its non-core component, mainly by the expected evolution of energy prices, which for the short term are foreseen to locate below of what was previously anticipated, but going forward their annual variations contribute to the upside. As for the core component of inflation, although from August to October moderate pressures to the upside were perceived relative to what was anticipated, particularly in merchandise prices, in the first fortnight of November important price reductions were observed due to the sales season known as *El Buen Fin*. As such, the forecast for the fourth quarter of the year remains similar to the one of the previous Report. Nonetheless, the expected trajectory of inflation for 2021 onward has been influenced by diverse counterbalancing factors. On the one hand, to the upside, due to the effects of the pressures that had materialized up to October, as well as to the reduction in the expected slack in the economy in the current baseline scenario with respect to the intermediate scenario previously anticipated. On the other hand, to the downside, due to the reductions in some price categories in November as result of the effects of *El Buen Fin*, although they are incorporated in the forecast mainly as transitory, and to an exchange rate that has located at more appreciated levels. In sum, from 2021 onward, core inflation may display a downward path, although somewhat slower than the one presented in the previous Report. This path shows a convergence towards 3%, as the shocks to which it has been exposed fade and the effects of a widely negative output gap become more apparent. As a result, it is also anticipated that in a forecast horizon of 12 to 24 months, annual core inflation will be around 3%.

Chart 3
Headline Inflation
Annual variation in percent



The vertical line indicates the fourth quarter of 2020.
Source: Banco de México and INEGI.

Chart 5 shows, for headline and core inflation, the rates for the annual variation and the seasonally-adjusted annualized quarterly variation in the forecast horizon. As it can be seen, given the aforementioned factors, core inflation may display a seasonally-adjusted quarterly rate lower than the annual rate in the fourth quarter, but this would be reverted by the first quarter of 2021. For the subsequent two quarters, the quarterly rates lie below its observed levels in the second and third quarters of 2020, periods that were subject to upward pressures in the context of the pandemic. These quarterly rates, in addition, are lower than the annual rates, which are affected for a whole year by the shocks they have encountered.

Inflation has been affected by several shocks of different sizes and in opposite directions, a situation which poses significant risks and trade-offs for monetary policy. Indeed, the evolution of input and finished good prices worldwide, the depreciation of the real exchange rate, and the effects on the costs of provision of several goods and services, are combined with the broad slack in the economy and changes in the composition of household spending. For example, given the available information, it is difficult to assess the persistence of the reductions in the prices of some non-food merchandises in the first fortnight of November, in the context of *El Buen Fin* and of the wide economic slack. These shocks have affected inflation during the months of the health contingency, and it will be important to be vigilant of its consequences going forward. The balance of risks for the expected trajectory of inflation is uncertain. In particular, the following risks to the downside stand out:

i. A greater-than-expected impact of the widening of the negative output gap, additional social distancing measures that decrease the demand for goods and services, or that, given the weakness of aggregate demand, the price reductions observed during the *El Buen Fin* turn out to be more persistent.

i. Downward inflationary pressures worldwide.

ii. An appreciation of the peso exchange rate.

iii. Energy prices below the expected figures.

iv. Given the current slack conditions in the economy, that wage revisions do not exert pressures on prices.

Regarding the risks to the upside, the following stand out:

i. A greater persistence of core inflation.

ii. Episodes of exchange rate depreciation.

iii. An increase in the relative demand for certain goods in the context of the health crisis, thus exerting upward pressures on prices.

iv. Energy prices lying at higher-than-anticipated levels.

v. Different cost pressures that affect firms, such as logistical problems, the implementation of sanitary measures, a considerable revision of wages or more expensive recruitment conditions being passed on to consumer prices despite the ample slack in the economy.

Given that the pandemic is still underway, additional shocks or nonlinearities stemming from ongoing impacts are likely to lead to pressures on inflation different from those observed in less extreme circumstances. Indeed, in an environment where slack persists, the pass-through of the exchange rate to prices could be lower than usual. Likewise, although there has been some recovery, if the global economy continues weakening, the prices of several inputs or finished goods could decrease worldwide, which would also be reflected in downward pressures on prices in Mexico. In contrast, given the uncertainty in the current economic environment, although the peso exchange rate has appreciated slightly from the levels observed at the beginning of the pandemic, further episodes of depreciation cannot be ruled out, possibly exerting a greater pass-through effect on prices. Moreover, although some productive activities have been adapting to the new circumstances, the pandemic could continue to affect the terms, conditions, and costs at which various goods and services are supplied to the economy. In addition, pressures on public finances related to the pandemic could put pressure on risk premia and the exchange rate.

Table 1

Headline and Core Inflation Forecasts

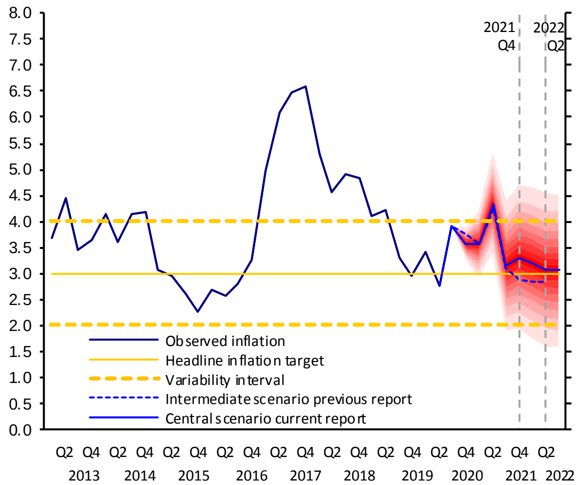
Annual change in percent

	2020				2021				2022		
	I	II	III	IV	I	II	III	IV	I	II	III
CPI											
Current report1/	3.4	2.8	3.9	3.6	3.6	4.3	3.1	3.3	3.2	3.1	3.1
Previous report2/	3.4	2.8	3.9	3.7	3.6	4.2	3.1	2.9	2.8	2.8	
Core											
Current report1/	3.7	3.6	3.9	3.8	3.9	3.6	3.0	3.1	2.9	2.9	2.9
Previous report2/	3.7	3.6	3.9	3.8	3.8	3.5	3.0	2.8	2.7	2.7	

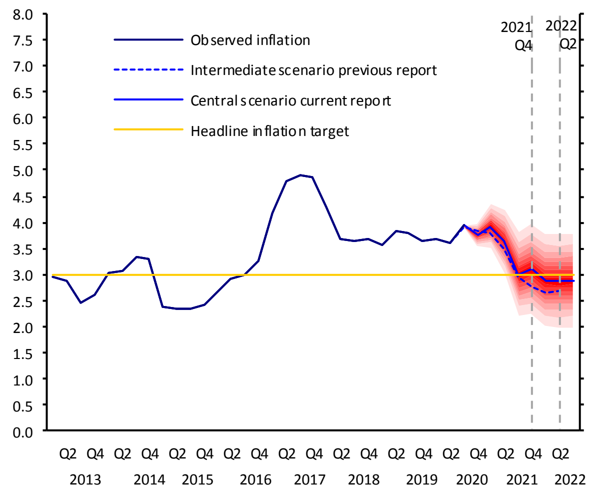
Note: Projections for inflation in the previous report were estimated based on the evolution of macroeconomic variables in the three scenarios described in that Report. The minimum and maximum for inflation between scenarios was estimated for each quarter on the forecast horizon. This Table reports the path that inflation would follow if it were to lay in the forecast horizon at an equidistant point to such maxima and minima.
1/ Forecast from November 2020.
2/ Forecast from August 2020.
Source: Banco de México with data from INEGI.

Chart 4

a) Fan Chart: Annual Headline Inflation 1/
Percent



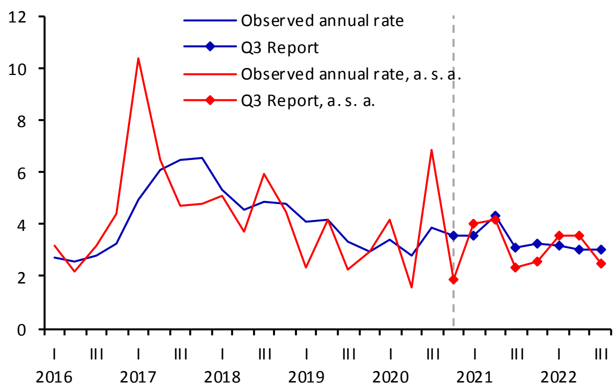
b) Fan Chart: Annual Core Inflation 1/
Percent



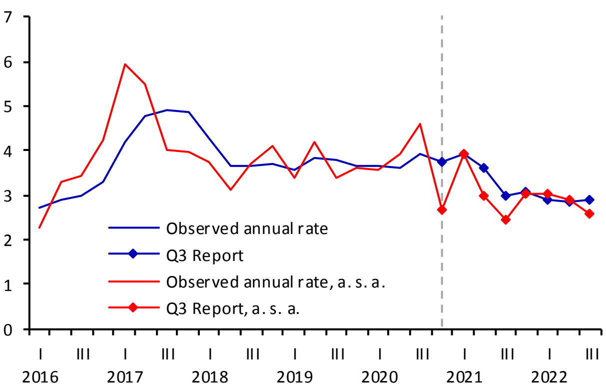
1/Quarterly average of annual inflation. The next four and six quarters are indicated with vertical lines, using as a reference the fourth quarter of 2020, that is, the fourth and second quarters of 2021and 2022, respectively, time frames in which the monetary policy transmission channels flluy operate.
Source: Banco de México and INEGI.

Chart 5

a) Headline Index
Quarterly variation, annualized and s.a., and annual variation in percent



b) Core Index
Quarterly variation, annualized and s.a., and annual variation in percent



s. a. seasonally adjusted figures.
a. s. a. annualized seasonally adjusted figures.
Vertical line corresponds to fourth quarter of 2020.
Source: Banco de México and INEGI.

Although the gradual reopening of various productive activities since June has enabled a recovery, following the distress caused by the health emergency in April and May, it is important to consider that a high uncertainty persists regarding the evolution of the pandemic. Additionally, the most lasting implications and effects on the economy, and its growth potential, remain to be determined. In this regard, economic policy, including monetary and fiscal realms, continues to face, in the short term, the challenge of taking actions to achieve a widespread, sound, and expedite recovery of the economy and the labor market, supporting the reactivation of consumption and investment. All of the above should be carried out without jeopardizing the strength of the Mexican economy's macroeconomic fundamentals. Such reactivation also requires fostering the conditions to attract more investment, improve the perception on the country's business climate, and reduce domestic economic uncertainty. The challenge of possibly more persistent effects of the pandemic on some sectors and regions is also faced in the medium term. Thus, it is necessary to allow the adjustments of the economy that are needed to promote the reactivation of productive activity and employment, allowing for flexibility in the allocation of resources, and ensuring a proper microeconomic functioning. In addition, solving the institutional and structural problems that have led to low levels of investment for several years, and that have prevented the country from increasing its productivity, must continue to be addressed. Similarly, as mentioned in previous Reports, efforts to strengthen the rule of law, fight insecurity, corruption and impunity, and ensure respect for property rights must also continue. All these measures will lead to a greater dynamism in the economy, thereby allowing better development opportunities and a greater well-being for all the population, not only during the recovery phase but especially in the longer term.

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