Regional Economic Report

April – June 2020

Summary

During the second quarter of 2020, the effects on economic activity caused by the COVID-19 pandemic and the actions implemented to contain it intensified considerably. These events affected negatively economic activity both on the supply side, given the restrictions on production in various sectors classified by the authorities as non-essential, and, on the demand side, given the lockdown and social distancing measures, in addition to the increased weakness of the global economy. In particular, in April, the main components of aggregate demand and the production of goods and services fell sharply. In May, economic activity continued to contract, albeit at a more moderate rate. In June the economy began to recover as some restrictions on business operations and population mobility started to loosen since late May and external demand recovered slightly. However, given the extremely low levels of activity in April and May, this recovery was moderate, in the context of a persisting environment of uncertainty. Consequently, for the quarter as a whole, GDP contracted abruptly and sharply.

The fall in domestic economic activity during the reported quarter responded to a significant decrease in production across all regions originated by the effects of the COVID-19 pandemic and the measures to contain it. Based on available information, a widespread decline in trade, construction, manufacturing, mining and tourism across regions is expected to have contributed to this outcome. However, the COVID-19 pandemic has had a differentiated impact across Mexican regions depending on the region's participation in those sectors that have been most affected by the supply and demand shocks caused by the health emergency. The Northern and Central regions were particularly affected by the decline in manufacturing due to their greater degree of specialization in that sector, while within said sector there is a high concentration in activities initially declared as non-essential, such as the automotive industry. In the South, the evolution of non-manufacturing activities, specifically tourism, to a large extent explains the contraction that is expected to be observed in the referred region during the second quarter of the year.

In addition to the supply and demand shocks on economic activity derived from the COVID-19 pandemic, Mexico has been affected by a financial shock that was particularly adverse in March. Regarding the latter, the country faced a considerable increase in global risk aversion, a fall in crude oil prices and reductions in the sovereign and Pemex's credit ratings, which after a very short time led to significant increases in interest rates and in risk premia, as well as to a significant depreciation of the Mexican peso. Nevertheless, during the second quarter of the year, the prices of financial assets in Mexico exhibited a more stable behavior in line with the recovery of international financial markets and in response to the measures adopted by Mexico's authorities to preserve an orderly functioning of financial markets.

In this context, inflation in the regions considered in this Report was determined by both downward and upward pressures from the shocks caused by the COVID-19 pandemic and by the measures taken to prevent its spread. In all regions, inflation was remarkably low in April as a result of declines in energy prices, which had a downward impact on non-core inflation. In addition, in all regions, social distancing and lower mobility measures implemented to contain the spread of the virus generated lower growth rates in the prices of various services, especially tourism. However, during the following months, inflation has increased in all of these regions due to an increase in energy prices, which has exerted upward pressures on non-core inflation, while core inflation has increased. Within the latter component, all regions have seen a significant restructuring, with downward pressures on services inflation and upward pressures on goods inflation. Inflation in the Southern region stands out for having increased the most and for having remained at the highest levels among the different regions, largely influenced by upward pressures on food commodity prices.

To complement the analysis of regional economic activity, Box 1 describes the evolution of the number of new cases of COVID-19 in Mexico's regions. Box 2 documents that while, at the aggregate level,

remittances have shown resilience, there was heterogeneity among Mexico's states regarding these inflows. Those entities for which a greater proportion of their remittances is estimated to come from Texas and California are found to be those that tended to show higher increases in revenues from remittances during the second quarter of the year. Box 3 shows that the probability of an IMSS-insured job separation increased more for workers aged 15 to 19 than for other age groups in the context of the pandemic, which seems to be attributed to the fact that they are workers with lesser experience and low wages. Likewise, the elements that help to explain the greater increase in the probability of job loss in men relative to women during the pandemic are found to be the sector to which each gender belongs and the type of work (either temporary or permanent).

Regarding the demand for businesses' goods and services, after the significant deterioration in expectations for the next twelve months among business agents interviewed between March 23 and April 23, 2020 for the first quarter Report, the results of the most recent interview program, carried out between June 22 and July 16, indicate a certain improvement in those expectations in all regions of the country. However, the diffusion indices that capture their expectations remain at relatively low levels, albeit above 50 points in all regions except the Northern one. In terms of expectations about the number of hired personnel in firms, the indicator remained below 50 points, and at a level similar to that of the previous quarter, in all four regions. As for expectations for investment in fixed assets for the next twelve months, in all regions except the North-Central one, this indicator was below 50 points and does not show a clear recovery from the levels reported in the previous quarter. In all regions the highest proportion of consulted business agents responded that they expect their sales prices to remain at the same level during the next twelve months, compared to the previous twelve months. They also mentioned more frequently that they expect their input prices to increase at an annual rate similar to that observed in the previous twelve months. In terms of wage costs, most interviewed business agents across all regions expect these to remain the same in the next twelve months compared to the previous twelve months.

Interviewed business agents pointed out the following risks to regional economic growth. To the downside: i) that social distancing measures are extended or intensified due to new outbreaks, with the consequent impact on economic activity; ii) that public safety indicators continue to deteriorate; iii) that employment recovers slower than anticipated; and iv) that the environment of domestic uncertainty that has affected investment continues. To the upside, business contacts mentioned the following risks: i) that the measures implemented are effective in mitigating the spread of the pandemic in Mexico, and ii) that the stimuli provided in different realms contribute to protect employment and the productive apparatus.

Looking forward, the recovery of regional activity will depend on how the characteristics of each region interact with some factors, both domestic and external. Regions like the Northern one, which are oriented towards exports of manufacturing goods, and those specializing in exports of agricultural products, such as the North-Central region, are more likely to benefit from a more rapid recovery of economic activity of our main trade partners and the recent entry into force of USMCA. The Central region, which represents the largest share of the tertiary sector in regional GDP, is also closely linked to the evolution of the domestic market and, in particular, employment, and will, therefore, be more dependent on the reactivation of domestic demand, and, in particular, of consumption. Finally, the recovery of the Southern region will depend on the evolution of the tourism sector, as well as on how the federal government projects are developed in that region, which may have direct and indirect effects on other sectors and on households' income. The recovery of the regional economies and the possibility of greater long-term growth also requires addressing pending tasks such as strengthening the rule of law, fighting insecurity, corruption and impunity, and ensuring property rights. In sum, these measures will enable a more robust recovery of investment and economic activity and employment in the regions, and will boost capital accumulation and productivity growth that will result in a greater well-being for the entire population.