Regional Economic Report
July – September 2020
Summary

After having contracted sharply during the second quarter of 2020 as a result of the effects of the COVID-19 pandemic and the actions implemented to contain it, Mexico's GDP began to recover during the third quarter, although economic activity remained below pre-pandemic levels. This behavior has been driven by a strong rebound in external demand since the end of the second quarter, as well as by the easing of contingency measures implemented since the end of May -which led to the reopening of several productive sectors, the gradual resumption of others, and to population's greater mobility. However, domestic demand has been recovering at a more moderate pace than external demand.

The partial recovery of Mexico's economic activity in the reported quarter was also observed across all regions of the country, although in a differentiated manner depending on their different productive structures. The Northern, North-Central and Central regions are estimated to register higher economic activity growth than the South, mainly due to the performance of manufacturing. This reflects both the firms' reopening in that sector and a certain recovery in demand, especially external demand, as was the case with the automotive industry. In contrast, the South has been recovering at a relatively slower rate, due to the fact that production in that region is concentrated in non-manufacturing sectors, whose recovery has been weaker than in manufacturing, and especially in activities such as tourism, which have exhibited a notably less vigorous reactivation than tertiary activities on average.

At the sector level, during the third quarter, the recovery of manufacturing production is expected to be generalized across all regions, especially manufacturing production destined to the foreign market, as well as mining, particularly non-oil, in the Northern and Central regions. Certain tertiary activities, such as trade, have also registered a slight recovery in all regions, although others, such as tourism, have registred a slower recovery. Finally, the agricultural sector is at levels similar to those observed before the start of the pandemic in the different regions of the country, since most of its activities were declared essential since the beginning of the health emergency.

As observed at the regional level, and as illustrated in Box 1, the COVID-19 pandemic has affected differently the country's major metropolitan areas, depending on the relative concentration of each metropolitan area in those sectors that were affected the most by supply and demand shocks caused by the health emergency. Box 2 estimates the impact on regional production that could be attributed to a lower availability of imported inputs at the beginning of the health contingency. The results suggest that the disruptions in supply chains resulting from this shock would have had a contracting effect on gross national production that was heterogeneous across sectors and regions, depending on their productive structure and relative intensity in the use of imported intermediate goods. Also focusing on the heterogeneity of the health crisis impact, Box 3 analyzes how the rehiring of workers who temporarily lost their IMSS-affiliated-job at the beginning of the pandemic has differed among regions by gender and age.

In addition to the supply and demand shocks to economic activity derived from the COVID-19 pandemic, Mexico has been affected by a financial shock. However, during most of the third quarter of the year, financial asset prices in Mexico, in general, exhibited a positive, albeit volatile, behavior. Moreover, these assets have been subject to more episodes of higher volatility since mid-September, although their adjustments have been more limited than those recorded in March and April, when the pandemic caused a sudden and significant increase in global risk aversion. While longer-term interest rates have declined during the period covered by this report and the Mexican peso has appreciated, volatility in the foreign exchange market has

remained relatively high and further episodes of risk aversion and volatility cannot be ruled out, which would depend on the evolution of the pandemic, as well as on idiosyncratic and external risk factors.

The effects of the COVID-19 pandemic caused by supply, demand and financial shocks continued to affect the evolution of national and regional inflation during the third quarter. In particular, all regions recorded higher average annual inflation during the reference quarter compared to the previous quarter, as a result of higher levels of core and non-core inflation. In the case of core inflation, the effects associated with the pandemic led to an internal recomposition in all regions, with merchandise prices experiencing upward pressures that outweighed the downward pressures exerted on services prices. However, since the end of the third quarter, some of the shocks that had exerted upward pressure on core inflation moderated, while in November, sales during the Mexican shopping event "El Buen Fin" led to a significant reduction in inflation in all regions. As for regional non-core inflation, the increase between the second and third quarter mainly responded to the increases in energy prices associated with the behavior of their international references. Subsequently, at the end of the third quarter and the beginning of the fourth, increases in the prices of agricultural and livestock products offset the lower annual variations in energy prices, although in November both fell, leading to a significant reduction in non-core inflation in all regions.

To analyze in more detail the evolution of regional inflation during the health emergency, Box 4 shows that the higher levels of core inflation in the Southern region are attributed to both the higher growth of merchandise prices in said region and to the greater relative importance of goods (specifically food merchandise) in the weighting structure of the price index in that region. In turn, Box 5 presents evidence of heterogeneous effects on food price increases by region and income quintiles during the health emergency. Finally, Box 6 studies how the shocks caused by the COVID-19 pandemic have affected core inflation and its components (merchandise and services) in the country's cities.

Regarding the demand for firms' goods and services, the results of the most recent interview program indicate that, in general, expectations of business agents consulted across all sectors have further improved in such a way that the diffusion index that captures their demand expectations for the next twelve months was above 50 points for the first time in all regions since the beginning of the pandemic. As to agents' expectations regarding the number of their hired employees, for the first time since the start of the pandemic, the diffusion index was above 50 points in all regions, although in none of the regions has it recovered the level recorded in the last quarter of 2019. With respect to expected investment in fixed assets over the next twelve months, the diffusion index was above 50 points in all regions for the first time since the health emergency began, although it remains at relatively low levels.

In all regions, the share of business agents who expect their sales prices to increase at a slower rate, remain at the same level, or even decrease over the next twelve months has declined, especially in the Northern and Central regions, although this share remains below that observed before the pandemic began in Mexico. This may reflect that a lower slack in the economy is expected, especially in the Northern and Central regions, compared to the expectations recorded in the previous quarter. The percentage of interviewed business agents who expect their input prices to increase at a slower rate, remain at the same level, or decrease over the next twelve months lowered in the North and North-Central regions, while an increase was observed in the Central region and especially in the South. Finally, in all regions there was a decrease in the percentage of business agents who expect wage costs to increase at a lower rate, remain the same, or decrease over the next 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 resumed due to new outbreaks, with the consequent impact on economic activity; (ii) that public safety indicators continue to deteriorate; and (iii) that the environment of domestic uncertainty that has affected investment continues. To the upside, business contacts mentioned the following risks: i) that the spread of the pandemic is mitigated, possibly as a result of new treatments or the

introduction of an effective vaccine, and (ii) that private investment is reactivated, encouraged by stimulus measures in different realms for that purpose.

Looking forward, the recovery will most likely continue to show heterogeneous trajectories among the different regional economies. On the one hand, a high degree of uncertainty prevails regarding the future evolution of the pandemic in the different states, as well as regarding the measures that the government authorities at the federal, state and local level could implement to contain its spread, and its consequent effects on productive activity. Indeed, the responses of state authorities to the pandemic have not been homogeneous and have considered, in some cases, the challenges of some specific industries, such as the automotive or tourism industries. Even if an effective vaccine or treatment becomes available, the speed of its distribution and application may vary among regions depending on the local infrastructure. On the other hand, differences in regional production structures, as well as their relationship with domestic and foreign markets, will continue to be the determining factors during the recovery. The more permanent consequences of the pandemic on regional economies remain uncertain. In particular, during the health emergency, there has been a more intensive use of digital technologies linked to e-commerce and teleworking, an acceleration of automated processes in some activities, and variations in consumption patterns due to contagion risks, which will not necessarily be reversed once the pandemic is over. Thus, the regions' performance will depend on their flexibility in reallocating resources to activities that generate greater growth, in particular, their ability to adapt to the technological changes that have been adopted as a result of the pandemic and to consumer preferences. Finally, success of the regional economies, not only during the recovery phase, but also in the long term, requires addressing pending tasks such as strengthening the rule of law; fighting insecurity, corruption and impunity; ensuring property rights; and, fostering sustainable regional growth.