Regional Economic Report
October – December 2020
Summary

During the fourth quarter of 2020, Mexico's economic activity continued to recover, after the strong contraction registered during the second quarter in the context of the COVID-19 pandemic. During the fourth quarter of 2020, GDP grew at a more moderate rate than in the third one and registered some weakening by the end of the year. In particular, although economic activity continued to recover in October and November, in December it decelerated due to the intensification of the pandemic and new restrictions on production and mobility implemented in some states. At the sectoral level, performance remains heterogeneous due to the type of shock that has been faced. In this regard, industrial production has shown a relatively more dynamic recovery, especially manufacturing, while tertiary activities recovered at a slower pace and with a differentiated behavior among their components.

During the reference quarter, economic activity continued to recover in all regions of Mexico, although heterogeneously depending on their different productive structures. By the fourth quarter of 2020, the Northern, North-Central and Central regions are estimated to have shown a higher level of recovery than the South, as compared to pre-pandemic levels. This is mainly due to their higher specialization in manufacturing production, which has expanded faster than the rest of the activities, especially the export-oriented ones. In contrast, the Southern region has recovered at a slower pace, given that production in that region is relatively more centered on the non-manufacturing sectors, which have shown a less vigorous recovery and are also less linked to the external market. In this regard, Box 1 presents a decomposition analysis to quantify the effect of the regions' sectoral structure on the economic contraction and recovery they have undergone, and to distinguish such effect from more idiosyncratic factors of the regions that may also have influenced their evolution.

Across all regions, manufacturing production is estimated to have continued to recover during the fourth quarter, although with a certain loss of dynamism. Mining is expected to have expanded at a slower rate in the Northern and Central regions. Although construction expanded in the Central and Southern regions, driven by public sector projects, it declined in the other regions. Certain tertiary activities, such as retail trade and tourism, continued to recover, albeit at a slower pace than in the previous quarter. In this context, Box 2 estimates the effects that an increase in remittances by region may have had on mitigating the contraction of private household consumption during the pandemic. Box 3 estimates the direct and indirect effects of shocks to the tourism sector on regional economic activity in 2020. A scenario of that sector's performance in 2021 and its indirect implications for other sectors is also projected, based on expectations of interviewed business agents. Finally, regarding economic activities during the reference quarter, the agricultural/livestock products sector contracted in all regions, except in the North-Central one.

The evolution of inflation in Mexico's regions has continued to reflect the different shocks generated by the COVID-19 pandemic. A significant change in relative prices was still observed across all regions, with upward pressures on merchandise inflation and downward pressures on services inflation. In particular, supply shocks associated with measures adopted to contain infections have led to disruptions in global supply chains and to production cuts, while production costs have increased. Social distancing measures have also led to a lower demand for certain goods and, in particular, for various services, while the relative demand for food has increased. On the other hand, the depreciation of the exchange rate derived from the financial shock at the beginning of the pandemic, together with the aforementioned supply shocks, have exerted upward pressures on inflation, particularly in the case of non-food

merchandise, partially offsetting downward pressures derived from the greater slack in the economy.

In this context, between the third and fourth quarters of 2020, headline inflation in Mexico declined from an average of 3.90 to 3.52%, reflecting the reduction in headline inflation in all regions. Indeed, during the reference quarter, annual headline inflation in the Northern, North-Central, Central and Southern regions was 3.39, 3.53, 3.30 and 4.15%, respectively, as compared to the levels of 3.67, 3.79, 3.81 and 4.45% observed during the third quarter of 2020, in the same order. At the national level, core inflation decreased between the referred quarters (from 3.94 to 3.82%), which is explained by the reduction in core inflation in the Central and Southern regions, due to lower levels of merchandise and services inflation. In contrast, in the Northern and North-Central regions core inflation increased between the quarters, exhibiting higher merchandise inflation levels, even though services inflation also declined. During the fourth quarter, non-core inflation decreased in all regions, as a result of a decline in energy and in fruits and vegetables inflation.

In February 2021, and just as it did at the national level, annual headline inflation rose in the Northern, North-Central and Southern regions. In contrast, it decreased in the Central region, the region with the lowest annual variations in its headline price index. During that month, in the Northern, North-Central, Central and Southern regions inflation was 4.05, 4.26, 3.10 and 4.32%, respectively.

The results of the most recent survey indicate that business agents' expectations continued to improve, in such a way that, in all regions, the diffusion index of the expected demand for their goods and services reached levels similar to those corresponding to the fourth quarter of 2019. As for the diffusion index of agents' expectations regarding the number of their hired employees, it continued to increase in all regions of the country, registering a level above 50 points for the second consecutive quarter. Agents' expectations regarding their investments in fixed assets for the next twelve months also improved overall for the second quarter in a row, so that the corresponding diffusion index continued to be above 50 points in all regions.

Regarding the sales prices of the goods and services they offer, most interviewed business agents continue to expect these to increase at a slower rate, remain at the same level or decrease over the next twelve months as compared to the previous twelve months. However, in all regions, except the Northern one, there was an increase in the share of business agents who expect these to increase at a greater or the same rate over the next twelve months, as compared to the previous twelve months. Likewise, the percentage of agents who expect input prices to increase at a similar or higher rate over the next twelve months as compared to the previous year increased in all regions, except in the Central region. The percentage of agents who expect wage costs to increase at a similar or higher rate over the next twelve months was higher than in the previous quarter in the North-Central, Southern, and especially, the Northern region.

Interviewed business agents pointed out the following risks to regional economic growth. To the downside: (i) that social distancing measures are extended or stricter measures are resumed as a consequence of the pandemic; or that the vaccination process is less effective in boosting recovery due to delays in the production, distribution or application of vaccines; (ii) that public safety indicators continue to deteriorate; and (iii) that the environment of domestic uncertainty that has affected investment persists. To the upside, business agents mentioned the following risks: (i) that the pandemic dissipates in the short term as a result of an effective vaccination process, and (ii) that the stimuli that have been granted in different realms contribute to the recovery of the regional economies.

The beginning of the immunization process in several countries around the world, including Mexico, has improved expectations regarding the recovery and normalization of economic activity both globally and in the different regions of Mexico. However, this process is not risk-free and represents a great challenge. At the present time, it is difficult to anticipate with certainty the more lasting consequences of the pandemic on the regional economies. In any case, it is necessary to continue strengthening the regional economies' institutional framework in all its dimensions in order to achieve higher growth rates and the well-being of the

population. One strategic guideline in this regard, which is highlighted in this Report, is to achieve greater equality between men and women in the labor market. As shown in Box 4, the regions' long-term GDP per capita could increase significantly if the frictions that prevent women from participating to the same extent as men were eliminated.