Regional Economic Report
January – March 2020
Summary

Although since the beginning of 2020 and prior to the COVID-19 spread, economic activity in Mexico remained weak as had been the case for several quarters, at the end of the first quarter of 2020 production of goods and services was severely affected by the measures adopted to contain the spread of the pandemic in Mexico, by the major weakening of the global economy, and by the resulting disruption of global value chains. As a result, economic activity contracted considerably in the quarter as a whole. The impact of the outbreak is also estimated to have deepened during the second quarter and is foreseen to extend for a period that is difficult to precise, leading to a considerable generalized contraction of the main aggregate demand components. It should be emphasized that, indeed, high uncertainty still persists over the depth and duration of the foreseen deterioration of Mexican economic activity.

The contraction of economic activity observed during the quarter under analysis derived from a fall in productive activity across all regions. Indeed, not only the widespread weakness across regions that was already present at the beginning of the quarter continued, but the significant negative impact of the COVID-19 spread and the measures to contain it were evident in all regions by the end of said quarter. According to available information, in all regional economies the contraction of manufacturing together with the significant fall in tourism are estimated to have contributed largely to this result. Similarly, the fall in mining and commerce in the Northern and Central regions, the decline in the construction industry in the latter group of regions, and the negative performance of the agricultural and livestock products sector in the North-Central region are also expected to have contributed to the fall in economic activity.

In addition to the supply and demand shocks that have affected economic activity, under a considerable increase in risk aversion in international financial markets and the fall in crude oil prices, the Mexican economy was also affected by a financial shock, which brought about a considerable tightening of external financing as well as capital outflows, significant increases in interest rates and risk premia, and a strong depreciation of the peso exchange rate. However, in recent weeks, Mexican financial markets have performed better, registering lower yields on government securities for all terms, while the peso exchange rate appreciated and exhibited lower volatility.

The supply, demand and financial shocks caused by the COVID-19 pandemic affected the inflation process, both at the national and regional levels. Among the main effects of the pandemic on inflation are that, in response to the sharp fall in international references, energy prices decreased considerably in March and even more in April. This exerted significant downward pressures on non-core inflation in all regions, although more recently international energy references have recovered and, therefore, part of said impact has been reversed. Similarly, certain services' prices fell as a result of social distancing and reduced mobility measures. Nevertheless, upward pressures on the prices of certain goods such as food, medicines, and household goods have also been observed, which may have increased their demand as a result of the health crisis or because they might be facing supply-related shocks. In April 2020, annual inflation in the Northern, North-Central, Central and Southern regions was 1.45, 1.81, 2.35 and 2.86%, and in May, 2.42, 2.54, 2.87 and 3.55%, respectively.

To complement the regional economic analysis, Box 1 describes the evolution of the pandemic in all Mexican regions, along with the measures adopted at the federal and state levels to contain its spread. Box 2 analyzes the effect of different shocks generated by the pandemic on firms' operations, based on the results of a special survey among business contacts. Box 3 describes the strong fall in air passenger transportation observed at the end of the first quarter of 2020 across all regions, considering both interregional and international passengers. Box 4 shows that given the productive structure of regional economies, the shock of the COVID-19 pandemic on formal employment was larger in certain regions. Furthermore, in the future employment is anticipated to be affected not only in

those sectors that have productive links with the initially affected sectors (indirect effects), but also in sectors in which demand has decreased as a result of the impact on households' income (induced effects). Finally, Box 5 analyzes fruits and vegetables' distribution patterns from producers to consumers, highlighting that the presence of intermediaries in the provision of goods, more frequent in the cities of the Southern region, is associated with slightly higher price levels and with a somewhat higher probability of a shortage of said products, as compared to a situation where the cities would be supplied directly by producers. At the same time, it describes how in the long term there is a relative convergence of prices among cities, thus suggesting that markets are integrated. In the context of the pandemic, these findings reveal the possible risks associated with distribution problems that the cities that are being provided goods through intermediaries might face.

The health emergency significantly affected the expectations of business agents consulted throughout the country. Indeed, as to the demand for goods and services provided by firms, the diffusion index of all regions fell markedly to a level below 50 points. Consistent with the foreseen contraction of demand, the diffusion indices corresponding to hired personnel and physical capital stock also fell significantly to below 50 points in all regions, except for the Southern region in the case of businesses' physical capital. A predominant share of business agents expect labor costs and sales prices to remain at the same level for the next twelve months, despite the fact that the share of those who expect their input prices to grow at a higher rate increased.

Consulted business agents listed the following risks to regional economic growth. Among those to the downside: i) that the negative impact of the COVID-19 pandemic on regional economic activity extends more than expected; ii) that public safety levels deteriorate; and iii) that, regardless of the health emergency, private investment and employment remain weak. As to risks to the upside, some of the mentioned were: i) that employment protection and business support programs are implemented effectively; ii) that a more effective and faster-than-anticipated containment of the COVID-19 pandemic is achieved, and iii) that public investment in infrastructure recovers.

The COVID-19 pandemic, with its impact on public health and on regional economic activity, poses major challenges for both Mexico and for its society, as a whole. Indeed, both during the health emergency and afterwards, an environment of confidence and certainty must prevail that allows to attract investment and contributes to preserve the sources of employment in the states, in order to avoid the impact from becoming more permanent. Improving the microeconomic functioning of the regional economies is also required to achieve a better allocation of resources that allows to face the consequences of the pandemic in better conditions. This will increase the probability of a more rapid recovery of regional economic activity and, particularly, of employment.