Banxico's Q1-2020 Inflation Report: Higher inflation on sight as economic activity sharply contracts in the Central Bank's new projections

- Yesterday, Banco de Mexico published its new Inflation Report, corresponding to Q1-2020, which provides its first comprehensive public assessment of the Mexican economic landscape and its outlook after the hit of COVID-19.
- The Bank provided details about the already visible effects of the simultaneous supply, demand and financial shocks on economic activity and inflation.
- Nevertheless, all eyes were on Banxico's revisions of its growth and inflation projections:
  - Amid unprecedented uncertainty, it decided to present 3 alternative scenarios for economic growth, based on different assumptions regarding the depth and duration of the economic consequences of the pandemic. These scenarios consider contractions between -8.8 and -4.6% in 2020, and growth rates between -0.5 and 4.1% in 2021.
  - Relative to its past projections, the Central Bank expects inflation to go up from H2-2020 onwards, only to reach 3% at the end of 2021 as a result of average core inflation going up significantly in Q2-2020 and until Q1-2021 and an upward trend in non-core inflation.
- This was definitely a hawk outlook for inflation and a powerful message which, in our view, justifies the tone of the last monetary policy statement and the cautious pace that we expect with respect to future interest rate reductions –according to our estimates, the former will accumulate 100 bps more of monetary easing, with the next 50 bps reduction being on June 25th.

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Banco de Mexico published its new Inflation Report, corresponding to Q1-2020, yesterday afternoon. Importantly, its content represents the Central Bank's first comprehensive public assessment of the Mexican economic landscape and its outlook after the hit of COVID-19.

The Central Bank's narrative began with the outlining of the **severe and simultaneous shocks affecting the economy**, namely:

i) A negative supply shock coming from lockdown measures, which hindered the functioning of global value chains (GVC) and the supply of inputs for the production of national goods;

ii) A negative demand shock, on both the external and domestic fronts, due on the one hand, to the global-scale spread of the virus and, on the other hand, to social distancing measures, consumers' fear of contagion and reduced businesses and households' income; and

iii) A financial shock, which triggered restrictions to external financing, capital outflows, an increase in domestic interest rates and risk premia, and a sharp FX depreciation, amid greater risk aversion and falling international oil prices.

The Bank provided details about the already visible effects of these shocks on the economy

Regarding economic activity, it argued that in addition to the stagnant economic dynamics prevailing in previous quarters and in the first two months of this year, global economic weakness, GVC disruptions, and domestic social distancing measures also affected March data, thus translating into an important downturn in output growth during Q1-2020.

Concerning inflation, it pointed out that although international energy prices exerted downward pressures on non-core inflation in March and April, while some services prices also decreased, these favorable dynamics have been offset by increasing prices of selected goods –such as food, medicines and home and personal care products– and a partial subsequent reversion of low energy prices.

When describing the evolution of financial markets, it highlighted the deterioration of operating conditions and the increase in financial volatility when the initial effects of the shocks began to materialize, and the better overall performance observed during the past weeks. It also noted the recent rating downgrades to the sovereign and Pemex's debt (see Box 6 of the Inflation Report for details), and signaled that despite the slight improvement in recent financial conditions, important risks challenging financial markets prevail.

Finally, regarding its own policy actions, Banxico stressed the complex environment that the current situation poses to the conduction of monetary policy, and commented on the additional measures that it announced "to promote the orderly functioning of financial markets, strengthen the economy's credit channel and provide market liquidity". In addition, it presented a Box which takes stock of all the economic policy actions taken so far in the country, including a) details of its own measures, and b) the list of fiscal and c) financial measures that the federal government has announced and that, according to the monetary authority, account for 3.3, 1.0 and 0.3% of GDP, respectively (see Box 7 of the Inflation Report).

Nevertheless, all eyes were on Banxico's revisions of its growth and inflation projections

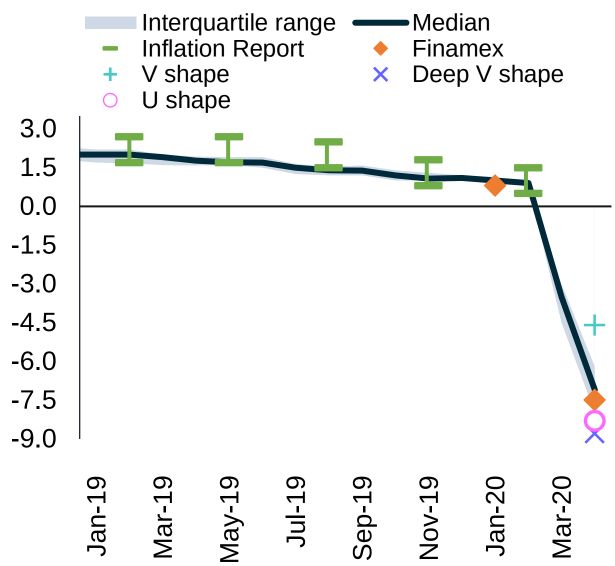
Banco de México explained that the fact that the pandemic is still materializing entails the prevalence of unusual uncertain conditions in at least three fronts: i) the duration and severity of lockdown measures; ii) the potential risk of a second wave of contagion once the former are relaxed; and iii) the timing when either an effective treatment or a vaccine would become massively available. Therefore, in contrast to its business-as-usual practice, and following the steps of other central banks, it decided not to rely on a baseline case but to present instead **3 alternative scenarios for economic growth, based on different assumptions regarding the depth and duration of the economic consequences of the pandemic** –described in Box 2 of the Inflation Report– (see Figures 1A and 1B). Specifically, the scenarios presented are:

1. A V-shaped scenario, that considers that economic damage is concentrated in 1H-2020 after which there is a fast recovery, thus entailing growth estimates of -4.6% in 2020, and 4.0% in 2021.

2. A deep V-shaped scenario, in which the economy is affected more intensely during 1H-2020 and in Q3-2020, followed by a recovery at the end of the year and forward. It implies growth estimates of -8.6% in 2020, and 4.1% in 2021.

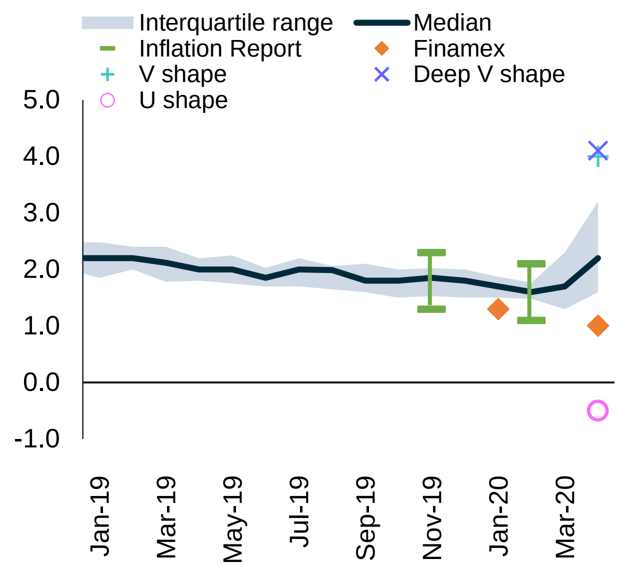
3. A deep U-shaped scenario that also assumes a deep but more protracted deceleration of economic activity and a slower recovery, in which there is a severe 8.3% contraction of growth in 2020, followed by a further YoY decrease of 0.5% in 2021. Worth noting, this scenario is close to Finamex's current baseline growth forecast, although it entails even more pessimistic GDP levels (see Figures 2A and 2B).

Figure 1A. 2020 GDP growth expectations (YoY %)



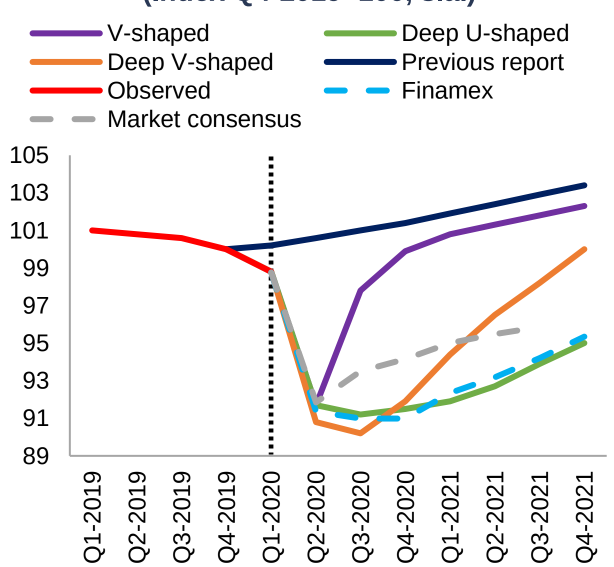
Source: Finamex Economic Research with data from Banxico's Expectation Survey and Inflation Reports.

Figure 1B. 2021 GDP growth expectations: (YoY %)



Source: Finamex Economic Research with data from Banxico's Expectation Survey and Inflation Reports.

Figure 2A. Mexico GDP estimates (Index Q4-2019=100, s.a.)



Source: Finamex Economic Research with data from Bloomberg and Banxico's Quarterly Inflation Report.

Figure 2B. Mexico GDP growth estimates (%)

Period		Banxico Scenario 'V'	Banxico Scenario Deep 'V'	Banxico Scenario Deep 'U'	Finamex	Market consensus
2020	Q2	-7.2	-7.2	-8.1	-7.5	-7.0
	Q3	6.7	-0.5	-0.7	-0.4	1.8
	Q4	2.1	0.3	1.9	0.0	0.7
	Annual	-4.6	-8.8	-8.3	-7.5	-6.5
2021	Q1	0.9	0.4	2.7	1.5	0.9
	Q2	0.5	0.9	2.2	0.9	0.5
	Q3	0.5	1.3	1.8	1.1	0.4
	Q4	0.5	1.2	1.8	1.2	-
	Annual	4.0	4.1	-0.5	1.0	2.0

Source: Finamex Economic Research with data from Banxico's Inflation Report. We calculate Banxico's quarterly growth scenarios as those implicit in their plots. Quarterly estimates are SA, and annual ones are NSA.

Accordingly, the Bank expects the loss of 1.4 to 0.8 million of formal jobs in 2020 and a range for new formal job posts between –0.2 and 0.4 million in 2021. Furthermore, the Bank pointed the extension of lockdown measures, additional episodes of financial volatility, ineffective support measures both here and abroad that risk the rise of more permanent damage in the economy, and other fundamental economic disruptions –such as changes in trade conditions and the breakdown of GVC– , as well as additional reductions to the sovereign and Pemex's debt ratings, as well as pervasively weak domestic demand conditions, among the downside risks for economic activity. Only a few upside risks were mentioned: An effective contention of the spread of COVID-19, efficiency of economic stimuli hear and/or abroad, and better investment prospects given the entry into force of USMCA.

Regarding its new inflation projections, Banxico explained that although each growth scenario entailed different paths for inflation –which in turn should correspond to different FX, risk premia, and wage dynamics, among others–, **inflation estimates are less disperse than growth forecasts, as contrasting forces implied in each one of the scenarios tend to offset each other.** In light of this, it only presented a range for the new inflation trajectory and, more importantly, it emphasized its mid-point.

Relative to its past projections, the Central Bank expects inflation to go up from H2-2020 onwards, only to reach 3% at the end of 2021. The former as a result, on the one hand, of average core inflation going up significantly in Q2-2020, and remaining at levels of 3.7 and 3.8% until Q1-2021 –between 40 and 80 bps above previous projections– and, on the other hand, of non-core inflation following an upward trend from current low levels (see Figures 3A, 3B, and 3C, as well as Table 1).

Table 1. Banco de México's inflation projections (YoY %)

	2020				2021				2022
	I	II	III	IV	I	II	III	IV	I
Headline inflation									
Q1-2020 Report	3.4	2.7	3.5	3.5	3.4	4	3.2	3	2.9
Q4-2019 Report	3.3	3.3	3.4	3	3	3	3.1	3	
Core inflation									
Q1-2020 Report	3.7	3.7	3.8	3.8	3.7	3.2	2.7	2.6	2.5
Q4-2019 Report	3.6	3.3	3.2	3	2.9	2.9	2.9	2.9	

Source: Finamex Economic Research with data from Banxico's Inflation Reports.

Figure 3A. Headline inflation projections: (%, average)

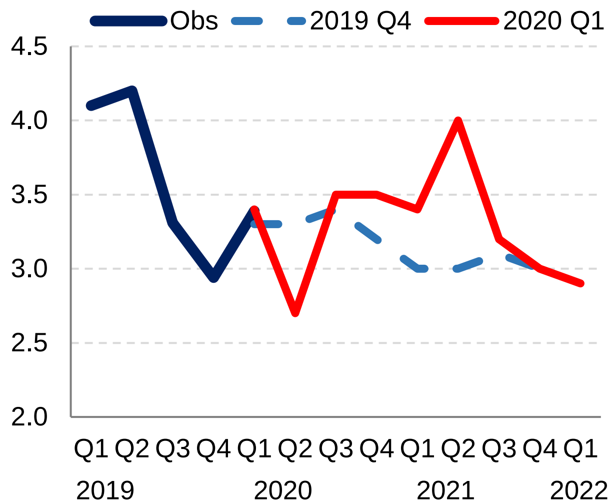


Figure 3B. Core inflation projections: (%, average)

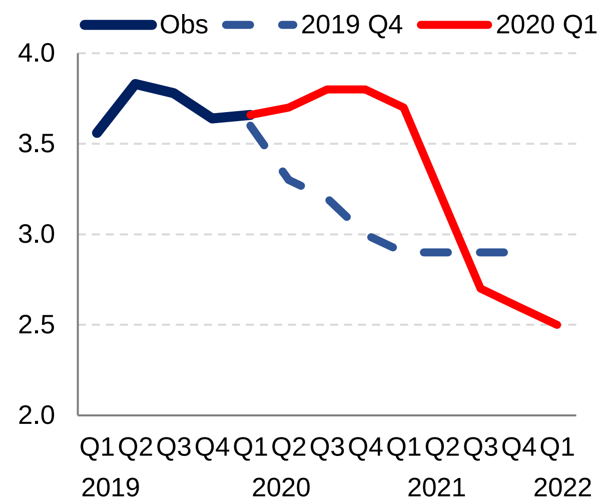
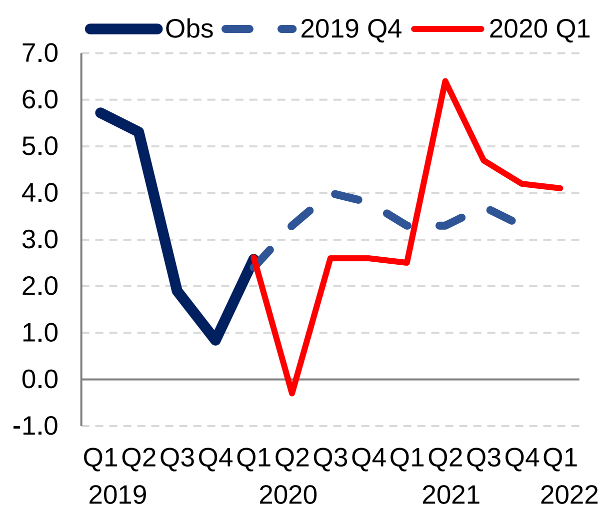


Figure 3C. Implicit non-core inflation projections: (%, average)



Source: Finamex Economic Research with data from INEGI and Banco de México's Inflation Reports.

This was definitely a hawk outlook for inflation for at least three reasons: i) the rise of new short-term cost-push and demand shocks related to lockdown measures which, together with what the Central Bank seems to interpret as a permanent FX depreciation, are enough to compensate for the substantial widening of slack conditions in the economy since Q1-2020; ii) the continued perceived persistence in core inflation and a delayed effect of worsening aggregate demand on prices; and iii) the fact that new projections suggest that the worse the economic outlook gets, the more inflationary pressures would arise –either because of higher FX or risk premia or because more supply-side shocks could enter into play–, hence offsetting disinflationary forces. Nevertheless, Banxico emphasized that inflation will remain within its +/- 1% variability interval around the 3% target during most of the projected path, although it also argued that the surge of nonlinear effects and additional side-effects on price dynamics cannot be discarded, thus maintaining the balance of risk for inflation as highly uncertain.

This is a powerful message which, in our view justifies the tone of the last monetary policy statement and the cautious pace that we expect with respect to future interest rate reductions, which in our view will accumulate 100 bps more of monetary easing, with the next 50 bps reduction being on June 25th.

The importance of correcting structural and institutional issues

Beyond emphasizing the need to preserve sound macro fundamentals and the stability of the financial system, and to adopt the necessary monetary and fiscal actions, the Central Bank did not miss the opportunity to emphasize the unrelenting need to correct the structural and institutional problems that had reduced the country's investment levels and hindered increases in productivity. "The health emergency should not make us forget these pending issues, on the contrary, it makes them more pressing," it argued.

Technical Boxes

Finally, in addition to the Boxes already mentioned (2, 6 and 7), the Report presented other four Boxes in which the Central Bank focused its attention on the Measures Implemented in Various Economies to Tackle the COVID-19 Pandemic (Box 1), the effects of COVID-19 on economic activity and inflation (Boxes 3 and 5), and the effects of monetary policy easing on firm's financing costs:

- <u>Box 3. Formal Employment in the Face of the COVID-19 Pandemic</u>. The COVID-19 pandemic represents a macroeconomic shock that has put the Mexican labor market into stress. Specifically, it could be affecting employment through four mechanisms: i) less availability of intermediate inputs, due to China's closure of manufacturing centers; ii) a decrease in external demand caused by the temporary closure of economic activity in the US; iii) the temporary closure of non-essential economic activities in Mexico, and iv) lockdown measures that have lead households to spend less. The significant destruction of formal employment has concentrated on the Industry and Services sectors. These sectors tend to have higher employment rotation, thus, the greater flexibility in hiring offered by temporary jobs suggests that the recovery could be faster once the shocks dissipate.

- Box 4. Impact of Monetary Policy Easing on Firms' Financing Costs. The analysis estimates the effects of the floating rate channel on the economy, i.e. the effect of lower reference rates on debt services paid by firms from August 2019 to April 2020. The results suggest that the Central Bank's monetary easing during these months has led to a moderation in the financial burden of private firms holding credits granted by commercial banks. Although this moderation has had a positive effect on the financial position of said firms, the relief has varied conditional on the firm size. Specifically, the benefits for large (small) firms who tend to have larger (smaller) loans, with an 85% (66%) proportion of them holding floating-rate loan contracts, has been greater (relatively minor) – with each percentage point of reduction in the reference rate decreasing their financial burden by 3.5% (2.2%).

- Box 5. Product Varieties Available Online on Supermarkets Websites in the Context of the COVID19 Pandemic. Throughout the year, thousands of products were surveyed online on the websites of the three most important supermarket chains in the country, and categorized according to the type of product. After the World Health Organization declared COVID-19 as a worldwide pandemic on March 11th, a steady decline in the variety of overall brands, sizes and flavors of the products available online up until Phase 2 started on March 25th was detected. Afterward, a sudden drop in the variety of products also stands out. Between the first two months of this year and April, there was a decrease in the variety of processed foods and non-alcoholic beverages, alcoholic beverages, home preservation goods and personal care goods of 6, 28, 24, and 15%, respectively. A drop of this magnitude in such a short time suggests supermarkets were facing a sudden increase in demand that was not able to be balanced out by more supply of such items. As a result, prices were also affected, as April's monthly inflation print of those four product categories was higher than their 2010-2019 average. While this is a short-term change in demand, COVID-19 may imply long-term changes in consumer behavior and supply shocks as a result of supply-chain disruptions.

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