Economic Analysis

Is the monetary stance in Mexico appropriate?

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A year ago, with data at the end of 2022, inflation in Mexico -measured as an interannual rate- was 7.8%, while the core inflation was 8.4%. Now, with data at the end of 2023, general inflation is 4.7%, while core inflation is 5%. Although it is still above the Bank of Mexico's target range, inflation is substantially lower than that observed a year ago.

In this sense, it is worth highlighting what happened with core prices, which, by eliminating the most volatile items (those of energy and fresh food), tells us about a medium-term inflationary trend much more benign than that observed a year ago. The above is valid, even considering the most recent inflation data for the second half of January, which brought general inflation to 4.9%, given that temporary increases in agricultural prices fundamentally explain the increase. What is relevant about the data for the first fortnight of January is the reduction in underlying inflation to 4.8% and, in particular, the drop in services inflation from 5.4% to 5.2%, data that reinforces the disinflationary process.

On the other hand, a year ago, the statistics reported by the Bank of Mexico showed that short-term inflation expectations (one to four years) were at 4%, while now they are at 3.7%, around the average inflation observed in the last two decades. Medium-term expectations (five to eight years) have been well-anchored during this inflationary episode.

Since Mexico is an open economy and closely interrelated with the United States, inflation in its northern neighbor has also been an essential factor in determining the behavior of prices in Mexico. Thus, at the beginning of 2023, general inflation in the United States was at 6.4% and core inflation at 5.6%, while now these variables are at 2.3% and 2.6%, respectively.

What has happened to monetary policy in this period? To answer this question, we must analyze real monetary policy rates, that is, adjusted for inflation. Using the one-year expected inflation, we can obtain these rates (the ex-ante rates). Thus, while the real monetary policy rate was 5.3% a year ago, it is now at around 7%.

Thus, today we find ourselves in a much more favorable environment with lower inflation (both general and underlying), lower inflationary expectations, and lower inflationary pressures from abroad, but with a monetary stance that is more restrictive than it was a year ago when The variables mentioned above appeared adverse. This is a situation that I believe suggests that there is room to begin to lower the monetary policy rate.

On the other hand, the fact that inflation has decreased, both in Mexico and in the United States, without monetary policy having had adverse effects on either growth or the labor market suggests that, to a large extent, the inflationary shock experienced by the world after the Covid epidemic was due to supply shocks, explained by the bottlenecks that the health contingency caused. In this sense, such a restrictive monetary policy was likely not required to reduce inflationary pressures since the dilution of said shocks (and not high-interest rates) largely explains the disinflationary process. With this, I do not mean that tightening monetary policy was not necessary: it was appropriate to avoid an

unanchorment of expectations because, thanks to this, the economic agents interpreted that the Central Bank would do what was required to prevent an inflationary spiral.

It may be argued that new supply shocks may come, for example, with attacks on ships in the Red Sea, which may bring further price increases and that, therefore, it is not the time to ease monetary policy. Although these distortions can indeed occur, we should recognize that they would again be increases explained by temporary supply shocks against which monetary policy is ineffective. Based on the above, it seems to me that the conditions are in place, both in Mexico and the United States, for a cycle of relaxation in monetary policy to begin soon.

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