



BanxicoWatch

April 14th, 2009

We think that the monetary easing cycle is set to continue

- Banxico's balance of risks sheet continued to show a heavy bias towards weaker economic growth, while inflationary risks continued to lose relative weight, although at a slower pace due to the pressure still being exerted on some goods by the exchange rate (i.e. pass-through) and the impact of volatile components on inflation.
- Although at previous meetings, both the high volatility level in financial markets and the sharp depreciation of the Peso had been an important factor in not starting a more aggressive monetary easing cycle, the recent lightening of these pressures (largely due to the recent increase in available cash flow in Dollars through the IMF's Flexible Credit Line and the Fed's credit swap) has given more room to ease the monetary policy considerably. At the last meeting, Banxico sped up the bank lending rate lowering process in light of the financial stability observed. With this, the Bank of Mexico has, in theory, defined its relaxation strategy for the next meetings.
- We believe that the balance of risks will continue to deteriorate in terms of economic activity: the IGAE (Economic Activity Index) fell by 8.5% in seasonally adjusted terms, and early indicators hint that the economic contraction during this Q1 2009 will be the same as or larger than the one in the Q408. As for inflation, this was 0.2% in March compared to the average of 6.34% for the last three months. The downward trend continues, although various factors suggest a slightly slower reduction than forecasted. Inflationary risks will persist, although they will have less relative weight. Insofar as inflation expectations remain well-anchored and exchange rate stability prevails, the pass-through should be lower towards the mid-year to end-of-year period. We expect annual inflation to be around 3.8% at the end of the year, although with an upward bias.
- We think that in the current scenario, Banxico could continue with the monetary easing process that it started when the last monetary policy decision was taken. Therefore, we predict that at the next meeting the bank lending rate will be cut by at least 50 BP, being more likely to be cut by 75 BP or even more though.
- To sum up, in view of the deterioration in activity, the reduction in inflation and the sharp appreciation in the exchange rate, Banxico has more room to make its monetary policy decision. We consider that if the exchange rate stabilizes, the balance of risks, including inflationary risks, for economic activity will allow the bank lending rate to be cut to 5.0% over the coming months.