Economic Research Department

BBVA

Mexico

BanxicoWatch

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Banxico to cut lending rate by 50 bp to 4.75% at meeting on 19 June, getting closer to the end of the monetary easing cycle

- YTD, the policy interest rate has fallen 300 bp even though inflation levels are still outside Banxico's target range. The accrual of shocks in international commodity prices in 2007 and 2008 and the effects of the exchange rate depreciation delayed the downturn in inflation. Nevertheless, there was still room to ease the monetary policy in light of the sharp decline in economic activity and its impact on medium-term inflation.

- During 2008, in its monetary policy press releases, the Governing Board gradually attached more importance to risks over economic growth. This allowed the central bank's balance of risks to be included in a monetary policy structure in which the ultimate and only aim is to maintain price stability through a 3.0% inflation target (+/- 1% variation range). Therefore, as well as the publication of medium-term forecasts, the monetary authorities' communication strategy gave room to commence a monetary easing process in keeping with the balance of risks and in line with meeting the inflation target within the set timeframe.

- The current economic climate and prevailing uncertainty are both enough reasons to continue to adapt the monetary policy to the expected inflation trend, clearly downward. In addition, the outbreak of the virus A(H1N1) epidemic will have an impact on growth in the second half of the year, delaying the expected economic recovery in line with records in the US .

- In accordance with this situation and in light of the outlook that inflation has started a downward trend that will take it below 4% at the end of the year, we think that Banxico could lower the bank lending rate by 50 bp at its next meeting, although we are clearly near the end of the easing process. In its latest press release, Banxico highlighted that the bank lending rate will continue to fall but to a lesser extent – *"the actions taken so far have been of a preventative nature, and future measures will probably be of a narrower scope"*. However, there is a risk that the uncertainty that domestic financial markets are facing for the future could be good reason to bring forward the monetary policy pause. The press release will be important to help to gauge expectations.

- In any case, the flexibility that managing the balance of economic risks gives central banks in a system of inflation targets, especially in a context of downward risks on activity and well-anchored inflation expectations (and without signs of changing in the short term) in extreme circumstances such as today's, would be enough reason for a long monetary policy pause this year and over into 2010. Insofar as international bond markets do not face an extreme situation, the central bank's room for maneuver will be larger.

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