Economic Research Department

BBVA

Mexico

Banxico Watch

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Banxico to maintain its benchmark interest rate at 4.5%, in line with its announced monetary pause, though a cut to 4.25% in last quarter has not been ruled out

- **The Mexican economy has seen off the most intense phase of the adjustment, and may begin a moderate recovery**. Economic indicators (mainly the U.S., with Mexico lagging behind) suggest that the worst of the recession is over. This is particularly noticeable in industrial output, as U.S. companies restructure their inventories. Recovery in the labor market, and thus in consumer spending, will take longer and not be as strong. In Mexico, after four quarters of falling GDP from 3Q08 through 2Q09, at an average quarterly rate of -2.8%, we expect a return to growth starting in 3Q09, although the rates will be moderate, in line with the weak recovery expected in global demand. This implies that by the end of 2010, GDP in Mexico will still not have returned to pre-recession levels (2Q08). Thus the product gap will continue to extend over the next few quarters.

- **Inflation will continue to fall over the coming months. The weak economic scenario has a greater effect in this regard than risks in terms of commodities or regulated prices**. The extension of the product gap is the main factor behind the trend for falling inflation (which took time to take effect due to the major depreciation of the peso), and it will continue to give support to a further reduction. We expect an addition fall of more than one percentage point on current levels (5.4% annual) by December. In terms of core inflation, the stronger peso will sustain a continued fall in goods prices, while the economic recession will do the same for services. Although increases in public prices may be introduced in the budget, and these could have an impact on inflation, this situation would be temporary in character and have a very limited impact due their relative weight in the basket. Thus, although the inflation scenario for 2010 is not without risks, inflation is expected to fluctuate within the bands established by the Bank of Mexico (Banxico).

- **The balance of risks will continue biased towards lower inflation, and thus towards the maintenance of monetary relaxation for a prolonged period of time.** We expect that in this meeting Banxico will initiate the monetary pause announced in July and leave the benchmark interest rate at 4.5%. However, we believe that there is a good chance of an additional cut in the coming months. This will depend on the extent to which inflation falls, and on the expected recovery in economic recovery.

- **Banxico could be more explicit in its communications by stressing the prolonged nature of the monetary relaxation, and thus influence interest rate expectations.** The resistance of long-term interest rates to a reduction, together with the implicit assumption by markets of a positive probability to an upturn in the benchmark interest rate within the next six months, suggest that the markets are still not accepting that the extended nature of the monetary pause. Banxico could therefore take advantage of an alternative policy tool by being more explicit in its communications, in particular in terms of the balance of risks justifying a prolonged monetary pause.

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