Economic Research Department

Mexico

BBVA

Banxico Watch

September 18, 2009

Banxico maintains rate at 4.5% and announces future decisions to include inflationary impact of fiscal package and output gap. In turn, the reference to 2010 to bring inflation in at 3% is eliminated

- **Better outlook on the global economic scenario**. The Bank of Mexico highlighted evidence pointing to a global economic recovery in comparison to the previous release stating it had bottomed out. The mention of risks with regard to the recovery's strength in the face of weak job markets in industrialized nations was also pointed out again, as too the high level of household debt. We believe the doubts surrounding the strength and duration of economic recovery, especially in the US, will continue to affect risk assessment.

- **The release was also relatively positive on the Mexican economy, highlighting it had already "bottomed out".** After the major economic contraction in the first six months of the year, due to the strong ties to the US economy, Banxico continued to set out expected improvements in the second half. In fact, it was relatively more positive when pointing out the recent development in indicators such as industrial output, employment and consumer confidence, stating "they seem to indicate the economy has bottomed out". However, there is also uncertainty as to the strength of the recovery of domestic demand. This depends largely on the rate of reduction in the output gap.

- **Inflation scenario unchanged for 2009**. As regards inflation, the monetary authorities stated that this has maintained its downtrend in light of the fall in the goods sub-index since May and the fall in the services sub-index over several months. In turn, annual inflation is predicted to converge at 4% at year-close.

- **Board decided to maintain benchmark rate at 4.5%. Risk assessment to include effect on inflation due to fiscal package approved by Congress, as well as the development in output gap.** In our opinion, the fiscal measures to increase special taxes, public prices and consumer prices will temporarily displace it from the Banxico forecast range for 2010. In turn, the major accumulated job losses over three quarters, the outlook for a moderate upturn in foreign demand and the impact of the proposed 2010 fiscal measures all point to slow domestic recovery. Although inflation will temporarily diverge from the 2010 Banxico range, the wide product gulf should limit the persistence of this shock, without affecting salaries or medium term inflation perspectives. In fact, by being introduced in a set time period, other reforms to be discussed in Congress to make the economy more flexible and boost growth should contribute to reduce downward resistance in inflation over the medium and long term.

- **Banxico extends margin of maneuver in the face of forecast inflationary shock due to the fiscal package and doubts as to the strength of economic recovery.** By removing 2010 for achieving the target 3.0%, Banxico has extended its margin of maneuver so as to assess the possible effect of a second round and the impact on inflationary pressures due to fiscal policy. We expect a monetary pause at the next meeting and see no reason to expect rate increases over a prolonged time period.

Ociel Hernández Zamudio
o.hernandez@bbva.bancomer.com

Liliana Castilleja Vargas
liliana.castilleja@bbva.bancomer.com