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BanxicoWatch

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At the last meeting of the year (Friday, November 27), Banxico will keep the fondeo rate at 4.5%. The risk assessment supports a continuation in the accommodative monetary policy stance for more time than that discounted by markets

- **The Banco de Mexico (Banxico) has aggressively lowered the fondeo rate over 2009, cutting in by 375 bp between January and July. For the first time since Banxico adopted the inflation target scheme, the real (post facto) rate was negative: the yearly average being -0.2% and -0.7% since April.** It should be highlighted that despite the major inflation deviations with regard to the target in 2008-2009, this unprecedented relaxation was possible thanks to gained credibility (anchoring long-term inflation forecasts). A tool contributing to provide space for taking on this accommodative stance was the use of an expected inflation movement in release language, i.e., the reference to the target --given the major supply shocks-- would be achieved in the long run ("in forecast time periods"). Another major element was to highlight the role of risk assessment development (between inflation and economic growth) as a determining factor in monetary policy decisions. In this way, Banxico could cut the interest rate in a weak economic setting (wide output gap) despite the short-term inflationary environment not being favorable. **Banxico has been flexible and focused on risk management**.

- **For monetary policy to have greater effect on rates, it would be wise to continue driving transparency in monetary policy decisions, adding the publication of meeting minutes to the forecasts.** At the start of the year, the market did not expect major reductions in the lending rate. In our opinion, communication, as well as the doubt that may have been transmitted to economic agents due to the different rate cut sizes at the beginning of the easing cycle in 1Q09 (-50 bp in January, -25 bp in February and -75 bp in March), meant the preferences of the Board with regard to the major recession were not clearly passed on. In part, this explains that by not discounting major permanent changes to the short-term rate (the market was always behind the curve), the effect monetary policy had on the long end of the yield curve was below what it could have been. With the inflation target scheme and the growth in credibility, there is capacity for greater monetary policy flexibility when the risk assessment is under stress, such as in 2009. For monetary policy to come close to what is desired, economic agents need the greatest clarity possible with regard to the risk assessment effect on short-term interest rates. In this sense, a continued advance in communication is desirable and the publication of the minutes would be a good step in that direction.

- **The new timeline for reaching the inflation target (we believe it could now be towards the end of 2011) should provide Banxico with more space to prolong the monetary pause beyond what is already discounted.** In the next few days, the Central Bank will publish its new inflation forecast range for 2010 and 2011. This forecast will include the effects of the rise in taxes approved in next year's fiscal budget. We think the new range that the authorities forecast will rule out the possibility that inflation will converge at 3.0% in 2010, and postpone this convergence until the end of 2011. We therefore believe that the monetary policy statement at the next meeting, together with the statement in January 2011, could be determining factors when it comes to interest rate and inflation expectations.

- **In our opinion, the balance of risks will continue to justify the extension of the monetary pause.** On the one hand, inflation will upturn next year due to the fiscal supply shock; however, this shock should be temporary and have a limited intensity, meaning average inflation in 2010 will clearly come in below 2009. On the other, the output gap is wide and will take time to shrink back. This means the risk assessment could not justify an increase in the fondeo rate in the coming months. We believe Banxico will be in no hurry to increase short-term interest rates, except if there is an adverse reaction in inflation forecasts and/or salaries which we do not see occurring. In addition, financial conditions will be milder in 2010 than in 2009. Therefore, we think Banxico will continue to ensure that the balance of risks is in keeping with inflation convergence, in line with new forecasts (higher-than-expected inflation in 2010) and predicted timeframes (end of 2011).

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