Economic Research Department

Mexico

BBVA

BanxicoWatch

January 14th, 2010

Banxico's Meeting on January 15th

- Banxico set to keep lending rate at 4.50%
- The statement will indicate that the increase in inflation in 2010 will be temporary, and that Banxico will be watchful to prevent second-round effects from pushing inflation up in the mid-term
- We reckon that the balance of risks is still consistent with a monetary pause for a lengthy period of time

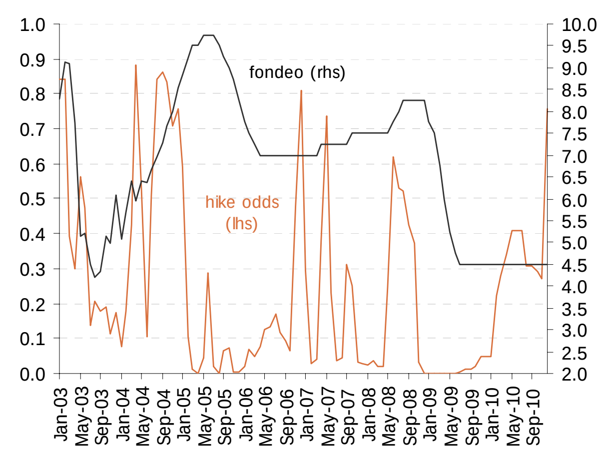
Fondeo Rate: 4.50%
Next Meeting: January 15th

In the second half of 2009, the Mexican economy began a recovery process consistent with the context of global economic upturn. This boost was the result of improved external demand, which became more noticeable in the associated services. When US companies began to restructure their inventories, Mexican industrial output and exports started to recover. This trend is now being reflected in a gradual recovery of employment, mainly in the manufacturing sector. Should the US economy continue to pick up, it will likely affect Mexican internal demand in a positive way. At present, the relevant indicators still suggest a certain lag, although the trend points to an improvement in the economy.

The inflation trend in the last months of 2009 was very favorable and in line with our estimates. This process of gradual convergence with the target was supported mainly by a wide output gap, the mitigation of the effect of the exchange rate depreciation, the freezing of public prices and a strong downward trend in food prices. In contrast, although the first two factors will continue to contribute to keep inflation down in 2010, price trends face a new supply shock: tax changes and increases in public prices. This is further compounded by the impact of higher commodity prices in a climate of global recovery, which could put upward pressure on both food (effect on non-core and core inflation) and construction materials (effect on core inflation). As a result, a significant, although temporary, increase in inflation during the year is expected, which has already been acknowledged by the central bank in its new trend estimate. The anchoring of the inflation outlook will be a determining factor in establishing the duration of the monetary pause.

Balance of Risk's Assessment: Although the balance of risks for 2010 is beginning to lean moderately towards higher inflation –in a climate of CPI acceleration, but with a wide output gap–, we believe that it is still consistent with a Banxico policy stance of around 4.5% (see table on the following page). We reckon that although the lending rate will very likely rise, it will still be moderate in 1S10, below the relevant threshold of the models being considered (see chart), around 40%. We think that the rate-rise risks will be more concentrated around 4Q10 when, according to our forecast, inflation could be higher than the average range of the trend expected by Banxico. **To conclude, we still believe that the Board will be in no hurry to raise the interest rate, except in reaction to adverse inflationary expectations and/or an accumulation of supply shocks that results in a new upward revision of inflation forecasts**. In his latest statement the new governor of Banxico was explicit in his assessment: "In principle, the Bank of Mexico should not counteract the direct impact of the fiscal measures on prices". This position is having an influence on analyst and market expectations, which have moved closer to our extended pause scenario.

Fondeo Ordered-Probit Model: Hike
(Probability of a rate hike vs. fondeo)



Inflation Forecast 2010-2011
BBVA vs. Banxico (% yoy, avg)

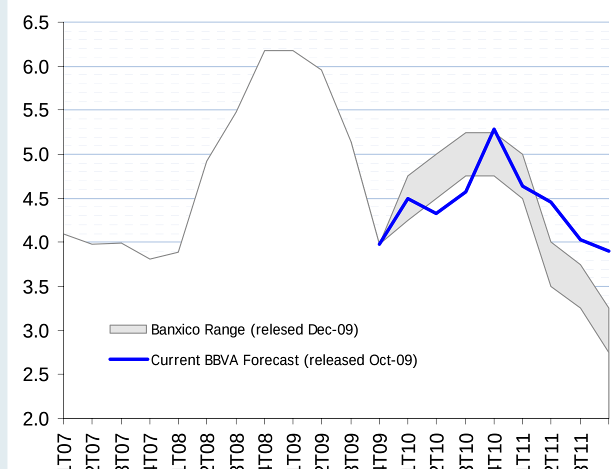


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Table 1: Balance of Risks

	1T09	2T09	3T09	4T09[1]	Effect[2]	Value[2]
IGAE (YoY, %)	-8.1	-10.2	-6.4	-5.3	↓	-1
Capacity Utilization (average, %)	68.6	68.3	69.1	69.4	↓	-1
Industrial Production (QoQ annualized, %)	-16.6	-2.9	7.1	5.2	↔	0
Industrial Production (YoY, %)	-10.1	-9.6	-6.6	-3.2		
Manufacturing IMEF (index, average)	44.3	47.3	51.0	52.6	↔	0
Unemployment rate (average, %)	4.8	5.7	5.9	5.7	↓	-1
Employment (IMSS, QoQ annualized, %)	-6.4	-4.3	-0.8	2.8	↓	0
Employment (IMSS, YoY, %)	-2.3	-3.8	-3.8	-2.2		
Real Wage (YoY, %)	-1.7	-1.4	-0.4	0.1	↓	0
Retail Sales (QoQ annualized, %)	-5.5	-3.0	-4.7	-7.7	↓	-1
Retail Sales (YoY, %)	-4.4	-5.6	-4.9	-5.2		
Consumer Confidence (index, average)	80.1	80.5	82.9	78.4	↓	-1
Headline Inflation (fdp, % anual)	6.18	5.96	5.14	3.98	↔	0
Core Inflation (fdp, % anual)	5.79	5.59	5.11	4.65	↑	1
Inflation Expectations (12-month)	4.08	4.06	4.20	4.75	↑	1
Inflation Expectations (3-year)	3.56	3.52	3.70	3.86	↔	0
Inflation Expectations (10-year)	3.39	3.38	3.46	3.49	↔	0
Inflation Deviation (Q-Q, pp)[3]	2.18	1.96	1.14	-0.02	↔	0
Sum	-6	-7	-5	-3		
Weighted Sum[4]	-0.6	-2.4	-0.3	0		
Qualitative Assesment	**Easing**	**Easing**	**Pause**	**Pause**		

[1] Only considers the months of the quarter with available information

[2] Own interpretation of the effect of each variable on monetary policy: ↑ restrictive, ↓ easing, ↔ neutral; a 1 is assigned to ↑, a 0 for ↔, and a -1 for para ↓; therefore, a sum greater (lower) suggestes a greater (lower) probability of a hike in the fondeo rate

[3] Difference between inflation and the upper-limite of Banxico's target variability range

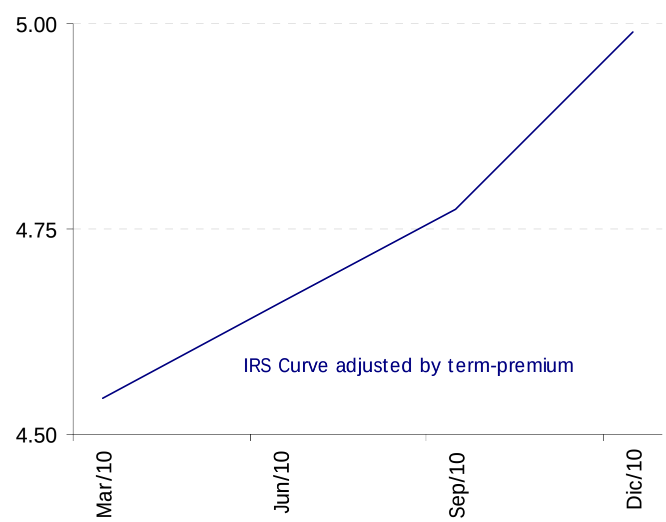
[4] Assigns a weight consistent with a Taylor Rule

Fondeo Analysts Forecasts

	Next Expected Movement	Month	2010 (eop)	2011 (eop)
Current (Jan12th)				
Median	0.25	**Jul-10**	5.50	6.38
Max*	0.50	Jan-11	6.50	9.00
Min*	0.25	Mar-10	4.50	6.00
Prev. month (Dec7th)				
Median	0.25	**Apr-10**	5.50	6.50
Max*		Jan-11	7.00	9.00
Min*		Jan-10	4.50	4.50
BBVA	0.50	Jan-11	4.50	6.50

* Analyst with the maximum (minimum) time expected for the next interest rate hike

Implicit Fondeo in IRS Curve



Source: Own calculations with Valmer's data