

Mexico

BanxicoWatch

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Banxico to maintain its lending rate and announce inflation risks

Decision on monetary policy. January 21th

Economic Analysis

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- **The central bank will maintain its lending rate at 4.5% and the message will once again imply a continued pause, in spite of the tone focused on inflation risks due to supply side clashes in the area of primary food commodities.**
- **We believe that while inflation forecasts continue unchanged—as is likely to be the case against a backdrop of growth that still does not close the product gap—it is premature to forecast an early increase of the lending rate in 2011; especially with the upward pressure on the exchange rate linked to capital inflows**

Since the last Banxico meeting, general external prospects have improved, and the Bank will address this in its statement, although it will also mention the high degree of uncertainty at hand. The search for profitability as a consequence of high liquidity and debt crisis in the euro zone continue to be the factors influencing financial variables at the global level. However, increased expectations of growth for the US and the granting of tax cuts has generated a new optimism reflected in gains in the stock markets and rises in interest rates. Additionally, over the last weeks, talk is being heard in the financial markets regarding the impact on inflation and the earlier and/or more dramatic tightening of monetary policy due to the worldwide increase in the price of commodities, and of foods in particular.

In domestic terms, activity continues to grow at a moderate rate and inflation, in spite of the increase at the end of the year, stood at the inferior limit of the central institute forecast range for 4Q10, which allows us to conclude that the scenario is adequate for the continuation of the monetary policy pause, at least for 2011. Therefore, with regard to activity, we do not expect substantial changes to previous announcements, and expect that we shall again witness moderate growth in internal demand and a slowdown of external demand. Still, with regard to inflation, we must monitor the messages from the monetary authority regarding the effects that the rise in commodities may have on prices and the expected inflation, given that this has been emphasized in the latest statements.

All in all, it will be important to follow scrupulously all messages concerning capital flows and their impact on the exchange rate or in the yield curve, especially the short end, which has been the focus of foreign capital investments.

In sum, Banxico will adapt its message to the changes in the worldwide and domestic outlook, but it will still indicate a protracted monetary policy pause.

Table 1:

Balance of Risks

	1Q10	2Q10	3Q10	4Q10 ¹	Effect ²	Value ²
IGAE (YoY, %)	4.5	7.8	5.6	4.3	↔	0
Capacity Utilization (average, %)	70.8	71.7	71.7	73.0	↔	0
Industrial Production (QoQ annualized, %)	8.0	5.9	2.4	-0.4	↔	0
Industrial Production (YoY, %)	5.4	7.5	6.5	4.3	↔	0
Manufacturing IMEF (index, average)	52.6	53.9	53.1	52.9	↔	0
Unemployment rate (average, %)	5.2	5.5	5.3	5.5	↓	-1
Employment (IMSS, QoQ annualized, %)	6.2	6.1	4.3	4.9	↔	0
Employment (IMSS, YoY, %)	1.0	3.7	4.9	5.4	↔	0
Real Wage (YoY, %)	-2.0	-1.3	-0.4	-0.5	↓	-1
Retail Sales (QoQ annualized, %)	6.5	5.7	4.3	4.0	↔	0
Retail Sales (YoY, %)	1.2	2.1	3.2	5.9	↔	0
Consumer Confidence (index, average)	81.5	84.9	89.2	89.6	↔	0
Headline Inflation (fdp, % anual)	4.75	3.96	3.67	4.25	↔	0
Core Inflation (fdp, % anual)	4.57	4.05	3.70	3.61	↔	0
Inflation Expectations (12-month)	4.37	4.19	4.30	3.88	↔	0
Inflation Expectations (3-year)	3.62	3.59	3.59	3.66	↔	0
Inflation Expectations (10-year)	3.41	3.38	3.38	3.43	↔	0
Inflation Deviation (Q-Q, pp)³	0.75	-0.04	-0.33	0.25	↔	0
Sum	-3	-2	-2	-2		
Weighted Sum⁴	-1	-1	-1	-1		
Qualitative Assesment	Pause	Pause	Pause	Pause		

1/ Only for the months in the quarter for which information is available.

2 Interpretation of the effect of each variable on monetary policy: ↑ restriction, ↓ relaxing, ↔ neutral; 1 is assigned to ↑, 0 to ↔, and -1 to ↓. Therefore, a greater (lesser) sum suggests a greater (lesser) likelihood of an increase in the bank funding rate.

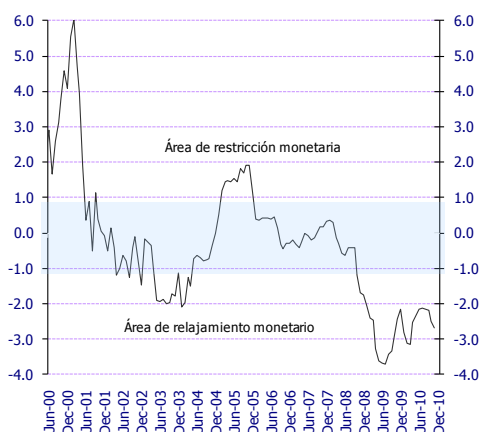
3 Difference between inflation and the upper limit of the Banxico objective variability range.

4 Assigns a weighting consistent with a Taylor's Law.

Source: BBVA Research with data from Bloomberg., INEGI, Banxico and IMSS.

Chart 1

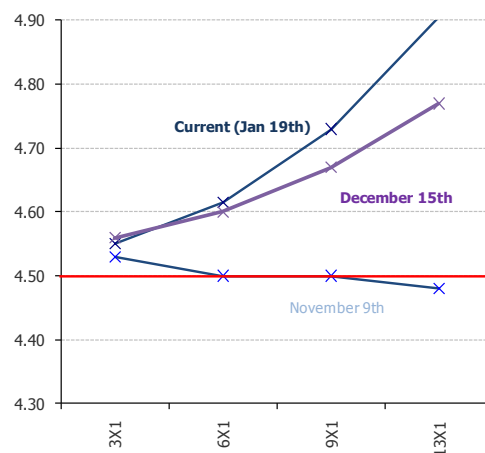
Monetary Conditions Index



Source: BBVA Research

Chart 2

Expected Funding in the IRS Curve* (%)



Source: BBVA Research with data from Valmer. *Implicit Funding: adjusted by the balance spread between TIIE and Funding, and by the premium-period in the IRS curve.

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