

Mexico

BanxicoWatch

Monetary Policy Decision

Banxico gives itself room for maneuver

Lending rate remains at 4.5%. January 21

January 21 2011

Economic Analysis

Julian Cubero
 Juan.cubero@bbva.bancomer.com

Iván Martínez
 ivan.martinez.2@bbva.bancomer.com

- **Banxico sends a more optimistic message as regards activity. It estimates that the output gap will turn positive, probably towards the second half of 2011**
- **Banxico reaffirms its expectation of a clear downward trend in inflation in 2011, while pointing out that 3% inflation is a permanent target, removing the reference to its achievement towards the end of 2011**
- **We believe that Banxico is increasing its room for maneuver in light of uncertainty surrounding the possible performance of exchange rates, the final impact of commodity prices on inflation or the updating of the CPI basket**
- **However, we claim that the monetary pause can be maintained beyond 2011, although eliminating the probability of a quick fall and with a possibility that the rise may take place earlier than indicated**

As we anticipated, the central bank sent a more optimistic message as regards the external environment for 2011, while expressing “*concern*” for the fiscal and financial problems facing several European countries. The rise in commodity prices was attributed mainly to the abundant international liquidity.

As regards domestic activity, the most important change is the assertion that “*the output gap has been closing more quickly and will probably turn positive towards the second half of 2011*”. We believe that this message excludes the (reduced) possibility of falling rates in early 2011.

As for inflation, the message is less emphatic than expected as regards the effect of international commodity price increases on domestic prices. Although the statement acknowledges that there has been an “*obvious*” increase in some domestic products, it points out that both the base effect (a result of the fading of inflationary effects in early 2010) and the appreciation of the exchange rate have partially offset these effects. As a result, it reiterates that inflation “*will resume a clear downward trend in 2011*”. This mention, combined with the belief that the rise in international prices is partially a result of the abundance of international liquidity, suggests that the risk of higher inflation being considered by the central bank on account of this supply shock may not be as high as predicted by the markets in recent weeks.

As for inflows, the statement is less explicit than previous ones, but it does mention that they continue to be significant.

In the paragraph announcing its decision, inflation convergence towards a 3% target is no longer seen as a goal for “late 2011”, but rather a “... permanent 3% target”. We interpret this change as a hedge that increases the room for maneuver of Banxico in the face of a possible increase in inflationary pressures in the case of commodities, and the aforementioned increase in activity towards the second half of the year.

In short, Banxico has given itself greater room for maneuver in monetary policy by eliminating the time reference to the achievement of the price stability target in a scenario where the risk balance in activity moves up while in inflation it remains more focused, by combining upside risks (commodities) with a favorable exchange rate, on the anchoring of expectations and the additional uncertainty resulting from the CPI base change.

Table 1:
Summary of the Monetary Policy Statements

	Oct 15	Nov 26	Jan 21	Appraisal*
Global Context	The global economy is continuing to grow, but at a slower pace. The outlook for 2011 points to even lower growth. In the United States unemployment remains high and consumption remains below pre-crisis levels; this reflects the efforts of households to adjust their spending to make it sustainable over the longer-term. Despite growing more rapidly than the developed economies, some emerging economies have also started to show signs of slowing down. In response to the weakness of production activity, employment and future payroll expectations, the major developed economies are continuing with loose monetary policies against a background of very low inflation. Many central banks, such as the Federal Reserve, have signaled that they will maintain this position for a prolonged period, and that there is also a possibility that it will be relaxed even further. Substantial international liquidity has produced incentives for investors to search for better returns, generating enormous capital inflows to emerging economies; the appreciation of their currencies; upwards pressures on commodity prices; and sizable accumulations of international reserves.	The global economy is continuing to grow, but at a slower pace. Domestic demand in the main developed countries continued to be affected by the weakness of their labor markets, the process of household debt reduction, weak consumer confidence and reduced exposure to risk of their financial institutions. In this context, the US economy seems to be slowing down. In response to the weakness of its economic output, of employment and of its outlook, the Federal Reserve Bank increased the degree of laxness of its monetary policy, which will lead to a gradual but substantial increase in liquidity. This phenomenon has generated considerable capital inflows into the emerging economies, the appreciation of their currencies, upward pressures on the prices of their assets, and substantial accumulation of international reserves. However, risk perception and the volatility in some variables of the international financial markets have increased significantly lately, due in part to the uncertainty surrounding the potential effectiveness of the monetary measures taken by the US and, perhaps more importantly, in response to the recent increase in the fiscal and financial vulnerability of some European countries, notably Ireland. The main emerging economies have shown a faster rate of growth which, together with the expansionary monetary policy adopted in most advanced countries, has contributed to the recent rise in commodity prices.	The outlook for the world economy in 2011 has improved, although there are differences in growth prospects between countries and regions. There has been an economic recovery in the US, possibly in response to fiscal and monetary stimulus. This has resulted in an upwards revision of the economic activity rate forecast for that country in 2011. In Europe, the fiscal and financial problems facing several member countries of the Union continue to be a major cause for concern. Strong growth in emerging economies has also had an influence in the more favorable prospects for global growth. As for external pressures, we should point out the significant increase in the price of some basic goods, a result of the abundant international liquidity, the greater rate of growth (in particular in emerging economies) and adverse weather conditions.	Expectations of a greater rate of growth.
Economic Growth	In Mexico, industrial production and manufacturing exports have continued to grow rapidly, although this may be affected by the slowdown in the US economy. Despite a recent bounce back in the consumer confidence index, consumer spending continues to grow slowly; we are just starting to see some early signs of increases in investment spending. The flow of foreign funds has increased, which reflects the robustness of the country's macro-economy and the high levels of global liquidity. These capital inflows have contributed to the recent appreciation of the exchange rate; the accumulation of international reserves; and the continuing decrease in interest rates all along the yield curve.	In Mexico, industrial production and manufacturing exports continued to grow, although some recent indicators suggest that the rate of growth of aggregate demand will slow down to some extent. This reflects less dynamism of foreign demand and weakness of domestic demand, especially as regards investment. However, the output gap has been closing relatively quickly, due in part to the uninterrupted expansion of the economy since the third quarter of 2009. In line with the greater global liquidity and the country's macroeconomic soundness, the flow of resources from abroad has increased significantly, although it seems to have slowed over the past few days.	Recovery of the Mexican economy continued over the last months of 2010. Recently, external demand seems to have picked up steam. Expansion of internal demand has been more obvious and widespread. Private consumption remained dynamic, while investment already shows a clearer positive trend, although it remains at low levels. The output gap has been closing more quickly and will probably turn positive towards the second half of 2011. In line with the country's macroeconomic solidity and greater global liquidity, capital inflows continue to be significant.	Output gap closing more quickly and likely to turn positive towards the second half of 2011.
Inflation	General annual inflation continues to be below the lower limit of the Bank of Mexico's forecast; this has been the case during the last two quarters. This highlights the performance of core inflation for goods and mainly reflects the appreciation of the local currency; the low level of global inflation; and the negative output gap, together with seasonal and background factors. Inflation in the coming quarters is expected to remain below the aforementioned lower forecast limit, although it is expected to increase towards year-end and then resume its downward trend in 2011.	After several months showing a downward trend and in line with the forecasts of the Central Bank, annual headline inflation rose in October 2010. This was due to the increase in non-core inflation, driven mainly by the rise in the prices of agricultural products. The core inflation trend continues to reflect the appreciation of the national currency, the negative output gap, wage moderation, and the low level of inflation worldwide. Inflation is expected to continue to rise during the rest of 2010 in line with the characteristic price pattern of agricultural goods and electricity, and should resume its downward trend in 2011.	In December of 2010, annual headline inflation stood at 4.40 per cent. The upturn during the close of that year was in line with the Central Bank's forecast and was associated mainly with the greater impact of the non-core component, in particular of agricultural products. Average inflation in the fourth quarter was at the lower end of the forecast range, which was adjusted downwards in the latest Inflation Report. During the last three months of the year, annual core inflation remained stable, and for 2010 as a whole showed a reduction of 85 base points compared to its closing in 2009. Among other factors, these results can be attributed to the favorable performance of exchange rates, the negative output gap and moderate cost pressures. Although there has been a significant increase in the price of some products in the domestic economy, several of them in response to the increase in the international prices of primary products, we should point out that: first, many of those price revisions are commonplace at the beginning of the year; second, this month has seen the fading of the upward effects on annual inflation recorded at the beginning of the previous year due to both the fiscal changes made in 2010 and the increase in certain rates by local governments; and finally, the appreciation of the exchange rate has partially offset the upwards effects of the increase in the international prices of various commodities. We therefore expect annual headline inflation to resume a clear downward trend in 2011.	Favorable assessment. Inflation clearly heading down in 2011. The effect of price increases on commodities is limited.
Risk Balance	In light of the above, the Board has decided to hold the target for the overnight Interbank Interest Rate unchanged. The Board will continue to monitor forecast inflation performance, the output gap, public prices, cereal prices and other determining factors for inflation that may point to unexpected general pressures on prices. The aim is for the Central Bank to be able to adjust its monetary stance if necessary in order to reach the 3 percent inflation target by the end of 2011.	In light of the above, the Board has decided to keep the target for the overnight Interbank Interest Rate unchanged. The Board will continue to monitor forecast inflation performance, the output gap, public prices, cereal and other commodity prices, and other determining factors for inflation that may point to unexpected general pressures on prices. The aim is for the Central Bank to be able to adjust its monetary stance if necessary in order to reach the 3 percent inflation target by the end of 2011.	In light of the above, the Board has decided to keep the target for the overnight Interbank Interest Rate unchanged. The Board will continue to monitor forecast inflation performance, the output gap, public prices, particularly cereal and other commodity prices, and other determining factors for inflation that may point to unexpected general pressures on prices. The aim is for the Central Bank to be able to adjust its monetary stance if necessary in order to reach the 3 per cent inflation target.	Prolonged pause and more room for maneuver
Policy Decision	0.0	0.0	0.00	
Fondeo Rate	4.5	4.5	4.50	

* Interpretation by BBVA Research of Banxico's opinion in accordance with the latest monetary policy statement.

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