

Mexico

BanxicoWatch

March 2, 2011

Banxico will keep the lending rate unchanged and will tackle the risk of supply shocks on the inflation outlook

Economic Analysis

Monetary policy decision on March 4, 2011

Arnoldo López Marmolejo
arnoldo.lopez@bbva.bancomer.com

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

- **The central bank will maintain the lending rate at 4.5% and could comment on the impact of the rise in the price of oil on inflation, emphasizing the role of expectations**
- **The recent rise in the price of oil, insofar as it is temporary, will have a limited effect on inflation and growth**

In recent weeks, the international economic environment has been dominated on the one hand, by the increase in the price of oil as a result of the political tensions in countries in the Middle East and North Africa, and on the other hand by new data from the US that somehow support the idea of the country's economic recovery. The first factor has generated greater uncertainty and risk aversion on the markets owing to potential lower growth and an increase in inflation in importing countries, in view of expectations of lower demand and higher production costs. The intensity and duration of these tensions will determine the extent to which they spread to production and price variables and to their expectations. As regards the second factor, the Federal Reserve mentioned in the minutes of the January meeting that the factors behind the strength of recent figures could be temporary and that a significant change in the recovery outlook can only be justified by sustained improvement of the indicators. In short, the foundations of recovery are not yet solid.

On the domestic front, 4Q10 GDP grew by 1.3% Q/Q, close to Banxico's forecast (1.1%) and above BBVA Research's estimate (0.6%). However, there is not yet evidence of demand pressures on prices (reduced foreign deficit, real wages with negative variations and spare production capacity). In addition, inflation has shown a downward trend in the first months of the year and we expect it stays in the interval forecasted by Banxico. Analyst expectations of inflation in the medium and long term show no relevant changes, as happens with market expectations (i.e., difference between the interest rates of 10-year Udibono bonds and government bonds). We should mention that the increase in the price of oil has a very limited direct effect on the price of gasoline and energy products included in the CPI due to the existence of subsidies. However, it represents a risk factor insofar as it affects inflation expectations through higher expected production costs. We should bear in mind that, according to Banxico's communication, those expectations constitute one of the relevant factors in the decision on adjusting its monetary policy stance.

In short, Banxico will maintain the lending rate unchanged and we expect the statement to address new risk components, without eliminating the prospect of a pause.

Table 1:

Risk Balance

	1Q10	2Q10	3Q10	4Q10 ¹	Effect ²	Value ²
IGAE (YoY, %)	4.5	7.8	5.6	5.0	↔	0
Capacity Utilization (average, %)	70.8	71.7	71.7	72.5	↔	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	52.8	↔	0
Unemployment rate (average, %)	5.2	5.5	5.3	5.5	↓	-1
Employment (IMSS, QoQ annualized, %)	6.2	6.1	4.3	4.8	↔	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	2.9	↔	0
Retail Sales (YoY, %)	1.2	2.1	3.2	3.4	↔	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	3.57	↔	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.

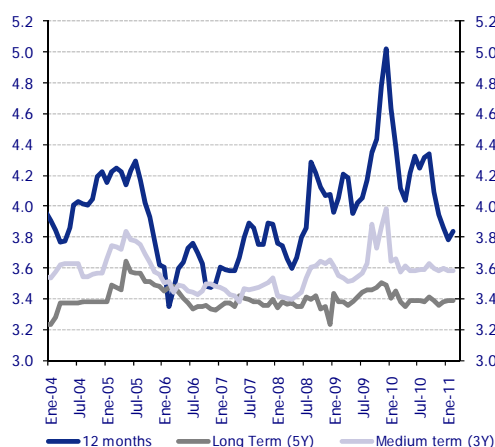
2 Interpretation of the effect of each variable on monetary policy: ↑ restriction, ↓ relaxing, ↔ neutral; 1 is assigned to ↑, 0 to ↔, and -1 to ↓. Therefore, a greater (lesser) sum suggests a greater (lesser) likelihood of an increase in the bank funding rate.

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

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

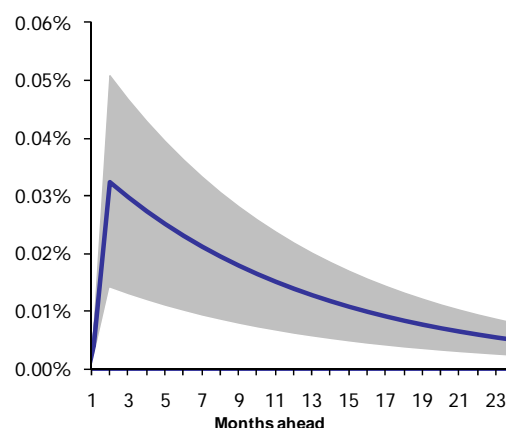
Source: BBVA Research with data from Bloomberg., INEGI, Banxico and IMSS.

Chart 1

Market inflation expectations


Source: BBVA Research with Infosel survey data

Chart 2

Mexico: Effect on the price of energy products of a 1% increase in the price of oil


Source: BBVA Research. Energy products include electricity, domestic gas and gasoline.

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