Mexico

Banxico Watch

Monetary Policy Decision. March 4

March 4 2011

Greater caution in the face of inflationary risks

Lending rate remains at 4.5%

Economic Analysis

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- **Banxico adopts a notably more cautious message with regard to inflation in view of the impairment of the risk balance deriving from recent supply shocks**
- **Of particular importance is the mention of a possible positive output gap toward mid-year, without this entailing pressures on prices, given the safety margin existing in the factor markets**
- **However, Banxico sees no demand tensions on prices and does not mention any risks in inflationary expectations, which is the key for implementation of its monetary policy. We thus expect the monetary pause to remain in place throughout 2011**

As we anticipated, the central bank devoted a large part of its statement to the increases in commodity prices. At global level, such increases are mentioned as an “element of risk for the recovery of the world economy and for inflation in virtually all the countries”. However, the tone was more optimistic than in previous statements when referring to the upturn in economic activity, particularly in the U.S. and in emerging economies. The problems facing the financial system and the fiscal situation in Europe are still a factor to be considered.

The greatest change in the statement was the mention of the impairment of the inflation risk balance. Banxico emphasized the uncertainty surrounding the future prices of grain and other commodities, the effects of the recent frost spells in Sinaloa on domestic prices, and possible pressures on the exchange rate due to an increase in global risk aversion. These factors are detrimental to its inflationary balance. However, it pointed out that the performance of inflation during the first months of the year has been in line with its forecast, and reiterated that it expects the situation to remain unchanged for the rest of 2011. We interpret this change in the statement as a more cautious message by the central bank in the face of uncertain factors that have aggravated in recent weeks. We do not believe this change to be a sign of an immediate upward trend, since there has so far been no mention of effects on inflation expectations, which according to the recent communication, are one of the key elements in Banxico’s decision to change its monetary policy stance.

As for domestic economic activity, the language is also more optimistic, with a mention of the possibility of the output gap turning positive “toward mid-2011”. However, in our opinion it is clear that right now there is no evidence of inflationary pressures along this path, given the “safety margin” still shown by various indicators of the output factor markets (e.g., unemployment, installed capacity and credit to households and companies).

In short, Banxico sends a signal of greater caution as regards inflationary risks, absence of demand pressures on prices and greater optimism in terms of activity. Based on this we believe that there are still elements for maintaining the monetary pause throughout 2011.

Table 1:

Summary of the Monetary Policy Statements

	Nov 26	Jan 21	Mar 4	Appraisal*
Global Context	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, week 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	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.	The world economy continues to grow, although with significant differences between countries and regions. In the advanced economies, the upturn in activity has been based on both the foreign sector and on domestic demand. In the US, economic activity has improved driven by fiscal and monetary stimuli. Several EU countries continue to be dogged by fiscal problems and financial system woes. Meanwhile, several emerging economies have recorded strong growth. As for inflation, the rise in the prices of various basic commodities (a result of the abundant international liquidity), the greater rate of growth (in particular in emerging economies), adverse weather conditions, and the geopolitical conflicts in the Middle East and North Africa represent an element of risk for the recovery of the world economy and for inflation in virtually all the countries. In particular, in several emerging economies the combination of increased spending and the rises in commodity prices has heightened risks for inflation.	**Greater optimism concerning global economic activity. Greater risks due to commodity price rises**
Economic Growth	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.	In Mexico, economic activity continues to show a positive trend. Improvement of the world economy, in particular in the U.S., has been reflected in strong manufacturing exports. Meanwhile, domestic demand is improving gradually. The most relevant indicators show that private consumption continues to recover, while investment shows a clear upward trend. As a result, the output gap is likely to continue to close, and the possibility of it turning positive toward mid-2011 persists. However, several indicators of the output factor markets still show some safety margin. In particular, the unemployment rate, although lower than in 2009, has remained at relatively high levels in recent months, and the growth rate of lending to households and companies is turning positive, while the use of installed capacity is still below pre-crisis levels.	**Output gap closing more quickly and likely to turn positive in mid-2011**
Inflation	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	Inflation in early 2011 has been in line with the Bank of Mexico's forecast. Among other factors, this result was due to the favorable performance of the exchange rate, the negative output gap, moderate cost pressures and the disappearance of the impact related to the tax changes that came into effect last year and slower growth of the rates authorized by the local governments. Inflation fell despite the tax hike on tobacco and increased corn prices. Looking ahead, there are risks owing to the high degree of uncertainty surrounding the future performance of international and domestic prices of grains and other commodities. In addition to the pressures on the prices of basic commodities from abroad, domestic prices will be affected by the effects of the recent frost spell in Sinaloa and in other states of the Republic. There is also a risk that the aforementioned geopolitical conflicts may generate reassignments in portfolios and capital flows which could lead to pressures on the exchange rate. All these factors impair the inflation risk balance, although inflation in 2011 should be in line with the forecast offered in the latest Inflation Report published by the Bank of Mexico.	**Greater caution. Impaired inflation risk balance**
Risk Balance	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.	In light of the aforementioned, the Board has decided to keep the target for the overnight Interbank Interest Rate unchanged. The Board will monitor inflation expectations, the output gap, public prices and, particularly, cereal and other commodity prices, as well as other determining factors for inflation that may point to unexpected general pressures on prices. Should this last eventuality materialize in the Board's opinion, the Central Bank will adjust its monetary stance if necessary in order to reach the 3 per cent inflation target.	**Pause and greater caution as regards inflationary risks**
Policy Decision	0.0	0.00	0.00	
Fondeo Rate	4.5	4.50	4.50	

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

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