BBVA | RESEARCH

BBVA Economic Research
Department

Banxico Watch

Mexico

April 13, 2011

Economic Analysis

Julián Cubero Calvo
juan.cubero@bbva.bancomer.com

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

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

No change to lending rate. Growing inflationary risks in the future

Monetary policy decision on April 15, 2011

- **Banxico will keep the lending rate at 4.5% and monitor the risks affecting the inflationary balance, including the rising price of commodities and the foreign capital inflows in the coming months**

In recent weeks, the international outlook has been mixed. On the one hand, the risks to economic growth and inflation generated by rising oil prices, and the possible effects on supply chains resulting from the worsening of the nuclear crisis in Japan, are generating volatility in high-risk financial assets and in capital flows to emerging economies. On the other hand, some data on the US economy is generating optimism among investors and could even lead the markets to demand a higher inflation premium, as the Federal Reserve is showing no signs of monetary tightening.

In Mexico, the economic indicators continue to reflect a cyclical situation consistent with a negative output gap that is gradually closing, without any evidence of demand pressures on prices. Inflation unexpectedly dropped in March, contributing to the adjustment in the same direction of the medium- and long-term inflation expectations of both analysts and markets, which is a key to the implementation of Banxico's monetary policy. Meanwhile, foreign inflows into the fixed-income government market, primarily, continues to grow compared to 2010, when they reached an all-time high. All this suggests an outlook of monetary pause which we believe will continue beyond next summer. However, the rise in the international prices of commodities (e.g., oil and corn), which is greater than the one foreseen by BBVA Research at the beginning of the year, is an element of risk. Although the direct effect of oil prices on inflation is limited, due in part to the lack of demand pressures and in part to the existence of gasoline subsidies, at least the first element is likely to fade away in the coming quarters. The statistical effect in the measurement of price increases will contribute to these tensions being reflected in inflation in the summer months, with rates slightly above 4%, which combined with an output gap that is expected to close in the second half of the year, could encourage an increase in inflation expectations that could translate into a more restrictive monetary policy stance in the fourth quarter of 2011.

The significance of these risk factors is clear in view of the recent statement from the central bank. The minutes of the meeting held last March clearly show a higher level of debate among the members of the Board in relation to the possible effects of the rises in commodity prices on inflation, and the possible pressures resulting from a positive output gap. However, as the Governor of Banxico has made clear in recent statements, only in so far as these risks translate into increased inflation expectations would a monetary policy response be fitting.

We thus believe that in the current situation Banxico will keep the lending rate unchanged at 4.5%.

Table 1
Risk balance

	2T10	3T10	4T10	1T11[1]	Effect[2]	Value[2]
IGAE (YoY, %)	7.8	5.6	4.7	5.9	↔	0
Capacity Utilization (average, %)	71.7	71.7	72.5	72.7	↔	0
Industrial Production (QoQ annualized, %)	5.9	2.4	1.5	11.2	↔	0
Industrial Production (YoY, %)	7.5	6.5	4.4	5.8		
Manufacturing IMEF (index, average)	53.9	53.1	52.8	52.6	↔	0
Unemployment rate (average, %)	5.5	5.3	5.5	5.2	↓	-1
Employment (IMSS, QoQ annualized, %)	6.1	4.2	4.8	4.6	↑	0
Employment (IMSS, YoY, %)	3.7	4.9	5.4	4.9		
Real Wage (YoY, %)	-1.3	-0.4	-0.6	-0.6	↓	-1
Retail Sales (QoQ annualized, %)	2.3	3.2	5.4	2.3	↔	0
Retail Sales (YoY, %)	2.1	3.2	3.3	3.3		
Consumer Confidence (index, average)	84.9	89.2	89.6	92.1	↔	0
Headline Inflation (fdp, % anual)	3.96	3.67	4.25	3.46	↔	0
Core Inflation (fdp, % anual)	3.91	3.69	3.57	3.25	↔	0
Inflation Expectations (12-month)	4.19	4.30	3.88	3.83	↔	0
Inflation Expectations (3-year)	3.59	3.59	3.66	3.57	↔	0
Inflation Expectations (10-year)	3.38	3.38	3.43	3.39	↔	0
Inflation Deviation (Q-Q, pp)[3]	-0.04	-0.33	0.25	-0.54	↓	0
Sum	-2	-2	-2	-2		
Weighted Sum[4]	-1	-1	-2	-2		
Qualitative Assesment	**Pausa**	**Pausa**	**Pausa**	**Pausa**		

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

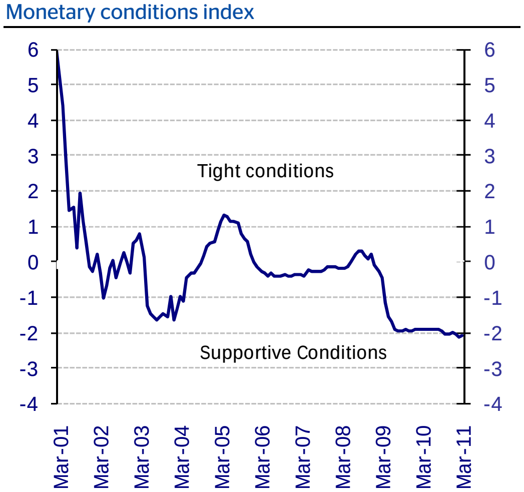
2 Interpretation of the effect of each variable on monetary policy: ↑ restriction, ↓ relaxing, ↔ neutral; 1 is assigned to ↑, 0 to ↔, and -1 to ↓. Therefore, a greater (lesser) sum suggests a greater (lesser) likelihood of an increase in the bank funding rate.

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

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

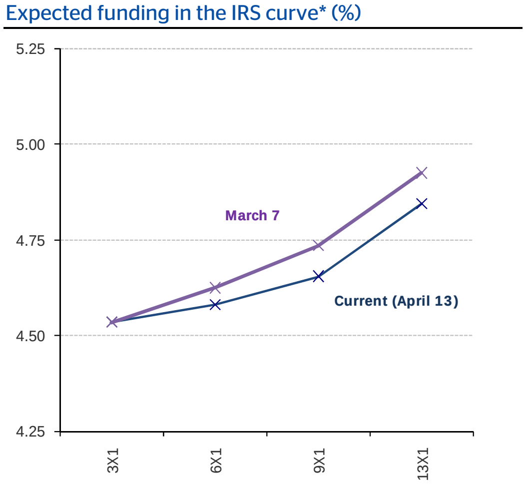
Source: BBVA Research with data from Bloomberg, INEGI, Banxico and IMSS.

Chart 1
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 difference between TIIE and Funding, and by the premium-period in the IRS curve.