

Banxico Watch

Mexico

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Economic Analysis

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Banxico awaits the magnitude of the next upturn in inflation

Monetary policy decision on April 15, 2011

- **Banxico keeps its lending rate at 4.5%, with no major changes in its announcement.**
- **Inflation in April and May is very relevant for the monetary policy stance for the rest of 2011**

The central bank's statement can be considered a transition between a stage of low inflation and improved growth of activity and one with an outlook for acceleration of prices and a high degree of uncertainty in terms of its magnitude as a result of foreign risk and potential demand pressures in the medium term.

In terms of domestic activity, the tone was slightly more optimistic than in previous statements, with mention being made of an economy that "continues to accelerate" and a "more balanced development of aggregate demand". As in the last statement, and in line with the recent declarations made by the governor, the output gap is expected to turn positive in mid-2011. Nevertheless, it was also emphasized that the "slack" in important variables of the economy prevents the presence of demand pressures on prices.

In terms of prices, the Central Bank indicated that the low levels of inflation recorded to date are due in part to the performance of non-core inflation, and recognizes that it is "foreseeable that part of this reduction will revert in coming months" in line with BBVA Research's scenario. As regards risks for the future, the increase in the prices of commodities and possible exchange rate risk as a result of portfolio reallocation and capital flows remain on the horizon, though the central bank does not indicate that they are worsening. Thus the expectation that inflation should be in line with the forecast offered in the latest Inflation Report was reiterated. We believe that the moderate tone maintained by Banxico could become slightly more restrictive based on the magnitude of the price increase in April and May. As such, if higher-than-expected inflation rates are observed in the summer months, Banxico would toughen its tone in order to prepare the path for a rate increase in the last quarter of the year.

The tone was less optimistic for the global context as the US economic recovery was discussed and mention was even made regarding the uncertainty of said recovery once the monetary and fiscal stimuli were withdrawn. Comments were also made about the withdrawal of monetary stimuli in several countries as a result of the upturn in inflation generated by commodity price increases and an overheating of their economies.

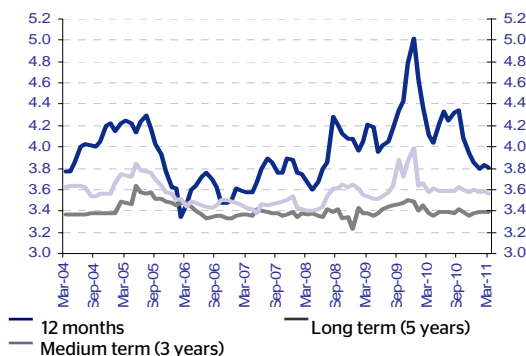
Banxico maintains the tone of its statement and will await the announcement of the magnitude of the upturn in inflation before establishing its monetary policy for the rest of the year. In our opinion, a significant upturn in inflation in the summer, together with a positive output gap which reduces the slack in the economy, is consistent with an increase in the lending rate for the last quarter of 2011.

Table 1
Primary elements of the Monetary Policy Statements

	Jan-11	4-Mar	15-Apr	Appraisal*
Global Context	<ul style="list-style-type: none"> Upward revision in the forecasted US economic activity rate in 2011 	<ul style="list-style-type: none"> Economic activity is improving in the US 	<ul style="list-style-type: none"> More moderate tone regarding the US recovery 	Moderate tone in global activity and emphasis on the withdrawal of monetary stimuli in various countries
	<ul style="list-style-type: none"> Significant rise in the prices of certain basic commodities 	<ul style="list-style-type: none"> The price increases for certain basic commodities represents an element of risk for the world economy and for inflation in nearly all countries 	<ul style="list-style-type: none"> Central banks in different countries have gradually withdrawn the strong monetary stimuli in response to an increase in inflation resulting from the increase in prices of basic commodities, as well as to an overheating of their economies 	
	<ul style="list-style-type: none"> Europe as a cause for concern: financial and fiscal problems 			
Economic Growth	<ul style="list-style-type: none"> Output gap closing more quickly and likely to turn positive towards the second half of 2011. 	<ul style="list-style-type: none"> The output gap is likely to continue to close, and the possibility of it turning positive towards mid-2011 persists 	<ul style="list-style-type: none"> The output gap is likely to continue to close and will turn positive towards mid-2011 	More optimistic but without price pressures in the short term
		<ul style="list-style-type: none"> Output factors still show some safety margin 	<ul style="list-style-type: none"> Different variables still show some signs of slack 	
Inflation	<ul style="list-style-type: none"> Increase in the price of some products in the domestic economy in response to the increase in the international prices of commodities 	<ul style="list-style-type: none"> Factors impair the inflation risk balance: uncertainty surrounding international prices (frost in Sinaboa) of commodities, potential pressures on the exchange rate caused by reallocation of portfolios and capital flows as a result of geopolitical conflicts 	<ul style="list-style-type: none"> Does not include any additional risk factor 	No changes in the tone and awaiting the magnitude of the next upturn in inflation in coming months
	<ul style="list-style-type: none"> However, Banxico continues to expect inflation to resume a clear downward trend in 2011 due to: fading of the upward effects due to 2010 fiscal changes, appreciation of the exchange rate 	<ul style="list-style-type: none"> Banxico expects inflation in 2011 to be in line with the forecast. 	<ul style="list-style-type: none"> Inflation on target in March, but foresees that part of this reduction will revert in coming months 	
			<ul style="list-style-type: none"> Banxico expects inflation in 2011 to be in line with the forecast 	
Policy Decision	0	0	0	
Lending rate	4.5	4.5	4.5	

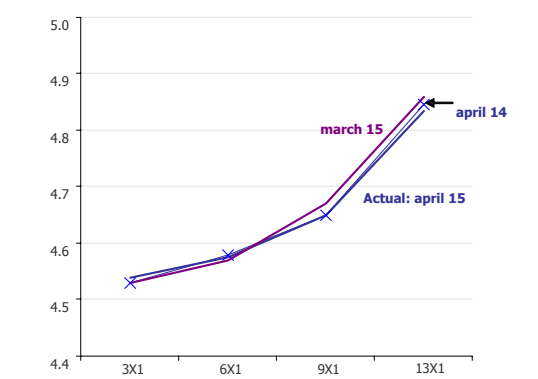
Source: BBVA Research with Banxico data * Interpretation by BBVA Research of Banxico's opinion in accordance with the latest monetary policy statement.

Chart 1
Market inflation expectations (% yoy change)



Source: BBVA Research with Infosal data

Chart 2
Expected funding in the IRS curve* (%)



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

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