

Banxico Watch

Mexico

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Economic Analysis

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No change to lending rate. There is a decreased chance of a rate hike in 4Q11 Monetary policy decision on May 27, 2011

- **Banxico will maintain the lending rate at 4.5% at its next meeting and will assess the new aspects of the balance of risks on forecast inflation and the slack in factor markets.**
- **The recent downward surprises of inflation, especially relevant in May due to the effect of comparison, make an increase of the lending rate at the end of 2011 less probable.**

The inflation and economic activity data released in recent weeks sustain the monetary policy stance indicated by Banxico in their most recent announcements (statements of decisions, minutes and inflation report). On the one hand, growth data for the first quarter GDP and for employment in the month of April presented a decrease in their rates of growth. On the other hand, inflation has surprised on the downside such that it stood at 3.29% on an annual basis in the first two weeks of May, below prior expectations. Thus, the increase of inflation resulting from the high commodities prices does not appear to be materializing; therefore, the scenario of an inflation rate sustained above 4 percent in summer 2011 and its potential effect on the inflationary expectations is less probable. In fact, the downward surprise of inflation in the first two weeks of May has led the trajectory of our outlook for annual inflation to drop 30 bp on average for the rest of 2011. Thus, inflation would close at 3.8% in December (see Chart 2). Therefore, it is now more likely that the medium-term inflationary expectations remain well anchored and supported by a backdrop of stability in the exchange rate and with a positive growth rate that will very gradually reduce the current slack in the factor markets. As a result, the need for Banxico to increase the lending rate in the last quarter of 2011 is now reduced.

Despite the absence of price pressures in the current situation, we will have to wait for the release of the inflation figures for the second half of May, as well as the report next Friday, to understand if the risks mentioned in the previous reports (e.g. increase in commodity prices and pressures on the exchange rate) are dissipating. Likewise, we must pay attention to any mention of the signs of slack shown by some markets in the economy, given that this topic led to debate among members of the Board of Governors.

In terms of global activity, we expect Banxico to maintain a tone of uncertainty with regard to the recovery of the US in the absence of fiscal and monetary stimuli, and even more so when the most recent data point to a slowdown of growth. Also, we believe that the issue of the crisis in Europe and its potential effect on global risk aversion will have a greater presence in the report than in previous occasions.

Thus, the most recent data leads us to believe that the transmission of the high prices of commodities to inflation does not appear to be materializing in a generalized manner. Thus, the forecast of inflation over 4 percent is unlikely. As a result, we believe that, should the inflation profile indicated by the figure for the first half of May be maintained, the scenario for an end to the monetary policy pause in the last quarter of 2011 will be decreasingly likely.

Table 1
Risk balance

	2T10	3T10	4T10	1T11 ¹	Effect ²	Value ²
IGAE (YoY, %)	7.8	5.6	4.7	5.0	↔	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	↔	0
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	4.4	↓	-1
Employment (IMSS, YoY, %)	3.7	4.9	5.4	4.9	↓	-1
Real Wage (YoY, %)	-1.3	-0.4	-0.6	-0.3	↓	-1
Retail Sales (QoQ annualized, %)	2.3	3.2	5.4	1.3	↔	0
Retail Sales (YoY, %)	2.1	3.2	3.3	2.1	↔	0
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	3.85	↔	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	-4	-4		
Weighted Sum⁴	-1	-1	-3	-3		
Qualitative Assessment	Pause	Pause	Pause	Pause		

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

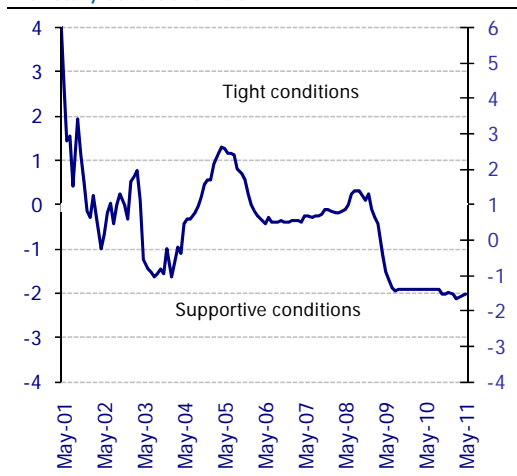
2 Interpretation of the effect of each variable on monetary policy: ↑ restriction, ↓ relaxing, ↔ neutral; 1 is assigned to ↑, 0 to ↔, and -1 to ↓. Therefore, a greater (lesser) sum suggests a greater (lesser) likelihood of an increase in the bank lending rate.

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

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

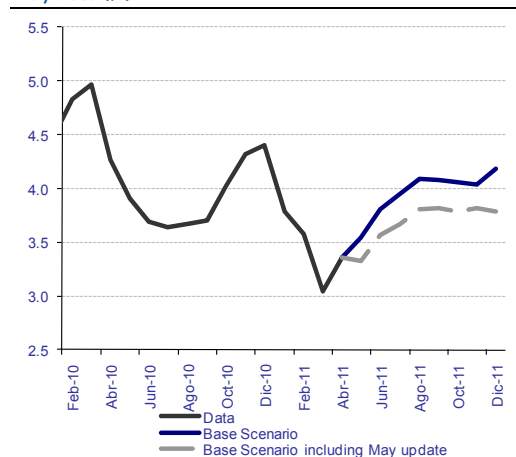
Source: BBVA Research with data from Bloomberg, INEGI, Banxico and IMSS.

Chart 1
Monetary conditions index



Source: BBVA Research

Chart 2
Annual inflation: forecast and adjusted forecast with May data (%)



Source: BBVA Research

The adjusted forecast with the May data includes the same expectations for monthly inflation from our scenario as of June, but for the May figure it considers the observation of the first half of the month that was recently released.

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