

# Banxico Watch

## Mexico

May 27, 2011

### Economic Analysis

Julián Cubero Calvo

juan.cubero@bbva.bancomer.com

Arnoldo López Marmolejo

arnoldo.lopez@bbva.bancomer.com

Iván Martínez Urquijo

ivan.martinez2@bbva.bancomer.com

## Inflation and output make monetary pause throughout 2011 more likely

### Monetary policy decision on May 27, 2011

- **The inflation risk balance improves. The pace of closing the output gap slows and the slack in some markets remain.**
- **In a setting free from financial turbulence, Banxico is not likely to raise rates at least for the rest of 2011.**

Based on recent data, Banxico adopted a more positive tone on inflation leading us to believe an unchanged monetary policy stance is likely for the rest of the year. The performance of two factors is key to explaining this. Firstly, the slowing pace in closing the output gap. Since November 2010 Banxico has highlighted the output gap closing relatively rapidly. This had been interpreted as a sign of possible short-term demand pressure. However, today's press release from the Central Bank recognizes a slower pace of closing, which combined with the slack job and credit market, and the installed capacity still available in manufacturing, leads it to conclude there are no general price pressures. Secondly, the level of potential upward risks appearing for inflation seems to be less intense than previously thought. Last March, Banxico emphasized the uncertainty over commodity prices and the consequences of geopolitical conflicts were making its inflation risk balance worse. However, today's release states that the balance showed improvement. Combining this with the better-than-expected inflation data suggests that these risks appearing and their transfer onto inflation has been limited. Consequently, Banxico expects inflation to remain within its forecast range. It should be stated for this first point that due to an expected higher commodities pass-through to prices than seen till present, BBVA Research forecasts have been higher than those from Banxico.

The tone is more moderate with regards to the global situation since it states that world growth has seen some impairment while inflation, despite showing some bounce, has maintained favorable performance. Specifically, a slowdown in the US economy, a higher deterioration in some European economies and a possibly higher-than-expected economic impact due to the terrible earthquake in Japan can be seen. Inflation's benign performance is due to the stability in long-term forecasts and low core inflation levels seen in advanced economies despite commodity prices moving up.

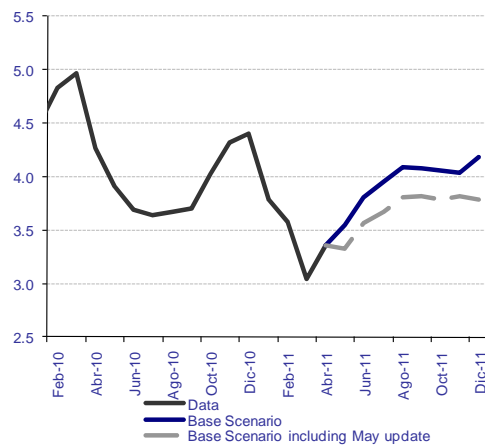
In this sense, in an inflation risk setting with limited effects till present, economic output slowing its increase rate, lower-than-expected inflation data and no financial turbulence, the likelihood of a rise in the monetary policy rate in 2011 is greatly reduced.

Table 1  
Primary elements of the Monetary Policy Statements

	04-Mar	15-Abr	May-11	Appraisal*
<b>Global Context</b>	<ul style="list-style-type: none"> <li>Economic activity is improving in the US</li> <li>The price increases for certain basic commodities represents an element of risk for the world economy and for inflation in nearly all countries</li> </ul>	<ul style="list-style-type: none"> <li>More moderate tone regarding the US recovery</li> <li>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</li> </ul>	<ul style="list-style-type: none"> <li>Risk balance for world growth has deteriorated</li> <li>Highlights: i) the US slowdown and ii) possibly higher-than-expected adverse impact for the terrible earthquake in Japan</li> </ul>	More moderate tone in global output with some deterioration in risk balance
<b>Economic Growth</b>	<ul style="list-style-type: none"> <li>The output gap is likely to continue to close, and the possibility of it turning positive towards mid-2011 persists</li> <li>Output factors still show some safety margin</li> </ul>	<ul style="list-style-type: none"> <li>The output gap is likely to continue to close and will turn positive towards mid-2011</li> <li>Different variables still show some signs of slack</li> </ul>	<ul style="list-style-type: none"> <li>Reduction in the pace of closing the output gap</li> <li>Different variables still show signs of slack</li> </ul>	
<b>Inflation</b>	<ul style="list-style-type: none"> <li>Factors impair the inflation risk balance: uncertainty surrounding international prices (frost in Sinaloa) of commodities, potential pressures on the exchange rate caused by reallocation of portfolios and capital flows as a result of geopolitical conflicts</li> <li>Banxico expects inflation in 2011 to be in line with the forecast.</li> </ul>	<ul style="list-style-type: none"> <li>Does not include any additional risk factor</li> <li>Inflation on target in March, but foresees that part of this reduction will revert in coming months</li> <li>Banxico expects inflation in 2011 to be in line with the forecast</li> </ul>	<ul style="list-style-type: none"> <li>Risk balance has showed improvement</li> <li>Core component with downhill trajectory – below 3% target excluding tortillas and tobacco</li> <li>Banxico expects 2011 to see headline and core inflation moving in line with forecasts</li> </ul>	More positive tone and describing more elements in this sense
<b>Policy Decision</b>	0	0	0	
<b>Lending rate</b>	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.

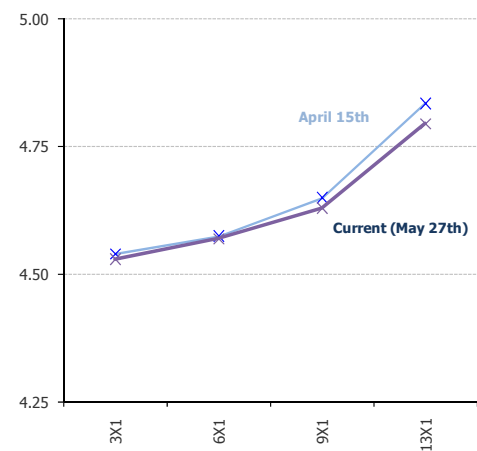
Chart 1  
Annual inflation: forecast and adjusted forecast with May data (%)



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

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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