# Banxico Watch

Mexico

August 24, 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

## Monetary pause at least until the summer of 2012

### Monetary policy decision on August 26

- **Banxico will keep the lending rate at 4.5% at its next meeting and insist on the absence of demand pressures on prices.**
- **Be aware of the central bank's opinion on the potential impact in Mexico of recent events in the U.S. and Europe.**
- **No conditions are seen for a reduction in the lending rate.**

In recent weeks, the uncertainty surrounding the strength of growth in the U.S. and the absence of definitive solutions to the sovereign debt problems in Europe have dominated the international markets. Although the U.S. GDP revision for the first quarter was relevant, it was due, at least in part, to negative temporary factors which have run out. The latest data does not suggest a recession scenario in the U.S., but rather points to more moderate economic growth. Given Banxico's doubts on the sustainability of economic recovery in the U.S. if the monetary and fiscal stimulus packages are withdrawn, and the uncertainty on the solution to the sovereign debt crisis in Europe, the central bank's assessment of the risk balance on global growth and its possible impact on Mexico will be relevant.

In the domestic environment, the central bank's tone as regards economic activity will be particularly significant. The previous statement already pointed out the possibility of a slowdown, which in the subsequent Inflation Report for the 2nd quarter was reflected in a slight reduction in the growth forecast for 2011 and 2012.[1] In the first half of the year, average growth was 4.0%, which is consistent with our 4.1% forecast for 2011. In short, a slow rate in the closing of the output gap, which also suggests a very low risk in these times of demand pressures on prices. Thus, as regards inflation, we expect Banxico to reiterate once again that inflation will be in line with its forecast, and that there will be no widespread pressures on prices, given the slack in some markets.

In this scenario marked by the lack of pressures on prices and uncertainty surrounding economic growth, and following the Fed's announcement of lax monetary conditions for an extended period of time, the financial derivatives market discounts a reduction in the lending rate at the end of 2011, something we consider unlikely according to our economic scenario (see Mexico Outlook 3Q11[2]). Firstly, the information available at this time is consistent with the continuation of positive growth in the second half of the year, which means that the economy's output gap should keep closing. Secondly, inflation expectations in the medium term are anchored at around 3.5%, above the permanent price stability target of 3%. This point is relevant given its significance in Banxico's statement and the constant exchange of opinions, reflected in the minutes, on the downward resistance of expectations.

In short, the latest data is consistent with an impairment of the domestic activity risk balance, which does not suggest upward pressures on prices in the short term, or a recession scenario. We therefore believe that the monetary pause could be maintained for an extended period, at least until the summer of 2012.

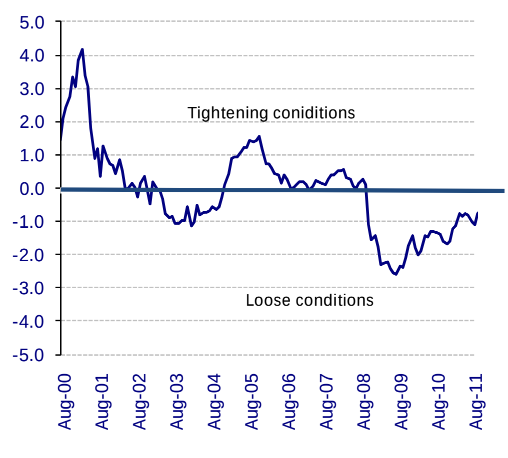
[1] Banxico expects the economy to grow by between 3.8 and 4.8% in 2011 (between 4.0 and 5.0 in the previous report) and between 3.5 and 4.5% in 2012 (between 3.8 and 4.8% in the previous report).
[2] Available at: http://www.bbvaresearch.com/KETD/fbin/mult/1108_SituacionMexico_3T11_tcm346-265671.pdf?ts=2582011.

Table 1
Risk balance

| | 3Q10 | 4Q10 | 1Q11 | 2Q11[1] | Effect[2] | Value[2] |
|---|---|---|---|---|---|---|
| **IGAE** (YoY, %) | 5.6 | 4.4 | 5.1 | 3.3 | ↔ | 0 |
| **Capacity Utilization** (average, %) | 71.7 | 72.5 | 73.7 | 72.8 | ↔ | 0 |
| **Industrial Production** (QoQ annualized, %) | 3.2 | 4.5 | -3.8 | 10.4 | ↔ | 0 |
| **Industrial Production** (YoY, %) | 6.2 | 4.8 | 5.2 | 3.4 | | |
| **Manufacturing IMEF** (index, average) | 53.1 | 52.8 | 52.6 | 53.6 | ↔ | 0 |
| **Unemployment rate** (average, %) | 5.2 | 5.4 | 5.1 | 5.5 | ↓ | -1 |
| **Employment** (IMSS, QoQ annualized, %) | 4.2 | 4.7 | 4.4 | 3.6 | ↓ | -1 |
| **Employment** (IMSS, YoY, %) | 4.9 | 5.4 | 4.9 | 4.3 | | |
| **Real Wage** (YoY, %) | -0.5 | -0.5 | 0.5 | 1.0 | ↓ | -1 |
| **Retail Sales** (QoQ annualized, %) | 3.5 | 4.7 | 2.2 | 1.4 | ↔ | 0 |
| **Retail Sales** (YoY, %) | 3.3 | 3.3 | 2.2 | 3.0 | | |
| **Consumer Confidence** (index, average) | 89.2 | 89.6 | 92.1 | 90.7 | ↔ | 0 |
| **Headline Inflation** (fdp, % anual) | 3.67 | 4.25 | 3.46 | 3.30 | ↔ | 0 |
| **Core Inflation** (fdp, % anual) | 3.69 | 3.57 | 3.25 | 3.18 | ↔ | 0 |
| **Inflation Expectations** (12-month) | 4.30 | 3.88 | 3.85 | 4.03 | ↑ | 0 |
| **Inflation Expectations** (3-year) | 3.59 | 3.66 | 3.57 | 3.57 | ↔ | 0 |
| **Inflation Expectations** (10-year) | 3.38 | 3.43 | 3.39 | 3.41 | ↔ | 0 |
| **Inflation Deviation** (Q-Q, pp)[3] | -0.33 | 0.25 | -0.54 | -0.70 | ↔ | 0 |
| **Sum** | -2 | -1 | -1 | -2 | | |
| **Weighted Sum**[4] | -1 | 1 | 1 | 0 | | |
| **Qualitative Assesment** | **Pause** | **Pause** | **Pause** | **Pause** | | |

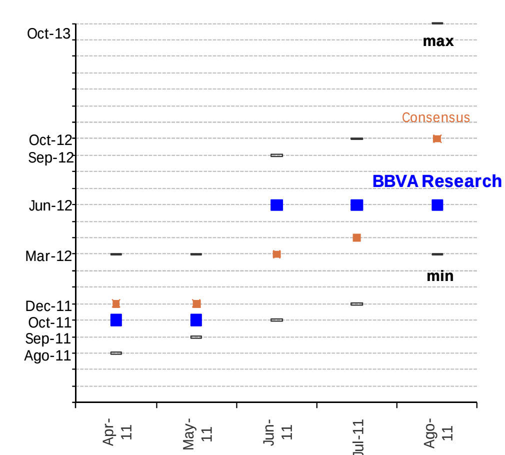
1 Only for the months in the quarter for which information is available.
2 Interpretation of the effect of each variable on monetary policy: ↑ restriction, ↓ relaxing, ↔ neutral; 1 is assigned to ↑, 0 to ↔, and -1 to ↓. Therefore, a greater (lesser) sum suggests a greater (lesser) likelihood of an increase 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
Analyst expectations regarding the next move in the lending rate




Source: BBVA Research and Infosel. No analysts discount a reduction in the lending interest rate.