Banxico Watch

Mexico

August 26, 2011

Economic Analysis

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A change in communication making a cut in the lending rate possible

Monetary policy decision of August 26, 2011

- **Banxico includes a paragraph indicating that if monetary conditions tighten unnecessarily, a monetary policy adjustment could be considered**
- **The activity and prices scenario of BBVA Research and that of Banxico's continue to be consistent with a prolonged monetary pause.**
- **Still, should a deterioration of the growth rate be confirmed in a climate of significant deceleration in 2011 and 2012 and the exchange rate were to maintain more appreciated than its current level, the lending rate could be reduced by at least 25 points.**

Banxico announcement adopts a more relaxed posture and provides margin for a possible reduction in the monetary policy rate should it prove necessary. This change in tone is partly due to the fact that the central bank is more pessimistic with regards to the external environment, which can be seen in its various references to the weakness of current growth and structural problems in the US. As a result, Banxico states that the domestic growth rate has lost momentum.

In this context of reduced economic activity, the reduction of inflation and resulting increase in the real interest rate has generated less supportive monetary conditions, which have been compensated in part by the depreciation of the exchange rate, as the central bank noted in its second quarter inflation report. In our opinion, these conditions do not for the moment amount to a sure sign that the lending rate will be reduced. However, if the exchange rate remains under 11.5 pesos per dollar, assuming our inflation forecast and that the nominal rate remains stable, our Index on Monetary Conditions (IMC) will approach levels suggesting more neutral monetary conditions. Given recent uncertainty on the solidity of growth in the US, it is possible that the central bank will have a certain preference for maintaining relaxed monetary conditions and, should the latter experience an unnecessary tightening, as it stated in its announcement today, it could evaluate the appropriateness of adjusting monetary policy.

On the other hand, based on our Taylor Rule[1], it can be seen that the scenario for the lowest part of Banxico growth forecasts range (3.8% in 2011 and 3.5% in 2012) is not consistent with a reduction in the lending rate. The same occurs with our current economic growth scenario (4.1% in 2011 and 3.8% in 2012). In addition, given our inflation perspective, we believe that expectations of a deceleration between 2011 and 2012, to levels lower than 3.6% and 3.0% respectively, would be signs for a reduction in the lending rate.

In short, it is our view that the current scenario continues to be consistent with a protracted pause until at least mid-2012. However, should monetary conditions tighten and an additional deterioration of growth take place, in keeping with the mentioned figures, a lowering of the monetary policy rate could be seen.

[1] Statistical relationship explaining the lending rate based on the existing gaps between growth and inflation and long-term growth and the central bank's inflation target, respectively.

Table 1

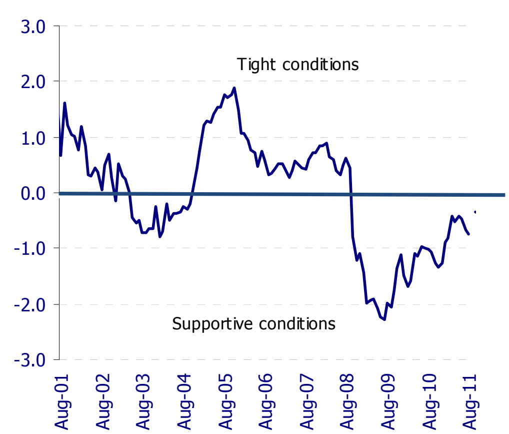
Primary elements of the Monetary Policy statements

	May 27	July 8	August 26	Appraisal*
Global Context	•**Risk balance for world growth has deteriorated** •Highlights: i) the **US slowdown** and ii) possibly higher-than-expected adverse impact from the terrible earthquake in Japan	•**Risk balance for world growth deteriorated** •Highlights: i) Downward revision of US growth forecasts, and ii) Growing concerns about the European debt crisis and possible "contagion" to the financial markets.	•**Risk balance for world growth continued to deteriorate** •Of particular note: a) Weak US growth and b) debt crisis in Europe worsened	**More pessimistic tone in global output with some deterioration in risk balance**
Economic Growth	•**Reduction in the pace of closing the output gap** •Different variables **still** show signs of **slack**	•**Output gap to close more slowly than expected** •Different variables **still** show signs of **slack**	• Should the **evolution of the national economy** [...] result in an **unnecessary tightening** of monetary policy, the **Board will consider its adjustment**	**Margin for a possible revision of monetary policy**
Inflation	•**Risk balance has showed improvement** •**Core component with downhill trajectory – below 3% target** excluding tortillas and tobacco •Banxico expects **2011 to see headline and core inflation moving in line with forecasts**	•**The balance of risks continued to improve** •**The core component with a downward trajectory –below objective of 3%** excluding tortillas and tobacco •Banxico hopes that **during 2011 headline and core inflation will behave as expected**	•Banxico expects **2011 and 2012 to see headline and core inflation moving in line with published forecasts**	**No price pressures expected**
Policy Decision	0.00	0.00	0.00	
Lending rate	4.50	4.50	4.50	

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

Chart 1

Monetary Conditions Index



Source: BBVA Research. The monetary conditions index is calculated using the weighted average of the variables of the Cetes real interest rates over 28 days and the real exchange rate compared to its average level between 2001 and 2011. The weighting factor for each indicator is of 0.5. Upward trends in the real interest rate and/or appreciation of the exchange rate increase the Monetary Conditions Index. Therefore, an increase in the index suggests relatively tighter conditions.

Table 2

Lending rate under various GDP growth scenarios

Scenario	GDP Growth (%) 2011	2012	Change in fondeo rate
BBVA: Base	0.0	0.0	0.0
Banxico: Inferior limit	0.0	0.0	0.0
Rate cut (25pb)	0.0	0.0	-25.0

Source: BBVA Research. Note. Estimates based on a Taylor Rule. It is assumed that the lending rate remains at the same level for at least three quarters.