Banxico Flash

As BBVA Bancomer called it, Banxico cuts the monetary interest rate. If the economic weakness continues, another cut cannot be dismissed.

Considering that "economic slack will prevail for a prolonged period of time, along with the expectation that public finances will be strength", Banxico decreases the monetary policy rate in 25 basis points to 3.75%.

- With respect to the global economic activity, Banxico stresses that in spite of the gradual improvement in private demand and employment in the US, there has been a lag in the growth in the industrial sector in this country. In the eurozone, activity pulls out of contraction and in the emerging markets growth remains weak. In sum, in balance, "the risks to the global economic growth remain tilted to the downside".

- In the domestic front, Banxico underlines that the weakening of the services sector "was faster and deeper than previously anticipated" . This factor is highly relevant given that the services sector represents 62% of the GDP. In addition, Banxico announced that the GDP growth in 2013 and 2014 will be below its forecasts (2.0-3.0% in 2013 and 3.2-4.2% in 2014). BBVA Research estimates a GDP growth of 1.4% in 2013 and 3.1% in 2014. Therefore, the slack in the economy will remain for a prolonged period of time, being this factor the main determinant of the rate cut.

- Banxico also suggests that the strength of the public finances could generate a transitory impact on inflation that would not have relevant second order effects. However, its mention as a determinant of the rate cut suggests that it could have a relevant effect on private demand in the short term.

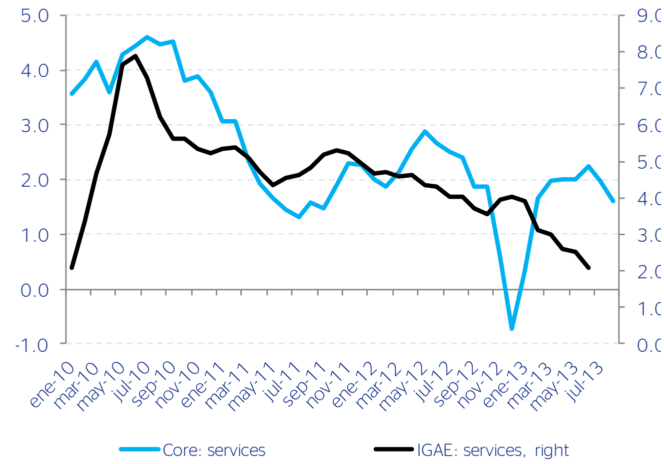
- The announcement indicates that both the general and core inflations declined below the levels previously anticipated and that the core inflation will remain at historically low levels in the following 18 months (see graphs below about the relationship between the core inflation components and the economic slack). BBVA Research estimates that core inflation will be around 2.5% in December 2013.

- In the financial markets, in spite of the recent volatility generated by the possibility that the Federal Reserve will begin tapering its bond purchasing program, the variations in the financial markets in Mexico have maintained an orderly behavior and have not affected the inflation expectations. Given this external environment, in spite of the monetary rate cut, the Mexican peso appreciated. It is expected that the effect of the rate cut on the exchange rate will be marginal.

- Finally, as a result of the low levels of inflation and the possibility that the economy remains weak, the door remains open for an additional rate cut in the following months.

Graph 1

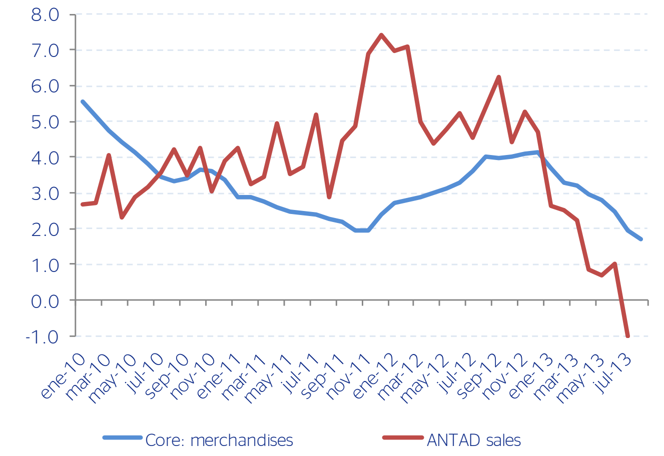
IGAE services and inflation in services (% YoY)



Source: BBVA Research and INEGI.

Graph 2

ANTAD sales and inflation in merchandises (% YoY)



Source: BBVA Research, ANTAD, and INEGI.

Table 1

Highlights from last statements

	12-Jul-13	06-Sep-13	Bottom line*
Global context	•Downward risks on global activity remain •The weakness of global economic activity has increased •Lower inflation outlook in most countries is expected	•**Mixed performance:** improvement in advanced economies, gradual strengthening in the US continues; **growth in emerging countries has weakened** •**Downside risks prevail** •**Low global inflation**	**Downside risks prevail**
Economic activity	•Downward risks on domestic activity have intensified, given the speed and depth of the deceleration • Deceleration worsened significantly in 2Q13 by a significant slowdown in exports and weak domestic demand • Economic slack has increased	•**Weakness significantly intensified, more than anticipated** • **Output gap has widened significantly** • **Growth in 2013 will be much lower than currently expected and growth for 2014 will also be revised downwards**	**Large output gap for a prolonged period**
Inflation	• The balance of risks for inflation has improved • Inflationary effects from the recent currency depreciation are not expected • Downward expectations on inflation prevail	• **Further improvement in the balance of risks; core inflation will remain close to all-time low levels for the next 18 months** • **Reforms progress could lead to lower inflation in the mid-term; changes in relative prices due to the fiscal reform would have temporary effects** • **Elxchange rate pass-through to inflation would be low if the MXN depreciated further**	**Economic weakness could lead to downward pressures**
Policy decision	0.00	-0.25	**The door for an additional cut remains open**
rate	4.00	3.75	

* Own interpretation based on the tone and wording of the Policy Statement

Source: BBVA Research and Banxico

Carlos Serrano
carlos.serranoh@bbva.com

Arnoldo López Marmolejo
arnoldo.lopez@bbva.com

Javier Amador
javier.amadord@bbva.com

Av. Universidad 1200, Col. Xoco, México 03339 D.F. | researchmexico@bbva.bancomer.com | www.bbvaresearch.com | Follow us on Twitter