

Mexico | Increase in inflation: a passing phenomenon

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So far this year we have seen a significant increase in inflation. From 2.1% at the end of 2015 and 3.3% at the end of 2016, we can see that annualised inflation at the end of April 2017 had increased to 5.8%, above the central bank's 3% target and indeed above the 4% upper limit of the tolerance band. I believe it may even exceed 6% in the next few weeks. Is this cause for concern? To answer this question, it is necessary to understand what is behind this price dynamic.

The increase in inflation is basically due to two reasons. The first is the depreciation of the currency, which has been translated into increased prices of imported goods. The second is the increase in the price of petrol that came into force in January this year. As for the first factor, we are seeing an increase in relative prices, with imported goods becoming more expensive than domestic goods.

This, it seems to me, is a positive reaction by the economy to an external shock. It is one of the advantages of a flexible exchange rate: in response to an external shock - and in this case we have had two, the fall in the price and production of oil and the uncertainty surrounding the future of NAFTA - the currency depreciates, making imports more expensive and exports more competitive, allowing the shock to be absorbed with improvements in the balance of trade. One result of this process is the change in relative prices already referred to.

Another significant factor regarding the increase in prices of imported goods is that it is a temporary phenomenon. Next year, to the extent that the currency strengthens, which is what I believe will happen once the uncertainty surrounding NAFTA starts to clear, we will see a reduction in the rate of inflation on the price of imported goods. In other words, we are seeing a transitory increase in some prices. As for the second factor, the increase in petrol prices, this too is a one-off increase which will be of a transitory nature.

It was also, as I have mentioned before, an astute public policy measure which eliminated a regressive and environmentally damaging subsidy, as well as being a responsible public finance measure. Without it, Mexico's sovereign debt rating might well have been downgraded.

So we are talking about two changes in relative prices, both of which are of a transitory nature. The important thing is that there are no secondary effects in the form of generalised price increases throughout the economy.

More important than observed inflation is the development of inflationary expectations. Because if these increase, they are likely to lead to an increase in future inflation. And what we see is that these expectations remain well anchored. Both economic analysts and, more importantly, the markets, think that medium- and long-term inflation in Mexico will be around 3.5%, within the central bank's tolerance band.

In this regard, the central bank has done the right thing in increasing its monetary policy rate. We should not forget that a couple of years ago it stood at 3.25% and is now at 6.5%. This has helped anchor inflationary expectations. It seems to me that much of the work has now been done and that we are close to the end of the upward monetary policy cycle. I believe we will see two or three more increases of 25 bps each, one of them at the next meeting in May. These hikes will be necessary to reinforce the anchoring of expectations, but I do not think it will be necessary to extend the restrictive cycle for much longer, given that we are not

seeing a sustained or generalised price phenomenon.

In summary, we are witnessing a transitional increase in inflation which is largely the result of adjustments that are necessary and good for the economy. In 2018, starting in January when the effects of this year's fuel price increases dissipate, we are going to see inflation start to fall, dropping below 4%.

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