

## Central Banks

# Banco de México: the right decision

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Carlos Serrano

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Last week saw the publication of the minutes of the Banco de México Governing Board's latest monetary policy meeting. As we already knew, it was decided to leave the monetary policy rate unchanged at 7.75%, in a split vote in which four members voted in favour of no change and one voted to increase the rate by 25 basis points. In my view, the majority decision seems to be the right one.

Firstly, while it is true that headline inflation has seen an uptick, this is basically due to higher energy prices, corresponding to a transitory supply-side shock to which it is not appropriate for monetary policy to react. The important thing is that core inflation is holding steady, with no indication that it is likely to rise. The dissenting member argued that “core inflation currently shows a high degree of persistence...”. In my opinion, the remarkable feature of core inflation is not its persistence but its stability within a context of strong shocks from increasing energy prices. It is true that core inflation increased 4 bps, up from 3.63% in August to 3.67% in September.

I believe it would be a serious mistake for monetary policy to react to this change, with just one observation. Secondly, it should be acknowledged that monetary policy is already highly restrictive. The real interest rate is more than 4%, whereas its neutral value should be between 1.5% and 2%. This is the highest rate in the past ten years and one that is already having a negative effect on demand for certain types of credit. The dissenting member also based his vote on the view that “the current forecast for headline inflation is unlikely to be attained”. I do not think that this should be an argument for raising interest rates. Is it really necessary to put pressure on monetary policy so that a forecast can come true, knowing that inflation is going to fall anyway, that monetary policy is already restrictive and that the economy will be saddled with extra cost?

Of course, monetary policy should act firmly to combat inflation when there are demand pressures or when inflationary expectations have slipped their anchor, even if this hampers growth. But it should not react to temporary supply shocks, particularly when falling prices are on the horizon and expectations are firmly anchored. To do so would mean losses in terms of growth without gains in terms of inflation, since monetary policy is inefficient in responding to supply shocks. Faster approximation to the inflation target can always be achieved by raising interest rates, but the effects on the economy must also be taken into account.

In this regard I believe it would be worth reviving the concept of an efficient convergence of inflation that the Governing Board used a few years ago. Particularly so in a context in which there is a negative output gap, in other words the economy is growing below its potential. For this reason I think the Governing Board was right to say that it would be keeping a close watch on the slack in the economy. Thirdly, we have not seen a pass-through effect from the exchange rate to prices. This was to be expected in a year in which the peso has appreciated against the dollar and the sudden depreciation scenarios have seemed more remote due to the announcement of a new trade agreement among Mexico, the United States and Canada.

Of course, the Banco de México should, as asserted in the communiqué, be attentive to any possible pass-through from the exchange rate to prices and the relative monetary policy position between Mexico and the United States. However, these two factors do not in fact represent pressures on inflation. The dissenting member said that not raising interest rates “could be very costly for the central bank’s credibility”. On the contrary, I believe the four members who voted to maintain the rate unchanged helped to maintain this credibility, as this decision was consistent with previous communiqués.

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### **CONTACT DETAILS:**

BBVA Research – BBVA Bancomer: Paseo de la Reforma 510, Colonia Juárez, 06600 Mexico D.F, Mexico  
bbvaresearch@bbva.com www.bbvaresearch.com