



# Banxico Watch

June 19, 2009

## **Banxico reduces the policy rate by 50 bps (4.75%), confirming that the cycle of easing is about to end: we expect an additional movement of 25 bps**

- The statement by the Bank of Mexico has confirmed that the balance of risks continues biased towards those associated with less economic activity. However, an increase in output is expected in 2H09.
- As in previous statements, the monetary authorities highlight the perception of an improvement in industrialized countries' economic activity, although it warns, its force might vary across regions. We consider that although economic activity is beginning to bottom out, mainly in the U.S., the strength of the recovery will not be particularly vigorous, so we do not expect an increase in the Fed rate over the coming quarters, unlike what the market is discounting.
- Likewise, the Bank of Mexico insists that the economic contraction in Mexico during 1H09 is severe highlighting the negative effects not only from the global economic crisis but also from the measures implemented to prevent the spread of the type-A flu virus (H1N1). Banxico states that the rate at which economic activity has contracted is slowing, and its performance is expected to improve in 2H09. In our opinion there will be an upturn in economic growth in the second half of the year, but we do not expect it to be very vigorous. Thus, it is highly probable that the factors related to economic activity continue to have a greater weight on the risk balance.
- Regarding inflation, the monetary authorities point out that it has fallen in line with its forecasts, and it is expected to continue converging. As we have mentioned before, the amount by which inflation will fall over the coming months depends to a great extent on the trend that prices of the merchandise component follows, which has been strongly affected by exchange rate depreciation. We expect this component to continue weakening, together with services, given the effects of the strong economic contraction.
- We believe that Banxico could reduce the lending rate by an additional 25 bps in its next meeting. This would bring an end to the cycle of monetary relaxation, although we would not completely rule out that this relaxation could be extended a little more in terms of a further cut of up to 50 bps within up to two rate cuts. As we have been pointing out for months, the Central Bank's balance of risks justified reducing the policy rate to these levels, and maintaining a long monetary pause; above all in a context in which - we insist - the exchange rate has shown itself not to be linked to monetary policy instrumentation.