Economic Research Department

BBVA

Mexico

BanxicoWatch

September 14, 2009

Banxico set to keep reference rate at 4.5% at next meeting on September 18.

- ***Data increasingly point to the global economic recovery starting to consolidate, but with uncertainty as to its strength and duration.*** Although economic indicators continue to point to the worst of the recession being behind us; this recovery is seen in a scenario of a weak job market and the need to correct high consumer debt levels in some developed countries. But also after a financial crisis still requiring better banking sector health in these countries.

- **In Mexico, the industrial output and services data, as well as the moderation in the fall of formal employment, suggest that the end of the recession has begun, although relatively slowly.** The slower GDP fall in 2Q09 is based on manufacturing and services, supported by a recovering foreign demand and a more benign financial environmental, as well as the boost provided by public investment programs. However, the intense destruction of employment over three quarters, the perspective for a slight upturn in external demand and the impact of the proposed 2010 fiscal measures, point, as a whole, to a slow domestic recovery.

- **Inflation will continue to fall in the last quarter of 2009, but the fiscal measures to increase special taxes, public prices and consumer prices will temporarily displace it from the Banxico forecast range for 2010. While the upturn fails to transfer to salaries or inflation expectations, we do not expect Banxico to respond with higher interest rates in the face of a provisional shock.** The economic package for 2010 plans to cover the advance deficit with a combination of spending cuts, revenue increases – tax, controlled prices and non-recurrent earnings increases – and a temporary additional increase in debt. The project is required and ambitious, incorporating permanent tax increases and spending cuts boosting the sustainability of public finances. The increases in public prices, special taxes and consumer taxes will lead to a temporary provisional inflation shock in 2010, with the risk of it coming before if the price increases for activities less exposed to competition are brought forward. Although inflation will temporarily diverge from the 2010 Banxico range, the wide product gulf should ensure the persistence of this shock is minimal, without affecting salaries or medium term inflation perspectives. In fact, other reforms to be discussed in Congress to make the economy more flexible and boost growth should contribute to reduce downward resistance in inflation over the medium and long term.

- **A context of lower aversion levels and clear fiscal uncertainty in international markets would support peso appreciation and the fall in the curve slope.** Although no major upturn is expected in the appetite for risk, the global economic cycle will limit greater aversion movements. If the risk premium decreases for public finance sustainability, the negative difference for domestic financial variables will reverse.

- **Monetary pause set to remain for a prolonged period.** Until a few months ago, the balance of economic risks had moved steadily towards lower growth risks. Although the beginning of the end of recession and the uncertainty as to the size of the temporary inflationary fiscal shock are starting to balance this assessment out, we still believe that there is a slant towards lower growth, leading to a prolonged pause.

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