



Banxico Watch

October 13, 2009

Banxico will keep the reference rate at 4.5% at its meeting on October 16. The monetary pause will hold.

- **The most recent economic data confirm that the recession has bottomed out, although there are still doubts about the duration and strength of the recovery.** In particular, the U.S. labor market, and thus its domestic demand, continue to be weak; while consumer confidence and lending remain at very low levels in most developed countries. In contrast, some emerging economies, particularly in East Asia, are leading economic recovery through their strong domestic demand and export capacity.
- **Mexico has emerged from the deep recession experienced in the second half of 2008 and the first half of 2009. However, the way out will be sluggish.** Data on industrial output and activity in the service sector, mainly boosted up by the revival in external demand, suggest a recovery of economic activity. It is also hoped that the current inventory restocking process will enhance the rate of improvement in some manufacturing activities. An upturn in overall economic growth is also expected after four consecutive quarters of decline, although its strength and duration will depend on the dynamics of demand in the U.S., Mexico's main economic partner. However, the intensity of the recession led to such a steep fall in the level of domestic economic activity that it does not appear likely to recover to previous levels for another two years.
- **Inflation validates its downtrend and will close 2009 slightly under 4%. Possible fiscal measures lead to uncertainty about 2010.** Although inflation showed some resistance to decline at the start of the year, mainly as a result of exchange rate depreciation, it has maintained a downward trend in recent months and is expected to reach levels below 4% by the end of the year. The accumulated output gap and the relative stability in the exchange rate both imply somewhat moderate pressures on the price level until the end of 2010. However, the budget for next year, currently being debated in Congress, will probably involve measures such as higher taxes on consumption, special taxes and changes to public prices. These will put an upward pressure on prices in 2010, though the inflation rate will converge in 2011.
- **The risks of lower growth and higher inflation are better balanced.** Until a few months ago, the balance of risks had leaned heavily towards the side of lower growth risks due to the size of the economic slump. However, the recent recovery in domestic activity and the uncertainty regarding the inflationary effect of the proposed fiscal reforms have meant that the balance of risks is beginning to even up.
- **The monetary pause will be extended for some time.** We expect that Banxico will maintain the monetary pause and leave the reference rate at 4.5% at its meeting on October 16. Despite the relatively even balance of risks, in its latest report the central bank not only eliminated the mention of a time horizon for achieving the goal of 3% inflation, but also included the impact of the output gap as a relevant factor for assessing inflationary perspectives. This posture allows Banxico greater room for maneuver when assessing the inflationary pressures arising from the fiscal reform and the strength of the underway economic recovery.