Mexico

# Banxico Watch

Monetary Policy Decision

August 20, 2010

## The more accommodating tone in the last release gives a strong signal to a prolonged pause

Fondeo rate remains at 4.5%. August, 20

**Economic Analysis**

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- **Banxico adapts its message to a better balance of risks for inflation**
- **Central bank shows a qualitatively less positive view of growth and more for inflation**

**Banxico gives a clear sign of a prolonged pause in the plainly accommodating release tone**

As stated, the release tone incorporates significant new qualitative indications summed up in a clearly more accommodating tone heightening the already clear sign of a prolonged pause, highlighting the lower dynamism forecast for the US (and its impact on Mexico), the maintaining of the FED monetary stance for longer, the role of core inflation in the fall seen in headline inflation and high probability that this remains under the lower Banxico target limit during Q310.

Banxico presents a more negative and uncertain picture of global economic activity than in its previous statement, pointing to: i) the US output rate "*reducing*" due to continued high unemployment, households reducing debt and difficulties in the housing market; and, more significantly, ii) "*all this points to lower dynamism in that economy in the future*". The Federal Reserve maintaining its monetary stimulus stance for longer in response is also highlighted. With regard to Mexico, assessment can be summed up as less optimism and greater caution in the future, in line with the lower forecasts for the US economy. It also states that recent data point to private demand "*beginning to see a more favorable performance*" and manufacturing output and exports continuing at quicker rates, warning that "*this dynamism could slow down due to the outlook for the US*".

As we set out in the Banxico Watch prior to this monetary policy decision, regarding inflation the changes in tone in the releases center around an improvement in the balance of risks for inflation given the lack of demand pressures on better-than-expected price performance and the reduction of the relative weight of more volatile products apportioned to the fall in CPI: i) the role of the "*better performance of core inflation*" stands out in the decline in headline inflation; and ii) inflation is "*highly likely*" to come in below the lower limit of the target range in Q310.

In short, Banxico is adapting its message to the recent news on the balance of risks for inflation, in line with a scenario of lower growth in coming quarters and a milder inflation performance where the role of core inflation takes on greater weight. The changes in the *policy* paragraph implicitly point to the bank being watchful of inflation forecasts in the short-term, removing the explicit reference to "*medium- and long-term*" and to the "speed" at which the output gap closes. This intends to avoid speculation on possible interest rate reductions. In all, after today's release tone, there is a lean towards a more prolonged pause, i.e. a higher probability of the 1st Banxico increase not coming until Q311.

Table 1
## Summary of the Monetary Policy Statements

| | Jun.18 | Jul.16 | Aug 20 | Appraisal* |
|---|---|---|---|---|
| **Global Context** | The recent instability in the EU has accentuated the differences in economic growth prospects between regions and countries. In the U.S.A., consumption and non residential investment have improved. Unemployment, however, remains high. The impact of economic events (in the USA) on Europe seems limited… Even though volatility in the financial markets in the EU has decreased recently, the region's need to strengthen its fiscal well-being has been highlighted. Thus, its downside risk for worldwide economic growth has been accentuated. As to the principle emerging economies, they have sustained robust growth and in some there are even concerns of overheating and inflation. This has led to less synchronous monetary policies in countries… | Recent developments in the world economy continue to reflect a modest recovery in advanced countries and strong growth in the emerging ones, especially in Asia. Industrial activity in the United States in the second quarter has been vigorous, and the forecast for domestic spending has improved. Nevertheless, unemployment remains high, families are shedding debt, and there continue to be difficulties in the housing sector. Europe has made progress in addressing the sovereign debt problems of some countries. However, the financial situation and growth prospects in the region remain vulnerable elements. All of the above has led to inflation and the expectations surrounding it to remain at low levels in advanced economies. | Economic recovery in advanced economies continues to be modest, while emerging economies still see strong growth, particularly in Asia. **Different indicators in the US point to the output rate reducing.** This is due to the persistently high unemployment rate, households reducing debt, as well as difficulties still present in the housing market. **All this points to lower dynamism in the economy here on in. In response, and in a scenario with historically low inflation, the Federal Reserve has expressed its intentions to maintain the current monetary policy position for a longer period** and also avoid reducing its balance sheet. Sovereign debt markets in Europe have trended towards norms. | **Lower dynamism expected in US** |
| **Economic Growth** | In Mexico, manufacturing production and exports have been reflecting the vigorous industrial activity in the United States. Sector consumption and investment have remained sluggish, although they have recently shown a bit of improvement. The uncertainty associated with the downturn in Europe generated greater volatility in the exchange market… Nevertheless, the exchange rate has tended to stabilize, even showing a rise recently. On the other hand, long-term interest rates have gone down significantly… | In Mexico, manufacturing production and exports have been going up steadily, in response to greater foreign demand. Private sector consumption and investment remain at relatively low levels, even if they already seem to be showing an upward trend. Despite the recent period of volatility in international financial markets, the exchange rate for the national currency has remained relatively stable. Likewise, long-term interest rates have continued to decline significantly, yet further flattening the yield curve for public debt. | In Mexico manufacturing production and exports continue to grow at fast rates; however, this **dynamism could slow due to the outlook for the US.** Consumption and investment continue at low levels, but recent data shows private domestic demand starting to show a better performance. The national currency has remained stable, while long-term interest rates continue to see significant falls, favoring an additional flattening in the domestic public debt yield curve. | **Impact on Mexico of expected lower dynamism in the US** |
| **Inflation** | Annual inflation fell again in May. If this indeed reflects seasonal and business-cycle effects, it is also true that the underlying and non-underlying components showed favorable development that goes beyond these effects. Moving forward, inflationary behavior is estimated to continue to match the forecast published in the supplement to the Report on Inflation for third quarter 2009. | Within this context, general inflation in annual terms, as well as two components, continued to decrease. In fact, both components registered better development than forecast, although it must be pointed out that a significant part of this is due to seasonal and business-cycle effects. Along these lines, average general inflation in the second quarter stood at 3.96 per cent, 0.54 percentage points below the lowest benchmark forecast for this period published in the supplement to the Report on Inflation for third quarter 2009. Moving forward, inflationary behavior is estimated to be in line with the forecasted path, which predicts a spike towards the end of the year that will then level out and trend downward in 2011. | Recent inflation figures came in better than both market and Central Bank forecasts Although some of this performance is due to seasonal and contextual factors, some is due to the **better performance of core inflation**. The elements leading to this include the lower than expected effect of the tax changes on prices, the output gap, strong competition between some shopping chains and the greater exchange stability in tandem with lower international inflation. **Inflation is expected to show increases towards the end of the year over present levels, but with a high chance it remains below the lower limit of Bank of Mexico forecasts for the first quarter.** In any case, inflation is expected to return to a downward trend in 2011. | **Better balance of risks; the role of core inflation stands out in the fall in headline inflation.** |
| **Risk Balance** | Due to the above, the Government has decided to hold the 4.5 per cent target for the one-day interbank interest rate. It will continue to monitor the path of medium- and long-term inflation expectations, the speed at which the production gap closes, as well as other inflation determining factors that could signal unexpected and generalized price pressures. All with the objective that in this event, the *Instituto Central* would adjust monetary policy in order to reach the goal of 3 per cent inflation toward the end of the next year. | In light of the above, the Government has decided to hold the 4.5 per cent target for the one-day interbank interest rate. It will continue to monitor the development of medium- and long-term inflation expectations, the speed at which the production gap closes, as well as other inflation determining factors that could signal unexpected and generalized price pressures. All with the objective that in this event, the *Instituto Central* would adjust monetary policy in order to reach the goal of 3 per cent inflation toward the end of the next year. | In light of the above, the Board decided to keep the target for the overnight Interbank Interest Rate unchanged. **The Board will continue to watch over inflation forecast performance, the output gap and other determining factors that may point to unexpected general pressures on prices.** The aim is for the Central Bank to be able to adjust the monetary stance if necessary in order to reach the 3 percent inflation target by the end of 2011. | **Prolonged pause** |
| **Policy Decision** | 0.00 | 0.00 | 0.00 | |
| **Fondeo Rate** | 4.50 | 4.50 | 4.50 | |

* Interpretation by BBVA Research of Banxico's opinion in accordance with the latest monetary policy statement.

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