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Economic Research Group (New York)

Magalí E. Solimano
Latin America Economist
TEL: (212) 782-5708
msolimano@us.mufg.jp

MEXICO: BANXICO DELIVERS 25BP CUT AND INTENDS TO HOLD

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Decision: Banxico's 25bp Cut Lowers Policy Rate to 3.5%

Mexico's Central Bank (Banxico) reduced the overnight policy rate by 25bp to 3.5% per year on Friday, October 25th. The decision follows a surprise 25bp cut in September. (Figure 1.) In the statement accompanying today's decision, Banxico clearly cites its intention to end current monetary easing.

Banxico views that the incipient economic recovery is underway however, downside risks to growth—though eased since the previous meeting—remain elevated and a considerable degree of slack in the economy persists.

From the statement accompanying the decision: "Taking the expected fiscal policy into consideration, the Committee assesses that the monetary policy stance is congruent with the efficient convergence of inflation to the 3% target, but considers that additional cuts are not recommended in the near future. In any case, the Committee will remain vigilant to the implications on the inflation outlook from the evolution of economic activity and the stance of monetary policy relative to the US, among other factors, with the goal of having conditions in place to reach the inflation target."

With low core inflation, focus of cut is on economic activity

Internal and external conditions support Banxico's latest rate cut. With low inflation and a negative output gap, Banxico has flexibility to maneuver monetary policy to support growth. At the same time, the US Fed's decision in September to not yet begin QE tapering extended the window of opportunity for Banxico to act to lower the overnight rate. To preserve financial market stability, Banxico has been placing importance on the stance of monetary policy relative to that of the US.

The 12-month consumer price inflation rate came in at 3.39% in September, within the target range of 3% +/- 1%. Core inflation remains near its record low. The reading was 2.52% in September and 2.46% in 1H October. (Figure 2.)

The economy's broad-based cyclical deceleration in 2013 has been reflective of the weak external environment, lower government spending, and slowed construction activity. Exports and manufacturing should drive the cyclical acceleration in 2H13 and into 2014, in turn supporting a modest recovery of domestic demand.

There are signs that economic activity started to pick up in 3Q after a weak 1H, albeit at a slower than expected pace. The index of economic activity (IGAE)—a monthly GDP proxy—rose 0.22% month-on-month/sa in August after rising 0.47% mom in July. In annual terms, the IGAE posted modest expansion of 0.84% year-on-year in August. (Figure 3.)

Industrial production rose 0.49% mom/sa in August—marking four consecutive months of sequential growth since May—despite the 0.7% yoy drop. Moreover, September's trade balance results—released this morning—point to a pick-up of manufactured exports, which rose 11.8% yoy versus 6.2% in August and 5.6% in July.

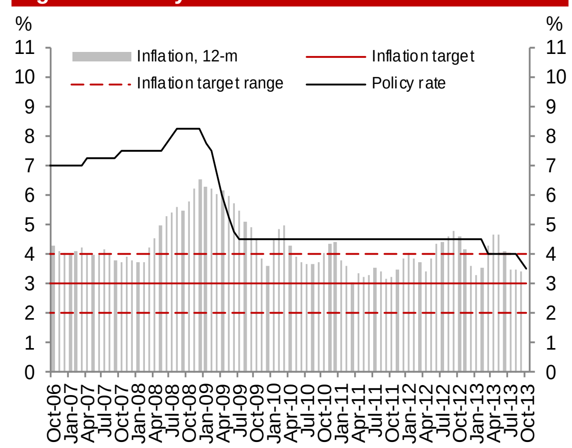
On the domestic demand front, private consumption has subdued upon lower employment creation and consumer confidence. Retail sales dropped by an unexpected 1.4% in August compared to July—following three months of growth—resulting in a 2.2% yoy decline.

Banxico's signal to hold amid proposed widening of fiscal deficit

Since its meeting in September, it seems that Banxico considered the government's proposed transitory widening of fiscal deficits in 2013 and 2014 to be an important change to the macroeconomic policy mix. Indeed, in the accompanying statement, Banxico clearly cited the expected fiscal policy as a reason for not seeing further monetary policy cuts as advisable in the near future.

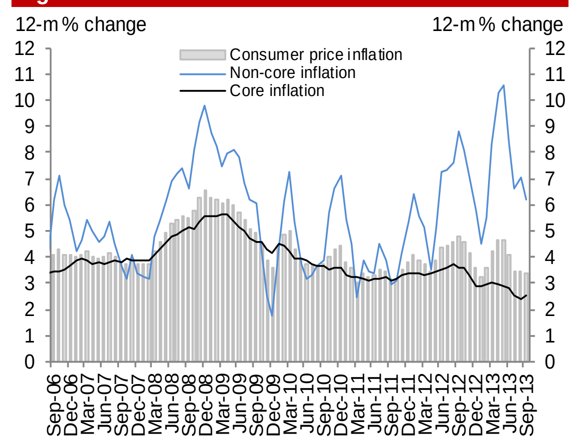
Under current conditions, we expect the policy rate to stay on hold at 3.5% at Banxico's next meeting on December 6th. Though Banxico intends to hold, a final 25bp cut in December is not yet ruled out. Monetary policy will be guided by the evolution of inflation, economic activity, and financial market conditions, as well as by the final version of the fiscal reform.

Figure 1: Policy rate and 12-month inflation



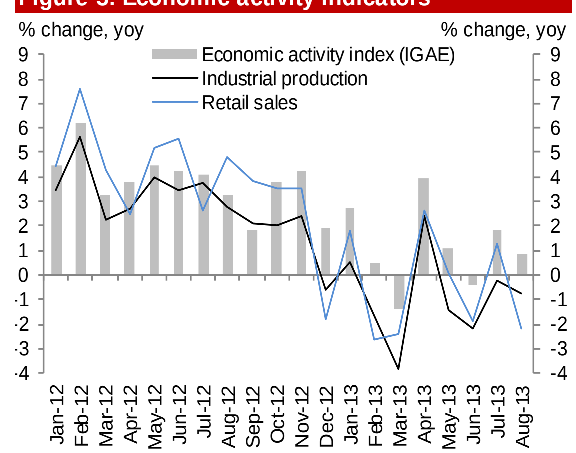
Source: Central Bank; BTMU Economic Research.

Figure 2: Core and non-core inflation



Source: Central Bank; BTMU Economic Research.

Figure 3: Economic activity indicators



Source: INEGI; BTMU Economic Research.

For historical data and commentary following BTMU's Economic News Releases, see our website at: http://www.bk.mufg.jp/report/ecolatin2013/index.htm