 September 6, 2013

Mexico-X-Press

Daniela Blancas
+1 416 862-3908
daniela.blancas@scotiabank.com

Banco de Mexico Changes Course

Event

On Friday September 6th, Banco de Mexico (Banxico) loosened monetary conditions by cutting the reference rate by 25 basis points (bps) to 3.75%.

Significance

Banxico's move reflects the concerns of policymakers globally regarding the deceleration in economic growth momentum in emerging economies. Additionally, Mexican authorities remain mindful of the possible shift in US monetary policy and its impact on local financial markets.

Financial Market Reaction

The reaction in Mexican financial markets was positive. The Mexican peso (MXN) closed the day 1.5% stronger vis-à-vis the US dollar (USD), the Mexican 10-year bond yield traded 20 basis points (bps) lower than its previous close and the equity market was up by 0.6% on the day. However, this favourable reaction also reflects the US employment report, which was worse-than-anticipated, lowering the possibility of a shift in the Federal Reserve asset purchasing program on September 18th.

Analysis and Outlook

Banxico highlighted two key messages in its announcement: *i)* Mexican economic data are pointing towards a weaker growth outlook for the 2013-14 period and *ii)* inflation has finally returned to within the central bank's tolerance range of 2-4% and is expected to remain well-contained over the medium term. With this, the central bank is leaving the door open for further cuts later this year. The previous policy adjustment took place in March when the central bank reduced the reference rate by 50 bps to 4%, signaling that the move was not a beginning of an easing cycle but a one-off adjustment to reduced inflation risks.

Mexican real GDP expanded by 1.0% y/y in the first-half of the year, its slowest rate since 2009. The industrial sector's (particularly construction) deceleration weighed more heavily on GDP performance, while the services sector also moderated its pace. After surpassing the central bank's tolerance range (2-4%) in the March-June period, headline inflation decelerated to 3.5% y/y in July.

Today's statement came a few weeks before the US Federal Reserve (Fed) meeting that will possibly deliver an announcement regarding a reduction of the US government and agency bonds purchase program. Against this background, Banxico seems to be preparing for a US monetary normalization with a low economic performance domestically. However, in our view the timing of the decision adds uncertainty to the outlook. Volatility in global financial assets has increased since May, and Mexican assets have not been immune to significant swings in risk aversion. The MXN has lost 10% against the USD from May to September, while the 10-year bond yield moved from 4.7% to 6.2% during the same period. Additionally, in the political arena the fiscal reform proposal is expected to be announced shortly, together with the 2014 budget, leaving local financial markets more vulnerable to higher volatility.

Further monetary easing will depend on two key factors: the local economic performance and the US monetary policy outlook. As the impact of monetary actions on the real economy tend to lag, the central bank is projecting that economic growth in the second half of the year will remain subdued, adding to the risk of our current real GDP growth forecast of 1.9% for 2013 and 3.7% for 2014. The minutes of today's meeting (to be released on September 20th) will be closely analyzed by market participants. In addition, there is a possibility that the Fed's decision to adjust liquidity could be delayed until December, when new macroeconomic projections will be released.

INTERNATIONAL ECONOMICS GROUP

Pablo F.G. Bréard, Head
1 (416) 862-3876
pablo.breard@scotiabank.com

Daniela Blancas
1 (416) 862-3908
daniela.blancas@scotiabank.com

Sarah Howcroft
1 (416) 862-3174
sarah.howcroft@scotiabank.com

Tuuli McCully
1 (416) 863-2859
tuuli.mccully@scotiabank.com

Estela Ramírez
1 (416) 862-3199
estela.ramirez@scotiabank.com

Scotia Economics

Scotia Plaza 40 King Street West, 63rd Floor
Toronto, Ontario Canada M5H 1H1
Tel: (416) 866-6253 Fax: (416) 866-2829
Email: scotia.economics@scotiabank.com