The Trough Deepens

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Mexican Monetary Policy: Between a Rock and a Hard Place

The Mexican central bank faces one of the toughest environments to conduct monetary policy as inflationary pressures, while abating, continue to remain above the institution's target of 3.0% +/- 1.0%, even though the economy is suffering the worst contraction since the Great Depression of the 1930s. In fact, as the world economy entered one of the worst periods since the Great Depression, inflationary pressures were still building in the Mexican economy as food and petroleum prices increased until July of last year. That said, the Mexican inflation rate went from 3.72% in February of 2008 to 6.53% by the end of the year.

Starting in January of 2009, when the rate of inflation began to trend downward, the central bank began its campaign to lower interest rates. However, the economy was already experiencing the worst recession since the 1930s and little could be done at that time. This does not mean that the failure to react back in September of 2008, when the U.S. Federal Reserve started to lower the Federal Funds rate, would have made any difference for the Mexican economy. But it's clear that domestic inflationary concerns were at the top of the agenda for central bank officials in Mexico while not so much for central bankers in the U.S. In fact, the different reaction of prices in the U.S. and Mexico is a clear indication that the rate of inflation in Mexico is much more resilient than its U.S. counterpart. By July of 2009, the rate of inflation in Mexico was still high at 5.4%, while the rate in the U.S. was -2.1%. Consumer prices in the U.S. were at 5.6% in July of 2008. This means that the 3.0% inflation target established by the Mexican central bank may not be sensible in a country where structural issues prevent the rate of inflation from falling towards the target even during strenuous economic circumstances.

Of course, for the central bank, changing the target for the rate of inflation is a very difficult proposition, since they'll likely face a serious issue with the resetting of inflationary expectations across the economy that could trigger even higher future inflation. Thus, the Mexican central bank is between a rock and a hard place, having established a target that is, under normal circumstances, impossible to achieve while at the same time trying to convince economic agents that the target is feasible.

Having a higher target for inflation could have allowed the Mexican central bank to start lowering interest rates before January of this year. While it is clear that this may not have been enough to prevent the collapse in economic activity that ensued, it may have allowed domestic consumption to partially fill the consumption gap opened due to the collapse in foreign consumption.

This latest crisis shows the limitations faced by monetary policy in a highly open and globalized world when faced with a collapse in demand from your most important trade partner. This time around, the Mexican crisis was not triggered by domestic events, as was the case during the Tequila Crisis of 1994-1995. During that downturn, domestic consumption collapsed but foreign consumption remained strong, preventing an even more serious crisis. During the current meltdown, foreign demand collapsed and domestic demand did not step up to the plate and save the day.

Taking all of this into consideration, the central bank of Mexico did not have much of a choice. Furthermore, this response shows the clear differences in mandates between both institutions north and south of the border. The Mexican central bank mandate is almost singular in nature, being entrusted with keeping inflation down. The U.S. Federal Reserve must make a value judgment between different objectives such as price stability, full employment, economic growth, and financial stability among others

—Dr. Eugenio J. Alemán , Wells Fargo Bank

Mexico Consensus Economic Forecast
3rd Quarter Summary

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As the third quarter of 2009 comes to a close, the Mexican economy remains severely battered. The latest INEGI data indicate that the second quarter of 2009 brought with it an annual GDP decrease, in real terms, of nearly 10.3 percent. The current consensus outlook calls for the light at the end of the tunnel to appear in 2010. In spite of this austere outlook, the financial system in Mexico has fared better than it did in prior recessions and the economy seems poised for growth once exports recover.

The consensus outlook for real gross domestic product (GDP) calls for a noticeably sharp decline in 2009 of 7.1 percent. Relative to the consensus from last quarter, that represents a sharp downward revision. Individual panelist forecasts range from a drop of 6.5 percent to a steeper decline of 8.2 percent. An important source of the more pessimistic outlook is private consumption. Compared with the previous quarter, Mexican consumers are expected to reduce purchases by 6.9 percent, more than double the rate of decline expected three months ago.

Fiscal stimulus efforts in Mexico will likely continue in response to a struggling national economy. Given this, the consensus forecast calls for an increase in government consumption of 2.3 percent in 2009, a projection that is basically unchanged from last quarter. Confidence in Mexican business performance will likely remain weak throughout the remainder of the same twelve-month period. As such, the panelist consensus expects total fixed investment to decline even more sharply than was the case earlier this year. The contraction is now predicted to exceed negative 11 percent, with two panelists calling for declines of 15 percent or worse.

The pace of U.S business cycle recovery will not be rapid enough to prevent steep double-digit declines in manufactured product exports in 2009. That combines with the sharp fall in petroleum prices to pull down total exports by a whopping 20 percentage points according to the consensus. As other sectors of the Mexican economy continue to falter, Mexican imports of goods and services are also likely to shrink by more than 20 percent. The latter also reflects the loss of consumer purchasing power that resulted from the depreciation of the peso during the second half of 2008.

Five of the nine panelists anticipate consumer price increases of no less than 5.4 percent, while the remainder expect price increases ranging from 3.7 to 5.0 percent. That translates to a consensus rate of 5 percent in 2009 and represents a more optimistic figure than what was anticipated last quarter. Accompanying that change is a consensus exchange rate forecast of 13.39 pesos per dollar, also an improvement from three months ago.

The panel does not anticipate that higher yields will be required for currency market tranquility. In fact, the consensus outlook calls for an 80 basis point drop for 28-day Treasury Certificates (CETES) relative to the forecast from last quarter. The 5.5 percent rate of return currently expected for 28-day CETES is not much higher than the rate of change predicted for the CPI, reflective of the modified central bank policy stance discussed above. That represents a sharp departure from recent years when inflationary pressures in Mexico were more intense.

Although the 2009 outlook has worsened, a much more solid recovery is now anticipated for 2010. GDP is forecast to display an increase of 2.3 percent, outpacing the moderate 1.3 percent clip projected last quarter. Private consumption is also projected to recover in 2010. A less noticeable increase in government spending, however, is expected by the forecast panel. In this economic climate, enhanced business conditions are projected to strengthen fixed investment. As these trends unfold, Mexico's imports and exports will likely accelerate, but there are wide ranging differences among the individual forecasts for these items. In spite of the acceleration in overall economic activity, consumer price inflation is expected to continue to decelerate in 2010 and fall to 3.9 percent. Over the course of those twelve months, the panelists further anticipate stronger macroeconomic conditions to help the Mexican peso to hold steady at 13.38 P/$. The panel forecast of 5.2 percent for the 28-day CETES rate in 2010 reflects ongoing monetary policy accommodation by the central bank.

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2009 Mexico Consensus Economic Forecast **Annual Average**

Annual Percent Change, 2009 from 2008

	GDP	Private Consumption	Government Consumption	Total Investment	Exports	Imports	Consumer Price Index	Exchange Rate	CETES 28 Day
American Chamber Mexico	-7.4	-8.3	1.1	-11.7	-24.4	-26.4	4.2	13.57	5.4
JPMorgan Chase Bank	-6.5	n/a	n/a	-25.0	-20.0	-30.0	3.7	13.50	5.4
BBVA Bancomer	-8.2	-7.9	4.3	-9.7	-20.9	-19.1	5.4	13.50	5.3
Wells Fargo Bank	-7.2	-8.0	0.7	-10.3	-14.1	-14.6	5.4	13.55	5.4
Center for Economic Forecasting of Mexico	-7.2	-6.8	-0.5	-11.1	-14.8	-16.5	5.4	13.40	5.4
UACJ	-6.0	-4.0	-1.0	-3.7	-2.5	-2.0	5.0	13.35	5.8
ITESM	-7.0	-6.0	0.5	-8.0	-35.0	-25.0	4.5	13.00	5.2
COLEF	-7.2	-8.0	12.0	-15.0	-27.0	-28.0	6.1	13.00	5.5
UAdeC	-7.0	-6.0	1.5	-11.7	-22.0	-21.0	5.4	13.60	6.0
Consensus -- this quarter	-7.1	-6.9	2.3	-11.8	-20.1	-20.3	5.0	13.39	5.5
-- last quarter	-4.8	-3.0	2.5	-6.4	-14.1	-11.9	5.6	13.63	6.3

2010 Mexico Consensus Economic Forecast **Annual Average**

Annual Percent Change, 2010 from 2009

	GDP	Private Consumption	Government Consumption	Total Investment	Exports	Imports	Consumer Price Index	Exchange Rate	CETES 28 Day
American Chamber Mexico	2.6	2.9	0.6	6.0	8.8	9.4	3.9	13.40	5.0
JPMorgan Chase Bank	5.0	n/a	n/a	18.0	17.0	-12.0	3.4	13.00	5.8
BBVA Bancomer	2.3	1.0	2.3	4.4	11.5	8.9	3.8	13.00	4.2
Wells Fargo Bank	2.2	2.5	2.3	1.1	2.7	2.3	3.8	13.10	4.5
Center for Economic Forecasting of Mexico	3.0	3.2	2.5	6.5	4.5	5.5	3.6	12.75	4.5
UACJ	2.5	2.0	1.5	2.0	3.0	4.0	4.0	13.00	5.0
ITESM	2.0	2.0	6.0	4.0	10.0	15.0	4.0	13.20	5.0
COLEF	-0.8	1.0	0.0	-2.0	-1.0	-2.0	4.0	15.00	6.0
UAdeC	1.5	1.3	-1.0	2.8	3.8	3.0	5.0	14.00	7.0
Consensus -- this quarter	2.3	2.0	1.8	4.8	6.7	3.8	3.9	13.38	5.2
-- last quarter	1.6	1.3	1.6	4.8	4.4	4.2	4.6	13.60	6.3

Annual Averages

Historical Data		GDP (2003 Pesos, billions)	Private Consumption (2003 Pesos, billions)	Government Consumption (2003 Pesos, billions)	Total Investment (2003 Pesos, billions)	Exports (2003 Pesos, billions)	Imports (2003 Pesos, billions)	CPI June 2002 = 100	Nominal Exchange Rate Pesos/ Dollars	CETES 28 Day
2008		8,928.6	6,220.0	930.5	2,050.6	2,710.2	3,057.6	129.2	11.14	7.68
	Percent Change	1.35%	1.54%	0.59%	4.94%	1.40%	4.29%	*5.13%*	*1.92%*	
2007		8,809.9	6,125.5	925.0	1,954.0	2,672.9	2,931.7	122.9	10.93	7.19
	Percent Change	*3.33%*	3.86%	2.14%	7.17%	*5.66%*	*7.00%*	3.97%	*0.28%*	
2006		8,526.0	5,897.8	905.6	1,823.3	2,529.7	2,740.0	118.2	10.90	7.19
	Percent Change	*5.13%*	*5.68%*	*1.72%*	*9.78%*	*10.94%*	*12.57%*	3.63%	*-0.16%*	
2005		8,110.2	5,580.7	890.3	1,660.8	2,280.3	2,434.0	114.1	10.92	9.20
	Percent Change	*3.21%*	*4.78%*	*2.44%*	*7.46%*	*6.75%*	*8.48%*	*3.99%*	*-3.29%*	
2004		7,857.7	5,326.0	869.1	1,545.5	2,136.1	2,243.8	109.7	11.29	6.82
	Percent Change	*4.00%*	*5.62%*	*-2.76%*	*8.01%*	*11.50%*	*10.74%*	*4.69%*	*4.63%*	
2003		7,555.8	5,042.8	893.8	1,430.9	1,915.8	2,026.2	104.8	10.79	6.23
	Percent Change	*1.35%*	*2.22%*	*0.80%*	*0.37%*	*2.70%*	*0.70%*	*4.55%*	*12.05%*	
2002		7,455.0	4,933.1	886.7	1,425.6	1,865.5	2,012.2	100.2	9.63	7.09
	Percent Change	*0.83%*	*1.59%*	*-0.33%*	*-0.64%*	*1.44%*	*1.46%*	*5.03%*	*3.10%*	
2001		7,393.9	4,856.1	889.6	1,434.8	1,839.0	1,983.2	95.42	9.34	11.31
	Percent Change	*-0.16%*	*2.48%*	*-1.98%*	*-5.64%*	*-3.60%*	*-1.63%*	*6.36%*	*-1.27%*	
2000		7,405.5	4,738.7	907.6	1,520.5	1,907.6	2,016.1	89.71	9.46	15.24
	Percent Change	*6.60%*	*8.18%*	*2.38%*	*11.36%*	*16.28%*	*21.47%*	*9.50%*	*-1.05%*	
1999		6,946.9	4,380.3	886.5	1,365.4	1,640.5	1,659.7	81.93	9.56	21.41

Note: 2008 Data are preliminary and subject to revision

*GDP: Producto Interno Bruto, INEGI, 2003 Pesos

*Private Consumption: Consumo Privado, INEGI, 2003 Pesos

*Government Consumption: Consumo de Gobierno, INEGI, 2003 Pesos

*Total Investment: Formación Bruta de Capital Fijo, INEGI, 2003 Pesos

*Exports: Exportación de Bienes y Servicios, INEGI, 2003 Pesos

*Imports: Importación de Bienes y Servicios, INEGI, 2003 Pesos

*CPI, Banco de México, Annual Average, Base = June 2002

*Exchange Rate, Banco de México, Peso-to-Dollar, Fecha de Liquidación, Annual Average

*CETES 28 Days, Banco de México, Annual Average

México Consensus Economic Forecast, a quarterly publication of the Border Region Modeling Project, a research unit within the Department of Economics & Finance at the College of Business Administration of The University of Texas at El Paso, is available on the Web at: **http://academics.utep.edu/border**. Econometric research assistance is provided by Emmanuel Villalobos and EnedinaLicerio. For additional information, contact the Border Region Modeling Project - CBA 236, UTEP Department of Economics & Finance, 500 West University Avenue, El Paso, TX 79968-0543, USA. (915) 747-7775.