Monetary Program

2011

BANCO DE MÉXICO

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1. Monetary Program for 2011

Article 51 of Banco de México's Law stipulates that in January of each year the Central Bank must send the guidelines defining the monetary policy conduct for the respective year to the President and the Congress. In compliance with the abovementioned article the specifications of the monetary policy to be followed in 2011 are detailed below.

In order to fulfill the constitutional mandate of pursuing stability of purchasing power of the national currency, from 2001 onwards Banco de México has conducted its monetary policy under inflation-targeting scheme. The Monetary Policy Program for 2001 presents the most significant considerations about choosing this scheme, such as the official announcement of an inflation target and a continuous effort to improve transparency and communication with the public. Specifically, Banco de México has defined as a permanent objective reaching an annual inflation of the Consumer Price Index (CPI) of 3 percent.

However, even when the monetary policy is conducted in line with the attainment of the abovementioned inflation target, there is a certain margin of uncertainty as to its accurate and precise realization. This is due to a wide variety of factors affecting inflation evolution, which are beyond control of the monetary authority. In view of this degree of uncertainty, Banco de México has defined a plus/minus one percentage point variability interval around the inflation target of 3 percent. This interval should not be interpreted as indifference on the part of the monetary authority towards different realizations of the inflation rate within it. The interval determination is simply one way of taking into account the existence of various disturbances, such as relative prices adjustments that can affect the short-term inflation and place it above or below the target of 3 percent. In this context, a practical way of representing this inherent variability linked to inflation behavior, and thus the uncertainty associated to the precise attainment of the target, is establishing the abovementioned interval.

As it has been repeatedly mentioned, the constitutional mandate that establishes Banco de México's objective of pursuing stability of purchasing power of the national currency is based on a number of reasons. It is worth mentioning some of the most relevant, as established in the Monetary Policy Program for 2010:

1. Regressivity of inflation tax.

2. Loss of competitiveness and the economic activity deterioration caused by the inefficient resource allocation, when, in the context of high inflation, prices are subject to constant and uneven adjustments that generate changes in relative prices.

3. Reduction in forecast horizons of the economic agents, as frequency, dispersion, and intensity of price variations increase.

4. Establishment of stability of the purchasing power of currency as a necessary, but not sufficient, condition for achieving sustained economic growth.

Keeping inflation under control is not an objective opposed to economic growth. On the contrary, high levels of inflation have coincided with periods of low economic growth in various countries, as it has happened in Mexico in the past. This is due to the fact that social costs originated by inflation increase together with inflation and can have an important effect on the growth. In the same way, the abovementioned costs tend to be moderate when inflation is low and stable, creating adequate environment for the development of productive activities.

Taking into consideration the reasons set out here; in the Monetary Policy Program for 2011 Banco de México's Board of Governors reiterates its commitment to maintaining a monetary policy with the invariable priority of preserving the purchasing power of the national currency, bearing in mind its importance for economic growth and Mexican's wealth.

As to the monetary policy conduct, the Central Institute should take into consideration that the monetary policy actions affect economy with certain lags, especially, price evolution; and moreover, that these lags are long and variable. This is why the monetary authority should take decisions after a careful evaluation of the economic environment, pondering a balance of the prevailing monetary and financial conditions, as well as the outlook for future inflation, among other factors.

In order to maintain a low inflation equilibrium, the monetary policy should respond to different shocks affecting the economy. In this sense, Banco de México adjusts its monetary policy according to the prevailing economic conditions, as well as the features of the inflationary pressures it faces, particularly, when Banco de México perceives that the expected inflation is steadily moving away from the annual target of 3 percent.

When inflationary pressures stem from aggregate demand and are generalized, it is advisable for the monetary authority to tighten its monetary policy stance. That is, an increase in aggregate demand, that would allow foreseeing that the total expenditure growth would exceed the level consistent with the economy's productive potential, would eventually lead to generalized pressures on prices, which could additionally move the medium-term inflation expectations further away from the inflation target. In this case, the Central Institute would tend to react by increasing its target of the overnight reference interest rate, a tool used to operate its monetary policy. The adjustment of the mentioned rate would reduce inflationary pressures through different channels, explained below.

In view of an increase in the central bank's short-term interest rate target, the monetary authority affects conditions under which it supplies liquidity to the money market, which in general should influence interest rates for all horizons. However, short-term rates would suffer the most significant effect, while it would be less pronounced in the case of longer-term rates. The impact on the rates for different terms principally depends on three factors: 1) the expected short-term interest rate trajectory in the future; 2) long-term inflation expectations; 3) determined risk premia in financial markets. In turn, these elements are influenced by the credibility of the Central Bank as to its commitment to maintaining price stability. As the Central Bank has more credibility, longer-term rates will have lower upward pressures in the context of reference interest rate increases. This happens as a consequence of anchoring of medium- and long-term inflation expectations. In fact, high credibility could cause longer-term rates to suffer very low impact, or even decrease, which would "flatten" the yield curve in the context of increases in the short-term interest rate target.

The first transmission channel occurs directly through its upward impact on the rest of the interest rates, in particular, on the real interest rates. An increase in the real interest rate affects household and firms' decisions on savings and investment. The former would have more incentives to postpone their consumption in time, which would moderate the current aggregate demand. In turn, the financing cost for firms increases.[1] These effects tend to moderate the expansion rate of the aggregate demand, which helps to decrease generalized pressures on prices.

As to the channels operating through their effect on credit supply, there are two possibilities: bank credit channel and broad credit channel. As to the former, banks can limit credit grants as they perceive that those willing to take credits with higher interest rates are also the ones willing to start projects with higher risks. In the same way, financing supply conditions can also be affected by a broader credit channel. A higher interest rate can cause changes in the expected net income of the firms and in their balance sheet of assets and liabilities, in such a way their risk would increase and thus they would have to pay an additional risk premium for their loans.[2] In both channels, the reduction in financing decreases the aggregate demand pressures on prices.

The monetary policy also affects inflation through its impact on the exchange rate. In a small economy with free capital mobility, when domestic interest rates increase with respect to the rates prevailing in the international financial markets, the exchange rate would be expected to appreciate at the margin. This, in the light of the relative increase in the demand for financial instruments denominated in national currency related to those denominated in foreign currency. In this context, there are two transmission channels: a supply channel and a demand channel. With respect to the first, an appreciation of the exchange rate would lead to a reduction in firms' costs for imported inputs which contributes to lower inflation pressure. On the demand side, an exchange rate appreciation might cause a price increase of domestic goods with respect to the foreign produced ones. This could lead to a decline in net exports which in the end results in a reduction of aggregate demand and hence into lower inflation.

An additional channel through which an increase in interest rates contributes to moderating spending is the channel of asset prices, such as public and private debt securities, stocks, and real estate prices. An increase in the interest rate that reduces these asset prices can lower households' and firms' spending through its effects on their wealth, moderating aggregate demand and leading to lower pressure on these prices. As expected, in more developed economies this channel operates more intensively due to the fact that the amount and the variety of financial assets and real estates, which are traded in their financial systems and might be used as backup for financing consumption and investment expenditure, are higher.

[1] However, as investment is more dependent on longer-term rates, if the short-term rate increase flattens the yield curve, investment could decrease less than in a situation where inflation expectations are not anchored.

[2] An increase in interest rates can affect firms' accounts by reducing the cash flow, increasing the value of the debt, as well as decreasing the price of firms' assets.

Finally, an increase in the short-term interest rate target also operates through its effect on inflation expectations. As will be mentioned later on, the functioning of this channel crucially depends on the credibility of the monetary authority.

On the other hand, when the increase of inflation is the result of relative price changes, it is not desirable for the monetary authority to offset these pressures if the effect on inflation is transitory. For instance, in view of the increase in international references of some food commodity prices, as it was the case during 2006-2007, and to a lesser extent recently, relative prices show adjustments. In this case, and considering that the effects of the monetary policy on inflation need certain time to realize, in general it is barely effective for the central bank to try offsetting a temporary increase of inflation of this nature. Additionally, trying to counteract these effects can have undesirable consequences on the economy and national financial markets. However, if the Central Bank considers that there is a risk of contaminating the inflation expectations or the process of determination of other prices or, if so, that the inflation risk balance could show deterioration, the monetary policy should be restricted to avoid taking these counteracting measures.

As outlined above, due to its importance for the decision making of the monetary policy, the correct identification of the origin of inflation pressures and its possible effects on economic agents' expectations stands out. Additionally, it should be noted that the effectiveness of the monetary policy actions on the economy and, in the end, on inflation, mainly depends on the credibility in the central bank with respect to its commitment of maintaining price stability. When this credibility is high, households and firms determine their prices anticipating that the central bank will take the necessary measures to counteract inflation pressures. So, the credibility permits a more effective functioning of the before mentioned transmission channels and therefore, that changes in the short-term interest rate target might have a greater effect on inflation, thereby reducing the costs associated to fighting inflation.

Central banks' communication strategy is another important element that influences their credibility. With regard to this, Banco de México's Board of Governors considers convenient to expand the communication mechanisms with the public, starting from this year. Thereby, it ratifies its purpose of increasing even more the Central Institute's transparency and reiterates its commitment to continuing to increase the quality of the analysis it provides to be in line with the best international practices in the matter.

To expand the communication mechanisms, from this year onwards, the Minutes of the Board of Governors meetings with respect to monetary policy decisions will start to be published. This aims to increase even more the Central Institute's transparency and thereby offer more information to the market and the public about the monetary policy decision making process, highlighting the most influential factors in the decisions of the Board of Governors' members. Additionally, considering the convergence process of inflation towards low and stable levels during the last years, the Board of Governors considered it as appropriate to reduce the number of predetermined monetary policy announcement dates to 8. Nevertheless, as in previous years, the Board of Governors reserves the right to announce changes in the monetary policy stance at dates different to those previously scheduled, in the case of extraordinary events or situations requiring the Central Bank's intervention. Besides, although the number of monetary policy announcements during the year is reduced, through the publication of the Minutes the amount of information released to the market in this matter increases.

With respect to the commitment of continuing to increase the quality of the analysis the Central Institute provides, the following was decided:

i) To modify the publication format of the forecasts of the main macroeconomic variables. These forecasts are useful to transmit to the public the economic perspectives of the monetary authority, which, in turn, constitutes a fundamental element in the inflation expectations anchoring. Considering the before mentioned, starting with the Inflation Report of October-December 2010, to be published on February 9, 2011, Banco de México's forecasts of inflation and economic activity will be presented using Fan Charts. These graphs illustrate the uncertainty associated with the variable to be forecasted, make explicit the probability with which the forecasted variable is expected to be within different intervals, and are considered as some of the best international practices in central banking.

ii) As part of the continuous revision and improvement of statistics that the Central Institute produces and disseminates, following the best international practices in the matter, and in coordination with the National Institute of Statistics, Geography and Informatics (*Instituto Nacional de Estadística y Geografía*, INEGI), it was decided to update the basket and weighting structure used to elaborate the National Consumer Price Index from January 2011 onwards. This allows maintaining the representativeness of the indicator, as well as incorporating some methodological updates that will contribute to maintaining a higher level of quality in this statistic.[3]

In addition to the aforementioned, another element that is important to consider in order to assure an environment of stable prices in the medium and long term is the adequate functioning of the financial system. The accumulation of economic and/or financial imbalances can considerably affect the evolution of the economic activity through a wealth effect that disrupts the aggregate demand and consequently the inflation dynamics. Therefore, to seek price stability, monetary policy conduct should consider the time horizon sufficiently extensive to allow the identification of the risks implicit in the evolution of the financial variables, such as the credit aggregates and financial solvency indicators.

Given the aforesaid, it is important to recognize the complementarity that exists between price stability and financial stability. In particular, it is noteworthy that the monetary policy should be congruent with the macro-prudential policy in order to contribute to preventing situations that might put at risk the adequate functioning of the national financial system and the evolution of the economic activity and inflation. Additionally, the referred congruence is important in order to

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[3] It should be noted that in compliance with the establishments in the National System's Geographical and Statistical Information Law (*Ley del Sistema Nacional de Información Estadística y Geográfica*), the elaboration of the National Consumer Price Index (CPI) will be transferred to INEGI on July 15, 2011. The effort with respect to the continuous revision and improvement of the statistics is also part of the comprehensive strategy established by Banco de México and INEGI to successfully transfer the process of the before mentioned indicator. See Press Release as of January 7, 2011 for further details.

facilitate a rapid response of the financial authorities in the case of possible contingencies.

With regard to this, it should be highlighted that, on a global level, Mexico is one of the pioneering countries in forming institutional arrangements between monitoring authorities and financial system regulators in order to coordinate policies leading to the preservation of financial stability.[4] Banco de México plays a central role within the referred arrangements, participating in the recently created Financial System's Stability Committee (*Consejo de Estabilidad del Sistema Financiero (CESF*)).

So, and considering the elements shown in this monetary program, throughout the year Banco de México will carefully monitor the evolution of inflation and its expectations. In the case of an adverse change in the behavior of inflation determinants (such as the output gap, the public prices, the grain and other commodities prices), or if a sustained difference of the inflation expectations with respect to the permanent 3-percent target is detected, the Central Institute will adjust its monetary policy. Thus, Banco de México will fulfill the constitutional mandate assigned to it.

[4] See Financial System Report from June, 2010.