Bank of Mexico Raises Rates to Contain Inflation

Central bank increases overnight rate by a half percentage point to 4.75%

By
Juan Montes
Wall Street Journal, Sept. 29, 2016

MEXICO CITY—The Bank of Mexico raised interest rates by a half percentage point Thursday, making good the expectations of most economists, in a bid to contain inflation and bolster a peso hovering near record-low levels.

The central bank led by Agustín Carstens increased the overnight rate to 4.75%. But the bank sought to reassure investors that the half-percentage-point rate increase won't necessarily be repeated at the next meeting, saying that "it isn't the start of a tightening cycle."

In an unusually candid statement, the Bank of Mexico said the move "seeks to counter inflationary pressures and keep inflation expectations anchored."

Few analysts, though, expected the move would cause the peso to appreciate significantly, or guarantee more peso stability.

"It helps for sure, but it does not solve the problem, as it is external risks (and some domestic ones as well, but to a lesser degree) that are currently afflicting the peso," Nomura said a note to clients.

The peso is the 10th most-traded currency and frequently used as a proxy to hedge global risks. In the past year, it has suffered selloffs caused by different factors, from Britain's vote in June to leave the European Union to increasing expectations the U.S. Federal Reserve will raise interest rates this year and uncertainty surrounding the U.S. presidential election.

It is the third time this year that the bank has increased borrowing costs, having made moves of the same size in June and February.

Annual inflation has been below the bank's 3% target for the past 15 months but picked up in the first half of September to its highest level in seven months. The bank has a sole mandate to keep inflation under control.

The peso has been a concern for the central bank, as the 13% depreciation of the past year could end up triggering price increases and pushing inflation above target. A weak peso makes imports more expensive.

The peso strengthened after the rate increase but gave back most of the gains and was quoted in Mexico City late Thursday around 19.48 to the U.S. dollar, compared with 19.50 before the decision and 19.3730 Wednesday.

In its policy statement, the Bank of Mexico said it is "closely watching the exchange rate and possible pass-through to prices" but added that it isn't targeting a specific exchange rate. The bank didn't rule out further depreciation of the currency due to an "uncertain external environment."

More recently, the U.S. presidential race has driven peso volatility. On Monday, the peso made the second-largest gain of the year after Democratic candidate Hillary Clinton was widely seen as the winner of the presidential debate against Republican Donald Trump, whose protectionist proposals could be potentially catastrophic for Mexico.

"It appears that a majority of policy makers were still spooked by the 4% drop in the peso against the dollar over the past month—which appears to have been due at least in part to Donald Trump's greater chances of winning the U.S. election in November," research firm Capital Economics said in a note.

With its Thursday decision, the central bank disappointed a minority of economists who argued the bank should stand pat on rates to keep some leverage to act in the event Mr. Trump wins the November election, or some other potential negative shocks.

Several economists said a rate increase could hurt further an economy that is already slowing down. The economy shrank 0.2% in the April-June period compared with the previous quarter.

The central bank said it would remain vigilant and prepared to take any action, "with all flexibility, and whenever conditions dictate." Most economists expect the bank to raise rates again if the Fed does in December.

The central bank's five-member board said inflation is expected to gradually increase and end the year slightly above the 3% target. The economy, meanwhile, remains weak and growth prospects have deteriorated, the bank said.