World Economic Situation and Prospects
Weekly Highlights

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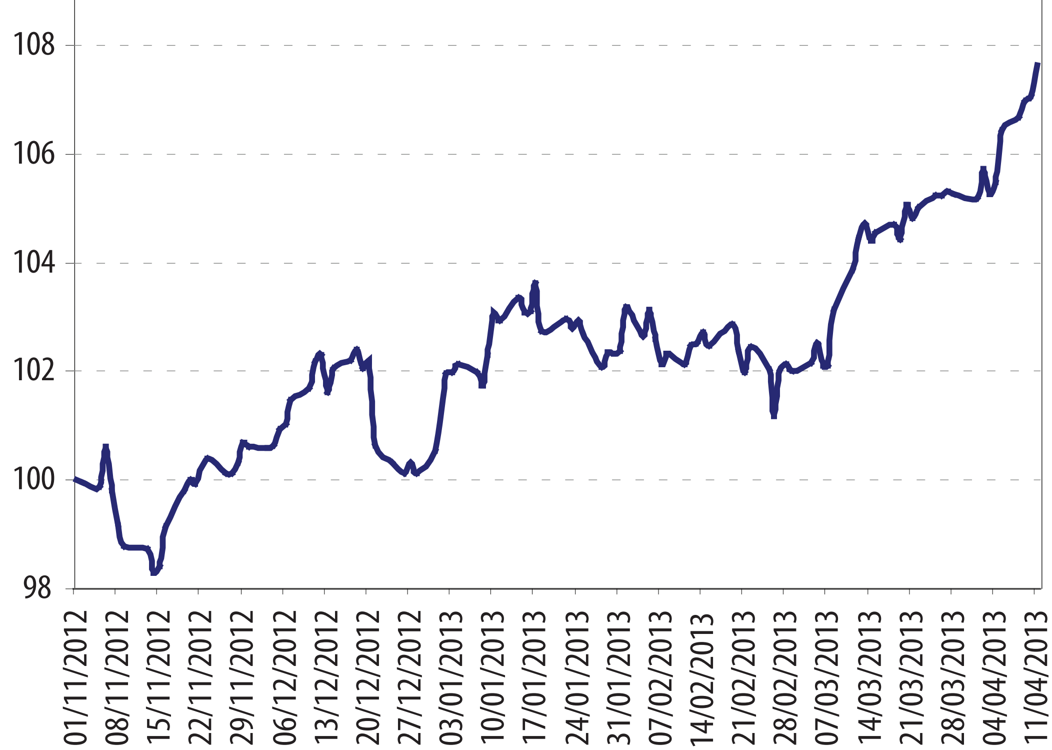
Is there a monetary dilemma in Mexico?

Capital inflows, especially portfolio investments, have continued to surge in Mexico since the beginning of the year. This comes on the heels of an already sharp increase in the second half of 2012, when foreign portfolio investments reached $23 billion in each of the last two quarters, more than double the quarterly average of the previous two years. Increases in global liquidity and improvements in financial markets, along with enhanced economic prospects for the Mexican economy—which have been boosted by an aggressive structural reform agenda pursued by the Government—have encouraged capital inflows. This trend has underpinned an appreciation of the peso by 8 per cent against the dollar since last November to a new 20-month high.

Exchange rate of the Mexican peso against the United States dollar

Index: 100 = November 1, 2012 (Greater than 100 indicates appreciation)



Source: JP Morgan.

At the same time, consumer price inflation has also increased recently. In February and March, the consumer price index rose by 0.49 and 0.73 per cent, respectively, which is significantly faster than in the same months in 2012. On an annual basis, consumer price inflation rose to 4.25 per cent in March, slightly higher than the upper limit of the central bank's target range of 4.0 per cent.

For policymakers, this is creating a challenging situation. While the pick-up in inflation would merit a stricter stance, increasing capital inflows, exchange rate appreciation and the possible negative impact of these factors on exports would justify a more accommodative monetary policy. The central bank cut the reference interest rate by 50 basis points to 4.0 per cent on 8 March. However, this decision has not slowed the momentum of the currency appreciation. Since further interest rate cuts could become problematic regarding the inflation target, monetary policy may have to increasingly rely on alternative measures such as direct interventions in foreign exchange markets. A first move in this direction has already been the suspension of daily-dollar auctions by monetary authorities. A further step could be the reactivation of foreign reserve accumulation.