The Company Newsletter for Supply Chain Finance.

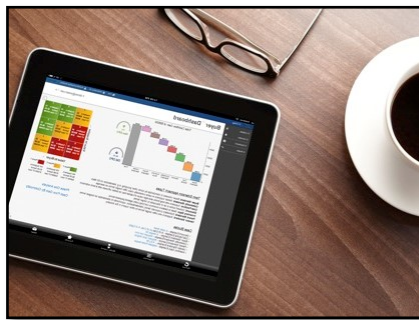# E FACTOR NETWORK NEWSLETTER

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HOW MUCH CAN THE INTEREST RATE DROP IN THE FUTURE?

Written by Edgardo A. Ayala G.

Neither the Federal Reserve and the Bank of Mexico made any adjustment to the interest rate in their last monetary politics reunion. Even more, the Fed anticipated that it is less likely to make changes during all the year.

On the other hand, the forecasts of Mexico's economic analysts are divided in this area. In the survey among analysts conducted Citibanamex on March 20, 11 of 21 analysts consulted expect at least a 25 basis point cut (PB) in the target rate of Bank of Mexico during 2019, while the remaining 10 estimate that will remain unchanged During the year. Although at the beginning of the year there were analysts who had a last increase in rates during the 2019, and nobody of the consulted shares that expectation.

Economists think that rates will tend to decline as the declining trend of inflation is consolidated. In addition, weakness in growth should reduce any upward pressure on rates. In this way, it is advisable to ask what level the interest rate levels can descend over the next few years, this issue we dedicate this month's note. Sabemos que el principal instrumento de la política monetaria de un banco central que establece metas de inflación es la tasa interbancaria de objetivo, o tasa objetivo.

We know that the main monetary policy instrument of a central bank that sets inflation targets is the interbank target rate, or target rate. In the United States,

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the Fed's mandate is twofold: to maintain the inflation rate in the goal and the economy in full employment. In Mexico, the mandate is unique, only on the inflation rate, although informally, it is given some weight to the stabilization of the product, especially if the first goal is satisfied.

However, central banks adjust nominal interest rates by waiting for them to translate into real interest rate changes, which are actually affecting both consumption and investment decisions. If inflation is above the target and/or the product above the potential, then the nominal and real interest rates will increase, waiting with this to contain the growth of consumption and investment, and to appreciate the real exchange rate, reducing net exports, and eliminating pressure on inflation via exchange rate. Si existen brechas recesivas y la inflación queda por debajo de la meta, entonces el banco central busca estimular la economía disminuyendo las tasas de interés real ajustando a la baja la tasa objetivo.

Thus, the central bank modulates inter-bank interest rates around a long-term level, compatible with the inflation target being met and with the economy in full employment, at this level of real interest rate is called neutral Real interest rate. The problem is that this long-term interest rate, to which the real inter-bank interest rate should converge, is not observable. But fortunately, economists have devised some methods of estimation, in this note we address two of them.

The first method is to obtain averages throughout complete cycles of the economic activity of the real inter-bank interest rate ex ante. To this end, we proceed to calculate the ex ante real interest rate as the difference between the nominal interest rate and the expected inflation for the next twelve months. We do this by taking the balance interbank interest rates to 28 days (TIEE28) and the objective rate of Bank of Mexico. We estimate the inflation expectation with the median inflation expected by economic analysts according to the survey of specialists in private Sector Economics (EEESP) that collects each month bank of Mexico. Graph 1 shows its evolution from January 2000 to December 2018.

Graph 1
Real Interest Rate In Mexico

Source: Estimated with information from Banco de Mexico
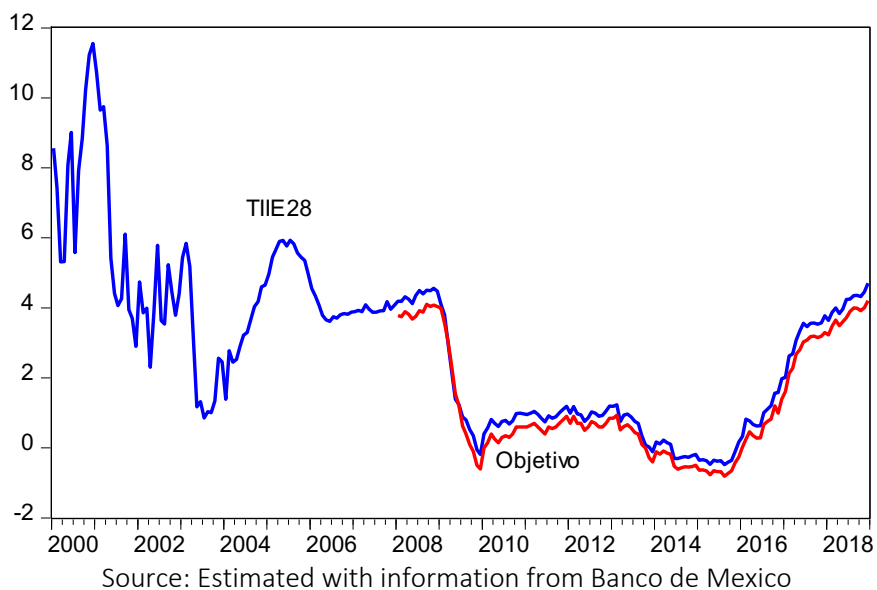
As you can see, real interest rates were very high at the beginning of the last decade in part because there were no specific inflation targets, it was established up to 2003. Moreover, in the beginning, inflation was consistently maintained above inflation targets and did not converge on the established band until the mid-decade. If we take from January 2002 to June of 2008, period that corresponds to the whole phase of expansion of the economic cycle and before the financial crisis, the average real interest rate was 4%. If we take the average of 2002 at the end of 2018, the estimate of the neutral rate is 2.4%. Finally, if we take the objective interbank rate that the Bank of Mexico dictates since 2008, the estimate of the neutral rate is 1.2%.

In our opinion, the 4% estimate is strongly marked by the high rates of the beginning of the years 2000, before the monetary policy framework was consolidated. On the other hand, the average of the target rates is skewed downward by the large capital inflows in the period of monetary relaxation or Quantitative Easing (QE) which followed the Great Recession of the 2008. We take, therefore, the estimate of 2.4%.

The other method is to estimate what we know as Taylor's rule, which is a simplified representation of the central bank's reaction to the deviations of the interest rate to the goal and the product gap to potential. From the econometric estimate of the constant of this equation we can infer the neutral rate, i.e. the real interest rate that will prevail if both the inflationary and product gaps are zero. As suggested in the literature, we estimate Taylor's rule recursively, every two years and estimate the neutral rate, the results are found in table 1.

Table 1
Estimate of the actual neutral interest rate according to Taylor's rule

Period	Real neutral interest	
	Interbank	Goal
2002-2004	-1.348	
2003-2005	2.703	
2004-2006	4.272	
2005-2007	4.153	
2006-2008	3.644	
2007-2009	2.544	
2008-2010	1.118	1.656
2009-2011	1.443	1.068
2010-2012	1.857	1.500
2011-2013	1.563	1.264
2012-2014	1.153	0.891
20013-2015	0.574	0.270
20014-2016	0.810	0.471
20015-2017	1.150	1.784
20016-2018	2.150	1.770

Source: Estimates made with information from Banco de Mexico and INEGI

The neutral rates, thus estimated, have an important downward trajectory of 2004 to 2015 explained by the consolidation of the monetary policy and the expansion of the global liquidity, reverting the trend in the last years. The most recent estimate points to a range of 1.8 to 2.1%.

Based on these two estimates, we consider that 2.5% is a conservative, but useful approximation of the real neutral interest rate. If inflation were to remain in the range of 3% to 4% in the long term, this would mean that nominal inter-bank interest rates would converge to the range of 5.5% to 6.5%. This means that the Bank of Mexico has a mattress to reduce the target interest rates from 1.75% to 2.75%. Of course, the timing is important, the safest thing is that the bank prefers to keep that leeway for a while, buy time to see how the environment unfolds.

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