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Mexico Central Bank Unexpectedly Raises Rate to 7.50% (Update5)

By Patrick Harrington

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Oct. 26 (Bloomberg) -- Mexico's central bank unexpectedly raised interest rates and said inflation will take longer to retreat than policy makers previously estimated.

The five-member board, led by Governor Guillermo Ortiz, lifted the benchmark rate a quarter percentage point to 7.50 percent, surprising 22 of 29 economists surveyed by Bloomberg. The peso climbed to a three-month high.

Inflation hasn't slowed as quickly as the central bank predicted in May, when it said the rate would fall to 3 percent by the end of next year. Today, the bank revised its outlook to estimate the target won't be reached until the end of 2009 because of rising food prices and higher taxes approved by Congress last month. It also dropped its ``restrictive bias,'' hinting it doesn't intend to follow with more increases.

``They had to show commitment to the target,'' said Alonso Cervera, a Latin America economist at Credit Suisse Group in New York, who predicted the increase correctly. ``It would have been very odd for them to increase their inflation forecast and then not come through with a rate hike.''

The economists who predicted today's increase, such as Cervera, Dresdner Kleinwort's Omar Borla and RBS Greenwich Capital Markets' Benito Berber, said they don't expect the bank to raise interest rates again this year. In today's statement, said the threat to Mexico's economic expansion from a decelerating U.S. economy had increased.

`Preventive'

``Clearly it was a preventive move,'' Borla said.

The decision marks the second time this year the central bank unexpectedly raised borrowing costs in Latin America's second-largest economy. The bank in April also unexpectedly increased its rate by a quarter percentage point.

Mexico's benchmark stock index rose 250.66, or 0.8 percent, to 32,123.6. The peso gained 0.7 percent to 10.7345 per dollar.

A report Oct. 24 showed core inflation rose more than expected in the first half of October because of higher prices for pasteurized milk and tobacco.

Core consumer prices, which exclude fresh food and energy, rose 0.21 percent, more than the median estimate of 0.15 percent in a Bloomberg survey of 18 economists, putting them at 3.87 percent on an annual basis, higher than the 3.5 percent forecast the central bank has for the end of the year.

Core Prices

That report led RBS Greenwich's Berber to change his forecast to predict central bankers would raise to 7.50 percent today. The central bank has missed its 2-to-4 percent inflation target in eight of the past 13 months.

Rising food prices may lead Mexico to suspend import duties on wheat for three months to reduce costs for local food producers, El Milenio newspaper reported Oct. 24, citing Economy Minister Eduardo Sojo.

Rate increases put the central bank at odds with President Felipe Calderon's administration.

Finance Minister Agustin Carstens criticized the bank in April for raising rates, saying it had acted ``prematurely'' at a time of slowing economic growth. In an Oct. 23 interview from Washington, Carstens said Mexico doesn't have an inflation problem and ``there are no underlying inflation pressures.''

Central bankers seemed to disagree with that assessment today in their statement, saying ``greater pressures on food prices and the probable impact of the recently-passed tax reform'' had led to their inflation-outlook change.

Fuel Tax

Congress last month passed tax legislation backed by Calderon that includes a 5.5 percent levy on gasoline that will take effect in January.

Meanwhile, Mexico's economy is expected to slow on falling demand from the U.S. According to the IMF's World Economic Outlook released Oct. 17, Mexico's economic growth will fall to 2.9 percent this year from 4.8 percent in 2007. Growth in 2008 is forecast at 3 percent.

Mexico sold a record $211.9 billion, or about 85 percent of its exports, to the U.S. last year.

Yields on Mexico's 10-year benchmark security have risen 28 basis points since the end of May on concern that U.S. growth will decline as subprime mortgage loan defaults push up borrowing costs.

Today's decision follows months of warnings from policy makers that they were prepared to raise rates should inflation not begin to decelerate fast enough to reach 3 percent by the end of 2008.

`End of the Line'

In May, the same month it introduced its 3 percent forecast, the bank adopted a ``restrictive bias,'' meaning it was more likely to raise rather than cut rates. In subsequent months, central bank surveys showed economists did not believe inflation would decelerate so rapidly.

Inflation will end 2008 at 3.69 percent, according to the average estimate of 33 economists surveyed by the bank between Sept. 24 and Sept. 28.

``In October the Bank of Mexico reached the end of the line,'' said Guillermo Aboumrad, an economist with Banco UBS Pactual in Mexico City, who forecast policy makers would increase borrowing costs today. ``Either they're meeting the inflation targets or they're not.''

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