CENTRAL BANKS

# No pause in May. Tightening cycle will continue to tame second-round effects…

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## … and to have more room to hold rates thereafter

Banxico's monetary policy meeting will take place on Thursday, May 18th. We expect Banxico to increase the policy rate by 25bp to 6.75%. Inflation continues picking up its pace and has not peaked yet. It is likely to reach 6.0% in June and we expect it to average 6.0% from May to August. Thus, the inflation backdrop remains challenging and the risks of second-round effects have not faded away. Banxico's decision on March to moderate the pace of rate hikes (to +25 bp) signaled that the end of the hiking cycle is closer. MXN's strengthening (on a higher probability of NAFTA 2.0) lowered inflation risks going forward, giving Banxico room to moderate the pace of rate hikes and probably to end its hiking cycle at a lower monetary policy rate than previously expected. However, we do not think that current inflation risks justify a pause in the hiking cycle. We think that is better for Banxico to continue with its preemptive monetary policy strategy to anchor inflation expectations and prevent second-round effects from spreading (recent prints now show some second-round effects into services, see Chart 1). In our opinion, the sooner Banxico takes its monetary policy stance to the level they think is appropriate, the lower the inflation risks going forward

All in all, although we recognize it will be a close call, we think the tightening cycle will continue based on the following:

1. There are signs of second-round effects into services and spreading risks linger. Although core inflation upward trend is mostly explained by a change in relative prices (on the back of the lagged pass-through from the cumulative MXN depreciation), core goods inflation continues to accelerate (it reached 6.05% in April) and services inflation has pricked up pace (rising 0.3 pp in April to 3.6%).

2. Recently, mid and long-term market inflation expectations implied by fixed income securities have risen somewhat (see chart 2), partially offsetting the downward trend seen since the MXN began to appreciate in late January.

3. Recent communication is less dovish than the tone of the last statement. On April 20th governor Carstens stated: "*Markets still need some convincing that inflation is well anchored" "We are happy with what we have achieved, but there are still some issues that need to be taken care of*". In addition, Banxico warned clearly that one of the main upside risks to its inflation forecasts was a new depreciatory

episode that could rise inflation expectations again. Although a positive outcome from commercial negotiations with the US seems more probable now, pressures on the MXN could resurface.

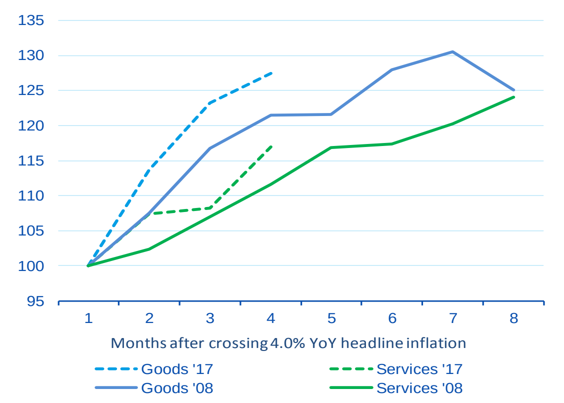
4. 1Q GDP growth surprised on the upside and the economy remains resilient. Although it is set to decelerate in 2Q, over the whole year, growth is now expected to increase at a higher pace than previously thought.

5. Conditions have turned somewhat restrictive but the real monetary policy rate is low and would most likely decrease if Banxico pauses its tightening cycle in May. As of now, the real rate is lower than 1.0%, well below the 3.6% level reached in 2007, when inflation breached consistently the 4.0% threshold. Similarly, even after Banxico has raised 325bp in the last 15 months, at 6.50%, the monetary policy rate is not significantly above the neutral estimated level (5.5%).

Going forward, we expect Banxico to raise its monetary policy rate one last time in June, taking the reference rate to 7.0%. We consider that in the most probable scenario the reference rate will be on-hold during 2H17, particularly considering that inflation should start a downwards trend in September. This scenario is based on the assumptions of a stable exchange rate given a high likelihood of a successful NAFTA renegotiation, and a gradual US monetary policy normalization (i.e. just two more 25bp rate hikes in 2017). If either of the above mentioned assumptions are not met, and MXN and inflation risks increase again, Banxico could be forced to adjust rates accordingly.

Chart 1

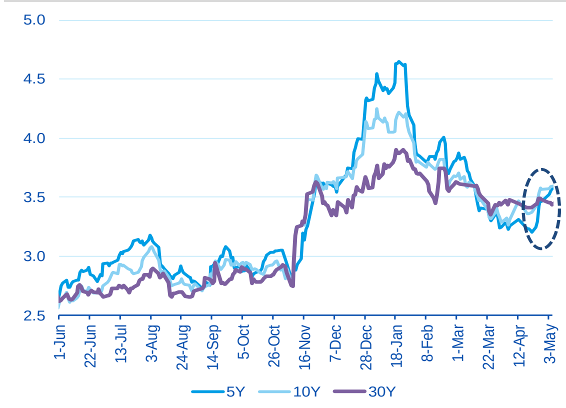
**Goods and services inflation trend, 2008 and 2017 (Index, after headline crossed the 4.0% threshold) (%)**




Source: BBVA Research based on Bloomberg data.

Chart 2

**Inflation breakevens * (%)**




Source: BBVA Research based on Bloomberg data. *Inflation breakevens are adjusted by 40bp of inflationary risk.

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