Banxico set to take a pause

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The next monetary policy meeting will be held on Thursday August 10th. We expect Banxico to hold the reference rate at 7.0% inaugurating a period of monetary pause. In its last statement the central bank stressed that June's rate hike was the end of the tightening cycle as the rate level was consistent with the process of efficient convergence of inflation to the 3.0% target. Several elements of the current context remain in line with Banxico's expectations, supporting the idea of a monetary pause:

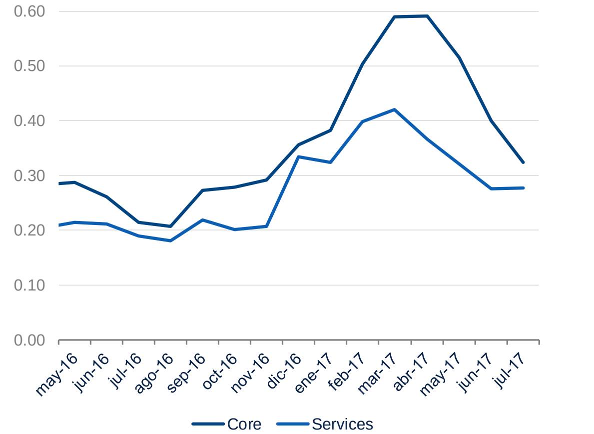
i) Core inflation continues to show signs of stabilization. In July it came at 0.28%, the third consecutive month that the monthly rate comes at or below 0.3%, a clear contrast with the 0.59% monthly average growth rate during the first four months of the year. Inside core inflation, the prices of goods grew at 0.12% in July, the lowest rate since November last year and one-fifth of the average monthly growth during the first half of the year. This figures suggest that exchange rate passthrough is waning and so the risks of second-round effects on prices. Besides, this stabilization of the core component suggest that the peak of inflation is close. We expect inflation to trend downwards after the summer and more clearly during the fourth quarter and thereafter giving Banxico more room to hold rates.

ii) Regarding the relative monetary stance with the US, the probability of a more gradual FED normalization than previously expected has increased. US inflation figures have been below expectations even as the labor market approaches to full employment. Given that the FED has stressed that his stance is data dependent they might wait to have more evidence to conclude that inflation slowdown responds entirely to temporary factors. As a consequence the probability of a FED rate hike in September slumped and therefore the markets discount just one more rate movement this year in December.

iii) Domestic demand remains feeble as inflation has hit real wages and remittances will no longer be a boost for economic growth as it did in 2016. In addition, investment growth rate has been negative almost all year. These developments are at odds with the concept of efficient convergence that Banxico has emphasized, especially since they consider that the current rate level will bring inflation back to the 3.0% target.

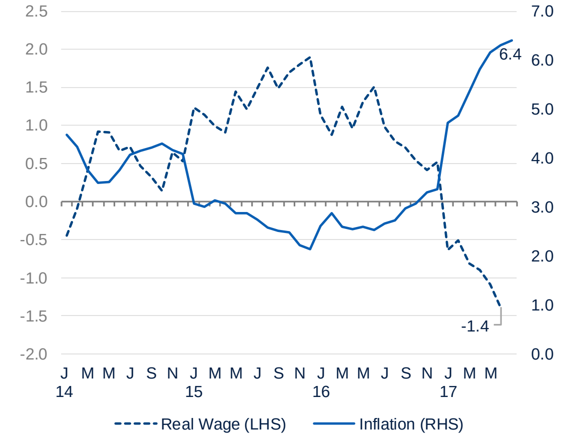
Going forward, we consider that, in the most probable scenario, the reference rate will be on-hold during the rest of the year and well into 2018. Banxico will maintain its restrictive current stance as inflation remains above the upper end of the interval around the inflation target. Similar to the June's statement the tone will be mostly neutral but emphasizing that the central bank will follow closely inflation dynamics in order to be ready to act if any major deviation from its outlook arises.

Figure 1. Core and services inflation
% MoM MA(4)



Source: BBVA Research based on Bloomberg data

Figure 2. Real wage and inflation
(YoY %)



Source: BBVA Research based on INEGI and IMSS data.

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