CENTRAL BANKS

Banxico: playing it safe

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9 February 2018

Banxico raised its policy rate by another 25bp to 7.5%, as widely anticipated, and in line with our and consensus call, given recent communication hawkishness and hints from Banxico's governor ahead of the decision. **The policy rate is now at a nine year high. The last time it was at this level was Feb 09). Headline inflation was on a clear upward trend. Core inflation was also on a diverging path from the target** (5.5% at the time of the decision) while **12-month inflation expectations had averaged 4.4% in the six months prior to the decision** –i.e., well above the upper limit of the 3.0% +/- 1pp target– ; and arguably they were unanchoring. All this in the context of a global credit crunch after the demise of Lehman that resulted in a risk-aversion on most asset classes, particularly emerging markets. **In our view, the inflation context now is much more positive. Headline inflation resumed its downward trend**, temporarily delayed by the inflation uptick over 4Q17 driven by temporary supply-shocks, slowing down to 5.5% in Jan from 6.8% in Dec. **The deceleration of core inflation** (down to 4.6% from 4.9% in Dec) **is starting to materialize, and** 12-month **inflation expectations** have increased only marginally to 4.0% during Dec-Jan from a stable 3.9% average during the previous six months, while medium and long-term expectations remain stable at levels of 3.5% i.e., expectations **remain anchored**. In addition, this hike means that real 12-month ex-ante real rates are at levels of 3.5%, well into restrictive territory --we think neutral levels for the real ex-ante rates are around 2%. They are at the highest level since 2008, and are already creating headwinds to the demand for credit and will thus, could soon begin to take a toll on economic growth.

The MPC argued in the policy decision statement that policy tightening was warranted mainly for three reasons. First, the cyclical position of the economy. Second, to counter the "high levels" of inflation "that could hinder the assimilation of supply shocks". Third, to keep pace with the Fed with a goal of maintaining a policy stance that reinforces the anchoring of inflation expectations to avoid second-round effects. In our view, concerns are overdone. Inflation is clearly on a declining path and is likely to fall below 5.0% by April (while core inflation will likely fall below 4.0% in the same month). Headline inflation declined in January at the expected path (as the energy prices base effects unwind). Core inflation also decelerated at the expected path as the FX-pass-through 1Q17 base effect also began to unwind. **The deceleration of inflation will likely do the job to further anchor inflation expectations. That is why we think that the last two hikes were not warranted.** Moreover, we do not see any signs of overheating in labor markets as salary mass growth remains steady.

We expected Banxico to deliver the signaled 25bp hike. We also anticipated Banxico to retain its hawkish stance to hike again if inflation dynamics deteriorate. However, we anticipated a less hawkish tone to reflect the improvement in the inflation outlook and to have more flexibility to stop hiking rates in coming meetings. In fact, Banxico's statement not only reveals that it is expecting positive inflation dynamics to continue throughout 2018, it also reveals that they anticipate these dynamics to be more positive than consensus and our own forecasts, as they continue to expect headline inflation to reach its target of 3.0% by the end of 1Q19 (BBVA Research: 3.6% in March 2019).

Nevertheless, contrary to our expectations, the tone of the statement was even more hawkish. There is little the policy rate can do to stop MXN from weakening if the context is unfavourable. The MXN has not strengthened on relative terms following the last two hikes. The main driving factor behind MXN dynamics will likely continue to be NAFTA 2.0 expectations. Yet, **Banxico seems to be focus on trying to support the MXN with the policy rate to avoid a possible new round of FX pass-through**. This is unlikely in our view unless the ER depreciates on YoY terms and perhaps even unless it reaches levels above 22.0ppd, the levels reached in early 1Q17 when much of the FX pass-through took place. **Its argument on the importance of keeping pace with the Fed reflects, in our view, that position. All wording tweaks (changes) in the statement point to a disposition to hike the policy rate again, and reflect that it would not take much for Banxico to hike again, namely a change in Fed's expected hiking pace, a fresh supply shock, some MXN depreciation, and/or a slower pace of core inflation deceleration**. Banxico also argued that the 25bp hike attempts to "reinforce the downward trend of headline inflation toward its goal". It seems that it will take little for Banxico to “reinforce it” again soon. We expect the Fed to hike rates in March, although not in our base scenario, NAFTA concerns could resurface, while the electoral process could be already weighing on the MXN at the time of the next policy meeting (12 Apr). We think that the statement hawkishness reflects that the new governor and MPC continue to believe that there is a need to continue to enhance their inflation-fighting credentials and will thus likely continue playing it safe despite the fact that 12-month inflation expectations will decline following actual inflation data as they have always done. **We are changing our call and we now expect Banxico to hike again in April taking the policy rate to 7.75%.**