Central Banks

We expect Banxico to hike the policy rate

A deterioration of inflation risks tips the balance towards a hike

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- We expect Banxico to hike the policy rate by 25bp to 7.75%
- Even though a weaker peso should not trigger an additional pass-through round in the near-term unless it weakens further, and there are no demand-side pressures, energy prices will be limiting headline inflation's downward trend pace
- The wording is likely to remain cautious as NAFTA-related risks point to continued MXN weakness; yet, the MPC might acknowledge that the room for a more restrictive real rate is limited

A deterioration of inflation risks tips the balance towards a hike

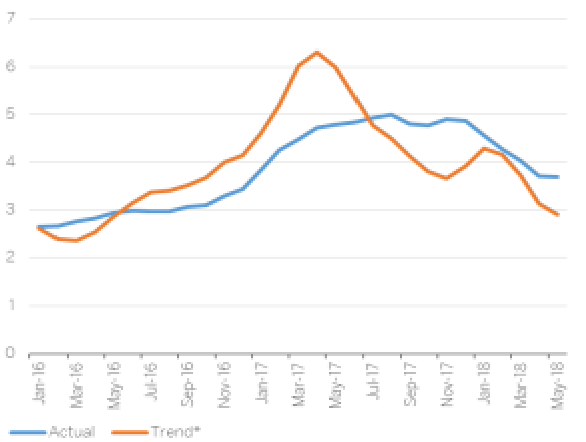
We expect Banxico to hike the monetary policy rate by 25bp to 7.75%. The balance of risks to inflation has deteriorated recently mainly as NAFTA's risks point to a much weaker MXN in 2H18 than previously expected. Not only does the outlook for NAFTA 2.0 has complicated, on balance the FOMC has a more hawkish stance. At the May 17 meeting, the MPC left rates unchanged but delivered a cautious tone, pointing out that in setting monetary policy going forward they will closely monitor the "potential pass-through of the exchange rate variation to prices, the relative stance of monetary policy vis-à-vis the US, and the evolution of the output gap." The MXN strengthened from Jan to Apr on signs of progress in NAFTA's negotiation, but has since weakened sharply with NAFTA's worsening prospects. The FOMC has a more hawkish stance and is expected to hike two more times this year. Although there are no signs of demand-side pressures on inflation and the output gap is likely to remain hovering around zero, economic activity has been more solid than expected in 1H18.

Inflation is set to decrease at a much slower pace ahead

Annual inflation decelerated less than expected in May. Headline inflation is set to decrease at a much slower pace ahead. In fact, it is now likely to hover around 4.5% for the next five months, before decreasing in Nov-Dec. Core inflation is likely to stabilize at slightly lower levels in the short-term. Although the falling trend in core goods inflation remains broad-based, with the significant weakening of the MXN seen since mid-April, risks to the upside have intensified. More importantly, given that the odds of NAFTA 2.0 in 2018 are now quite low, the MXN is unlikely to recover significantly after the election as we previously thought. We do not expect significant changes for our core inflation path through the rest of the year. We now expect core inflation to hover around 3.5-3.6% over the next five months and we fine-tuned our year-end core inflation forecast from 3.3% to 3.4%. However, in a context of deterioration of the NAFTA outlook, and considering that MXN weakness pass-through has a 6-9 month lag and that the ER is likely to remain above 20 ppd in the near-term, risks have deteriorated. International energy price pressures have continued beyond what was expected at the beginning of the year. That trend along with a more permanent weakening of the MXN will translate in higher domestic energy prices than previously expected. Non-core pressures from energy prices push up our year-end headline inflation forecast to 4.1%.

Core inflation is set to slow down further in the near-term…

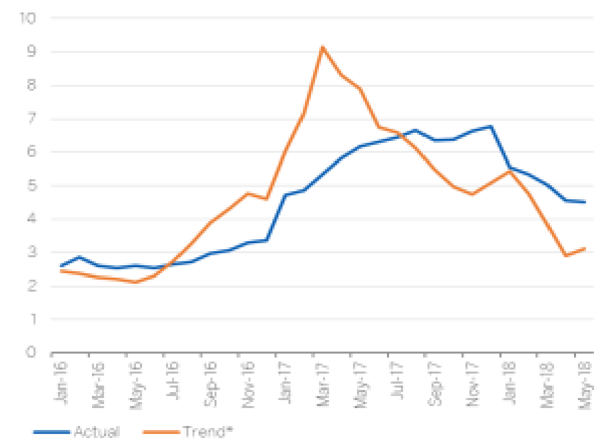
Figure 1. Core inflation: actual & trend*
(YoY % change & 3Mo3M saar)



* Based on own calculations of the seasonally-adjusted CPI index.
Source: BBVA Research / INEGI

… but headline inflation is likely to turn sticky to the downside in the coming months

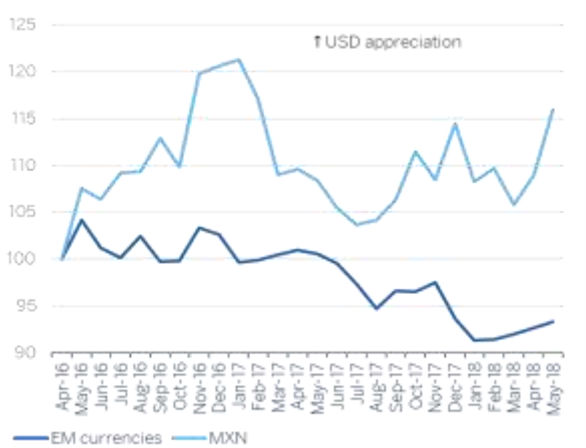
Figure 2. Headline inflation
(YoY % change & 3Mo3M saar)



* Based on own calculations of the seasonally-adjusted CPI index.
Source: BBVA Research / INEGI

The MXN has weakened sharply with NAFTA's worsening prospects

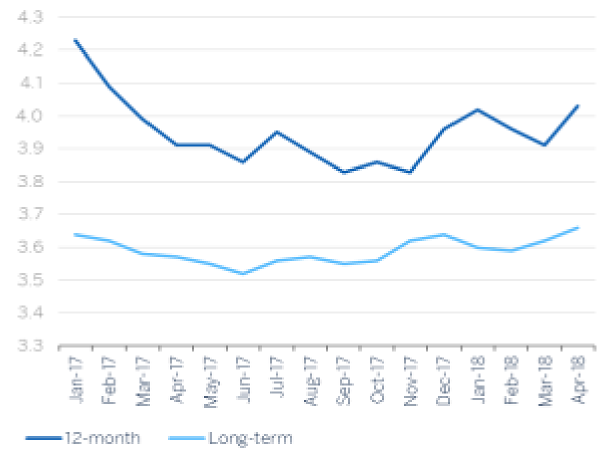
Figure 3. MXN & EM currencies*
(Index April 2016=100)



* Own calculations based on a reweighting of the JP Morgan Emerging Market Currency Index after taking out the MXN.
Source: BBVA Research / Bloomberg

While inflation expectations remain well-anchored, they have increased recently, responding to MXN weakness

Figure 4. Analysts' inflation expectations
(Banxico Survey, %)



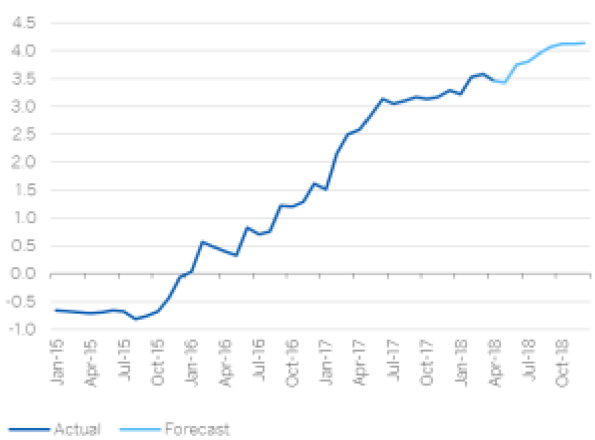
Source: BBVA Research / Banco

Furthermore, although inflation expectations remain well anchored, they have increased somewhat recently, responding to MXN weakness. In its last statement the MPC repeated the warning that "[…] if needed, the MPC will act opportunely and firmly to strengthen the anchoring of medium- and long-term inflation expectations". Overall, the MPC is likely to justify a fresh 25bp hike on the grounds of a deterioration of the balance of risks to inflation.

Although short-term inflation risks are still contained in our view, and the room for a more restrictive stance of monetary policy seems limited –the real ex-ante monetary policy rate will likely hover slightly above 3.5% the rest of the year in a context of no demand-side related inflation risks–, a new speed bump in inflation's downward trend is likely in the short-term. Although the expected headline inflation stickiness is explained by a supply shock, which has been mainly driven by the combination of higher international energy prices and the MXN weakening, Banxico will likely remain cautious and deliver a 25bp hike which markets have already priced in. The wording is likely to remain hawkish but the MPC might acknowledge that the real monetary policy rate is already high, signaling that further pre-emptive hikes are unlikely unless the inflation outlook deteriorates appreciably.

If Banxico delivers the 25bp expected hike, the real ex-ante monetary policy rate will likely hover around 4.0% in 2H18 which is high by historical standards

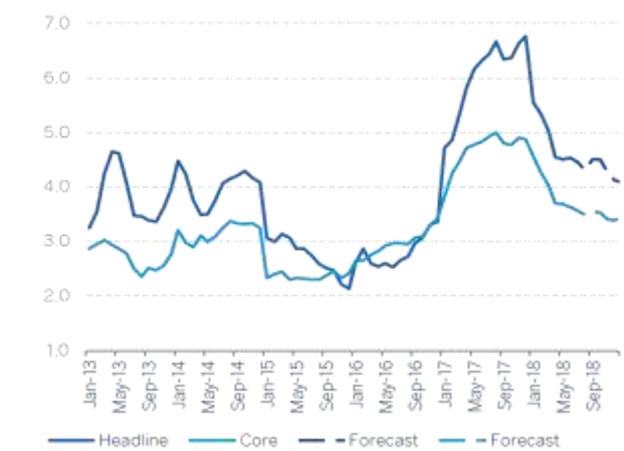
Figure 5. Ex-ante real monetary policy rate* (%)



* Calculated as the difference between the nominal rate and 12-month inflation expectations from the Banxico survey for actual data and our 12-month inflation forecasts for projected data.
Source: BBVA Research / Bloomberg / Banxico

Stickiness ahead for headline inflation

Figure 6. Inflation outlook (YoY % change)



Source: BBVA Research / Bloomberg

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