BBVA Research

Central Banks

Banxico to hike with higher uncertainty and risks

We expect Banxico to hike the policy rate 25bp to 8.00% given MPC's hawkish forward guidance and the materialization of some risks, especially a weaker MXN

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- **A lot has changed in the intermeeting period and in our view a hike is warranted**
- **We are not expecting an additional hike in December for now, but will depend on the MXN performance which will most likely be driven by the fiscal budget outcome**

Banxico will likely resume its tightening cycle and stay hawkish

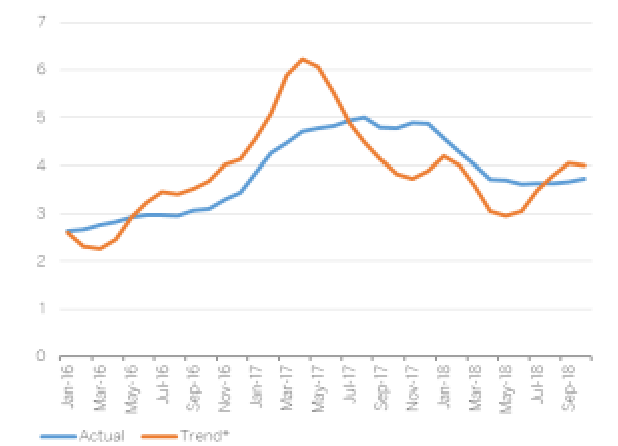
Before the previous meeting, we argued that there were two main reasons for Banxico to hold the policy rate steady: no deterioration of inflation risks and the appreciation of the MXN. We were expecting a "hawkish hold", but the wording of the accompanying statement was surprisingly hawkish in our view, and importantly it was a split decision in which one member voted for a 25pb hike. The statement had several hawkish tweaks. Banxico seemed to take comfort from the transitory nature of the energy-led headline inflation uptrend that began in June but argued that fuel price pressures had slowed the pace of decline in core inflation. That is, the MPC was already uncomfortable with core inflation stickiness and vowed to "preserve a prudent monetary stance and to continue to especially monitor the potential pass-through of the exchange rate variation to prices". On the relative monetary policy stance, Banxico still seemed concerned with the Fed "in the context of an adverse external backdrop". Notably, the MPC not only stated that they would continue with its vigilant stance but also indicated their readiness to "a possible strengthening of the monetary stance if deemed necessary" ie, the MPC undoubtedly left the door open for an additional hike if conditions were to deteriorate. The minutes also showed a hawkish tone with concerns about the inflation outlook and risks skewed to the upside. Importantly, the main argument of the dissenting vote was a possible loss of credibility if Banxico did not react to increasing risks and a slower convergence.

In spite of Banxico's hawkish rhetoric, the question was not the direction of inflation but rather the speed at which it was likely to decline and Banxico signaled that the policy rate was already tight. It seemed that most voting members were comfortable staying on hold in the near future. The tightening cycle was behind in our view and the next rate movement was likely to be down. Discussion did not center on whether another preemptive hike was likely but rather on the likely room for Banxico to begin to lower rates at some point in 2019. However, a lot has changed for the worse since the last meeting and discussion shifted again on whether the MPC would hike at least once more, resuming again its tightening cycle. What was the cause of this shift? The cancellation of the new airport and the proposal by one Senator of AMLO's party to forbid a series of banking commissions that triggered uncertainty about the decision-making process for economic policy going ahead. In other words, conditions have deteriorated and warrant a 25bp hike.

In our view, Banxico will increase rates for four main reasons. First, a weaker MXN, which increases concerns on the pace of decline in core inflation. Second, a deterioration of inflation expectations, especially of market-based measures. Third, credibility risks if Banxico does not deliver a hike following its recent communication and the materialization of some upside risks to inflation. Fourth, concerns and uncertainty related to the policy approach of the upcoming administration that adds risks to the MXN and therefore inflation.

On the first reason, although as was expected, headline inflation likely peaked in September (at 5.02%) –it already moved lower in October (to 4.90%) and is set to decreased markedly in the last two months of the year driven by a favorable base-effect and a slower pace of increase in gasoline prices–, core inflation edged up 0.1pp in the last two months (from 3.63% to 3.73%) and has been sticky, moving in a narrow 3.6%-3.7% over the last seven months (see Chart 1). Besides, there is a risk that with MXN recent weakness core inflation might remain more sticky than expected (see Chart 2). We still expect core inflation at 3.4% by year-end, but the uncertainty is taking a toll on the MXN and skewing risks to the upside.

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

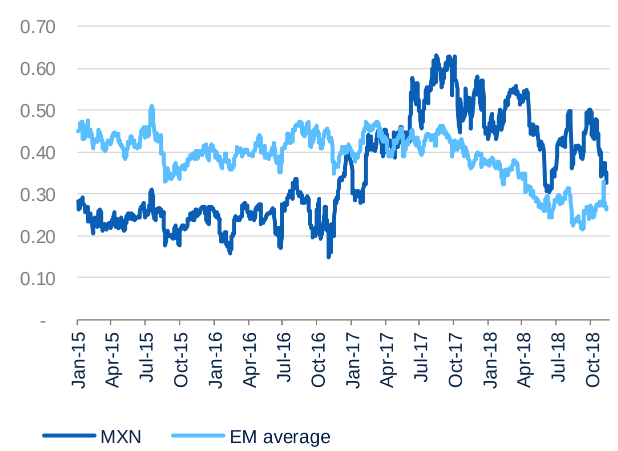


* Based on own calculations of the seasonally-adjusted CPI index.
Source: BBVA Research / INEGI

Chart 2. Non-food core goods inflation and exchange rate* (% and YoY % change)

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

Chart 3. Risk-adjusted carry-trade (%)



Source: BBVA Research / INEGI

Chart 4. Long-term market based-inflation expectations and exchange rate (% and YoY % change)

Source: BBVA Research / INEGI

On the second reason, recently there has been an upward trend in inflation expectations eg, the median headline inflation forecast for 2019 increased from 3.70% to 3.80% in the intermeeting period and it has moved 0.2pp higher since July. The upward trend has been especially noticeable in market-based breakeven measures suggesting mounting concerns on price dynamics going forward with MXN-related risks. Noticeably, at 4.74% the 10-year breakeven inflation rate is now at a higher level than the one reached when Trump took office in January 2017 (see Chart 4). Besides, Banxico is concerned on the relative stance of monetary policy "in the context of an adverse external backdrop". Well, with increased uncertainty and MXN volatility, the risk-adjusted MXN carry-trade, which had stayed above EM average since July 2017, has trended lower since the cancelation of the new airport (see Chart 3).

On the third reason, Banxico's guidance and risks have shifted expectations for the policy rate. Markets assign a +80% probability of a hike while analysts' consensus expectations are that Banxico will hike the policy rate 25bp, to 8.00% (2/3 of analysts are expecting a hike). Banxico's forward guidance has been undoubtedly hawkish and in the last statement the MPC argued that they will stand ready to hike rates if conditions warranted a hike. In our view, Banxico does not only risk confusing markets with its communication if it does not hike the policy rate but even a possible toll on its credibility if it stays put.

Last, with added risks to the MXN and inflation driven by a possible discretional policy approach of the upcoming administration, markets are concerned about fiscal policy and might be expecting a signal from Banxico that they stand ready to partially offset probable policy mistakes on other fronts. A hike not resulting from making assumptions on the budget, but driven by a deterioration in the balance of risks for inflation triggered by a policy mistake (ie, the cancelation of the new airport) would signal that Banxico reacts to the implications of policy mistakes once they materialize. This by itself could give some comfort to markets which now seem ready to overreact to any possible policy mistake.

All in all, in our view all signs point to a hike. We expect Banxico to remain hawkish and keep the door open for another preemptive hike in December that we are not expecting now but will depend on the MXN performance which in turn will most likely depend on the fiscal budget outcome. We now expect the policy rate of 8.00% by year-end 2018 and of 7.75% by year-end 2019. That is, we do not rule out a possible cut next year but we no longer expect the easing cycle to begin in Q2 (we now expect it to begin in Q4, conditional on a reasonable fiscal policy) as we think Banxico will likely be even more cautious when facing added risks.