Central Banks

Banxico to hike the policy rate and remain hawkish

The 25bp hike to 8.25% would be consistent with Banxico's forward guidance and justified given core inflation's stickiness to the downside and concerns on inflationary expectations

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- **In our view, the balance of risks to inflation did not deteriorate in the intermeeting period (in fact it somewhat improved) but it remains skewed to the upside**
- **Thus, the MPC will likely remain vigilant; yet, we expect a less hawkish forward-guidance**

Banxico continues to face a challenging inflation backdrop

Since the last meeting, some risks to inflation have eased: (1) the 2019 fiscal budget shows a commitment to fiscal discipline[1], (2) the MXN has recently strengthened somewhat (see chart 4), and (3) energy prices are declining, reducing pressures on non-core inflation. Yet, other risks have increased: (1) the 16% increase in the minimum wage is not consistent with productivity gains[2], (2) long-term market-based inflationary expectations remain high (see chart 3) and analysts' expectations have recently increased somewhat, and (3) recently, pressures in agricultural prices have built and prevented headline inflation from declining more rapidly. In the previous statement, the MPC stated "*the balance of risks for inflation is skewed to the upside and has deteriorated considerably for both the short- and medium-term*." This time around, we are expecting a less hawkish wording as, in our view, the balance of risks to inflation has not deteriorated since the previous meeting; yet, the MPC is likely to stay hawkish, as the inflation backdrop remains challenging.

In our view, Banxico will increase rates for three main reasons. First, a still weak MXN will not significantly ease concerns on the pace of decline in core inflation. Second, long-term market-based measures of inflationary expectations remain high and other measures have recently deteriorated. Third, credibility risks if Banxico does not deliver an expected hike following its recent hawkish and ready-to-act forward guidance –not hiking might be risky as it might weakened the MXN after its recent stabilization.

On the first reason, although as was expected, headline inflation peaked in September (at 5.02%) and moved lower in October (to 4.90%) and in November (to 4.72%), it will end the year somewhat higher than expected due to recent pressures in agricultural prices. More importantly, core inflation remains sticky to the downside and there is a risk that with a still weak MXN the pace of decline in core inflation will remain slow going forward. We now expect core inflation at 3.6% by year-end (compared to 3.4% previously). Although core inflation will benefit from lower VAT taxes along the border in January, its trend suggests that in the absence of this one-off factor, it is likely to continue in a narrow range going forward (see chart 1).

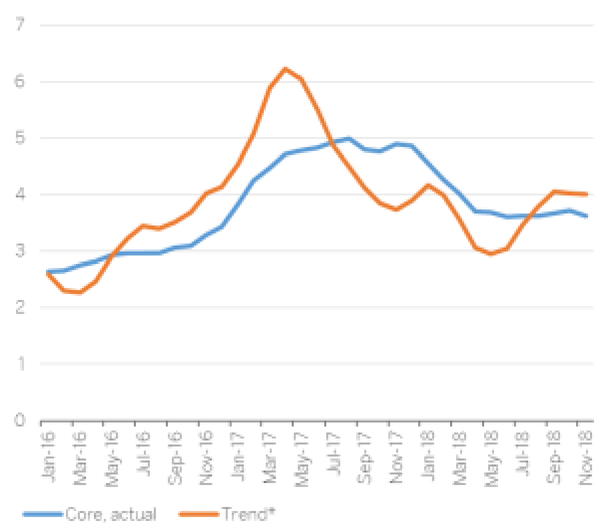
1: Yet, there are still doubts on what the government would do if for some reason the fiscal targets were unlikely to be met i.e., whether they would choose to miss the fiscal targets or reduce promised spending if needed
2: Yet, in our view, the announced increase will not be inflationary but it undoubtedly represents and upward risk to inflation according to Banxico

On the second reason, long-term market based inflation expectations remain high (see chart 4) and analysts' expectations have moved up. In the latest Banxico survey, the median headline inflation expectation for 2020 rose to 3.8% from 3.5%. This reflects doubts on inflation going forward as it is unusual for expectations of more than one year ahead to move up. Banxico will likely think that there is a need to bring down inflation expectations by reinforcing credibility.

On the third reason, Banxico's hawkish guidance and +50bp dissenting vote in the previous meeting have shifted expectations on the policy rate. Although the slight MXN recovery and reduced concerns on Mexico following the public budget have reduced the implicit probability of a hike on Thursday assigned by markets (to 74%), it is still widely expected. Moreover, the TIIE swap curve is not only currently pricing a 25bp hike this week but is also discounting a high probability of another 25bp hike in 2019. Besides, the majority of analysts expects a hike. Banxico's forward guidance has been undoubtedly hawkish and in the last statement, the MPC signaled a ready-to-hike stance if risks continued. In our view, Banxico risks a negative market reaction at a time when market-based inflation expectations remain stubbornly high and analysts' expectations have moved up.

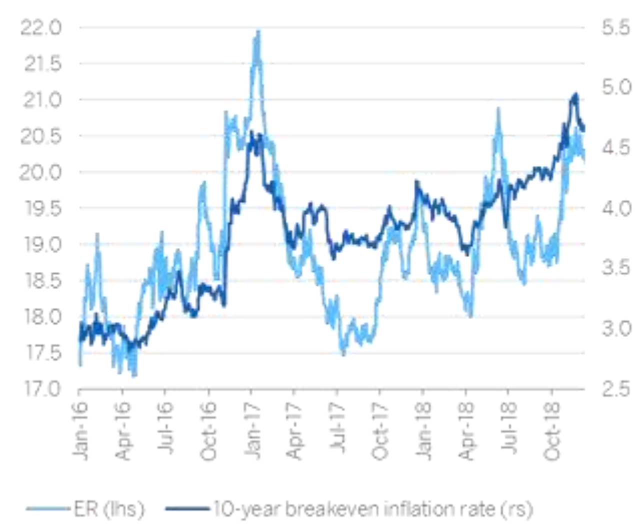
Bottom line: Core inflation's stickiness to the downside and concerns on inflation expectations justify an additional 25bp hike to 8.25%. Not hiking rates will be a surprise as Banxico's hawkish forward guidance and will likely result in an adverse market reaction.

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

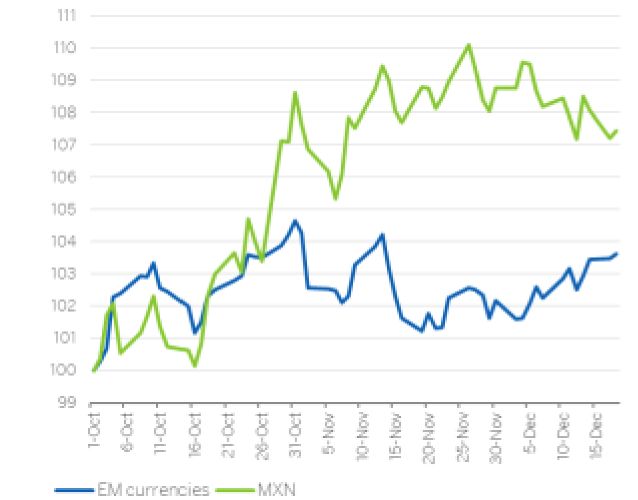


* Based on own calculations of the seasonally-adjusted CPI index
Source: BBVA Research / Bloomberg

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

Source: BBVA Research / Bloomberg

Chart 4. MXN vs EM currencies*
(% and YoY % change)



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

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