

Banco de México: End of the cycle of rate hikes

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Banco de México (Banxico) last Thursday increased its monetary policy rate by 0.25% to 7%. With this increase, Banxico has indicated that the monetary cycle has come to an end, confirming the expectation I commented on in a previous column that the rate would reach 7% at the end of the cycle. This cycle started in December 2015, when the rate was 3%. In other words, in a period of two and a half years, Banco de México has implemented a significant cycle of monetary restriction in which the base rate increased by 4 percentage points.

These monetary policy actions have had positive effects. In the first place, they have led to investment strategies in short-term Mexican assets appearing attractive compared with those of other emerging countries. Risk-adjusted short-term rates are currently significantly more attractive in Mexico than in the majority of comparable emerging countries. This positions the country well, vis-à-vis the fairly gradual rising cycle that the US Federal Reserve is implementing, meaning that the risk of outflows of short-term capital is minimised.

Secondly, the cycle of restrictive monetary policy has succeeded in anchoring inflationary expectations, which is essential to avoid headline inflation increasing in reaction to changing prices of certain goods. Medium-term inflationary expectations, as gauged from the implied inflation in inflation-adjusted bonds, are at around 3.5%, within the Banco de México tolerance band. We should note that these expectations remain well anchored in spite of the significant depreciation of the peso which we have seen since October 2014, something which is an unprecedented situation. Previously, currency depreciation always led to significant increases in both inflation and inflationary expectations.

It is interesting to note that these inflationary expectations remain well anchored in a context in which inflation is at its highest point in the past few years. With data up to the first half of June, annual inflation is running at 6.3%. We should remember that inflation in 2015 was 2.1%, while in 2016 it was 3.3%. However, partly thanks to the measures adopted by the central bank, this is a temporary increase in inflation. We are not seeing a generalised, sustained increase in prices, but changes in relative prices. In particular, increases in energy prices and prices of imported goods, which are basically explained by the depreciation of the currency. However, we have not seen a generalised contagion with regard to other prices.

Inflation is close to reaching its highest point. It should reach 6.4% in July and then start a gradual descent, which will be more pronounced in January when the effects of the increases in petrol prices are diminished, before entering the Banco de México's tolerance range (less than 4%) towards the summer of 2018. The fact that inflation is about to start falling will mean that the central bank will not have to continue with its cycle of rate hikes. My view is that we will enter a period of paused monetary policy actions, which will last until autumn, when Banxico will start to reduce the benchmark rate gradually to around 5.5%, a normal or neutral level. This will be possible given the convergence of inflation to the range of tolerance of Banxico. If it did not implement these cuts in the nominal monetary policy rate, Banxico would in fact be unnecessarily restricting monetary conditions. If the rate is held at the current level of 7%, the real (inflation-adjusted) rate at the end

of 2018 will be just over 3%, compared with the 1% we forecast for the end of this year. This would imply a cost in terms of economic activity, one which so far has not been significant, as real rates are at levels of less than 1%.

The fact that this cycle of increases started before increases in inflation had been observed, and that it has been much more pronounced than that being implemented by the Federal Reserve, has meant that inflation is not going to get out of control and there have been no significant outflows of capital from Mexico.

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