CENTRAL BANKS

Banxico is set to hike the policy rate by 50bp to 6.25%…

Javier Amador / Iván Martínez / Carlos Serrano

Banxico is likely to retain a pre-emptive approach to anchor inflation expectations

… and keep a vigilant forward bias, leaving the door open for further hikes

Banxico's board will meet tomorrow to discuss interest rates. We expect Banxico to hike the policy rate by 50bp to 6.25% so that the further adjustment in relative prices –due to both the MXN depreciation and the surge in gasoline and LP gas prices– continues to take place without generating second-round effects.

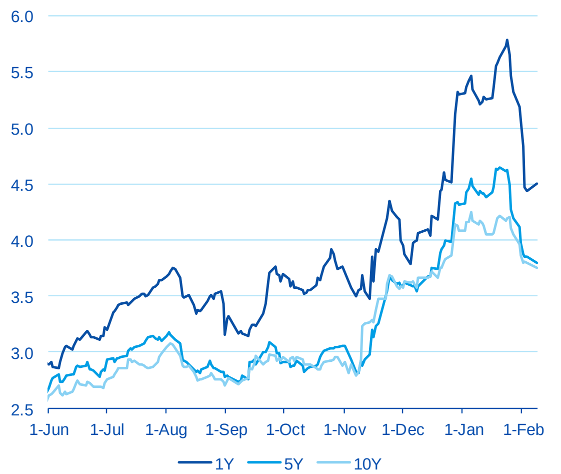
As expected, inflation jumped significantly above the 4.0% tolerance ceiling (to 4.8% in the first fortnight of January) while mid and long-term inflation expectations from fixed income securities remain above 3.5% (see chart 1) as analysts move their expectations closer to our above-consensus forecast (6.0% by year-end). Although the peso has recovered somewhat recently, its depreciation following the US election outcome will drive further exchange rate pass-through in coming months which coupled with possible second-round effects from the surge in energy prices will likely push core inflation to 4.8% by year-end.

At 5.75%, the monetary policy rate is close to neutral (in a recent report Banxico considers the level of the long term neutral rate to be 5.5%). Yet, our Taylor Rule shows the need for additional hikes in coming months (using our projections for headline inflation, forecast to accelerate throughout the year to 6.0% by end 2017, and the evolution of the output gap consistent with our growth forecasts) that could go even further if we take in count that the inflation risks have risen. Besides, monetary conditions remain accommodative. Thus, we think that Banxico will continue to move rates to contain second-round effects risks and to anchor inflation expectations. The current level close to neutral gives Banxico room to adjust rates to limit inflation risks with core inflation and expectations dynamics still worsening.

Summing up, Banxico will remain focused on containing FX pass-through by avoiding second-round effects and anchoring expectations. We think that Banxico will remain on a hawkish mode and one step ahead of the Fed (which will likely do not rise rates until June). We expect Banxico to hike rates slightly more than most expect (BBVA 7.50% vs consensus 7.25% by year-end). Rising inflation risks support this scenario. If as we think the hiking cycle still has legs, the wording will be key. We think that the statement will continue to leave the door open for further tightening and that although they will signal that the balance of risks for both growth and inflation has showed additional deterioration, the wording will give more importance to the latter.

Chart 1

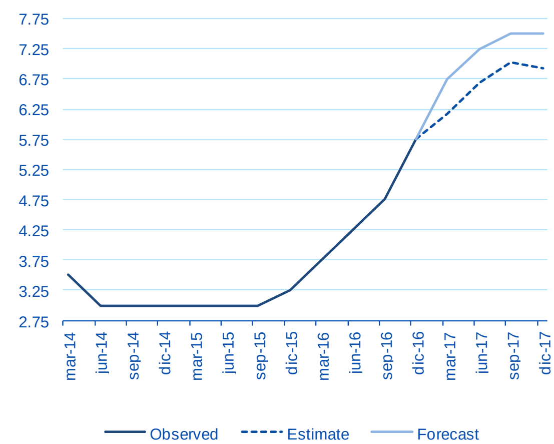
Inflation breakevens* (%)



Source: BBVA Research based on Bloomberg data. *Inflation breakevens are adjusted by 40bp of inflationary risk.

Chart 2

MP rate according to a Taylor Rule estimation* (%)



Source: BBVA Research. * Taylor Rule estimation considers an upper bound inflation limit of 3.5%

Disclaimer