Central Banks

Banxico delivers second 50bp hike in a row

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February 10, 2022

The hiking cycle has further to run but the Board might take the foot off the gas in coming meetings if, as we expect, core inflation starts to ease

- **In a split 4-1 vote, with the new governor siding with the hawkish side of the Board, Banxico hiked the policy rate by 50bp for the second consecutive meeting, taking it to 6.00%.** The decision was not a surprise as most analysts were now anticipating it, but the change was gradual and one month ago less than half of analysts thought, as we did then, that Banxico was going to increase the policy rate by 50bp again as it did back in December. We highlight two things about the split vote. First, as we had assumed, the new Governor Victoria Rodríguez sided with the hawkish side -and with the majority- of the Board. The backdrop called for that. As we argued, she was going to face its first vote with core inflation at multi-decade highs, with signs of some second-round effects, the need to avoid a probable deanchoring of inflation expectations with its first policy decision, and with consensus expectations anticipating a 50bp hike. Second, all five members voted for a hike, even if once again Gerardo Esquivel would have preferred a smaller 25bp hike. The latter suggests that probably all members of the Board think that the central bank still needs to tighten further the monetary policy stance but that some think that either there is a need to reach a certain level sooner rather than later, while Esquivel probably considers that a more gradual approach is more appropriate.

- **The decision of a large majority of the Board, the hawkish tone of the statement, and the upward revision of the inflation forecasts, point to additional hikes ahead.** In spite of the recent softness of economic activity, with GDP contracting in the last two quarters along with ample slack in the labor market, Banxico remains focused on the continued increase of core inflation, which rose to 6.2% YoY in January and the risk that mid and long-term inflation expectations could contaminate by current elevated inflation readings. As we argued in our note anticipating today's decision (see), Banxico signaled that concerns on inflation have not eased. With core inflation still in an upward trend, Banxico upwardly revised its core inflation forecasts by 0.2pp on average each quarter of this year, to a 6.4% average in 1Q, up from 6.2%, and a 4.3% average in 4Q. These revisions have two important implications in our view. First, Banxico now thinks that core inflation could reach a peak of slightly above 6.5%, in either February or March i.e., that it is set to accelerate further. Second, the forecast for average core inflation in 4Q is now 4.3%, up from 4.1%, i.e., Banxico now thinks, in line with our baseline scenario, that core inflation will ease more slowly, and will end the year at levels closer to 4.5% than 4.0% (our forecast for year-end core inflation has been 4.5% since December). Also importantly, Banxico now forecasts that headline inflation will average 4.0% in 4Q, up from 3.5% anticipated in December. Banxico's new forecasts are now more aligned with our own i.e., inflation will remain above 4.0% throughout the year and core inflation will ease more slowly. With a hawkish central bank, that tends to react more to observed rather than to expected inflation. these forecast changes point to additional hikes.

- **Looking ahead, with core inflation set to further increase and to ease more slowly than headline, with the latter set to remain well above target throughout the year, with the Board still decisively hawkish under the new Governor, and with the Fed about to start a hiking cycle, it seems clear that Banxico is**

set to continue tightening the monetary policy rate. We continue to expect Banxico to take the policy rate to 7.0% by year-end but we anticipate that it will likely take the foot off the gas at the next meeting and return to a more gradual pace of tightening. We anticipate four 25bp in the remainder of the year, in March, June, September and December. With the drivers of the inflation surge not related with demand pressures, past and upcoming tightening would likely prove ineffective. In our view, under this context, and considering that headline inflation already peaked and core inflation will peak this quarter, it will be wiser to take a more gradual approach going forward and avoid excess tightening that would further hurt economic activity without promoting a faster inflation easing.

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