Banxico Watch

Banxico will act "more forcefully", and deliver, a (now) widely anticipated, larger 75 bp hike

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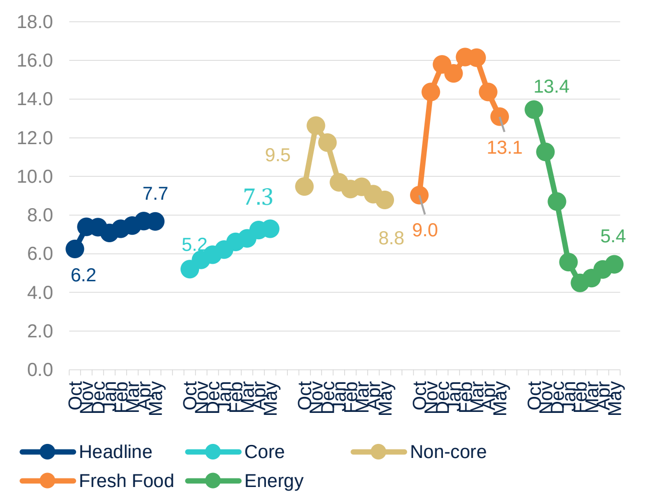
Banxico will likely match Fed's expected rate hikes in 2022

- **We think that Banxico will move the policy rate by 75bp, to 7.75%.** During the intermeeting period, core inflation rose further (to 7.3% YoY), the Fed pivoted to a more aggressive approach (sharply shifting rate hikes expectations), the Mexican peso weakened, and long-term core inflation expectations (for 5-8 years ahead) edged up. Besides, one board member (Irene Espinosa) would have preferred a 75bp hike at the last meeting, the minutes showed than others could have leaned to that larger hike, but did not want to surprise markets, and during the intermeeting period Jonathan Heath indicated that he would most likely vote for a 75bp hike and expected the majority of the Board to do the same. At the time we changed our call, about three weeks ago, many other analysts also shifted their expectations for this meeting to a larger 75bp hike (22 out of 34), while markets had also priced in a 75bp move. The Banamex Survey released yesterday shows that now 33 out of 34 analysts are expecting this move. We think that given all the above, there will be a large majority for this move with Governor Victoria Rodríguez and board member Galia Borja also likely to vote for a 75bp hike.
- **There is (now) a wide consensus that Banxico will match Fed's expected hikes through December, taking the policy rate to 9.50% by year-end** (Figure 5). Following the Fed's hawkish shift, most analysts, us among them, have adjusted their rate hike cycle peak sharply to the upside. The Fed is determined to slow demand until the imbalances that have been driving up inflation decrease. Besides, it is looking for "compelling" evidence that the inflation rate is falling and starting a convergence path with the 2% objective before it shifts to smaller hikes, we think the Fed will hike the fed funds rate by 75bp for the second time at the next FOMC meeting in July. After that, with some "progress on inflation", the Fed might shift back to a 50 bps hike in September, followed by two 25 bps hikes in November and December, once inflation starts to show clear signs that it is coming down. Such a path would bring the target range of the fed funds rate to 3.25%-3.5% by year-end. We think that after June, Banxico will also deliver 175bp worth of additional hikes, matching each of the Fed's expected moves, taking the policy rate to 9.50% by year-end.
- **Along with its monetary policy decision, Banxico will also release its updated inflation projections**. Although headline inflation is showing signs of stabilizing, helped by the recent easing in non-core inflation pressures, core inflation has risen further, and pressures remain broad-based (Figures 1 and 2). Although we think that both headline and core inflation likely peaked in May, we expect both to flatten out during 2Q and 3Q, before they start to show clearer signs of easing (Figures 3 and 4). We thus anticipate that Banxico will revise its headline inflation forecasts upwards, as well as its core inflation expected path.
- **We do not expect Banxico to continue to follow the Fed in early 2023.** Banxico will take the monetary policy rate well beyond neutral to try to influence price dynamics through two channels: inflation expectations and the ER i.e., will tighten further to avoid long-run expectations de-anchoring and to keep a wide interest rate spread. Yet, Banxico does not need to slow demand (there is still plenty of slack in the Mexican economy) and

most drivers of high inflation are global and beyond its control. Given that we expect inflation to ease during 2023, we think that with an increasing real policy rate, Banxico will not match Fed's expected hikes in early 2023, allowing the spread to shrink somewhat. Banxico´s tightening will result in strong headwinds to the economy, something that, considering the time horizon in which monetary policy operates, will become evident next year. The wide interest rate differential vis a vis the fed funds, along with an economic slowdown and a falling inflation rate, will allow Banxico to decouple from the FED next year and to start a gradual easing cycle in the last quarter.

Although headline inflation is showing signs of stabilizing, helped by the recent easing in non-core inflation pressures…

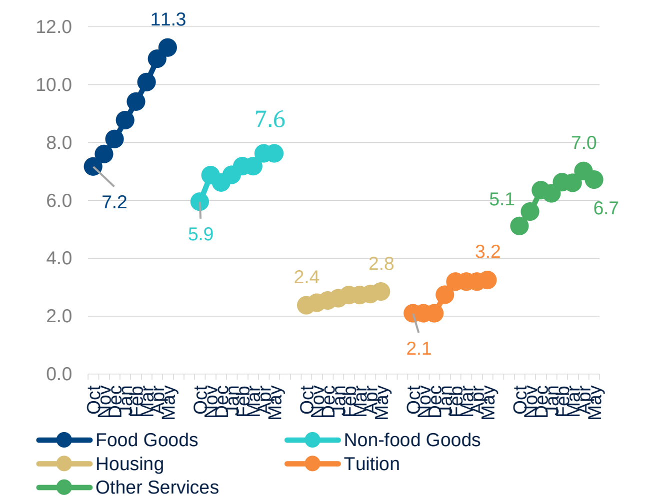
Figure 1. **HEADLINE INFLATION BREAKDOWN (YoY % CHANGE)**



Source: BBVA Research based on data by INEGI.

… core inflation has risen further, and pressures remain broad-based

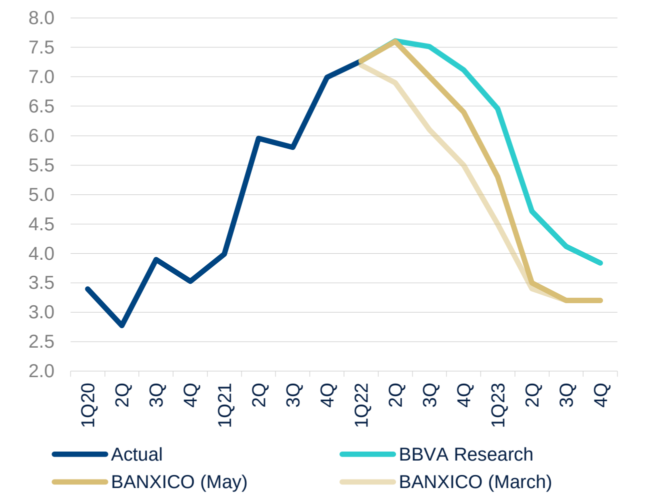
Figure 2. **CORE INFLATION BREAKDOWN (YoY % CHANGE)**



Source: BBVA Research based on data by INEGI.

We anticipate that Banxico will revise its headline inflation forecasts upwards…

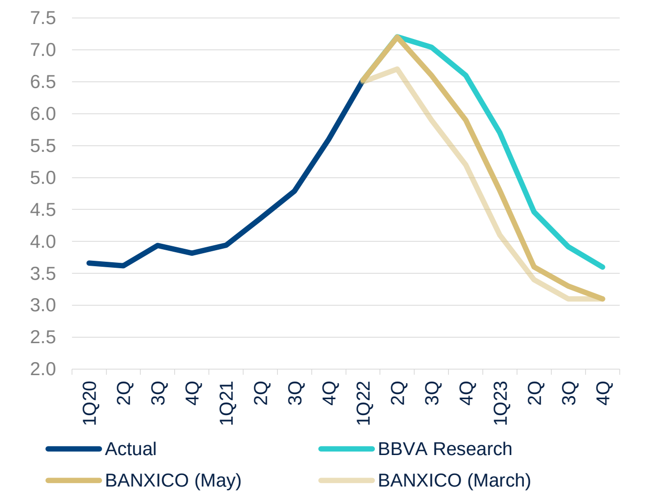
Figure 3. **HEADLINE INFLATION OUTLOOK (YoY % CHANGE, QUARTERLY AVERAGE)**



Source: BBVA Research based on data by INEGI and BANXICO.

… as well as its core inflation expected path

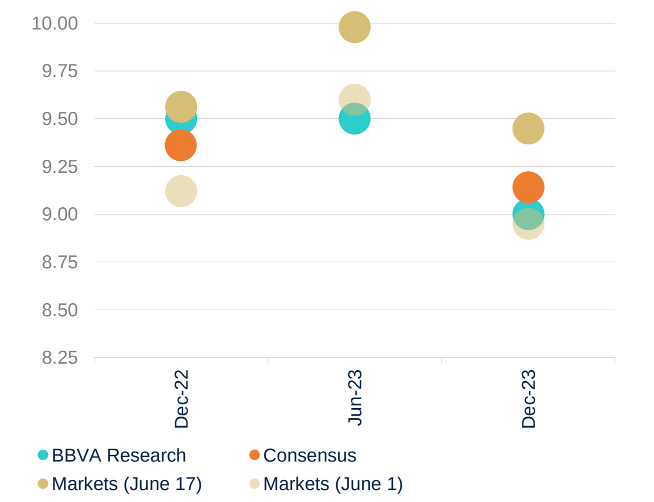
Figure 4. **CORE INFLATION OUTLOOK (YoY % CHANGE, QUARTERLY AVERAGE)**



Source: BBVA Research based on data by INEGI and BANXICO.

There is now a wide consensus that Banxico will match Fed's expected hikes through December, taking the policy rate to 9.50% by year-end…

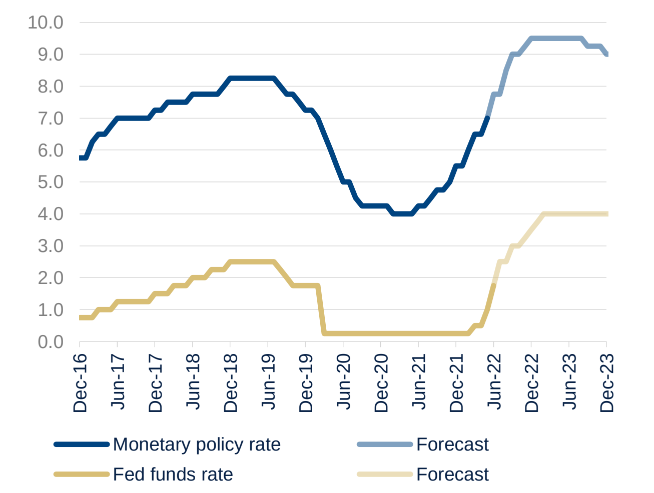
Figure 5. **MONETARY POLICY RATE OUTLOOK (%)**



The latest Banamex Survey was released on June 21. Source: BBVA Research based on data by Bloomberg and Banamex Surveys.

… but, in contrast to market expectations, we think that Banxico might not match the two additional expected Fed hikes in early 2023

Figure 6. **CORE INFLATION OUTLOOK (YoY % CHANGE, QUARTERLY AVERAGE)**



Source: BBVA Research based on data by INEGI and BANXICO.

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