Banxico Watch

Banxico hikes policy rate to a fresh all-time high of 9.25% as widely expected

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Banxico will most likely stick to following in the footsteps of Fed's upcoming hikes

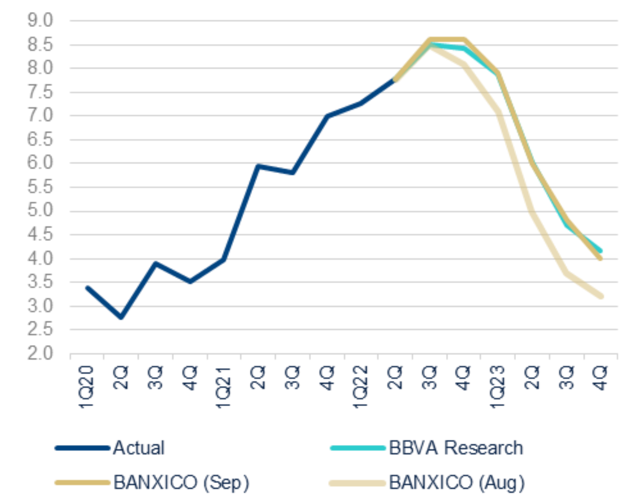
- **Following in the footsteps of the Federal Reserve, Banxico delivered the widely expected third consecutive 75bp hike, raising rates to a fresh record high of 9.25%.** The vote for the outsized hike was unanimous. The tone of the statement remained hawkish. The balance of risks to inflation "continues with a considerable upward bias". Although mid-term inflationary expectarions remain well anchored. Banxico is clearly uncomfortable with the fact that they are above the objective (they have been above it well before the current inflationary episode, as inflation has averaged 3.6% instead of 3% during the last decade). As we anticipated, Banxico revised sharply to the upside its inflation forecasts, and their projected paths for both headline and core inflation now mimic ours (see figures 1 and 2). In an arguably big shift, Banxico now expects, as we do, core inflation to remain well above 4.0% over the next four quarters before easing to levels slightly above 4.0% in 4Q23.
- **Decoupling from the Fed in the near term remains quite unlikely; little forward guidance but hints point to more outsized hikes in the next two meetings.** Although there is no explicit forward guidance in the statement, the wording suggests that Banxico will most likely continue to match upcoming hikes in the fed funds rate. The Board considers that with this hike, "the monetary policy stance is adjusted to the trajectory required for inflation to converge to its 3% target within the forecast horizon". Moreover, also considered the increasing challenges "for conducting monetary policy in the face of tightening financial conditions". With the Fed set to continue to increase rates at a fast pace, Banxico will most likely follow suit and continue to match each of the next Fed movements to keep unchanged the 600bp interest rate spread it has kept since the Fed started to lift rates. That is, Fed's moves will remain the most important indicator the Board looks at in the short term. Banxico will continue to match each additional Fed hike to avoid the risk of large capital outflows that would trigger a sharp depreciation. Banxico will continue to limit potential depreciation risks in a context in which headline inflation has likely not peaked yet and core inflation will still push higher.
- **We expect 125bp worth of additional tightening by December, lifting the policy rate to 10.50% by year-end.** We continue to expect a fourth 75bp hike in November, followed by a 50bp one in December, in concordance with ours and market´s expectations for the Fed.. We think that after a final 25 bps hike in January to match Fed's last movement, Banxico will keep rates unchanged at the cycle peak of 10.75% through the summer. Early next year will still be soon to decouple from the Fed and allow the interest rate spread to shrink[1]. Yet, real ex ante and ex post real rates will likely be close to 7.0% and 6.0% by next summer

[1] "In my opinion we cannot afford to separate for at least the next six months, at least until the end of the year. I wouldn't even consider it," Heath said in a recent interview.

in a context of easing inflation risks and a likely (much) weaker economy. The US economy is decelerating sharply if it is not already in a recession, and tight monetary policy will take a toll on investment and consumption, especially of consumer durables and automobiles. Thus, we think that by then Banxico should and will shift to a more data-driven approach and start an easing cycle in 3Q, even if the Fed keeps the fed funds rate on hold for longer. Therefore, we anticipate that the policy rate will end next year at 10.00% and that Banxico will feel confident enough on the inflation front to speed up the easing pace in 2024 to avoid an unwarranted tightening of monetary policy conditions with easing inflation in a context of an economy with plenty of slack.

Banxico revised up its inflation forecasts as expected…

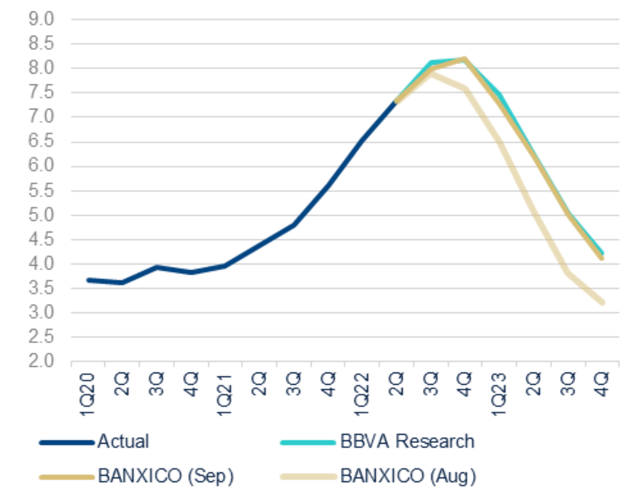
Figure 1. **HEADLINE INFLATION OUTLOOK (YoY % CHANGE, QUARTERLY AVERAGE)**



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

… their projected paths now mimic ours

Figure 2. **CORE INFLATION OUTLOOK (YoY % CHANGE, QUARTERLY AVERAGE)**



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