Banxico Watch

Banxico delivers a hawkish hold even as core inflation has eased meaningfully

Javier Amador / Iván Fernández / Carlos Serrano

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Its hawkish rhetoric, along with the upward revision to its inflation forecasts, closes the door for the start of an easing cycle this year

- **As widely expected, in a unanimous decision, Banxico kept the policy rate unchanged at 11.25% for the fourth consecutive meeting.** As we anticipated (see), the central bank closed the door for the start of an easing cycle in the short term, as it continued to convey its intention to keep the policy rate unchanged "at its current level for an extended period." The decision to continue to signal a long-lasting pause was likely mainly influenced by the recent signals from the Fed about the need to hold their policy rate at a restrictive level for longer, along with its hawkish rhetoric. Banxico brought its 2024 headline inflation forecasts closer to ours (Figure 1) and revised up its core inflation expected path, also bringing its 1H24 projections closer to our expectations (Figure 2). Both headline and core inflation are now expected to average 4.7 and 5.3% in 4Q23, only slightly up from the previous 4.6 and 5.1% forecasts. Banxico chose not to comment on it, but part of a slight rebound in store for inflation in 4Q23 will be clearly attributable to base effects. Revisions were more significant for next year's projections: both headline and core inflation forecasts were revised upwards by 0.3 pp for each of the first three quarters of the year, which implies that headline inflation is now expected to fall below the upper limit of the target range only until 3Q24 (2Q24 previously) and closer to the 3% point target in 2Q25 (4Q24 previously).

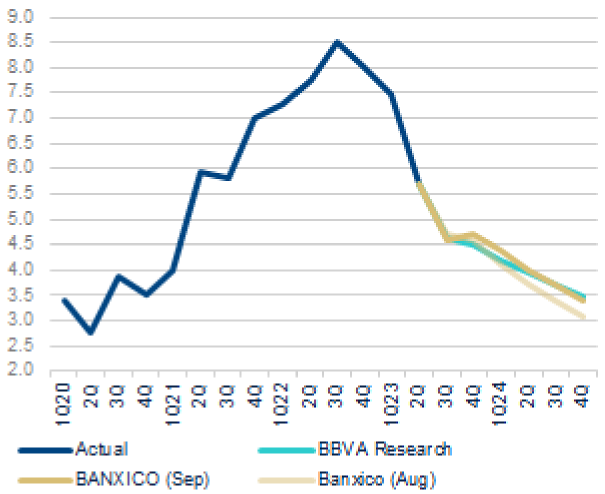
- **The main reason behind Banxico's upward inflation forecasts revisions appears to come from "an environment where economic activity is more resilient than previously anticipated"**, which seems to have intensified Banxico's concerns about the evolution of core prices: the statement points out that core inflation "keeps showing a resistance to decline," even after it eased (-)1.6 pp from March to the first half of September and is set to drop by c. (-)1.0 pp further through year-end. The recent depreciation of the peso could also explain Banxico's toughening tone, even as some of its own staff's research has sometimes concluded that the pass-through of a strong US dollar to the general price level is relatively weak.

- **Concerns about the outlook for core inflation were reflected elsewhere in the statement:** Board members continue to point out that "economic activity shows resilience and the labor market remains strong," and, more importantly, they removed the previously-held message that "the balance of risks to growth is equilibrated," which implies a perception among members of an economy growing uncomfortably above its potential. This hawkish shift was reflected in the balance of risks for inflation, which continues to be biased to the upside after adding a new inflationary risk: "that the economy's resilience contributes to a more gradual decline in inflation than foreseen". Riks on the downside were also changed towards a less optimistic outlook for inflation: the risk related to "a larger than anticipated effect from the Federal Government's measures to fight elevated prices" was removed. We argued yesterday that at least some Board members were likely to discuss the possible implications of the most recent Economic Package for 2024, but no hints about this likely debate were reflected in the statement. The meeting minutes that will come out in a couple of weeks will give us more light on this issue.

- **Banxico's renewed inflation forecasts do not change our long-held opinion that the real ex-ante interest rate is set to remain very high (and will rise more) in the coming months as inflation continues to ease.** Even though Banxico pointed out that inflation expectations for the end of this year increased during the intermeeting period, it also noted that longer-term ones remained relatively stable. The monetary stance will continue to tighten during the rest of the year and the beginning of the next, given that lower inflation will most likely bring about a decline in 12-month inflation expectations, which, in our opinion, still remain high (they stand at 4.3%, 0.7 pp above our inflation forecast of 3.6% YoY for September 2024). In a context of gradual convergence of inflation to target and amid a slight but likely slowdown of economic activity next year, in our view, Banxico will eventually begin an easing cycle next year to avoid an additional and unnecessary tightening of the monetary policy stance. The exchange rate reaction to today's decision was muted.

Banxico brought its 2024 headline inflation forecasts closer to ours…

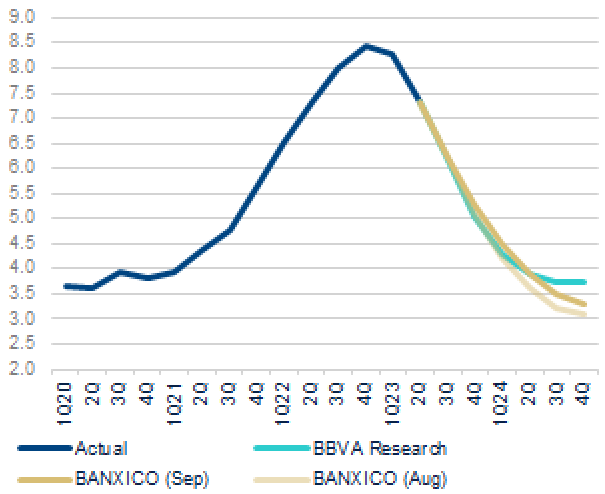
Figure 1. **HEADLINE INFLATION OUTLOOK**
(YOY % CHANGE, QUARTERLY AVERAGE)



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

… and revised up its core inflation expected path, bringing its 1H24 closer to our expectations

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



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

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ENQUIRIES TO:
BBVA Research: Paseo de la Reforma 510, Colonia Juárez, C.P. 06600 Mexico City, Mexico.
Tel.: +52 55 5621 3434
www.bbvaresearch.com