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Banxico Watch

The window for the rate cut cycle to start in 4Q23 seems to have closed…

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… but it will likely open in the first quarter of next year

- Although we do not expect the current 575bp spread between Mexico and US's policy rates to fall back in coming months, as we continue to think that the Fed is done raising rates, the updated Summary of Economic Projections (SEP), especially the dot plot, reinforced the FOMC's higher for longer rhetoric. The "dot plot" now pencils in fewer rate cuts for 2024 (-50bp worth of cuts, down from -100 bps in June). The main takeaways from last week's FOMC meeting are that the Fed, in the context of a still strong economy, is still not fully confident about inflation and feels it needs to strengthen market's expectations about the need for "higher for longer" rates. Markets have reacted and mid- and long-term rates in both the US and Mexico have risen. Risk aversion has taken hold of markets, and the USD has appreciated markedly. Under this context, and with inflation still above target, Banxico will not feel compelled to signal that a rate-cut cycle is in store anytime soon, even amid high real interest rates and a gradual disinflation process. In particular, we do not believe that the Board will signal the beginning of the easing cycle until they have certainty that the Fed is done with the hiking cycle and, after last week's FOMC's statement, Q&A and SEP, this is unlikely to happen this year.

- **Banxico may add a new inflationary risk to its monetary policy statement following the presentation of the 2024 Economic Package with a larger deficit.** The statement will likely continue to express that the balance of risks for inflation remains biased to the upside. The recent depreciation of the Mexican peso due to volatility in international financial markets as well as pressures on oil prices, will keep the Board's attention focused on the risks that could complicate the task of bringing inflation back down to target. At least some Board members are likely to discuss the possible implications of the most recent Economic Package for 2024. In our opinion, the package was built with realistic macroeconomic assumptions, but a projected public deficit of 4.9% of GDP for next year (an all-time high since 1990), in a year where GDP is expected to grow above potential and interest rates to be at extremely high levels, will likely be considered as an additional inflationary risk. Indeed, sub-governor Jonathan Heath has publicly expressed concerns about the potential divergence between fiscal and monetary policies in 2024, which could complicate Banxico's fight against inflation. Banxico's reaction regarding this issue will likely be limited to reinforcing its long-held commitment to "maintain the reference rate at its current level for an extended period." Like some other major Central Banks, the Board will continue to convey the need for a cautious approach for monetary policy, "favoring a flexible monetary policy stance, dependent on incoming data" as shown in the August meeting minutes.

- **Thus, Banxico will likely remain backward-looking in the short term and keep its policy rate steady for at least this upcoming meeting and the following two in 4Q23.** Inflation is coming down broadly in line with Banxico's recently updated expected path, so we are not anticipating major changes to its inflation forecasts. Headline inflation dropped back to 4.6% YoY in August and is set to ease further in September to 4.5% YoY, 3.3 percentage points (pp) below 2022's year-end level (7.8%). Core inflation has come down more slowly but also noticeably, to 5.7% YoY, (-)2.6 pp year to date. Core inflation is set to continue to drop further (Figure 2).

Trend measures and our expected path suggest that headline inflation is going to slow down further in Sep-Oct but will rebound somewhat in Nov-Dec before resuming its downward trend at the turn of the year. What about inflation expectations? Since the last meeting, 12-month headline and core inflation expectations have continued to come down, 0.1 each to 4.3% and 4.2%, respectively. We think they have room to come down further (our current 12-month expectations are 3.6% and 3.8%, respectively). Thus, the real ex-ante rate is set to remain very high, with inflation dropping back and will most likely continue to increase in the coming months. Medium-term expectations remain well-anchored at levels close to the average inflation rate observed in the last fifteen years.

- **To sum up, even if Banxico is unlikely to signal the start of a rate cut cycle in the short term, eventually, probably at the start of 2024, it is likely to join other countries such as Chile and Brazil, which are already easing their restrictive stance.** What will it take for Banxico to start a rate cut cycle to avoid an unwarranted increase in the real ex-ante rate? Despite the recent depreciation, the peso strengthening during 2023 along with high real rates, have brought monetary conditions to a very restrictive territory. Although we have delayed the expectation of the start of a rate cut cycle to 1Q24, we continue to think that in a backdrop of falling inflation, Banxico will eventually try to avoid a further tightening of the monetary policy stance, even if the Fed ends up hiking rates one more time or is still holding rates steady. Some hints about the roadmap for the rate cut cycle will be useful but seem unlikely in the short term.

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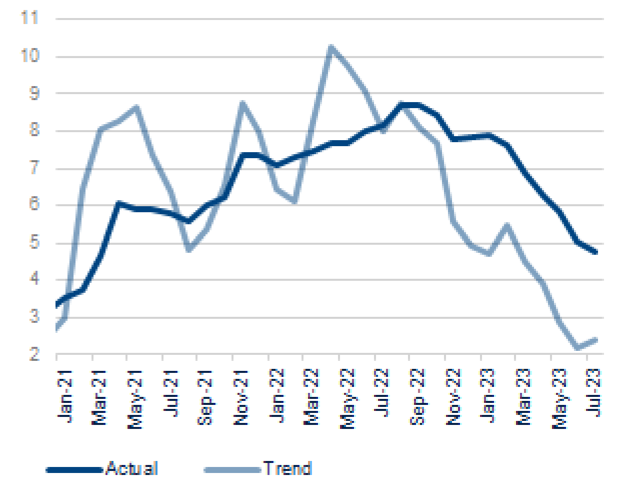
There is a bump in the road in store for headline inflation in Nov-Dec…

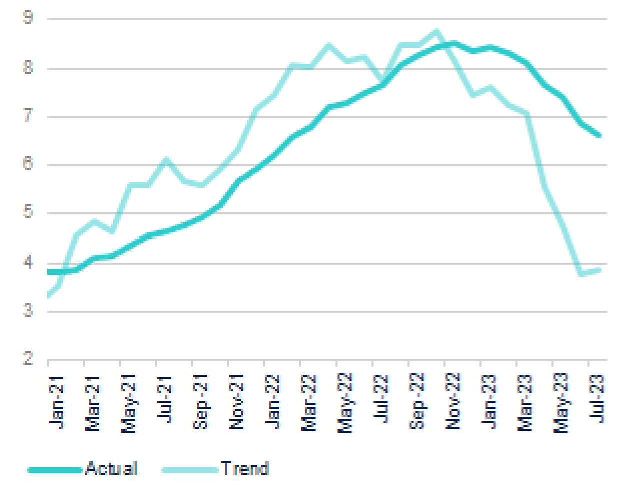
Figure 1. **HEADLINE INFLATION: ACTUAL & SA TREND***
(YOY % CHANGE & 3MMA MOM ANNUALIZED % CHANGE OF SA INDEX)



Source: BBVA Research based on data by INEGI.
*Own calculations.

… but also a further drop for core inflation, as signaled by trend measures

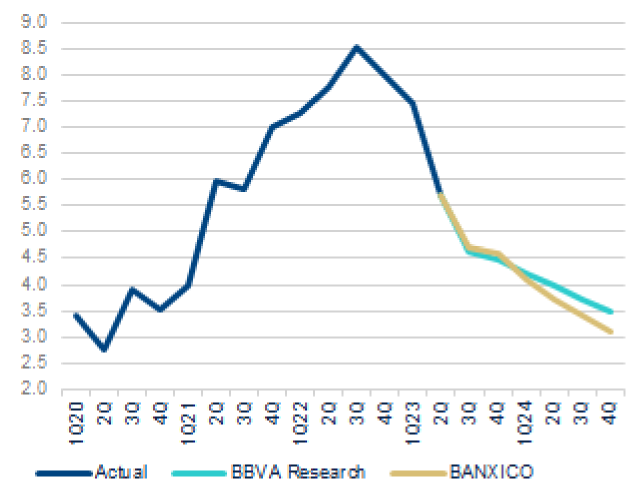
Figure 2. **CORE INFLATION: ACTUAL & SA TREND***
(YOY % CHANGE & 3MMA MOM ANNUALIZED % CHANGE OF SA INDEX)



Source: BBVA Research based on data byINEGI
*Own calculations.

Inflation is coming down broadly in line with Banxico's recently updated expected path…

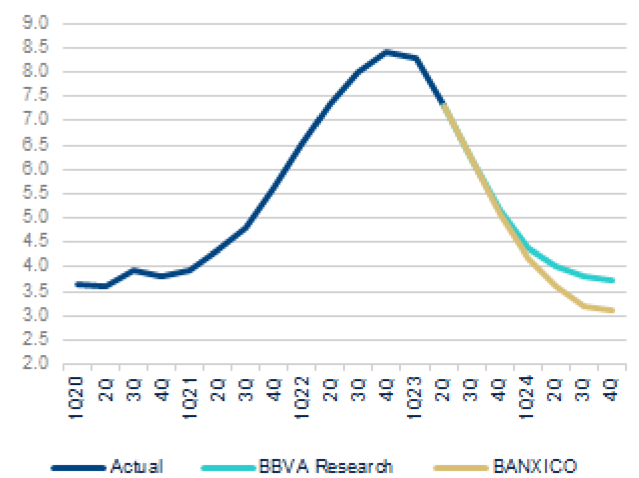
Figure 3. **HEADLINE INFLATION OUTLOOK**
(YOY % CHANGE, QUARTERLY AVERAGE)



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

… so we are not anticipating major changes to its inflation forecasts

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



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

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