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Banxico Watch

Banxico will likely stay on the sidelines one more meeting

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Will it continue to pave the way for an upcoming rate cut in March?

- **Last week, the Fed kept the fed funds rate unchanged and hinted that the rate-cut cycle is not likely to start in March, which gives Banxico more time to stay cautious.** During the press conference Chair Powell explicitly stated that he did not think a March rate cut was likely: "I don't think it's likely that the Committee will reach a level of confidence by the time of the March meeting [...] I don't think that's the base case." The odds of a US policy rate cut in March moved down sharply as a consequence and, at the time of writing this report, stand at around ⅕ after hovering around 50% over the previous weeks (see). Nevertheless, we think that Banxico is set to avoid an unwarranted further increase in the real ex-ante rate. The reassessment of the short term path for the fed funds rate should not derail Banxico's plan to "fine-tune" its policy stance given its much more restrictive level as compared to other countries (Figure 1). Although Banxico does not usually signal clearly any future decision in the wording of the statement, it might give another clue to signal that it is still planning to fine-tune the nominal interest rate in the short term.

- **The most recent data for headline inflation have been somewhat higher than expected driven by non-core prices, but core inflation has continued decelerating.** Headline inflation ended 2023 at 4.7% YoY, well below the corresponding figure of 2022 (7.8%), but slightly above expectations (4.6%) driven by a large supply shock reflected in a 7.1% MoM jump in fruits and vegetables prices. The first inflation release for this year showed that a further 5.0% FoF increase in fruits and vegetables prices drove up the headline index to 4.9% YoY, somewhat above expectations (4.8%). However, core inflation eased further to 4.8% YoY in the first fortnight of January (down from 5.0% in the second half of December), with almost twelve straight months in decline. While core disinflation in 2023 was mostly driven by lower core goods inflation, the most recent inflation report signals that core services inflation is off to a much better start in 2024 (Figures 2 and 3). If our forecasts prove accurate regarding the January inflation data set to be released on Thursday morning (before the meeting), core services inflation will likely have eased to 5.2% YoY in January after staying sticky at 5.3% from October to December. Core goods inflation will likely have dropped further from 4.9% YoY in December to 4.3% in January. Core inflation averaged 5.3% YoY during 4Q23, 0.1 pp below Banxico's forecast. Thus, while Banxico will likely adjust its headline inflation forecasts as a result of the jump in the non-core index (Figure 4), we think Banxico will also downwardly adjust its short-term core inflation forecasts bringing them closer to ours and to its previous expected path (Figure 5). Non-core inflation is out of the control of monetary policy and thus, we think Banxico will focus on the improvement of core inflation as it cautiously proceeds with its plan to prevent the real ex-ante rate from increasing during 1H24.

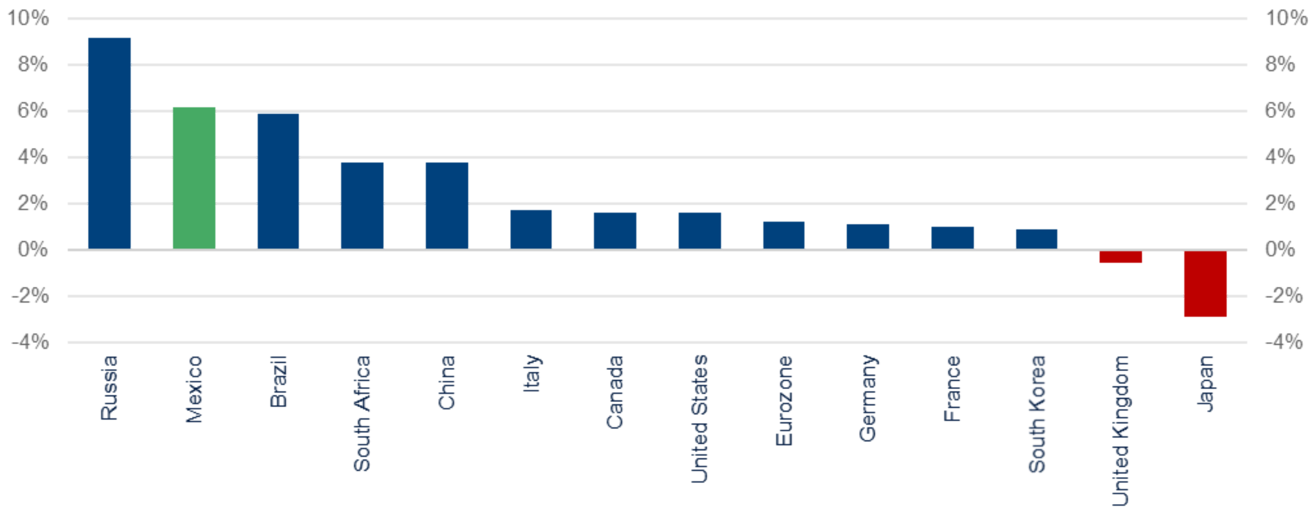
- **Today, most variables suggest that there is ample room to begin to normalize the monetary policy stance.** US inflation data has continued to suggest that the global inflationary issue is largely resolved. Though still above Banxico's target range, inflation is substantially lower than a year ago. Besides, short-term inflation expectations (one to four years) were at 4% a year ago, while now they are better anchored at the 3.7%

average inflation observed in the last two decades. Medium-term inflation expectations (five to eight years) stayed well-anchored throughout the recent higher inflation period (2021-23). Thus, while the real ex-ante monetary policy rate (i.e., the difference between the current policy rate and the expected inflation rate) was 5.3% a year ago, it is now above 7%. To sum up, today we find ourselves in a much more favorable environment with lower headline and core inflation, lower inflationary expectations, and lower inflationary pressures from abroad, but with a monetary stance that is more restrictive than it was a year ago when all those variables were more adverse. Today, most variables suggest that there is ample room to begin to normalize the monetary policy stance. Yet, amid Banxico's cautiousness along with core services inflation stickiness and the negative supply shock mentioned above, we think that Banxico will likely continue to describe (for the last meeting?) inflation risks as biased to the upside.

- **Banxico is thus set to hold the policy rate at 11.25% at this meeting but will likely continue to pave the way to cut it as soon as in the following meeting in March.** As argued above, core services inflation might be about to turn a corner and seems to be off to a better start in 2024, and the core disinflation pace remains promising—dropping 0.7 pp in 4Q23 and set to drop 0.8 pp in 1Q24 according to our forecasts. Headline inflation will likely show some stickiness in the short term but we anticipate it is set to gradually ease from February onwards. Thus, we think that Banxico is likely to continue to pave the way to "fine-tune" the monetary policy stance and cut the policy rate by 25 bps to 11.0% in the next meeting in March to avoid an unwarranted increase in the policy rate. Although we think that Banxico should not skip rate cuts at any meetings next year, its cautiousness, hawkishness, and recent hints suggest that consecutive rate cuts are unlikely at the start of the gradual easing cycle. Moreover, Banxico could stay cautious in the next few quarters and avoid cutting rates by 50 bps at any meeting this year even if that implies keeping the stance excessively restrictive. Thus, we continue to expect Banxico to bring down the policy rate to 9.0% by year-end 2024, but risks are tilted to a somewhat higher rate.

The reassessment of the short term path for the fed funds rate should not derail Banxico's plan to "fine-tune" its policy stance given its much more restrictive level as compared to other countries

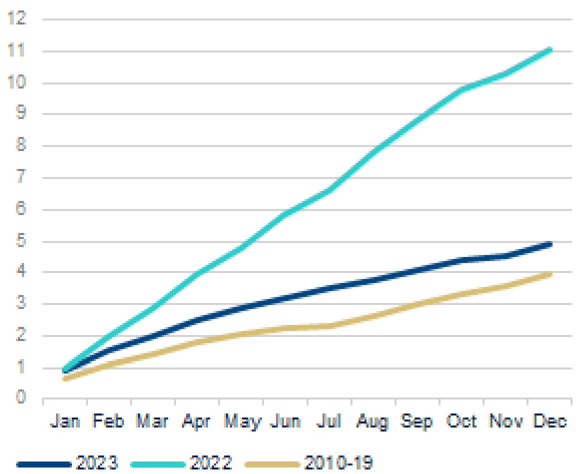
Figure 1. **CENTRAL BANK RATE MINUS CORE CPI YoY FOR SELECTED G20 COUNTRIES** (%)



Source: BBVA Research / Bloomberg

While core disinflation in 2023 was mostly driven by lower core goods inflation, the most recent…

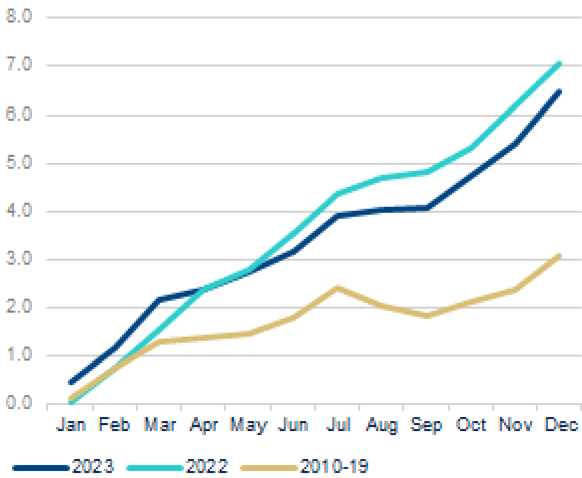
Figure 2. **CUMULATIVE CORE GOODS INFLATION** (PER YEAR, %)



Source: BBVA Research / INEGI
*Own calculations.

… inflation report signals that core services inflation is off to a much better start in 2024

Figure 3. **CUMULATIVE CORE SERVICES EX-HOUSING & TUITION INFLATION** (PER YEAR, %)



Source: BBVA Research / INEGI
*Own calculations.

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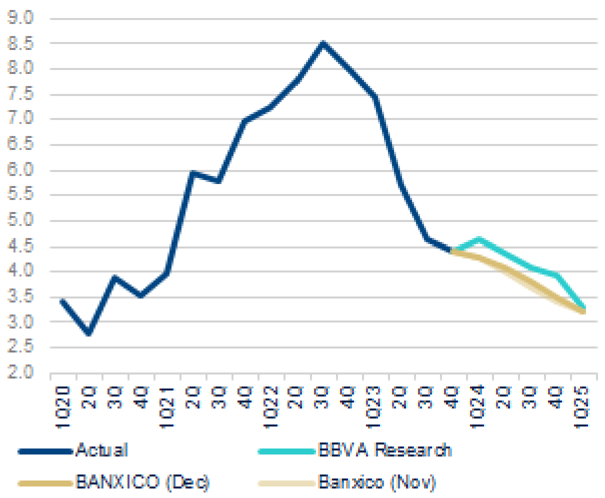
Banxico will likely adjust its headline inflation forecasts on higher non-core inflation and…

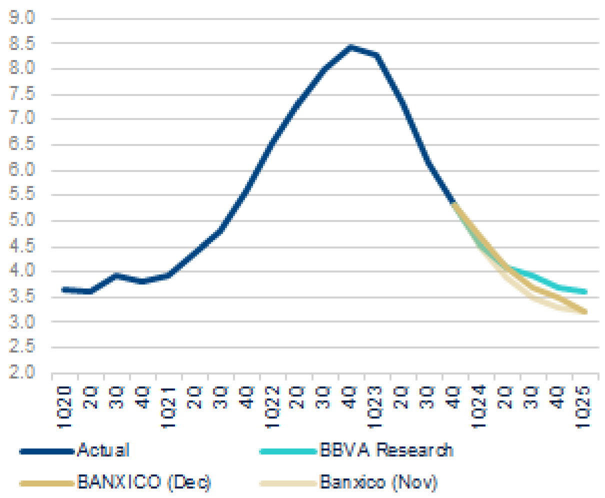
Figure 4. **HEADLINE INFLATION OUTLOOK (YOY % CHANGE, QUARTERLY AVERAGE)**



Source: BBVA Research / Banxico / INEGI

… will also downwardly adjust its short-term core inflation forecasts bringing them closer to ours

Figure 5. **CORE INFLATION OUTLOOK (YOY % CHANGE, QUARTERLY AVERAGE)**



Source: BBVA Research / Banxico / INEGI

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