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Banxico to stay the course amid weak growth and disinflation

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Peso further appreciation and Fed recent dovish shift reduce constraints on Banxico's easing cycle

Last week, the Fed delivered a widely anticipated 25bp rate cut, lowering the fed funds rate target range to 4.00-4.25%, and signaled that further easing is likely. The statement indicated the move was made "in light of the shift in the balance of risks." While the Fed noted for the first time this year that "inflation has moved up," it also acknowledged that "downside risks to employment have increased." The updated Summary of Economic Projections (SEP) showed GDP growth forecasts edged up for this year and next, while those for inflation and unemployment were largely unchanged. The question now is whether last week's cut kicks off a string of rate cuts or if the path toward neutral will unfold more gradually. The dot plot continued to show a split within the FOMC, but with a majority and the median now indicating that two more cuts this year in October and December are likely (Figure 1). Powell was careful to leave the door open to a pause next month, but also stressed that the policy focus has shifted towards a more balanced one, noting that the risks to the two goals "have moved meaningfully towards equality and that means [the Fed] should move in the direction to neutral"—a clear signal of further cuts ahead. While a short-term upside inflation surprise or sudden rebound in the labor market could justify a pause, both scenarios seem unlikely in the short term. Thus, the chances of a second cut in a row in October have increased, tilting our baseline scenario toward two additional cuts this year (click here and here for additional details on last week's FOMC meeting). With the Fed having resumed its easing cycle, the risk of further narrowing in the policy rate spread has diminished. This should offer Banxico greater flexibility to continue its own rate-cutting cycle without putting undue pressure on the peso or broader financial conditions.

In Mexico, economic data released since the last Banxico monetary policy meeting confirm that activity remains weak despite the temporary boost in Q2. Industrial production fell 1.2% m/m in July, led by contractions in both manufacturing (-1.6%) and construction (-1.2%) that more than offset a 1.9% uptick in mining. Preliminary data showed that FDI rose 10.2% y/y in 1H25 amid a surprising ~350% increase in new investment flows, albeit from a very low base. In contrast, the broader measure of gross fixed investment dropped 1.2% m/m in June and is down 6.3% y/y in 1H25. While private consumption scored a 0.8% m/m real growth rate in June driven by imported goods (4.9%), services consumption weakened (-0.1%). The 2Q GDP positive surprise was likely driven by temporary distortions, such as front-loaded exports amid tariff-related uncertainty. However, these effects are unlikely to persist and may already be unwinding, as suggested by recent weakness in industrial output. Formal job creation reached a record high in July, but this was mostly due to the statistical incorporation of digital platform workers; excluding that effect, formal employment actually contracted 0.1% y/y. This, together with the 0.1% m/m decline in formal job creation in August, points to continued labor market slack. As a result, the real wage bill slowed further, weighing on consumption. Overall, activity data continue to reflect that underlying domestic demand remains subdued. With the economy facing headwinds from weak investment, sluggish employment, tight fiscal and monetary policy, we think Banxico will continue to judge that “economic slack prevails” and emphasize the “weakness of economic activity” in its inflation outlook, supporting the continuation of the easing cycle.

The Q2 rebound in headline inflation has continued to unwind in Q3; core inflation will likely ease as the balance between goods and services inflation normalizes. Headline inflation averaged 4.2% y/y in Q2—up from 3.7% in Q1—but declined to 3.5% in July-August, as expected. This moderation reflects lower core goods inflation, a deceleration in services, a drop in non-core components, and favorable base effects. A temporary uptick to 3.7% y/y is likely in September due to a low comparison base from last year, but headline inflation is expected to stabilize around 3.7% in Q4, ending the year at 3.8%. Core inflation—key to medium-term trends—has remained stable at 4.2% y/y in recent months, slightly above Banxico’s 2-4% target range (Figure 2). Although it had fallen below 4.0% in Q4 2024 and Q1 2025, stronger-than-expected core goods inflation and persistent services inflation have pushed it back above the upper bound. Still, signs of gradual improvement have emerged: core goods inflation slowed to 0.2% m/m in July-August, and services inflation dropped to 0.3% m/m—its slowest pace in over a year. Year-on-year, services inflation declined from 4.6% in Q2 to 4.4% in July-August, with broad-based easing across housing, tuition, and other services. Looking ahead, we expect a continued rebalancing between goods and services inflation, consistent with a still-weak aggregate demand environment. We believe most Banxico board members will remain confident in this disinflation outlook.

Dovish signals from Board members and supportive financial conditions suggest the policy environment remains conducive to further easing. Since the August decision, the peso has continued to appreciate, gaining around 2% and bringing year-to-date gains to 11% (Figure 3). Volatility remains subdued and has consistently stayed below its historical average since May. These developments, alongside shifting expectations for renewed Fed easing, have reduced concerns over the narrowing policy rate spread with the U.S., increasing Banxico’s room to continue normalizing policy without jeopardizing financial stability. At the same time, sovereign risk indicators have improved notably, contributing to a decline in long-term yields. The minutes of the August meeting reinforced this view, showing broad support within the Board for further rate cuts. While the overall tone remained data-dependent, several members clearly continued to lean dovish. One emphasized the need to “proceed firmly within monetary policy’s room for maneuver,” citing slack conditions, while another noted that “both the relative and absolute monetary stances provide room for additional adjustments.” A third highlighted expectations of rising slack and further labor market cooling, justifying continued easing. Notably, no member echoed Heath’s hawkish stance or shared his skepticism about the inflation outlook. Overall, the Board appears increasingly confident that policy can be eased further to guide rates toward a clearly neutral stance without compromising financial stability. Moreover, neither the financial system nor corporates carry significant exchange rate mismatches on their balance sheets, a fact evidenced last year when the MXN depreciated by about 20% without causing any meaningful impact on financial stability.

We expect Banxico to deliver a 25bp rate cut this week and to signal that the easing cycle still has room to continue. A 4-1 vote is likely, with Deputy Governor Heath again dissenting in favor of a pause. As it continues to approach a neutral stance, the Board is likely to maintain its strategically ambiguous forward guidance—reiterating a data-dependent approach while keeping all options on the table. The ex-ante real rate will remain in restrictive territory following the rate cut, just about 20 bps above the upper bound of Banxico's estimated short-term neutral range, but still roughly 100 bps above its 2.7% midpoint estimate (Figure 4). In our view, further easing toward at least the midpoint remains warranted. Domestic demand is weak and will likely support a further deceleration in core inflation, which has recently shown signs of gradual improvement. On top of this, external constraints have eased amid renewed Fed dovishness and stable financial conditions. Against this backdrop, Banxico can continue guiding rates toward a more neutral stance without compromising its inflation target or financial stability anchors. We thus maintain our call for a year-end policy rate of 7.0%.

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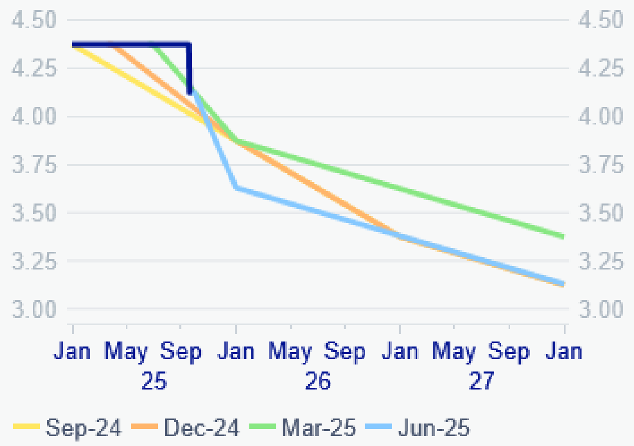
The median FOMC participant now expects two more cuts this year in Oct and Dec

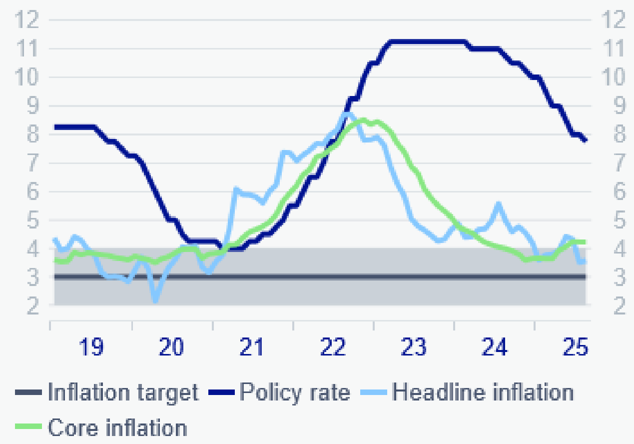
FIGURE 1. FOMC PROJECTED FED FUNDS RATE (%)



Source: BBVA Research / Fed

Core inflation has remained stable at 4.2% y/y in recent months, slightly above target

FIGURE 2. INFLATION AND BANXICO POLICY RATE (%)



The shaded area indicates the inflation target range
Source: BBVA Research / INEGI / Banxico

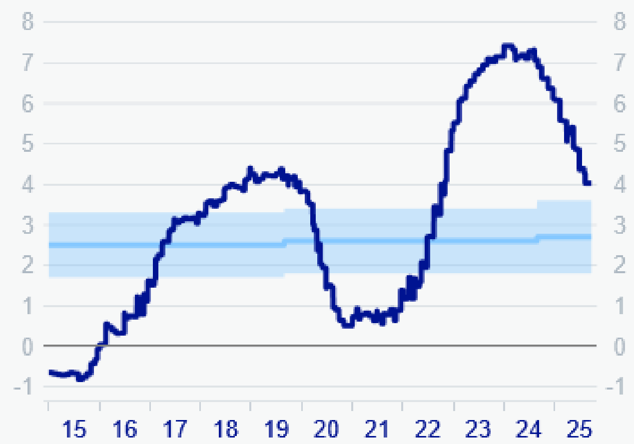
The peso has continued to appreciate, bringing year-to-date gains to 11%

FIGURE 3. S&P BMV IPC INDEX AND USDMXN (THOUS. INDEX POINTS AND PPD)

Source: BBVA Research / BMV / Macrobond

Further easing toward Banxico's neutral rate midpoint estimate remains warranted

FIGURE 4. REAL EX-ANTE POLICY RATE (%)



The shaded area indicates Banxico's estimated interval for the short-term neutral rate in the long term; the solid aqua line indicates the midpoint estimation. Source: BBVA Research / Banxico / INEGI

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