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Banxico cuts to 7.00% and signals a pause in the easing cycle

Javier Amador, Iván Fernández, Carlos Serrano

It stuck to optimistic inflation forecasts, though the Board itself signaled further revisions ahead

Banxico delivered a widely expected 25bp rate cut, to 7.00%, and clearly signaled that the easing cycle is now effectively on hold, though not yet over. The Board continued to note the weakness of economic activity, which is expected "to have remained weak in the fourth quarter of 2025," with "the environment of uncertainty and trade tensions" still identified as the most significant sources of downside risks. With the policy rate now in neutral territory, Banxico kept an easing bias, but a greater focus on short-term inflation risks and changes to its forward guidance gave the policy statement a less dovish tone. Beyond the reasons for greater caution associated with the persistence of services inflation, which explained the upward revision to short-term inflation forecasts (see below), Banxico explicitly addressed the uncertainty surrounding the inflation shock expected in early 2026 stemming from recently approved fiscal measures (IEPS changes and tariffs), which "are estimated to have a temporary effect, not necessarily proportional, on prices." On that front, Banxico warned that "a comprehensive assessment of their impact will require incorporating additional information as it becomes available […] and will evaluate updating the inflation forecast to reflect the effects associated with said measures more accurately," pointing to further revisions to its inflation forecasts ahead.

Banxico modestly revised up its short-term inflation forecasts, while still projecting convergence to the 3.0% target by 3Q26, a timeline that is set to be revised soon. Headline inflation projections were revised up by only 0.2 pp in both the current and the next quarter (to 3.7%), and by 0.1 pp in 2Q26. Core inflation forecasts were adjusted by the same magnitude over the same horizons, to 4.3%, 4.0% and 3.4%, respectively, revisions that Banxico explained as reflecting "mainly a more gradual-than-expected reduction in services inflation," rather than a materially worse outlook stemming from core non-food goods inflation, which accounted for the main upside surprise in November's INPC print. Banxico's upward revision of inflation forecasts seems nowhere near sufficient and still overlook the temporary uptick we expect in 1Q26, as they flagged. Moreover, it is puzzling that Banxico left unchanged its headline and core inflation paths from 3Q26 onward, when inflation is still expected to converge to the 3.0% target despite the anticipated supply shocks. However, the nuance provided by the central bank's acknowledgment that it has yet to fully incorporate the impact of fiscal adjustments set to take effect in coming weeks suggests that these projections should not be taken at face value, as they are going to be revised toward a later and more realistic

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convergence to the target.

The forward guidance clearly signaled a pause in the easing cycle, while leaving the door open to further adjustments. Looking ahead, Banxico stated that “the Board will evaluate the timing of additional adjustments to the reference rate,” replacing its previous guidance that it would “evaluate reducing the reference rate.” This shift in wording—while expected—marks an important change for the policy outlook, suggesting that: i) the room for near-term rate cuts has been exhausted in light of the expected inflation uptick, and ii) any further moves will be data-dependent. While the door to cuts is likely to remain shut in 1Q26, with our expectation of headline inflation averaging 4.3% on average and core inflation at 4.5-4.6%, it could gradually begin to reopen in 2Q26 amid much lower monthly inflation prints and pronounced weakness in domestic demand. The deliberate ambiguity around the “timing of additional adjustments” is likely aimed at preserving flexibility and signaling a near-term pause. Once near-term inflation risks fade, this language leaves open the possibility for Banxico to use any remaining easing space to bring the policy rate closer to the midpoint of its estimated neutral range, which after today’s rate cut, still lies about 30 bps away in real ex-ante rate terms.

Looking ahead, we continue to expect Banxico to remain on hold in the coming months, as it assesses the temporary shocks anticipated in early 2026. Overall, the outcome of this meeting was broadly in line with our pre-meeting expectations. The main deviation from our baseline scenario lies in Banxico’s inflation forecasts which are not yet consistent with the most likely outlook (Figures 1 and 2), though Banxico explicitly acknowledged that it has yet to fully incorporate the impact of recently approved fiscal measures. In our view, this makes the projected convergence to the 3.0% target at that horizon overly optimistic, and we expect these forecasts to be revised upward. Once these risks fade, and provided that domestic demand will continue to face headwinds—including ongoing, albeit softer, fiscal consolidation, as well as the uncertainty around next year’s USMCA revisions—we believe the central bank will still have scope to resume gradual rate cuts later in 2026 (in June and September, 25 bps each), ultimately bringing the policy rate closer to the midpoint of its estimated neutral range, around 6.50%.

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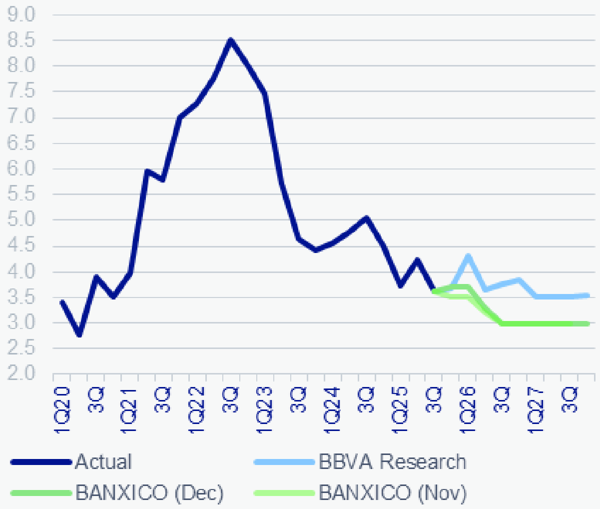
Banxico's upward revision of inflation forecasts seems nowhere near sufficient…

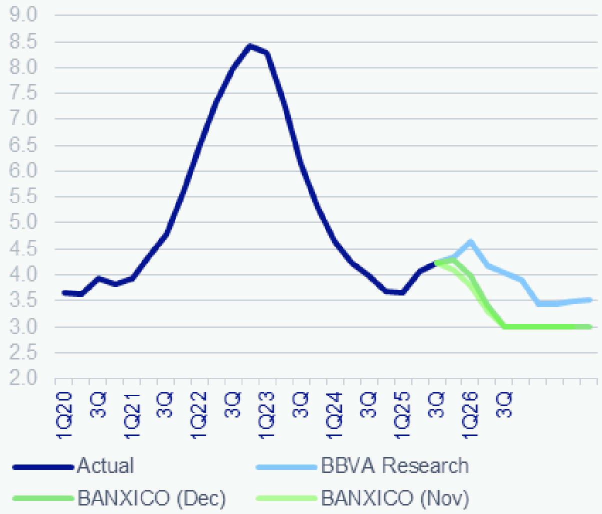
FIGURE 1. HEADLINE INFLATION OUTLOOK (YOY % CHANGE)



Source: BBVA Research / Banxico / INEGI

… and still overlook the temporary uptick we expect in 1Q26

FIGURE 2. CORE INFLATION OUTLOOK (YOY % CHANGE)



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