BBVA Research

Banxico delivers surprise cut, signals prolonged pause

Javier Amador, Iván Fernández, Carlos Serrano

The upcoming minutes may shed light on Banxico's perceived macroeconomic benefits of this unexpected 25bp adjustment

In a split 3-2 decision, Banxico unexpectedly cut its policy rate by 25 bps to 6.25%, while signaling that the move is a one-off adjustment ahead of an extended pause. The Board argued —in a backdrop of strengthening growth and a weakening peso— that "under the prevailing slack conditions, the pass-through of exchange rate fluctuations to consumer prices would be limited", while stressing that "no demand-side pressures are currently perceived" and that past monetary restraint "continues operating." Through August, Banxico had indicated that it would "be appropriate to maintain the reference rate at its current level." In September, the Board noted that future decisions would hinge on the disinflation process and its underlying drivers, while stressing that Banxico need not move in lockstep with expected Fed hikes —giving policymakers the flexibility to stay on hold. Now, following a puzzling rate cut, the forward guidance has become much more explicit. The wording explicitly states that keeping the newly "attained" 6.25% rate unchanged "for an extended period" would support inflation convergence and help address external macroeconomic challenges. This clearly signals that today's rate cut is a one-off. We expect the upcoming minutes to shed some light on the rationale of an ill-timed rate cut, and to reveal why the three members that voted for a cut are markedly more comfortable holding at 6.25% than they were at 6.50%. It is hard to see why such a marginal cut would suddenly inspire that level of policy conviction to now explicitly signal an extended pause. Market reaction was subdued. The peso initially depreciated around 0.5% to 18.85 pesos per dollar before erasing losses, suggesting that for now investors largely accepted the trade-off between a surprise cut and a prolonged policy pause.

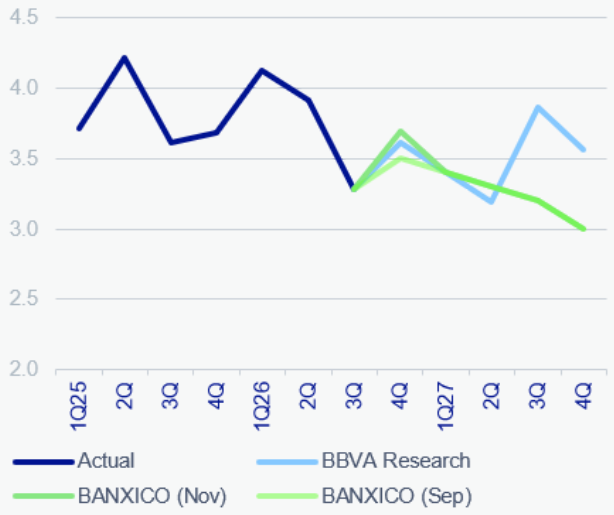
Banxico's confidence in the ongoing disinflation process appears stronger than recent inflation data and its own updated forecasts would suggest. The Board emphasized that "the disinflation process continues," even while saying that annual core inflation had declined marginally in the intermeeting period, from 3.79% in the first half of September to 3.78% in the first half of October, when they could have said that it moved mostly sideways. It is actually set to edge from 3.75% in September to 3.78% when October's print is released tomorrow. Moreover, Banxico revised slightly up its core inflation forecast for 4Q26 to 3.7% from 3.6%, likely reflecting the persistent stickiness of services inflation. We think they fell short, our own forecast is 3.8%. Still, the Board left the expected convergence to the 3.0% target in 4Q27 unchanged. The balance of risks remained tilted to the upside, with peso depreciation moving to second place among upside risks, which is consistent with our view that peso dynamics could

become more consequential for the policy rate path should a risk-off shift in global financial markets leads to an even steeper currency depreciation, compounding the +10 pp drop already observed. This, together with a strengthening economy, are at odds with improving inflation outlook. Yet most at Banxico appear confident that prevailing economic slack and the absence of demand-side pressures will allow disinflation to proceed as forecast. The decision will likely fuel criticism. Unlike the Fed chair's insistence that there is "no soft inflation target" and that the central bank will restore price stability with "no ifs, ands, or buts," Banxico's latest decision risks conveying that an inflation rate merely below 4% serves as its *de facto* soft target, risking a de-anchoring of inflation expectations. In our view, policymakers would have been far better off lowering rates to today's level six months ago and signaling an extended pause, rather than delivering an unexpected and ill-timed cut now.

We now expect Banxico to keep the policy rate at 6.25% through end-2027. The upcoming minutes should shed light on what the Board believed it stood to gain from today's surprise move. That question ought to take center stage in the upcoming quarterly inflation report. Given the considerable uncertainty surrounding the neutral real interest rate, it is difficult to establish why 6.25% is materially more appropriate than 6.50%, particularly when the Board itself now signals such high conviction in an extended pause. If today's muted exchange-rate (ER) reaction holds for the next months it will reinforce our view that Mexico can sustain a narrower policy-rate differential with the Fed without triggering disorderly peso movements. The policy spread has now shrunk to 225 bps and could hit 200 bps if the Fed delivers another hike in December. Although the current ER level is close to our fair value estimates, risks are now tilted toward further peso weakness rather than a recovery after the recent overshooting. Still, we believe a more aggressive Fed tightening cycle —not our baseline scenario- would worsen global financial conditions enough to force Banxico to reassess its stance. For this reason, we believe it would have been prudent to adopt a conservative approach and wait for a more favorable juncture to lower rates.

Banxico nudged up its 4Q26 headline and core inflation forecasts…

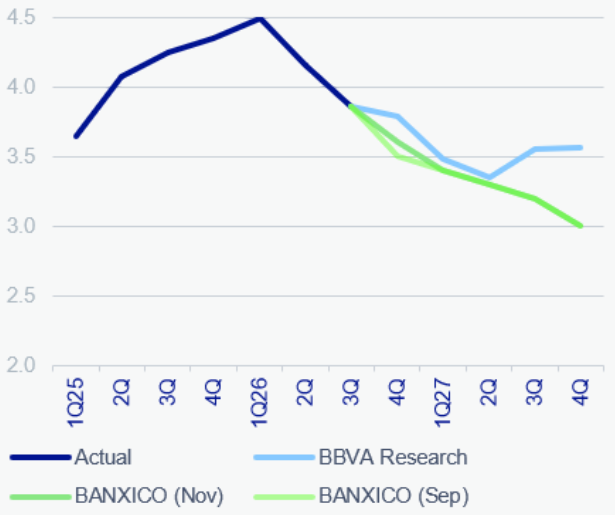
FIGURE 1. HEADLINE INFLATION OUTLOOK (YOY % CHANGE)



Source: BBVA Research, Banxico, INEGI.

… but kept the rest of the projected path unchanged

FIGURE 2. CORE INFLATION OUTLOOK (YOY % CHANGE)



Source: BBVA Research, Banxico, INEGI.

BBVA Research

DISCLAIMER

This document does not constitute an "Investment Recommendation" as defined in Article 3.1 (34) and (35) of Regulation (EU) 596/2014 of the European Parliament and of the Council on market abuse ("MAR"). In particular, this document does not constitute "Investment Research" or a "Marketing Communication" for the purposes of Article 36 of Commission Delegated Regulation (EU) 2017/565 of 25 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms ("MiFID II").

Readers should be aware that under no circumstances should they use this document as a basis for making their investment decisions and that the persons or entities that may potentially offer them investment products will be legally obliged to provide them with all the information they need to make such decision.

This document, prepared by the BBVA Research Department, is for informational purposes and contains data or opinions as of the date hereof, prepared internally or obtained from or based on sources that we consider reliable, without having been independently verified by BBVA. BBVA therefore provides no express or implied warranty as to their accuracy, completeness or correctness.

The content of this document is subject to change without prior notice depending, for example, on the economic context or market fluctuations. BBVA assumes no obligation to update such content or communicate such changes.

BBVA assumes no liability whatsoever for any loss, direct or indirect, that may result from the use of this document or its content.

Neither this document nor its content constitutes an offer, invitation or solicitation to acquire, divest or obtain any interest in assets or financial instruments, nor may they serve as a basis for any contract, commitment or decision of any kind.

The content of this document is protected by intellectual property legislation. Its reproduction, transformation, distribution, public communication, making available, extraction, reuse, forwarding or use of any nature, by any means or procedure, is expressly prohibited, except in cases where legally permitted or expressly authorised by BBVA on its website www.bbvaresearch.com.

Certain content or analytical elements of this document may have been prepared with the assistance of Artificial Intelligence (AI) tools. In all cases, such content or elements have been subject to prior review, verification and validation by the BBVA Research Department. The use of AI tools does not in any way alter the liability regime applicable to the work, the protection granted by intellectual property legislation or the prohibitions on unauthorised use set out in this notice.