

Banxico Minutes – Strong discussions around the persistency of inflation

- Banxico published the minutes of the decision held on August 12th, in which, in line with expectations, they hiked the rate by 25bps to 4.50%
- In line with our view, the tone remains hawkish. The debate about inflation remains in the spotlight. The dissenters, which were Deputy Governors Galia Borja and Gerardo Esquivel, maintained a quite dovish position, resulting in a highly polarized Board
- Among the comments about prices, we highlight that:
 - (1) The hawkish members see relevant risks from the high level of core inflation, including to expectations;
 - (2) Dissenters believe that higher rates are not needed when inflation rises temporarily; and
 - (3) Although most consider that pressures are transitory, the risk of an impact to the price formation process persists
- They acknowledged an important economic recovery in 1H21, but with some headwinds in the short term, keeping an eye on the next normalization of monetary conditions by the Fed
- In this context, a wide discrepancy over the actions from the institution continues, with strong differences between hawkish members, arguing for preemptive actions, and those more dovish, stating that there is no need for adjusting the monetary stance
- We still expect three additional 25bps hikes this year, with the rate ending at 5.25%. For 2022 we see two more hikes of the same magnitude at the start of the year and one more at the end, closing at 6.00%
- Local rates' reaction suggests a market moderating its expectation on rate hikes

The minutes continue to expose a divided Board. Banco de México published the minutes of the meeting held on August 12th, in which they hiked the reference rate by 25bps to 4.50%. In our opinion the tone remains hawkish, with discussions on the outlook for prices remain at the center of debate. As already known, the two dissenters –once again Deputy Governors Galia Borja and Gerardo Esquivel– keep the Board divided. Overall, their preference for keeping the rate unchanged seems to reside on the expectation that high levels of inflation are transitory and will fade in the future, even adding that hikes could give credence to the notion that increases in these could be permanent. On the contrary, most concerned members seem to focus their attention on high levels of core inflation and the need to reduce the risk of mid-term inflation expectations de-anchoring, especially given the possible impact on the price-formation process due to second-round effects. Based on our view of inflation remaining in a complicated spot both globally and locally, and that the Fed will likely start tapering this year, among others, we still expect three additional 25bps hikes in the reference rate this year, taking it to 5.25%. In addition, for 2022 we see two additional increases of the same magnitude at the start of the year and one more at the end, closing at 6.00%.

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Banxico's 2021 policy decisions

Date	Decision
February 11	-25bps
March 25	0bps
May 13	0bps
June 24	+25bps
August 12	+25bps
September 30	--
November 11	--
December 16	--

Source: Banxico

Document for distribution among the general public

Debate on inflation continues, with transience at the center of discussions. In line with expectations, comments on this section were very relevant. Specifically, we believe that the most relevant was the analysis behind current dynamics and risks going forward. On the former, there seems to be greater consensus behind the factors, which include impacts to global supply chains –also driving inflation at an international scale– as well as changes to consumption patterns from households. In this sense, although most seem to come from supply factors, one member suggests that some could also be surfacing from the demand side. In this backdrop, there was also debate on the transience of the shocks. Although most believe these will be transitory, differences among member’s opinions is wide. In our view, the hawkish wing is concerned over the impact this can have on price formation through second-round effects. Nevertheless, dovish members maintain that the effect from these should fade, thus not being a cause for concern. In turn, this is related to the view on expectations, with the first group warning that the increase in short-term ones can contaminate those further along. Meanwhile, the second one believes that medium- and long-term expectations are well anchored. On risks ahead, details on factors to the upside is quite extensive relative to downside risks, consistent with the expected skew by the institution. On the addition of updated inflation forecasts in the last statement, comments were brief, with the convergence now expected in 1Q23. Nevertheless, we highlight the view from one member that “...*these forecasts assume less accommodative monetary conditions over the forecast horizon...*”. We consider that this argument is key to support our view that the hiking cycle will continue in the remainder of the year.

The recovery continues, but still with challenges on the horizon. Banxico’s Board showed a clear consensus by recognizing that Mexico has had a significant recovery in the first half of the year, with a rebalancing of the sources of growth as tertiary activities had greater relevance in recent months. However, they also warned that the recovery continues to be weak and heterogeneous across sectors. Within the components of GDP, a greater consensus was perceived among the members of Banxico on the weakness of investment, as well as the challenges that disruptions in the global supply chain represent for industrial activity (especially the export sector). Nonetheless, there is a greater discrepancy between consumption dynamics, with the majority acknowledging an important recovery, but some differing on the challenges it will face in coming months due to the rebound in the pandemic, among other factors. Regarding the labor market, there is a vision shared by the majority about a recent improvement, although stressing out an interesting discussion about the degree of slack it presents and the expectations for the future. In general terms, the members of the Governing Board have recognized a high degree of uncertainty about the dynamics of recovery in the face of the disruptions that the emergence of new variants of COVID-19 could bring with it, which have so far caused a significant rebound in the contagions curve. Mobility restrictions, adjustments in consumption patterns and companies’ business plans, and the outcome of bottlenecks in the global supply chain are some factors to monitor closely. For this reason, we consider that Banxico will continue to be highly dependent on the economic reports and the emerging evidence.

Banxico will keep a close eye to the challenges for the global monetary policy, with special emphasis on the Fed. The minutes showed a consensus view on the dynamics of global growth, recognizing a recovery that is still underway, but with latent risks of the emergence of new strains of COVID-19 (e.g. the Delta variant). This probably suggests that the inequality in growth rates between countries will continue due to the heterogeneity of the application of vaccines, the evolution of the pandemic and economic policy stimuli. Likewise, Banxico's members recognize that there are significant inflationary pressures in the world, although there is an important debate about how transitory they are and nature of the shocks that have originated them. The implications of this backdrop on the performance of global monetary policy are extremely relevant, mainly in the US. In this context, the Board warned of the possibility that the Federal Reserve Bank would normalize its assets purchase program very soon, being a determining factor for the behavior of financial markets and the reaction of the rest of the central banks.

Strong discussions about the appropriate policy response from the central bank. We must remember that, unlike previous minutes, on this occasion we already knew the identity of the dissenting voters, these being Deputy Governors Galia Borja and Gerardo Esquivel, showing a substantially dovish tone. In our opinion, the division between them and the rest of the Board remains wide, if not exacerbated relative to the previous decision. Broadly speaking, the most hawkish members, these being Governor Alejandro Díaz de León and Deputy Governors Irene Espinosa and Jonathan Heath, continue to be concerned about the dynamics that current shocks may have in future inflation, even despite their transitory nature. On the contrary, the more dovish members argue that the distortions will be temporary, and considering that they are due to supply shocks, it is not necessary to restrict the monetary stance, since doing this can be detrimental for both expectations and economic activity.

Focusing on the first group, we think that Governor Díaz de León mentioned that “...*maintaining a distinctly accommodative monetary policy stance [...] could lead to a de-anchoring of price formation...*”. At the same time, he also focused on the pressures on the core component, citing that in only two episodes (prior to the current one) it had exceeded the level of the reference rate, being 2009 and 2014, both in situations markedly different from the current one. We consider that given this last factor –and with our expectations that inflation dynamics will remain deteriorated–, the Governor will continue to vote in favor of additional rate hikes. For her part, we believe that Deputy Governor Espinosa maintained a similar tone, mentioning “...*that the monetary policy action adopted [...] does not seek to solve the effects of supply shocks, but is rather a fundamental signal that reinforces the commitment of convergence to the target...*”. In addition, she mentioned that if Banxico doesn't act timely, later it may be necessary to make more pronounced adjustments that could incur in higher costs. Finally, we think that, on the sidelines, Deputy Governor Heath was a little less hawkish than in the last decision. Specifically, although he seems to think that “...*if the reference rate is not increased, there would be no convergence in the foreseen horizon...*”, he also mentioned that the new stance could be sufficient for the time being, increasing the data dependency of future decisions.

Also supporting this, he added that Banxico should avoid an overreaction of market expectations in terms of further rate hikes, not necessarily implying a restrictive cycle. Despite this, we believe that conditions will continue to be adverse, suggesting that he will remain supportive of additional increases in the reference rate.

Turning to the dovish wing, Deputy Governor Borja emphasized that the hike would validate expectations of a higher interest rate in the future, reaffirming that the communication of the June decision was “...*controversial*...”. In this sense, she advocated for a better communication guide, especially in a still uncertain environment. Finally, Deputy Governor Esquivel remained critical of the hikes, since “...*an interest rate increase would have no effect on inflation stemming from supply shocks*...” but could compromise the convergence of inflation to the target. This would be derived from the fact that the monetary restriction signal could suggest that the shocks are of a more permanent nature, thus contaminating expectations. Like Borja, he proposes to explain more clearly the nature of the increases and reiterate their transitory nature. In this context, given the absence of new shocks of a relevant magnitude, we do not believe that the position of both groups could change in the short term, probably maintaining split decisions.

We expect the hiking cycle to continue despite a divided Board. In our view, the minutes clearly reflect the high level of uncertainty about the inflation outlook, with very diverse and deep opinions among members. This situation has a direct influence in their call about the best monetary policy stance given the cyclical position of the economy. In this respect, data dependency remains key, especially for Deputy Governor Heath. Among the most recent developments we highlight [the relatively low headline inflation in 1H-August](#), driven strongly by the decline in LP gas prices. We think that the path in this good due to the establishment of price ceilings may be very important for inflation ahead, both because of its direct and indirect (*e.g.* passthrough) effect on other components. Nevertheless, most members will likely remain cautious as core inflation remains on the rise. On the other hand, we will look very closely to Jerome Powell’s speech in Jackson Hole tomorrow. Market focus will be on potential signals about tapering, which we currently see announced in September and starting in December of this year. This is also key in a backdrop in which monetary policy has started to normalize in other countries, mainly emerging markets. In addition, in the last few days we have seen an upward adjustment in the MXN, in our opinion impacted at least in part in anticipation of Powell’s comments on said event.

In this sense it’s important to remember that an additional depreciation of the exchange rate is an additional upward risk for the inflation outlook, which in turn could support more hikes (at least at the margin). It will also be important to see if we have important changes in the macroeconomic outlook –and even in forecasts for inflation, despite Banxico changing them less than a month ago– in the 2Q21 *Quarterly Report*, to be published on August 31st. We think these will be moderate, having little influence on the monetary policy view in the short-term. Based on our view that inflation will remain in a complicated spot, the economy will maintain its recovery in 2H21, and the Fed starting to taper asset purchases later this year, among other factors, we maintain our view unchanged.

In particular, we still expect three additional 25bps hikes in the reference rate this year, taking it to 5.25%. In addition, for 2022 we see two additional increases of the same magnitude at the start of the year and one more at the end, closing at 6.00%. Nevertheless, it is important to mention that given high uncertainty and data dependency, the outlook might change due to unexpected circumstances that impact the path for inflation and its expectations.

From our Fixed income and FX strategy team

Local rates' reaction suggests a market moderating its expectation on rate hikes. The Mexican rates' market experienced a relevant reaction to the minutes, where short- and mid-term securities rallied around 5bps in Mbonos and TIIEs (as much as 10bps for the 1-year TIIE-28 swap) reverting previous pressures of 1-2bps. This performance suggests a market acknowledging comments from Banxico's dovish wing, amid the possible bias the Board could tilt to for 2022. This situation has also validated a market pricing that in the last weeks had moderated regarding the expected hikes to the reference rate. In particular, the curve is currently pricing-in rate hikes for end of 2021 under 60bps from around 70bps a week before, an adjustment that was in part triggered by a compression in global rates and US breakevens last week. The market incorporates a more moderate view for rate hikes this year (two 25bps increases) vs our estimate of three hikes (of the same magnitude). This suggest that the short-end could adjust going forward as economic data -especially CPI- and greater evidence of a Fed normalization soon increases the probability that Banxico's hiking cycle will continue in line with our call. Meanwhile, in our view the Fed's tapering announcement will result in greater financial tension and pressures for US Treasuries, reason why we wait for better entry levels for long positions in long-term Mbonos whose spreads vs American bonds trade markedly wide, suggesting a potential correction soon.

In the FX market, the Mexican peso reacted mutedly to the minutes, holding a price action guided by the global risk appetite at levels close to USD/MXN 20.40 (-0.5% d/d) after reaching up to 20.46 last Friday, its weakest level since June. Recent performance has been determined by a greater US dollar strengthening impacting EM currencies in a widespread fashion, amid a backdrop that looking forward we still expect to be USD supportive, especially as the Fed's monetary normalization announcement takes place. Despite current levels, low conviction on any surprise coming from the Jackson Hole meetings, and next support figures at USD/MXN 20.70, we still see appropriate buying USD in dips for trading purposes.

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