

Banxico preview – Setting the table for a rate hike in September

- Banxico will announce its monetary policy decision this week (August 11) at 2:00pm (EDT)
- We expect the monetary authority keep the reference rate on hold at 4.25%
- However, we expect a hawkish tone in the *communiqué*, in which the central bank will probably emphasize on the following issues:
 - (1) The balance of risks for inflation in the horizon, in which monetary policy operates, has continued to deteriorate, highlighting an upward trend in core inflation;
 - (2) A higher probability of financial volatility on the back of geopolitical risks including the US elections, China's economic and financial situation, and the expectation of further monetary easing from advanced economies; and
 - (3) Lower growth prospects for the Mexican economy, given the moderation of external demand, the contraction in Mexico's mining sector, and low levels of public investment, as a result of recent fiscal consolidation efforts
- Looking ahead, we anticipate that the central bank will increase the reference rate 50bps in September, and then again in December, leaving it at 5.25% by year-end, as we are still forecasting a highly volatile USD/MXN
- The minutes of this meeting will be published on August 25, and the next monetary policy announcement will take place on the 29th of September

No move, hawkish tone. This week, Banxico will hold its sixth policy meeting of the year. The monetary policy *communiqué* will be published on Thursday (August 11) at 2:00pm (EDT). We believe that board members will remain on hold, leaving the reference rate at 4.25%. However, we expect a hawkish tone in the communiqué, in which the central bank will probably emphasize on the following issues: (1) The balance of risks for inflation in the horizon, in which monetary policy operates, has continued to deteriorate, highlighting an upward trend in core inflation; (2) the higher probability of financial volatility on the back of geopolitical risks including the US elections, China's economic and financial situation, and the expectation of further monetary easing from advanced economies; and (3) lower growth prospects for the Mexican economy, given the moderation of external demand, the contraction in Mexico's mining sector, and low levels of public investment, as a result of recent fiscal consolidation efforts.

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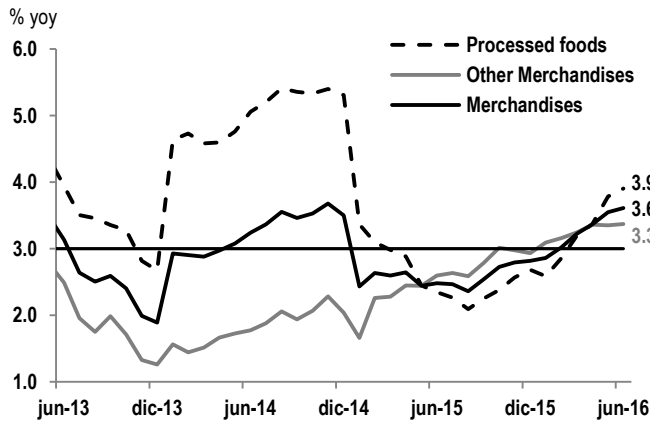
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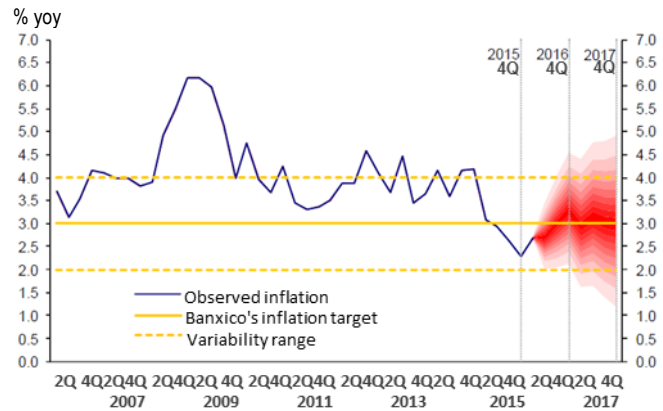
The balance of risks for inflation has continued to deteriorate. Even though Mexico’s headline CPI index has remained below Banxico’s 3% target, most of the board members believe that the balance of risks for inflation has deteriorated. In particular, core inflation has maintained an upward trend, where we highlight the recent acceleration in the merchandise sub-index (refer to the chart on the left). In fact, most of the Board members expressed this concern in the last monetary policy statement. In this context, we believe this week’s monetary policy statement will incorporate Banxico’s concern that there is a possibility that the depreciation of the Mexican currency will exacerbate the growing trend of core inflation, and could affect the trajectory of the non-core sub-index, through energy tariffs, particularly through gasoline prices. However, even though Banxico has expressed a growing concern regarding the deterioration of the balance of risks for inflation, Banxico’s inflation forecast –published in their fan charts–, does not show a significant inflationary risk (refer to the following chart on the right). In this context, we continue to believe that inflation will stand around 3% by year-end.

Merchandise inflation



Source: Banorte-ixe using INEGI's figures

Banxico's inflation forecast: Fan Chart



Source: Banxico

FX volatility. Banxico has strongly highlighted the importance of keeping inflation expectations firmly anchored in line with its 3% target. In fact, most of the board members agreed that the 50bps rate hike in June was justified by the significant depreciation of the Mexican currency, and its potential negative impact on inflation expectations.

Lower economic growth. According to *INEGI's* preliminary GDP report for the second quarter, the Mexican economy grew a scant 2.4%, driven by the slowdown in external demand, coupled with the reduction in public investment given the fiscal consolidation efforts of the Federal Government. However, private consumption has maintained a favorable rate of expansion, as shown in the upward trend of retail sales. In our view, it is likely that the central bank will continue to highlight the risk involved in the current account deficit, given that its financing structure is highly dependable of short-term capital flows.

We expect Banxico's next rate hike in September. Taking into consideration that Banxico has not only made explicit references to possible geopolitical events that could increase the volatility of financial markets –including the US elections–, but also taking into consideration the deceleration of the Mexican economy, it is likely that the central bank will wait until September to increase the reference, given that this will be the last monetary policy meeting before the US elections. In this regard, we continue to believe that the central bank will increase the reference rate 50bps in September, and then again in December, leaving it at 5.25 % by year-end.

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