

Banxico preview – The central bank will implement a 50bps preemptive hike

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- **Banxico will announce its monetary policy decision tomorrow at 2:00pm (EDT)**
- **We believe Banxico will hike the reference rate by 50bps**
- **We have observed a higher pass-through effect of the depreciation of the Mexican currency to prices during the last two months**
- **In addition, the higher volatility in the MXN could induce a deterioration of inflation expectations**
- **We expect that within the *communiqué*, 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 given the higher pass-through effect of the depreciation of the MXN to prices;**
 - (2) **A higher probability of financial volatility on the back of geopolitical risks, including the US elections; and**
 - (3) **The necessity to adapt Banxico's monetary policy in order to prevent that the depreciation of the Mexican currency and the adjustment in relative prices translate into a deterioration of inflation expectations**
- **Looking ahead, we anticipate that the central bank will increase the reference rate 50bps 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 October 13, and the next monetary policy announcement will take place on the 17th of November, 9 days after the US elections**

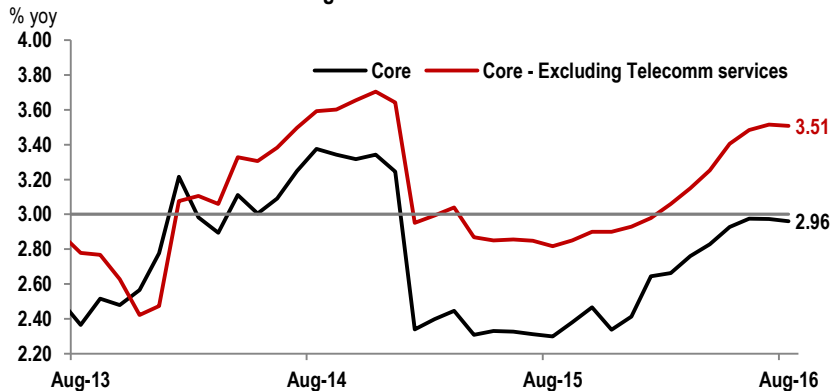
50bps rate hike. Tomorrow, Banxico will hold its seventh policy meeting of the year. The monetary policy *communiqué* will be published at 2:00pm (EDT). We believe that board members will increase the reference rate by 50bps to 4.75%. In particular, we have observed a higher pass-through effect of significant depreciation of the Mexican currency to prices during the last two months. In addition, the higher volatility in the MXN could induce a deterioration of inflation expectations.

Within the *communiqué*, 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 given the higher pass-through effect of the depreciation of the MXN to prices; (2) a higher probability of financial volatility on the back of geopolitical risks, including the US elections; and (3) the necessity to adapt Banxico's monetary policy in order to prevent that the depreciation of the Mexican currency and the adjustment in relative prices translate into a deterioration of inflation expectations.

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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, we 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 core index excluding telecommunications services (refer to the chart below). In fact, most of the Board members expressed this concern in the last monetary policy minutes. In this context, we believe this week’s monetary policy statement will incorporate Banxico’s view 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.

Core Inflation: Total and Excluding Telecommunication Services



Source: Banorte-ixe; INEGI

In addition, we believe that the recent evolution of several economic indicators suggests that Banxico’s assessment of the prevailing slack in the economy could be overstated. The current account deficit –which can be interpreted as the difference between an economy’s total expenditure relative to the income generated– amounts 3% of GDP, its highest level since the 1994 economic crisis. Similarly, the unemployment rate has maintained a downward trend, while most of the economic indicators associated with private consumption –such as family remittances and retail sales–, has sustained a significantly higher growth, compared to the overall Mexican economy. Furthermore, alternate estimations of Mexico’s output gap suggest that it has remained positive, not only during the first half of 2016, but over the past two years (*for further information refer to our research note: “Mexico: How big is the slack in the Mexican Economy?” [\[here\]](#)*).

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. In addition, in the minutes of their last monetary policy meeting, several board members agreed that Banxico's monetary policy tightening in June helped to stabilize inflation expectations, which was reflected in the flattening of the yield curve

We expect Banxico's next rate hike in December. 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–,we continue to believe that the central bank will increase the reference rate by 50bps in December leaving it at 5.25 % by year-end.

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