

Banxico preview – We expect a 25bps hike in December

December 16, 2015

- Banxico will announce its monetary policy decision tomorrow (December 17) at 2:00pm (EST)
- We expect that Banxico will decide to increase by 25bps the reference rate
- Thus, the new reference rate will stand at 3.25% from 3% in October
- We highlight that Banxico's rate hike will take place right after the Fed starts its hiking cycle
- We believe that Banxico will justify the rate hike given Mexico's relative monetary conditions, particularly with the U.S. despite the absence of inflationary pressures and moderate growth
- The minutes of this meeting will be published on December 31, and the next monetary policy announcement will take place on February 4

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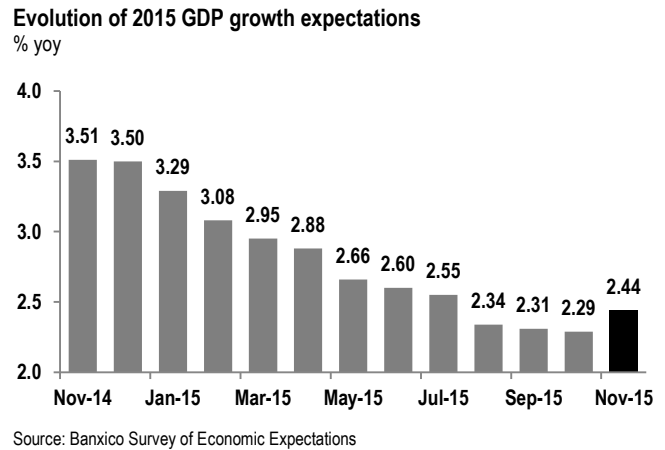
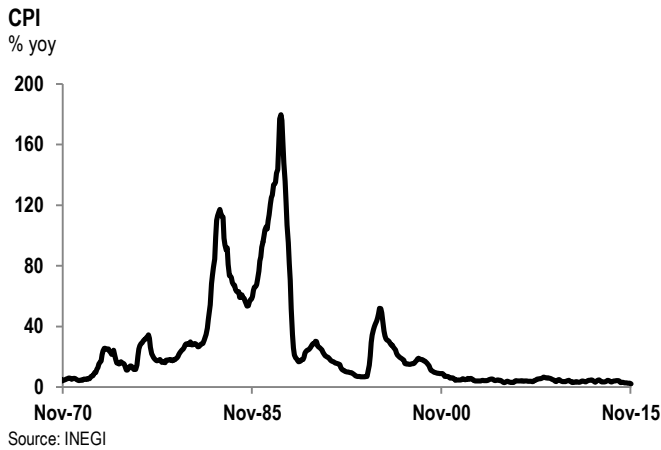
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25bps rate hike after a 18-month pause. Tomorrow, Banxico will hold its final monetary policy meeting of the year. The monetary policy *communiqué* will be published on Thursday (December 17) at 2:00pm (EST). We believe that board members will decide to increase by 25bps the reference rate, as it is widely expected. Thus, the new reference rate will stand at 3.25% from 3%.

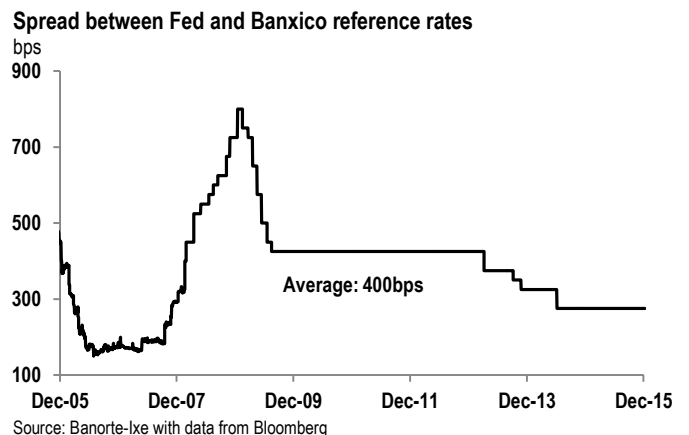
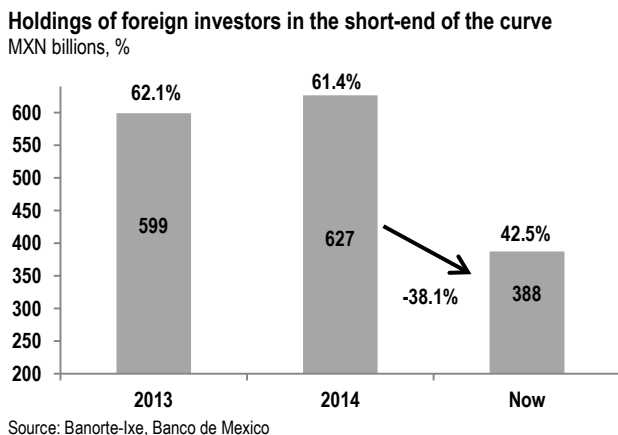
We highlight that the last time that Banxico raised the reference rate was in August 2008, and the last downward movement was in June 2014. This implies that the reference rate has stood at 3% for 18 months consecutive months. In addition, Banxico's rate hike will take place just a day after the Fed starts normalizing rates in the United States today. We believe that the Board will justify the increase, given the importance of Mexico's relative monetary conditions, particularly with the U.S., despite the absence of inflationary pressures and moderate economic growth.

Moderate growth and low inflation. Given Mexico's slow economic growth, the absence of inflationary pressures, and the Fed's current monetary policy, common sense would dictate that Banxico should not raise the reference rate, until the Fed begins its hiking cycle. Inflation is at historically low levels (refer to the chart on the left), and even though Mexico's economic growth has been higher in 2015, growth expectations have been continuously revised downwards (refer to chart on the right). Similarly, Mexico's economic outlook is not encouraging in 2016. The current situation of low crude oil prices given Mexico's heavy dependence on oil revenue (~25%), the government's commitment to reduce the fiscal deficit to 0.5% of GDP in 2016, and the new fiscal regulations that will affect Mexico's federal entities and municipalities accounts, will translate into a lower public spending, hindering 2016 GDP's growth below 3%.

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Rate hike in Mexico, despite sluggish activity and low inflation. Despite moderate economic growth and low inflation, we believe that an increase in the U.S. reference rate is a sufficient condition to trigger a rate hike in Mexico – despite the fact that economic activity has been sluggish and that inflation could converge to the 3% target this year-, given that the holdings of foreign investors in the short-end of the curve is elevated (refer to the following chart on the left), making even more relevant the spread between Mexico’s reference rate and the *Fed funds* rate, as shown in the chart on the right. In this regard, given that Mexico continues to be a small and open economy, Banxico does not manage the reference rate in absolute terms but, given the global influence of the U.S. monetary policy, it only sets the spread between Mexico’s rate and the U.S. *Fed funds* rate. Thus, if the U.S. Fed decides to hike its rate in December, almost independently of Mexico’s economic cycle and inflation, Banco de Mexico “will have to maintain” the differential between the interest rates in both countries. Particularly given that not doing it could trigger a significant and erratic depreciation of the Mexican peso against the dollar.



In summary. While Banxico's central scenario seems to be of economic activity weakness and inflation below target until year-end, the prospects of higher rates in the United States pose a significant risk to exchange rate and inflation levels in Mexico. Given this, we believe that Banxico will start its hiking cycle when the Fed begins its own normalization of monetary policy next today. Looking ahead, we believe that Banxico will follow the Fed in its monetary tightening cycle, but Banxico's monetary stance could diverge from the Fed's if the business cycles between both countries show major differences.

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