

## Banxico preview – Focusing on relative monetary conditions

- Banxico will announce its monetary policy decision tomorrow at 3:00pm (EDT)
- We expect the monetary authority to keep the reference rate unchanged at 3%
- We believe that the board will maintain a hawkish tone in the *communiqué* that will accompany the monetary policy decision
- In our view, the most important factor to focus on Banxico's *communiqué* will be any comments on “*relative monetary conditions*”, particularly with respect to the U.S., and the depreciation of the Mexican currency
- We believe that the tone of the statement will provide support to our call (and consensus) that Banxico will begin a hiking cycle in 2H15
- The minutes of this meeting will be published on April 9, and the next monetary policy announcement will take place on April 30

**Monetary policy decision on Thursday: Rate unchanged, but hawkish tone.** This week, Banxico will hold its second monetary policy meeting of the year. The monetary policy communiqué will be published on Thursday (March 26) at 3:00pm (EDT). We believe that board members will decide to leave the reference rate at 3%, as it is widely expected. Nonetheless, we believe that Banxico will maintain a hawkish tone in the statement accompanying the decision, denoting a greater bias towards hiking.

**Rate hike in Mexico, despite sluggish activity and low inflation.** The latest US Fed's monetary policy statement suggests that the FOMC is about to start normalizing monetary conditions in the United States. In our view, a rate hike in the US will trigger a similar action from Banxico (current reference rate is at 3% since March 2014). In fact, 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, making even more relevant the spread between Mexico's reference rate and the *Fed funds* rate.

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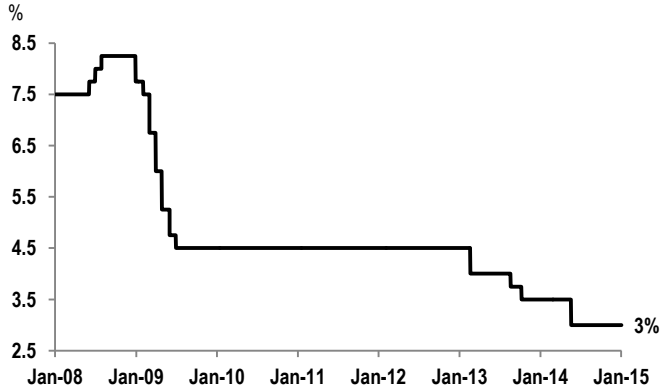
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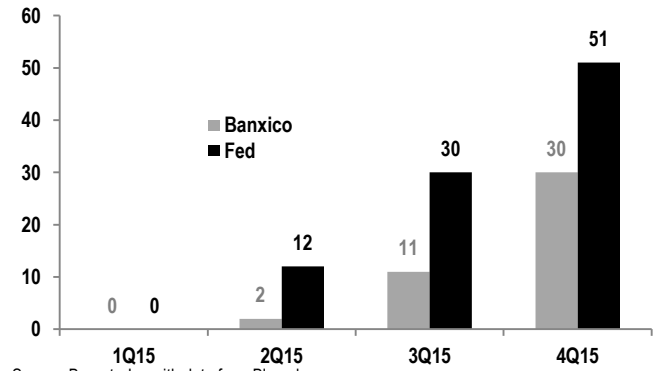
**Banxico's reference rate**



Source: Banco de Mexico

**Cumulative implicit movements in reference rates**

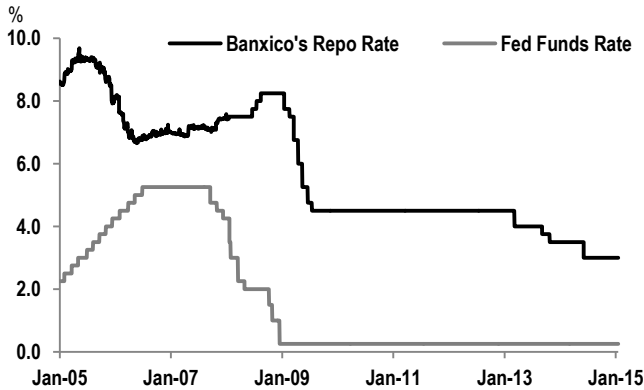
Basis points, using interest rate futures



Source: Banorte-Ixe with data from Bloomberg

**Interest rate differential between Mexico and the U.S.** 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 (refer to the chart below). Thus, if the US Fed decides to hike its rate in June, 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.

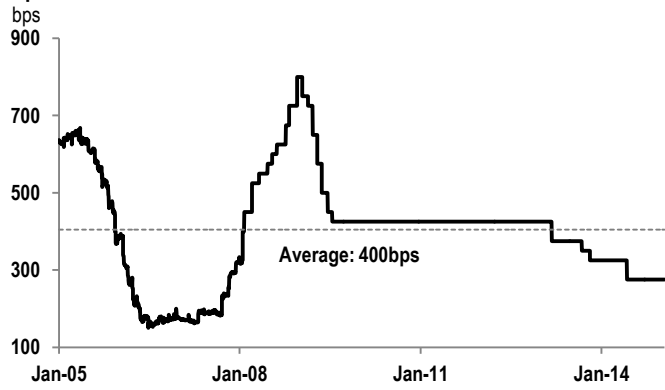
**Fed and Banxico reference rate\***



Source: Bloomberg, Banco de Mexico

\* Previous to 2008 effective repo rate, Fed: funds rate upper bound

**Spread between Fed and Banxico reference rates**



Source: Banorte-Ixe; Bloomberg

**To sum up.** Given that economic activity in Mexico will expand at a higher rate this year (*vis-à-vis* last year) and that the US Fed will raise the *Fed funds* rate (probably in June), we consider it highly likely that Banxico will also start a hiking cycle (in July), even though inflation in Mexico will be around its 3% target. In this regard, we believe that the restrictive monetary cycle will be of 100bps in 2015. Finally, we believe that the hawkish tone in the communiqué will be reflected in: (a) A much more optimistic outlook for the US economy, especially in light of the recent economic data, and growth momentum given the lower gasoline prices (in that country); (b) greater concern for the pass-through effect of the depreciation of the peso against the dollar to inflation; and (c) they will probably be more empathic about Mexico's relative monetary conditions, in particular to the U.S., given that it is a key factor to decide Mexico's reference rate path. In this context, we acknowledge that given the global deflationary environment, there is a chance that the US Fed might postpone the beginning of its hiking cycle.

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