

## Banxico minutes – Monetary authority could hike rates even if the Fed postpones its first rate lift-off

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- Banxico published today the minutes of its monetary policy meeting held back in July 30, in which the board decided to leave the reference rate on hold at 3%
- We highlight the following features of the meeting:
  - (1) The decision was not unanimous, with one member voting in favor of a 25bps rate hike;
  - (2) Banxico's deputy governor, Manuel Ramos Francia, was not at July's meeting; and
  - (3) The Minister of Finance, Luis Videgaray, was at the monetary policy committee in question
- In our view, the most important issues discussed were:
  - (1) The balance of risks for growth in Mexico, which deteriorated over the inter-meeting period;
  - (2) The balance of risks for inflation that improved from previous meeting, but with upside risks in the medium term; and
  - (3) Strong discussions on the need to act preemptively, even before the Fed's first lift-off
- In our opinion, despite a dissident vote, the minutes kept the same tone we perceived in the last *communiqué* given that Banxico's monetary policy is "tied" to the Fed's decision, with the majority of board members arguing that the costs of anticipating any Fed action are far greater than the benefits
- As a result, we continue to believe that Banxico's next move will be a rate hike, immediately after the Fed's lift-off in September

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**Monetary policy unchanged with a dissident member.** Banco de Mexico just published the minutes of its monetary policy meeting held back in July 30, in which the board decided to leave the reference rate on hold at 3%. We highlight that one member was in favor of a 25bps hike in July, while other three members voted in favor of leaving the rate unchanged. Deputy Governor, Manuel Ramos Francia, was absent the day of the vote.

**Luis Videgaray, Minister of Finance, was as at the meeting.** For the past six years, a representative of the Ministry of Finance is invited to Banxico's monetary policy meetings. Normally, the Minister of Finance, Luis Videgaray, appears once a year, being the last time the meeting of January 29, 2015. On this particular occasion, the appearance of Mr. Videgaray is explained in the context of the announcement of the changes in the daily dollar auctions made by the *Foreign Exchange Commission*, which is headed by the MoF.

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**Moderate growth, low inflation and strong debate regarding the timing of Banxico's normalization process.** In our opinion, despite the vote favoring a rate hike, the minutes kept the same tone we perceived in the last *communiqué*. In this context, we highlight that the most important issues discussed were: (1) The balance of risks for growth in Mexico, which has deteriorated over the inter-meeting period; (2) the balance of risks for inflation that improved from previous meeting (inflation will fluctuate below 3%), but with upside risks; and (3) we perceive a strong debate within Banxico's board members about the inherent risks for its own monetary policy cycle, if they were to start hiking rates before the Fed does.

**The balance of risks for growth has deteriorated.** All board members agreed that the balance of risks for the Mexican economy has deteriorated. While most of the members recognized that private consumption has shown an improvement, they also acknowledged that other indicators such as those associated with the non-automotive manufacturing industry, mining and construction continued to show a poor performance. In this context, one member stressed out that despite the sharp depreciation of the Mexican currency, Mexico's manufacturing production was affected by the contraction of this same sector in the U.S., during the first half of the year. Similarly, several members commented that the economy is expected to continue showing a negative output gap, and this situation should prevail at least until 2016. In this context, we highlight that Banxico already revised down its growth estimates for 2015 (to a range of 1.7% to 2.5% from the previous one of 2% to 3%) in its *Quarterly Inflation Reportk* released yesterday.

**The balance of risks for inflation has improved, but there are still upside risks.** Most board members agreed that the balance of risk for inflation has improved from the previous meeting. In particular, all members agreed that the pass-through effect from the depreciation of the Mexican currency to prices has been limited, and that inflation will remain below 3% target for the remainder of the year. Nevertheless, they discussed some upward risks in the medium term.

**A vote in favor of a 25bps rate hike.** In contrast with monetary policy decisions in the recent past –when decisions were unanimous-, one member argued in favor of a rate hike as soon as in the meeting in question. In particular, he said that amid the likely actions by the U.S. Fed, Banxico's board should take a preemptive stance. In particular, he argued that such a stance could avoid making more aggressive changes to monetary policy afterwards, and that it would help mitigate doubts about the future evolution of relative monetary conditions between Mexico and the United States.

**Higher costs of acting before the Fed.** Even though one board member argued in favor of anticipating the Fed's decision, other member mentioned that a preemptive adjustment is not convenient amid a scenario with low levels of inflation, a sluggish economic activity, along with the uncertainty regarding the Fed's normalization process and its potential impact on Mexico's economy. This member highlighted that in the event of new outbreaks of volatility, the board could use other mechanisms such as the foreign exchange market's liquidity provision mechanism. Nevertheless, he acknowledged that in the event of disorderly adjustments in the financial markets that could jeopardize Banxico's control of inflation and financial stability, the central bank would have to act expeditiously, even if the Fed had not started its monetary normalization process.

**We maintain our view that the central bank's next move will be a hike, immediately after the Fed.** 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's next move will be a rate hike, immediately after the Fed starts its normalization of monetary policy in September 16-17. This implies that the central bank could be raising rates at its next regular meeting on September 21.

**Banxico's board is concerned about a disorderly depreciation of the Mexican currency.** While Banxico has sent a very clear signal that they still have other mechanisms to protect the Mexican economy to new episodes of volatility, we perceive an increasingly concerned monetary authority about a disorderly adjustment in the exchange rate, and its effect on inflation expectations. In this regard, we cannot rule out a preemptive tightening of Banxico's monetary policy if the Fed's monetary tightening is delayed beyond September. In any case, we still believe that Banxico will keep acting scheduled monetary policy meetings, as Governor Carstens mentioned yesterday during his press conference presenting the *Quarterly Inflation Report*.

*From our fixed income and FX strategy team:*

**Muted markets following Banxico's minutes but acknowledging its concerns on global dynamics and relative monetary conditions with the U.S.** Investors showed a muted reaction towards today's minutes, as most of the information portrayed in the document was lagged *vis-à-vis* the QIR released yesterday. However, this publication helped to confirming Banxico's willingness to hike rates in tandem with the Fed despite inflation expectations that remain well anchored and a dubious growth outlook ahead. The fact that one Board member voted in favor of an early 25bps hike will validate the nearly 60bps of implied cumulative hikes priced in the local yield curve by year-end, with a strong likelihood of additional implied increases in coming days. We continue expecting a further flattening of the yield curve with no changes in our view on Mexican bonds from those depicted in our research note "*Banxico's QIR – Slow growth and lower inflation will not stop a rate hike*" [<pdf>](#) published yesterday. The 10-year reference security Dec'24 is experiencing a modest profit taking of 1bp, currently trading at 5.99%, following the dynamics observed in the U.S. Treasuries. In terms of the FX market, the Mexican peso is losing 0.3% on the day to 16.33 per dollar, with no reaction to signals of greater concern about the potential effect of currency losses to inflation and financial stability. The latter is likely to be the main reason behind one member's vote to hike by 25bps. The recent hawkish shift by Banxico has increased short-term rates, while we believe that daily USD auctions have been effective in containing some of the upward pressures to short-term volatilities. This combination could result in greater vol-adjusted carry and give some support to the MXN, particularly relative to other risk-sensitive EM currencies such as ZAR and TRY. We still see an attractive valuation and positioning, so we maintain our positive peso stance for trading purposes despite losses accumulated in the last days. Even so, risk-reward is still not compelling enough given our view that the Fed's first rate hike will be announced in September, so we keep avoiding long directional MXN positions that could be more attractive in case of pressures around 16.50 per dollar.

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