

## Banxico preview – We expect a 75bps rate hike

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- **Banxico will announce its monetary policy decision tomorrow at 2:00pm (EST)**
- **We expect a 75bps rate hike, although we cannot rule out an increase of 50bps as Banxico has already increased the reference rate by 150bps year-to-date**
- **In our view, the effects of the Mexican peso depreciation on inflation levels will be one of the key variables in Banxico's decision process**
- **In this context, 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 the considerable depreciation of the MXN;**
  - (2) **A higher probability of financial volatility on the back of the economic policies that Donald Trump could enact; and**
  - (3) **Banxico's need to adapt monetary policy in order to limit FX pass-through along with second round effects to other prices in the economy**
- **Looking ahead, we anticipate a highly volatile FX market, which makes us forecasting another 75 bps increase in the reference rate in December, leaving it at 6.25% by year-end**
- **The minutes of this meeting will be published on the 1<sup>st</sup> of December and the next monetary policy announcement will take place on the 15<sup>th</sup> of December**

**We expect a 75bps rate hike.** On Thursday, Banxico announce its monetary policy decision at 2:00pm (EDT). We expect a 75bps rate hike to leave the reference rate at 5.5%, although we cannot rule out an increase of 50bps as Banxico has already increased the reference rate by 150bps year-to-date. In this context, we highlight that the range of forecasts is quite wide, given the uncertainty regarding the economic implications of a Trump administration, and the fact that Banxico already reacted aggressively hiking 50bps in an extraordinary meeting back in February and another 50bps after the *Brexit*. In our view, the effects of the Mexican peso depreciation on inflation levels will be one of the key variables in Banxico's decision process, as higher volatility in the MXN could induce deterioration not only in inflation levels, but also in short and medium-term inflation expectations.

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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 the considerable depreciation of the MXN; (2) higher probability of financial volatility on the back of economic policies Donald Trump could enact; and (3) Banxico's need to adapt monetary policy in order to limit FX pass-through along with second round effects to other prices in the economy

**Negative risks for inflation due to FX volatility.** 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. The last inflation reports have shown a higher pass-through effect from MXN to prices –this is evident particularly in the upward trend of core inflation, particularly merchandise prices-. Moreover, the depreciation of the MXN since Donald Trump's victory could generate pressure not only on the consumer price index, but on inflation expectations on the medium and long-term.

**Inflation expectations and demand side pressure.** 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 hike in September was justified by the significant depreciation of the Mexican currency, and its potential negative impact on inflation expectations. 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?" [\[here\]](#)*). Although we expect Donald Trump's victory to have a negative impact on the Mexican economy (*for further information refer to our research note: "The world after November 8th – Revising our macroeconomic framework for 2017-2018" [\[here\]](#)*), current levels of USD/MXN on top of demand side pressures could trigger a disorderly behavior of inflation in the coming months.

**We expect Banxico's a 75 bps hike in December.** The board members have shown complacency with monetary policy actions, which have been effective in order to improve the balance of risks to inflation. In this sense, we consider that Banxico will increase another 75 bps in the reference rate in December, leaving it at 6.25% by year-end. 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. The minutes of this meeting will be published on December 1, and the next monetary policy announcement will take place on the 15th of December.

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