Banxico Watch

A more hawkish Fed means a higher peak for the policy rate in Mexico

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There's a lot of tightening still in the pipeline: Banxico will likely match the (now larger) Fed's expected rate hikes

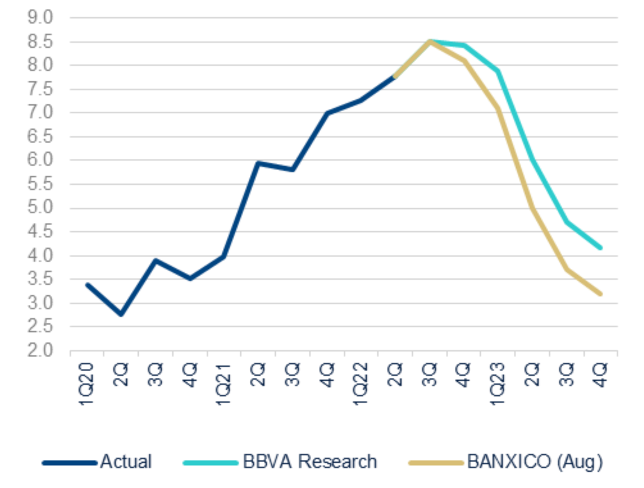
- **Banxico will continue following in the footsteps of the Federal Reserve (Fed) and will lift the policy rate by 75bp, to 9.25%.** Last week, the Fed delivered the third consecutive 75bp hike, taking rates to 3.0-3.25%, as widely expected, but surprised markets with a much more hawkish tone. Deputy Governor Jonathan Heath has made clear that Banxico will continue to match Fed's moves: "the most important indicator we look at is what the Fed is doing". With its actions, matching every Fed movement in this cycle, Banxico has made clear that the majority the Board shares this view (Gerardo Esquivel being an exception). Albeit the Mexican peso has outperformed most currencies since the Fed started its hiking cycle and is likely to weather the dollar strength and risk off global backdrop better, Banxico will likely aim at keeping the current 600bp rate spread unchanged to avoid large capital outflows and a sharp depreciation. Banxico wants to limit potential depreciation risks in a context in which headline inflation has probably not peaked yet with core inflation still pushing higher. The peso has weakened over the last week after the Fed signaled a higher peak for rates, shifting expectations of future hikes (for more see). During the intermeeting period, core inflation rose further (from 7.7% to 8.3% YoY), with both goods and services inflation pushing higher to 10.8% YoY (from 10.2%) and 5.4% YoY (from 5.0%), respectively. Decoupling from the Fed is unlikely, but if Banxico were to make a different move, it would hike more, not less. Thus, we think that albeit the odds are slim, a 100bp hike at this week's meeting is possible. Accompanying its decision, we expect Banxico to revise its inflation forecasts to the upside (see figures 1 and 2).
- **We now expect Banxico to take the policy rate to 10.50% by year-end on a more hawkish Fed and stronger core inflation.** With a Board convinced that it can't afford to de-link from the Fed in the short term, it seems quite clear that Banxico will continue to at least match the (now larger) Fed's expected rate hikes. The updated "dot plot" reinforced Fed's "higher rates for longer" approach: rates need to increase more and stay higher for longer to bring inflation back down to 2.0%. We now expect the Fed to continue to front load rate hikes adding 125 bps worth of additional tightening by December –lifting the target range to 4.25%-4.50%, with hikes of 75bp and 50bp in November and December, respectively. Thus, we think Banxico will follow suit and take the policy rate to 10.50% by year-end, after hiking rates by 75bp this Thursday, 75bp in November and 50bp in December. We think that after a final 25 bps hike in January, the Fed will keep rates unchanged at 4.75% through the end of next year (for more see). We think that Banxico will also match that last hike and take the policy rate to a cycle peak of 10.75%. Early next year will still be soon to decouple from the Fed and allow the interest rate spread to shrink[1]. Yet, real ex ante and ex post real rates will likely be close to 7.0% and 6.0%

[1] "In my opinion we cannot afford to separate for at least the next six months, at least until the end of the year. I wouldn't even consider it," Heath said in a recent interview.

by next summer in a context of easing inflation risks and a likely (much) weaker economy. Thus, we think that by then Banxico should and will shift to a more data-driven approach and start an easing cycle in 3Q, even if the Fed keeps the rate on hold for longer. Therefore, we anticipate that the policy rate will end next year at 10.00% and that Banxico will feel confident enough on the inflation front to speed up the easing pace in 2024 to avoid an unwarranted tightening of monetary policy conditions in a much benign inflation context.

We anticipate that Banxico will revise its headline inflation forecasts upwards…

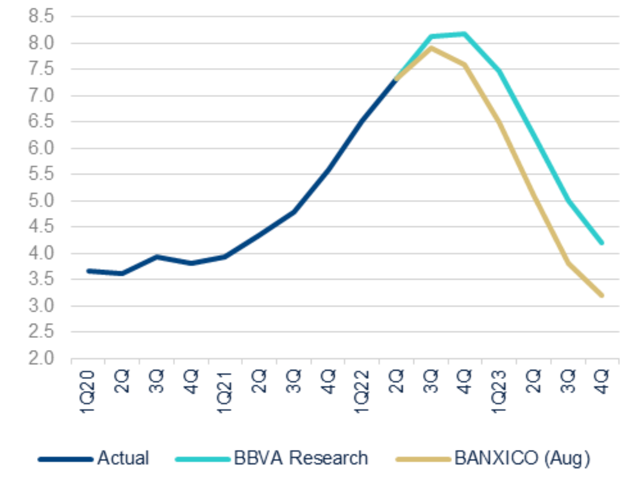
Figure 1. **HEADLINE INFLATION OUTLOOK**
(YoY % CHANGE, QUARTERLY AVERAGE)



Source: BBVA Research based on data by INEGI and BANXICO.

… as well as its core inflation expected path

Figure 2. **CORE INFLATION OUTLOOK**
(YoY % CHANGE, QUARTERLY AVERAGE)



Source: BBVA Research based on data by INEGI and BANXICO.

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