

## Sovereign Macro- Banxico decision and commentary, better late than never

December 16, 2021

Bottom line: in a 4 to 1 vote, Banxico decided to hike its policy rate by 50bp -deputy governor Esquivel voted for 25bp- to a still accommodative 5.5% which is equivalent to a real ex-ante policy rate of 1.4%, still shy of the minimum level of the policy neutrality range of 1.8% to 3.4%. The reasons behind the decision appear to be the hawkish turn of the FED as well as concerns about the upward drift of inflation expectations, the upward revisions to inflation forecasts (yes, they revised them up again though not unexpectedly) and a worsening balance of inflation risks which remain to the upside. Except for the FED's turn, all of these factors were present in the November decision, in which I argued for a 50bp hike. Better late than never. Importantly, Banxico dropped the characterization of "transitory" to describe inflation and the uncertainty about the duration of these effects. Instead, the decision to hike by 50bp seeks to prevent the contamination of inflation more generally – or re-anchor inflation expectations- and to compensate for the impending tightening of global financial conditions as per the FED and BOE decisions. The communique acknowledged in a subtle way that some of the risks to inflation had already materialized and abandoned the strategy to *"reinforce its monetary stance"* and said that *"on this occasion monetary policy is adjusting to its required trajectory to allow inflation to converge to the target of 3% within the policy horizon"*. This leaves the nagging feeling that the decision may be a one off but I choose to go with the interpretation of adjusting the pace because I see a more vigilant attitude of the central bank and a desire to act more decisively to tackle inflation. There are 3 key takeaways. One, is that the piecemeal approach of going meeting by meeting is over and it seems that the board will now give more weight to the policy trajectory and defining a terminal rate. Two, the forthcoming policy decisions will need to address the complex inflation outlook including strong persistence and the rise of inflation expectations, as well as the global outlook. Three, more hikes are coming. While today's decision is a step in the right direction, more needs to be done. With 12-month inflation expectations at 4%, at the very least we are looking at a terminal rate of 6.5-6.75% to only get to neutral. If one considers that Banxico should move to the upper end of the neutral range of 3.4%, then a terminal rate of 7.4% would be required. I am not too ambitious. I have a 4.5% inflation forecast for 2022 and would like to get to the midpoint of the neutral range at 2.6%. I believe that the policy rate should go to 7-7.25% in 2022, the sooner the better. With all the caveats that we know about the new configuration of the board, I am penciling in another 50bp for the February meeting to 6%. A slowing of the pace would be a mistake considering how much ground Banxico needs to cover to normalize policy.

Jaime Valdivia

Sovereign Macro

Founder and Chief economist

[jaime.valdivia@sovereignmacro.com](mailto:jaime.valdivia@sovereignmacro.com)