Latam Daily: All Eyes on Colombia's Monday Policy Meeting; Mexico's Surprise Hike

- **Colombia: Monetary Policy Meeting preview—BanRep expected to hold at 1.75% in a unanimous vote; mindful of hawkish peers in the region**
- **Mexico: A surprise rate hike; June inflation up; and a sluggish recovery in the labour market**

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COLOMBIA: MONETARY POLICY MEETING PREVIEW—BANREP EXPECTED TO HOLD AT 1.75% IN A UNANIMOUS VOTE; MINDFUL OF HAWKISH PEERS IN THE REGION

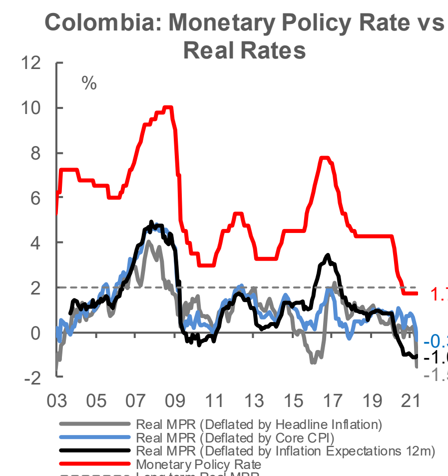
On Monday, June 28, BanRep will hold its regular monetary policy meeting. We expect the Board to keep the policy rate at 1.75%, but begin sending signals on future adjustments. At its April meeting, the Board kept the policy rate at 1.75% (where it has been since September 2020), but did so in a split vote. The lone member who voted for an additional cut of -25 bps had argued that the rate of credit growth to the private sector was below its long-run trend, hence the policy rate could be lower to incentivize borrowing and investment.

For Monday's meeting we expect, along with the market consensus, BanRep to keep the policy rate at 1.75% in a unanimous vote. We note, however, that economic resiliency, higher-than-expected inflation, and an international context with more central banks on the hawkish side, would skew BanRep Board to accommodate its language to a less expansionist side, anticipating a future change in monetary policy in the near term.

Key things to monitor:

- **The Board faces better GDP perspectives and higher-than-expected inflation:** Since its last meeting, the economy continued showing resiliency, and market consensus has improved its GDP growth forecast significantly. Additionally, inflation has strongly rebound and now exceeds the 3% target amid normalization in some prices and temporary factors due to the nationwide strike.
- **Real policy rates are deep on the expansionary side:** Inflation and inflation expectations rebound has pushed real rates to negative levels (chart 1), which would be incompatible with the expected macroeconomic conditions. The Board could therefore send signals on its willingness to start a normalization process in the coming months.
- **Hawkish approaches by other EM central banks should be calibrated against their particular market conditions, for instance:**
  - ◊ **Chile** has seen a more robust recovery but faces potential new lockdowns. Our economist in Santiago noted that these short-term uncertainties are likely to deter any MPR changes at the July and August meetings, supporting the view that the first hike of 25 basis points will occur in October.
  - ◊ **Brazil's** central bank, meanwhile, started its hiking cycle earlier, on the back of a significant rebound in inflation well above target, which is not the case in Colombia.

Chart 1



Sources: Scotiabank Economics, Banrep, DANE.

◊ In **Mexico**, yesterday's unexpected hike to 4.25% was a strategy to contain second-round effects of recent inflation acceleration, which posted significantly higher than its target.

BanRep pays close attention to the more hawkish tone by peer central banks in the region, but recent history shows this is not a strong enough factor to prompt rapid action in Colombian monetary policy. For now, the expected GDP recovery is aligned with the last staff forecast (6% y/y for 2021); while inflation is slightly above target (3.30% versus the 3% target, while 12-month inflation expectation remains close to the target at 2.97%).

We expect the central bank to start its monetary policy rate normalization by September/October 2021. We believe that an early adjustment is unlikely given that uncertainty on key issues remains: 1) the fiscal reform has not yet been approved; 2) there is no firm data yet on the effects of the strikes on economic activity; and, 3) some social tension remains. By September/October, the Board will have a clearer view as economic recovery consolidates and impacts on inflation from protests dissipates. By July's meeting, the Board will also have updated macroeconomic staff projections, hence that meeting will be particularly insightful.

Either way, the IBR swap market is anticipating an early hike, a further signal that could prompt the Board into action. We think a first signal would be a split vote with at least one board member supporting a rate hike. A second signal would surge if BanRep calls again to change its meeting schedule to make rate decisions every month. We assign a low probability to this scenario.

Overall, we believe the Board will still decide to keep the policy rate at 1.75% on Monday as it waits for more data on economic recovery and inflation expectations after the protests. We maintain our call that the BanRep Board will stay on the sidelines for the next two meetings at 1.75%, but will leave a door open to hikes before the 2021-end.

—Sergio Olarte & Jackeline Piraján

MEXICO: A SURPRISE 25 BPS RATE HIKE; JUNE INFLATION UP; AND SLUGGISH RECOVERY IN THE LABOUR MARKET

I. Banxico's Board surprises the market with hike to the benchmark rate by 25 bps to 4.25%, in a 3-2 split vote

As we reported in yesterday evening's *Latam Flash*, the Board of Mexico's central bank voted to raise the benchmark interest rate from 4.00% to 4.25%, in a 3-2 split vote. This followed the sharp increase in inflation in the first half of June, which came in well above expectations—more on this below.

In its recent communiqués, both in the latest minutes and in the Q1-2021 *quarterly report*, Banxico had underscored that the above-target inflation was expected to be a transitory phenomenon and that inflation was expected to return to its 3.0% annual target by the second quarter of 2022. Now, the Board members anticipate inflation to converge to the target one quarter later, in Q3-2021.

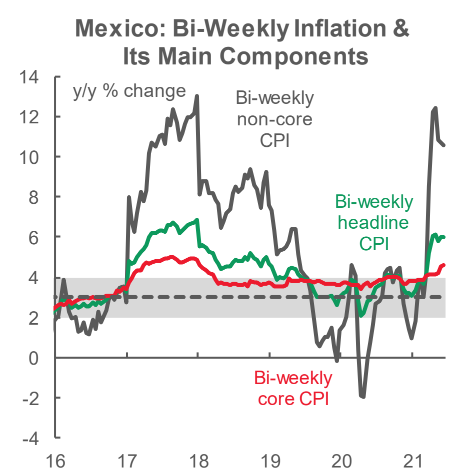
The Board noted that the balance of risks to inflation remains skewed to the upside, while the balance of risks to growth is balanced but with persistent slack conditions in the economy and with marked differences across sectors. In addition to the surge in inflation data and expectations, we believe yesterday's decision took into account the possibility that some emerging market central banks may begin to tighten monetary policy earlier than expected.

With this move, we raise our expectation for the monetary policy rate to 4.50% by the end of 2021, where we previously expected a hold at 4.00%, implying a further 25 basis point hike later this year.

II. Inflation surprised up in the first half of June

According to data released by statistical agency (INEGI) on June 24, annual headline inflation came in at 6.02% y/y (chart 2), significantly higher than the consensus forecast of 5.89% y/y in Bloomberg and up from 5.80% y/y in the previous fortnight, placing it for the sixth consecutive time above the upper limit of Banxico's monetary policy target range. This was an unwelcome surprise as the consensus and the Bank of Mexico itself had estimated that inflation would

Chart 2



Sources: Scotiabank Economics, INEGI.

begin to decline around June and July. For the coming months we expect inflation to remain very volatile and persistently above 4% y/y, our expectation for headline inflation for the end of 2021 rose to 4.73% y/y.

By components, core inflation advanced 4.54% y/y, from 4.51% y/y previously. Merchandise prices showed little variation (5.90% y/y from an earlier 5.91% y/y), in line with persistent disruptions in supply chains. On the other hand, services prices increased—for the seventh consecutive fortnight—from 2.98% y/y to 3.11% y/y, as the service sector continues to reactivate owing to the decline in COVID-19 contagion and progress in vaccination.

The non-core component remained high at 10.60% y/y from 10.69% y/y in the previous fortnight. Energy prices moderated slightly from 14.52% y/y to 13.36% y/y. Meanwhile, agricultural prices went up from 6.09% to 7.22% y/y pressured by supply disruptions due to droughts that affected several regions of the country.

In sequential terms, in the first fortnight of June headline inflation came out significantly higher than anticipated, with a variation of 0.34% 2w/2w, versus 0.20% 2w/2w on average expected in the Citibanamex survey and above our 0.14% 2w/2w expectation. The surprise came from the core component, which accelerated to 0.35% 2w/2w versus 0.20% 2w/2w on average expected, but non-core inflation is not showing convincing signs of a downward trend either.

As for core inflation (+0.35% 2w/2w) pressures persist on the side of merchandise, which rose to 0.42% 2w/2w from 0.26% 2w/2w previously. Meanwhile, services prices also increased from 0.18% 2w/2w to 0.28% 2w/2w driven by increases in the “other services” subcomponent (0.52% 2w/2w vs. 0.29% 2w/2w previous), which includes all sub-sectors relating to restaurants and tourism services.

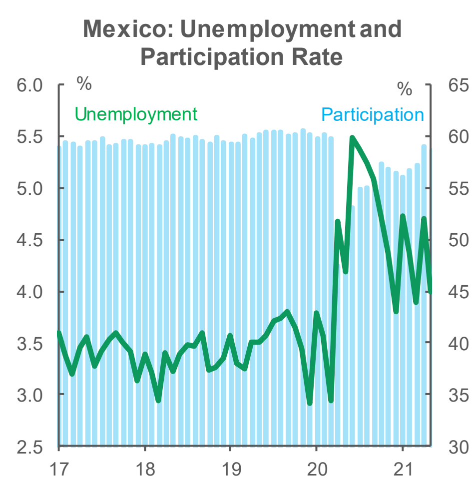
Non-core inflation accelerated to 0.31% 2w/2w from 0.03% 2w/2w previously. The energy subcomponent rebounded, this time from 0.01% 2w/2w to 0.59% 2w/2w, driven by upsurges in domestic gas and electricity prices; while, on the agricultural side, prices rose 0.13% 2w/2w from 0.04% 2w/2w previously.

III. Lower unemployment rate in May, yet also a lower participation rate

A further release by INEGI was the monthly data on its National Survey of Occupation and Employment (ENOE), which showed that in May, the unemployment rate contracted to 4.0% from a previous 4.7% (versus 4.2% a year earlier). However, the participation rate decreased from 59.1% to 58.7% (47.4% a year ago), which still evidences distortions and a slow pace of recovery in the labour market. (chart 3). The survey further reported little variation in the informality rate, at 55.5% from a previous 55.6%.

—Eduardo Suárez & Miguel Saldaña

Chart 3



Sources: Scotiabank Economics, INEGI.