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GLOBAL ECONOMICS

LATAM FLASH

December 18, 2025

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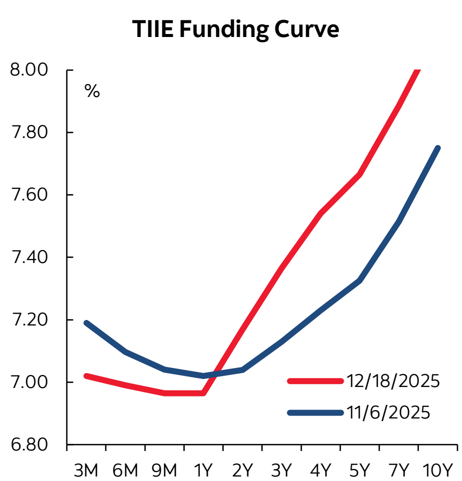
Mexico—Banxico Continues its Rate-Cutting Cycle Despite Inflationary Pressures

- **Banco de México's Governing Board cut the benchmark interest rate by 25 basis points to 7.00%, in line with consensus, following a split 4–1 vote. Headline and core inflation expectations were revised upward for year-end 2025 and the first quarters of 2026.**
- **The statement highlighted signs of moderation in global economic activity during Q4 2025 amid trade tensions and geopolitical conflicts, as well as a weakening in domestic economic activity for the same period, in a context of uncertainty and trade frictions.**
- **Monetary conditions are already in neutral territory, even though inflation and market/analyst expectations remain above target.**
- **The Governing Board's statement suggested that the door is open to pause the rate-cutting cycle. For now, we maintain our outlook for two additional cuts next year, anticipating a terminal rate of 6.50% in 2026.**

Banco de México's Governing Board decided to cut the benchmark interest rate by 25 basis points to 7.00%, in line with consensus, marking the fifth consecutive meeting with a split vote: once again, Deputy Governor Jonathan Heath dissented. This brings the total to twelve consecutive meetings with rate cuts: four 25 bp cuts last year, four 50 bp cuts during 2025, and four 25 bp cuts this year. On the other hand, the Board revised upward both headline and core inflation expectations. The forecast that inflation will converge to the 3.0% target by Q3 2026 remained unchanged, despite upward revisions for prior quarters.

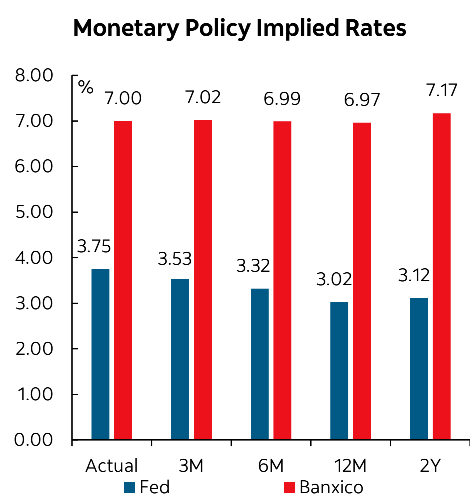
The statement indicated that during Q4 2025, global economic activity showed signs of moderation compared to the previous quarter, in a context marked by trade tensions and geopolitical conflicts. Both global and U.S. economies are expected to post lower growth rates for the remainder of the year and into 2026. In advanced economies, headline inflation has shown mixed behaviour in the second half of the year, while core inflation remains persistently high. In this environment, the Federal Reserve cut its benchmark rate by 25 basis points. Financial markets reacted with limited moves: the dollar depreciated and U.S. government bond yields fell across most maturities. Key global risks include worsening trade tensions and geopolitical conflicts, which could affect inflation, economic activity, and increase financial volatility.

Chart 1



Source: Scotiabank Economics.

Chart 2



Sources: Scotiabank Economics, Bloomberg.

Table 1: Banxico's Headline and Core Inflation Forecasts (%)										
Headline Inflation	**25Q3**	**25Q4**	**26Q1**	**26Q2**	**26Q3**	**26Q4**	**27Q1**	**27Q2**	**27Q3**	**27Q4**
Current (Dec. 25) e.o.p.	3.6	3.7	3.7	3.3	3.0	3.0	3.0	3.0	3.0	3.0
Previous (Nov. 25) e.o.p.	3.6	3.5	3.5	3.2	3.0	3.0	3.0	3.0	3.0	
Var. Current - Previous	0.0	0.2	0.2	0.1	0.0	0.0	0.0	0.0	0.0	
Core Inflation	**25Q3**	**25Q4**	**26Q1**	**26Q2**	**26Q3**	**26Q4**	**27Q1**	**27Q2**	**27Q3**	**27Q4**
Current (Dec. 25) e.o.p.	4.2	4.3	4.0	3.4	3.0	3.0	3.0	3.0	3.0	3.0
Previous (Nov. 25) e.o.p.	4.2	4.1	3.8	3.3	3.0	3.0	3.0	3.0	3.0	
Var. Current - Previous	0.0	0.2	0.2	0.1	0.0	0.0	0.0	0.0	0.0	

Source: Banxico

Domestically, the Board noted that during Q4 2025, economic activity is expected to weaken amid uncertainty and ongoing trade tensions, which continue to pose significant downside risks. It also highlighted that Mexican government bond yields rose across most maturities, while the USDMXN appreciated.

The Board mentioned that between the first half of October and the first half of November, headline inflation in Mexico increased from 3.63% to 3.80% year-on-year, while core inflation rose from 4.24% to 4.43%, mainly driven by higher prices for non-food goods. Market expectations for year-end 2025 and the first two quarters of 2026 were adjusted upward. However, the forecast remains that inflation will converge to Banxico's 3.0% target by Q3 2026 (table 1). Upside risks persist, such as peso depreciation, cost pressures, core inflation persistence, geopolitical conflicts, and climate-related shocks. Conversely, factors like weaker economic activity or USDMXN appreciation could help ease inflationary pressures.

Overall, the risk balance remains tilted to the upside, though less pronounced than in previous years, and changes in U.S. economic policy add further uncertainty to the inflation outlook.

We believe the monetary policy decision reflects a less restrictive stance compared to previous meetings, as a result of the new rate cut. However, it is noteworthy that monetary conditions are now within the neutral range despite ongoing inflationary pressures, mainly from the core component. The statement highlights the dissent, for the fifth consecutive meeting, of Deputy Governor Jonathan Heath, who voted to keep the rate at 7.25%.

A key change in language now states: "Looking ahead, the Board will evaluate the timing for additional reference rate adjustments", contrasting with the previous statement: "Looking ahead, the Board will evaluate reducing the reference rate." This suggests a higher likelihood of a pause, depending on upside inflation risks and the impact of domestic economic weakness on price dynamics, as well as exchange rate movements, labour market conditions, and U.S. inflation. These factors could significantly influence the Fed's next rate decision, which, along with other variables, could close the window for Banxico to continue its easing cycle. In this context, we believe the probability of Banxico ending the rate-cutting cycle at the February 5th meeting has increased, although a 25 bp cut remains our base case. We maintain our expectation of a 6.50% policy rate by year-end 2026, provided the Mexico-U.S. rate spread does not fall below 325 basis points. Finally, to better understand each Board member's stance, it will be particularly relevant to review the minutes of this decision, to be published on January 8th, 2026.

Regarding the market reaction, the exchange rate showed marginal changes after the decision, settling at $18.00 USDMXN. Meanwhile, the TIIE funding curve posted average declines of 3 bps, with the 4-year node showing the largest drop of 10 bps (chart 1). The 3-month implied curve stood at 7.02%, while the 1-year curve was at 6.97% (chart 2). Analysts surveyed expect the policy rate to end 2026 at 6.50%, with responses ranging from 6.00% to 7.00%.