Central Banks

Banxico’s rate cut cycle has legs; a faster easing pace is warranted but Banxico is likely to remain overly cautious

No signs that Banxico is willing to speed up the long overdue easing cycle

Javier Amador / Carlos Serrano

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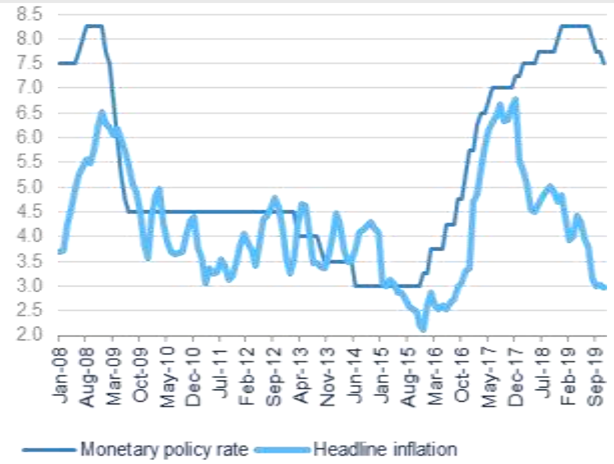
- **All members will vote for a rate cut, we expect a split vote again but a majority of three will vote again for only a 25bp rate cut**
- **A 50bp would be more appropriate but Banxico is unlikely to speed up the easing pace**
- **We expect the policy rate to reach 6.0% by August 2020; a faster easing pace and a looser monetary policy stance are warranted but we expect Banxico to remain cautious**

The rate cut cycle has yet to materially translate into a long overdue less restrictive stance

As can be seen in graphs 1 and 2, the monetary policy rate has stood at the highest level ever vis a vis the prevailing headline and core inflation levels. In our opinion, this implies that Banxico has maintained an excessively restrictive monetary stance given the context of inflation, growth and risks for both. In fact, the real exante monetary policy rate has barely eased even considering the three consecutive 25bp rate cuts already seen (-75bp in total), since 12-month inflation expectations have declined (-)0.5 pp since June, as should have been expected. That is, the monetary policy rate has remained at an overly restrictive level throughout 2018 and 2019, when it could be argued that the monetary policy stance should be not only neutral but accommodative in a context of soft inflation (headline inflation on target and core easing), a relatively stable exchange rate, well-anchored inflation expectations anchored, and with a very weak economy and an increasingly negative product gap.

Graph 1. **Monetary policy rate and headline inflation** (% and YoY % change)



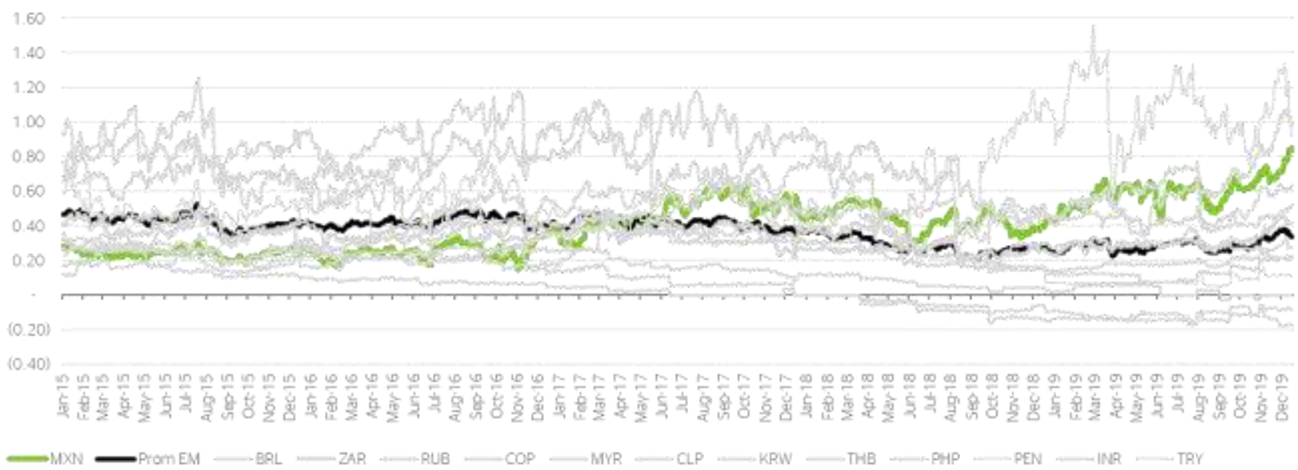
Source: BBVA Research / Banxico / INEGI

Graph 2. **Monetary policy rate and core inflation** (% and YoY % change)

Source: BBVA Research / Banxico / INEGI

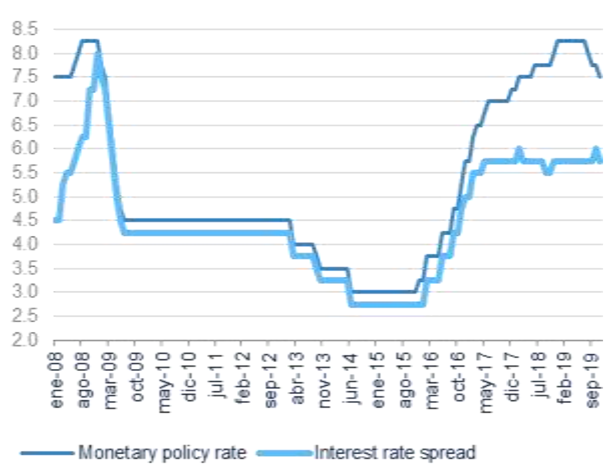
Why has Banxico kept such a cautious approach and such a restrictive stance? In our opinion, Banxico believes that the main factor behind the recent strength of the peso is the large interest rate spread between Banxico's monetary policy rate and the fed funds rate (see graph 3). This has resulted in Banxico having decided to keep the spread between the monetary rate and the US federal funds rate basically stable at 5.75% throughout 2018-19. (see graph 4). This implies that Banxico has "gone along with" the monetary policy decisions of the Federal Reserve in the last two years. Likely, Banxico fears that reducing this differential could result in pressures on the exchange rate, which in turn translate into greater risks for inflation. However, as shown in graph 3, the differential is very high for historical standards and interest rates around the world are lower and have decreased in many cases to a greater extent than in Mexico, which has led to an increasingly better-off position in both absolute and relative terms (see graph 3).

Graph 10. **Risk-adjusted carry-trade***
(Short-term interest rate spread adjusted with 1-month implicit ER volatility, %)



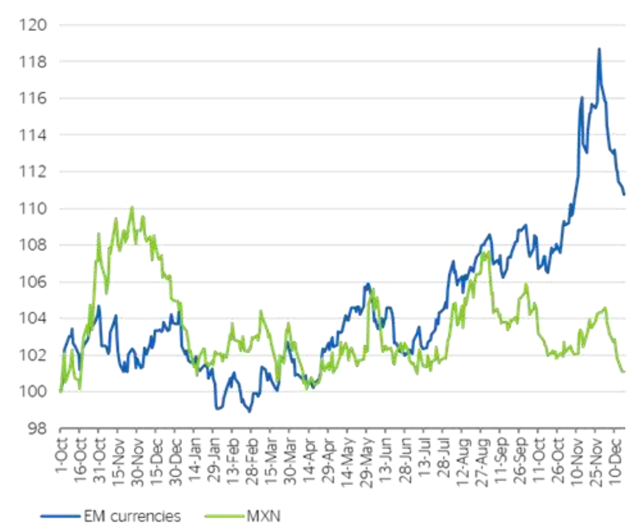
* Own calculations
Source: BBVA Research / Bloomberg

Graph 4. **Monetary policy rate and interest rate spread with the fed funds rate**
(%)



Source: BBVA Research / Banxico / Bloomberg

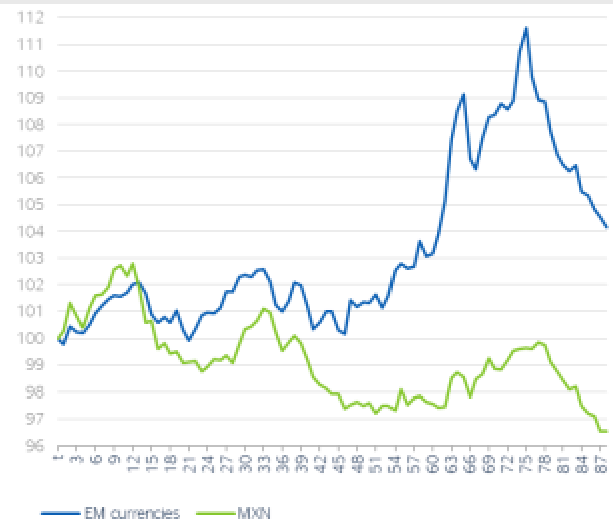
Graph 5. **MXN vs other EM currencies* since October 2018**
(Index 1 Oct 2018 = 100)



* Trade-weighted and liquidity weighted average based on a reweighting of the JP Morgan after taking out the MXN; own calculations
Source: BBVA Research / Bloomberg

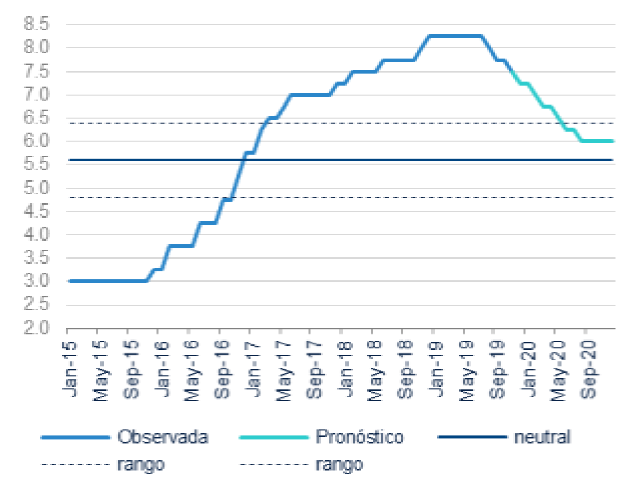
Three factors have contributed to large absolute and relative risk-adjusted carry-trade: i) high interest rates in Mexico, ii) lower interest rates in both the US and other emerging economies; and iii) the relative strength of the peso that has led to low implied volatility. The high interest rates together with the lower perception of risk give high attractiveness to investments in Mexican pesos. But, has the strength of the peso responded only or mainly to the high interest rate spread? Graph 5 suggests that it has not. As can be seen, the most significant turning points along with the overall trend of the peso's absolute and performance against the average of emerging market currencies are explained by factors other than the interest rate spread that, as explained above, has remained constant in 2018 and 2019. The peso had a marked relative underperformance in October and November 2018 resulting in a negative differentiation of 8pp (see graph 5). In December 2018, a responsible SHCP budget for 2019 resulted in a decrease in market concerns regarding Mexico that resulted in a better relative performance for the peso that regained its relative level compared to other emerging currencies in January 2019. Between January and August 2019, despite the high interest rates in Mexico and the larger spread, the exchange rate moved broadly in tandem with the average of emerging market currencies. Coincidentally, since Banxico began its downward cycle (which, as we mentioned earlier, does not yet imply a lower rate differential), the peso has strengthened and has outperformed (see graph 6). Why? Again, the main reason for the different relative performances in any given period does not seem to be associated with the interest rate spreads. In our view, mainly two factors have contributed to the outperformance: i) the expectation of an increasingly likely ratification of the USMCA by the US Congress, and to a lesser extent ii) the perception of lower short-term risks for PEMEX due to the financial support of the federal government and the stabilization of the production platform.

Graph 6. **MXN vs other EM currencies* since the start of Banxico's rate cut cycle**
(Index 1 Oct 2018 = 100)



* Trade-weighted and liquidity weighted average based on a reweighting of the JP Morgan after taking out the MXN; own calculations
Source: BBVA Research / Bloomberg

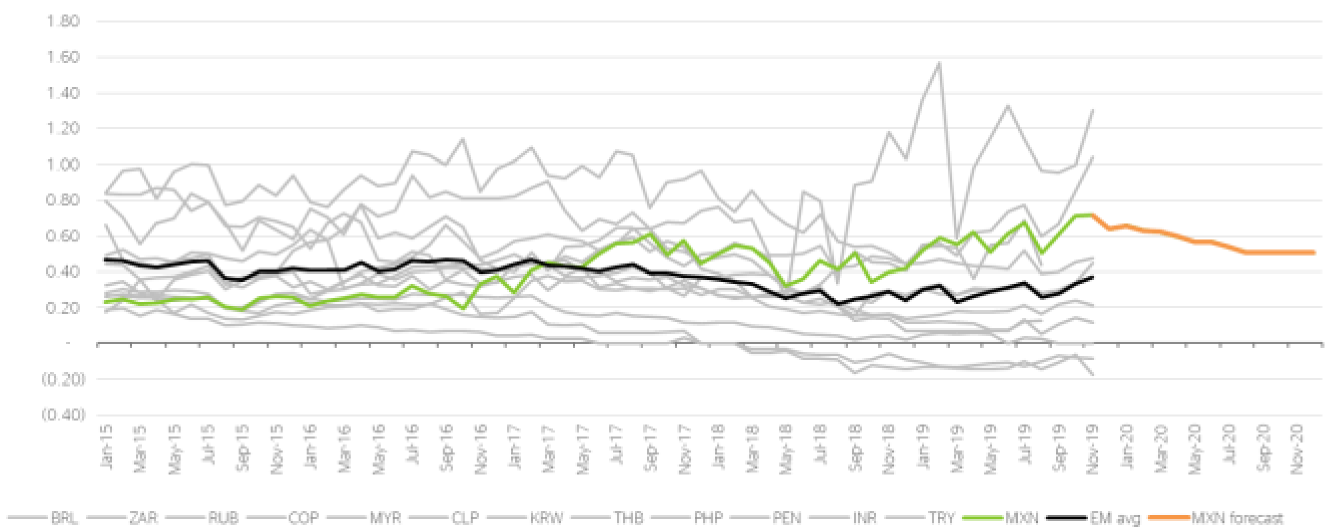
Graph 7. **Nominal monetary policy rate outlook and neutral rate range estimated by Banxico**
(%)



Source: BBVA Research / Banxico

Looking ahead, the peso's relative performance will likely continue to be influenced by other factors in addition to the interest rate spread and, in principle, there is no reason to believe that the risks to the peso will rise either in absolute or relative terms compared to other emerging market currencies. In fact, as shown in graph 8, our forecasts for the monetary rate in Mexico, the federal funds rate in the US and the implicit volatility of the peso implies that the risk-adjusted carry-trade will decrease as the monetary position gradually becomes less restrictive and reaches a neutral level in August next year. Besides, other central banks around the emerging world will likely maintain their more accommodative monetary policies, so although the risk-adjusted carry-trade will decrease, it will likely remain higher in absolute and relative terms (see graph 8). This in our opinion is most likely, but in any case, in an economy with a flexible exchange rate regime, the function is that of a shock absorber, and the current context of inflation, growth, cyclical position of the economy and risks, justify a much less restrictive monetary stance.

Graph 8. **Risk-adjusted carry-trade: actual and forecast***
(Monthly averages, pp)



* Based on our own fed funds, Banxico's monetary policy rate and MXN implicit volatility forecasts
Source: BBVA Research / Bloomberg

What do we anticipate going forward? We anticipate that Banxico will maintain excessive caution and will not take its monetary stance to an accommodative level in 2020. However, we also expect the rate cut cycle to continue with no pause until August 2020, bringing the nominal monetary policy rate and the monetary stance to neutrality in the summer of next year. Thus, we anticipate that the rate cut cycle has plenty of room to go. As we argued earlier, Banxico had not maintained such a high monetary policy rate with such low headline inflation and with core inflation easing in previous periods. This does not seem consistent with soft inflation (will close the year below 3.0%), well-anchored inflation expectations, stable exchange rate, weak economy and widening negative output gap. In our opinion, the monetary policy stance, which remains excessively restrictive, is weighing on growth and, more importantly, is not consistent with the context of inflation, growth and risks. Banxico should feel comfortable embarking on a rate cut cycle that at least brings its position to neutrality. Therefore, we anticipate that Banxico will cut the 25bp monetary rate in each of the next six meetings, bringing it to 7.25% tomorrow and to 6.0% in August 2020 (see graph 7).

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