Central Banks

Exceptional circumstances. Exceptional actions?

Banxico should speed up its slow pace of easing and implement additional liquidity measures

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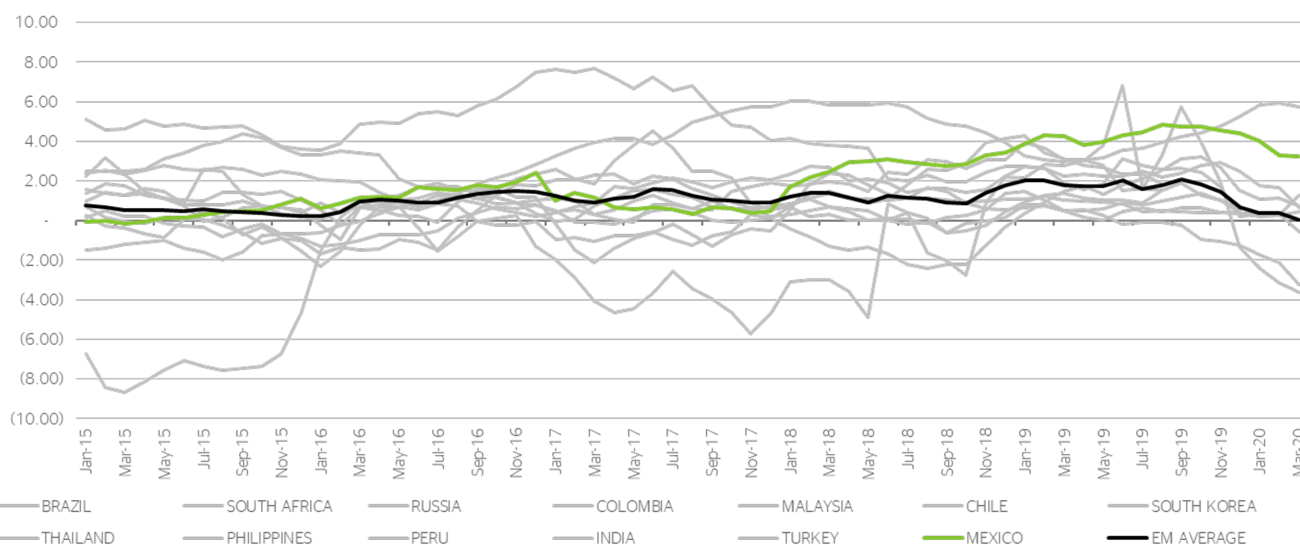
- **There is scope for both further cuts in the policy rate and implementing additional liquidity support measures**
- **Inflation concerns are overdone and lower inflation will continue to feed into lower inflation expectations**
- **Banxico's hawkish tone might have been already counterproductive in terms of inflation expectations, but it will not prevent them from declining in tandem with inflation**
- **Considering that expectations are and will remain well-anchored, Banxico should lose its fear of easing**
- **The relationship between interest rate spreads and the ER is temporarily broken and thus, if Banxico is keeping a restrictive stance and cautious stance to avoid a further MXN depreciation and/or capital outflows is in our view proving to be ineffective and costly**
- **A more aggressive pace of easing and an easing monetary policy stance are warranted**
- **We forecast that Banxico will take the policy rate to 3.0% by year-end; the lowest policy rate on record is warranted**
- **There is also further scope for liquidity measures. More steps should be taken in order to prevent liquidity constraints from potentially becoming solvency problems and to avoid a credit crunch scenario**
- **A more appropriate monetary policy stance would not only address the economy needs in terms of the scope of traditional monetary policy, but also reinforce liquidity measures and also potentially more widely open the door for expansionary policy if at some point in the near future the government realized that it is urgently needed**
- **An expansionary fiscal policy better suits the current needs of countercyclical economic policies, but monetary policy easing is also urgently needed**

What might be explaining Banxico's surprising cautious approach and overly restrictive monetary policy stance?

In a context of a much larger and sharply widening negative output gap, much lower-for-longer interest rates in advanced economies, more decisive monetary policy easing in emerging economies (see graph 1), easing inflation that will continue to feed into lower inflation expectations, and a currently restrictive stance strongly suggests that Banxico could and should cut rates further. As can be seen in graph 1, Banxico has more scope to cut rates that most central banks in emerging market countries that before the global pandemic, that is causing a deep economic recession and trigger downside pressures on inflation, had a much less restrictive stance to begin with and had cut rates in a more timely and decisive manner. The first questions that should be asked are thus: i) is there scope for monetary policy easing?, and ii) should Banxico speed up its pace of monetary policy easing? Judging by the global context, the relatively monetary policy position and the current excessively restrictive monetary policy stance we would argue that the answer to both questions is definitely yes. If now, when the deepest falls in aggregate demand since the Great Depression are expected, is not the time to act in a decisive way, then when? Moreover, considering the time horizon in which monetary policy operates, we believe that Banxico is lagging further behind the curve.

Graph 1. **Real ex-post monetary policy rates in selected emerging market central banks* (%)**



* Countries are the same as those on the JP Morgan Emerging Markets Currency Index (ie, are the most important and representative central banks in emerging market economies)
Source: BBVA Research / Bloomberg

The next questions we should ask ourselves are: i) why has Banxico remained on the sidelines for one month, and ii) why Banxico's wording in the last statement and general tone remained hawkish on balance?. In short, isn't a "cautious" approach in the current context actually an aggressive bet on something? If so, on what? The majority of the Board might well be thinking that upside inflation risks either outweigh downside risks or are roughly balanced. Another option is that Banxico considers that keeping a "cautious" approach and retaining a high interest rate (amplifying the

spread with the Fed and with other emerging market rates) would prevent further MXN depreciation and capital outflows. The combination of both likely has among its goals, preventing inflation expectations from unanchoring. Are those concerns overdone? Is that approach likely to succeed? We think that the answers to those valid questions are yes and no.

Inflation concerns clearly seem overdone and Banxico´s hawkish stance might be counterproductive in terms of inflation expectations

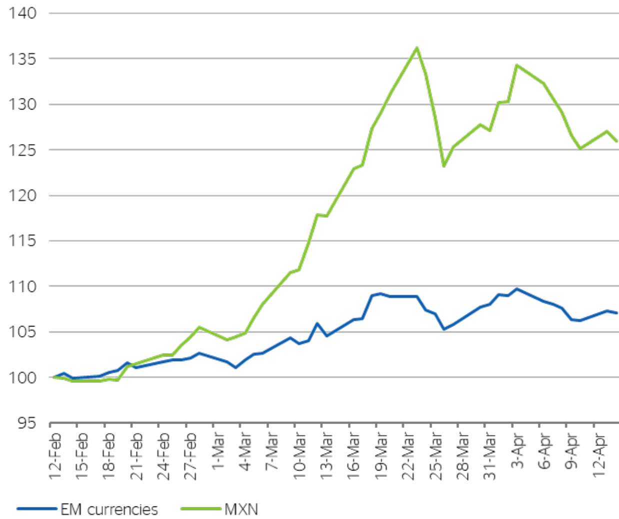
Banxico has not acknowledged yet that in the current context the balance of risks to inflation is tilted to the downside both in the short-term and the mid-term. In fact, as one member of the Board has argued, their communication has likely influenced recently inflation expectations in an unwanted way. In contrast with our initial reaction, markets and analyst's consensus initially anticipated that the current context will translate into somewhat higher inflation. Since the start of this crisis we argued that the opposite was the most likely scenario. What do recent data tell? That short-term downside pressures on both headline and core inflation are clearly outweighing upside pressures. Since the start of the economic lockdown only one bi-weekly inflation print has been released, the corresponding to the second half of March. Headline inflation declined (-)0.78% in the fortnight with core increasing a milder-than-usual 0.14%, bringing down annual rates to 3.25% (-0.45pp) and 3.60% (-0.06pp), respectively. The next print, corresponding to the first half of April, will be release this Thursday. We are expecting headline inflation to decline (-)0.64% FoF and core to increase a mild 0.12% FoF. If our forecasts prove accurate, annual headline and core inflation would slow to 2.2% and 3.3%, respectively. That is, headline inflation would approach the lower limit of Banxico's variability range around the 3.0% goal (ie, 2.0%) while core inflation would show clear signs of easing by breaking to the downside the 3.6-3.9% narrow range in which it has stayed since April 2018.

In qualitative terms, in March, as we expected, downside pressures on prices outweighed upward pressures, with lower energy prices offsetting higher fresh food prices while a downward core services trend and stable core goods prices drove down core inflation. We expect these trends to accentuate in April. We further revised down our year-end headline inflation forecast to 2.8% (from 3.2%), with core at 3.0%. Our bias to both forecasts is clearly on the downside as they account a relatively smooth global economic recovery that would translate into higher energy prices in the second half of the energy. The risks to those assumptions are tilted heavily on the downside, and thus, headline inflation might well remain closer to 2.0% than somewhat below 3.0% by year-end, while core inflation might likely fall below 3.0%. Should pass-through be a concern now? We think that it should not. In a deep recession, the ability of firms to pass higher costs and prices to consumers is limited. In the current much deeper than usual recession, with a starting cyclical position of an already negative and widening negative output gap –and with special characteristics such as an economic lockdown which combined with a plummenting consumer confidence will translate into the weakest demand ever for the core goods most affected by the exchange rate–, pass-through should be particularly low. In our view, it might not even take place until the economy is out of its lockdown and in a recovery path. That will take months and at that moment, global risk aversion should have already diminished substantially and thus, the exchange rate is likely to decline from the current "overshooting" level. In short, in our view, Banxico's inflation concerns are overdone and its excessively hawkish tone (surprising and even shocking for some) might be counterproductive in terms of inflation expectations, which nonetheless will continue to fall driven by lower actual inflation. That is, lower inflation will continue to feed into lower inflation expectations. Banxico should ease its tone to avoid unintended effects on inflation expectations and in our view, should acknowledge that the balance of risks to inflation is on the downside.

High interest rates are not currently supporting the MXN or influencing capital flows

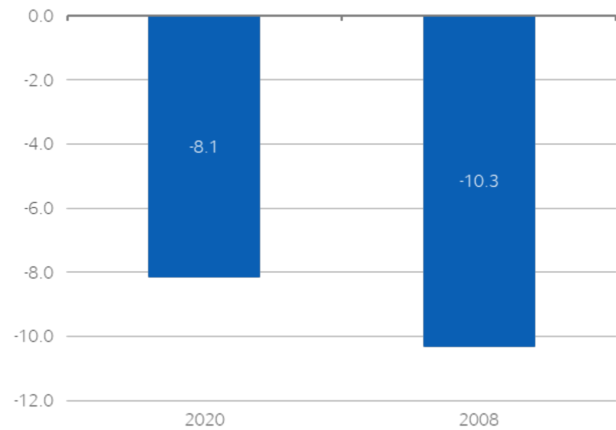
The next thing to consider is if the current restrictive monetary policy stance continues to give support to the Mexican peso and/or is preventing capital outflows. As can be seen in graph 2, the interest rate differential has not given any support to the exchange rate considering that in the current context the relationship is temporarily broken. In normal times, the clear relative underperformance and negative differentiation of the Mexican peso should be concerning and arguably Banxico should probably act cautiously, but considering that interest rates are not having any influence on the exchange rate (ER), a cautious approach is costly and unnecessary. It is true than the above-average spike in MXN implied volatility has translate into a much lower MXN risk-adjusted carry trade (see graph 4) which is now roughly the same as the average of emerging market currencies. It might well further decrease if the needed monetary policy rate cuts are not offset in the short term by a lower implied volatility of the ER, but once global risk aversion gradually eases in the next months, it would certainly come gradually back up, likely returning to above-average EM levels. That is, considering that the relationship between the interest rate spread and the ER will remain broken in the short term, there is no point to be excessively cautious now in terms of traditional monetary policy. Besides, ER current volatility and risks are better addressed by the Central Bank with liquidity measures granting the proper functioning of the ER market. Moreover, the free-floating ER should continue to do its work as a shock absorber for the economy. In short, in our view, Banxico should not be overly concerned by neither the current levels of the ER nor the MXN recent underperformance and likely continued underperformance in the short term. What about capital outflows? As can be seen in graph 3, Banxico's cautious approach has not prevented capital outflows which at least partially might have been driven not by a desire to leave Mexico but by a need to lower risky positions. As risk global risks ease, the risks of capital outflows will also ease. Banxico's monetary policy stance will neither prevent outflows not attract inflows in the current context. That is, these are not normal times, and usual ways of thinking about certain things might not be the best way of approaching them since certain decisions might prove ineffective but costly at the same time. As chart 3 shows, there have been considerable capital outflows, even in a context where Banxico has kept real rates at the second highest level in the emerging market world. As we argued, we believe this is the case because the link between rates and the FX is now broken. But even if we are mistaken, what is certain is that is has proved to be innefective and costly and in any case, considering that most Central Banks in the world have aggressively and rapidly eased monetary policy, Banxico has plenty of room to ease.

Graph 2. **MXN VS OTHER EM CURRENCIES* SINCE THE START OF THE CURRENT GLOBAL RISK-AVERSION EPISODE**
(Index 12 Feb 2020=100)



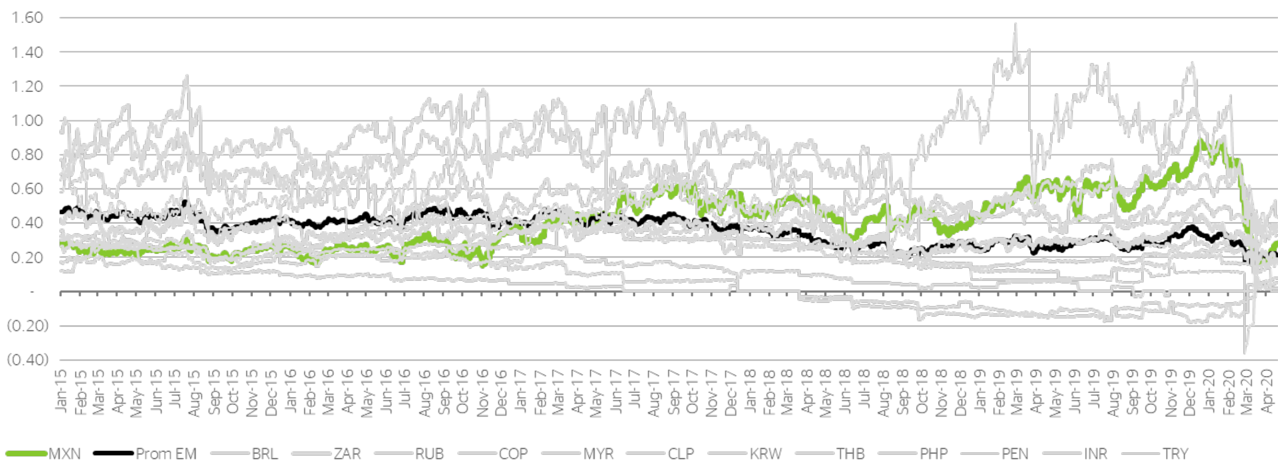
* Trade-weighted and liquidity weighted average based on a reweighting of the JP Morgan Emerging Markets Currency Index after taking out the MXN; own calculations
Source: BBVA Research / Bloomberg

Graph 3. **ACCUMULATED CHANGE IN THE FOREIGN HOLDINGS OF MBONDS, OCTOBER 2008 AND FROM FEBRUARY 12TH THROUGH MARCH 30TH 2020**
(USD BN)



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

Graph 7. **Risk-adjusted carry-trade***
(Short-term interest rate spread adjusted with 1-month implicit ER volatility, %)



* Own calculations
Source: BBVA Research / Bloomberg

A more aggressive easing pace and an easing monetary policy stance are warranted

In spite of Banxico's hawkish rhetoric, we continue to expect a more significant and rapid pace of easing. In our view, the current restrictive monetary policy stance is unnecessary and costly. Banxico should cut rates rapidly, considering the lagged effects of monetary policy and its forward-looking nature. With the economy entering a deep recession, even if we account for uncertainty, downward pressures on core prices will eventually more than outweigh upward pressures. Low inflation prints in March and April are likely to feed into lower inflation expectations, and ease Banxico's probable concerns. We think that Banxico should not wait until its next scheduled meeting (May 14) to cut its policy rate. In fact, we think Banxico will lower the policy rate 75bp in an out-of-schedule meeting before the end of the month and by another 75pb in another out-of-schedule meeting in May. That is, Banxico should not only bring forward to April its scheduled May meeting (as it did in March), but it should add an out-of schedule meeting in April and keep the one scheduled in May. Two consecutive 75bp rate cuts took place already in April and May of 2009 in a much more challenging inflation scenario (ie, with headline inflation above 6.0% and core inflation above 5.5%). In our view, a more aggressive easing pace and an easing monetary policy stance are warranted.

We have been arguing that Banxico should take the policy rate well below 5.0% this year, but that the most hawkish and cautious Banxico's Board ever made us hesitate with our forecast. However, the growth scenario is rapidly deteriorating while the inflation scenario is clearly improving. At the same time, there is no point or need to keep high interest rates. We now forecast that Banxico will deliver and take the policy rate to 3.0% by year-end. The lowest historical policy rate is warranted.

Lower rates will provide much needed relief to firms and families as a more appropriate monetary policy stance will lower their debt burden. At the same time, it will also might potentially open the door for the Federal Government if at some point they realize that an expansionary fiscal policy is urgent and decide to increase debt issuance in order to provide fiscal relief for the economy in a context of already increasing public debt in terms of GDP with a plummeting economy.

There is also further scope for liquidity measures

In the current context where economic agents are trying to hoard as much liquidity as possible, the possibility of observing a credit crunch has increased. Of course relaxing monetary policy will help to reduce these odds, but is not enough. Banxico should also provide much more liquidity into the markets. It has taken good steps, such as widening the scope of instruments eligible for repo operations and implementing auctions in the FX markets. Yet, we think that, in addition to these positive measures, they should start taking loans from the banking book as eligible collateral and that they should create a liquidity facility, in the spirit of the European LTRO, in order to provide liquidity to banks so that they could supply credit to companies in favorable conditions.

Monetary policy easing would reinforce liquidity measures and facilitate fiscal policy. It is urgently needed

A more appropriate monetary policy stance would not only address the economy needs in terms of the scope of traditional monetary policy, but also reinforce liquidity measures and also potentially more widely open the door for expansionary policy if at some point in the near future the government realized that it is urgently needed. An expansionary fiscal policy better suits the current needs of countercyclical economic policies, but monetary policy easing is urgently needed.

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