Central Banks

With the economy in freefall, inflation well below the target and expectations well anchored, Banxico should speed up its easing pace, but will they?

Banxico still has a very inappropriate restrictive monetary policy stance

Javier Amador / Carlos Serrano

May 12, 2020

- **Banxico should cut the policy rate by at least 75bp; the odds of a milder 50bp cut are not low, but we expect Banxico to take a bolder step and cut rates 75bp to 5.25%**
- **A freefalling economy and much lower inflation in a context of excessively high real interest rates overwhelmingly supports the case for faster easing.**
- **A loose monetary policy stance is not only warranted, but also urgently needed**
- **We think that the rate cut cycle has more legs than what markets and analysts are currently pricing in and anticipating, respectively**
- **We continue to expect that the monetary policy rate to reach 3.0% by year-end, well below the 4.75% level currently expected by consensus and the around 4.5% priced in by markets**
- **Lower rates would lower the financial burden of firms and families, would allow firms to refinance their debts at lower rates, would make Banxico´s liquidity measures much more effective, and would open the door to the federal government if at some point it decides to run a countercyclical fiscal policy to finance it with debt issuance at better terms.**

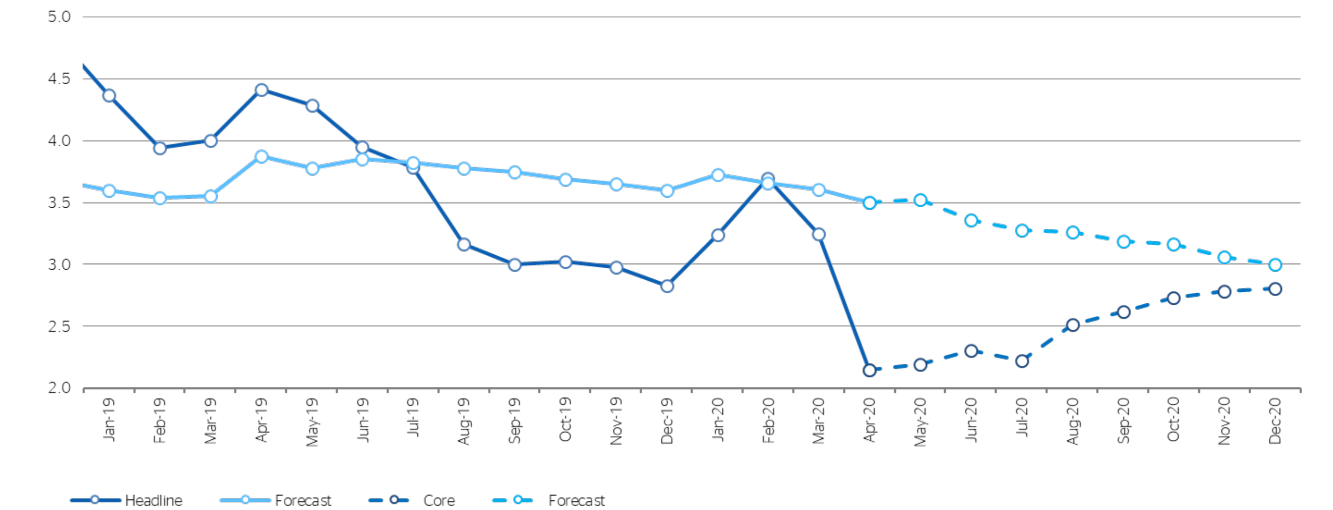
We continue to expect Banxico to cut rates much more than currently expected, at least until real rates are close to 0%

Prior to the previous (unscheduled) meeting, we tried to explain why Banxico was keeping a surprising cautious approach and overly restrictive monetary policy stance. We argued that Banxico's inflation concerns were overdone, that high interest rates were not supporting the MXN or influencing capital flows, and that a more aggressive easing pace and an easing monetary policy stance was warranted (for more see). Over the last three weeks, economic and inflation data has overwhelmingly been supporting our view of the urgent need for more aggressive monetary policy easing.

GDP fell (-)1.6% QoQ in 1Q20. Both the industrial and services sectors began to be largely affected by the global and domestic economic lockdown. Signs of severe disruptions in value chains are already eye-catching and point to an unprecedented drop in manufacturing production in 2Q. Manufacturing was hit hard in March (-4.8% MoM) but US ISM survey data in April (down 7.6% MoM from the March reading with the new orders index down 20.2%) along with a (-)99% drop in light vehicles production in Mexico point to the contraction in manufacturing output deepening sharply in the coming months. The services sector contracted (-)1.4% QoQ in 1Q even though social distancing startied in the second half of March (ie, in the last 1/6 part of the quarter). Our BBVA Consumption Index shows an annual drop of 24.9% in April, signaling the deepest deterioration of private consumption on record in 2Q20. We expect GDP to drop between 6% and 12% in 2020 and our bias is to the lower limit. Even if GDP ends up contracting -7.0%, GDP will not recover the 4Q18 level until 1Q24 ie, not only the negative output gap will widen significantly in the short term reaching levels never seen before, it will most likely remain negative for years to come. Banxico could take for granted that there will be no demand-side pressures whatsoever in years, and there will be downside pressures on inflation arising from a weak demand at least in the short term. In this context of depressed aggregate demand, exchange rate pass-through will be insignificant.

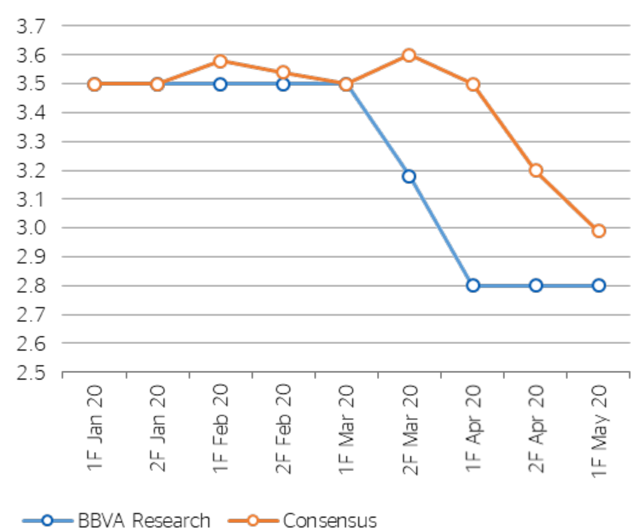
In fact, with the economy in freefall, headline inflation is already well below the 3.0% target and core inflation is already showing signs of easing. As we expected, annual headline Inflation dropped more than 1pp in April to 2.15%, close to the lowest level ever (2.13%). It declined (-)1.01% MoM (in line with our (-)1.00% expectation). In annual terms, it eased sharply (-1.1pp) from 3.25% in March. Core inflation came in slightly above expectations, increasing 0.36% MoM, compared to our 0.32% forecast. Yet, in annual terms it continued to ease, decelerating (-)0.1pp to 3.50% from 3.60% in March, and breaking to the downside the narrow 3.6-3.9% range in which it had fluctuated for the past two years (from April 2018 to March 2020). Processed food prices continued to increase sharply in the second half of April, preventing core inflation from decreasing more rapidly. Food core goods jumped 1.10% MoM (5.8% in annual terms, up from 5.1% in March). In contrast, non-food core goods inflation remained on a clear downward trend (2.3% YoY in April, down from 2.5% in March). In the same way, core services inflation eased sharply in April (to 2.8% YoY from 3.4% in March). In short, the large decline in prices during April was driven mainly by the (-)17.4% MoM decline in low-octane gasoline prices, but core inflation also eased with downside pressures on services and non-food core goods prices offsetting higher food core goods. Looking ahead, we do not expect annual headline inflation to decline further as gasoline prices are already increasing in May; yet, we continue to expect headline inflation to hover somewhat below 2.5% in the short-term before increasing somewhat in 2H20, with easing core inflation partially offsetting somewhat higher non-core inflation (see graph 1). Overall, inflation should not be a concern for monetary policy. Recent data supports our view that Banxico concerns before Thursday's scheduled meeting remain overdone. Actually, inflation has surprised to the downside Banxico (which according to the Minutes of the last meeting was expecting annual headline inflation around 3.0% in April), markets and analyst's consensus. As we expected, lower inflation is feeding into lower inflation expectations. As can be seen in graphs 2 and 3, after the initial reaction of expecting slightly higher inflation, analysts' consensus inflation expectations continue to converge with ours.

Graph 1. **Inflation Outlook**
(%)



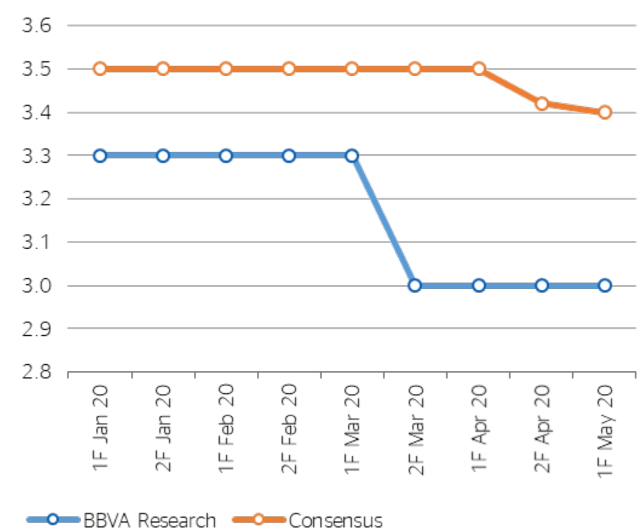
Source: BBVA Research / INEGI

Graph 2. **2020 YEAR-END HEADLINE INFLATION EXPECTATIONS: BBVA RESEARCH VS ANALYSTS' CONSENSUS**
(%)



Source: BBVA Research / CITIBANAMEX Surveys

Graph 3. **2020 YEAR-END CORE INFLATION EXPECTATIONS: BBVA RESEARCH VS ANALYSTS' CONSENSUS**
(%)



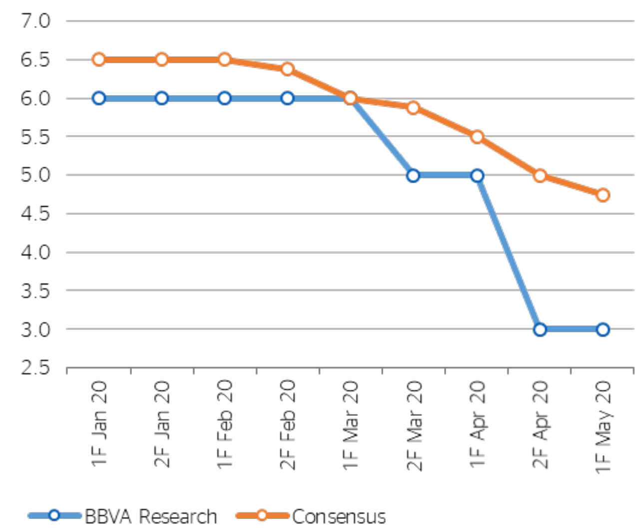
Source: BBVA Research / CITIBANAMEX Surveys

In spite of all this, the minutes of April's monetary policy meeting showed Banxico was still overly concerned about inflation. Surprisingly, three weeks ago, the majority of the Board remained overly concerned about inflation. In the view of the majority of the Board, inflation was facing "pressures in both directions". Although strictly speaking it is true, upward pressures are only seen in food prices, which we expect to subside and this is a factor that is being more than compensated by declines in other prices. Besides, most services in the economy remain closed and lower services inflation is at this moment only reflecting lower tourism-related prices, but soon should start to reflect the extremely weak demand. In short, going forward, downside pressures on prices should intensify while the only upward pressure should moderate. Lower core inflation is the most likely scenario and contrary to Banxico's view, we think that the balance of risks to inflation is clearly on the downside. Fortunately, and judging by the discussion, April's inflation substantially surprised to the downside the expectations of around 3.0% inflation of the majority of the board, and thus, we continue to think that Banxico should soon acknowledge that the balance of risks to inflation is now tilted to the downside.

Similar to what has been happening with inflation expectations, monetary policy rate forecasts of both analysts and markets are also converging with ours (see graphs 4 and 5). We think that there is room for rate expectations to adjust further to the downside, as the only monetary policy stance that is appropriate in the current context is a loose stance. In fact, surprisingly, Banxico continues to maintain a shockingly inappropriate restrictive monetary policy stance in stark contrast with central banks all over the world. Central banks in emerging countries are no exception: most have an appropriate loose monetary policy stance (see graph 6) with rates on average being close to zero; some Latin-American Central Banks such as Chile and Peru already have, adequately, negative real rates.

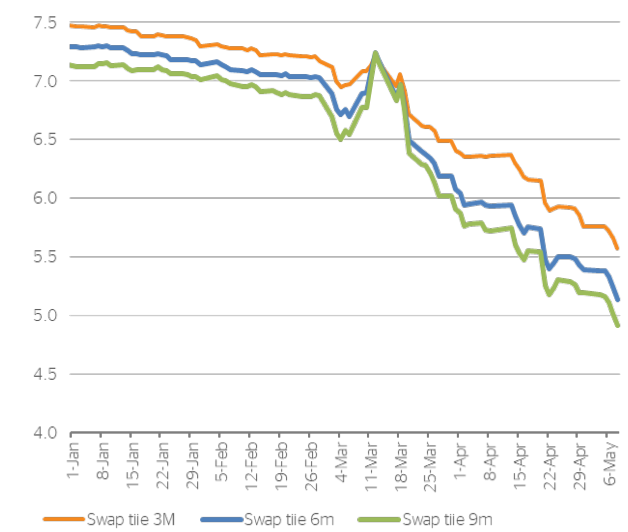
We continue to expect Banxico to cut rates much more than currently expected, until real rates are close to 0%. Banxico should cut the policy rate by at least 75bp this Thursday. We think that a 100bp cut would be more adequate. A freefalling economy and much lower inflation in a context of excessively high real interest rates overwhelmingly supports the case for faster easing. Lower rates would lower the financial burden of firms and families, would allow firms to refinance their debts at lower rates, would make Banxico´s liquidity measures much more effective, and would open the door to the federal government if at some point it decides to run a countercyclical fiscal policy to finance it with debt issuance at better terms. However, a hawkish Board and one of the most hawkish central banks in the world make us wonder whether they will start to take a bolder step this week. Unfortunately, the chance of a milder 50bp cut is not low. Nonetheless, we expect a 75bp rate cut to 5.25%. In any case, we think that the rate cut cycle has more legs than what markets and analysts are currently pricing in and anticipating. We continue to expect that the monetary policy rate to reach 3.0% by year-end, well below the 4.75% level currently expected by consensus and the around 4.5% priced in by markets.

Graph 4. **2020 YEAR-END MONETARY POLICY RATE FORECASTS: BBVA RESEARCH VS ANALYSTS' CONSENSUS**
(%)



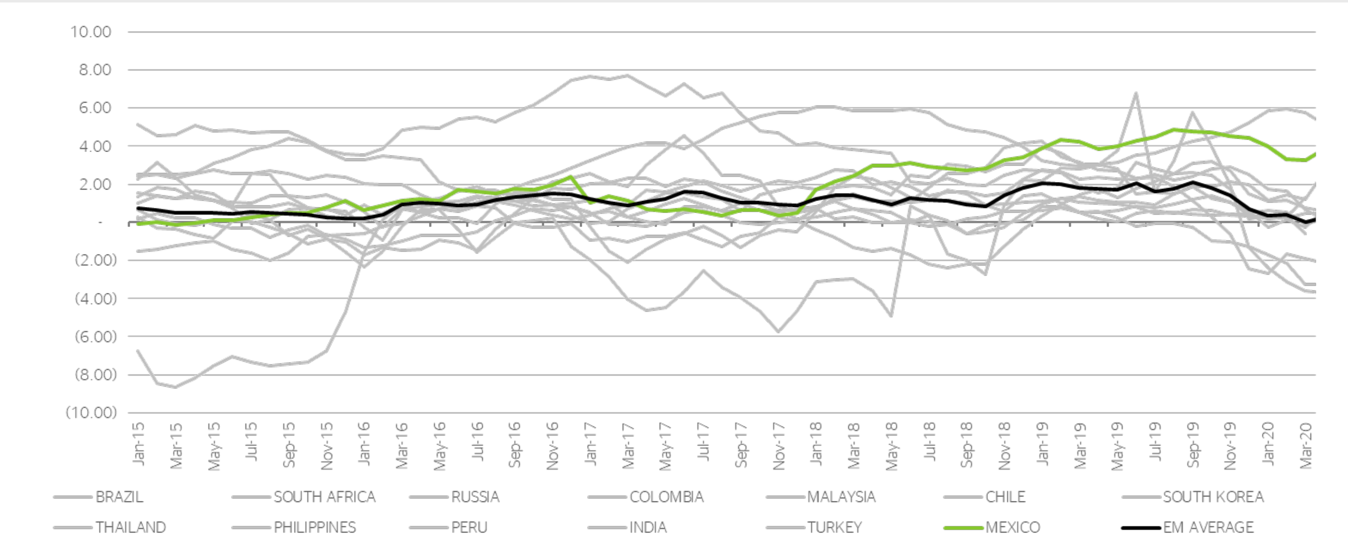
Source: BBVA Research / CITIBANAMEX Surveys

Graph 5. **MARKET EXPECTATIONS ON THE MONETARY POLICY RATE: IRS**
(%)



Source: BBVA Research / Bloomberg

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



* 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

Disclaimer