Central Banks

Easing cycle continues, but with another hawkish and cautious cut

Banxico is more focused on the MXN and capital flows than on inflation and the deepest economic recession ever

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- **Banxico cut the policy rate by 50bp to 5.50% but surprisingly continued to strike a hawkish tone**
- **It seems that the central bank is more focused on the exchange rate and capital flows than on inflation and economic activity**
- **More importantly, it seems that the Board (the majority of the Board?) thinks there is tradeoff between an appropriate monetary policy stance in the current context of inflation and economic growth and the peso and financial stability**
- **This clearly signals that Banxico will remain cautious and will continue to implement hawkish cuts in the next meetings**
- **Yet, we continue to expect Banxico to cut the policy rate to levels below the c. 4.50% that the markets are pricing in by year-end, but we recognize that our year-end 3.0% level became less likely after today's statement**

We continue to expect Banxico to cut rates more than the markets are pricing, but following today's statement our 3.0% year-end forecast became less likely

As widely expected, Banxico cut its policy rate by 50bp to 5.50%, the third consecutive 50bp cut. The 50bp cut was in line with consensus expectations, but smaller than the 75pb cut we thought was warranted with the economy in freefall, inflation close to historical lows, well-anchored inflation expectations, and a relatively more stable ER.

The wording of the statement continues to strike an excessively cautious tone in our view and remains hawkish. It seems clear that Banxico is more focused on the exchange rate and capital flows than on inflation and economic activity. The statement has many clues in that regard. There is plenty of room for Banxico to further cut rates in the coming months considering that the current stance of the monetary policy rate is neutral, and a loose stance is more than appropriate (for more see) considering that Mexico is facing its deeps recession ever. Yet, following today's statement, with clear hints on Banxico's main focus and concerns, the probability of a loose monetary policy stance is now lower. It is noteworthy to mention that the 4.75% currently expected by analysts' consensus would imply that Banxico would stop cutting the policy rate exactly when it reaches the lower limit of its own neutral rate range projections (4.8 to 6.4%). Therefore, and taking into account the current inflation, inflation expectations, economic growth and exchange rate (ER) outlook, we still expect Banxico to cut the policy rate to levels below the 4.75% currently expected by analysts' consensus and the c. 4.50% that the markets are pricing in by year-end.

It seems clear that going forward Banxico will continue to cautiously cut rates and that movements larger than 50bp are unlikely, even if in our view, there is no technical reason preventing the Central Bank from easing policy faster. Neither one of the lowest inflation levels on record nor the deepest contraction in economic activity ever would persuade Banxico to take "bolder" steps in the coming months. Banxico's assessment on economic activity is that "economic slack conditions continue to widen" and that the "balance of risks to growth is significantly to the downside". Yet, even in a context of an absence of demand-side pressures on inflation going forward with extreme demand weakness and a rapidly widening negative output gap, in their view, the balance of risks to inflation is not tilted to the downside and "remains uncertain". It is hard to understand that logic in the presence of one of the lowest inflationary levels on record and the biggest negative output gap ever. One has to wonder if for Banxico the possibility of observing the balance of risks to inflation tilted to the downside exists.

Moreover, not only their view on inflation is excessively cautious and the grim economic scenario is not enough to persuade them of taking bolder steps, but their focus is clearly on the exchange rate and capital flows. Banxico emphasizes the difficult context for EM currencies and portfolio outflows from EM economies, but does not acknowledge that outflows have been broad-based and not related to relative levels of interest rates. Capital flows have depended largely on risk sentiment and global credit conditions. More importantly, high interest rates in Mexico have not prevented those effects of the spike in global risk aversion. In fact, although Banxico has the second highest real expost policy rate among the most important EM economies, the MXN has underperformed significantly since mid-February. Besides, capital outflows from EM economies have taken place in countries with 0% nominal policy rates (ie, negative real interest rates) such as Chile and Peru, as well as in countries like Mexico with real rates above 3.5%. The negative underperformance of the MXN has been mainly explained by its high level of liquidity, but also driven by market expectations that the country will undergo a more gradual economic recovery process due to the lack of fiscal and monetary responses. In this regards, the strategy of keeping a restrictive/neutral monetary policy stance is self-defeating.

Perhaps the most important signal in the statement is the reference to the room for monetary policy given by "the risks […] for inflation, economic activity and financial markets" as if there was a trade-off between taking monetary policy to the appropriate stance and the stability of the ER and financial markets. In our view, either there is no tradeoff or it is much smaller than what Banxico seems to be thinking. ER and capital flows movements will continue to remain driven in the near future by global risk-aversion/appetite and not by interest rate differentials. Moreover, the recession is likely to be deeper and the economic recovery much weaker in Mexico due to the absence of countercyclical economic policies –with only a timid fiscal impulse and in the absence of a loose monetary policy stance. In fact, a more negative growth path is likely to weigh on the ER and in that sense. In short, arguably a looser monetary policy stance would not weigh significantly on the ER and capital flows in the short-term, and could negatively weight on both in the mid-term. Ultimately, risk appetite will have much more to do with the ER and capital flows than Banxico's policy rate.

Yet, Banxico is more focused on “supporting” the Mexican peso, something that has elevated costs to the economy considering that the exchange rate pass-though is likely to remain close to zero in the near-term and financial stability, and not on the inflation and economic growth path. In that sense, the statement clearly signals that Banxico will remain cautious and will continue to implement hawkish cuts in the next meetings. Overall, we continue to expect Banxico to cut the policy rate to levels below the 4.75% currently expected by analysts’ consensus and the c. 4.50% that the markets are pricing in by year-end, but our year-end 3.0% level became less likely after today’s surprisingly hawkish statement.

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