Central Banks

Easing cycle will continue, but Banxico will remain cautious

The Board's concerns on the ER should have eased in the intermeeting period

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- **Banxico will likely cut the policy rate by 50bp to 5.0%; forward guidance is unlikely**
- **The central bank likely continues more focused on the exchange rate and capital flows than on inflation and economic activity, but concerns should have eased in the intermeeting period**
- **The most significant change in the intermeeting period is that the growth outlook worsened further; risks of higher inflation continue to be extremely low while ER-related risks eased**
- **It seems that 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 until it reaches c. 0% real levels by year-end ie, 3.0% to 3.5%**

We continue to expect Banxico to cut rates more than the markets are pricing, to 3.0% by year-end

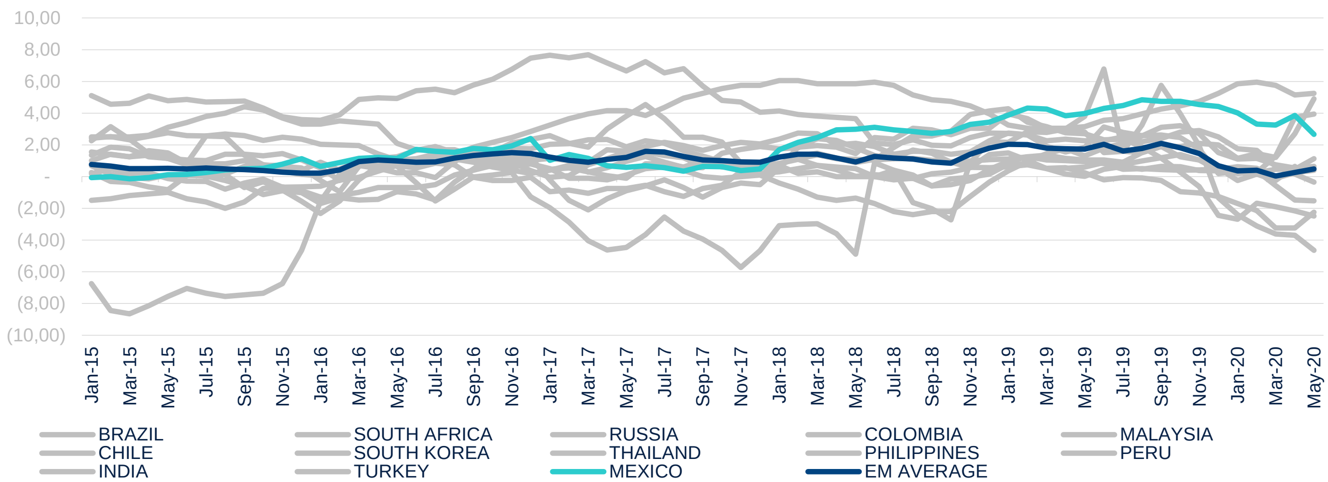
Banxico will most likely cut its policy rate by 50bp to 5.0%. The move is widely expected. The focus will be on the wording of the statement. In our view, the rate cut cycle is well behind the curve with the economy plummeting, inflation under control, inflation expectations well anchored, the peso off its recent lows and the Fed on the sidelines for years to come. In this context, the monetary policy rate remains within the estimated neutral range; we think it should be at 0% by now.

Further rate cuts, at least until the monetary policy rate is below the lower limit of the estimated neutral range (ie, 4.8%), are warranted. It seems clear that Banxico will cut the policy rate again by 50bp in the next two meetings (on June 25 and August 13). The question is whether Banxico will continue to ease the monetary policy after it takes the policy rate down to 4.5%. As usual, the statement is unlikely to give any forward guidance. Contrary to other central banks, particularly the Federal Reserve, the current Board is not keen on using communication as a monetary policy tool. In this context, forward guidance can help to push down longer term rates .Instead, they focus on striking a hawkish tone in a rate cut cycle. Even with inflation under control in a context of a rapidly widening negative output gap (which will stay negative for years to come), the Board has not (yet?) acknowledged that risks to inflation are skew to the downside. As industries reopen this crisis will fundamentally become one of insufficient aggregate demand. Banxico will likely continue to state that in their view the balance of risks to inflation remains uncertain. The central bank recently upwardly revised the 2020 core inflation forecast –from 3.0% to 3.8% in 4Q20–, but downwardly revised the 2021 forecast to 2.6% in 4Q21 from 2.9%. We continue to expect core inflation to gradually move towards 3.0% by year-end. In any case, Banxico forecasts that inflation will not be a concern for monetary policy in at least the next six quarters. Yet, we are not expecting significant changes to the wording of the statement; it will most likely continue to strike an overly cautious tone.

In the most recent statement, Banxico signaled that it is more focused on the exchange rate (ER) and capital flows than on inflation and economic activity. The statement had many clues in that regard. In this sense, Banxico's concerns should have eased markedly. The ER averaged 24.0ppd in the days before the previous meeting and now stands at 22.4ppd, ie, it strengthened around 7.0% in the intermeeting period. Besides, the Federal Reserve projects to keep its policy rate at zero through 2022 ie, Banxico can feel comfortable lowering rates as the interest rate spread will remain wide for years to come. Although Banxico seems to be focused on not rapidly lowering the interest rate spread, it should be clear by now that monetary policy has not been the main driver of the ER or capital flows, which have been more influenced by global risk aversion. Besides, rates in Mexico remain higher compared to those in emerging markets (see graphs 1 and 2). As can be seen in graph 1, real ex-post monetary policy rates in emerging markets are on average close to 0.0%. In the two countries in which they have recently increased, the rise is driven by negative inflation not by higher rates. In nominal terms, only Russia and Turkey have higher nominal rates, but Turkey's inflation stands at 11.4%. In short, even if the interest rate differential is not a driver in the short term, it will remain wide both with respect to the fed funds rate and with average rates in emerging markets.

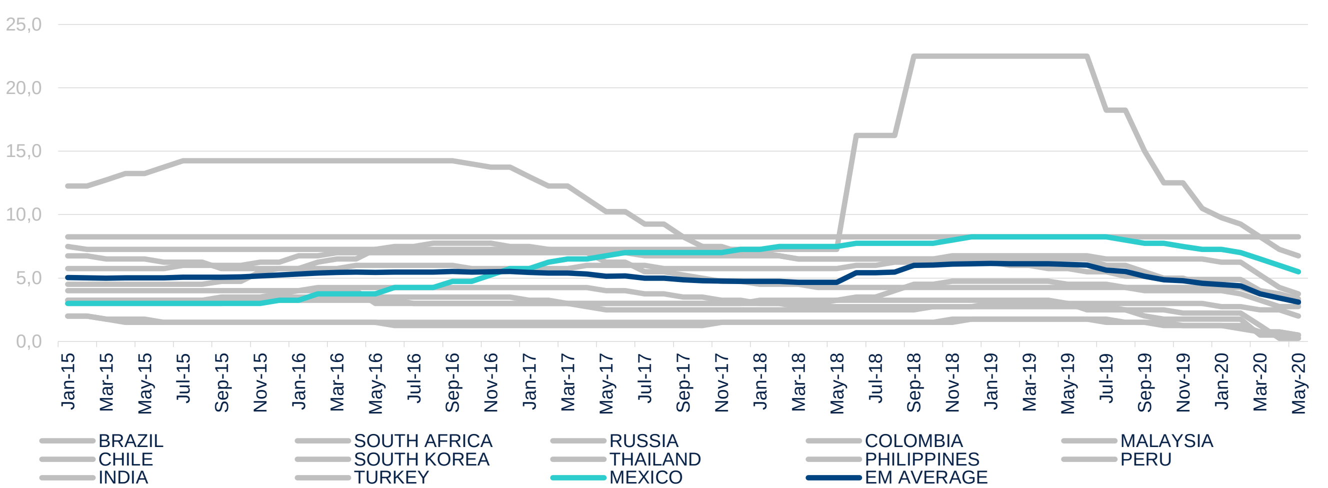
In our view, there is further room for rate cuts with easing ER and capital flows risks, along with the absence of demand-related inflation risks and a deep fall in economic activity. Besides, the current stance of the monetary policy rate is neutral, and a loose stance is more appropriate (for more see). Therefore, we continue to expect five more 50bp rate cuts this year to 3.0% by year-end. Yet, the risks are tilted to the upside as Banxico seems to be more focused on "supporting" the Mexican peso and financial stability and not on the inflation and economic growth path. Perhaps the most important signal in the last statement was 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, in this context, either there is no tradeoff or it is much smaller than what Banxico seems to be thinking (such a trade-off exists in normal times, but not in the current context of very high global risk aversion). ER and capital flows movements will remain driven in the near future by global risk-aversion/appetite and not by interest rate differentials. In our view, a looser monetary policy stance would not weigh significantly on the ER and capital flows in the short-term as global sentiment will continue to have much more to do with the ER and capital flows than Banxico's policy rate.

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, arguably the most representative central banks in emerging market economies)
Source: BBVA Research / Bloomberg

Graph 2. **Nominal monetary policy rates in selected emerging market central banks***
(%)



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