Central Banks

Banxico surprisingly and adequately strikes a dovish tone

Although it is warranted, no one was expecting it

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- **Banxico cut the policy rate by 50bp to 5.0% and surprisingly made significant dovish tweaks to the wording of the statement**
- **Although the changes were absolutely warranted, they were unexpected given Banxico's hawkishness and the recent larger-than-expected temporary rise in inflation**
- **The tone of the statement is dovish for the first time in the rate cut cycle and points to multiple 50bp rate cuts going forward and a more appropriate and looser monetary policy stance by year-end as long as the peso continues to hold up**
- **We continue to anticipate four more 50bp rate cuts in the second half of the year (200bp of rate cuts), which is four times what consensus is currently expecting (50bp) and much more than the view currently priced in by markets (75bp)**
- **Both market and consensus expectations will likely come down following today's statement**

Today's dovish statement supports our well-below-consensus 3.0% year-end monetary policy rate forecast

As widely expected, Banxico cut its policy rate by 50bp to 5.0%. The decision was fully priced-in by markets and in line with consensus expectation. The focus was going to be on the wording of the statement. Although a change in tone was warranted, Banxico's cautiousness and hawkishness make the notable changes all the more significant.

Following a consistent set of hawkish statements accompanying the previous three consecutive 50bp rate cuts, today's statement is in our view much more adequate for the current context. In contrast with the previous hawkish statement, that even made us recognize that our forecast for a 3.0% monetary policy rate by year end became less likely (see), today's statement clearly suggests that the end in the rate cut cycle is not close. The more dovish tone along with an anonymous vote suggest that additional 50bp rate cuts remain the most likely scenario, unless the ER sharply increases. As long as the peso does not weaken significantly, Banxico can remain focused on bringing down the real policy rate to an appropriate level ie, close to 0% or even negative as other emerging market central banks are doing (see). As such, we now feel more comfortable with our well-below-consensus 3.0% year-end monetary policy rate forecast. We continue to anticipate four more 50bp rate cuts in the second half of the year (200bp of rate cuts), which is four times what consensus is currently expecting (50bp) and much more than the view currently priced in by markets (75bp). Expectations will likely come down following today's statement.

Banxico put more emphasis on economic weakness and the widening output gap and less on temporary increases in inflation. We think this is a positive development considering the strongest recession in the last hundred years and that inflation is not going to be an issue. The Board continued to emphasize the significant “downside risks to growth” and highlighted that the negative output gap will continue to widen in the coming quarters[1]. More importantly, Banxico brushed aside the recent larger-than-expected rise in headline inflation, which is surprising given its pretty hawkish backbone which usually makes them overly cautious when inflation jumps as it has recently (from 2.1% in April to 3.2% in the first half of June). The Board kept the reference that the “balance of risks to inflation remains uncertain” but also stated that inflation might run somewhat below their expected trajectory[2] and put a greater emphasis on downside risks by bringing them before upside risks in the inflation paragraph. This is important as it implicitly acknowledges that in spite of inflation volatility, inflation pressures are more likely than not to remain subdued, which is also relevant because we are now expecting headline inflation to increase somewhat above 3.5% temporarily during the summer months. Based on today’s statement, this will not overly concern Banxico. We completely agree with this notable change. Finally yet importantly, Banxico also seemed to give some forward guidance by acknowledging that based on their “foreseen scenarios” they have space to ease monetary policy. While not as strong as the guidance provided by other central banks, this is a quantum leap for Banxico.

Overall, the tone of the statement is dovish for the first time in the rate cut cycle and points to multiple 50bp rate cuts going forward and a more appropriate and looser monetary policy stance by year-end. As long as the peso does not return to the lows seen earlier this year, Banxico is likely to continue easing the monetary policy rate in 50bp steps. The peso did not react to the dovish statement confirming our view that, in this context, the interest rate differential is not a significant driver of the exchange rate which is now responding almost entirely to global changes in risk aversion.

1: “Greater economic slack is expected within the time frame in which monetary policy operates”.

2: Regarding the expected trajectory for inflation, its determinants have reduced it slightly in relation to the announced one.