Central Banks

Banxico will cut its policy rate 50bp to 4.50%

We are sticking with 50bp cuts in the policy rate in each of the 2020 remaining scheduled meetings (to 3.00%)

Javier Amador / Carlos Serrano

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- **Forward guidance is unlikely but we expect Banxico to remain dovish and to brush aside the recent temporary and supply-driven inflation increase**
- **There is plenty of room for further easing: we continue to anticipate the policy rate to reach 3.0% by year-end**
- **Although risks are tilted to smaller further cuts after Thurday's likely 50bp cut due to Banxico's hawkishness, an easier stance will remain more appropriate and with inflation easing after the summer, Banxico will likely find no reasons to stop easing until the policy rate reaches c. 0.0% real ex-ante levels by year end**

We continue to expect Banxico to lower its policy rate more than what markets are pricing, to 3.0% by year-end

Following four consecutive 50bp rate cuts, some start to think that Banxico should not press ahead with its easing cycle. We do not share that view. A handful of analysts think that Banxico will not cut its policy rate further (two out of 28 in the latest CitiBanamex survey) due to inflation concerns. Some others think that the chances of a 25bp rather than 50bp cut have increased (six out of 28 expect only a 25bp rate cut). Yet, most share our view that the monetary policy stance should be eased further and Banxico will cut its policy rate by 50bp to 4.50% at its meeting on Thursday (20 out of 28). That is, an additional 50bp cut is expected and a smaller cut would be surprising.

The focus will be on the wording of the statement, which turned dovish (for Banxico´s standards) for the first time in the rate cut cycle in the previous meeting (see). The significant dovish tweaks made to the wording of the statement were absolutely warranted but were unexpected given Banxico's hawkishness and the recent larger-than-expected temporary rise in inflation. 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]. We estimate that the slack will not be absorbed in the next four years. 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

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

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 inflation will run above 3.5% temporarily during the summer months. Based on the last 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, including those in many emerging markets, it is significant and, considering that the latest increases in inflation are completely explained by temporary supply shocks, we expect the tone of the statement to remain mostly unchanged, signaling that rates are likely to go down further.

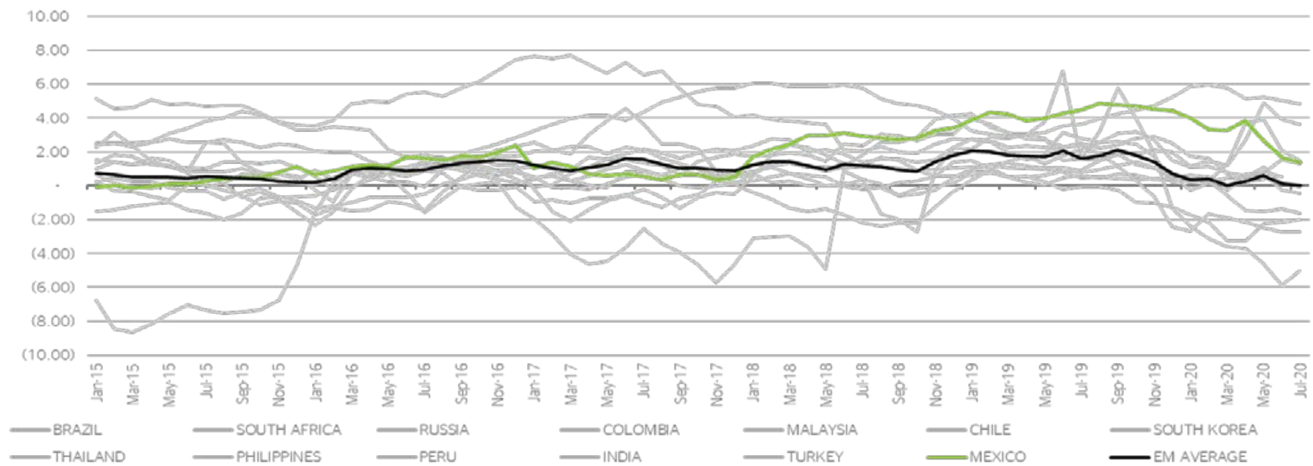
We thus expect Banxico to remain dovish in light of recent economic activity data and in spite of the recent transitory rise in headline inflation and core inflation's stickiness. We do not think that inflation above the 3.0% mid-point of Banxico's target range should be a cause of concern. Headline inflation has been pushed higher by the rise in global energy prices while core inflation has remained sticky to the downside mainly due to higher processed food prices – driven up temporarily in our view due to supply disruptions along with higher fresh food prices, probably some exchange rate pass-through and possibly higher mark-ups. Even if some pass-through is observed, as long as it does not affect inflationary expectations, it should not affect Banxico´s reaction function, as it would mean a change in relative prices, exactly the form in which a flexible exchange rate regime helps the economy to absorb shocks. The rise in core goods prices (temporary in our view) has been mostly offset by lower services inflation, down 1.1 percentage points (pp) from February to July (from 3.5% to 2.4% YoY). We think that in the current context of a widening negative output gap and weak demand, the services inflation trend better reflects the underlying core inflation trend. We think that core inflation will resume in August the downward trend seen in 1Q and contrary to consensus expectations but in line with Banxico's forecasts, we anticipate below-3.0% inflation in 2021. Thus, we do not think recent inflation data will prevent Banxico from lowering rates further or slowing its easing pace, especially if we consider that Banxico, like us, thinks the spike in inflation is transitory.

In the current context, the monetary policy rate remains within the estimated neutral range; we think it is behind the curve it should be at 0% by now. Thursday's likely 50bp rate cut will only take the rate slightly below the lower limit of the estimated neutral range (ie, 4.8%) and into the easing range. The question is whether Banxico will continue to ease the monetary policy after it takes the policy rate down to 4.5%. We think that considering that monetary policy has not been the main driver of the ER or capital flows, which have been more influenced by global risk aversion, and the Peso has remained relatively stable following Banxico's cuts, the central bank related concerns should have eased further in the intermmeting period. 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 0.0%. 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 (which is likely to remain at 0.0% through 2022) and with average rates in emerging markets. Therefore, we continue to expect 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). Risks are tilted to less easing but we think that Banxico has plenty of space to cut rates.

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

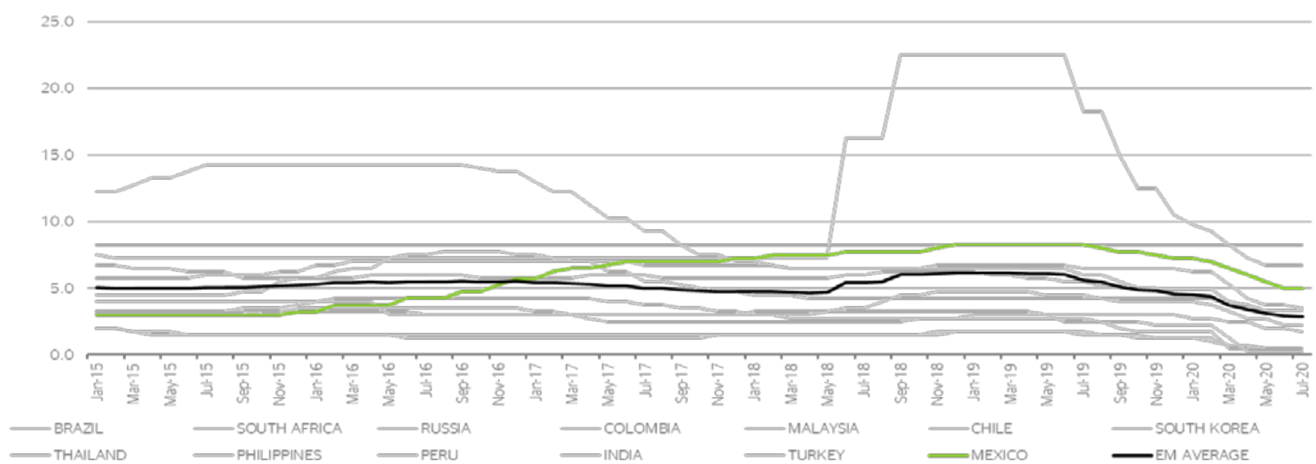
By reducing rates, Banxico can provide some relief to firms, considering that the majority of corporate loans are contractually tied to TIIE. It would also help the federal government as they will need to place additional debt in markets in the next months as fiscal revenues will be significantly less than what was considered in the budget, and existing rainy funds will not be enough to compensate for the decline in tax intakes.

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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