BBVA Research

Central Banks

Banxico cuts 50bp to 4.50%; dovish tone suggests the easing cycle has legs

A notably dovish tone alongside a widening negative output gap backdrop points to further cuts in line with our view

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- **Banxico strikes again a remarkably and warranted dovish tone**
- **The Board brushed aside the recent inflation rise (as we anticipated) and clearly signaled that inflation is not a worry for monetary policymakers, as we have been arguing**
- **The dovish statement along with a deep recession and a widening output gap clearly suggests further monetary policy easing**
- **In such a backdrop and given that inflation is not a concern, Banxico will likely find no reasons to stop easing until the policy rate reaches c. 0.0% real ex-post levels by year end**
- **We continue to expect a further 150bp of rate cuts in the easing cycle, taking the policy rate to 3.00% by year end ie, we are sticking with our call of 50bp cuts in the policy rate in each of the three remaining scheduled meetings in 2020**
- **Both consensus and market expectations will likely come down following today's decision and accompanying dovish statement**

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

In a split decision, Banxico cut its policy rate by a further 50bp, to 4.50%, in line with our call and as anticipated by a majority of analysts. As we argued, a slower pace of easing was unlikely at this point and the focus would be on the tone of the statement (see). The tone was notably dovish as we anticipated, leaving the door wide open for additional cuts in the coming meetings. Considering analysts' consensus was until today expecting Banxico to hold rates at 4.5% through the end of next year while markets were pricing in only 25bp worth of additional easing, both expectations are likely to adjust to the downside following today's decision alongside the accompanying dovish statement. We continue to expect a further 150bp of rate cuts in the easing cycle, taking the policy rate to 3.00% by year end ie, we are sticking with our call of 50bp cuts in the policy rate in each of the three remaining scheduled meetings in 2020. Although it might be argued that the split vote (with one member voting for a smaller 25bp cut) could be a sign that the easing cycle will slow soon, the more dovish tone suggests that the majority of the Board members see the need for further easing in a backdrop of a deep recession and a widening output gap.

The dovish tone of the accompanying statement is remarkable. Not only did Banxico brushed aside the recent inflation rise, as they should given its temporary and supply-side nature, but they also clearly signaled that inflation is not a worry for monetary policymakers, as we have been arguing since the pandemic began. In line with our view, Banxico argued that the recent rise was mostly due to higher energy and food prices. Notably, the central bank also shrugged off the recent moderate rise in core inflation saying that we have been observing a "recomposition in core inflation, decreasing that of services and accelerating that of goods". In fact, in the description of risks to inflation, it could be argued that Banxico implicitly acknowledged that the declining trend in services inflation would likely be more relevant and persistent than the upward trend in core food goods, which has been in part associated with "logistics and supply problems […] and higher costs associated with the adoption of sanitary measures". To us this is a tacit acknowledgement that recent rises in inflation have been driven by temporary supply shocks. Although they highlight the continuation of these problems as an upside risk (the bottlenecks in distribution channels of food items), they seem less probable and relevant that the downside risks due to the widening negative output gap and lower demand of certain services arising from social distancing measures. Banxjco highlighted that the negative output gap will continue during the period of time in which monetary policy works. More importantly, the central bank stated that both headline and core inflation will likely "move around 3% within the 12-24 month forecast horizon" – ie, around Banxico's target. Thus, while they continue to say that the outlook for inflation remains uncertain, they also signal that inflation is not likely to be a concern for monetary policymakers in that period (in the next one to two years).

It is particularly relevant that Banxico stated that "financial conditions, both global and local will be subject mainly to the effects of the pandemic". This implies, as we have been arguing, that the dynamics of the pandemic are much more relevant for financial conditions, including the exchange rate, than the monetary policy stance.

In short, more easing is the most likely scenario and in our view Banxico will not find reasons to slow the easing pace in the coming meetings. Albeit it is true that headline inflation will accelerate somewhat more (to 3.8-3.9% in Aug-Sep), core inflation will likely resume its downward trend as early as August. Moreover, a headline rate close to 4.0% should not be a concern given that it would be driven by a base effect considering the unusual -0.02% MoM headline inflation print in August 2019. We agree with Banxico in that inflation, both headline and core, will hover around 3% in a 12 to 24 month horizon. We are sticking with our call of three additional 50bp rate cuts in 2020 but the risk is that Banxico could slow down the easing cycle if there is a negative surprise in core inflation between now and the next scheduled monetary policy meeting (Sep 24). As long as the peso continues to hold up –our baseline scenario–, Banxico will likely continue to ease its monetary policy stance. It is worth noting that today's cut took the monetary policy rate slightly below the lower limit of the estimated neutral range (ie, 4.8%) and into the easing range for the first time in the easing cycle. The deepest recession on record alongside a favorable context for inflation going forward warrants additional easing, at least until the real policy ex-post policy rate is close to 0.0%.

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