Creating Opportunities

Central Banks

Banxico will likely slow its easing cycle

We now think that Banxico will move in 25bp steps from here until the policy rate reaches 3.0% (now in May 2021)

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- **There is scope for further rate cuts but Banxico will likely slow the easing pace**
- **The minutes to the last meeting show a split within the Board and a more cautious Banxico. Recent inflation levels likely reinforce the shift towards more cautiousness and might even make at least one member vote for a pause**
- **Inflation concerns are overdone: in spite of the current change in relative prices, there will not be any demand-side pressures in the coming quarters, giving Banxico room to further cut rates**
- **The recent strengthening and outperformance of the Mexican Peso along with recent capital inflows should comfort Banxico**
- **We continue to expect Banxico to slash rates much further than currently expected, but we now expect a slower rate cut cycle (to 3.75% by year-end). We continue to think that the policy rate will reach 3.0% (now in May 2021)**

We continue to expect Banxico to lower its policy rate more than what markets are pricing, to 3.0% at the end of the easing cycle, now in 2Q21

Following five consecutive 50bp rate cuts, Banxico seems to be leaning to slow its easing cycle. We expect Banxico to cut the policy rate by 25bp to 4.25%. We already knew that one member (Irene Espinosa) voted for a smaller cut in August, on concerns about higher inflation, but the minutes to Banxico's last meeting revealed a split between hawkish and dovish members within the Board. Two other members also expressed hawkish sentiments. One saying that there is less room to further cut rates[1]. Another expressed that "monetary policy must be even more cautious" going forward, acknowledging that it has been up to now, but more importantly for the future path of rates, signaling either that he thinks that rates should not come down much more in the near-term. As we have been arguing, monetary policy has not been forward looking in the current easing cycle and therefore, rates have not come down as fast as needed and warranted. Hawkish comments from three members in the minutes point not only to a split within the Board but to a majority (3 to 2) leaning to ease the easing cycle onwards, and possibly to at least one member voting for a pause. These hawkishness was somewhat balanced by dovish comments from two other members. One sharing our view on inflation and monetary policy and leaning to take the "real interest rate close to zero or even negative", and another rightfully so in our view expressing concern about the deep recession and stating that "the economic and social crisis demands continuing decisively with the accommodative cycle". It should be added that the crisis demand more

1: The scope to "continue with monetary easing has diminished" decisive actions in terms of the interest rate and that we continue to think that considering the forward-looking nature of monetary policy and the lags with which it operates, Banxico should press ahead and continue to cut rates in 50bp steps.

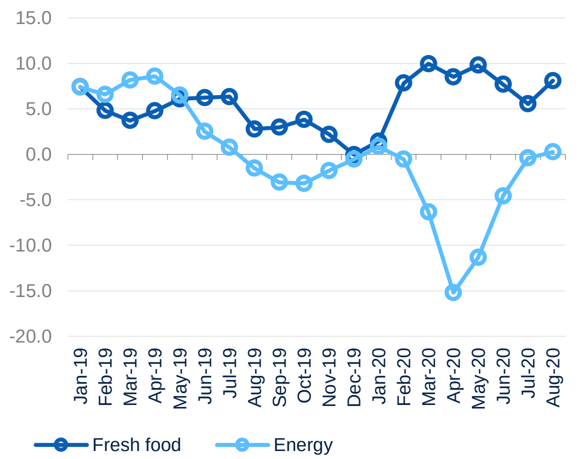
Yet, signs point to an even more cautious Banxico from now on. Mainly two factors worry hawkish members: higher inflation and the exchange rate (ER) and capital outflows. Although we think that inflation concerns are overdone, the most recent data, with both headline and core inflation at 4.0% YoY, likely reinforced the cautious shift in the intermeeting period. Meanwhile, the recent strengthening and outperformance of the Mexican Peso along with recent (albeit moderate) inflows that suggest a stabilization of capital flows point to lower concerns on this front. However, we think that inflation outsized concerns from hawkish members will outweigh all other considerations.

Why do we think that inflation worries are overdone? 1) Both headline and core inflation likely peaked in August and will start to ease in the first half of September (data will be released Thursday morning before Banxico's monetary policy decision). We are expecting small 0.08% and 0.05% HoH increases for headline and core inflation, respectively, taking annual rates down to 4.01% and 3.86% from 4.05% and 3.97%, respectively. After the second fortnight is accounted for in early October, we are expecting September annual rates to further ease to 3.93% and 3.80%, respectively. 2) The recent increase is mostly driven by rising food inflation and a sharp rebound in energy prices (see graphs 2 and 3). Non-core inflation has risen fast over the last four months, increasing 1.0% MoM on average. After sharply decreasing in March and April, energy prices have quickly rebounded (see graph 2), increasing 2.5% MoM on average over the last four months. Meanwhile, fresh food price inflation has remained high (see graph 2) while processed food prices have faced strong pressures throughout 2020. Food core goods annual inflation has increased from 4.4% in December 2019 to 7.0% in August, driving up core goods inflation to above 5.0% YoY in the last two months, more than offsetting the downward services inflation trend (see graph 3). 3) These food price increases represent a change in relative prices. The increases have been driven by stronger-than-usual food supermarket sales due to the economic partial lockdown (its effects are already easing), by temporary disruptions in production and supply chains (already behind us) and probably by higher margins. In a context of weaker demand ahead and a widening negative output gap firms will most likely be unable to further stretch margins. There are already signs of stabilization in the monthly increases of food core goods that point to lower annual increases ahead. 4) Weak services inflation more accurately reflects the underlying inflation trend as it is driven by (weak) demand as opposed to supply-side factors, temporary in nature.

Food price pressures are a global phenomenon, the difference is that in Mexico, the food core goods component represents slightly more than ¼ of core inflation (27%) and 20% of headline inflation while the non-core food component (fresh food) takes the weight of food prices in the overall basket to 30%. That is, the main reason food prices are pressuring inflation more in Mexico than in other countries is the simple fact that it weighs much more on the inflation basket and thus, its outsized increases have a larger effect, which nonetheless will prove temporary and only reflects a change in relative prices.

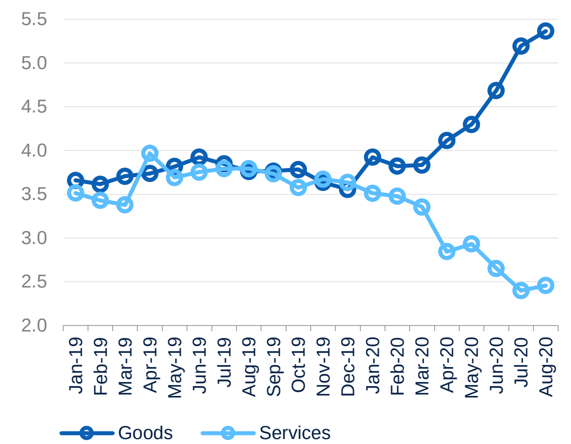
Summing up, both headline and core inflation both stand at 4.0% YoY: continued pressures in fresh food prices along with a quick rebound in energy prices are behind higher non-core inflation, while lower services inflation has not been enough to offset the upward trend in goods inflation, mostly driven by food core goods. Overall, core inflation will soften ahead and should fall below next year in a context of a large output gap. Although current inflation levels will likely concern hawkish members of the Board, the peak is behind; inflation will soften and will be closer to the target in coming meetings. With inflation slowing down, we think Banxico (the majority of the Board) will find no reasons to stop easing monetary policy. Not only do real rates remain positive in a context in which negative rates are warranted, going forward, they would increase if Banxico does not cut nominal rates with easing inflation, unnecessarily reverting some of the monetary policy easing. We do not think that will be the case. In spite of the current change in relative prices, there will not be any demand-side pressures in the coming quarters, giving Banxico room to further cut rates. We continue to expect that Banxico will slash rates much further than currently expected, until they are around 0% in real terms, but we now expect Banxico to slow the rate cut cycle (to 3.75% by year-end). We continue to think that the policy rate will reach 3.0% (now in May 2021).

Graph 2. **FRESH FOOD AND ENERGY PRICES** (YoY % CHANGE)



Source. BBVA Research / INEGI

Graph 3. **CORE INFLATION: GOODS VS SERVICES** (YoY % CHANGE)



Source: BBVA Research / INEGI

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