Central Banks

Banxico holds rates unchanged and signals that the “pause” is likely to continue in the near term

Decision might not mark the end of the rate cut cycle if with falling inflation Banxico resumes it in 2021

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- **Banxico continues to expect inflation to converge to 3.0% but once again opted to be backward and not forward looking**
- **It is surprising that they have decided not to procure further easing in financial conditions in the context of the largest economic contraction in at least 100 years**
- **In a shift from the previous two statements, the Board seems now to be more concerned about the recent, temporary in nature, inflation rise than the economic outlook**
- **With inflation gradually easing, a weak economy and a strong Peso, the case for further easing will become stronger in 2021; yet, with an overly hawkish central bank we should only expect that the door would open for one or two additional rate cuts**
- **We now expect Banxico to remain on the sidelines in December; future movements will only be possible if inflation eases towards 3.0-3.5%. With today´s pause, Banxico clearly signals that the real policy rate will remain above 0.0%, contrary to our expectation of 0.0% or slightly negative in the future**

Banxico reasons for pausing not clear in the statement

In a split decision, a majority of Board members (4 out of 5) decided to leave the policy rate unchanged at 4.25%. Only one member voted for a 25bp cut. Banxico’s wording choice for its decision, calling it a “pause”, leaves questions about future movements in a backdrop of a stronger Peso and a weakening economy following the 3Q rebound. This context alongside a gradual inflation easing in coming months suggests that the case for further cuts will remain strong. However, the lopsided vote, a history of hawkishness, and the absence of a forward-looking policy framework point to a pause in the next few meetings.

The reasons for the pause are not clear. We will need to wait for the Minutes to get a better sense of the reasons. Likely, inflation’s stickiness and the fact that inflation edged up to 4.1% in October are the main reasons behind the pause even if the statement acknowledges that the increase was mainly driven by non-core inflation where monetary policy is not effective. Besides, the overall inflation assessment remains broadly unchanged if we compare it to the previous statement in which Banxico cut the policy rate and said that the space for easing was limited. Banxico said that it had revised its inflation projections slightly to the upside but they continue to expect a convergence to 3.0% in a 12 to 24-month timeline.

Summing up, Banxico opted once again to be backward looking instead of forward looking as they decided to pause while acknowledging that non-core inflation was behind the most recent increase –likely, this forced the upward revision to their short-term inflation projections– and that they continue to expect inflation to gradually converge to 3.0%. This in a context, which the board acknowledges, of “ample slack conditions in the horizon where monetary policy operates”. It is hard to reconcile this with the decision to stop the easing cycle.

It now seems clear that Banxico will remain on the sidelines in December but the case for a resumption of rate cuts will likely become stronger in early 2021 with a weak economy, a strong peso and with inflation coming down. Future monetary policy decisions will rest mostly on current inflation, as opposed to expected inflation as it should be the case. Banxico is now an outlier in a situation where most central banks that have inflation under control and a large output gap have taken monetary policy rates to negative territory.

Following a pause, Banxico might resume the rate cut cycle with one or two rate cuts in the first half of next year. We now expect the policy rate to remain at 4.25% in December and to come down, probably to 3.75%, next year.