Central Banks

Should Banxico hold the policy rate steady, reacting to a temporary –supply-shock driven– rise in inflation?

We stick with our call of a 25bp rate cut to 3.75%, but the odds became closer, 60-40 leaning to a cut in our view

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- **A majority of analysts still expect the next movement of the monetary policy rate to be a rate cut to 3.75% this Thursday**
- **The MPC should not react to temporary increases of inflation, already acknowledged in its communication and expected by everyone (ie, markets and analysts)**
- **Arguments for the MPC to keep the policy unchanged are not solid in our view**
- **Still, we think that the odds of a hold are not low (40%)**

We expect Banxico to cut the policy rate to 3.75% and to possibly signal the end of the rate cut cycle or date-dependency of decisions going forward

Banxico's Monetary Policy Committee (MPC) will meet on Thursday to take a monetary policy decision. In the last meeting in February, the MPC resumed its easing cycle with a 25 bp rate cut, taking the policy rate to 4.00%. The wording of the statement was unequivocally dovish, and contained forward-looking tweaks, which suggested that additional rate cuts in the coming meetings were likely. A dovish MPC left the door wide open for additional cuts, even after acknowledging that headline inflation was set to temporarily rise in the near-term, driven by both a supply-shock in fuel prices and base-effects following the sharp inflation drop in Mar-Apr 2020.

Two weeks ago, 17 out of 28 analysts in the CitiBanamex Survey were expecting a rate cut in this upcoming meeting, us among them. In yesterday's published Survey, 11 out of 29 were still expecting a rate cut, again, us among them. One has to ask, what changed in the last two weeks? Ultimately, what changed in the intermeeting period? After all, even if the consensus expectation is still that the MPC will cut the policy rate one more time in 2021, and the majority of analysts still expects the MPC to make that cut this Thursday, that majority came down from 61% of analysts two weeks ago to 38% this week.

The first argument for a pause is inflation pressures. Yet, the recent pressures have been on non-core inflation, particularly on fuel prices. That is, the pressures have been on headline inflation –core inflation remains sticky– and driven by a supply shock. A central bank should not react to supply shocks and should disregard this temporary rise as long as it remains contained only to non-core inflation, as is the case now. Another argument for the MPC to hold the policy rate steady this week is that pressures will intensify in March and April. That argument is a stretch in our view. As the MPC acknowledged in its most recent communication (namely, February's statement accompanying the decision of a 25bp rate cut and the Quarterly Inflation Report), inflation is set to rise driven by base-effects. It is important to say that headline inflation will rise above the 4.0% upper limit of the 3.0% +/-1 target range in April, and above 5.0% in April, before declining rapidly to below 4.0% in June and below 3.5% during the summer. That is, the rise will prove temporary, will not occur in core inflation, which will likely start to decline during 2Q, and this trend is anticipated, and has been already acknowledged by the MPC. Therefore, the second question we need to ask is if the central bank should react to a temporary –base-effect driven– rise in inflation. In short, monetary policy operates with a lag, and should not react to either a supply-shock or a base-effect driven temporary increase in headline inflation.

A second argument for a pause is the supposed generalized shift in monetary policy among emerging market central banks. It has been argued that there are hawkish monetary winds sweeping through emerging markets following rate hikes in Brazil and Turkey. Is that so? Alternatively, are there idiosyncratic conditions that led the central banks of those countries to hike the policy rate? We think that is the second. For example, Turkey is in a long-overdue need of regaining confidence to anchor inflation expectations and better conduct monetary policy. Meanwhile, in Brazil the central bank is simply partially removing a part of the monetary accommodation. The CB raised the policy rate to 2.75%, but it remains much more accommodative than in Mexico, in a context in which inflation pressures are evident and inflation expectations are not well anchored –eg, year-end inflation expectations stand at 4.7%, well above the 3.75% target. Banxico has ample credibility –ie, it is in no need of recovering or gaining it–, and inflation expectations in Mexico remain well anchored. In short, it is not a good argument, and each country has its own special conditions. Moreover, the countries in which the monetary policy rate has recently been hiked still have a much more accommodative stance of monetary policy –ie, lower real rates.

A third argument has to do with the recent peso weakening. One would have to ask whether that weakening is likely to intensify or, on the contrary, is likely to revert, as has been the case over the past two weeks in which the exchange rate (ER) has come down from 21.5 to 20.6ppd. In our view, ER-related risks are contained. The recent increase in the ER has been associated with global movements, particularly the increase in US long-term interest rates. In our view, the increase doesn't have more legs, particularly in a backdrop in which the Federal Reserve has insisted that the fed funds rate will not start to increase until full-employment is reached, even if inflation stays above the 2.0% target. Under this context, Banxico should not worry too much about the ER, unless there is a disordered event of capital outflows that we are not foreseeing in a context of ample global liquidity and gradual normalization in the global economy.

A fourth argument is that the Mexican economy has had a stronger-than-expected performance during 4Q20 and 1Q21. That is true, the economy continued growing at a fast pace in 4Q20 and is decelerating less than previously expected during 1Q21. However, the output gap is ample and is unlikely to close in 2021 or 2022. Besides, internal demand remains weak, and in spite of a statistically driven rebound in 2021, risks to growth remained tilted to the downside, as Banxico has signaled in its most recent communication.

Another argument for a cut is that the recent rise in long-term interest rates (M10 rates have increased 1pp compared from December's level) is tightening financial conditions in Mexico in a context of a weak economy. Besides, with these higher levels, bonds have become more attractive, and could attract inflows, which lowers the risk of sudden or rapid outflows, further limiting ER risks.

Overall, we think that Banxico should not pause again its rate cut cycle and should lean to additional easing that will likely prove useful in the context of the economy. Following the largest drop of GDP since the 1930s, the monetary accommodation should be larger. In terms of communication it also makes sense. Communication is an important tool of monetary policy. Changes in the intermeeting period do not warrant a pause or an end of the rate cut cycle. Easing or hiking cycles should not have more than one pause, it is confusing, and windows might close soon. That is, the central bank should take advantage of the window that is now open, to take the policy rate where it should be, particularly considering that monetary policy operates with a lag. In our view, the MPC should make one additional 25bp cut to 3.75% and signal that either going forward it will be data-dependent, or that they feel comfortable with the level reached and it will maintain the accommodation in the foreseeable future. For us, risks of an additional cut are low, and will better situate the monetary policy rate in a more accommodative stance, which is warranted.

Having said this, the odds are possibly close and we think there is a 60% chance of a cut and a 40% probability of a hold. Following the recent changes within the MPC, with the appointment of Galia Borja, and the apparent implied shift in favor of the more dovish members of the MPC, it seems that the MPC will lean to another cut (that is why we think there is a higher-than 50% chance of a cut). However, Banxico has a history of backward-looking decisions, a tendency of being excessively cautious in our view, and to a degree, some disregard for the importance of clear communication as an important policy tool (that is why we think that the odds of the MPC holding the policy rate are not low, and close to 40% in our view).