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Banxico Watch

Banxico is set to start cutting the policy rate

Javier Amador / Iván Fernández / Carlos Serrano

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The policy stance has become overly restrictive, which limits the risk of a sharp MXN depreciation once it begins to normalize

- **Banxico has held the policy rate steady at 11.25% for the past seven meetings (11 months) since its last hike in late March 2023, but monetary policy has become more restrictive over that span.** During this extended pause, the Fed has hiked the fed funds rate twice by 25 bps each, and thus the target rate spread has narrowed 50 bps to 575 bps from this tightening cycle peak of 625 bps (Figures 1 and 2). Yet, the spread remains well above its 300 bp steady-state level, and its 450 bp average level observed in the decade prior to the pandemic. This partially explains why the exchange rate seems to remain unaffected by the somewhat lower spread, as the Mexican peso has outperformed strongly since Banxico moved to the sidelines in mid May 2023. The exchange rate came down from 17.7 to 16.7 ppd, a 5.7% appreciation, while the other nine most important emerging market currencies have depreciated on average c. 15%. Moreover, the peso has continued to strengthen despite the fact that markets have priced in that Banxico will slash rates next week while the Fed will likely push back the start of its rate-cut cycle to June, or possibly even July (see). Similarly, the peso appreciated in the past two weeks despite Trump's clinching the Republican nomination for this year's presidential election. In our view, Banxico should not be overly concerned about the risk of a sharp depreciation once it starts to gradually normalize the monetary policy stance. In fact, we believe the appreciated peso is now a headwind against the economy.

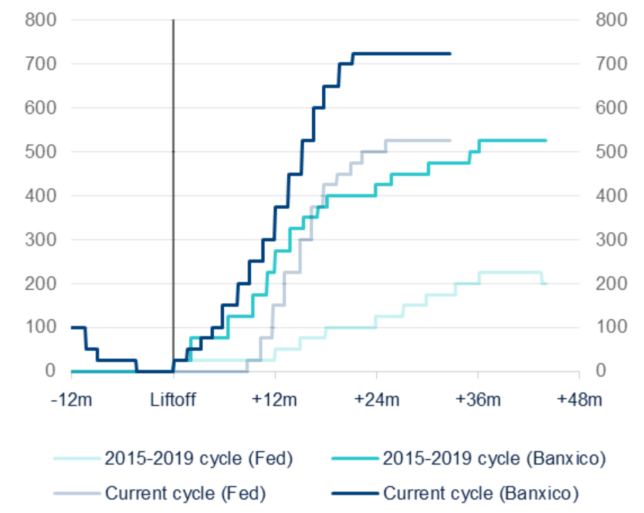
- **In this period, headline inflation has decelerated by 2.4 pp (Figure 3) while 12-month headline inflation expectations have come down by 1 pp (Figure 4).** Inflation data continues to show signs of moderation. The headline inflation rate dropped to 4.4% YoY in February from 4.9% in January, while core inflation eased (-)0.2 pp to 4.6% YoY. At 4.4%, headline inflation is now broadly half its Aug-Sep 2022 8.7% YoY peak level. Core inflation has also eased sharply: (-)3.9 pp to 4.6% YoY since it peaked, mostly driven by lower core goods inflation, which has come down (-)7.2 pp from its 11.3% YoY peak and it is now (at 4.1% YoY) closer to the upper limit of Banxico's target. Core services inflation continues to show stickiness and its current 5.3% annual rate is only slightly below its 5.7% recent peak, but services inflation excluding housing and tuitions has come down (-)1.6 pp since peaking, and is off to a somewhat better start in 2024. Moreover, we think that the current economic deceleration along with the slowdown in the job creation pace will contribute to gradually break this stickiness in coming quarters, i.e., we think that core services inflation is set to finally cool down this year. Notably, both 12-month headline and core inflation expectations are now below 4.0% and we think they still have room to come down further to levels closer to 3.5% (expectations have never anchored at 3% since Banxico adopted an inflation target). To sum up, lower inflation and inflation risks open the door for Banxico to start a rate-cut cycle.

- **The real ex-ante rate has risen from 6.4% to 7.4% since Banxico moved to the sidelines, and is now 4 pp above the upper limit of Banxico's estimated neutral range in the long run (Figure 5).** With actual inflation bringing down inflation expectations, which are now close to which they are likely to end up, the monetary policy stance has tightened further and has become too restrictive in our view, not only in absolute terms (why should policy be more restrictive during this span with lower and declining inflation, expectations, and inflation risks?), but also in relative ones with the real ex-post policy rate spread versus other emerging central banks widening further since Banxico started to keep the nominal policy rate unchanged at 11.25%. As shown in Figure 6, Banxico's stance is now the most restrictive among the most important emerging economies.

- **Banxico's board had already signaled that a rate cut next week was likely. We think that is a done deal following this month's inflation prints and the recent appreciation of the MXN. We expect Banxico to cut the policy rate by 25 bps, to 11.00%.** The focus will be on the signals about the upcoming rate-cut cycle. The vote will most likely be divided, but we are expecting a 4-to-1 majority for the rate cut. It seems that one member of the Board still thinks that in spite of a much more favorable inflation context, with the slowdown in economic growth further reducing the inflation risks ahead, Banxico should stick with the current nominal rate, which would imply a further tightening of the policy stance (unwarranted and even puzzling in our view). Another member seems set to vote for (at least) this first rate cut as in his view the real ex-ante rate can be fine-tuned so long as it remains above 7.0% (the member has not explained why it should remain at that overly restrictive level for some more time with much lower inflation risks, a stronger peso, and lower expectations; this is also unwarranted in our view). Another member has signaled that he shares our view on growing risks of monetary policy becoming too restrictive and thus seems set to vote for consecutive rate cuts in coming months (warranted in our view). The other two members have been less clear about their positions, but it seems they're leaning towards rate cuts in coming meetings. We continue to expect Banxico to cut the policy rate at each remaining meeting in 2024 (even if the vote becomes 3-2 two meetings ahead) to bring the policy rate down to 9.25% by year-end, thus avoiding an unwarranted further increase in the real ex-ante rate, and to start to gradually ease the very tight stance in 2H24. It is important to highlight that even if Banxico lowers the nominal rate to 9.25% by December and to 7.25% by the end of next year, the stance will clearly remain restrictive throughout 2024-25, and the real ex-ante policy rate will most likely still remain above the upper limit of the neutral estimated range of 3.4%. That is, even if Banxico remains cautious, we think it has plenty of room to cut the policy rate without skipping any meeting the rest of this year and in 2025.

Banxico has kept the policy rate at 11.25% for eleven consecutive months since the last hike…

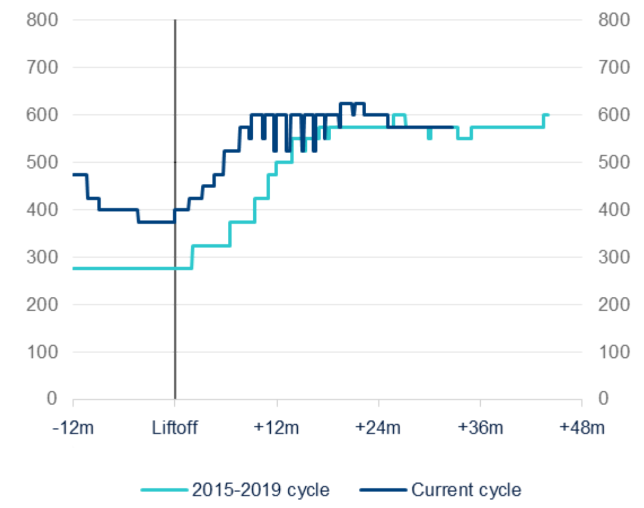
Figure 1. **MEXICO-US TARGET RATES IN MONETARY TIGHTENING CYCLES** (BPS VS RATE AT LIFTOFF)



The vertical line indicates Banxico's liftoff in each cycle.
Source: BBVA Research / Haver

… in March 2023; the spread remains well above its 300 bps steady-state level

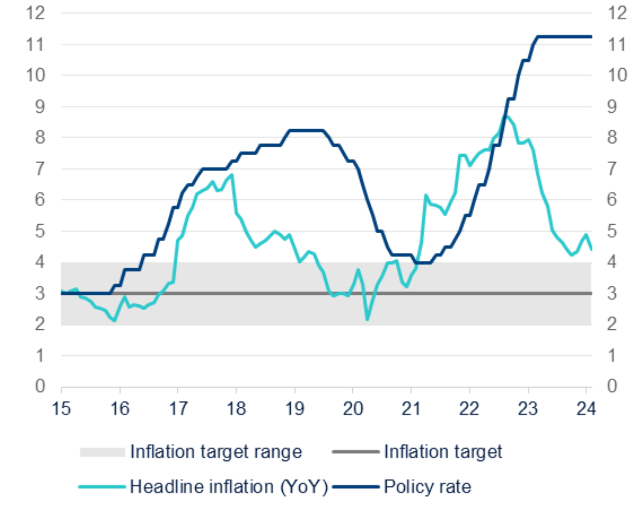
Figure 2. **MEXICO-US TARGET RATE SPREAD IN MONETARY TIGHTENING CYCLES** (BPS)



The vertical line indicates Banxico's liftoff in each cycle.
Source: BBVA Research / Haver

In this period, headline inflation has decreased by 2.4 pp…

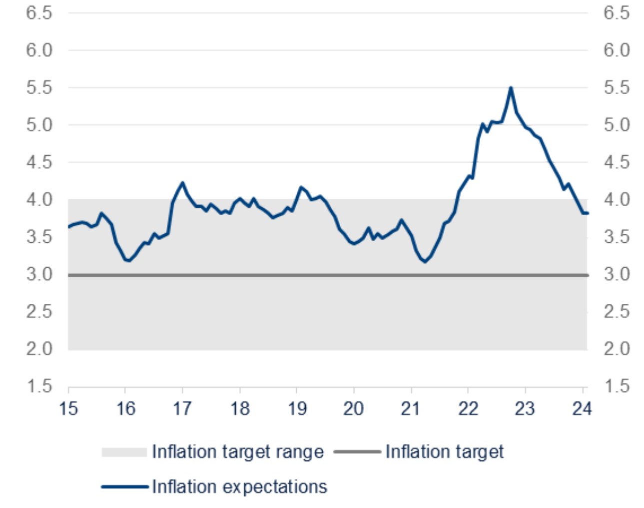
Figure 3. **INFLATION TARGET, HEADLINE INFLATION AND POLICY RATE** (%)



Source: BBVA Research / Haver

… while 12-month headline inflation expectations have come down by 1 pp, thus…

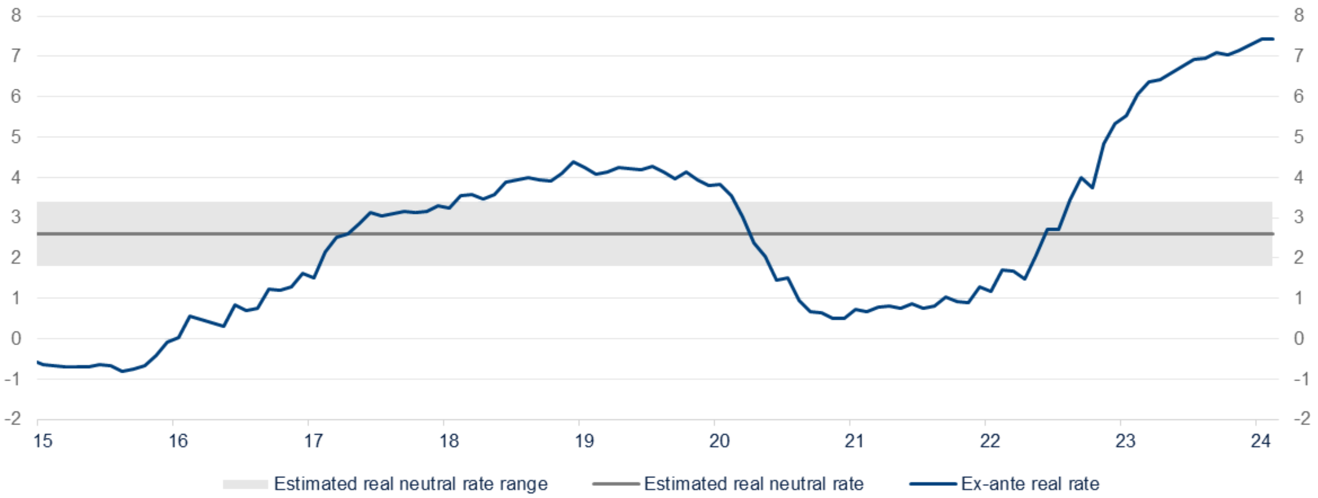
Figure 4. **INFLATION TARGET AND 12-MONTH HEADLINE INFLATION EXPECTATIONS** (%)



Source: BBVA Research / Haver

… the real ex-ante rate has risen from 6.4% to 7.4%, and is now 4 pp above the upper limit of Banxico's estimated neutral range in the long run

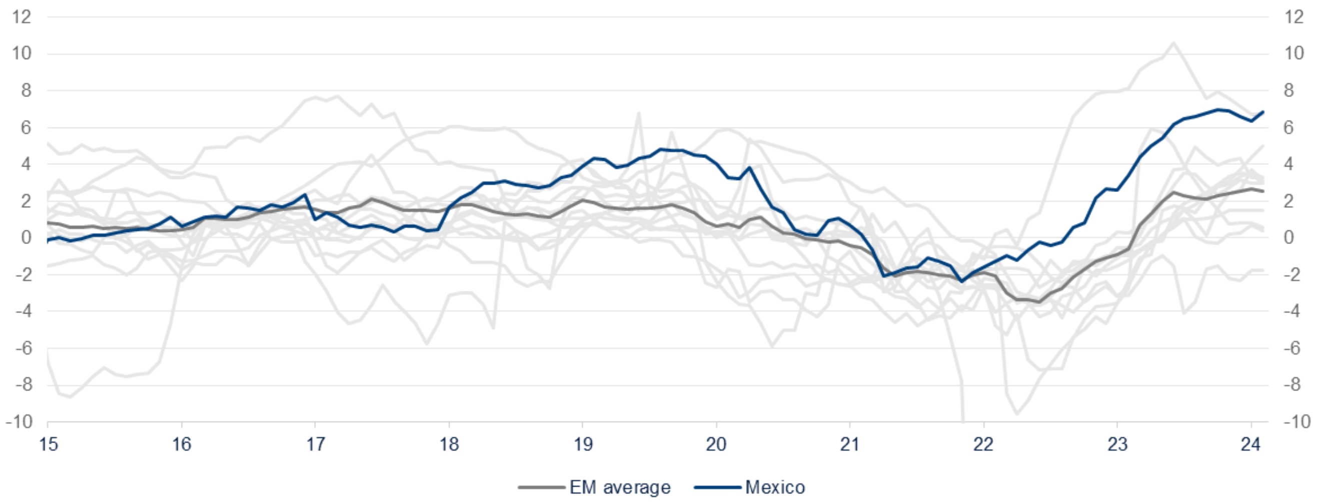
Figure 5. **ESTIMATED LONG-RUN NEUTRAL RANGE AND REAL EX-ANTE RATE**
(%)



Source: BBVA Research / Banxico / INEGI

In our view, Banxico has an ample room to begin to gradually normalize the monetary policy stance which has become too restrictive in absolute and relative terms

Figure 6. **REAL EX-POST POLICY RATES**
(%)



Light-gray lines indicate real ex-post policy rates for Brazil, Chile, Colombia, India, Malaysia, Peru, Philippines, Russia, South Africa, South Korea and Thailand.
Source: BBVA Research / Bloomberg

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