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Banxico Watch

Banxico is likely set to keep the policy rate steady

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Sticky core services inflation and delayed Fed rate cuts support Banxico's bias to a more gradual easing cycle

- **A further delay of the Fed's rate cut cycle amid the lack of further progress on inflation in 1Q24 adds to the view that Banxico will proceed cautiously.** Last week, the FOMC decided to leave the fed funds rate unchanged at 5.25-5-50% amid the recent lack of further progress on inflation and the continued strength of economic activity. Chair Powell noted that it will likely take longer than previously expected to gain enough confidence in the disinflation process—and thus longer to consider rate cuts. But he also avoided to strike an overly hawkish tone by dismissing the odds of possible rate hikes and stating that the policy focus continues to be on how long to keep policy restrictive. Indeed, market-based policy rate expectations eased somewhat following last week's FOMC meeting. The softer-than-expected jobs report from last Friday also contributed to a further reassessment of policy rate expectations. We expect the first fed funds rate cut to come in September and anticipate the Fed will cut the policy rate again in December to take it down to 4.75-5.00% by year-end. A more patient Fed gives Banxico further room to stick to its plan of cautiously adjusting its monetary policy stance.

- **Banxico's board members seem to agree on the view that it is too soon to consider that the March's rate cut marked the beginning of a non-stop monetary policy easing cycle.** While deputy governor Jonathan Heath had long called for an eventual fine-tuning of the policy rate to avoid an overly restrictive policy stance, it was less clear whether the rest of the board members (excluding the leading hawk Irene Espinosa) supported such a calibration approach rather than advocating for a continued easing cycle. March's meeting minutes pointed to the former. While there was ample acknowledgment of a less adverse environment for the inflation outlook than the one faced in 2022, the general opinion continued to be that Banxico should act cautiously going forward. One member considered that "the assessment of additional rate cuts would be made on a meeting-by-meeting basis," and that additional adjustments "would be gradual." Two of them were even more vocal, with one of them stating that "it is still not time to begin a rate-cutting cycle" and the other expressing that the March move "should not be interpreted as a normalization process."

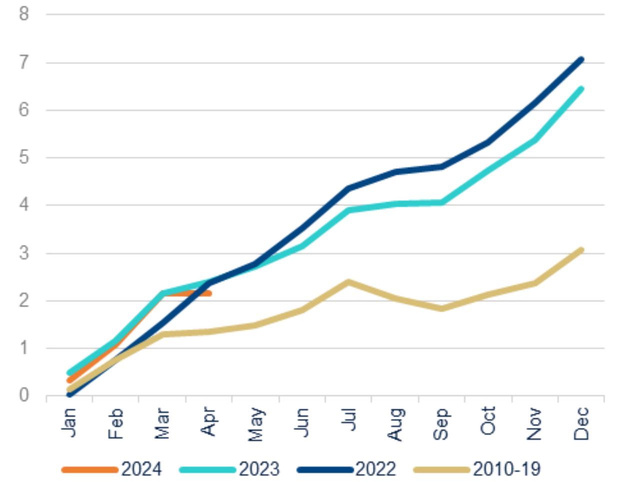
- **In the intermeeting period, headline inflation hit a bump in the road, but core inflation continued to ease.** After having dropped back to 4.4% YoY in February, headline inflation rebounded through the first half of April to 4.6% YoY and is set to remain at that level in April—the data will be released on Thursday morning, before Banxico's statement release. This short-term bumpiness has been driven by higher non-core inflation as core inflation has continued to ease from 4.7% at the time of the March meeting to 4.4% now. Core goods inflation has been below 4.0% YoY for three consecutive fortnights, but core services inflation has continued to show stickiness, averaging 5.3% YoY over the last three fortnights, the same average level as the previous three fortnights before the last meeting. In fact, services inflation excluding housing and tuition is set to have increased during the first four months of the year at broadly the same rate as last year (Figure 1). Moreover, although the trimmed mean core CPI continued to ease and is still pointing toward lower core inflation ahead, the supercore measure did not ease further over the intermeeting period (Figure 2).

- **Although core inflation is likely set to continue to ease ahead, Banxico's board will likely remain concerned about the continued stickiness in core services inflation.** 12-month inflation expectations came down to 3.85% from 4.00% in the intermeeting period, while long-run expectations were broadly unchanged. Given that core services inflation likely eased to 5.2% YoY in April from 5.4% in March, and somewhat softer demand points to lower pressures ahead, the door to lower the excessively high real exante rate remains wide open in our view. We believe it is difficult to justify that with both inflation and expectations being significantly lower than a year ago, the real monetary policy stance is tighter. In our view, the overly tight monetary policy is one of the factors that explain the sharp deceleration in economic growth in the last two quarters. Yet, as argued above, Banxico's board has signaled that consecutive rate cuts are not likely at this point. If Banxico stays on the sidelines at this meeting as we now expect, the real ex-ante rate will be at 7.15%, close to its recent peak and 3.75 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 relatively close to which they are likely to end up, the monetary policy stance is set to stay very tight in the near term in absolute terms (with easing core inflation, expectations, and inflation risks), but also in relative ones with the real ex-post policy rate among the highest compared to other emerging central banks (Figure 6).

- **Bottomline: The favorable core inflation trend, as well as the appreciated MXN, give Banxico room to continue lowering the policy rate, which will remain tight during 2024-25 despite a gradual rate cut cycle, but we now expect Banxico to pause the rate cut cycle this week and take rates down to 9.75% by year-end.** The 50 bps difference vs our previous 9.25% expectation comes from renewed expectations of both the pause at this meeting and Banxico's continued stress on being cautious ahead. It is not likely that it would ease policy more rapidly at any point ahead, even if the real ex-ante policy rate will most likely remain above the upper limit of the neutral estimated range of 3.4%.

Services inflation is running at broadly the same rate in 2024, pointing to stickiness…

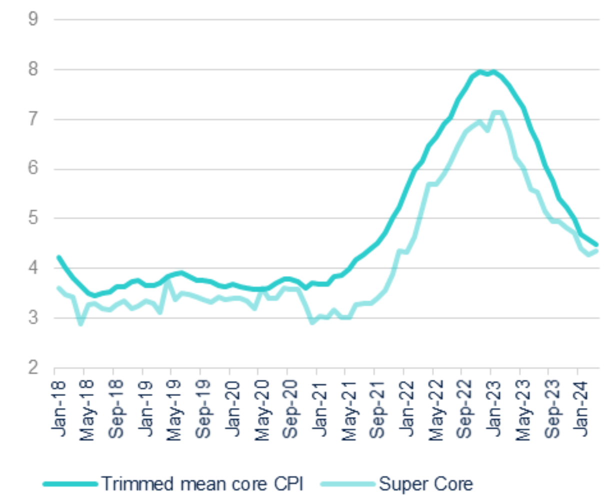
Figure 1. **CUMULATIVE CORE SERVICES INFLATION EX-HOUSING & TUITION** (%)



* April 2024 is forecast.
Source: BBVA Research / Inegi

… while supercore inflation paused its downward trend in its most recent reading

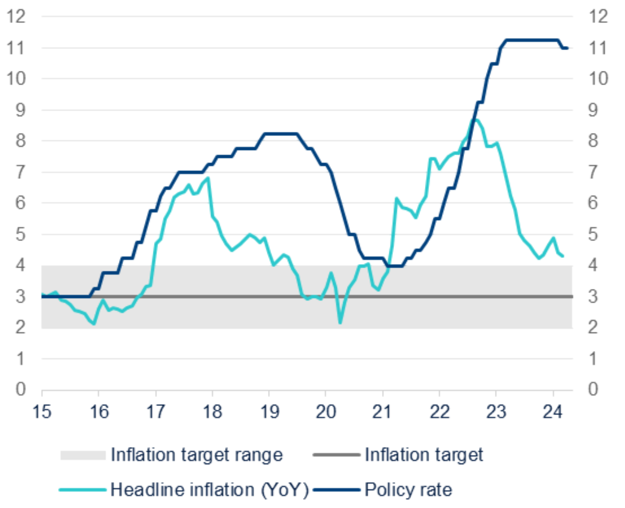
Figure 2. **TRIMMED AND SUPERCORE INFLATION** (YOY % CHANGE)



Source: BBVA Research / Banxico

Headline inflation has moved sideways recently on higher non-core inflation…

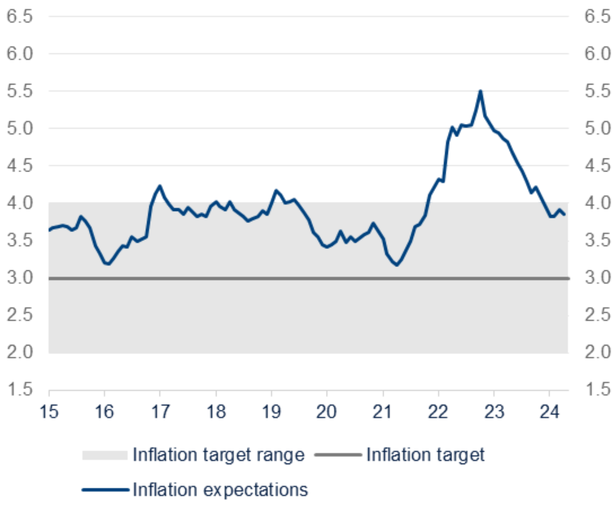
Figure 3. **INFLATION TARGET, HEADLINE INFLATION AND POLICY RATE** (%)



Source: BBVA Research / Haver

… while 12-month headline inflation expectations edged down in April but have not eased further

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



Source: BBVA Research / Haver

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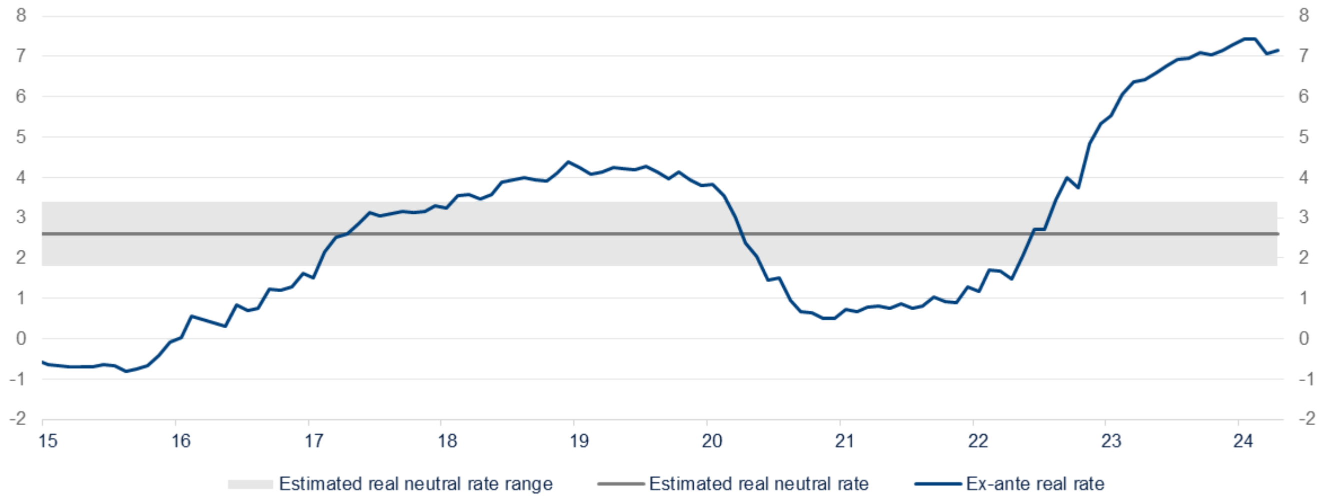
The real ex-ante rate is set to stay at 7.15%, 3.75pp above the upper limit of Banxico's estimated neutral range in the long run. Thus, the stance is set to stay very tight in the near term in absolute terms…

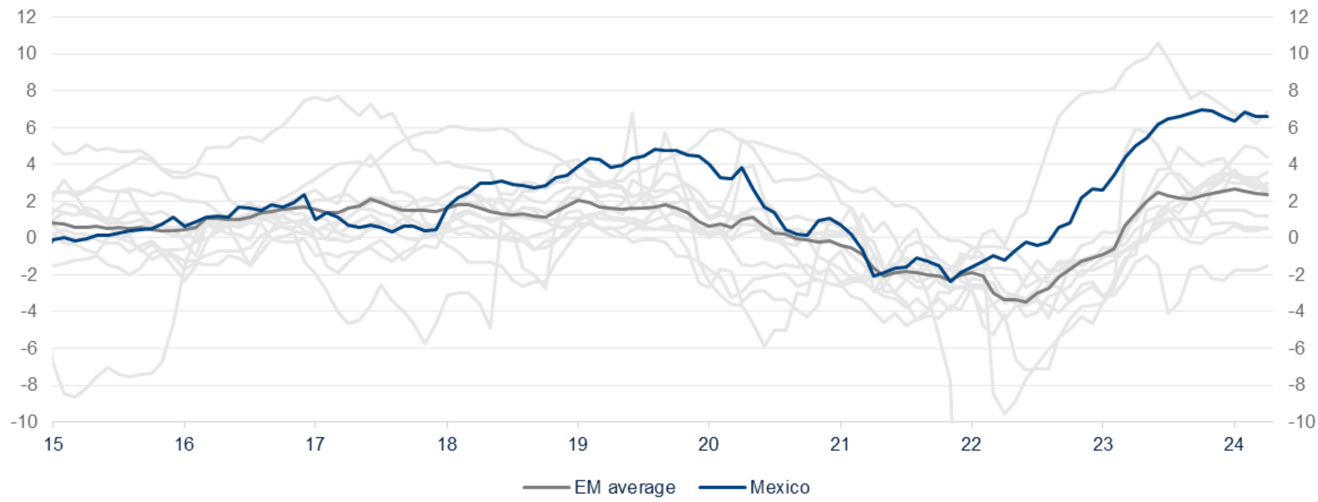
Figure 5. **ESTIMATED LONG-RUN NEUTRAL RANGE AND REAL EX-ANTE RATE**
(%)



Source: BBVA Research / Banxico / INEGI

… and in relative ones with the real ex-post policy rate among the highest compared to other emerging central banks.

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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