BBVA Research

Banxico Watch

With inflation in check, slowing growth, and a very restrictive policy rate, Banxico will deliver a second 50bp cut

Javier Amador / Iván Fernández / Carlos Serrano

March 25, 2025

Banxico's confidence in further big cuts is contingent upon the peso's orderly trading and the absence of a marked depreciation

- **Last week, the Fed kept rates unchanged at 4.25-4.50% and continued to signal two 25bp rate cuts later this year, but a rate cut in the near term is unlikely.** The policy statement's assessment of the economy remained unchanged, but it added that "uncertainty around the economic outlook has increased." The median FOMC participant sees slower growth and higher inflation: the GDP growth projection was lowered to 1.7% for 4Q25 (from 2.1%) and to 1.8% for 4Q26 and 4Q27. The median core PCE inflation projection for the end of 2025 was revised up to 2.8% (from 2.5%), while 2026 and 2027 forecasts were left unchanged at 2.2%. The dot plot still shows two 25bp rate cuts in 2025, but despite an unchanged 3.9% and 3.4% policy rate median projection for the end of this year and next, respectively (Figure 1), the few movements on the dots suggest that more participants are in no hurry to support a change in the monetary policy stance. During the Q&A session, Powell cited two complementary factors behind unchanged interest rate projections: i) weaker growth but higher inflation which "[...] kind of balance each other out"; and ii) uncertainty. The Fed also announced a further step in the process of reducing the size of its balance sheet: from April, it will "slow the pace of decline of its securities holdings by reducing the monthly redemption cap on Treasury securities from $25 billion to $5 billion." Powell carefully clarified that this action "isn't sending a signal in any hidden way" regarding the Fed's policy stance. We continue to think that the door to resume the rate cut cycle could open in late 2025 and, thus, we continue to expect two rate cuts this year, though uncertainty is high (see here and here for additional details on last week's FOMC meeting). In any case, despite the Fed's pause responding to continued economic robustness and still-uncertain tariff-related inflationary effects, **Mexico's improving inflation outlook amid a clear economic deceleration and a relatively stable exchange rate presents Banxico with ample margin to continue normalizing its monetary policy stance, independent of the Fed's decisions.** Indeed, the fact that the exchange rate pass-through is estimated to be very low, especially in lower parts of the economic cycle, and that Mexican capital markets are deeper than in the past, with a lower dependency on foreign portfolio inflows, results in a higher degree of freedom for Banxico to conduct monetary policy in a more independent way (relative to the Fed) compared to the previous decade.
- **Inflation readings released between policy meetings continued to support the Board's majority strategy to keep removing the still excessively tight monetary policy stance at a fast pace.** Yesterday's bi-weekly CPI release showed Mexico's headline inflation edging down by 0.1 pp to 3.7% YoY in the first half of March. This marks the sixth consecutive bi-weekly period that headline inflation has remained within Banxico's target range, below the 4.0% upper limit (Figure 2), aided by continued declines in fruit and vegetable prices (at -3.7% in the first half of March) and a slowdown in energy inflation (at 2.8%, down from 3.3% in the previous

fortnight). Following a slight rise to 3.7% in February, core inflation inched down to 3.6% in the first half of March, in line with its 2003-19 average and just a tad above its 2010-19 3.4% average. Core inflation has moved in a narrow 3.6-3.7% range since November (i.e., for the past nine fortnights) in spite of the (expected) uptick in core goods inflation that bottomed out in late 2024. This has been possible through lower core services inflation which is set to continue decelerating amid weaker economic activity. Core inflation's slight decline in the first half of March was primarily driven by a significant easing in core services inflation, which fell from 4.65% to 4.2%, a level not seen since January 2022. This improvement was driven by a slowdown in the broad "other services" subindex, from 5.5% to 4.7%, as well as by the moderation of housing services inflation, to 3.6%, with the latter potentially signaling an inflection point of an uncomfortable upward trend observed since May 2021 (Figure 3). The progress on core inflation occurred despite a marginal increase in goods inflation, which rose from 2.8% to a still target-consistent 2.9%. **We continue to think that a further rebalancing between (lower) services inflation and (somewhat higher) core goods inflation (the "last mile" in the disinflation process) will allow core inflation to edge a bit further down to 3.5% by the end of the year.**

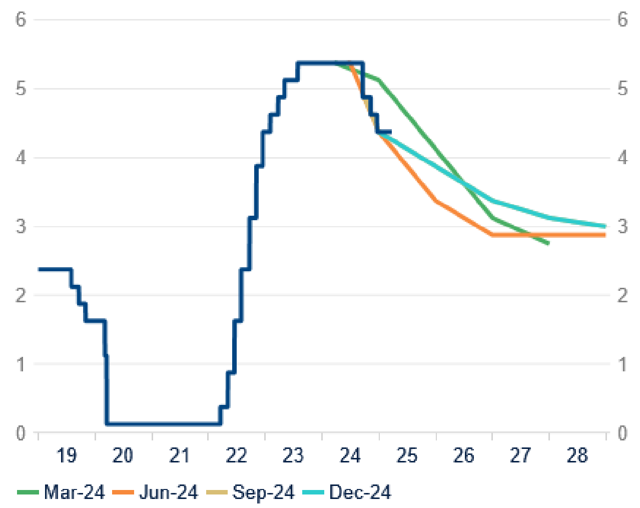
- **Board members' comments in both February's meeting minutes and the intermeeting quarterly report press conference from last month make a second consecutive 50bp rate cut a done deal.** Despite acknowledging "the risk of a greater foreign exchange depreciation," the minutes showed most members' determination to capitalize on the current period of subdued volatility in order to continue removing the still excessive policy restriction, in what they've termed a new monetary policy "phase." Two members were explicitly vocal in considering that a 50bp rate cut "could be considered at the next monetary policy meeting," and while the two other members' opinion was more nuanced (e.g., "monetary restriction can be calibrated more rapidly in some decisions"), they would probably also be in favor of a reduction of that magnitude at the next meeting. During last month's Quarterly Inflation Report press briefing, Governor Rodríguez continued to stress that Trump's-related uncertainty "must not lead us [...] to disregard the relevance of the concrete and significant advances we are seeing in our country's disinflationary process." With the knowledge at that time that real GDP contracted by 0.6% QoQ in 4Q24, which drove Banxico to bring down its 2025 GDP growth forecast to 0.6% from 1.2%, she emphasized that "going forward [they] could continue with the calibration of the monetary stance and continue adjusting it in a similar magnitude." Even Deputy Governor Heath, who voted against February's 50bp cut, might join the majority this week as he commented that "if core inflation keeps declining [and] if services prices decrease at a faster rate than the increase in goods prices" (which was the case in the most recent CPI report) "then there is plenty of room to continue lowering the rate." A 50bp cut is now expected by all analysts in the latest Citi survey. **The main question is whether Banxico will maintain a dovish tone, leaving the door open for a potential third consecutive 50bp rate cut in May.**

- **Banxico's confidence in delivering further big rate cuts is contingent upon the peso's orderly trading conditions and the absence of a marked depreciation that could prompt inflationary risks.** The (second) most recent agreement between Presidents Trump and Sheinbaum to postpone the imposition of broad-based tariffs on US imports of Mexican goods, coupled with the Mexican government's decision to forgo retaliatory measures against tariffs on steel, aluminum, and other products outside USMCA rules, has likely led market participants to assign a higher probability to a scenario where Mexico navigates Trump's April 2nd global tariff announcement relatively unscathed. The Mexican peso appreciated by slightly more than 5% to 19.9 ppd within days of the agreement, after hitting intraday levels above 21 ppd when the first grace period ended in early March (Figure 4). And, apparently more important for Banxico's reaction function, volatility in the FX market has been kept within bounds, at levels just above its historical average, but substantially lower than those observed following November's election results. On the other hand, the increasing evidence of the country's economic slowdown and labor market's deceleration, which we argue is partly explained by the excessively restrictive monetary policy that has remained in place thus far, suggests Banxico is unlikely to be concerned about demand-driven inflationary risks in the near term. The ex-ante real policy rate will decrease from 5.6 to 5.1% following this week's rate cut, still well above Banxico's own 3.6% estimation for the upper bound of the neutral rate range. This significant leeway suggests **Banxico could keep the door open to a third 50bp cut in May before slowing down to more cautious 25bp adjustments. This would strengthen our expectation that Banxico will bring down the policy rate to a below-consensus 7.5% by the end of this year (consensus: 8.0%, market: 8.0%).**

BBVA Research

The median FOMC participant still expects two 25bp rate cuts in 2025

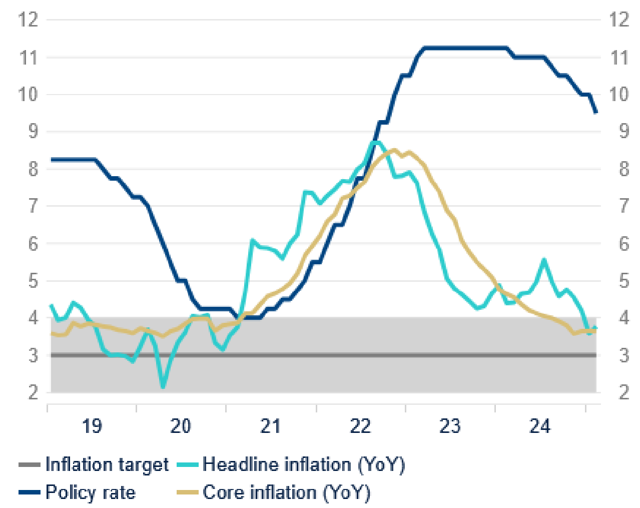
Figure 1. **FOMC PROJECTED FED FUNDS RATE (%)**



Source: BBVA Research / Fed

Following a slight rise in February, core inflation inched down to 3.6% in the first half of March

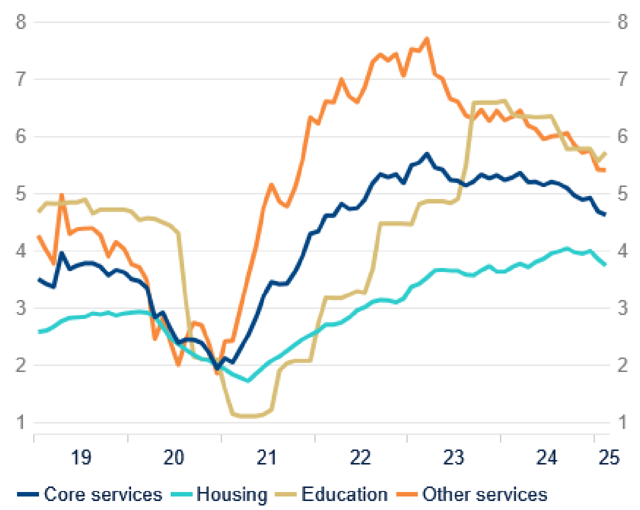
Figure 2. **INFLATION AND BANXICO POLICY RATE (%)**



The shaded area indicates the inflation target range
Source: BBVA Research / INEGI / Banxico

This improvement was driven by a slowdown in the "other services" subindex, from 5.5% to 4.7%

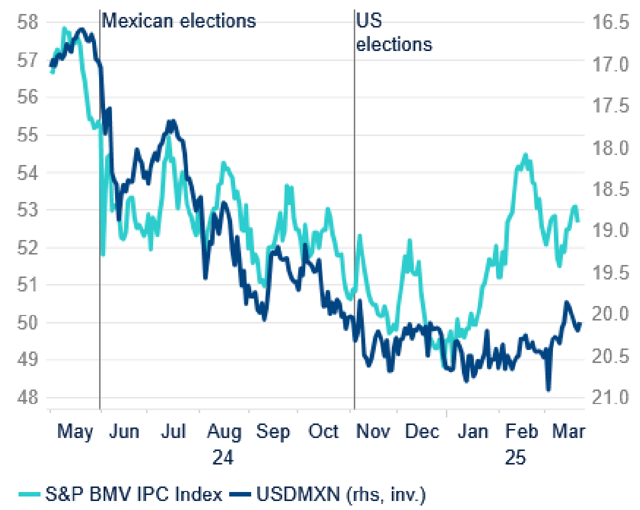
Figure 3. **CORE SERVICES INFLATION (%)**



Source: BBVA Research / INEGI

The Mexican peso appreciated by slightly more than 5% after hitting intraday levels above 21 ppd

Figure 4. **S&P BMV IPC INDEX AND USDMXN (THOUSANDS AND PPD)**



Source: BBVA Research / BMV / Macrobond

BBVA Research

DISCLAIMER

The present document does not constitute an "Investment Recommendation", as defined in Regulation (EU) No 596/2014 of the European Parliament and of the Council of 16 April 2014 on market abuse ("MAR"). In particular, this document does not constitute "Investment Research" nor "Marketing Material", for the purposes of article 36 of the Regulation (EU) 2017/565 of 25 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive (MIFID II).

Readers should be aware that under no circumstances should they base their investment decisions on the information contained in this document. Those persons or entities offering investment products to these potential investors are legally required to provide the information needed for them to take an appropriate investment decision.

This document has been prepared by BBVA Research Department. It is provided for information purposes only and expresses data or opinions regarding the date of issue of the report, prepared by BBVA or obtained from or based on sources we consider to be reliable, and have not been independently verified by BBVA. Therefore, BBVA offers no warranty, either express or implicit, regarding its accuracy, integrity or correctness.

This document and its contents are subject to changes without prior notice depending on variables such as the economic context or market fluctuations. BBVA is not responsible for updating these contents or for giving notice of such changes.

BBVA accepts no liability for any loss, direct or indirect, that may result from the use of this document or its contents.

This document and its contents do not constitute an offer, invitation or solicitation to purchase, divest or enter into any interest in financial assets or instruments. Neither shall this document nor its contents form the basis of any contract, commitment or decision of any kind.

ENQUIRIES TO:
BBVA Research: Paseo de la Reforma 510, Colonia Juárez, C.P. 06600 Mexico City, Mexico.
Tel.: +52 55 5621 3434
www.bbvaresearch.com